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## 1. The cost of the base level of service

- 1.1 At the presentation on Ofwat’s response to the companies’ statements of case, a panel member asked
- 1.2 “.. the relationship to base costs allow for service improvement and that the models include the cost of past service improvements. I was wondering if possible if you could expand a bit on how that actually happens in practice...”
- 1.3 This note focuses on the key area in which the disputing companies suggest that they require additional expenditure, which is the on the three common performance commitments where the improvement is based on the forward looking upper quartile: water supply interruptions, internal sewer flooding and pollution incidents. It should be noted that these common level performance commitments are only three out of around 30 to 40 performance commitments per company.
- 1.4 There are three reasons why our base cost allowances provide sufficient funding for the improvement in performance in water supply interruptions, internal sewer flooding and pollution incidents.
- The level of stretch on these three performance commitments is based on the **improvement forecast by water companies that they can achieve within base expenditure**, i.e. without additional funding from enhancement expenditure.
  - The base expenditure allowance is derived from **historical expenditure**, which includes the additional expenditure **spent making a similar improvement in performance in the last price control period**.
  - Several companies, including disputing companies, **have already met** the 2024-25 performance commitment level of at least one of these performance commitments.
- 1.5 We discuss each of these issues below in more detail.
- 1.6 **The level of stretch on these three performance commitments is based on the improvement forecast by water companies that they can achieve within base expenditure.** As part of our PR19 methodology, we asked companies to propose their view of the forward looking upper quartile, which would be funded within base costs. At final determinations we reviewed the

companies' proposed stretch on each of these performance commitments against historical improvements. We moderated the challenge on water supply interruptions. For internal sewer flooding and pollution incidents we found that the forecast forward looking upper quartile was stretching but achievable within base costs. The level of stretch on these three common performance commitments is consistent with the stretch achieved at PR14.<sup>1</sup> In PR14 this improvement was achieved without additional funding.

- 1.7 Evidence from company business plans and representations demonstrates consistency between the forward looking upper quartile level of service and our base cost allowances. Our final determination base cost allowances are very close to company business plan cost forecasts, just 0.4% below company representations on the draft determinations. In their representations, most companies also accepted the forward looking performance level.<sup>2</sup>
- 1.8 Thirteen companies accepted the proposed level of stretch without additional funding, and the challenge on some of these companies is higher than on the disputing companies.<sup>3</sup>
- 1.9 **Our PR19 base expenditure econometric models and therefore our PR19 cost baselines incorporate the historical costs incurred by the companies to improve performance** to upper quartile in the PR14 period on water supply interruptions, internal sewer flooding and pollution incidents. As we did not provide additional funding for the service improvement in PR14 then any additional expenditure is reflected in historical base expenditure. This includes any extra costs to earn outcome delivery incentive payments during the PR14. Consistent with our totex approach, these historical costs include both capital and operating costs.
- 1.10 Much of the effort required to improve performance on water supply interruptions, internal sewer flooding and pollution incidents relates to good management and operational practices that we expect of all companies. Indeed, this is one of the reasons that the three performance commitment were selected to have a common service level. These measures may have little financial cost, rather they require the application of management time and attention and good management systems and data. These can include aligning staff incentives to performance, rapid response to issues such as supply interruptions, better targeting of measures such as jetting of sewers to reduce

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<sup>1</sup> Ofwat, 'Reference of the PR19 determinations: cross cutting issues', March 2019, paragraph 3.32

<sup>2</sup> Ofwat, 'Overall level of stretch across costs, outcomes and allowed return on capital', December 2019, page 14 and table 9

<sup>3</sup> Ofwat, 'Introduction and overall stretch on costs and outcomes – response to cross-cutting issues in companies' statements of case', May 2020, tables 5.4 and 5.5

internal sewer flooding, and responsive and effective management of sewerage systems and sewage treatment works to reduce pollution incidents. Better monitoring and targeting may not increase costs overall as it would allow resources to be better directed to where they are most needed and can save on incident management costs.

- 1.11 If there are additional costs, the vast majority will be one-off expenditure. Some one-off measures such as upgrading local sewerage capacity to reduce internal sewer flooding and the installation of better monitoring equipment to reduce pollution incidents or the modification of pipework to allow emergency supplies to reduce supply interruptions could impose one-off costs or displace other planned expenditure. This one-off expenditure will deliver long lasting benefits for more than one control period and so would not need to be incurred again to maintain service levels. **As this expenditure is included in historical cost baselines, additional funding is not required** to make improvements in performance. The cost baselines already include an allowance for one-off expenditure based on the historical one-off expenditure made to make the performance improvements in PR14.
- 1.12 It is useful to illustrate the impact of one-off expenditure on cost baselines. If a company had a one-off cost of £5 million to fit storage tanks in the network to reduce internal sewer flooding in PR14, then that expenditure would not need to be incurred again in PR19 as the storage tanks will continue to provide that protection over the lifetime of the asset. As this expenditure has been undertaken it would be included in PR19 baselines (which are based on historical expenditure). Therefore there will be a £5 million allowance in the PR19 baseline to make a further reduction in internal sewer flooding in PR19. Additional funding for this reduction in internal sewer flooding is not required as the PR19 base expenditure allowance already has provision for this level of expenditure and the level of stretch in performance is consistent with the stretch achieved in PR14.
- 1.13 Some specific enhancement expenditure such as the environmental quality programme (national environment programme or WINEP) may also have contributed to improved performance in PR14, for example on pollution incidents through the provision of better monitoring equipment. This expenditure will not be included in historical base costs (as it was enhancement expenditure in PR14) and so is not reflected in the modelling for PR19 base costs. However new enhancement expenditure is allowed for in PR19 in addition to base expenditure. This enhancement expenditure has not been taken into account in the level of stretch on these common performance commitments. In PR19 we are increasing the enhancement expenditure from

£6.6 billion over 2014-19 to £8.3 billion over 2025, with a significantly expanded environmental programme. Our PR19 WINEP cost allowance includes for the installation of more than 3500 new monitors on sewer overflows which will help companies manage their networks and reduce pollution incidents. We have not increased the challenge on pollution incidents to take account of this additional expenditure.

**1.14 Some companies are already achieving the proposed level of stretch.**

Some companies perform well on both cost efficiency and service quality. Some cost efficient companies, individually, have already met the 2024-25 forward looking upper quartile on water supply interruptions, internal sewer flooding or pollution incidents. These companies are well placed to outperform the PR19 final determination and earn ODI outperformance payments. There is not therefore necessarily a trade-off between cost efficiency and outcome performance as good management and operations can improve both.

1.15 Five (out of 17) companies have had performance that has already met the 2024-25 performance commitment for water supply interruptions: Portsmouth Water and South Staffs Water (both companies are more efficient than our cost baseline for their water service), Hafren Dyfrdwy, Northumbrian Water and SES Water. Yorkshire Water is forecasting to meet the 2024-25 performance commitment level in 2024-25.<sup>4</sup>

1.16 Three (out of 11) companies have already met the 2024-25 performance commitment level for internal sewer flooding: Wessex Water, Anglian Water and South West Water. One company, Northumbrian Water, has met the 2024-25 performance commitment level for pollution incidents. Both Wessex Water and Northumbrian Water are cost efficient on their wastewater services, i.e. our base cost baselines will be higher than their historical expenditure.<sup>5</sup>

1.17 Some of these companies also made substantial improvements in performance over PR14. For example Northumbrian Water and SES Water reduced water supply interruptions by 65% and 71% respectively, South West Water and Anglian Water reduced internal sewer flooding by 51% and 40% respectively, and Northumbrian Water reduced pollution incidents by 71%.<sup>6</sup> It should be noted that we do not expect companies to have met all of their common

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<sup>4</sup> Ofwat, 'Introduction and overall stretch on costs and outcomes – response to cross-cutting issues in companies' statements of case', May 2020, table 7.2

<sup>5</sup> Ofwat, 'Introduction and overall stretch on costs and outcomes – response to cross-cutting issues in companies' statements of case', May 2020, table 7.3

<sup>6</sup> Ofwat, 'Introduction and overall stretch on costs and outcomes – response to cross-cutting issues in companies' statements of case', May 2020, tables 5.4 and 5.5

performance commitments already. We recognise that even an efficient company may be good in some areas and less good in others. We do however expect some companies to be well placed to earn outperformance payments over the 2020-25 period. On average the improvement required in PR19 (37%) is consistent with the improvement achieved in PR14 (35%).<sup>7</sup>

1.18 We are therefore confident that our base expenditure allowances provide sufficient expenditure for an efficient company to on average meet the water supply interruptions, internal sewer flooding and pollution incident commitment levels. We do not consider that customers should pay for catch-up for poorer performing companies to reach an efficient level of performance.

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<sup>7</sup> Ofwat, 'Introduction and overall stretch on costs and outcomes – response to cross-cutting issues in companies' statements of case', May 2020, tables 4.4