Ofwat webinar: Securing Cost Efficiency

25th July 2019, 0930 – 1030

Webinar slides are available on our website.

Question and answer session

Q. It seems the drivers for the alternative growth models that were criticised in the IAP models are the same relevant drivers in the base cost models and the power of these models are now weaker do you intend to investigate new drivers for growth or expect companies to submit relevant cost adjustment claims in the DD response?

Q. Regarding the remodelling of growth expenditure can you elaborate on the process undertaken to determine the suitability of the cost drivers used and the explanatory power of the model in relation to growth?

A. We have considered whether the inclusion of growth-driven expenditure is appropriate in principle, and whether overall it improves our approach to the combined assessment of base and growth expenditure. We think the answer is yes for both.

We explained in our cost assessment appendix that growth expenditure has similar characteristics to base expenditure. It does not exhibit dramatic changes and, we consider, can be explained by similar cost drivers. We tested to check that the models, unchanged, remain robust – and we consider that they do. We also tested alternative model specification, such as the change in the number of connected properties as a cost driver but found that it did not deliver a better model. After the IAP stage we issued a data request with a view to investigating the degree of self-lay penetration as a potential cost driver. Our analysis of the data did not show a clear relationship between self-lay penetration and new connection costs. This may be the result of data reporting inconsistencies between companies. We issued a further data request with the draft determinations in order to undertake further analysis.

Companies can respond to our draft determinations and propose alternative drivers for our econometric models or special circumstances that may require a cost adjustment. We will review companies' representations and amend our approach if required.

Q. Are you able to share the calculations for how Ofwat have determined the implicit enhancement opex? The technical annex provides narrative to the approach, but it would be useful to see the calculations.

A. Yes. We have published a feeder model on our website that sets out our calculations of the enhancement opex implicit allowance. See: https://www.ofwat.gov.uk/wp-content/uploads/2019/07/Enhancement-Opex-implicit-allowance_ST_DD.xlsx

Q. Did you consider any other methods of assessing enhancement totex rather than just summing the cash impact of them in the price control period?

A. We considered alternative methods, including those suggested by companies. With the limitations of the cost information that we have, we consider that our approach is intuitive and consistent with that of base costs. Alternative approaches would require strong assumptions. We investigated whether our approach has resulted in any opex or capex bias but do not consider that there is evidence of this.

Q. Concerning migration (proxy for transience), fixing both the historic and forecast values at 2016/17 may 'solve' the problem of achieving an intuitive positive coefficient but it does not appropriately reflect migration as all the within-company variation has now been removed from the model. It would be good to have your thoughts on this and if you think migration has been properly captured by using the same value all through.

A. Given the change in approach of estimating migration in 2016-17, we are faced with four options:

- Remove migration as an explanatory variable in our models
- Retain the full time series of the variable in our model, despite the structural break
- Use pre-2016-17 migration data
- Use post 2016-17 migration data

We consider that controlling for inter-company variation in the migration rates add value to our models. We therefore decided to retain the variable. We do not consider that using an inconsistent series is appropriate. We opted for post 2016-17 data rather than pre-2016-17 data as it is more up to date, more appropriate for setting forward looking allowances and it is based on a better (ie updated) ONS methodology for estimating the variable.

Q. Could you explain the logic of the calculation of the 9% adjustment to WINEP modelled enhancement costs?

A. Unlike at the IAP stage, for the DD we did not apply an efficiency assumption at the level of individual obligations but applied a single 9% challenge at programme level (for wastewater WINEP obligations). The 9% challenge corresponds to the upper quartile level of efficiency. However, as we explain in page 63 of our cost assessment appendix, “This challenge incorporates a catch up element (which we set at a level significantly less stringent than the ‘upper quartile’) as well as an expectation that companies will make a step-change in efficiency in the coming regulatory period due to the totex and outcomes approach and ongoing productivity improvements.”

The revised approach is deemed fairer in that it provides for any inefficiencies in individual obligations potentially to be offset where modelling shows a company is relatively cost-efficient in other individual obligations. As a result, overall totex allowances are higher than they would have been had the approach used at the IAP been followed.

Q. Using average bill size in real terms as a driver for bad debt or total retail that are captured in nominal terms seems contradictory. Please let us have your thoughts on the reason for doing this.

A. The use of average bill size in real terms to set allowances is consistent with the fact that we use historic average bill size in real terms to estimate the model. We consider that this is a consistent use of the model relative to an approach where we estimate the model with a real average bill and then plug a nominal average bill into the model to generate predictions.

Our allowances in retail are not automatically indexed to a measure of inflation. However, our allowances are anchored to business plans (hence business plans’ inflation assumptions) through the use of the forward-looking upper quartile.

Q. In the risk and return webinar, Martin Malinowski stated that you have switched from median to mean when looking at the cost of embedded debt as the median is skewed upwards by small companies. Shouldn't this also be the case for cost assessment?

A. This is not an accurate representation of what was said in the risk and return webinar, nor of our approach to embedded debt. Our allowance for embedded debt is above the company-level weighted average but below the company median.

Q. Given the big change to modelling on a base plus basis, did you consider giving companies advanced notice of the change?

A. Our draft determination consultation provides companies with an opportunity to respond to our cost assessment approach, and any change in approach since the initial assessment of plans.

Q. Could you confirm that the developer services tables should be based on the ONS data projections rather than company forecasts - it may be challenging due to the need to split for some actual growth sites such as NAV / SLP activity?

A. The data request should not be interpreted as a signal that companies should recast their overall population growth forecasts using any particular method. Rather it is intended to provide more granularity to the overall totals. This should allow us, in five years' time, to consider more fully reasons for variances from these forecasts. These may include differences in the actual number of properties supplied by a NAV, compared to that forecast. Also, any change in SLP activity will impact on the actual costs of connections compared with business plan forecasts.

Q. Now that the enhancement allowances are given as totex, how can we know how much of the allowance is capex vs opex, (and therefore calculate PAYG)?

A. We used each company’s business plan split between capex and opex and applied it to our totex allowance to work out a capex opex split which we used to calculate the PAYG rate. See section 8.5 of our cost assessment appendix.

Q. Will the revised cost sharing rates be applied to both the gap in the September business plan submission and the DD representation gap? Or will the old cost sharing rates be applied to the September business plan gap?

A. We propose to use the revised cost sharing rates instead of the original rates. We will use it in reference to a single gap, namely the gap between our final view of totex and the company view of totex, where the latter is calculated as the average of the company's view of totex in its September business plan and its view of totex at DD representations. As fast track companies accepted our cost baselines, as long as they continue to do so they will be awarded 50:50 sharing rate.

Q. How will Ofwat ensure that the cost sharing rates are based on genuine differences in efficiency and not differences in scope as is currently the case in Ofwat's quoted "efficiency gap"?

A. As we set out in our PR19 methodology, the cost sharing rates will be determined by the ratio of a company's business plan totex to our view of efficient totex.

Our view of totex incorporates our view of efficient cost and efficient scope of work. The differences between our view of totex and the company's view will be reflected in the cost sharing rates. Our proposal to place 50% on the company's view of totex at representation to draft determinations provides companies an opportunity to align their view of scope and efficiency with our view, and for this to impact its cost sharing rates.

We have not challenged companies' scope where the scope is underpinned by statutory obligation or where the need for an investment was identified at the WRMP.

Q. Given the change in the models and likely further changes indicated (e.g. developers, growth), may you reconsider the cost sharing weighting approach, should further changes arise which change the modelling position, particularly as the methodology change on timing of revenues.

A. We do not think that a change in the modelling position should necessarily affect the cost sharing weighting approach, nor should the change in approach related to the upfront payment. We will review responses to our draft determinations proposals and consider our approach for final determinations.

Q. Enhancement opex in growth: how does Ofwat justify its statement on p109 of the cost appendix that excluding enhancement opex for growth does not affect the assessment of costs?

A. The table on page 109 should be ignored as it merely duplicates table A1.2 on page 104. This has caused formatting issues that affected the coherency of the footnote. We have now re-published the 'securing cost efficiency' technical appendix here. We have removed the duplicated table and fixed the footnotes. Any remaining query should be submitted via the query process.

Q. In the tech appendix, it is mentioned that the econometric models will be re-run using 2018-19 data, when will you publish/share the new master data including this year?

A. We are in the process of updating our master data file taking account of the recent companies' APR submissions of 2018-19. During this process, it is likely we

will raise queries to companies as we quality assure the data. We aim to publish the updated master data file by 16th August. This will be communicated through our engagement team.

Q. Please could we have your thoughts on how the transience estimations will change if/when new additional values are released in August as stated in your appendix?

A. As we say in page 82 of our cost assessment appendix, in August 2019 the ONS is expected to release an additional year of migration data. We expect to incorporate the new release of data to our models and update our allowances for final determinations.

Q. On enhancement, such as on the WINEP 9% adjustment, have you considered whether companies had already reflected efficiency and frontier shift within their enhancement projections, before apply a blanket adjustment (or based on a historic base efficiency position)?

A. When considering applying frontier shift, real price effects and the impact of the totex and outcomes framework to enhancement expenditure we considered the extent to which companies had already factored in appropriate assumptions into their forecasts. In general, companies which explicitly considered frontier shift and real price effects on enhancement expenditure, assumed little or no overall reduction in costs, with some companies assuming that costs would increase in real terms over time. There was also little if any explicit consideration of the impact of totex and outcome framework in enhancement cost forecasts. When developing forecasts for the WINEP programme in particular, we have taken into account the impact of frontier shift, real price effects and the impact of the totex and outcomes framework, as well as catch up to upper quartile performance, when identifying an efficiency challenge of 9%.

Q. Where cost gaps remain, the cost sharing mechanism incentivises companies to align with Ofwat's view ie to submit costs that are not necessarily the company's best view. What do you expect companies to do given this incentive?

A. We expect companies to provide appropriate assurance on the information they submit to us.