

# **Wessex Water**

## **PR24 CMA Redetermination**

### **Reply to the Statements of Case of Anglian Water, Northumbrian Water, Southern Water, and South East Water**

**29 April 2025**

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# 1 Introduction

## Introduction

- 1.1 Wessex Water's reply to the other disputing companies' statements of case has been prepared to aid the CMA in understanding the alignment between the issues we raised in our own statement of case, and those issues raised by others. This is to allow the CMA to group and prioritise issues accordingly.
- 1.2 Overall, we note that there are no areas of significant disagreement between the issues we have raised and those of other companies – however due to the varying nature of our businesses and business plans we have each prioritised different areas for redetermination.

## Structure of our reply

- 1.3 This reply is structured as follows:
- (a) **Area of focus: Wholesale water base costs.** We find that all the other disputing companies have raised similar concerns to us with regards to Ofwat's approach. Most notably, we find considerable agreement in relation to long term resilience, and ongoing efficiency.
  - (b) **Area of focus: Phosphorus removal.** Two other disputing companies (Northumbrian Water and Southern Water) have raised issues in relation to phosphorus costs. We consider these touch on different issues from those set out in our own position, but note that Northumbrian Water has also raised concerns with Ofwat's models.
  - (c) **Area of focus: Cost of capital.** All disputing companies agree that Ofwat's allowed return is too low and that higher returns are needed to support the significant investment programme planned for the coming period. Common concerns with Ofwat's methodology include the risk-free rate, total market return, beta, cost of debt, and the limited use of cross-checks.

## Other areas not included in our reply

- 1.4 We note that the other disputing companies have raised various concerns regarding other cost areas. Furthermore, Anglian Water, South East Water, and Southern Water have raised various concerns regarding the outcome delivery incentive framework.
- 1.5 There are no areas where a company has raised an issue with which we fundamentally disagree. Therefore, consistent with the position in our statement

of case<sup>1</sup>, we do not provide further comment on these areas. However, we would be happy to make further submissions on these points if that would assist the CMA.

- 1.6 Equally, there are a number of areas which have been raised by the other companies where, given the nature of the concerns being expressed and the relevance of the issues to all disputing companies, if changes were made it would be appropriate to apply them to all disputing companies. For example, these areas include asset health allowances on wastewater; retrospective under-delivery adjustments (i.e. those referred to as AMP7 penalties by Northumbrian Water); Price Control Deliverables; the Outturn Adjustment Mechanism; and Ofwat's licence fee.

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<sup>1</sup> Wessex Water, Statement of Case (March 2025), Table 1 and Table 2.

## 2 Area of focus: Wholesale water base costs

### Introduction

- 2.1 As set out in chapter 8 of our statement of case, we have concerns with Ofwat's econometric modelling and regulatory framework, which we consider has resulted in underfunding. In Annex A9, we also resubmitted bottom-up engineering evidence on our costs, which were not fully considered by Ofwat in its Final Determination.
- 2.2 We therefore asked the CMA to allow our view of the efficient wholesale water base costs to ensure:
- (a) our base capital maintenance allowance is set using the bottom-up evidence presented in our business plan; and
  - (b) our base opex allowances are set using current rates of expenditure, recognising our long-standing track record of efficiency, and including the most recent forecasts of costs relating to business rates and National Insurance contributions.

### Long term resilience

- 2.3 In our statement of case, we set out that the regulatory model does not provide adequate allowances for companies to invest in the long-term resilience of their assets.<sup>2</sup> We also submitted an independent report from Economic Insight to support our position.
- 2.4 Consistent concerns have been raised by all the other disputing companies, to varying degrees, as we set out below. We consider this supports our ask to the CMA to consider alternative evidence in setting our base cost allowances.
- (a) Northumbrian Water noted, *"capital maintenance has been structurally underfunded through price reviews for many years"*<sup>3</sup> and *"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."*<sup>4</sup>
  - (b) Anglian Water stated, *"Ofwat's approach to asset health has consistently been inadequate over many years"*<sup>5</sup>, and considers a *"step-change in the approach to asset maintenance"*<sup>6</sup> is needed.

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<sup>2</sup> Wessex Water, Statement of Case (March 2025), page 5.

<sup>3</sup> Northumbrian Water, Statement of Case (March 2025), page 50.

<sup>4</sup> Northumbrian Water, Statement of Case (March 2025), page 68.

<sup>5</sup> Anglian Water, Statement of Case (March 2025), page 2.

<sup>6</sup> Anglian Water, Statement of Case (March 2025), page 20.

- (c) Southern Water considers *“Ofwat’s overall approach to funding capital maintenance through a base allowance set based on historical spend levels is not fit-for-purpose.”*<sup>7</sup>
- (d) South East Water noted that Ofwat’s approach to mains renewal and network reinforcement adjustments *“materially underestimates the efficient expenditure we require to meet the challenges of AMP8.”*<sup>8</sup>

## Mains renewal Cost Adjustment Claim (CAC) and Price Control Deliverable (PCD)

- 2.5 Consistent with the concerns relating to long-term resilience and asset health, all companies have raised concerns regarding Ofwat’s mains renewal cost adjustment.
- (a) Northumbrian Water asks the CMA to reconsider the level of mains renewal implicitly funded in Ofwat’s base costs models (and instead assume an implicitly funded renewal rate of 0.15%), and redetermine the size of the base cost adjustment accordingly.<sup>9</sup>
  - (b) Anglian Water asks the CMA to *“call out Ofwat’s mains renewal implicit allowance error, where it effectively penalised several companies for less than median historic spend on renewal so that Ofwat does not repeat this error in funding for other asset classes in its Asset Health Roadmap.”*<sup>10</sup>
  - (c) Southern Water considers that Ofwat has made three distinct *“errors in its assessment of mains renewal.”*<sup>11</sup>
  - (d) South East Water sets out that its efficient costs in relation to mains renewal are underfunded, as a result of Ofwat’s approach.<sup>12</sup>
- 2.6 We consider these are consistent with the concerns raised in our statement of case regarding the calibration and scope of Ofwat’s mains renewal cost adjustment and PCD.
- 2.7 Specifically, we asked the CMA to redetermine the size of the adjustment and set the PCD only in relation to uplifts to base expenditure.<sup>13</sup> We asked the CMA to do this with reference to our bottom-up capital maintenance expenditure proposal, this includes £34m to increase our annual rate of mains replacement from 0.24% to 0.40%.

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<sup>7</sup> Southern Water, Statement of Case (March 2025), page 200.

<sup>8</sup> South East Water, Statement of Case (March 2025), page 39.

<sup>9</sup> Northumbrian Water, Statement of Case (March 2025), section 4.4.

<sup>10</sup> Anglian Water, Statement of Case (March 2025), page 20.

<sup>11</sup> Southern Water, Statement of Case (March 2025), section 7.1.4.

<sup>12</sup> South East Water, Statement of Case (March 2025), page 34.

<sup>13</sup> Wessex Water, Statement of Case (March 2025), paragraph 2.52(b).

## Base cost model specification

- 2.8 Southern Water and South East Water have also highlighted issues with the base cost models. They have proposed changes to Ofwat's base cost models specification.
- 2.9 We note that the relatively small changes in the model specification proposed lead to large variations in the modelled cost allowances. This is consistent with the degree of sensitivity of the base cost models to small changes in modelling specification and input data, and the consequent risk of measurement error (as we set out in our statement of case).
- 2.10 As we also set out in our statement of case<sup>14</sup>, we consider that the outturn base spending (i.e. the input data to the models) is characterised by a period of systematic underfunding. Therefore, econometric modelling will bake in, and perpetuate, this systematic underfunding – under any given specification.
- 2.11 Therefore, whilst the proposals by Southern Water and South East Water represent their intention to work within the existing regulatory framework, any new model specification will perpetuate this underfunding, even if the new specification results in improved outcomes.
- 2.12 For the reasons set out above and in our statement of case, we therefore ask that the CMA uses our bottom-up modelling. Alternatively, if the CMA decided to re-run the econometric modelling, we ask that:
- (a) there is no material efficiency challenge within the model without external justification;
  - (b) the modelling accounts for forward-looking cost changes (e.g. for asset health); and
  - (c) appropriate weight is given to bottom-up engineering evidence of efficient costs.

## Other cost adjustment claims

- 2.13 Consistent with the above, we note that the other disputing companies have submitted a range of base cost adjustment claims. Whilst we do not comment on the detail of these, we consider that this outcome further supports the issues raised in our own statement of case regarding the regulatory framework, namely that the models are characterised by measurement error and are not designed to, or able to, deal with issues relating to historical underfunding.

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<sup>14</sup> Wessex Water, Statement of Case (March 2025), chapter 8.

- 2.14 Further, we consider Ofwat's process for assessing base cost adjustment claims restricts its ability to address these limitations. This is because the criteria Ofwat uses are not well designed to address concerns relating to long-term resilience, asset health and capital maintenance, and the evidential bar is unduly high.
- 2.15 Ofwat acknowledged this to some extent in its final determination and specifically cited problems relating to data and information available from companies, and the challenges in establishing the level of activity funded by its models.

*"Assessing capital maintenance cost adjustment claims is challenging. The challenge stems from the lack of available robust asset condition and asset workload data that is comparable across companies and time, which enable us to understand what companies should already deliver with base expenditure allowances so that customers do not pay twice. We have overcome some of these challenges at PR24 for water mains, sewers and bioresources assets. But not for other assets such as treatment works and service reservoirs. We intend to collect asset condition and workload data across a wide range of assets maintained by water and wastewater companies ahead of PR29."*<sup>15</sup>

## Ongoing efficiency challenge

- 2.16 Consistent with our own case, all companies have requested that the CMA sets an appropriate evidence-based ongoing efficiency challenge that recognises the potential for further efficiencies while considering the practical limitations faced by the industry.<sup>16</sup>

## Business rates and National Insurance

- 2.17 Our bottom-up base opex costs in our statement of case included revised business rates costs to reflect the latest information on the rateable value from the VOA. Consistent with our request, Northumbrian Water<sup>17</sup> and Anglian Water<sup>18</sup> also ask the CMA to use the most recent forecast data for the calculation of business rates.
- 2.18 Anglian Water also notes the impact of the recent increase in National Insurance on the labour RPE, which we include in our bottom-up approach and agree should be funded in redeterminations.

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<sup>15</sup> Ofwat, PR24 final determinations Expenditure allowances (December 2024), page 91-92.

<sup>16</sup> Northumbrian Water, Statement of Case (March 2025), pages 26-29; Anglian Water, Statement of Case (March 2025), pages 17-19; Southern Water, Statement of Case (March 2025), pages 16-18; and South East Water, Statement of Case (March 2025), pages 10-12.

<sup>17</sup> Northumbrian Water, Statement of Case (March 2025), Figure 53.

<sup>18</sup> Anglian Water, Statement of Case (March 2025), page 20.



## 3 Area of focus: Phosphorus removal

### Introduction

- 3.1 In chapter 9 of our statement of case, we explained that two-thirds of Ofwat's challenge to our proposed wastewater enhancement programme results from the mechanical application of a single suite of four models for phosphorus removal, each with an R-squared value in the range 0.299-0.530.
- 3.2 We raised concerns with Ofwat's modelling approach, and asked the CMA to reconsider these costs, including the engineering evidence we submitted in order to set an allowance that appropriately funds us to meet statutory obligations.
- 3.3 We also explained that we are disproportionately impacted by the models' limitations. Whilst we are one of four companies with a 35%-40% modelled efficiency challenge, the £254m cut in our expenditure in relation to phosphorus removal schemes represents half the total cut applied to the whole industry. This is because, despite only having 5% of the wastewater customers, we have 20% of the forecast industry spend.
- 3.4 Two other disputing companies (Northumbrian Water and Southern Water) raised issues in relation to phosphorus costs, as we set out in the following subsections. We consider the issues raised touch on different issues from those set out in our own position, but note that Northumbrian Water has also raised concerns with Ofwat's models.

### Northumbrian Water

- 3.5 Northumbrian Water has requested an uplift to its phosphorus removal allowances to reflect new information. (Specifically, changes to the EA's requirements for schemes to tackle phosphorus as part of the WINEP, in particular its decision to move from catchment nutrient balancing schemes to end-of-pipe solutions.)
- 3.6 In presenting its new needs, Northumbrian raises concerns with Ofwat's models as follows: *"The FD24 econometric model for phosphorus removal uses three cost drivers – as set out in Figure 14, these are: PE, existing consent, and new P consent. This does not capture all the relevant factors that drive scheme-level costs, such as: the best value option selected; any need to expand the existing site (including topography, geology, groundwater flows, land availability, planning constraints, and so on); existing treatment processes; and existing performance at treatment works. These types of schemes also vary depending on the receiving watercourse, including environmental constraints and site access. As a result, the efficient costs of delivering two schemes that seem similar can vary*

*enormously. For Northumbrian Water sites, this can be seen in the variability between the modelled costs and our bottom-up costs based on actual designs – for example, Barkershaugh, Barton, and Melsonby are all around 43% higher than the modelled costs (these are all sites where we would need to select chemical dosing). This is partly offset by sites such as Bradbury, Hamsterley, and Brancepeth where we can use wetlands to meet the requirement.”<sup>19</sup>*

- 3.7 We consider that these concerns are consistent with the concerns raised in our own statement of case.

## Southern Water

- 3.8 Southern Water has raised concerns with Ofwat's approach to setting allowances for phosphorus removal only in relation to shallow dives for *“Nature based solutions for sanitary parameters and P removal at 3 sites.”*<sup>20</sup>
- 3.9 We note these investments are distinct from those assessed in the final determination using Ofwat's models, and are therefore not relevant to our case.

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<sup>19</sup> Northumbrian Water, Statement of Case (March 2025), Appendix 1 pages 21 and 22.

<sup>20</sup> Southern Water, Statement of Case (March 2025), table 3.

## 4 Area of focus: Allowed return

### Introduction

- 4.1 In chapter 10 of our statement of case, we set out our view that Ofwat's final determination underestimates the allowed return, making it harder to attract or retain the financial capital that we need to meet our obligations and deliver the service our customers want. We asked the CMA to determine an appropriate cost of capital in line with sound economic theory and appropriate cross-checking.
- 4.2 All disputing companies agree that Ofwat's allowed return is too low and does not reflect the true value. For example, Northumbrian notes, *"We are concerned that Ofwat's allowed return on equity (Allowed-RoE) is materially below the market cost of equity (Market-CoE) impeding the ability of the sector to raise the equity capital required for the large investment programme, thereby delaying or reducing the benefits of that programme for customers."*<sup>21</sup>
- 4.3 There is a consensus on the need for higher returns to support the significant investment programmes over the coming period. Common concerns include the risk-free rate, total market return, beta, cost of debt, and limited use of cross-checks in Ofwat's approach.

### Cost of equity

- 4.4 There is consensus among the disputing companies on the need to adjust the risk-free rate to place weight on the yields of both indexed-linked gilts and AAA-rated corporate bonds, to use long-run historical data for total market return, and to include Pennon in the beta calculation while adjusting for the impact of Covid-19 and the increased risk in the sector. These are all points that we also support.
- 4.5 All disputing companies also question Ofwat's approach to aiming up, for example Anglian noting, *"The FD includes 'aiming up' of approximately 0.27% to reflect investor sentiment and the scale of the capital programmes under the FD. This is, however, far from sufficient to accurately reflect the risks associated with parameter uncertainty within CAPM. By comparison, the CMA included 'aiming up' of 0.25% on the mid-point of the cost of equity at PR19, a price control with much lower levels of investment and perceived regulatory uncertainty."*<sup>22</sup> Again, we support this position and the need a higher level of aiming-up at PR24 compared to PR19.

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<sup>21</sup> Northumbrian Water, Statement of Case (March 2025), page 149.

<sup>22</sup> Anglian Water, Statement of Case (March 2025), page 198.

- 4.6 All disputing companies also advocate for the use of cross-checks to validate the CAPM estimates, with Southern for example reviewing eight comparators including other asset classes, other sectors, market evidence and debt financeability<sup>23</sup>. This finds comparator costs of equity ranging from 5.22% to 8.56% versus Ofwat's final determination value of 5.10%. Again, we also agree that appropriate use should be made of cross-checks, such as market asset ratios and multi-factor models, when determining the cost of equity.
- 4.7 The cost of equity cannot be directly observed, but while each disputing company proposes a variety of values for each of the parameter estimates of the CAPM, the overall range for the resultant cost of equity is reasonably narrow:
- (a) Northumbrian Water: 6.05% (mid-point)
  - (b) Anglian Water: 6.25%
  - (c) South East Water: 6.32%
  - (d) Southern Water: 6.5% (restated for 55% notional gearing)
- 4.8 The median of the estimates is 6.29%, which is 1.19% higher than Ofwat's final determination of 5.10%.
- 4.9 We did not provide an updated view on the cost of equity in our own statement of case, instead setting out alternative perspectives and asking the CMA to scrutinise each component part of the WACC calculation in detail and, applying economic logic, take a balanced assessment of the required return in the round.
- 4.10 However, we note that the cost of equity included in our draft determination response of 6.0% (restated for 55% notional gearing) is broadly consistent with the other disputing companies' figures set out above.

## Cost of debt

- 4.11 Overall, there is a consensus among the disputing companies on the need to update the allowed cost of debt for latest market data, and to increase the allowances for issuance and liquidity costs. On the latter, companies propose costs ranging from 25 bps to 37 bps compared to the final determination allowance of 15 bps. Our own view in our draft determination response was 25 bps.
- 4.12 In addition, three of the four disputing companies (Anglian Water, Southern Water and South East Water) question Ofwat's estimation of the cost of embedded and of new debt.

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<sup>23</sup> Southern Water, Statement of Case (March 2025), page 413.

- 4.13 Compared to the cost of equity, there is a narrower range in disputing companies' cost of debt, and a narrower gap to Ofwat's final determination allowance of 3.15%:
- (a) Northumbrian Water: 3.37%
  - (b) Anglian Water: 3.71%
  - (c) Southern Water: 3.71% (sector average)
  - (d) South East Water: 3.71%
- 4.14 The cost of debt in our draft determination response, based on a market data cut-off date of June 2024, was 3.43%. Given market movements since that date, this figure would likely be higher with a contemporaneous cut-off date. As with the cost of equity, our assessment of the cost of debt is consistent with the other disputing companies.
- 4.15 Again, we reiterate our request for the CMA to scrutinise each component part of the WACC calculation in detail and, applying economic logic, take a balanced assessment of the required return in the round.