

Date: 3 February 2022

Ofwat
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By e-mail: CostAssessment@ofwat.gov.uk

Dear Sir,

PR24 CONSULTATION: APPROACH TO ASSESSING BASE COSTS

South West Water welcomes the opportunity to comment on Ofwat's approach to assessing base costs. The overall cost allowance is a key aspect of the price review and SWW considers it would be beneficial to have opportunity to consider and comment on Ofwat's proposed approach to assessing enhancement costs too. We have included our responses to your specific questions in Appendix 1.

We believe Ofwat's approach for assessing costs at PR24, should be an evolution of the approach at PR19, which was a step-change from the previous price review. We recognise and support that the cost models are anchored in actual historical data. However, consideration is needed on how changes in the future, such as legislation, regulation, and the emerging expectations for water companies, particularly for the environment, are appropriately reflected in the base cost assessment modelling where these may impact our underlying base operational costs in addition to enhanced capital investment.

At PR19 growth costs were included in the base modelling after the draft determinations and whilst we agree that some aspects of underlying growth expenditure may be sufficiently reflected in the base cost assessment there is a need to consider additional drivers of underlying growth costs (particularly the type and nature of schemes). In addition, in the South West we have seen a significant growth in how our existing housing base is being used – where the high number of second homes in our region which had previously been contributing to our summer peak period (and not reflected in our underlying population) these properties are now being utilised more frequently resulting in a growth in demand without the growth in new connections.

We also believe there is a need to assess enhancement growth expenditure outside of the base modelling. While a certain level of growth may be deliverable within existing historical capacity this may not be reflective of the future requirements or the additional capacity needed to support growth. This may be of particular focus as the economy recovers following the pandemic and there

could be variations in how regions adapt which could have a longer-term impact on growth requirements.

We support the early publication of base cost models, ahead of cost adjustment claims to ensure that any aspects which companies assumed would be reflected in the base models but were omitted could then be reflected in specific company cost adjustment claims. In addition, we would suggest a process whereby there is an opportunity for companies to submit “secondary” claims if felt necessary in light of potential unexpected downside adjustments arising from other company claims and the ‘symmetrical’ approach Ofwat is proposing.

We welcome Ofwat’s proposal to be clear on what “base buys” – particularly in terms of the maintenance and service levels that are associated with base, and that which falls into enhancement. We do believe there is evidence that that base maintenance (with a drive for further efficiency) can necessarily deliver a level of continued service improvements. We therefore support the need to identify the right drivers and service expectations in base cost models – with enhancement / quality drivers omitted – allowing companies to clearly put forward the appropriate enhancement expenditures and cost adjustment assessments for providing service beyond that funded through the base models.

We consider that the historical basis for the cost models may not fully reflect the current position, nor future unforeseen cost pressures. Whilst the current cost sharing mechanism goes some way in sharing the risk and benefits with customers, our voluntary PR14 WaterShare mechanism included specific costs items with specific customer sharing rates. These reflected both costs which would be impacted by external factors (such as inflation, bad debts and changes in legislation) but also those areas which were new and therefore more uncertain (such as new technology innovations or new markets). We believe this approach benefited customers and could be a positive way of managing future cost impacts.

We believe Ofwat’s approach to engagement with the industry in this area has been positive and continue to welcome collaboration and discussion on both the base and enhancement expenditure at PR24.

If you have any queries, or would like any further detail, please do not hesitate to contact us at finreg@southwestwater.co.uk .

Yours sincerely



Lisa Gahan
South West Water Regulatory Director

APPENDIX 1

1. Do you agree with our principles of base cost assessment?

We broadly support the principles of cost assessment as set out.

We agree with the view that the consistency with engineering, operational and economic rationale is a necessary condition when assessing the models used. Whilst some of the other principles need to be balanced against each other (e.g. the robustness of the econometric models vs. the sensibly simple and transparent approach), the rationale behind the model should “make sense”, and where this isn’t the case, alternative approaches to cost assessment should be considered.

South West Water agrees that it is right to primarily focus on exogenous cost drivers, but there should also be recognition that there is not a clear binary distinction between exogenous and endogenous particularly when looking at data over the long-term or forecast data. Rather the extent to which management have control over some of the data points will increase as the length of period under consideration increases amongst other factors. In fact, there could be benefits of considering endogenous cost drivers in some cases, as omitting important cost drivers purely on the basis of endogeneity could result in the estimated efficiencies being biased. Other regulators, including Ofgem, regularly include variables that Ofwat considers endogenous in their cost modelling.

The importance of a coherent cost assessment approach should be kept in mind when developing the separate work on the funding of Bioresources. There is scope for inconsistencies to arise and there should be regular read across of the methodologies developed by Ofwat over the coming months. It is not clear how Wastewater costs might be considered “in the round” to ensure that the separation of the Bioresources costs does not result in “cherry picking” when setting efficiencies.

Balancing a stretching cost efficiency target which is achievable will require a good understanding of company specific circumstances rather than placing undue weight on data and model outputs.

South West Water supports the earlier planned publication of the base models, but would like more clarity as to what stage of development these models would be at, and what further changes would be likely before they are used for Draft and Final Determinations (e.g. recalibration of coefficients using latest APR data).

2. Do you consider any important principles are missing?

The interdependencies between base, enhancements and cost adjustment claims need to be recognised, to avoid double counting of efficiencies and cost challenges.

Any cost efficiency challenges would also need a service level clarification alongside, so it is clear what the corresponding service level expectation is, and what the relevant time frame is.

Separation of Bioresources will add to the challenge of developing a cost allowance which makes sense “in the round” when all aspects of the business and the outcomes to be delivered are considered. South West Water would support the use of high level “sense checks” of the overall package to minimise the risk of double counting of efficiencies or allowances, and a consistent use of benchmarks.

Approach to wholesale base cost modelling at PR24

Scope of wholesale modelled base costs

3. Do you consider the scope of wholesale modelled base costs should be amended at PR24? If so, please explain how the potential amendment/s to wholesale modelled base costs can be justified based on our proposed assessment framework.

It is important to retain clarity over the different types of costs and the naming conventions. Whilst it may be possible to model some enhancement costs within the “botex plus” models, this is not necessarily the same as the costs themselves being base costs. To minimise ambiguity and blurring of cost boundaries, SWW would urge for clear delineation to be made between the cost type for reporting purposes, and the cost type for assessment purposes. Clarity early in the process on the scope of modelled base costs would be helpful to company’s in presenting their Business Plans and preparing their evidence base.

There are several areas within the base cost modelling at PR19 where further investigation is needed to see if the costs could be assessed in a more robust fashion:

- **Power** – given the recent volatility within the energy markets which is significantly increasing costs not only from wholesale charges but also reflecting the costs of transmission there is a need to carefully consider how energy price and consumption is reflected in the PR24 cost allowance. There may be a rationale for modelling power costs separately – with a focus on usage as well as alignment with Net Zero targets.
- **Growth** – At PR19 there was a late move of enhancement capex costs related to Growth to base model assessments. This happened after the Draft Determination was issued so there was limited opportunity to make representations on this expenditure. SWW does not consider the base cost models the appropriate place to assess enhancement capex for growth. It is “lumpy” investment which to an extent is dependent on existing capacity within networks, and the future may not be reflective of the past.

4. Would you recommend collecting additional data in relation to growth expenditure (cost and/or cost driver data) to improve cost assessment at PR24? If so, what additional data would you recommend collecting? Please provide definitions alongside suggested data additions.

At PR19, the models used ONS household projection numbers and derived growth rates for the companies’ regions. Given that growth is unlikely to be spread evenly across the regions, and the more highly clustered it is, the more likely to require step changes in expenditure, we would support the investigation as to whether these projections could be developed to better recognise the variation in growth within the regions.

We note that Ofwat recognises the uncertainty in population growth as outlined in its PR24 long-term scenario discussion paper, where both high and low demand scenarios are set out. This may support using a central estimate for growth assumptions based on a wider range of external information including taking account of specific local and regional plans.

In addition, growth is not necessarily simply housing growth (which is forecast by the ONS) but rather population and usage growth. For example, in the South West we have seen a significant growth in how our existing housing base is being used – where the high number of second homes

in our region which had previously been contributing to our summer peak period (and not reflected in our underlying population) these properties are now being utilised more frequently resulting in a growth in demand without the growth in new connections. Changes associated with domestic tourism and staycations; and movements from urban centres to rural communities in response to social distancing and home working have also led to growth in demand.

We would welcome population movements being included in the data collection. This may wish to consider seasonal variations: at South West Water we need to be ready to meet summer demands, which in our region means providing water for up to 9 million visitors, on top of our 2m resident population. We recognise the challenges of collecting consistent and comparable data in this area and considering what data, information, and evidence we will have available to support any cost adjustment claim for seasonality.

Sample period selection

5. Do you agree that we should utilise the full historical data series available to develop the wholesale base cost models at PR24 (from 2011-12 onwards) unless there is clear justification for using a reduced time series (e.g. structural break that cannot be addressed through other remedies)?

South West Water would support further investigation into model robustness before placing reliance on model outputs based on data from as far back as 2011-12. There have been significant efficiencies since this time as well as increasing cost pressures and expectations.

We consider that in general, a larger data set allows for more robust model building, however this needs to be empirically tested using statistical test of the historical data fit and whether structural breaks have occurred.

Furthermore, where there are reasons to believe that the past data may not be indicative of the future circumstances that models are being used to forecast, a more sophisticated approach may be required.

There are also challenges in obtaining historical data disaggregated at lower levels than previously recorded which may impact the robustness and comparability of data for modelling purposes. These challenges are likely to increase the further back the data extends. Where data must be back cast and reliant on assumptions to allocate, it is of lower predictive value than more robust recent data. This is a potential issue with regards to the separation and extraction of the bioresources historical data request, which will also impact on the Wastewater network modelling. It will be important for Ofwat to obtain guidance from companies on the reliability of any additional historical data not previously collated.

6. Should we consider including business plan forecasts in our wholesale base cost models at PR24?

Whilst use of forecast data may provide some value in terms of a cross-check on the robustness of the models used and for examining positive or negative step changes in costs compared to historical trends, South West Water's view is that the weight afforded to it in terms of setting model coefficients and final allowances may need to be limited given the inherent uncertainty in the inputs, and scope for inconsistency in allocation assumptions made across the sector.

However, where there are known changes in the expected cost base – for items which arise from changes in legislation, regulation, asset health improvements or expansion of services / targets (particularly those linked to the environment and population growth) we believe forecast cost information should be taken into consideration where historical levels may not fully reflect the future cost base. However, insights from business plan forecast data will require careful empirical examination.

Target modelling suite

7. Do you agree with our proposed target wholesale base cost modelling suite at PR24?

South West Water would like to see the development of wholesale wastewater models alongside the more disaggregated models. This would allow for review of the overall Waste allowance covering both Bioresources and Wastewater network plus and ensure that the overall final allowances made sense in aggregate. Without this, there is a risk of “cherry picking” in terms of efficiency in the separate controls and the overall efficiency targets being inappropriately stretching when combined.

8. Do you consider it would be worthwhile attempting to develop wholesale wastewater network plus models for PR24? If so, do you propose any potential wastewater network plus cost model specifications to consider?

South West Water supports the development of wholesale wastewater network plus models for PR24 as this would provide additional information for triangulation purposes which would help to assess overall robustness of estimates and identify an appropriate benchmark. We believe that given the significant increase in expectations on water companies around the environment and implications of the new environment act the base cost models (or indeed any enhancement expenditure models) need to ensure these aspects are considered – as these changes are not only linked to capital enhancement spend but also see underlying cost base increases.

Cost drivers and explanatory variables

9. Do you think we should reconsider the inclusion of APH in the wholesale water base cost models at PR24? If so, should it be a substitute for, or additional to, booster pumping stations per length of mains?

Following the response to question 3 above, South West Water considers there to be merit in Ofwat exploring the possibility of modelling power usage (and therefore costs) outside of the botex models. This would likely reduce the materiality of the topography variable within the existing models.

That aside though, SWW considers that Average Pumping Head (APH) potentially a better proxy for topography than number of booster stations and therefore should be considered at PR24 due to:

- The size and usage of the booster stations is not currently recognised in the modelling.
- APH is a weighted measure reflecting how much water and how hard you are pumping.

10. Should we consider replacing the existing 'load treated in size band 6' variable with 'load treated in band 8 and above' in the relevant wholesale wastewater base cost models?

South West Water would support a further disaggregation of the current band 6. The PR19 models based on 'load treated in size band 6' apply an economies of scale reduction to the cost allowance to treatment works at the lower end of this band in a way that is not consistent with the engineering and operational reality.

11. Please provide detailed proposals for any additional / alternative cost drivers and explanatory variables we should consider at PR24, including clearly defined data requirements that would need to be collected from companies.

- **UV Treatment** – The wastewater treatment complexity cost driver should be refined. Currently it only considers ammonia consents and ignores phosphorous consents or the need for UV treatment. At PR19 South West Water included a cost adjustment claim for the level and scale of UV disinfectant requirements at our sites – driven by the large number of bathing water in our region. This equates to over 70% of the South West Water population having UV treatment on their wastewater treatment – the highest level compared to any other company and we also have the requirement to operate these throughout the year in contrast to some other companies. If this is to be included in the base. Data from companies on the number, usage and permit requirements for UV would clearly highlight this difference (both for including as a base model driver or a specific cost adjustment claim). We also believe that given the potential environmental expectations for inland bathing water quality this requirement may increase across the industry putting pressure on the future cost base – above historical levels for base modelling.
- **Seasonality** – the variability of South West Water's demand – due to the rise in population (through tourism and visitor numbers) over the summer period results in peak demand requirements which are not necessarily seen by other companies. Therefore, we believe data and modelling which reflects this variability would be beneficial – taking a different approach to averaging certain drivers.

The models currently use data which is based on annual averages. These data fail to recognise variability across the year in terms of volume and load. This could be driven by regional-specific factors, such as population movements or weather.

Given the level of variation in terms of demand is not consistent by region and therefore company, there would be merit in exploring the use of metrics which aim to capture this dimension of operations, either in the form of peak to average ratios for water volumes and waste loads, or variance measures.

Model estimation method

12. Do you agree that we should maintain the use of random effects to estimate our wholesale base cost models at PR24?

The technical aspects of the modelling were considered in depth at PR19, and broadly we agree with the approach taken then. However, the models are based on the assumption that cost-driver relationships are constant over time, which becomes less certain the longer the dataset is used for modelling.

Random effects is a reasonable approach to use. However, the most appropriate approach is dependent on the data and should be empirically reviewed. Other techniques, such as data envelopment analysis and stochastic frontier analysis, which are widely used by other regulators, may be helpful in examining the robustness of the efficiency estimates and the chosen benchmark.

Model selection process

13. Do you agree with our proposed model selection process?

South West Water broadly supports the model selection process however we recognise that assessing the predictive power of the models may be more of a challenge for PR24 where the future may not be so reflective of the past.

There would be benefit in Ofwat providing further clarification as to how the predictive power might be assessed in a way that recognises the changes expected in the PR24 period in terms of outcome targets, Net Zero and environmental challenges.

Cost adjustment claims

14. Do you agree that the cost adjustment claim process at PR24 should be separated between base (wholesale and residential retail) and enhancement claims?

South West Water agrees that clear separation between base and enhancement claims is helpful.

Whilst extensive detailed information was provided at PR19, we would encourage Ofwat to present summarised data in ways that support clear understanding of how the overall Business Plan submission has been assessed and using which method.

15. What base cost adjustment claims (wholesale and residential retail) would you consider submitting if the PR19 base cost models were used to assess efficient costs at PR24?

Our current view is set out below, but this may change depending on the models that Ofwat ultimately develops.

- **UV treatment** – at PR19 South West Water had anticipated that scale of UV treatment may have been reflected in the base cost models. Following the exclusion of this we submitted a cost adjustment claim specifically for the high number of UV permits at our wastewater treatments works – reflecting the significant number of bathing beaches we have with high UV permits. This UV enhanced treatment has considerable costs and in order to model this we would expect data on treatment works could be collected from individual companies. . However, we consider that this would be best captured by amending the wastewater treatment complexity cost driver to include UV permits (and phosphorous consents).
- **Seasonality** – South West Water is significantly impacted by the rise in population (through tourism and visitor numbers) over the summer period, and in fact the pandemic has led to sustained increases in demand as the South West becomes not only a holiday destination, but a region favoured by second home users. As a result of this significant variation, much of South West Water's infrastructure needs to have the capacity to deal with these shorter-term peak demands and as a result 'averaging' drivers across the year does not

necessarily reflect the overarching cost base. Data from companies showing the demand data over the year enabling assessment of the peak vs underlying demand would be required to assess the impact of this.

- **Growth** – assuming growth costs were modelled in the same way as PR19 we would be submitting additional information to support key areas where our future plans identify the need for additional expenditure (either by scale or type) where historical costs were not reflective of the future. For example, if environmental regulations change additional permits or investments may be needed to support growth assumptions. In addition, the costs associated with growth activity (for example the level of self-lay in a region or the rurality of new developments) can vary between companies and should be taken into consideration either in base models or considered within enhancement expenditure. Furthermore, detailed analysis on the nature of developer services activity would be needed from companies to support any change here.
- **Economies of scale in wastewater treatment** – as per our response to question 10, we would support further disaggregation of the current band 6. If the model were not altered, then we would consider that a cost adjustment claim would be required.

16. What additional cross-sector data should be collected to support the submission of the claims indicated in response to the previous question? Please describe and explain the rationale behind the additional data that you consider should be collected and provide a draft definition.

We noted the type of data which would be needed to either include in consideration of the cost base models or indeed cost adjustment claims.

- **UV treatment** – in order to model this, we would expect data on treatment works could be collected from individual companies. However, we consider that this may be best captured by amending the wastewater treatment complexity cost driver to include UV permits (and phosphorous consents).
- **Seasonality** – Independent data from regional tourist bodies could be reviewed in conjunction with population data to demonstrate the magnitude of the transient population in comparison to the resident population. However, whilst this can provide useful context it might not be sufficiently comparable and appropriate for modelling purposes. Whilst we would like to see the base models better capture variability within the data both across time and region, we recognise it might be difficult fully account for the specific regional tourist demands faced by South West Water and therefore this may require a cost adjustment claim.
- **Growth** – given the uncertainty in population growth using a central estimate for growth assumptions based on a wider range of external information including taking account of specific local and regional plans would be appropriate. In addition, given the variation in the nature of developer activity (and therefore costs) detailed analysis on the nature of developer services activity would be needed from companies to take account of these differing approaches.

17. How can the cost adjustment claim guidance be enhanced to improve the quality of cost adjustment claim submissions?

To ensure fair and consistent treatment across the sector, Ofwat should set out clear guidelines on the presentation of Cost Adjustment Claims and how they will be assessed. This would be particularly useful regarding the calculation of the implicit allowance, which is a potentially complex area, and Ofwat have stated is a condition to pass the need for adjustment assessment gate.

The consultation also makes clear the need for companies to demonstrate that the claim remains material after deducting the implicit allowance. Further guidance on what constitutes material would enable an objective criterion to be set and avoid companies and Ofwat spending resources progressing claims which ultimately fail this test.

18. Would an early cost adjustment claim submission be welcome at PR24?

South West Water would welcome the opportunity for early cost adjustment claim submission, but this would need to follow or coincide with the publication of the base cost models to ensure if any aspects which companies assumed would be in the base modelling were omitted and therefore companies had further cost adjustment claims to make.

In addition, noting the comments in the consultation around Ofwat's intention to make symmetrical adjustments where possible, we would suggest a process whereby there is an opportunity to submit "secondary" claims or provide alternative evidence if felt necessary in light of potential unexpected downside adjustments arising from other company claims.

Capital maintenance and asset health

19. Do you agree with the different elements / approaches to introducing more of a 'forward-look' into our approach to assessing capital maintenance expenditure? Are there other elements / approaches we could consider?

Capital maintenance investment naturally comes in waves. Often assets are installed in phases, meaning that renewals of those assets can be similarly timed. This can drive what appears to be unsustainable renewal rates. For example – installing a cohort of assets in (say) 1970 that have a typical 60-year life could mean that until 2020 very few are renewed, with the bulk occurring between 2020 and 2040, with the final few after this point. Renewal rates for these assets would look uneven over this period – specifically too low, then too high, then too low again. That is why renewal rates are not on their own enough of an indicator of capital expenditure needs.

Asset bases in steady state are less of a concern – but post privatisation was significant investments in the asset base to drive new standards and meet environmental obligations. Much of the (non-infrastructure) investment will be nearing replacement time.

If asset health capital maintenance does not keep pace with asset deterioration there is inevitably an increase in asset failures and if not managed, this can ultimately result in a backlog of investment that then needs to be undertaken in a short period.

Many assets with long life (e.g., mains and sewers) tend to have very gradual increases in failure rates, meaning that in the short run there can be differences between asset deterioration and expenditure without causing a significant backlog of investment or impact on service. However, in

an industry that is facing changing expectations – with ever higher standards of service and environmental protection required from customers and stakeholders – any differences between expenditure and deterioration becomes even more important to understand. As these expectations rise, we need to fund asset health to at least, and potentially over and above, the deterioration rates of assets.

In the water industry we have seen improvements in asset health. To some extent this has been due to the asset health measures having some element of response (such as blockages and supply interruptions over 12 hours). These are simply not true measures of asset health as they reflect operational activities. In the long term, it simply cannot be the case that there can sustained increases in underlying asset health without commensurate changes in expenditure. For example, consider water mains where pressure management investment is used to prolong the life of the asset base. This is the right thing to do, as it is a cost-effective way to get more from our asset base. However, this may mean that if we only look backwards at our costs then we will not appropriately finance future investment needs.

Hence, it is essential to understand the relationship between asset health, service impact and expenditure to develop the right plans, and prevent large spikes of investment in the future, which could be potentially unaffordable and/or unfair for future customers. PR24 is likely to see us move to new “points” on the asset health, service impact and expenditure relationship curves.

This means that the past (and specifically past expenditure) is unlikely to be a good measure of the future. A forward-looking assessment is essential.

Ofwat could consider building up genuine cost-service-asset health curves, mapping the relationship between cost and asset health and service. We consider it a key part of our planning process to develop and refresh marginal costs for service improvements – all companies providing this would be incredibly useful data for the regulator and for the sector.

20. Do you have any comments on the proposed long list of asset health measures in Table 5, particularly in relation to their suitability and how feasible they are to collect? Please include any reporting or definition changes you would like us to consider and provide suggestions for other measures not included in this list

Asset health measures fall into leading or lagging. Leading are measures that companies should use to ensure they are tracking trends and being proactive. Lagging are measures that should be used by regulators, stakeholders, and companies alike as a check on progress. We would generally discourage Ofwat from using leading measures as regulatory measures.

For example, maintenance activity measures are leading measures. A company that moves further towards a fix on fail strategy (through increased redundancy and resilience) may see increases in unplanned maintenance or in the meantime to repair rates – but this does not necessarily mean there has been a deterioration of asset health. Looking at maintenance activity across companies may simply highlight different asset strategies and could be misleading if used to suggest asset health is failing. It is for companies to look at leading measures to test and adapt their strategies; with regulators focused on viewing the consequence of that via lagging i.e., outturn measures.

In terms of the measures proposed by Ofwat, we note that asset condition is a highly useful measure of asset health but is dependent on data quality and open to interpretation. These need to be consistent over the data points to be useful. There would likely be inconsistencies across the

sector and caution should be exercised to ensure that any condition data used for these measures is collected in a way that is representative of the asset base. Achieving this would effectively require companies to undertake an agreed level of somewhat random surveys across their asset base. Where-as our current strategy is to minimise unnecessary surveys by targeting surveys to assets that we believe to be in poor condition or providing poor services, such that we identify defects and rectify them quickly. Using the data, we currently collect would therefore distort our view of the condition of our asset base as it is not a representative sample of all our assets.

Ofwat rightly moved away from indices as measures in PR19 – these are not easy for customers and stakeholders to understand. They often can rely on unobservable factors such as the “likelihood of failure” – which would also lead to inconsistencies across the sector. This could mean that companies with the best data are at a disadvantage against companies with poor data (and therefore more flexibility in developing their estimates of monetised risk). In a sector with a small number of companies – such as gas distribution or electricity transmission - regulators can have the time to drive and challenge consistency, but with a sector with 17 companies this is unlikely to be feasible.

We would like to see the link between asset health and service explored. For example, the blockage rate per km of sewer; the % of collapses cause pollution or flooding; or the % of mains burst that cause interruptions over 12 hours. This would be very insightful data and would show to what extent service is a function of asset health or operational response. This would encourage collaboration as companies could learn from others how they have reduced service impacts from asset failures.

In summary:

Asset condition	Too vague – likely to be interpreted differently across companies. It is our view that it would require quite a prescriptive process of random/representative surveys to ensure consistency across companies and to establish a true reflection of asset condition.
Maintenance activity	Does not measure asset health but reflects renewal strategies and maintenance policies. As such, the measure is highly endogenous. We would discourage its use and note caution to include a normaliser that reflects the growing asset base if it were to be used.
Aggregated measures	Too opaque and likely to be interpreted differently across companies – scope to ensure consistency limited as too many companies in the sector
Asset and service performance	Service performance measures are useful, and we support but need to recognise these are a function of asset health and other factors. If these are collected, we would welcome exploring these factors to better understand how service is being delivered.

Cost-service link

21. Do you agree with the high-level approach to determine 'what base buys'? Can you define any additional analysis or information that could support this process?

SWW agrees in with the principle that customers should be protected from paying twice for the same performance improvements. Likewise, targets should be set for performance and costs in a way that mean companies are not facing efficiency challenges where performance improvements are double counted.

Figure 6.7 in the document shows base expenditure delivering steadily increasing annual performance and enhancement spend a step change. This is not consistent with the Regulatory Accounting Guidelines which define base, and enhancement as follows:

“Base expenditure is required to maintain the current level of service to customers. Base expenditure will include costs relating to the day-to-day running of the business and expenditure on maintaining the long-term capability of assets, as well as expenditure to improve efficiency. Enhancement expenditure is generally where there is a permanent increase or step change in the current level of service to a new “base” level and/or the provision to new customers of the current service level.”¹

As with the response to Q3 there needs to be clarity to ensure 'base' is not confused with 'botex' in terms of what is included in the modelling. Where enhancement opex is brought into the botex modelling, the boundaries between base and enhancement become blurred, along with the performance expectations around that expenditure.

There is only so far that companies that improve performance from base without increased expenditure – and as expectations are increasingly, assets will reach their renewal tipping points sooner, increasing expenditure needs further.

So, it is essential to be clear what base buys. The development of a clear definition of what base buys through base cost allowances will allow the cost implications of different service levels to be better understood.

It will be important to understand if base buys consistent absolute levels of service across the sector or where there will be differences based on previous quality schemes. For example, we have very high bathing water standards – some of our base is maintaining that at exceptionally high levels. Two companies don't even have bathing waters and none of the rest are maintaining such high standards. Understanding whether absolute or relative service levels are included in base is essential to understand.

You note that it may be necessary to consider the impact of historical enhancement allowances and expenditure on company performance when determining the performance level funded by base. We also believe it is important to understand when the run-off costs from historic enhancement expenditure convert into base when setting base allowances. For short lived assets,

¹ <https://www.ofwat.gov.uk/publication/rag-4-09-guideline-for-the-table-definitions-in-the-annual-performance-report/>

particularly some leading control/monitoring technology, this may start to incur base maintenance costs within the following AMP.

22. Do you consider it would be feasible to assess the ‘efficient’ baseline performance level for each company for individual PCs such as leakage and PCC through econometric modelling? Are there any other PCs where you consider this could feasibly be attempted?

We consider that it is unlikely that it will be feasible to model costs and PCs at the individual PC level – given the significant cost allocation issues involved.

We would urge caution around this. It is important that consider this cost models have acceptable confidence bounds and can produce accurate results.

We note that at SWW we have a robust costing process, which includes a mix of top down and bottom-up cost evidence e.g., statistical modelling of outturn costs, the use of contractor rates, etc; which are used to build up the evidence base for the efficient costs to delivery outcomes. We would welcome Ofwat collating companies’ bottom-up estimates of marginal cost curves – for Ofwat to collate and aggregate. This would support the identification of efficient costs to meet base and enhanced levels of service. We note that this would need some defined rules to ensure consistency (e.g. rules on the allocation of costs across joint services) but would be very valuable to companies and regulators.

23. The need to collect further granular data to elucidate the cost-service relationship was highlighted by companies in response to our PR24 May consultation. Can you propose any data it would be proportionate to collect to support the high-level approach outlined in this chapter?

As noted above, we believe that the cost-service relationship is essential to understand. We look to continually understand this relationship internally but understanding how this benchmarks with other companies would be useful. This could be the in form of marginal cost curves. We also think that the link between asset health and service would be useful to explore – such as the link between blockages and pollutions, or bursts and interruptions.

24. What are your views on attempting to use of a composite variable to investigate the cost-service relationship, in the context of the methodological issues and complexities we outlined?

In theoretical terms, South West Water supports the assessment of costs with regard to service quality. Without this link, there is a risk that cost efficiency targets are set that does not allow the improving service performance and outcomes needed.

However, there would be significant difficulties in weighting the different service outcomes to derive a meaningful composite variable that would be relevant across the sector. It is not clear if the weights would reflect the relative priorities of aspects of service to customers or stakeholders or would reflect customers willingness to pay for improvements or willingness to accept for deteriorations. It is recognised through the existing framework that different regions have customers and stakeholders with differing priorities (e.g., clean beaches) and it would not be possible to capture these variances within a single variable.

25. Do you have any proposals for how to make adjustments where a performance commitment level differs from that expected to be delivered from base costs?

It is important to be clear what “base buys” and to reflect those aspects – ensuring that performance above or below the baseline is reflected. This approach could be very difficult in practice and we would recommend using other regulatory mechanisms to adjust cost assessment if these are not able to be robustly included in the base cost modelling.

Residential retail cost assessment

We note that retail cost modelling and assessment is not considered in detail and we would welcome further discussion and analysis on the potential modelling approaches for PR24 given the PR14 and PR19 approach of not allowing indexation on retail costs – despite being largely driven by wages which have seen significant inflationary pressures.

26. Do you have any comments regarding our proposal to ask companies to separate out the part of their provision of bad debt costs to do with Covid-19 that was made outside of their standard methodology in the PR24 business plan tables?

South West Water supports the intention to separate out atypical bad debt costs related to Covid-19. The approach proposed to look at the provision based on the standard policy and then any additional provision seems to be a reasonable method to identify the Covid-19 related provision, however as with the main provision it would be subject to accounting policies and judgements.

27. What guidance would aid companies to provide appropriate data related to the provision of bad debt costs to do with Covid-19?

Many companies recognised atypical or exceptional charges for the impact of Covid-19 in recent years and as a minimum this should be clearly identifiable (and previously reported in Annual Reporting). The future underlying longer-term impact that may arise depending on the economic conditions in future years would need to be considered within business plans and cost assessments if this can be identified.