

2 October 2023

Cost assessment team  
Ofwat

BY EMAIL

Dear Ofwat,

**RE: Approach to energy cost forecasts in PR24**

In this letter we provide commentary to accompany the spreadsheet data on energy costs.

In our PR24 plan we have set out our proposals on energy costs in document “NES04 - A3 Costs” in Section 3.5 and Annex 2. As part of this, we have proposed:

- An uplift to modelled costs from the econometric base cost models to account for the significant recent increase in energy costs. This is necessary as the 5-year window used to calculate efficiency scores effectively uses the average energy price over those 5 years which is not representative of the energy costs that we face or are likely to face in AMP8.
- An end of period true-up with respect to an industrial customer energy price index published by the Department for Energy Security and Net Zero. This is because there continues to be significant uncertainty around the expected changes in these costs over AMP8 and, therefore, there are inherent uncertainties around any RPE estimates. The benefit of true-up mechanisms is that they shield customers from overpaying if outturn costs are lower than expected, while also shielding companies from bearing the risk of outturn costs (which are outside management control) being lower than expected.

Due to the volatility and unpredictability of energy costs we have not included an energy cost forecast in our plan and have instead assumed that they will track CPIH, i.e. an RPE of zero. We do not think that it would be productive to engage in a lengthy and detailed exercise to forecast something which will almost definitely be inaccurate as energy costs are so dependent on global macroeconomic events which are impossible to foresee. For example, the Covid-19 pandemic and Ukraine war during AMP7 both had significant impacts on energy costs which were completely unforeseen when PR19 was set. We therefore think it is prudent to use a true-up mechanism instead of trying to set a forecast that will likely be materially inaccurate in any event.

The index that we have proposed is based on a survey of suppliers and therefore reflects price paid by industrial users. This will therefore include an efficient amount of “fixing” or “hedging” as part of the index. This will avoid the index tracking wholesale energy prices which are much more volatile and could result in more significant volatility to customer bills. Using such an index will also

encourage companies to engage in an efficient level of hedging as they will likely try to engage in similar level of hedging as the index.

For the spreadsheet data file we have included projections based on energy market forward curves and have not made forecasts of future energy costs for the reasons stated above. We hope that this is helpful for Ofwat to view alongside our business plan. In addition we would make the following comments alongside this data:

- The key purpose of hedging is not to outperform the market, but to avoid risk exposure to significant swings in the energy price. In a competitive market it is equally likely for a hedged price to be higher or lower than the on the day spot price.
- To properly understand our energy costs, we think that each energy vector (electricity, gas, etc.) needs to be considered separately. We have therefore provided additional data on each vector but we do not consider that some of the metrics make sense at an aggregated level. The most material vector to consider is electricity because our gas position is largely offset via exports.
- To fully consider energy costs, one must look at non-commodity charges as well as energy markets – over the past decade there has been unprecedented growth in network charges, EMR costs and green levies. In some cases these have been exacerbated by exemptions being granted to other market participants, with remaining market users (including WASCs and WOCs) covering the costs of those exempted parties.
- The CfD mechanism (used to encourage renewable generation such as offshore wind) is a natural hedge<sup>1</sup> which is passed through to energy users in line with their market share and the strike prices agreed through the auction process. This introduced volatility into pricing and in NWL's view should be considered as part of any hedge – not least because the current CfD contracts are equivalent to a 30% hedge by the end of AMP8.

We recognise that energy costs and their potential volatility over AMP8 are a material issue for PR24 and we are keen to support Ofwat in reaching a pragmatic solution that meets the needs of all stakeholders and avoids unnecessary complexity. We hope that our PR24 proposals achieve this and would be happy to discuss our position in more detail with you.

Please do get in touch with Geoffrey Randall ([regulation.postbox@nwl.co.uk](mailto:regulation.postbox@nwl.co.uk)) if you would like to discuss any of this further.

Yours sincerely,

Northumbrian Water

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<sup>1</sup> When wholesale prices are greater than the CfD strike price the generator returns the excess revenue to the generality of customers. Conversely, when wholesale prices are below the strike price, the shortfall to the generator is made up by the generality of customers. This has a similar impact as a hedge to our energy cost exposure.