

December 2019

PR19 final determinations

**Affinity Water – Cost efficiency
final determination appendix**

PR19 final determinations: Affinity Water – Cost efficiency final determination appendix

About this document

This document is a cost efficiency appendix to 'PR19 final determinations: Affinity Water final determination'. This document provides further details of the company specific issues related to cost allowances and is structured as follows:

- Section 1 provides a summary of our decisions on the company's cost adjustment claims;
- Section 2 provides a summary of our decisions on the company's enhancement proposals, by enhancement area;
- Section 3 provides our decision on costs proposed by the company under the transition programme;
- Section 4 provides our decision on unit cost adjustments related to the WINEP uncertainty mechanism.

Further information on our assessment and our approach can be found in the 'Securing cost efficiency technical appendix' and the various excel feeder models that we have published.

1. Cost adjustment claims

Table 1 summarises our consideration and allowances for the cost adjustment claims submitted by the company. For completion we include all claims that were part of our draft determination decisions, as well as additional or revised claims the company submitted in its representation to the draft determination. We give further details in our published cost adjustment claim feeder model for Affinity Water.

Table 1: Cost adjustment claims and our allowed totex adjustments, 2020-25 (£ million of 2017-18)¹

Description of Claim	Value of company claim	Our allowed adjustment	Rationale for decision
Population transience – regional operating circumstances	7.8	0.0	The company argues that companies with higher transience incur higher retail costs (eg it is more expensive to recover debt). Although we accept that transience may increase costs, we reject the claim because our models already account for transience as a cost driver via the inclusion of a total migration variable in two of our residential retail cost models. The company has not raised substantive issues in its representation and we retain our draft determination assessment.
Regional wages – regional operating circumstances	12.5	0.0	The company submits a cost claim for having a high wage premium. We reject the claim as it fails to account for (a) the off-setting benefits in regions of high labour costs, such as higher labour productivity and economies of density related to the supply chain, and (b) wage savings due to factors that are under management control. We also note that Thames Water and SES Water, which are exposed to even higher regional wages, have not submitted a similar claim. The company has not raised substantive issues in its representation and we retain our draft determination assessment.

¹ The value of the cost claim for the residential retail control ('population transience') is in nominal terms.

2. Enhancement assessments

Our approach to assessing enhancement expenditure is detailed in our publication 'Securing cost efficiency technical appendix'. We generally assess enhancement expenditure separately for each enhancement category, as defined by the individual enhancement cost lines in company business plan tables. We assess multiple lines together where there is a potential for costs to be apportioned differently by companies and where there is some synergy between programmes.

Our preferred method of assessment is benchmarking analysis. Where the investment area does not lend itself to statistical modelling we rely more on the evidence provided by companies in their business plans. We follow a risk-based process of having a lighter touch ('shallow dive') assessment for low materiality costs and a more thorough assessment of the evidence ('deep dive') of high materiality costs.

Table 2 summarises our consideration and allowances for the enhancement expenditure cost lines submitted by the company. We give further details in our published enhancement feeder models for Affinity Water.

Table 2: Assessments of water enhancement expenditure, 2020-25 (£ million of 2017-18)

Enhancement cost	Company view in August 2019 business plan (after reallocations)	Our final determination allowance	Rationale for decision
Meeting lead standards	8.4	8.4	We use a benchmark model to make allowances for these costs. Affinity Water is more efficient than our benchmarks and we allow the full amount requested.
Supply and demand side enhancements: Total	75.6	62.7	We do not allow enhancement costs for leakage reduction, because the company's stretching performance commitment level does not go beyond the forecast upper quartile threshold. Our allowances for short term and long term supply-demand balance components both remain unchanged for final determination. See the 'Affinity Water final determination' for further details.
Investment to address raw water deterioration	3.0	3.0	We use our shallow dive approach to set an allowance. The company shallow dive efficiency factor is 0% and we allow the requested cost in full.

Metering (excluding new connections) for meters requested by optants, customers and businesses	58.9	57.3	As at draft determination we make an allowance for metering based on our unit cost model. At final determination we apply the frontier shift to the model output which results in a £1.6 million reduction in the allowance for final determination compared to the draft determination.
Resilience	13.6	13.6	We use our deep dive approach. We are satisfied with the evidence the company presents and allow the requested cost in full.
Total clean water WINEP	116.9	121.0	<p>We use our shallow dive approach to set our allowance, applying the company specific efficiency challenge only, for the invasive non-native species programme, although for Affinity Water the challenge is set to zero.</p> <p>As we explain in 'Affinity Water final determination', we now allocate a DPC allowance of £4.5 million relating to Brett sustainability reduction to the water framework directive measures allowance. This means we are allowing more costs than the company requests in this area but we remove the Brett sustainability reduction from the WINEP unit cost adjustment mechanism (see table 3 below).</p> <p>We use our deep dive approach to set allowances for water framework directive measures and water investigations programmes. In both cases we find insufficient evidence that costs are efficient and apply the deep dive company specific efficiency challenge. We use our deep dive approach to assess the ecological improvements at abstractions programme and are satisfied with the evidence provided and allow the costs.</p>
Improvement to river flows	0.5	0.5	We do not challenge the costs for this area of expenditure due to its low materiality.
Aggregated free form lines	73.5	0.0	<p>The company requests £83.3 million to develop strategic regional water resource solutions and we make an allowance of £83.3 million. This allowance is recorded separately to the other enhancement expenditure in our models because it is outside of cost sharing. See 'Strategic regional water resource solutions appendix' for further information.</p> <p>Affinity Water adds an item of -£9.8 million opex in its enhancement business plan table it submits with its representation. This was in response to our draft determination and the calculation of enhancement opex implicit allowance allowed for in our base models. Since our base models have changed since the draft determination, our implicit allowance has changed too. We do not make the adjustment Affinity Water proposes in its plan, but we recalculate the value of the enhancement opex implicit allowance and take it away from our base modelled allowance. We explain this in the 'Securing cost efficiency technical appendix.'</p>
Total water enhancement	350.4	266.6	

3. Transition expenditure

Affinity Water does not request any expenditure under the transition programme.

4. 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.

Table 3 sets out the adjustments we will make for each scheme in Affinity Water’s WINEP programme that is currently unconfirmed, if the scheme is confirmed as not required for the period 2020-25. We will make the adjustments at the end of the control period. Our adjustments are based on the company’s totex estimates (after reallocations) as adjusted by our company specific efficiency factor.

Table 3: WINEP uncertainty mechanism – cost adjustments for unconfirmed WINEP schemes included in our final determination (£ million in 2017-18 prices)

Unique ID	Scheme category / name	Company’s totex unit rate	Our allowed totex unit rate
WINEP/NEP ~ Ecological improvements at abstractions			
7AF100131	RIVER RESTORATION PROJECTS - UPPER COLNE (This unique ID accounts for 4 projects)	£0.331m per project	£0.261m per project
7AF100132	RIVER RESTORATION PROJECTS - BULBOURNE (This unique ID accounts for 4 projects)		£0.319m per project
7AF100133	RIVER RESTORATION PROJECTS - CHESS (This unique ID accounts for 4 projects)		£0.270m per project
7AF110002	LOWER COLNE U/S MAPLE LODGE SEWAGE TREATMENT WORKS - RIVER RESTORATION (This unique ID accounts for 4 projects)		£0.347m per project
7AF10008	Higham Bridge / Lattinford Bridge / Shelley Hall / Stoke by Nayland - 1 & 2 Stratford St Mary (Woodhouse Farm), Dedham P.S., Lawford P.S. (This unique ID accounts for 4 projects)		£0.306m per project
7AF100032 7AF100034	Implementation Scheme: Undertake river restoration to mitigate the effects of abstraction. (Each unique ID accounts for 4 projects)		£0.296m per project

Unique ID	Scheme category / name	Company's totex unit rate	Our allowed totex unit rate
WINEP/NEP ~ Water Framework Directive measures			
7AF10008	Higham Bridge / Lattinford Bridge / Shelley Hall / Stoke by Nayland - 1 & 2 Stratford St Mary (Woodhouse Farm), Dedham P.S., Lawford P.S.	£3.260m per MI/d of deployable output	£3.086m per MI/d of deployable output
7AF100116	ALMA ROAD PUMPING STATION	£0.042m per MI/d of deployable output	£0.044m per MI/d of deployable output
7AF100119	CHARTRIDGE PUMPING STATION		
<p>Additional sustainability reduction for the company's Brett region should it be required to be delivered by the Environment Agency during 2020-25. Based on the company representation we are moving this out of the WINEP uncertainty mechanism. We consider the best way to manage the risks relating to the Brett licence changes is to allow a direct procurement for customers development allowance and define a notified item. In 2021 when the scale of the change and likely solution is known, a decision can be made about the funding approach.</p>			
n/a	Sustainability reduction in Brett region not in WINEP (from 2.6 MI/d to 4.6 MI/d)	£3.260m per MI/d of deployable output	We make a direct procurement for customers development allowance of £4.5 million in the Water Framework Directive feeder model.
n/a	Sustainability reduction in Brett region not in WINEP (from 4.6 MI/d to 20 MI/d)	£6.67m per MI/d of deployable output	

Ofwat (The Water Services Regulation Authority) is a non-ministerial government department. We regulate the water sector in England and Wales.

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December 2019

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