

Wessex Water Services Ltd Response to Ofwat's PR19 Draft Determination – August 2019

Representation reference: Cost Assessment C21

Representation title: Frontier shift and RPEs

Summary of issue

Although allowing wholesale RPEs of c0.4% per annum in relation to CPIH is a step forwards compared to the IAP position, it is still not a true reflection of what we would expect in the context of a productivity improvement assumption of -1.5% per annum.

Change requested

So that the determination is consistent with financial resilience, ensure that RPE assumptions are consistent with the wider economic assumptions included within the determination.

By this in practical terms we mean that if high productivity assumptions are maintained use the high case RPEs implied by the evidence we have commissioned from Economic Insight (attached as appendix C21.2)

If productivity assumptions are adjusted to be more in line with the central cases of independent economic forecaster expectations such as the OBR then it would be reasonable to use the central case RPEs from the attached report.

Rationale (including any new evidence)

In our September 2018 submission we submitted a report by Economic Insight outlining its view on RPEs as they would apply to Wessex. Economic Insight has updated this report in line with more recent market data and we submit it as appendix C21.2 to this representation.

In our response to the IAP we provided a further report from Economic Insight that explained why it was important to understand that the productivity, input price and cost of capital assumptions in the determination need to be consistent with each other and that at the time of Ofwat's initial assessment this was not the case.

Our IAP response then explained that a 1.5% productivity assumption could be acceptable as part of an "in the round" assessment of the financeability of the plan and the other economic parameters, including the view of input cost increases at the efficiency frontier.

The draft determination continues to have a mismatch between these two items, one of which implies high economic growth in the economy and the other implies low growth.

This is important for the financial resilience of a determination, not least because in this regard, economic theory suggests the probability of both the RPE and productivity outcome occurring simultaneously is very low.

Similarly the consequences of this are now more severe - as under the draft determination Wessex will have to bear c.64% of any resulting cost over-runs compared to 50% at PR14.

Section one of our summary representation document explains in detail how this issue contributes to an overall lack of resilience in the draft determination.

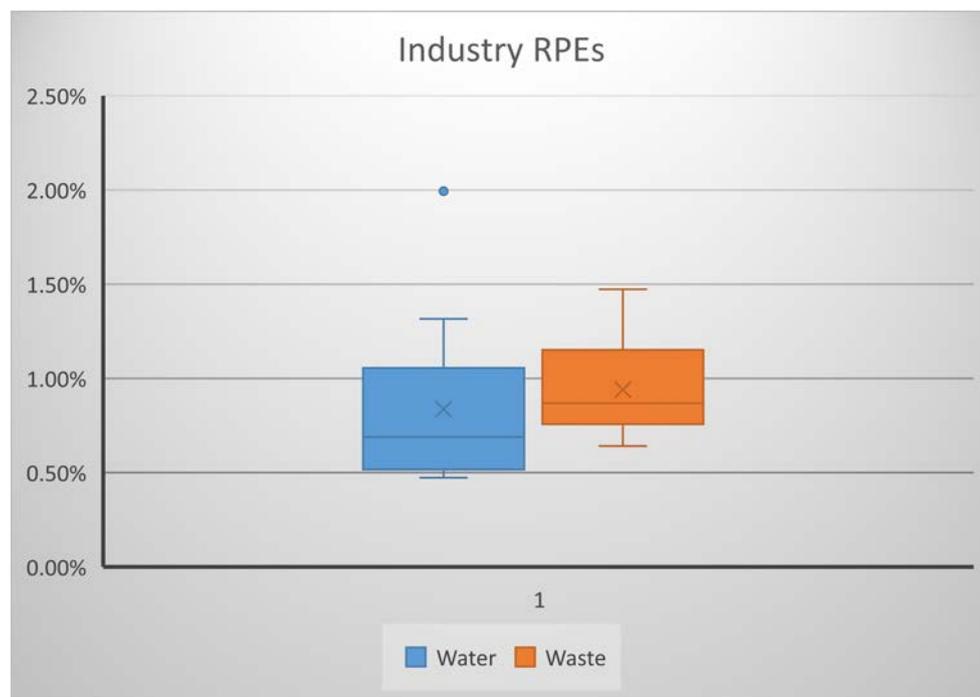
If the determination retain its use of a productivity assumption of 1.5% per annum we therefore suggest it also applies the 'high-case' RPE assumptions that have been provided to us in the accompanying RPE report (appendix C21.2). We have taken these and applied them to the weightings implied by the new base plus cost models as follows:

Table 1

	20-21	21-22	22-23	23-24	24-25	Avg
Water resources	1.1%	1.0%	0.9%	0.8%	0.9%	0.9%
Water Network+	0.9%	0.7%	0.9%	0.8%	0.7%	0.8%
Wastewater network+	1.5%	1.3%	1.3%	1.3%	1.3%	1.4%
Bio resources	0.7%	0.5%	0.6%	0.5%	0.7%	0.6%

We note that this values are consistently within the range of industries views (based on initial submission data tables) as shown in the table below.

Figure 1



Why the change is in customers' interests

Financial resilience is in the interests of customers and the determination should be concerned of the risks that companies are underfunded as well as over-funded.

To deliver resilience Ofwat should consider the likelihood and consequence if the determination's assumptions are indeed wrong and to consider whether the cost and service package as whole and the incentive regime surrounding it is likely to allow the company sufficient financial flexibility and headroom.

In this context there is good reason to believe that the determination assumptions will not occur simultaneously. There is also a significant increase in the consequence for Wessex in the event that the draft determination's assumptions are not seen in reality given that under the cost sharing formula the company will suffer c.64% of any cost overrun.

Links to relevant evidence already provided or elsewhere in the representation document

We provide a July 2019 report titled "Gross input price inflation" from Economic Insight as an appendix C21.2 to this document.

We also reprovide the Economic Insight report that formed a part of our IAP response "Ensuring consistency in key PR19 parameters" given that the arguments within it are central to our case as appendix C21.1.

Section 1 of our summary response document provides more detail about financial resilience more generally and provides wider context for this individual representation.