

# Information notice

IN 18/11 June 2018



This is a formal document that alerts our stakeholders to a change in the way that we regulate the water sector in England and Wales.

## Enhancement expenditure: setting expectations for well-evidenced proposals and clarifying interaction with cost adjustment claims

Enhancement expenditure refers to expenditure for the purpose of enhancing the capacity or quality of service beyond current levels. The expenditure may be driven by a number of factors, including population growth, new statutory obligations and strategic prioritisation by company Boards (which should be in consultation with their customers).

The purpose of this information notice is to clarify:

- The evidence we expect to receive in support of proposals for enhancement expenditure when companies submit their business plans to us by 3 September 2018; and
- The interaction between our approach to enhancement and our approach to cost adjustment claims.

We are also providing a revised template for submission of summary information about cost adjustment claims.

### Evidence we expect to receive in support of proposals for enhancement expenditure

Enhancement expenditure is often company-specific and irregular. In our [PR19 final methodology](#) we said that we will use a range of approaches to address different types of enhancement expenditure. Our approach will depend on (a) the type of enhancement activity (for example, quality driven activity versus growth driven activity); (b) how well its costs

are distinguished from base costs or those of other enhancement activities; (c) its materiality; and (d) the amount of data that we have to assess the cost through benchmarking analysis.

We said that our assessment will use any additional available information, including company business plan information, where there is insufficient data for robust benchmark analysis. As our assessment approach to enhancement is less mechanistic than our

approach to base expenditure, we expect companies:

- to explain why the expenditure is classified as enhancement and not as base, including identifying the driver of the expenditure and what the expenditure enhances; and
- to provide high quality evidence to support their enhancement proposals. We expect the evidence to be proportionate to the materiality of the expenditure. Where the expenditure is material, we expect the same quality of evidence as we expect for cost adjustment claims. It is important that in all cases companies provide high quality evidence to support the need for the expenditure and the efficiency of the cost.

## Interaction of our approach to enhancement with cost adjustment claims

Our [PR19 final methodology](#) confirmed that we will have a cost adjustment process.

The process allows companies to make well-evidenced claims for unique and material costs that are unlikely to be captured by our cost baselines. Examples may include an atypically large investment by the company, or regional operating circumstances with significant impact on costs.

In IN18/02 we said:

“Submission of cost adjustment claims should not depend on the specific approach that we use to assess the enhancement activity. Our cost assessment approach will deliver cost allowances that cover an efficient level of totex for each company, including an efficient

allowance for its new statutory and growth enhancement activities. Whether our approach is based on benchmarking analysis or an analysis of business plans, cost adjustment claims should only be submitted where they reflect unique and material company circumstances, which make the company stand out.”

On 3 May we received informal submissions of cost adjustment claims from companies. These submissions revealed that companies adopted different approaches to raising cost adjustment claims related to enhancement expenditure.

We reiterate that we do not expect companies to submit cost adjustment claims for all material enhancement expenditure. We will assess enhancement expenditure in companies’ business plans and make an efficient allowance for it in our cost baselines.

Given our non-mechanistic approach to assessing enhancement expenditure, we do not expect many cost adjustment claims for enhancement costs. Cost adjustment claims should reflect unique company circumstances, such as operating circumstances which impact on its potential to achieve as low a unit cost as other companies in delivering a given outcome or a programme of work.

For example, companies are required to deliver environmental enhancement schemes under the Water Industry National Environment Programme (WINEP) in England or the National Environment Programme (NEP) in Wales. We would not generally expect a company to submit such investment as a cost adjustment claim, except where it considers that it has unique circumstances that materially

impact the unit cost of the investment relative to other companies.

While we do not expect companies to raise all enhancement expenditure as a cost adjustment claim, we expect high quality evidence to support enhancement expenditure, as we have set out in the section above. In particular, for material enhancement expenditure companies should provide the same quality of evidence as for cost adjustment claims. We set out the types of evidence we expect companies to submit in support of cost adjustment claims in section 4 of appendix 11 of our PR19 final methodology.

We remind companies that we expect a balanced approach to raising cost claims, by considering offsetting favourable circumstances.

## Revised template for cost adjustment claims

To help us navigate the information submitted to support cost adjustment claims in business plans, we are providing a revised two-page template, which will provide a summary of each claim, the evidence to support it, and a signpost to any further evidence relevant to the claim (for example, to the evidence demonstrating the need for the investment, the robustness and efficiency of the cost, etc.). Given that the required evidence to support enhancement expenditure is similar to that for cost adjustment claims, this template can also be used for enhancement expenditure if appropriate.

### More information

[Revised pro-forma for cost adjustment claims](#)

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 trusted and respected regulator, working at the leading edge, challenging ourselves and others to build trust and confidence in water.

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