south east water

PR24 Redetermination

Submission on Other Disputing Companies' Statements of Case

29 April 2025

South East Water
Rocfort Road
Snodland
Kent
ME6 5AH

Contents

1 Overview

1.1 South East Water Limited (**SEW**) welcomes the opportunity to make a short submission on the Statements of Case submitted by the other four Disputing Companies – Anglian Water, Northumbrian Water, Southern Water and Wessex Water.

1.2 We note from our review of these Statements of Case that there is a high degree of thematic consistency across the submissions made by the Disputing Companies.

1.3 Whilst there are inevitably some differences both in the framing of issues and in how companies propose the CMA might address them, all Disputing Companies are, in essence, requesting **higher totex allowances**, **more realistic performance targets, a fresh look at the allowed return** and **higher allowed revenues**.

1.4 We consider these high-level, thematic points further in this Section 1 before addressing specific points under each price control 'building block' in Sections 2 to 5.

Clear and consistent themes

1.5 SEW considers that there is a significant degree of consistency in terms of the high-level themes which emerge from the Disputing Companies' Statements of Case.

1.6 In particular, we have identified the following key thematic areas of alignment:

(a) The identification of long-term concerns, spanning multiple price controls, which are now critical for customers, companies, and investors.

(b) The miscalibration of PR19 – which no company managed to deliver – with significant overspending and many unable to earn their base returns.

(c) Inadequate base allowances in Ofwat's PR24 FD, with a consistent message coming from companies on underfunding of essential maintenance and the need for a forward-looking approach to asset health.

(d) The importance of enhancement allowances and securing long-term resilience, which is becoming more acutely pressured by (among other things) accelerating climate change. Also, the lack of necessary standards against which resilience should be assessed.

(e) Reduced flexibility for companies to adjust their investment programmes and respond to emerging risks, due to Ofwat's new extensive use of Price Control Deliverables (**PCDs**).

(f) The imbalance of risk and return in Ofwat's PR24 FD, including unrealistic performance targets, inflexible and overly prescriptive PCDs and the vicious cycle of penalties.

(g) Ofwat's PR24 FD estimate of the cost of equity was not risk-reflective and the allowed return was excessively low and not commensurate with the returns that global equity investors can obtain on comparable investment opportunities. This adversely impacts the ability of companies to secure critical investment to deliver for customers and support the UK government's growth mission.

1.7 These common themes also lead to a common conclusion – namely that Ofwat's PR24 FDs were inconsistent with its statutory duties and the government's strategic priorities and objectives for Ofwat's regulation of the water sector as they did not: protect the interests of consumers, secure that companies' functions are properly carried out and that companies are able to finance those functions; or secure long-term resilience. The PR24 FDs also did not reflect proper consideration of the importance of the promotion of economic growth, in line with Ofwat's growth duty.

SEW's company-specific focus on resilience

1.8 Notwithstanding these common themes, our PR24 Business Plan, and our case to the CMA, are uniquely founded on the need to improve resilience and water security in our area. We face challenges in relation to resilience which – due to factors outside our control – are not faced to the same extent by the rest of the industry. The PR24 FD failed to take proper account of these challenges, and in so doing, undermines our plan to re-establish headroom, operational flexibility and resilience.

1.9 As we explained in our Initial Presentation, there are a number of factors which influence the resilience and water security challenges we face, and SEW is the only company which faces all of these compounding issues:

(a) **Complex geography**, including being a designated area of water stress, our chalk and sandstone geology, and consequent large number of small sources, and large number of small WTW.

(b) **Inherent characteristics of our network**, including limited local storage and limited interconnectivity between WRZ and sub-zones, influenced by our formation through numerous mergers and acquisitions.

(c) **Challenges posed by our local demand profile**, including a prime commuter belt customer base with demand patterns significantly affected by Covid-19 and the enduring 'new normal', a very high level of customer metering, comparatively high demand from agriculture, a lack of 'deindustrialisation windfall' in terms of network capacity, and high population and housing growth.

1.10 There are also several important differences to our case, given our position as a small company supplying water only, all of which relate directly or indirectly to our central case on resilience and water security:

(a) SEW is distinct from the other four Disputing Companies as having no wastewater issues;

(b) SEW raises a greater number of smaller enhancement schemes in its Statement of Case due to the nature of its supply area and the specific issues arising; and

(c) SEW requests a company specific adjustment (**CSA**) on the cost of debt, reflecting its status as a small company that historically has issued debt relatively infrequently.

1.11 We urge the CMA to ensure that company-specific issues, which were not properly taken into account in Ofwat's PR24 process, are given due consideration in the PR24 redetermination process, alongside the clear cross-cutting themes which have been identified by Disputing Companies.

2 Costs

Base costs

Asset health

2.1 Disputing Companies' Statements of Case are broadly aligned in arguing that Ofwat's approach in the FD underfunds efficient base costs. Other Disputing Companies present this as a particularly important issue in relation to asset health. For example:

(a) **Anglian**: *"the PR24 FD fails, once again, to set reasonable expectations of "what base buys", underfunding capital maintenance activities and thereby compromising asset health";*[1]

(b) **Northumbrian**: *"Ofwat failed to adopt an approach to the assessment of the efficient levels of base costs for capital maintenance and asset risk management in AMP8 that is adequate";*[2]

(c) **Southern**: *"Asset health - Ofwat's overall approach to funding capital maintenance through a base allowance set based on historical spend levels is not fit-for-purpose";*[3]

(d) **Wessex**: *"In our view, the regulatory model does not provide adequate allowances for companies to invest in the long-term resilience of their assets"*.[4]

2.2 Our position is aligned with those of the other Disputing Companies and we share the same concerns identified above: the base costs section of our Statement of Case explained that our Business Plan *"set out the need for increased levels of expenditure on base activities to operate, maintain and replace a larger and deteriorating asset base, while delivering higher levels of service and resilience",*[5] and that *"[w]ithout adequate base funding, these assets risk gradual deterioration, leading to increased risk of asset failure"*.[6]

2.3 Our requested remedies to resolve asset health risks arising from the FD include: (i) correcting Ofwat's cost models so that they no longer underfund our efficient base costs; (ii) adjusting Ofwat's post-modelling adjustments for mains replacement and meter renewals; and (iii) allowing our requested Cost Adjustment Claims (**CACs**) for WTW-level economies of scale and network reinforcement, in full. We also proposed an uplift to our base costs allowances to reflect the fact that Ofwat's FD implies a mains replacement rate of 0.43%, compared to our DDR assumption of 0.28%.[7]

2.4 As other Disputing Companies have noted, the Asset Health Roadmap which Ofwat published alongside the PR24 FD is inadequate to address the shortfalls in funding for asset health.[8] This is firstly because any additional funding granted as a result of this workstream is highly uncertain and will not be sufficiently timely: Ofwat has referred to *"providing additional base expenditure allowances either in-period or through the PR24 end-of-period reconciliation"* but without indicating a timeframe for any in-period adjustments.[9] Secondly, Ofwat has already signalled that it would apply the same approach to penalising companies for alleged historic under-delivery. As explained in our Statement of Case, Ofwat's approach of removing allowances on this basis is an arbitrary, asymmetric and retrospective regulatory intervention that is inconsistent with the

1 Anglian Water, March 2025, Statement of Case, page 2.
2 Northumbrian Water, March 2025, Statement of Case, page 68.
3 Southern Water, March 2025, Statement of Case, Chapter 2, page 200.
4 Wessex Water, March 2025, Statement of Case, paragraph 2.28.
5 SEW, March 2025, Statement of Case, paragraph 4.9.
6 SEW, March 2025, Statement of Case, paragraph 4.10.
7 SEW, March 2025, Statement of Case, paragraph 4.36.
8 See Northumbrian Water, March 2025, Statement of Case, paragraphs 227-233; Anglian Water, March 2025, Statement of Case, paragraph 353-361
9 Ofwat, December 2024, PR24 FD, Roadmap for enhancing asset health understanding in the water sector, page 10.

principles of the PR19 price control, which was supposed to support optimisation of programmes to deliver defined outcomes.[10]

2.5 Disputing Companies have proposed slightly different figures for the mains renewal rate implicitly funded by base costs, ranging between 0.15% and 0.24%, compared with Ofwat's 0.30%. We maintain our view that the appropriate figure should be 0.15%, based on the industry average renewal rate from the last five years, consistent with the benchmarking period. However, our requested remedy from the CMA is an uplift of £54m in order to fully fund us to meet Ofwat's overall mains renewals target from base costs of 0.43%, compared to our DDR proposal of 0.28%, rather than adjusting the implied base mains renewal target. If the CMA concluded that a different mains renewal target should be funded from base costs, our uplift should be adjusted pro-rata and the PCD adjusted accordingly.

Inclusion of average pumping head (APH) in base cost models

2.6 **Southern** argues that Ofwat should not have included APH as a variable in its wholesale water base cost models because APH is subject to "significant data issues".[11] SEW's position is that APH should not only be retained in the wholesale water base cost models, but that it should be included in the same models as Booster Pumping Stations (**BPS**), rather than Ofwat's PR24 FD approach of triangulating across models that include one or other variable, for the reasons set out in the Oxera Base Costs Modelling Report.[12] For example, Oxera notes that while both BPS and APH capture costs associated with topography, they measure different cost pressures, with APH being *"a direct proxy for power costs, given that it measures the vertical distance that water needs to be pumped"*, while BPS *"may better capture the costs associated with operating, maintaining and replacing a large number of network assets"*.[13]

2.7 Southern bases its case on alleged data quality issues affecting Ofwat's APH dataset, identified in a report commissioned by Ofwat from Turner and Townsend dating from March 2022.[14] Southern acknowledges that significant updates have been made to Ofwat's APH dataset since the Turner and Townsend report, and that Ofwat's own assessment concludes that *"significant APH data quality improvements have been made in recent years"*,[15] but notes that it has not had an opportunity to review the revised dataset.

2.8 Our position remains that there are strong grounds for including APH in the same base cost models:

(a) There is a strong engineering rationale for inclusion of APH alongside BPS, because APH measures the vertical distance that water needs to be pumped, while BPS captures the costs associated with operating, maintaining and replacing a large number of network assets.[16] Therefore, these two measures capture different aspects of topography and network complexity. Given the topography of our network, APH captures the energy costs we bear more accurately than BPS. Not including APH in all base cost models inappropriately underfunds companies such as SEW which must carry out comparatively more pumping, for example due to the geology of our area (with a relatively higher number of greensand sources than other companies) which results in deeper boreholes.

(b) APH and BPS are weakly correlated, which suggests they capture different operational characteristics, and therefore omitting APH entirely leads to omitted variable bias, and results in potentially significant underfunding of base costs for companies like SEW, which are exposed to high APH.

(c) As noted by **Anglian**, there is a *"broad consensus that APH represents the best measure of topography, both for cost modelling and for the purpose of internal energy efficiency*

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10 SEW, March 2025, Statement of Case, paragraph 4.26.
11 Southern Water, March 2025, Statement of Case, Chapter 2, paragraph 73.
12 Oxera, March 2025, Wholesale base expenditure modelling.
13 Oxera, March 2025, Wholesale base expenditure modelling, page 7.
14 Southern Water, March 2025, Statement of Case, Chapter 2, paragraph 58.
15 Ofwat, December 2024, PR24 FD: Expenditure allowances – base cost modelling decision appendix, page 23.
16 Oxera, March 2025, Wholesale base expenditure modelling, page 7.

optimisation".[17] Pumping costs are one of the major costs facing a water company, typically representing about 10-15% of botex. APH measures the amount of pumping that a water company must do, and there is no good substitute variable for this.

2.9 We agree that there is value in including BPS in base cost models, but it is not a reliable measure of the amount of pumping that is required to move water from its source to the customer tap. We maintain the position in our Statement of Case that that both APH and BPS should be included in the same base cost models as BPS, rather than Ofwat's PR24 FD approach of triangulating across models that include one or other variable.

Regional labour cost adjustment

2.10 **Southern** has submitted that it is exposed to higher-than-average labour costs in the South East, and that contrary to Ofwat's assertions, these are not adequately reflected in the PR24 base cost models. Southern proposes one of two alternative remedies, either a pre-modelling adjustment (similar to Ofgem's approach in the energy sector); or a "within modelling" approach which incorporates regional wage differences as a cost driver in the base cost models.[18]

2.11 Our Statement of Case highlighted that similarly to Southern, we are also exposed to average population density but high wage levels,[19] and Southern acknowledges that we are one of the few other companies in this position.[20] Our Statement of Case did not propose a standalone modelling adjust to account for the higher wages we must bear, but cites this issue as a supporting reason for why changes are needed to the post-modelling adjustment for mains renewals.[21]

Energy allowance adjustment

2.12 **Southern** has requested the CMA use an extended time period of 2011/12 to 2023/24 to estimate its power cost share assumption given company-specific circumstances relating to its recent hedging position, and then use that to re-estimate its energy allowance based on Ofwat's energy adjustment model. We do not express a view on Southern's claim, but note that this claim is based on company-specific circumstances that do not apply to the wider industry, and therefore Ofwat's approach of using the shorter time period of 2019/20 to 2023/24 should be retained for other companies, including SEW, for whom power cost share increased from 2021 due to geopolitical factors.

Enhancement costs

2.13 All Disputing Companies have highlighted serious flaws in Ofwat's assessment of enhancement costs, and have proposed remedies which are specific to their circumstances and investment needs. Likewise, our Statement of Case identified the enhancement cost lines where the PR24 FD jeopardises our ability to deliver the resilience improvements and water security that our customers want, and the investments which they supported in our PR24 business plan.

2.14 Our enhancement costs case is vitally important because we face company-specific challenges in relation to supply resilience and water security, to an extent which the other Disputing Companies simply do not face. As explained in Section 2 of our Statement of Case, company history has meant that our network is characterised by limited interconnectivity, and a large number of small local sources.[22] These factors, when combined with a recent step-change in demand in our area during AMP7, and several extreme weather events, neither of which could reasonably have been anticipated at the last price control, has led to a deterioration in our water supply interruption (**WSI**) performance.

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17 Anglian Water, March 2025, Statement of Case, paragraph 170(ii).
18 Southern Water, March 2025, Statement of Case, Chapter 2, paragraph 219.
19 SEW, March 2025, Statement of Case, footnote 52; paragraph 4.68 (in relation to enhancement costs).
20 Southern Water, March 2025, Statement of Case, Chapter 2, paragraph 190.
21 SEW, March 2025, Statement of Case, paragraph 4.27(a)(i).
22 As previously noted, other companies will share some of these characteristics (e.g. Wessex also has a large number of small sources), but it is the combination of factors we face that is unique.

2.15 The significant cuts made to our proposed enhancement programme in the PR24 FD jeopardise our plan to remediate the water security and resilience issues we have recently begun to face. The enhancement cases we have presented to the CMA are all connected to our Resilience Strategy, and are important to improving our WSI performance, which is a priority for our customers. As we explained in our Statement of Case, the extensive and inflexible nature of Ofwat's PR24 PCD framework (across base and enhancement costs) also limits our ability to accept underfunding of specific enhancement costs, as we will have less flexibility than previously as to how we optimise our investment programme.

Frontier shift

2.16 All Disputing Companies have asked the CMA to reduce frontier shift from Ofwat's excessively ambitious 1.0%, to a level which reflects what is realistically achievable for the water sector in the context of slower economy-wide productivity growth. The CMA should focus on the basic intuition and consistent evidence that water companies cannot be expected to outperform the wider economy, and consider the evidence put forward in Economic Insight's Frontier Shift Report.[23]

Price Control Deliverables

2.17 All Disputing Companies support PCDs in principle in order to protect customer interests, but argue that Ofwat's approach is overly prescriptive, reduces flexibility and undermines companies' ability to make efficient decisions. SEW agrees with **Anglian**, **Southern** and **Wessex** that the introduction of widespread PCDs on base and enhancement expenditure will increase asymmetric risk in the overall PR24 package.[24]

2.18 Other Disputing Companies have also requested specific remedies in respect of PCDs, including: removing time limits and time delivery incentives;[25] introducing more flexibility into PCDs in relation to base expenditure PCDs;[26] a within-AMP adjustment mechanism to reflect developments since the PCD was set;[27] introducing a mechanism to ensure companies are not penalised twice in respect of PCD and ODI penalties;[28] and taking into account the level of residual asymmetric risk from PCDs when setting the cost of capital.[29]

2.19 Our position remains that the most critical remedy is for the CMA to properly fund our efficient base and enhancement costs. However, we would welcome the CMA taking a more in-depth assessment of the PCD framework, including PCDs applicable to SEW, and considering whether some or all of Disputing Companies' proposed remedies would address the problems identified with the FD PCD framework. In particular, we support two conceptual changes across the suite of base and enhancement PCDs:

(a) Removal of annual time limits and annual time incentives for delivery across all PCDs. Annual targets are a major source of inflexibility in the PR24 FD PCD framework, and will inhibit our ability to deliver an optimised investment programme in accordance with customer priorities and which is responsive to operational issues arising during the AMP.

(b) PCDs should be specified at a less granular level, to achieve a better balance between the flexibility companies need, and an appropriate level of customer protection. For example, in respect of enhancement costs, rather than setting 15 separate PCDs for 15 different funded interconnector schemes, there should be a single PCD which measures outputs across the relevant category of spend, to enable companies to reprioritise investment as needed during the AMP.

23 Economic Insight, March 2025, Frontier shift at the PR24 Redeterminations.
24 Anglian Water, March 2025, Statement of Case, page 155; Southern Water, March 2025, Statement of Case, Chapter 5, paragraph 61; Wessex Water, March 2025, Statement of Case, Annex A5, paragraph 1.42.
25 Anglian Water, March 2025, Statement of Case, paragraph 627.
26 Northumbrian Water, March 2025, Statement of Case, paragraphs 505-522; Southern Water, March 2025, Statement of Case, Chapter 5, paragraph 149.
27 Southern Water, March 2025, Statement of Case, Chapter 5, paragraph 150.
28 Southern Water, March 2025, Statement of Case, Chapter 5, paragraph 152.
29 Anglian Water, March 2025, Statement of Case, paragraph 628.

Summary: Costs

- *On **base costs**, we share other Disputing Companies' concerns with insufficient asset health funding. Our proposed remedies are the corrections to Ofwat's base cost models, post-modelling adjustments, and CACs we set out in our Statement of Case.*
- ***APH** should be included in the same models as BPS in wholesale water base cost models.*
- ***Regional disparities in labour costs** support the post-modelling adjustment for mains renewals we advocated in our Statement of Case.*
- *The **energy allowance adjustment** for SEW should continue to use the shorter time period of 2019/20 to 2023/24.*
- *Disputing Companies' cases on **enhancement costs** are driven by their circumstances and investment needs. Our proposed enhancement costs are vitally important for addressing our company-specific challenges in relation to supply resilience and water security.*
- *Disputing Companies agree that Ofwat's 1.0% **frontier shift** is excessively stretching.*
- *Changes are needed to Ofwat's **PCD framework**, which is overly prescriptive, reduces flexibility and undermines companies' ability to make efficient decisions.*

3 Outcomes

3.1 The Disputing Companies are aligned in arguing that there is an inappropriate downward skew in the FD outcomes package, a point we also made in our Statement of Case:[30]

(a) **Anglian** argues: *"It is clear that there is significant risk asymmetry within the overall FD ODI package"*;[31]

(b) **Northumbrian** observes that: *"Ofwat's FD24 does not reflect a robust consideration of the risk in the settlement in the round. When the settlement is compared to current expenditure levels and service improvement rates FD24 is, once again, unlikely to be achievable for the average or median performer in the sector"*;[32]

(c) **Southern** states: *"The FD's ODI package, as well as Ofwat's overall approach to the PCs and ODIs framework, are skewed towards penalties";*[33]

(d) **Wessex** refers to: *"A downside ODI risk driven by the asymmetric risks of meeting some of our performance commitment targets"*.[34]

3.2 Disputing Companies have generally taken a proportionate approach of asking the CMA to focus on targeted specific issues which have the largest impact, but there is a consistent message that the PR24 outcomes package is excessively stretching and exposes companies to a high risk of penalties. This is consistent with the experience at PR19, which history has revealed to be excessively stretching, and where only three companies have been able to outperform their ODI targets overall.

Water supply interruptions PCL and ODI

3.3 Two other companies – **Anglian** and **Southern** – raise concerns with the WSI PCL, as we did in our Statement of Case. Both companies agree with SEW's position that the PCL is set at an excessively stretching level which does not reflect sector outturn performance, and should therefore be amended, though the proposed remedies differ.[35]

3.4 In relation to the PCL:

(a) **Anglian** proposes that the 2024/25 baseline is set based on the median of companies' performance over the last four years, and that the PCL for each year of AMP8 is set based on a glidepath from the 2024/25 baseline to the median of companies' PCLs for 2029/30.[36]

(b) **Southern** proposes that the PCL for 2025/26 is set based on the industry median outturn performance, with a 2029/30 target set at the industry actual upper quartile, with a straight-line trend between the two.[37]

3.5 **Southern** also: (i) supports SEW's position that the penalty collar should be aligned with most other PCs at -0.5% RoRE;[38] and (ii) argues that the ODI rate should be amended by changing basing the calculation on performance data from PR19 only, and not PR14, because the PR14 ODI included a severe weather exclusion and so company performance from that period is not consistent with subsequent performance data.[39]

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30 SEW, March 2025, Statement of Case, paragraph 1.19.
31 Anglian Water, March 2025, Statement of Case, page 113.
32 Northumbrian Water, March 2025, Statement of Case, page 108.
33 Southern Water, March 2025, Statement of Case, Chapter 6, paragraph 4.
34 Wessex Water, March 2025, Statement of Case, paragraph 1.53(b).
35 Anglian Water, March 2025, Statement of Case, paragraph 553; Southern Water, March 2025, Statement of Case, Chapter 6, paragraph 101.
36 Anglian Water, March 2025, Statement of Case, paragraph 553.
37 Southern Water, March 2025, Statement of Case, Chapter 6, paragraph 103.
38 Southern Water, March 2025, Statement of Case, Chapter 6, paragraph 109.
39 Southern Water, March 2025, Statement of Case, Chapter 6, paragraphs 104-107.

3.6 The arguments raised by other companies support our position that the PR24 FD WSI PCL and ODI are seriously flawed, and that changes to the PCL and penalty collar are necessary. While a range of different remedies are proposed, the need for a company-specific PCL is explained in detail in Part B of Annex F of our Statement of Case, and is driven by the unique combination of circumstances we face that are not faced by other companies, including a step-change in the demand we face since Covid-19, combined with our limited operational headroom and network interconnectivity due to the historical make-up of our network.[40]

3.7 Part B of Annex F of our Statement of Case also explained the recent challenges on WSI performance we have experienced during AMP7, and the excessive risk in the PR24 FD as a result of the WSI PCL and collar. The analysis we carried out, with the assistance of KPMG, indicated that the 5 minute PCL in the FD is unachievable for SEW in AMP8, on both a mean-expected P50 and plausible downside P10 analysis. If the FD WSI ODI stands, we expect to incur £31m of automatic penalties across AMP8 (based on mean expected P50 performance).[41]

3.8 As set out in our Statement of Case, the CMA should amend the penalty collar to -0.5% RoRE and adjust the PCL to the level set out in Table 5.4 of our Statement of Case. A remedy which involved adjusting the PCL only to reflect average (or upper quartile) sector-wide outturn performance on WSI would not take sufficient account of the company-specific circumstances behind our recent performance challenges (which are outside company control), and therefore would not address the significant unjustified risk exposure we face on the WSI ODI. Ofwat's teach-in slides to the CMA on outcomes noted that a company-specific PCL is appropriate when there is *"valid justification for varying levels between regions"*.[42] This is plainly the case in relation to WSI, for the reasons set out in Annex F of our Statement of Case.

C-MeX

3.9 In line with SEW's position, **Southern** also argues that the C-MeX methodology involves setting a PCL which is too stretching, and exposes companies to the risk of unjustified penalties. Southern points out that water companies are natural monopolies whose customers are unable to switch, and that this explains why the median water company score has historically been materially below the UKSCI all-sector average which Ofwat's FD used to calibrate the C-MeX ODI.[43] We have made the same point to Ofwat in our DDR.[44]

3.10 To remedy the issues identified with the C-MeX PCL, Southern proposes an increased downward adjustment to the UKSCI, compared to the level of the downward adjustment set by Ofwat in the FD (which Ofwat had introduced in recognition of the long-term difference between the UKCSI all-sector average and the UKCSI utilities sector average). SEW agrees that an increased downward adjustment would be an appropriate remedy to properly account for the downwards bias the water industry faces relative to the overall cross-sector UKSCI benchmark.

3.11 However, this is a separate issue to the one we identified in our Statement of Case, namely the *regional* bias in customer satisfaction scores we face as a company operating in the south east, compared to companies operating in other areas of the country. To address this separate issue, we maintain our position that the CMA should make an additional change to the C-MeX methodology to ensure that we are benchmarked against the UKSCI all-sector average for the south east, and not the UKSCI all-sector overall average.[45]

Extreme weather

3.12 All Disputing Companies have highlighted the increasing risks posed by extreme weather events, and noted that Ofwat's approach to the outcomes framework wrongly places all weather-related

40 SEW, March 2025, Statement of Case, Annex F paragraph 94.
41 SEW, March 2025, Statement of Case, Annex F paragraph 36.
42 Ofwat, 20 February 2025, "Delivering outcomes for customers and the environment at PR24", slide 12.
43 Southern Water, March 2025, Statement of Case, Chapter 6, paragraph 169.
44 SEW, August 2024, DDR – Performance Commitments and Outcome Delivery Incentives (SEW163), page 42.
45 SEW, March 2025, Statement of Case, paragraph 5.47.

risk on companies, and this is a flawed approach which is inconsistent with the approach of other regulators:

(a) **Anglian** argues in relation to the total pollution incidents ODI that *"there are no incentive benefits from exacting heavy underperformance payments on companies for uncontrollable weather events."* [46] The same is true in relation to the WSI ODI.

(b) **Northumbrian** notes that: *"[t]he regulatory framework in the water sector is unusual in comparison to other regulated sectors in that it allocates the full risk of severe weather events, which are outside of companies control, to those companies."*[47]

(c) **Southern** argues: *"Ofwat has not considered exogenous factors (i.e. extreme weather events, unique geographical characteristics) and incidents beyond management control when setting ODIs and PCLs. Again, this would likely result in penalties that the company could little to change. This is inconsistent with past regulatory precedents and other sectors where fair and achievable incentives have been set…"*[48]

(d) **Wessex** notes that: *"We disagree with Ofwat's approach to setting enhancement cost allowances for resilience, specifically in respect of climate change risks. Companies will each face unique challenges in this area and the requested funding in their business plans will reflect these circumstances."*[49]

3.13 As explained in Annex F to our Statement of Case, climate specialists at AtkinsRéalis used spatially coherent temperature and precipitation daily timeseries in 12km grid-squares from the UKCP18 regional climate model (**RCM**) to better understand how climate risks differ between the Kent, Sussex and Western regions of our supply area and their potential impact on our assets and operations: this work fed into the analysis in Annex F on the expected number and type of extreme weather events in AMP8.

3.14 Subsequent to submission of our Statement of Case, AtkinsRéalis have broadened their analysis of recent extreme hot spell events across our area of appointment, with key findings being:[50]

(a) AMP7 observed hot spell frequency and duration is in line with 'high' climate change scenario in the Met Office UKCP18 projections (Probabilistic RCP8.5), but with higher sustained temperatures than the 95th percentile of the projections.

(b) 2022 exhibited a sustained hot period of 38 days, a situation that was not projected in climate models until AMP18 (2075-2080) and only in the hottest 5% of possible outcomes.

(c) The July 2022 heatwave was 2.29°C hotter than 2022 projected median (35.94°C), which was only predicted in the hottest 5% of projections for 1-in-100-year return of Probabilistic RCP8.5 of climate extremes (38.09°C).

3.15 AtkinsRéalis' findings therefore show that AMP7 was more extreme for hot spells than had been expected in the past. Therefore, the WSI incidents we have experienced during periods of high demand / hot weather are reflective of extreme weather events beyond what could reasonably have been predicted at PR19, and not of poor management performance or investment decisions.

3.16 AtkinsRéalis also identifies that the trend of extreme temperatures is expected to increase over time. This therefore supports the needs case for our enhancement cost proposals pursuant to our resilience strategy, which will reduce the impact of future extreme weather on customers.

3.17 Naturally, the way in which extreme weather risks are manifested varies between Disputing Companies, based on the nature of their activities and network. Northumbrian and Wessex both

46 Anglian Water, March 2025, Statement of Case, paragraph 520.
47 Northumbrian Water, March 2025, Statement of Case, paragraph 35.
48 Southern Water, March 2025, Statement of Case, Chapter 6, paragraph 4.
49 Wessex Water, March 2025, Statement of Case, Annex A5, paragraph 1.24.
50 AtkinsRéalis, 10 April 2025, Adaptive Planning Scenarios: Hot spells climate projection analysis. SEW would be happy to provide a copy of this report to the CMA on request.

highlight the risks of flooding due to extreme weather on resilience at Treatment Works, pumping stations and Water Recycling Centres. For SEW, the risks arise in relation to WSI due to our network configuration and lack of operational headroom in Kent and Sussex. However, Disputing Companies are aligned in highlighting increasing risks from extreme weather due to climate change, and that the PR24 FD is wrong in allocating those risks wholly to companies, with insufficient funding to address those risks.

3.18 As set out in our Statement of Case, we have considered a remedy which would involve an extreme weather exclusion from the scope of the WSI ODI.[51] However, we are mindful of challenges both in designing an extreme weather exclusion, and also in the ongoing operation and assessment of such an exclusion. Our proposed remedy in relation to WSI is therefore to amend the PCL as set out in Table 5.4 of our Statement of Case, and to amend the penalty collar to -0.5% RoRE.

Summary: Outcomes

- *The **WSI PCL** should be amended to reflect company-specific circumstances, as proposed in our Statement of Case. The ODI penalty collar should be set to -0.5% RoRE.*
- *On the **C-MeX ODI**, we support an increased downward adjustment to the UKSCI to reflect the long-term difference between the UKCSI all-sector average and the UKCSI utilities sector average, in addition to our proposed adjustment to address regional bias in customer satisfaction scores.*
- *Disputing Companies are aligned in pointing to increasing risks from **extreme weather**, and Ofwat's outcomes framework wrongly places all such risk on companies.*

[51] SEW, March 2025, Statement of Case, paragraph 5.27(b)(i).

4 Risk and return

4.1 All Disputing Companies are aligned on the position that a higher WACC is needed, based primarily on a higher Cost of Equity, and that this is particularly important in the context of a step-up in capital investment, accompanying delivery risks, and required equity in AMP8.

4.2 Inevitably, there is some variation in the precise figures put forward, but there is a high degree of consistency in the substance of companies' arguments, as further highlighted below. The evidence submitted by Disputing Companies consistently points towards Ofwat's PR24 FD Cost of Equity being out of line with observable rates of return that investors can earn elsewhere, and the CMA should therefore carry out a fresh estimation of the Cost of Equity.

Cost of Debt

4.3 The CMA has received a broadly consistent set of arguments from Disputing Companies on the calibration of the industry-wide Cost of Debt allowance. In our Statement of Case we also pointed out the greater variance that we have historically faced in our out-turn interest costs as a smaller, infrequent issuer of debt. Given that this heightened variance has resulted in higher-than-average embedded debt costs, we asked the CMA to provide in its determination for a company-specific adjustment to the allowed cost of debt for SEW, so that the costs we face do not fall solely on shareholders.

4.4 **Southern** in its Statement of Case also argues for recognition of its company-specific debt costs. We agree with many of the observations that Southern makes about the natural variation in the Cost of Debt across companies and the unfairness that there is in systematically over-funding some companies' efficiently incurred costs while under-funding other companies' efficient costs. However, it is important that the CMA appreciates that there is an additional layer in the arguments that we have presented as a small company. Our request was deliberately presented as a company-specific adjustment for infrequent issuers, where the difference in the cost of our embedded debt vs Ofwat's methodology is shared 50:50 with customers. We impress upon the CMA the importance of this key piece of context when it assesses our Cost of Debt allowance.

Summary: Risk and return

- *Disputing Companies are aligned that a higher **WACC** is needed in the context of a step-up in capital investment and delivery risks in AMP8.*
- *Our **CSA to the embedded Cost of Debt** is based on our company-specific characteristics as a historically relatively infrequent issuer of debt.*

5 Financeability and investability

5.1 Disputing Companies are aligned on the position that the PR24 FD imposes excessive risk on companies and does not constitute a settlement which is achievable in the round. For example:

(a) **Anglian** concludes that *"the FD fails to strike a balance between risk and return capable of attracting the level of investment the sector needs."*[52]

(b) **Northumbrian** finds that: *"Ofwat's FD24 does not reflect a robust consideration of the risk in the settlement in the round. When the settlement is compared to current expenditure levels and service improvement rates FD24 is, once again, unlikely to be achievable for the average or median performer in the sector."*[53]

(c) **Southern's** position is that: *"Our analysis indicates a materially negative base-case RoRE (simulated) P50 and thus an expected return less than the allowed return. This is a significant and material penalty and impedes an investor's ability to earn the allowed return – even in the best-case scenario the RoRE (simulated) P90 is negative. The degree of negative RoRE means that the FD is not a 'fair bet' as investors are not likely to earn the required return."*[54]

(d) **Wessex** states: *"Ofwat's approach to risk and return has not achieved the right alignment […] it results in considerable downside risk for the efficient company, such that it cannot expect to earn [the allowed return]."*[55]

5.2 This is consistent with our position, where, as set out in our Statement of Case: *"Ofwat's FD puts us in a position where we need everything to 'go right' in the next five years in downsides that we are exposed to are potentially very severe, with equity investors potentially able to lose all of their real returns – and more – in the event of plausible downside events."*[56] As explained in our initial presentation to the CMA, everything "going right" in this context means:

(a) No extreme weather events, including no droughts, heatwaves, severe storms, freeze-thaw events of the kind seen in the recent past, even despite continuing climate change.

(b) Delivering all of our investment schemes for substantially lower funding than we put into our business plan, and delivering some schemes that were not funded at all by Ofwat.

(c) Delivering all of those schemes early, or at least on time (otherwise PCD penalties would apply).

(d) Avoiding any supply failures on single sources of supply.

(e) Dramatically and quickly reversing the trend of customers using more water.

5.3 We accept that risk analysis is challenging, and can only approximate likely sector performance, but the weight of evidence put forward shows that Disputing Companies' assessment of the balance of risk better reflects likely outturn performance at AMP8 than Ofwat's analysis in the FD.

5.4 As set out in our Statement of Case, the appropriate remedies are to:

(a) adjust upwards the allowed return (including any aiming up for otherwise unmitigated skew in the outcomes package);

52 Anglian Water, March 2025, Statement of Case, paragraph 6.
53 Northumbrian Water, March 2025, Statement of Case, page 108.
54 Southern Water, March 2025, Statement of Case, Chapter 1, paragraph 7.
55 Wessex Water, March 2025, Statement of Case, Annex A5, paragraph 2.43.
56 SEW, March 2025, Statement of Case, paragraph 7.13.

(b) address at source excessive risk in relation to underfunded base and enhancement cost allowances, and an excessively stretching outcomes package; and

(c) amend risk mitigations by changing the ASM thresholds to reflect a ±2.00% “lower” threshold at 50% sharing and ±3.00% “upper” threshold at 90% sharing and removing the OAM deadband of ±0.5% to address expected underperformance.

Summary: Financeability and investability

- *Disputing Companies are aligned on the position that the PR24 FD imposes excessive risk on companies and does not constitute a settlement which is achievable in the round.*
- *Remedies for addressing financeability issues include upwards adjustment to the allowed return; addressing excessive risk at source in the costs allowances and outcomes package; and improving the ASM and OSM risk mitigations.*