

12 May 2023

██████████  
██████████  
PR24 and Beyond  
Ofwat  
Centre City Tower  
7 Hill Street  
Birmingham  
B5 4UA

By email: [CostAssessment@ofwat.gov.uk](mailto:CostAssessment@ofwat.gov.uk)

Dear ██████████

## **CONSULTATION ON ECONOMETRIC BASE COST MODELS FOR PR24**

This is a brief covering letter for our response to the Econometric Base Cost Models consultation for PR24. We have supplied our detailed response points in the accompanying response template. We welcome the clear approach to the PR24 base cost models Ofwat are taking and the consultation has allowed us to make a full and carefully considered response.

We broadly welcome the proposed suite of base cost models and therefore only summarise in this response letter the key points where we have specific and material proposals that we believe require further consideration.

On the wholesale water base models:

- We believe the evidence strongly supports the use of length of mains as a scale driver in the wholesale water models, given the strong economic rationale and engineering logic for this. Given both properties and length of mains are plausible scale drivers, both should be used.
- The inclusion of a time trend is essential, particularly in the water models where it is significant. This reflects the rising trend in water costs identified in the CMA PR19 determinations, which continues and is necessary to deliver the improving service levels Ofwat assumed in base at PR19.
- We think Ofwat can now replace the booster pumping stations variable with Average Pumping Head given the greater engineering logic of the latter.
- We propose that the MSOA LAD density driver should be dropped, as the greater level of granularity means the MSOA level data is a more accurate driver covering the same approach, and properties per length of mains remains as the alternative density specification.

On the wastewater base models:

- We believe the composite STW complexity measure we proposed should be used, as the only reason for not doing so is based on the perception of complexity of interpretation which we do not think holds – the measure reflects the nature of STW consents so has engineering logic (treatment costs are a function of a combination of consent requirements rather than being incremental to the different consent elements).
- We suggest that weighted average treatment complexity should be preferred to the use of a scalar with the arbitrary threshold of 100,000 population served.
- We disagree with the removal of squared density forms for sewerage collection costs – this approach is inconsistent with other base cost models and the modelling is more robust with its inclusion. The perception that the variable is not statistically significant is due to the specification of other variables. We refer in particular to the urban rainfall data which lacks logic, not least because of the use of total length of mains. Once a corrected total rainfall variable is used, squared density terms become statistically significant as previously.

On bioresources models:

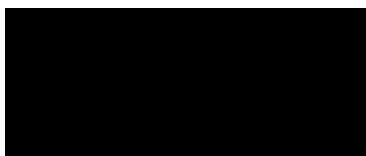
- We believe Ofwat should focus on unit cost rather than econometric models, as this is consistent with the form of the control and is also statistically better supported.
- We disagree that for a five-year price control disposal route is endogenous and a management choice. The Environment Agency are deciding treatment type through WINEP with the alternative for the South West for liming, and have not supported the change in treatment type so far. This provides strong evidence that treatment route is exogenous and therefore the statistically more robust models we proposed should be included.

We make a number of detailed comments on the retail models, covering economies of scale, migration and the recognition of “proportion of metered customers” as a variable across retail cost models (as at previous reviews).

We believe the consultation approach provides us with sufficient information to provide the initial submission of base cost adjustment claims by 9 June 2023.

Please let me know if you have any questions or would like to discuss any aspects of our model submission further.

Kind regards



**Iain McGuffog**  
**Director of Strategy & Regulation**

E: [REDACTED]

M: [REDACTED]