

Notice of our consultation on econometric cost models for PR19

Overview

This briefing sheet is to alert stakeholders to our intention to publish a consultation at the end of March 2018 on a set of econometric cost models for PR19. We invite stakeholders to submit suitable cost models to be considered for inclusion in this consultation, by 13 March 2018.

This consultation will allow stakeholders to provide feedback on proposed models and help us to select a set of robust cost models for our efficiency assessment in PR19.

Background

In PR19 we will set up to six different controls for the larger water companies¹ in England and Wales. The controls are

- Water resources
- Water network plus
- Wastewater network plus
- Bioresources
- Residential retail
- Business retail (where appropriate)

On 13 December we published [Delivering W2020: Our final methodology for the 2019 price review](#). In chapter 9, securing cost efficiency, and appendix 11, we discussed our approach to cost assessment. We said that for all controls, except the business retail controls², we will develop econometric models as a tool to assess cost efficiency.

¹ By which we mean companies holding appointments as water and/or sewerage undertakers.

² The business retail controls will apply to only to companies whose areas are wholly or mainly in Wales, and those water companies whose areas are wholly or mainly in England who have not exited the business retail market by the time we set price controls.

During 2016 and 2017, we have been working with stakeholders, through our cost assessment working group, to develop and refine our data and tools for cost assessment. In July 2017, companies submitted data tables with cost, and relevant non-cost information (eg “cost driver” information) on their wholesale water and wastewater services in the preceding six years, 2011-12 to 2016-17. Based on this data submission, and information from the annual performance reports for retail, we are developing econometric cost models for PR19. We are also aware that several companies have developed econometric models for various controls.

The econometric cost models are an important component of our cost assessment approach. Our forecast of efficient expenditure, which is largely informed by results from these econometric models, will play an important role in our initial assessment of business plans, and later, in setting efficient cost allowances in draft and final determinations.

The consultation

We propose to give stakeholders the opportunity to review and comment on our models and models developed by companies for PR19. We will present a range of econometric cost models, with a short set of supplementary information for each model, such as a set of diagnostic tests and a brief comment on the relative strengths and weaknesses of the model. We will invite stakeholders to comment on the published models. The aim is to have a focussed consultation and receive feedback on models that have been developed and tested.

In our draft and final methodology we indicated our intention to develop a suite of models that include ‘top down’ models (eg models that assess the efficiency of wholesale costs or network plus costs in aggregate) and more granular models (eg models that assess the efficiency of individual services’ costs, such as treatment, distribution, water resources and bioresources). Consistent with what we have said in our methodology, our consultation will include the following models:

In wholesale water:

1. Water resources
2. Raw water distribution
3. Water treatment
4. Treated water distribution
5. Water resources plus (water resources + raw water distribution + treatment)
6. Network plus water (raw water distribution + treatment + treated water distribution)
7. Wholesale Water (water resources + network plus)

In wholesale wastewater:

1. Wastewater collection
2. Wastewater treatment
3. Bioresources
4. Bioresources plus (treatment + bioresources)
5. Network plus wastewater (treatment + collection)
6. Wholesale wastewater (network plus + bioresources)

In residential retail:

1. Bad debt and debt management costs
2. Total retail costs less bad debt and debt management costs
3. Total retail costs.

In line with what we said in our PR19 methodology, the econometric models will cover base costs (ie operating expenditure and maintenance capital expenditure), and, if appropriate, elements of enhancement expenditure. We will exclude enhancement activities that we consider more appropriate for a separate assessment. We will also exclude business rates and pension deficit recovery costs.

Enhancement expenditure

Enhancement expenditure refers to expenditure for the purpose of enhancing the capacity or quality of service beyond current levels. Enhancement expenditure can be quite company-specific, irregular and difficult to predict. In our PR19 methodology we said that we will develop a number of approaches to deal with different types of enhancement expenditure.

As part of this consultation, we will publish a number of models to assess areas of enhancement expenditure. We will not cover all areas of enhancement expenditure – only those areas where we would like to get feedback on our proposed model at this point. We invite stakeholders to propose suitable cost models, by 13 March, for the different areas of enhancement expenditure.

We expect to publish the consultation by 29 March. We will allow four weeks for responses.

Stakeholder input

We are aware that companies have been working to test the July 2017 data and develop robust cost models. Some companies have published reports with their

proposed cost models for different parts of the value chain, while other shared initial results with us.

We invite the water companies and other stakeholders to submit their proposed cost models to be considered for inclusion in our consultation. The deadline for submissions of models is 13 March 2018. Those submitting models should ensure that, where relevant, all necessary rights have been obtained for the models to be used by the Water Services Regulation Authority (Ofwat).

Following the consultation

Our final set of models for PR19 will be informed by responses to our consultation. However, our final set of models will also be informed by further analysis, by the 2017-18 data submission, due in July 2018, and by data submitted in company business plans. This means that we will not publish final cost models before companies submit their business plans.

We remind companies that we do not consider that publication of our final cost models is an essential input to development of company business plans – companies should focus on developing efficient business plans that deliver for their customers. Companies' business plans should not be driven by regulatory models of cost assessment.

Enquiries

If you have any questions about this briefing sheet please submit your query to PR19@ofwat.gsi.gov.uk.

More information

[Delivering Water 2020: Our final methodology for the 2019 price review](#), December 2017

[Delivering Water 2020: Our final methodology for the 2019 price review. Appendix 11: Securing cost efficiency](#), December 2017

Ofwat (The Water Services Regulation Authority) is a non-ministerial government department. We regulate the water sector in England and Wales. Our vision is to be a leading economic regulator, trusted and respected, challenging ourselves and others to build trust and confidence in water.

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