

Ofwat webinar: Securing cost efficiency

7th February 2019 12:00 – 13:30pm

Q and A

Areas covered:

- Securing Cost Efficiency

[Webinar slides are available on our website.](#)

Question and answer session

Q. There is an efficiency challenge table for companies in the notes section of the SDB model, (tab strategic schemes), how can we find the derivation of this table?

Q. Can you say a bit more about the company specific efficiency challenge applied in some of the enhancement models?

A. These efficiency challenges are based on the gap between company business plan base costs and our view of efficient base costs (our view in this case includes only the upper quartile efficiency challenge without the frontier shift challenge). In wastewater we also used our phosphorous removal model to inform the company efficiency challenge.

Q. What's your rationale for revising companies submitted cost drivers?

A. Our approach is consistent with our methodology. In the methodology we explained the importance of establishing independent cost baselines under an incentive based approach. We have therefore developed an independent view of the cost drivers for our econometric models (although in a small number of cases we used company forecasts rather than our own forecast). Generally, using our view of cost drivers rather than the companies' view had a relatively small impact and does not account for a large share of the efficiency challenge.

For WINEP/NEP costs, we adjusted company drivers where it did not align with the driver information in WINEP/NEP and the business plans did not provide information to explain or justify the discrepancy.

Q. Why have you not excluded enhancement opex from modelled Botex?

A. Modelled base costs is based on historical data where opex was not reported separately for enhancement activities. So we couldn't exclude it.

Q. Will Ofwat publish the file showing the calculation of weighted average density?

A. Since the webinar, we have published the file and you can find it here: <https://www.ofwat.gov.uk/wp-content/uploads/2019/02/Density-indices.xlsx>

Q. Why have you excluded enhancement opex that is new (i.e. not related to historical enhancement capex)? How does this work with a totex approach?

A. We have included enhancement opex where we considered it to be material (e.g. SDB enhancement, p-removal). But in most cases we considered that enhancement opex is included in our base cost allowance. For draft determinations we will consider whether it is appropriate to include enhancement opex in other areas of enhancement.

Totex approach is broader than cost assessment. It is mainly about equalising cost recovery and cost performance incentives between opex and capex. With better information on enhancement opex in future cost reporting we will look to assess capex and opex together for enhancement activities.

We also note that just as there are enhancement activities that are new, there are typically enhancement activities that are no longer required, or that are no longer considered “enhancement”. Since opex associated with these activities is included in the historical data used for our econometric models, it will be reflected in allowances.

Q: How will Ofwat calculate the cost sharing rates?

Our policy on the calculation of cost sharing rates is as set out in the PR19 methodology. As set out in this document, the cost sharing rates are based on submitted business plans.

Q. Will Ofwat publish the calculation file for the weighted average water treatment complexity variable please?

A. We prepared a note setting out the calculation and circulated it to companies on Friday 15 Feb. We note that the calculation is already in the Stata “Do” file.

Q. Please can Ofwat explain the basis for the 20% efficiency challenge on enhancement deep dives?

A. This is a benchmark number used for consistency purposes. Given the asymmetry of information that exists, we considered it appropriate to apply this material challenge.

Optioneering is fundamental: in many cases not enough options were presented – and sometimes quite significantly lower cost options were available but not mentioned.

Where there was additional evidence or reasonable optioneering, but not entirely sufficient, we have applied a smaller efficiency challenge. This is a risk based approach and a clear call for further evidence in revised plans.

Q. Given companies are not currently delivering 15% leakage reductions can you explain how the base model (based on historical data but not using leakage as a cost driver) provides an allowance for delivering this level of service?

A. Network maintenance and leakage reduction is a longstanding and ongoing activity for all companies. Companies have been reducing leakage in the past and the costs of these activities are therefore included in our base allowance.

We note that two companies do not request enhancement funding to deliver their leakage reduction in 2020-21 to 2024-25, with both planning to meet the 15% challenge. These companies plan to achieve this level of performance through their base totex allowance. Also, the three fast track companies have accepted our base allowance to achieve 15% leakage reduction.

Different companies also forecast different levels of leakage reduction. Where companies go beyond upper quartile we make an allowance. Likewise, if companies go beyond 15% we make a cost allowance if we consider that the target is stretching.

In our methodology we said that we expect companies to catch up with “upper quartile” performance and that customers shouldn't pay. We expect companies to achieve this through innovation and working efficiently.

Q. What external / third party review has been undertaken on this assessment please?

A. For the econometric models we worked with CEPA which had its own academic panel to review the models. In March 2018 we [consulted](#) on our econometric models. We then worked with Vivid Economics to consider responses to the consultation and develop models in wastewater. The consultation and the consultants’ reports helped us reach a final and informed set of cost models. We also had two academics from Leeds University to quality-assure the approach throughout. See our [Supplementary technical appendix: Econometric approach](#).

We also had rigorous internal governance and assurance for IAP cost assessment decisions, including drawing on technical expertise within our delivery partner.

Q. Do you expect to recalibrate your enhancement models for DD?

A. Not automatically. Only where good strong evidence for changes are presented by companies. It will be considered where appropriate.

Q Will you set up any cost assessment workshops on specific matters or do we need to ask for them?

A. We will consider setting up a workshop where companies have queries that are better addressed as a group. Companies don't need to ask for the workshops.

Q. Are you continuing to work on base cost models, or will they remain as is now?

A. We expect to retain the models as they are now. However, if companies provide sufficient and convincing new data and evidence, we will consider whether we need to update/change the models.

Q. Was there any kind of 'common sense' check of the botex models to check that the models produced accorded with engineering understanding of how the industry works? If yes, what form did these tests take and how did they affect the outcome?

A. Throughout the design of the models we have focused on the engineering and economic rationale underpinning them. We consider that our models results broadly reflect expectations.