# WSX-R07 – Cost recovery plan

Response to Ofwat's PR24 draft determination

Wessex Water
YTL GROUP

FOR YOU. FOR LIFE.

# Representation reference: WSX-R07

# Representation title: Cost recovery plan

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# 1. Summary

Given the significant evolution of the investment programme since initial submission we have updated our full suite of cost recovery models.

This results in the restatement of our PAYG and RCV run-off rates.

## 1.1. PAYG rates

Given the lower bill impact in our DD response financial model we are proposing to partially revert our PAYG methodology. We set out in table RR1, the natural rate under a methodology consistent with 2020-25. However, to keep overall bill levels acceptable as set out in WSX-R06, we are proposing adjusting the PAYG ratios. This is also set out in RR1. It means we are recovering net opex and 85% of capitalised IRE as fast money. It results in the PAYG rates set out in Table 1 below.

*Table 1: DD Response PAYG ratios*

| | 2025-26 | 2026-27 | 2027-28 | 2028-29 | 2029-30 |
|---|---|---|---|---|---|
| Water Resources | 56.67% | 55.47% | 45.02% | 45.48% | 49.39% |
| Water Network plus | 58.41% | 56.79% | 54.15% | 58.29% | 59.62% |
| Wastewater Network plus | 34.93% | 33.14% | 32.44% | 23.76% | 19.43% |
| Bioresources | 58.96% | 49.69% | 53.12% | 33.39% | 32.07% |

## 1.2. RCV run-off rates

We are retaining our proposed approach to RCV run-off rates in our initial submission. That is, we aim to recover our forecast of accumulated CCD through RCV run-off over the period by applying a consistent rate each year. We have re-run our AMP8 CCD models to give an updated view of CCD consistent with our investment programme. Where the natural rates exceed the caps set out in the final methodology we have reduced run-off to these caps. We still disagree, as set out in our initial submission, with the principles of this but have weighed this up against the affordability impact and retained it at this stage. Our full run-off rates are set out in Table 2 below.

*Table 2: DD Response RCV run-off rates*

| | Legacy RCV | New RCV |
|---|---|---|
| Water Resources | 4.50% | 4.50% |
| Water Network plus | 3.57% | 4.50% |
| Wastewater Network plus | 3.81% | 3.24% |
| Bioresources | 8.00% | 8.00% |

# 2. PAYG rate calculation

Given the lower bill impact in our DD response financial model we are proposing to partially revert our PAYG methodology to the one used throughout 2020-25. This is to ensure consistency with our current revenue streams, and reduce the bill impact on future customers, given we expect multiple AMPs of high investment. This is consistent with the rest of the industry who have no fundamental change to cost recovery between 2020-25 and 2025-30.

As we set out in WSX-R06 if there is additional bill pressure on top of what is modelled here, we would expect this to be mitigated through adjustments to these PAYG ratios.

The ratios presented here are calculated theoretically by:

$$PAYG\ Ratio = \frac{Net\ Opex + 85\% * IRE}{Net\ Totex}$$

And in practice by the following data table references:

$$PAYG\ Ratio = \frac{RR2.7\ to\ 2.10 * 85\% + RR2.19\ to\ 22 - RR2.37\ to\ 40 - RR2.43\ to\ 46}{RR2.1\ to\ 2.4 + RR2.7\ to\ 2.10 - RR2.25\ to\ 2.28 - RR2.31\ to\ 2.34 - RR2.37\ to\ 2.40 - RR2.43\ to\ 2.46}$$

The calculation of these is left within the submitted financial model.

# 3. RCV run-off calculation

We are retaining our proposed approach to RCV run-off rates in our initial submission. That is, we aim to recover our forecast of accumulated CCD through RCV run-off over the period by applying a consistent rate each year. We have re-run our AMP8 CCD models to give an updated view of CCD consistent with our investment programme. Where the natural rates exceed the caps set out in the final methodology we have reduced run-off to these caps. We still disagree, as set out in our initial submission, with the principles of this but have weighed this up against the affordability impact and retained it at this stage.

For our legacy run-off rates, we have made no fundamental change to our calculation. Updating for the latest view of inflation and the RCV this creates the legacy rates set out in Table 3 below.

*Table 3: Changes to legacy RCV run-off rates*

| | FBP | DD Response |
|---|---|---|
| Water Resources | 4.5% | 4.5% |
| Water Network plus | 3.6% | 3.6% |
| Wastewater Network plus | 3.9% | 3.8% |
| Bioresources | 6.4% | 8.0% |

Where we balanced Bioresources run-off rates over legacy and new assets this has a more material impact. We cover this in detail below.

For run-off rates on new assets our forecast CCD gives us the rates set out in Table 4 below.

*Table 4: Changes to new RCV run-off rates*

| | FBP | DD Response |
|---|---|---|
| Water Resources | 4.5% | 4.4% |
| Water Network plus | 3.9% | 4.5% |
| Wastewater Network plus | 2.7% | 3.2% |
| Bioresources | 6.4% | 8.0% |

The changes to the investment plan has created some material changes here. These are summarised below.

1. Water Resources

We have revised our accounting treatment of investigations in line with the Accounting Standard IAS16 Property, Plant & Equipment. Previously these were considered capital investment with short asset lives, however where we are unable to demonstrate it is probable that future economic benefits associated with the item will flow to the Company we are now including these as opex. This has the effect of reducing the overall CCD and hence the run-off rate.

2. Water Network Plus & Wastewater Network Plus

With less additions to the RCV (see our calculation of PAYG ratios) we are seeing a lower denominator in the calculation of the natural rates, creating upward pressure.

3. Bioresources

The more significant changes to investment in bioresources has resulted in less investment in longer life assets over 2025-30. This has the effect of increasing the RCV run-off rate. To meet the efficiency challenges we were faced with on bioresources we have re-prioritised investment as well as rationalised our IED proposals to ensure low regrets investment within AMP8 given the recent increase in risk to the biosolids land bank disposal route.

We maintain that artificially capping the rate could lead to market distortions, as we set out in our initial submission, but recognise the impact increasing run-off rates has on affordability hence retain the final methodology caps in our response.

We maintain that cross checks on these rates are important and set out our depreciation, revenues collected through run-off and capital maintenance in Table 5 below.

*Table 5: Comparison of nominal depreciation, run-off and maintenance proposed.*

| | Depreciation | Run-off | Capital Maintenance |
|---|---|---|---|
| Total | 1197.4 | 1168.1 (-2.4%) | 1062.4 (-11%) |

In the round these figures remain close and represent a sustainable level of remuneration and investment in our assets. We set out in our representations on base costs, why it is important that maintenance continues at broadly the pace of depreciation.

# 4. How further efficiency cuts should be interpreted

If further efficiency challenges are applied on top of the stretching costs we are proposing then careful consideration needs to be given to how they are interpreted to ensure that our plan remains financeable.

Efficiency challenges on enhancement expenditure should be applied at the PAYG rate proposed for that specific activity, derived from CW3 / CWW3.

For base costs, the majority of the real increase is driven by increased capital maintenance requirements. Therefore, we would expect any further efficiency challenges to be interpreted as predominately capex.

We would also expect the principle of RCV run-off recovering depreciation to be preserved. To do this we would propose a pro rata reduction in new depreciation, applied to the revised RCV to recalculate run-off.