December 2019

PR19 final determinations

South East Water – Cost efficiency additional information appendix

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Assessment of growth-related expenditure related to intra-zonal schemes for Ashford and Basingstoke

1 Our draft determinations

At the draft determination we assessed £58 million that South East Water included as supply-demand balance expenditure. As this expenditure relates to intra-zonal schemes (rather than inter-zonal) and is largely linked to areas with high development, particularly Ashford and Basingstoke, we considered this to be growth expenditure. After considering the evidence in the business plan we allowed £41.8 million compared to £58 million which was requested.

Companies receive grants and contributions from developers towards the cost of new developments and new connections. We calculate the grants and contributions receivable by applying a recovery rate to our cost allowance for new developments and new connections. As we considered this expenditure to be growth, we applied a 75% recovery rate from developers' grants and contributions. This ensures that developers pay a fair share towards costs to connect new properties.

2 Stakeholder representations

South East Water represents on the 75% recovery rate from grant and contributions that we apply. The company classifies this expenditure in the business plan as related to supply demand balance, and as such argues that it should be funded by customers in general rather than by developers. The company states that this is in line with historical practice.

In addition, the company submits a cost adjustment claim of £23 million related to growth costs. The company claims that it has atypical on-site costs that have been increasing over time for reasons outside its control, due to: to sites becoming larger and having longer mains per property; more excavation work being carried out by the company rather than the developer; and other factors such as new requirements for crushed concrete or the increased precautionary use of barrier pipes on contaminated sites. The company claims these high costs are incorrectly captured as inefficiency in our 'base plus' econometric models. It also claims that it will incur higher off-site network reinforcement costs due to some of its water resources zones reaching maximum capacity.

3 Our assessment and reasons

We maintain the view that a 75% recovery rate is appropriate. The expenditure relates to intra-zonal transfers at a local level. We would consider this expenditure to be of for supply demand balance if the transfers were between water resource zones rather than within a zone. Other companies, such as Anglian Water, have forecasts for growth expenditure in order to address expansions of existing urban areas. These are similar to those forecast by South East for Ashford and Basingstoke. Other companies do plan to use developer contributions as part of the funding for these schemes and we expect South East Water to do the same.

In relation to the cost adjustment claim for growth costs, we consider that some of the variables in our econometric models (such as length of mains) should capture the impact of growth on the company's on-site costs, and the company does not present sufficient evidence that it faces unique circumstances that would justify a further adjustment to our modelling results. The company does not demonstrate that it is unique in its requirements on more excavation and reinstatement work, or on other factors such as the use of crushed concrete or the precautionary use of barrier pipes at contaminated sites. Overall, South East Water does not provide convincing evidence to demonstrate it has materially higher on-site costs than other companies.

In relation to its off-site costs, we do not consider that investing to increase capacity of off-site assets necessarily requires an adjustment to our modelled allowance. All companies face periodically the issue of running out of headroom capacity, and South East Water is not unique in this. Companies routinely make investments to increase capacity, and a certain level of allowance for this activity is reflected in our base allowances. A company may exceed this implicit allowance in periods when it is running out of capacity, but equally, may incur lower costs in periods when it does not need to invest in additional capacity. Therefore, we consider that from a multi-period perspective our base allowance adequately funds the company's investment needs. In addition, companies should proactively plan for network capacity over the long term and are therefore best suited to balance expenditure requirements between multiple regulatory periods.

We make an upward adjustment of £7.1 million to South East Water's wholesale base costs as we consider that our modelling results do not adequately compensate for companies with a high growth forecast such as South East Water. In the absence of evidence of other unique circumstance that drive up the company's on-site and off-site unit costs relative to other companies, we expect Southern Water to meet its expenditure requirements through our overall totex allowance.

We note that the company is not clear on the exact value of this cost claim, as it quotes different values (£23 million and £27 million) in different parts of its representation.

4 Our final decision

We retain our draft determination £41.8 million allowance for intra-zonal schemes allowance. We continue to apply a 75% developer recovery rate.

We reject the cost adjustment claim for growth expenditure the company submits in its revised business plan because it fails our test on the need for adjustment to our modelled allowance.

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

Ofwat
Centre City Tower
7 Hill Street
Birmingham B5 4UA

Phone: 0121 644 7500
Fax: 0121 644 7533
Website: www.ofwat.gov.uk
Email: mailbox@ofwat.gov.uk

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