

Our Ref: PK/LAT/Ofwat

Your Ref:

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Dear Ofwat

Response to the consultation on PR24 econometric base cost models

Many thanks for this opportunity to respond to the above consultation on one of the most important aspects of the price review. Please find attached our detailed responses to the questions raised in the consultation.

We welcome Ofwat's constructive approach in engaging at an early stage regarding base cost modelling and in publishing the wide range of models that it is considering. It is challenging to model efficient costs accurately, and we think that publishing a broad range of models helps to highlight which work well and which work less well.

However, the varied performance of the models based on Ofwat's own tests means that, as we are all aware, there is considerable work to be done to update, select and weight models from the longlist of proposed models. Whilst we understand that Ofwat will not publish its final view of model selection and efficient costs prior to Business Plan submission, we would welcome a summary response to this consultation from Ofwat in which it addresses and provides further guidance on the questions we have raised.

In particular, we wish to highlight the following key points for Ofwat's consideration:

- Based on Ofwat's tests, some models perform significantly better than others. There are clear grounds for using a small subset of models to assess efficient costs. Specifically:
 - Wholesale models that include Average Pumping Head (APH) are superior to those that exclude it. Whilst models including APH do not necessarily capture the associated costs in full, they do a better job of reflecting the underlying drivers of companies' costs.
 - Models of Retail non-bad debt costs perform poorly and should be rejected. They do not add robustly to the evidence base available to Ofwat. By extension, bottom-up modelling is unsuitable as a basis for assessing efficient costs – though the debt management cost models remain relevant as a cross-check on the functional form of the total cost models.

- Retail total cost models that include Ofwat's proposed scale variable are superior to those that exclude it. The results demonstrate that companies' costs are driven, in part, by scale effects and there are no grounds for excluding this variable from the model specification.
- As a smaller company, we are particularly sensitive to a small number of decisions on variable selection, model specification and model variation. The process nevertheless requires us to submit cost adjustment claims before these decisions will have been resolved. Our cost adjustment claims will therefore need to accommodate a particularly wide range of potential outcomes, specifically concerning the implicit allowance made for our specific circumstances. In our view, it is appropriate to acknowledge and reflect that uncertainty in our cost adjustment claims by recognising a range of possible implicit allowance. We would welcome confirmation from Ofwat that this approach is reasonable and consistent with submitting a high quality and ambitious October Business Plan.
- Ofwat's preference for symmetry in cost adjustment claims further supports the rationale for including the two specific variables mentioned above. The econometric models will help provide symmetry in relation to APH and scale, whereas this would be more difficult, more contentious and costly to achieve via separate off-model calculations through the cost adjustment claims process.

We are happy to engage in further discussion and consultation to improve modelling approach for cost assessment in the future.

Yours faithfully



Paul Kerr
Group Chief Financial Officer