

Meeting note

Thursday 15 April 2021
11:30 am to 1:00 pm

Cost assessment working group (CAWG)

Attendees

Anglian Water	Richard Goodwin
Dŵr Cymru	Charlotte Beale
Hafren Dyfrdwy	Kristinn Mason
Northumbrian Water	Crawford Winton
Severn Trent Water	Rob Holdway
South West Water	Judith Corbyn
Southern Water	Kevin Wightman
Thames Water	Peter Trafford
United Utilities	Sam Crook
Wessex Water	David Peacock
Yorkshire Water	Daniel Chubb
Affinity Water	Carolyn Cooksey
Bristol Water	James Holman
Portsmouth Water	Steve Morley
SES Water	Van Dang
South East Water	Tim Charlesworth
South Staffs Water	Daniel Haire
CEPA	Daniel Mitchell
Ofwat	Tim Griffiths, Alison Fergusson, Beckie Paterson, Jake Wood, Paul Martin, Simon Harrow, Dave Watson, Jennie Seymour, Kerry Clayton, Joe Proffitt

Ofwat opened the meeting with an introduction to the Cost Assessment team and setting out the purpose of the CAWG.

Terms of reference

Ofwat talked through the terms of reference for the group, provided on one of the slides.

Points raised:

- Several companies welcomed the revival of the CAWG and thought it had been useful at PR19.
- Is there a planned end point for the CAWG? At PR19 it was after the modelling consultation so would it be similar this time?

There is no end point in mind at present.

- At one point there was talk of Ofwat publishing annual efficiency assessments, is this something that is still being considered? It's something that Ofwat used to do for the opex models and it provided companies with an incentive.

It's something that Ofwat is still considering but the information is available in the APR annually so anyone could update the models. We saw the impact of adding the 19-20 data so without an explanation for the changes one year's data makes to the models it may not be that useful. Also if the model coefficients change then that would change efficiency rankings for all companies.

- The terms of reference don't include retail, is there a plan for that to be included? It would be useful for retail to be discussed particularly bad debt forecast modelling.

We are happy to consider retail issues for discussion at the CAWG. However the retail models are more straightforward. If there is anything particular that companies want to discuss then we can include it.

- Will this group consider frontier shift and RPEs?

It's not something that has been included in the CAWG before and it is a separate workstream with different people involved, so it's not intended to be discussed here.

- Will somewhere be set up for contributions to be submitted between meetings?

Definitely something to take away to consider. In the meantime anything can be emailed to CostAssessment@Ofwat.gov.uk.

- Can more than one representative from each company attend?

Ideally we will keep the meetings to one representative from each company to keep discussions manageable and to give everyone chance to contribute. If a company is presenting at one of the meetings it is reasonable to have a second attendee to assist.

Boundary between base and enhancement

Ofwat talked through the current definitions, issues that arose at PR19 and through the lessons learnt exercise, and aims for this area of work.

Questions discussed in breakout groups:

- What issues are there in defining the boundary between base and enhancement?
- Where do you consider that there is inconsistent reporting across the industry?
- Are the principles for cost allocation in RAG2 sufficient for companies to allocate costs between base and enhancement?

Feedback from discussion groups

- One group thought that the distinction was pretty clear but issues arise where companies have to exercise judgement and this leads to more inconsistency. The main areas of judgement are in proportional allocation between base and enhancement and between price controls.
- Resilience is a more problematic area.
- Leakage and sewer flooding were included in econometric models at PR19 but they have historically been enhancement – this has clouded the boundary between base and enhancement somewhat.
- The boundary between growth and maintenance is difficult to define.
- If enhancement at one review then maintenance of that enhancement becomes base at the next review, do the RAGs sufficiently isolate this effect?
- The ‘permanent change’ referenced in the enhancement definition is more nuanced for supply demand balance and capacity related activity. (Current RAG4 definition provided at the end of the meeting note for reference.)
- Proportional allocation is necessary but more complex for large schemes that have an element of betterment to be allocated to base.
- As noted, some enhancement opex is future maintenance, and difficulties come in with proportional allocation, especially with overheads.

- Anywhere that definitions can be tightened up then that would be helpful, particularly on enhancement cost lines.
- Similarly allocation rules could be tightened. These work well for wholesale/retail allocation so could be improved for allocation between different areas of wholesale.

Potential approaches to the water resources control

Ofwat presented asking whether the water resources control had achieved what it set out to, key issues that need addressing.

Questions discussed in breakout groups:

- Is there scope to improve cost allocation guidance to allow separate water resource cost models to be estimated?
- Would amending the boundary to include raw water distribution assist in allowing separate models to be estimated? What are the issues involved?
- Would we need to amend the boundary to include water treatment to allow separate models to be estimated? What are the issues involved?

Feedback from discussion groups

- There is scope to improve with a focus on what we are trying to achieve and what value there is in a water resources price control. Currently companies are favouring collaboration over competition in sharing water resources.
- There was some agreement that there is a more obvious split with water resources, raw water distribution and water treatment considered together, separately from treated water distribution.
- It's unclear whether the objective is achievable by amending cost guidelines.
- There was a feeling that this should be focussed on future opportunities due to the large RCV discount and sunk costs on current water resource assets.
- It's clear that widening the pool of costs improves the models but this is due to the vertical integration of the services.
- This area may be more suited to opex modelling due to the capex being lumpy and having a disproportionate effect on a small business unit.
- Either incentivising trades or finding which model works well could dictate where the boundary should be drawn. It would be better to set the boundary for the right incentives and then get cost assessment to work for that boundary.
- It's unlikely that the efficiency challenge on a water resources control can be wholly independent of the network+ control efficiency due to trade-offs with raw water distribution and water treatment. This effect could be much reduced for an expanded water production control (WR/RWD/WT) and water distribution control (TWD) meaning we could apply challenges to both independently.

Future topics and next steps

One topic noted for the next meeting is enhancement opex, nature based solutions and the potential for capex bias. United Utilities has submitted a paper to the Future Ideas Lab and will present on this to the group.

Ofwat asked companies to send thoughts on future topics that should be discussed with the group as well as reflections on the points raised at the meeting.

The next meeting date is 26 May.

From RAG 4.09

13. Reporting base, developer services and enhancement expenditure

Broadly, **base expenditure** is required to maintain the current level of service to customers. Base expenditure will include costs relating to the day-to-day running of the business and expenditure on maintaining the long-term capability of assets, as well as expenditure to improve efficiency.

Developer services expenditure is that required by developers to provide the same current level of service to newly connected customers. It also includes expenditure to divert water and sewer mains in connection with property developments, road improvements etc.

Enhancement expenditure is generally where there is a permanent increase or step change in the current level of service to a new “base” level and/or the provision to new customers of the current service level.

Enhancement expenditure should be based from 1 April 2020.

Enhancement operating expenditure can be classified as:

- expenditure incurred in the creation and running of new capital assets; and
- expenditure on operating solutions instead of (or alongside) capital solutions to deliver service enhancements.

All of these categories of expenditure should be reported within enhancement operating expenditure.

Companies should report expenditure in the year consistently with the final determinations.

Operating expenditure for enhancement projects should continue to be reported as enhancement so that the full impact of all enhancements in the AMP is visible. If a project is commissioned mid-year companies would only report part-year running costs in year one but whole-year running costs in year two. These enhancements would then be considered base in the next period.

Local authority and cumulo rates should not be included in enhancement expenditure but reported wholly in base expenditure.