WONDERFUL ON TAP

SEVERN TRENT

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Sent via email

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Dear Kirstin,

Water PR24 provisional determinations

Thank you for the opportunity to comment on the CMA's provisional determinations of PR24 for the five disputing companies. As a third party, we would like to raise two issues.

The Outturn Adjustment Mechanism (OAM)

We wrote to the CMA on 22 April 2025 about the potential for the PR24 redeterminations to adversely affect the non-disputing companies through the Outturn Adjustment Mechanism (OAM).

We welcome that you have taken account of our concern and suggested a workable solution for Ofwat to apply at paragraph 8.189:

> "For Disputing Companies, the OAM could be calculated using our revised PCLs and ODI rates for all 16 companies in the sector, while for the non-disputing companies it could be based on Ofwat's PR24 FD package for all companies." (Paragraph 8.189 of Volume 4: Chapters 7-10).

While this is a decision for Ofwat it would be really helpful if the CMA could repeat this statement in your final determinations to ensure the non-disputing companies are not adversely affected by the PR24 redeterminations through the OAM.

The new base cost models

We recognise that the CMA's base cost models will not be applied to the non-disputing companies, including Severn Trent. However, as these models could set a precedent for future price reviews we would like to raise five main concerns.

First, there has been a lack of engagement on the new base cost models ahead of the provisional determinations. We recognise that the CMA has limited time for its redeterminations, but the base cost models informed the setting of £60bn of base cost allowances at PR24 therefore some engagement is important. Ofwat's base cost models have evolved over three price reviews with extensive engagement with stakeholders through working groups and consultations. This has allowed water companies to identify errors, put the case for improvements and make the case for adjustments outside the models to correct for their shortcomings, such as cost adjustment claims or real price effects. While we consider Ofwat's models could be improved, we think the CMA should do this incrementally and with more consultation.

Second, the engineering rationale for the CMA's base cost models is significantly reduced compared with Ofwat's models. One of Ofwat's principles of base cost assessment is that models should be "consistent with engineering, operational and economic rationale" (page 15 of Econometric base cost models for PR24 consultation, April 2023). A quantitative variable selection process (such as LASSO), can have benefits by allowing different cost drivers to be appraised together (for example the inclusion of both pumping head and pumping stations/length in water models). However, it needs to be deployed in a way that complements an underpinning appraisal of engineering rationale, rather than replacing it.

The CMA's approach also goes in the opposite direction to the final report of the Independent Water Commission ("the Cunliffe review") which states:

> "The Commission considers that Ofwat has relied too heavily on a data driven, econometric approach, and has not taken sufficient account of company-specific conditions and challenges" (paragraph 417, page 193 of Independent Water Commission Final Report).

An example of a lack of engineering rationale in the CMA's base cost models is that they include multiple density drivers in the same model. The competing density drivers have coefficients with different signs (one says costs increase with density, the other says costs reduce with density) which does not fit with an underlying causal relationship. It also appears to us that the population density variables are being asked to do too much and are picking up the underlying cost drivers of economies of scale, congestion effects and network length.

We also note that pre-existing weaknesses or misspecifications in Ofwat's models remain unaddressed. For example, companies have fed back to Ofwat that the treatment complexity drivers currently used do not adequately reflect the differences in the costs we incur. The CMA's alternative method for selecting explanatory variables does not remedy this shortcoming if more appropriate variables, that better describe the different costs that companies incur, are not introduced for consideration.

Third, the new base cost models find that the industry should be spending less on base costs: £36.7bn versus £41.1bn at PR24 (see page 28 of Volume 5: Appendices and glossary). This goes against the views of the National Infrastructure Commission, Ofwat through its Asset Health Roadmap process and the Cunliffe review recommendation about introducing statutory resilience standards for water companies (page 377 of Independent Water Commission Final Report). We suggest there is need to stand back and review what the models say at an aggregate level to see whether they make sense in the broader context of the sector. If there is a desire to address a specific company's base costs, then in our view this could be done through a bespoke adjustment.

Fourth, we are concerned about the stability of the base cost models. The LASSO approach is likely to prioritise different variables as new annual data is added to reduce the root mean square error (RMSE). This could lead to significantly different models and base cost allowances for companies. Our concern is heightened by the CMA using only three models (two for water and 1 for waste) meaning updates to the variables will have a larger effect on companies' allowances, compared with Ofwat's use of multiple models and triangulating between them.

We would prefer to see more stability in the base cost models' design, which can be justified based on the underlying engineering relationships. More stable models means that their shortcomings can be adjusted for, for example through cost adjustment claims, real price effects and the rest of the price control package. Using more models for water and wastewater and triangulating between them can lead to more stability in the modelled base costs allowances. This will increase regulatory certainty for companies and their investors.

Fifth, including price pressures in the base cost models makes them more opaque. For example, the models pick up price pressures interacting with other variables, which makes them harder to understand. In the waste model it is not clear what pumping is included in pumping capacity (it might just be network pumping and not treatment pumping) and electricity usage that is not related to pumping (e.g. blowers at Activated Sludge Plants) will not be captured. In addition, the LASSO approach has only picked up wage pressures in water networks and not the other two models, but we know that wages costs are a major component of water treatment and wastewater base costs.

The inclusion of price pressures in the base cost models also makes them harder to true up for at the end of the price control period because it is harder to calculate what allowances companies have actually been given for energy, wages and plant / machinery / equipment. One of the big improvements at PR24 was the creation of a real price effects (RPEs) and true ups for energy and plant / machinery / equipment prices in addition to the existing one for wages. This is a key risk mitigant for customers, companies and investors. We think there is a good case for taking price pressures back out of the models and reinstating the true ups.

If you would like to discuss any of our points further, please don't hesitate to contact me.

Yours sincerely,

[redacted]

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