

## Annex 1: Summary of cost base feedback

This annex summarises all of the feedback that we have received about the cost base following PR04, previously detailed in annex 1 of RD17/06, and explains what changes if any we are making to address each issue. As before we have grouped the comments into three categories: strategic / conceptual, policy & process and operational.

<b>Strategic/ conceptual</b>	
This section covers the feedback that challenges the fundamental purpose of the cost base.	
<b>Issue</b>	<b>Outcome/ action</b>
All companies have consistently outperformed the final determination assumptions, and therefore the efficiency targets must have been insufficiently challenging and the cost estimates in the business plans were not sufficiently detailed or accurate.	<ul style="list-style-type: none"> <li>• We believe there is still scope for efficiency and we intend to continue to use cost base as our tool for deriving part of the efficiency challenge.</li> <li>• We will be commissioning a study of the scope for efficiency, with input from the industry.</li> </ul>
The link between the cost base estimates and the business plan estimates is weak, not transparent and therefore cannot be used to identify inefficiencies. This point was amplified by the statement in the Arup/ EC Harris report <sup>1</sup> which indicated that in some instances companies are adjusting their unit costs by up to 70% to derive the standard (cost base) cost.	<ul style="list-style-type: none"> <li>• We are asking companies to provide a breakdown of each standard cost within a structured template (Cost Breakdown Structure or CBS). This is primarily to address comparability issues but within this template companies will also be required to reference previous and/or planned projects, unit cost models or standard practice documents to demonstrate that the solution they are costing in the cost base reflects normal practice. We will compare the cost breakdowns to expose outliers and focus our challenge. However the overall assessment will be based on the total standard cost.</li> <li>• To improve transparency, after the final determination we will hold a</li> </ul>

<sup>1</sup> The independent "Review of the Cost base process" can be downloaded from the Water UK library [www.water.org.uk](http://www.water.org.uk)

	<p>workshop to communicate the reasons for differences and the opportunities for efficiency savings that we think the cost base has identified.</p>
<p>The cost base will not be appropriate going forward because it doesn't align with new contracting agreements. As partnering and contracting become standard practice there is a concern that the ability/ data needed to derive detailed capital cost estimates will be lost.</p>	<ul style="list-style-type: none"> <li>• Companies should put systems in place to capture the information and therefore understand the costs that they need to run their businesses efficiently. The Jacobs study concluded that a cost capture system is the key enabler, regardless of the procurement route.</li> <li>• If the cost capture system doesn't align with the template (CBS) that will be required as part of the PR09 cost base then companies can indicate any misalignment (e.g. if design costs are embedded within the Contractors direct costs then a note can be added to the 'design costs' cell to explain this).</li> </ul>
<p>There is a concern that validating cost estimates is not always possible, for reasons such as: the lack of detailed cost information exploring reasons for variance between tender to out-turn costs; poor comparability because of significant changes in scheme solution between the original estimate and final delivered solution. This means that the cost base estimate may not represent actual project costs and therefore cannot be used to derive the scope for efficiency improvements.</p>	<ul style="list-style-type: none"> <li>• This issue is broader than just the cost base. The work looking at the robustness of the estimating process might uncover areas where this is a concern.</li> <li>• We have made the guidance on tender to outturn adjustments clearer.</li> <li>• We have reduced the number of standard costs. And companies will only complete costs in areas where they have forecast expenditure greater than 2% of the total service area. This should reduce concerns about validation.</li> </ul>
<p>There is a concern that the reporters appeared reluctant to be critical of their companies. This means that the challenge across the industry is</p>	<ul style="list-style-type: none"> <li>• The reporter guidance will list specific checks to make.</li> <li>• We will hold a series of meetings with reporters from the same reporting company (or group of single reporters) during the analysis phase (eg in</li> </ul>

not consistent and therefore the cost estimates are not comparable.

May 2008). The meetings will discuss comparability issues, review queries, and outline our analysis of outliers. We will collate and circulate the outputs from these meetings. This will be repeated following the Final Business Plan submissions if required.

**Policy & processes**

This section covers issues concerning the way in which the cost base is used to determine the efficiency challenge. It covers issues such as the role of the reporter and whether the standard cost descriptions are appropriate and representative of companies' capital programmes.

<b>Issue</b>	<b>Outcome/ action</b>
A proportion of the variance between companies' cost base costs (non-infrastructure standard schemes in particular) does not represent differences in efficiency. Suggested reasons include: misinterpretation of the standard cost descriptions, different approach to estimating (top-down/ bottom-up), differing assumptions and methods for adjusting costs for compliance with cost base descriptions and company specific issues (special factors).	<ul style="list-style-type: none"><li>• We are asking companies to provide a breakdown of each standard cost within a structured template (CBS). This breakdown will be used to identify outliers and to target the challenge used to test comparability.</li><li>• Companies will only complete costs in areas where they have forecast expenditure greater than 2% of the total service area. This will enable companies to focus on producing the standard costs that most relate to their investment programme.</li><li>• We are improving the guidance to rationalise and clarify key principles, as well as to tighten the specifications where there are specific ambiguities.</li><li>• We are improving guidance for reporters and including checklists covering the most frequent and significant mistakes. As mentioned above, we will hold a series of meetings with reporters during the analysis phase to improve comparability.</li></ul>
Making significant changes to the reporting requirements between March 2003 and the final business plan submission was responsible for some of the vast changes in the costs submitted. It required reviewing the whole submission in	<ul style="list-style-type: none"><li>• There will only be two opportunities to submit costs (March 2008 and Final Business Plan update in April 2009) so there will be less opportunity for adjusting costs.</li><li>• Companies will be expected to justify reasons for movement in costs between submissions (this will be included on the standard template for</li></ul>

<p>detail at least twice, which was a time consuming process and led to a lot of mistakes. Several comments were received concerning the lack of transparency regarding the reasons for such large movements in costs between submissions.</p>	<p>each standard cost). We will also explain reasons for any changes made to the guidance between submissions.</p> <ul style="list-style-type: none"> <li>• We will publish information on the typical reasons for movements in standard costs.</li> </ul>
<p>There is a concern that there are conflicting requirements within the cost base approach. Companies are unclear about whether it's a tool for measuring procurement efficiency or innovation (through technology and delivery procedures). There is a concern that the standard cost descriptions cannot be used to assess both.</p>	<ul style="list-style-type: none"> <li>• The cost base mainly measures project procurement and delivery efficiency. We acknowledge that for us to achieve comparability the descriptions have to be relatively prescriptive and that process choices are limited in the current descriptions.</li> <li>• Companies will be allowed to put forward alternative solutions for non-infrastructure standard costs providing this technique is normal practice and they are planning to use it in the next AMP period. Companies will be asked to put a project (or standard practice document) reference in the standard template so that the reporter can test the link between the cost base and the business plan.</li> </ul>
<p>The early cost base submission (i.e. March 2003) assisted with balancing workload and deadlines throughout the periodic review.</p>	<ul style="list-style-type: none"> <li>• We are keeping the same timing for PR09. The first cost base submission will be required in March 2008.</li> </ul>
<p>Positive feedback was received about the consultation, clarification and other modifications made to several of the standard costs but several criticisms have also been received stating that the standard costs don't reflect the majority of their future capital programme.</p>	<ul style="list-style-type: none"> <li>• We have reviewed standard costs with the working group to establish which ones represent material investment areas. As a result, we have reduced the number of standard costs by around a quarter.</li> <li>• Where forecast expenditure is less than 2% of the total in that service, the associated standard cost will not be required. This reduces the workload for companies and avoids poorly supported estimates being put forward.</li> </ul>

<p>Having different efficiency frontiers for operating and capital expenditure leads to unrealistic benchmark targets and doesn't encourage least whole life cost solutions.</p>	<ul style="list-style-type: none"> <li>• We do not accept the argument about unrealistic benchmark targets, as one company has been the frontier company for both operating and capital expenditure.</li> <li>• We have decided it is impractical to address whole-life costing by requiring standard costs to include the NPV of operating costs.</li> <li>• We are reviewing the guidance on trade-offs between operating and capital expenditure (whole life costing).</li> </ul>
<p>There are some concerns that the time period defined for "catch-up" is insufficient (in particular for enhancement schemes where catch-up has to be achieved in year 1).</p>	<ul style="list-style-type: none"> <li>• We will address this in the October methodology paper.</li> </ul>
<p>It has been suggested that companies should have company specific catch-up, which uses a relationship between project outturn and predicted costs.</p>	<ul style="list-style-type: none"> <li>• We are not planning to have company-specific catch-ups.</li> </ul>
<p>Concerns have been raised about the uncertainty and lack of visibility for assigning the weightings to each standard cost area based on the proportion of forecast capital expenditure.</p>	<ul style="list-style-type: none"> <li>• The information requirements include a worked example.</li> </ul>

**Operational**  
This section collates the feedback received about the mechanics of the process, covering issues concerning the consistency and accuracy of the standard cost descriptions and checklists and thoroughness of the guidance.

Issue	Outcome/ action
<p>Positive feedback was received about the clarity of the guidance between revisions. (eg through highlighting the changes).</p>	<ul style="list-style-type: none"> <li>• We will do the same for PR09.</li> </ul>
<p>More consideration is needed concerning special factors, in particular the need for:</p> <ul style="list-style-type: none"> <li>• a special factor that considers economies of scale.</li> <li>• a special factor that adjusts for variance in costs experienced by companies (e.g. proximity to sites/ materials etc, land availability, company size, planning constraints).</li> <li>• a review of the application of the regional adjustment special factor. The adjustment was only made to companies operating in high cost areas and no upward adjustment was made to reflect companies operating in low cost areas. (Several benchmark companies are operating in low cost areas that others feel they cannot replicate).</li> </ul>	<ul style="list-style-type: none"> <li>• We will consider special factor claims, but companies should not make adjustments themselves to their standard costs to reflect these claims.</li> <li>• We are reviewing our approach to regional price adjustments for both the cost base and for econometrics.</li> </ul>
<p>Should there be a reward mechanism for companies with costs below the benchmark?</p>	<ul style="list-style-type: none"> <li>• No; we do not think an additional incentive is necessary.</li> </ul>

<p>The independent assessment of the process (Arup/ EC Harris report) was carried out too late in the PR04 process to enable any significant changes to the process to be made.</p>	<ul style="list-style-type: none"> <li>• We have responded to concerns and involved the industry in resolving them.</li> <li>• If others wish to commission an assessment of our process, this is a matter for them.</li> </ul>
<p>There were too many mistakes and inaccuracies in the submissions, which resulted in a large number of queries having to be issued.</p>	<ul style="list-style-type: none"> <li>• Between publication of the information requirements in November / December 2007 and the deadline for cost base submissions in March 2008, we will hold a log on our website of queries on the information requirements and our responses.</li> <li>• We will discuss the queries raised / identified in the analysis process in confidence in the above-mentioned meetings with reporters (around May 2008).</li> <li>• We will publish final clarification / guidance on the website and clearly mark any resulting modifications in the Final Business Plan information requirements.</li> <li>• We are considering dealing with simple queries by telephone, with confirmation by email to provide an audit trail.</li> </ul>
<p>Mixed feedback was received about the checklists. Generally the checklists were considered to be helpful, but inconsistencies between them and the standard costs descriptions sometimes caused confusion. Exactly what the checklists were being used for, and the expectation in terms of associated commentary was unclear.</p>	<ul style="list-style-type: none"> <li>• We will not require checklists at PR09.</li> </ul>