

July 2019

Trust in water

# PR19 draft determinations

## South East Water – Cost efficiency draft determination appendix

## **PR19 draft determinations: South East Water - Cost efficiency draft determination appendix**

## **1. Wholesale water activities**

### **1.1 Enhancement**

The tables below summarise the adjustments we make to set the efficient level of enhancement totex for the water resources and network plus water price controls. Where appropriate, we reallocate enhancement expenditure between enhancement activities. In the table, we present the company requested cost for each activity where we made a material challenge, after any reallocation that we may have done. Our disallowances to company enhancement proposals include a challenge on the need to invest, on the efficiency of the proposals or on the classification of the expenditure as enhancement (in which case we consider that the expenditure is covered by our base allowance). For draft determinations we make an adjustment to the enhancement allowances to account for an implicit allowance for enhancement opex included within our base models. We set out our method of estimating the opex implicit allowance in 'Securing cost efficiency technical appendix'. Costs for new developments, new connections and addressing low pressure are now considered within wholesale water base ("totex plus") econometric models. We show details of specific areas of material disallowance or efficiency challenge in the table below and we provide details in our published feeder models.

**Table 1: Material disallowances of and efficiency challenges to enhancement costs for the water resources price control 2020-25 (£ million of 2017-18)**

<b>Area of enhancement</b>	<b>Company requested totex</b>	<b>Ofwat view of requested totex after reallocations</b>	<b>Our allowance</b>
All Enhancement totex	44.0	44.0	36.8
<b>Material areas of disallowance and efficiency challenge in enhancement totex (£ million)</b>	<b>Ofwat view of requested totex after reallocations</b>	<b>Our allowance</b>	
Supply and demand enhancements: Total	5.7	2.1	
Resilience	0.4	0.0	
WINEP / NEP ~ Drinking Water Protected Areas	6.6	6.2	
WINEP / NEP ~ Investigations	19.6	18.6	

Note: Our enhancement totex allowance is net of an implicit allowance for enhancement opex. We have not netted off an implicit allowance for enhancement opex from our allowances for the individual enhancement lines.

**Table 2: Material disallowances of and efficiency challenges to enhancement costs for the water network plus price control 2020-25 (£ million of 2017-18).**

<b>Area of enhancement</b>	<b>Company requested totex</b>	<b>Ofwat view of requested totex after reallocations</b>	<b>Our allowance</b>
All Enhancement totex	217.2	217.2	135.1
<b>Material areas of disallowance and efficiency challenge in enhancement totex (£ million)</b>	<b>Ofwat view of requested totex after reallocations</b>	<b>Our allowance</b>	
Supply and demand side enhancements: Total*	128.5	46.9	
Resilience	33.6	3.5	
Investment to address raw water deterioration	17.1	15.3	
WINEP / NEP ~ Invasive non-native species	32.1	30.5	
Vulnerable customer support (free form line)	4.2	0.0	

Note 1: The disallowance of £81.6m for supply and demand side enhancements has been partially offset by £41.8m that we have allowed for intra-zonal schemes, largely linked to areas with high development, particularly Ashford and Basingstoke, and which we considered as growth expenditure.

Note 2: Our enhancement totex allowance is net of an implicit allowance for enhancement opex. We have not netted off an implicit allowance for enhancement opex from our allowances for the individual enhancement lines.

## **1.2 Transition expenditure**

South East Water does not request any expenditure under the transition programme.

## 2. Cost adjustment claims

Table 3 summarises our consideration and allowances for the cost adjustment claims submitted by the company. We give further details in our published cost adjustment claim feeder model for South East Water. In its resubmitted plan South East Water withdrew one of its cost adjustment claims from its original plan. The remaining claim is for base expenditure for the water network plus price control.

**Table 3: Cost adjustment claims and our allowed totex adjustments, 2020-25 (£ million of 2017-18)**

Description of Claim	Value of company claim	Our allowed adjustment	Rationale for decision
Geological factors - diseconomies in network plus treatment plants and abnormal groundwater complexity	20.0	0.0	<p>The claim focuses on a large number of low volume water sources and accompanying treatment works driving additional costs. We consider this is a water resources issue and, as such, is more suited for assessment as a claim in the Water Resources price control.</p> <p>We reject this claim as the company does not provide sufficient evidence that inclusion of the number of sources as a driver in the Water Resources price control has a significant and intuitive impact on the results.</p>

### **3. WINEP uncertainty mechanism**

Our totex allowance for companies includes an allowance for environmental obligations set out in the Water Industry National Environment Programme (WINEP). Some of the requirements in WINEP are not expected to be confirmed until December 2021 at the earliest, which is after we make our final determinations in December 2019. Unconfirmed requirements in WINEP are known as 'amber' schemes.

Where we make an allowance for amber schemes, we use a mechanism to adjust our totex for schemes which are later confirmed as not required.

In its response to query SEW\_IAP\_CE\_002 South East Water stated that the 'amber' schemes listed in the March 2018 release of WINEP have all since been confirmed by the Environment Agency to be 'green' (ie certain). Emails from Environment Agency staff attached to an update to the query response confirm this. Accordingly, we do not consider that a cost adjustment mechanism is required for South East Water.



Ofwat (The Water Services Regulation Authority) is a non-ministerial government department. We regulate the water sector in England and Wales. Our vision is to be a trusted and respected regulator, working at the leading edge, challenging ourselves and others to build trust and confidence in water.

Ofwat  
Centre City Tower  
7 Hill Street  
Birmingham B5 4UA

Phone: 0121 644 7500  
Fax: 0121 644 7533  
Website: [www.ofwat.gov.uk](http://www.ofwat.gov.uk)  
Email: [mailbox@ofwat.gov.uk](mailto:mailbox@ofwat.gov.uk)

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