

WSX-C04 – Retrospective nature of draft determination

Response to
Ofwat's PR24 draft
determination



Wessex Water
YTL GROUP

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Representation reference: WSX-C04

Representation title: Retrospective nature of draft determination

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1. Summary

The draft determination introduces various *additional* mechanisms to “to prevent customers from paying twice”. We firmly support this aim, and our plan includes no proposals which have been previously funded by our customers.

The nature of network companies, and indeed the incentive-based regulation the water sector is subject to, means that the use of simple tests or assumptions cannot be used to establish what has been funded. Indeed, we think that any analysis should reflect:

- Symmetry, such that the assessment considers and reflects areas where companies may have over-delivered in some areas.
- The implication of outcome delivery penalties, which in effect return money to customers for under-delivery.
- The nature of the totex and outcomes framework introduced at PR14, under which companies are not funded to deliver specific outputs or schemes.¹ On this basis, companies have been specifically encouraged and incentivised to consider *in-period* whether any cost allowances could be reallocated and used to deliver different but better outcomes at lower costs for customers as a result of reprioritisation and efficiencies.
- Consistency across all areas of the price control. The approach to assessing what is funded in base is directly contradictory to the approach to assessing what is funded in base costs specifically. For example, in relation to assessing enhancement, Ofwat considers companies are able to make the appropriate trade-offs to prioritise their base costs for some additional activities (e.g. in relation to our proposal to significantly increase CCTV monitoring). However, in relation to base costs, Ofwat considers companies are funded to deliver a specific level of output (e.g. in relation to metering or mains replacement). It is our view that both cannot be simultaneously true.
- The wider context of systematic underfunding in the water sector historically, as set out in our response on base costs.

2. Change requested

In its final determination, we ask Ofwat to assess whether, and the degree to which, customers have already funded investment using a consistent and coherent approach which is grounded in sound economics, and consistent with the principles of its totex and outcomes framework. This will result in greater efficiencies, as per the intentions of the framework.

- Firstly, to address the **principle-based contradiction** and ensure consistency with the totex and outcomes framework, there is a greater need to consider what has been actually delivered relative to what has been funded at a high (or, price control) level (i.e. not in relation to individual assessments of specific low-level outputs). This would require greater scrutiny of what companies have *delivered in the round*; and acknowledgement of the trade-off's each company makes relative to its own individual circumstances to deliver efficiencies for customers.
- Secondly, to address **the contradiction in application** various changes could be made to ensure consistency. To be consistent with Ofwat's view on base costs (and specifically, the base cost adjustment

¹ Page 7&8, [PR24-draft-determinations-Expenditure-allowances-to-upload.pdf \(ofwat.gov.uk\)](#)

claims, under which companies are funded to achieve a specific output); one option could be to increase base costs where Ofwat consider enhancement requests can be better funded by an increase in a specific output that it considers is delivered through base.

3. Rationale

Ofwat's draft determination has introduced various mechanisms "to prevent customers from paying twice". Specifically, Ofwat sets out that:

*"We have put in steps to prevent customers from paying twice. We have removed expenditure requested by companies that is already covered in base expenditure allowances. [...]. Overall, around 20 to 30% of our enhancement cost challenge is removing schemes which we considered should be funded through base expenditure allowances, and 10 to 20% is the removal of schemes that have been previously funded."*²

Whilst we firmly support the principle that customers should not pay a second time for investment which has already been funded, Ofwat's approach here appears to have significant flaws. The way in which the methodology has been applied:

- Goes **against the basis of incentive regulation** (i.e. the principles on which Ofwat regulates water companies). This is because price controls are set by Ofwat and, accepted by companies, "in the round" and are intended to reveal efficient cost and outcomes over repeated price reviews. Furthermore, it goes against the specific framework which Ofwat introduced at PR14 which focuses on **totex and outcomes**.
 - Ofwat's states its framework was introduced to "*focus companies on delivering the outcomes that mattered to their customers, and gave companies the flexibility to choose the most efficient solutions to do this. This contrasted with the outputs-based approach at previous price reviews, in which companies committed to delivering specific schemes.*"³
 - That is, under this framework, companies are not funded to deliver specific outputs but instead incentivised to find the most efficient ways to deliver the right outcomes for customers.
 - Thus, even where Ofwat has provided enhancement in relation to specific schemes in the past (e.g. to increase capacity), companies have been specifically encouraged and incentivised to consider *in-period* whether such funding could be reallocated and used to deliver different but better outcomes at lower costs for customers as a result of reprioritisation.
 - Ofwat's draft determination represents a concerning retrospective clawing back of such efficiencies, and risks undermining the very basis of the framework. We ask this is remedied in Ofwat's final determination.
- **Contradicts itself in its application.** This is because the way in which it has applied the tests to enhancement and base expenditure are directly contradictory. We provide examples below.
 - Our business plan included an enhancement expenditure request to roll out CCTV across our network to enable enhanced monitoring and more targeted capital maintenance ("smart wastewater network"). In its deep dive assessment of our request, Ofwat sets out that such investment can be funded from our base costs, despite specifically stating that we had only conducted trials in the current 2020-2025 period. That is, Ofwat expects us to increase investment within base allowances to fund this scheme – which can only be delivered through a reprioritisation of (i.e. change in the way we spend) our base allowances.⁴

² Page 7&8, [PR24-draft-determinations-Expenditure-allowances-to-upload.pdf \(ofwat.gov.uk\)](#)

³ Page 19, [PR14 Review Paper Jan 2022.pdf \(ofwat.gov.uk\)](#)

⁴ Cell "C15", Tab "WSX_Smartnetwork" [PR24-DD-WW-Resilience-2.xlsx \(live.com\)](#)

- Whereas in assessing the level of mains replacement funded in base costs, Ofwat basis its view of the funded level on the average level delivered by the industry in the base costs modelling period.
- Whilst we consider both approaches are fundamentally flawed, for the reasons set out above and in the remainder of our cost assessment representations, we also note the assumptions which underpin both are in direct contradiction. This is because Ofwat must believe that companies are able to make the appropriate trade-offs to prioritise (as per its view in relation to investment that can be funded from base); or are funded to deliver a specific level of output (as per its view in relation to the industry wide base cost adjustments). Both cannot be simultaneously true.
- Is **asymmetric** in so much as it only considers where companies have underdelivered against Ofwat's view and does not consider whether companies have overdelivered in a given area.
- Does not consider the implication of outcome delivery payments and penalties, which in effect return money to customers for underdelivery.
- Is in **tension with the view that the water industry has been systematically underfunded historically**, this is especially concerning when you consider the scale of cuts made in the draft determination on this basis (as set out above). The issue of systematic underfunding has been identified and acknowledged by both the National Infrastructure Commission and House of Lords.⁵ We discuss the cycle of underfunding further in WSX-C01.
- **Has specific issues.** As an example, Ofwat asserts that “*base expenditure for IED compliance is covered by base allowances*” but has not sought to understand in any detail: (a) the level of compliance that is covered in base allowances; (b) the level of compliance that is now expected of companies; and (c) the relationship between (a) and (b) in terms of costs. We detail these further in the remainder of our cost assessment representations.

⁵ House of Lords (March 2023) ‘The affluent and the effluent: cleaning up failures in water and sewage regulation’; and <https://nic.org.uk/app/uploads/Letter-to-Ofwat-on-asset-management-18-May-2023.pdf>