

# PR19 final determinations

**South East Water – Cost efficiency  
final determination appendix**

## **PR19 final determinations: South East Water – Cost efficiency final determination appendix**

## About this document

This document is a cost efficiency appendix to 'PR19 final determinations: South East 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 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 of 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 South East Water.

**Table 1: 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	The claim relates to a large number of low volume water sources and treatment works driving additional costs. We rejected this claim at draft determination as the company did not provide sufficient evidence that inclusion of the number of sources as a cost driver in our models has a significant and intuitive impact on the results. The company has not raised substantive issues in its representation and we retain our draft determination assessment.
New connections expenditure	23.3	0.0	The company claims to have atypical costs for population growth which are not captured in our econometric models. We reject this claim as we do not find sufficient and convincing evidence that the company faces unique circumstances driving its growth costs, which would justify a further allowance above the £7.1m base adjustment the company receives at final determination for its expected high growth rates. For further detail see 'South East Water – cost efficiency additional information appendix'.
Treated water distribution model underestimates efficient cost level	14.1	0.0	South East Water claims that our wholesale water econometric model for treated water distribution is misrepresenting its efficiency, and proposes an alternative density driver (properties per length of mains). We reject this cost claim as we do not find evidence that our density driver is biased against the company. We also do not consider the driver proposed by the company to be a suitable alternative to our density variable. While it performs well in the treated water distribution model, it performs poorly in the other wholesale water models.

## 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') for high materiality costs.

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

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

Enhancement cost	Company view in August 2019 representation (after reallocations)	Our final determination allowance	Rationale for decision
Supply and demand side enhancements: Total	134.2	70.6	<p>We partially allow enhancement costs for leakage reduction because the company's performance levels are forecast to pass beyond the quartile threshold during the 2020-25 period. We use the leakage reduction unit cost the company identifies and apply the company specific efficiency factor to make our allowance. We still consider that the activities identified by the company for future water resource planning are adequately funded through the base allowance and do not make an allowance for these. See 'South East Water final determination' for further information.</p> <p>At the draft determination we assessed as part of our base allowance £58.3 million associated with new developments, which the company included as enhancement expenditure for supply demand balance, and made a partial allowance of £49 million. We</p>

			retain this allowance to base costs for final determination although it is not presented as allowance for this expenditure line. See 'South East Water – cost efficiency additional information appendix' for further information.
Investment to address raw water deterioration	17.5	14.9	We assess this expenditure with a deep dive approach. We allow the capex spend to which we apply the company deep dive efficiency factor to set the efficient allowance. We make no allowance for operating expenditure as operational costs of the enhanced works are captured in our econometric models for base costs, which include a variable for water treatment complexity.
Metering (excluding new connections) for meters requested by optants, customers and businesses	0.6	0.6	We use a unit cost model to make allowances for these costs. South East Water is more efficient than our benchmark and we allow the requested costs
Resilience	34.0	10.9	We use our deep dive approach and challenge the need, cost efficiency and/or optioneering of the proposed investments. See 'South East Water final determination' for further information.
Total clean water WINEP	69.0	63.7	We use our shallow dive approach to set our allowance, applying the company shallow dive efficiency factor only, for ecological improvements at abstractions and Water Framework Directive measures programmes. We use our deep dive approach to set allowances for invasive non-native species, drinking water protected areas and water investigations programmes. For drinking water protected areas and water investigations programmes we find insufficient evidence that costs are efficient and apply the company deep dive efficiency factor. For the invasive non-native species programme we are satisfied with the evidence provided and allow the cost the company requested in its April 2019 business plan submission. See 'South East Water final determination' for further information.
Improvement to river flows	1.7	1.7	We do not challenge the costs for this area of expenditure.
Aggregated free form lines	4.2	0.0	The company requests £4.2 million to cover the costs of an increase in the number of customers on its Priority Service Register. We consider that the company fails to provide sufficient and convincing evidence to demonstrate it faces unique circumstances and we therefore do not make an allowance. See 'South East Water final determination' for further information.
<b>Total water enhancement</b>	<b>261.2</b>	<b>162.4</b>	

### **3. Transition expenditure**

South East 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.

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' (i.e., 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.

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