SRN-DDR-017: Wastewater Growth Network Reinforcement

Cost Adjustment Claim

28th August 2024

from Southern Water

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1. Background

Thames Water submitted a cost adjustment claim (CAC) for network reinforcement which was accepted by Ofwat in the draft determination. The claim was based on Thames Water's high level of population growth expected in AMP8. It was submitted in their Business Plan rather than the June 2023 early submission date, which Ofwat introduced to allow other companies to comment. Thames Water said that they were not proposing a symmetrical adjustment and therefore did not expect other companies would need to comment on this claim. We would like to comment on this claim and provide additional evidence to support our cost adjustment claim on wastewater growth.

We support this claim and agree that population growth above that funded in the base allowance should be funded as a cost adjustment. As stated by Thames Water in their CAC submission, Ofwat confirmed that network reinforcement will continue to form part of base expenditure allowances and that Ofwat will consider cost adjustment claims for companies that expect to deliver a higher amount of network reinforcement than is funded from cost models.[1]

Southern Water submitted a similar cost adjustment claim which included both network reinforcement and atypical growth. The atypical growth at treatment works was considered enhancement. However, following review of Thames Water's successful claim, we believe that a similar cost adjustment for network reinforcement should be provided to Southern as an asymmetric adjustment for its high forecast growth above that funded in the base cost models. This representation adds evidence to the network reinforcement element of our cost adjustment *SRN22 – Network and WTW Growth Cost Adjustment Claim*, which is now material in its own right.

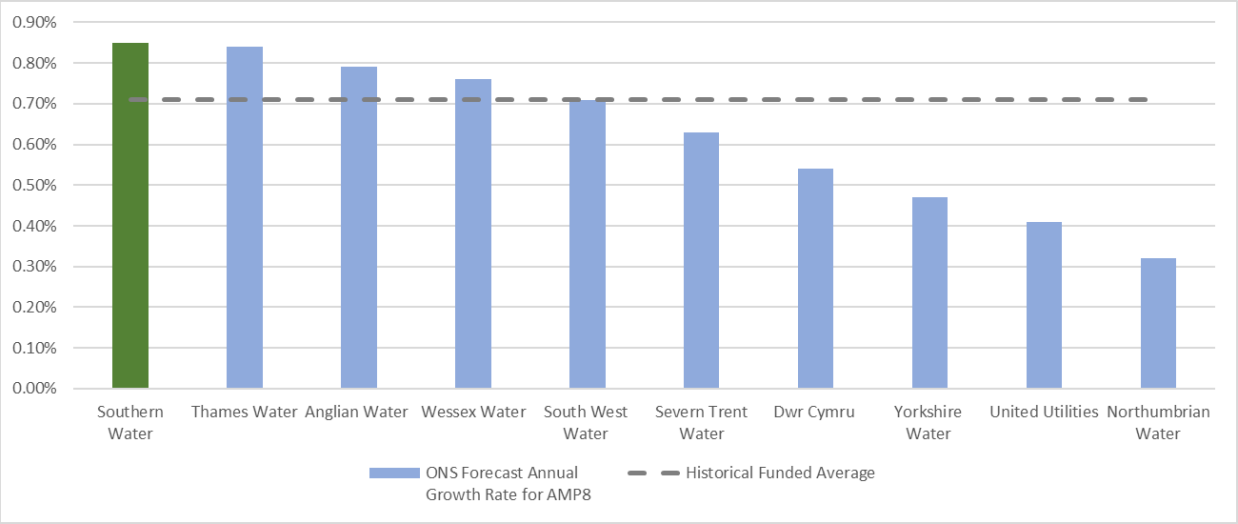
Name of claim	Wastewater growth – network reinforcement
Business Plan Tables where botex claim is reported	CWW18
Price control the claim relates to	WWN+
Total gross value of claim for AMP8	£62.302m
Total implicit value of claim for AMP8	£12.515m
Total net value of claim for AMP8	£49.787m
Materiality for relevant price controls	£33m

[1] Creating tomorrow together, Our Final Methodology for PR24, Appendix 9 Setting expenditure allowances p13 (Ofwat 2023)

2. Need for cost adjustment

Southern Water, as set out in our wastewater growth cost adjustment claim, is in the unique circumstance of having the highest forecast growth of all water companies. Over the 5 years of AMP8 (2025-30), housing in the Southern Water region is projected to grow at 0.85% per year [2]. This is the highest forecast growth rate in the industry as illustrated in Figure 1. This is considerably higher than that funded in the base models, which is based on the average historical annual growth rate. The estimated growth rate in our region is higher than the growth forecast in the Thames Water region in AMP8.

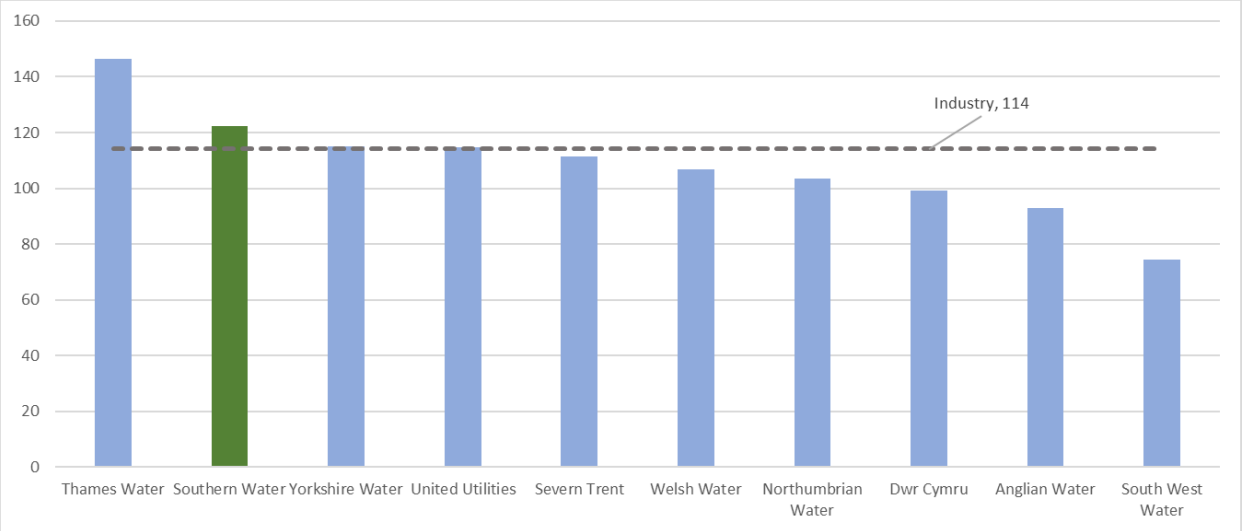
Figure 1: Forecast annual growth of connected wastewater properties in AMP8



As high-lighted by Thames Water, growth resulting from new developments in the (densely populated) South East uses up available capacity in the local sewerage network to accommodate new demand. Whilst we have continued to invest in network reinforcement, this high level of growth exerts pressure on an already loaded network. Figure 2 illustrates that Southern Water has the second highest average volumetric load when normalised by sewer length and demonstrating the need for additional investment.

[2] Southern Water Business Plan "SRN22 Network and WTW Growth Cost Adjustment Claim" (Southern Water, 2023)

Figure 2: Population Equivalent per sewer length (PE/km)



Further evidence of the need for adjustment is provided in our original cost adjustment claim submitted as part of our October 2023 Business Plan submission (SRN22 – Network and WTW Growth Cost Adjustment Claim).

3. Quantification of the cost adjustment

Thames Water valued their cost adjustment claim by deriving the implicit allowance using the average of four methodologies and subtracting this from the gross AMP8 network reinforcement capex forecast.[3]

3.1. Implicit Allowance for Network Reinforcement

Thames Water used a balanced approach utilising 4 different methods to calculate the implicit allowance. We adopt the same approach as Thames Water with the 4 methods, as defined below:

- Method 1 uses our best view of the PR24 models (improving on PR19). We removed all network reinforcement capex for all company historical datasets and then compared this with the models with network reinforcement capex included.
- Method 2 is an extrapolation of a moving average of our historical expenditure on network reinforcement capex based on the last 5 years.
- Method 3 takes the historical percentage of network reinforcement across the industry and we apply this to our econometric base allowance with network costs included in the model.
- Method 4 is the unit price using the median unit cost applied by Thames Water, scaling by number of wastewater connections.

In all methods we use data from Annual Performance Reports and Ofwat base cost models consultation dataset, April 2023.

Based on this methodology, accepted at draft determination, we have calculated an equivalent value of the implicit allowance for network reinforcement to be applied to Southern Water. The results of each method for wastewater network reinforcement are summarised in Table 1 below.

Table 1: Implicit allowance for wastewater networks reinforcement

Wastewater – Network reinforcement implicit allowance	£m
1. Using Econometric Improved Models PR24	8.729
2. Extrapolating Moving average of Actual Expenditure with efficiency Challenge	9.665
3. Industry Historical Expenditure Avg. Proportion to AMP8 Model efficiency allowance	20.006
4. Median (Unit Cost)	11.658
Average of 4 methods	**12.515**

Note: All figures are calculated in 2022-23 cost base

This results in an implicit allowance of £12.515m for wastewater.

3.2. Calculating the cost adjustment

[3] Thames Water Business Plan "TMS20 Cost Adjustment Claim: Network Reinforcement (Thames Water, 2023)

Replicating the Thames Water methodology, the calculated implicit allowance is then deducted from our AMP8 forecast to calculate the cost adjustment. The gross value of the claim is based upon the AMP8 forecast network reinforcement expenditure taken from our data table DS3.1. This results in a cost adjustment for wastewater network reinforcement for Southern Water of £49.8m as summarised in Table 2 below.

Table 2: Summary of wastewater network reinforcement cost adjustment claim

	Wastewater (£m)
AMP8 network reinforcement capex – Gross value of the claim*	62.302
Implicit allowance (average of methods)	12.515
Net value of cost adjustment claim	**49.787**

* The value of the forecast network reinforcement expenditure is taken from our data table DS3.1
Note: All figures are calculated in 2022-23 cost base

3.3. Materiality of the claim

Using the Thames Water methodology, the value of Southern Water's wastewater network reinforcement claim is above the Ofwat materiality threshold of 1% of totex. The claim is 1.4% of the wastewater price control and is therefore material.

3.4. Customer Protections

The cost adjustment to the Network Plus price controls will not have any impact on end-consumers. This is because all costs related to network reinforcement are recovered through the infrastructure charges paid for by developers. As stated by Thames Water, should we fail to invest in network reinforcement in time, underperformance will be reflected in the D-MeX score received from developers and NAVs, incurring financial penalties. Furthermore, poor network performance will impact Performance Commitments which has the potential to trigger ODI penalties for internal and external sewer flooding.

There are also new protections to ensure developers are not over or under charged for network reinforcement and ensure that any revenue received from infrastructure charges from developers does not pay for reinforcement that has already been funded. In their August 2023 consultation 'Changing Ofwat's charging rules to support the new developer services framework'[4], Ofwat have proposed to amend rule 52 of the English New Connection charging rules to allow a downward adjustment to the infrastructure charge for any over-recovery of revenue received in previous charging years where revenue has exceeded investment. This consumer protection is expected to be in place by April 2025 for the start of AMP8 period.

Therefore, we consider customers are sufficiently protected through existing and new protection mechanisms and do not consider a Price Control Deliverable to be needed or, indeed, proportionate.

[4] Changing Ofwat's charging rules to support the new developer services framework (Ofwat, 2023)

4. Conclusion

Thames Water submitted a cost adjustment claim (CAC) for network reinforcement which was accepted by Ofwat in the draft determination.

Southern Water submitted a similar cost adjustment claim for wastewater growth. As detailed in that claim, Southern Water, is in the unique circumstance of having the highest forecast growth of all water companies, higher than that of Thames Water.

We used the Thames Water approach, accepted by Ofwat, to recalculate the value of our network reinforcement claim. We replicated the methodology to derive the implicit allowance and calculate the net value of the claim. This resulted in a net cost adjustment claim for network reinforcement of £49.8m for the wastewater network plus price control. This is above the 1% totex materiality threshold set by Ofwat.

The evidence that the cost assessment criteria for network reinforcement adjustment is contained within our original claim[5]. Furthermore, the need for adjustment, unique circumstance and management control in the Thames Water claim is directly relevant to this claim.

We believe that a cost adjustment for network reinforcement, accepted by Ofwat for Thames Water having higher than average growth, equally applies to Southern Water. Therefore, it should be provided with an equivalent asymmetric cost adjustment of £49.8m for forecast growth above that funded in the cost models. The case for a cost adjustment is further substantiated given the evidence that Southern Water has the highest forecast growth rate in the sector, above that even of Thames Water.

[5] Southern Water Business Plan “SRN22 Network and WTW Growth Cost Adjustment Claim” (Southern Water, 2023)