Securing cost efficiency

19 July, 2017

Aim

To explain draft methodology to assist your response

To take clarification questions – not for views on methodology (this is for your response)

We will provide stops in the presentation to allow questions

Structure

Key themes of the **Securing Cost Efficiency** chapter

New cost sharing incentive

Benchmark analysis

Enhancement expenditure

The adjustment process

Retail cost assessment

Initial assessment of business plans

A step change in cost efficiency at PR19

- Strong expectation of **step up in efficiency** for PR19, sharing efficiency benefits of totex and outcomes framework with customers.
- **Challenging cost baselines**, which will incorporate catch-up efficiency as well as forward looking dynamic efficiency and evidence from other sectors.
- A new **cost sharing incentive** to reward efficient business plans and penalise inefficient business plans. No menus. (slide 4)
- Benchmark analysis using econometric modelling and a mix of **top-down and granular models** (slide 5)
- For **enhancement expenditure**, use of historical as well as forecast cost information to identify efficiency benchmark. A different approach to funding of **unconfirmed environmental requirements** (slide 6)
- Warranted cost adjustment claims trigger **symmetrical cost adjustments** to cost baselines (slide 7-8)
- On **retail controls**, an econometric approach to benchmark companies' costs and set efficient baselines, plus take account of cross sector comparators. No indexation to inflation index. No glide path. (slide 9)

No menus in PR19 – instead, a cost sharing incentive to submit efficient plans and to deliver these plans to customers

- ✓ Clear and effective incentive to deliver efficient cost projections
- ✓ An incentive for efficient companies to stretch the frontier. This will improve our efficiency challenge to all companies and provide benefits to all customers
- ✓ Greater protection to customers of inefficient companies. Customers will pay less of the company's underperformance (and will get more of any outperformance)

When a company submits its business plan, its cost sharing rates are determined based on the ratio of its totex to our view of totex

Efficient business plans ← | → Inefficient business plans

Ratio of company view to our view of totex	80%	85%	90%	95%	100%	105%	110%	115%	120%
Cost sharing rate (outperform)	60%	58%	55%	53%	50%	48%	45%	43%	40%
Cost sharing rate (underperform)	40%	43%	45%	48%	50%	53%	55%	58%	60%

← Direction of incentive

Approach to cost modelling

- We will continue to use **benchmarking analysis** for cost assessment
- Benchmark analysis using **econometric models**
- A mix of **top-down and granular** benchmarking analysis
- Greater use of **forecast data**, but only for benchmarking. Not for direct setting of cost allowances.
- No discussion of model specification

Our proposals for assessing enhancement expenditure

- Preference is for a fully integrated totex approach to assessing costs. Where possible we will include “suitable” enhancement activities in high level benchmarking models.
- Where this is not possible, we will use alternative approaches eg unit cost models for specific types of quality enhancement
- Use of historical or forecast data as appropriate
- Proportionate approach. Expert review of material areas of expenditure

New approach for **dealing with unconfirmed environmental requirements**

  - Conservative allowance at PR19 allowing companies to seek funding for remainder of programme at PR24 after WFD requirements are confirmed in 2021-22.

  or

  - Fully fund those elements of the ‘Managing uncertainty’ programme anticipated by company which are linked to an outcome and a unit cost adjustment mechanism

Adjustments to our cost baselines

Why adjustments?

Statistical models cannot take into account all relevant factors that affect costs. There may be instances where an adjustment is required to correct these imperfections.

Expectation – companies should avoid raising claims wherever possible

All companies have special circumstances, some circumstance increase their costs, but others reduce their costs. In many cases companies can avoid the need to raise cost adjustment claims by taking a more balanced approach.

Symmetrical process – adjustments should be two-sided

Statistical models may overestimate or underestimate companies' efficient costs. In P14 adjustments were one-sided. Adjustments should be two-sided.

1. We will scrutinise business plans to identify appropriate downward adjustments to our cost baselines. We will particularly scrutinise business plans that include a large number of cost adjustment claims.
2. Mechanism to counter certain adjustments (eg regional factors), which affected models' data and, therefore, modelling results

Early submission – early information on cost adjustment claims by 3 May 2018

To assist the review process, in particular, it will provide valuable additional time to assess cost adjustment claims in the IAP.

Cost adjustment claims – high evidential bar for allowing adjustments

- **Need for cost adjustment/claim**: is there evidence that the claim is not in our models and that the cost cannot be accommodated without a claim?
- **Robustness and efficiency of costs**: is there persuasive evidence that the cost estimates are robust and efficient?
- **Management control**: is the cost driven by factors beyond management control? Did the company take all practicable steps to control the cost?
- **Need for investment**: is there evidence that the investment is required, where appropriate through customer support?
- **Best option for customers**: is there best practice CBA to support adopted option?
- **Customer protection**: are customers protected if the investment is cancelled, delayed or reduced in scope?

Our proposals for assessing retail costs

Benchmark residential retailers' using an econometric approach

- Move away from the PR14 Average Cost to Serve (ACTS) approach and use an econometric approach to set efficient baselines
- Develop a separate benchmark model to asses the efficiency of bad debt costs
- Retain an Efficient Cost to Serve (ECTS) approach if we are unable to produce robust econometric models

Setting efficient baselines

- Sharpened incentives to submit efficient retail costs; our baselines will be set using our efficient benchmark, not by company forecasts
- No gradual catch-up (glide path) to the efficient frontier
- We will use evidence from other sectors to stretch our baselines for water companies, particularly in relation to levels of bad debt in the water sector

A proportionate assessment approach for business retail

- We will compare projected costs to historical levels and to evidence from the English business retail market

No indexation of the residential and business retail controls

- Where applicable, our preference is to deal with input price pressure as part of our totex allowance

Strong incentives for retailers to beat our cost allowance

- Companies get to keep 100% of any cost outperformance

Initial assessment of business plans – cost assessment tests

- How well evidenced, efficient and challenging are the company's forecasts of **wholesale water expenditure** including water resources costs?

- How well evidenced, efficient and challenging are the company's forecasts of **wholesale wastewater expenditure** including bioresources costs?

- How well evidenced, efficient and challenging are the company's forecasts of **retail expenditure** including doubtful debt costs?

- To what extent are **cost adjustment claims** used only where prudent and appropriate, and where they are used, are costs adjustments well evidenced, efficient and challenging?

Any questions?

Annex – consultation questions

Q1. Do you agree with our overall **approach to cost assessment**?

Q2. Do you agree with our proposed **cost sharing incentive**? We welcome thoughts on the calibration of the incentive.

Q3. Do you agree with our proposals to **funding unconfirmed environmental requirements**? Which of the two options do you consider is more appropriate, and why?

Q4. Do you agree with our **approach to cost adjustment** and our proposed approach to make the process more **symmetric**?

Q5.Do you agree with our proposed **approach for assessing retail** (residential and business) costs at PR19?

Q6. Do you agree with our preferred **approach not to index the retail** controls to a measure of general inflation, and, if appropriate, deal with input price pressure as part of our totex allowance?

Q7. Do you agree with our proposals for the **transition programme**?