Centre City Tower, 7 Hill Street, Birmingham B5 4UA
21 Bloomsbury Street, London WC1B 3HF

Meeting note

Wednesday 26 May 2021
11:00 am to 1:00 pm

Cost assessment working group (CAWG)

Attendees

Anglian Water	Darren Rice
Dŵr Cymru	Charlotte Beale
Hafren Dyfrdwy	Kristinn Mason
Northumbrian Water	Crawford Winton
Severn Trent Water	Rob Holdway
South West Water	Mark Worsfold
Southern Water	Kevin Wightman
Thames Water	Carlos Pineda Bermudez
United Utilities	Sam Crook
Wessex Water	David Peacock
Yorkshire Water	Daniel Chubb
Affinity Water	Martin Hall
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, Matt Greetham, Stewart Loftus, Alex Whitmarsh

Ofwat opened the meeting and set out the agenda:

- Removing remaining capex bias
- How do we reflect future maintenance needs in cost assessment?
- Future meetings and CAWG plan

Removing remaining capex bias

Ofwat talked through what we mean by enhancement opex and how we made allowances at PR19.

United Utilities then presented to the group its paper “Evolving WINEP to deliver greater value” focussing on the capex bias that still remains within enhancement funding.

Questions discussed in breakout groups:

- Is there a problem to resolve?
- How material are opex solutions likely to be?
  For example is this likely to impact all nature based solutions?
  What proportion of enhancement expenditure is covered by on-going opex only solutions?
- What are the potential advantages and disadvantages of UU’s proposed approach?
  How do we separate out on-going opex only solutions from other enhancement opex?
  Will it impact on notional financeability?
- Are there alternative approaches to resolving the potential issue?

Feedback from discussion groups

- Overall the groups thought that materiality of the issue is low currently but this is becoming a bigger issue. For example this could also impact other measures such as PCC reduction. However, if all companies are addressing issues at the same pace then opex costs may be reflected in base cost models
- Assessment should be proportionate to the issue. The use of cost adjustment claims might work in the short term when it is company or scheme specific, although it was noted the high evidential bar for claims.
- Companies suggested that a NPV assessment with an associated RCV equivalent could provide certainty of ongoing funding.
- Alternatively they suggested that adding to the RCV could address this issue in principle but concerns were raised that this would break the link between the RCV and underlying assets. Any RCV additions would be susceptible to changes in WACC and run-off rates so is not necessarily a steady revenue stream and could also impact on financeability. An alternative suggested could be an RCV equivalent that is amortised over time.

- A further alternative suggestion was a multi-AMP commitment to on-going opex allowances although concerns were raised that this was not easy to implement, and requires clear definition of qualifying costs.
- It was noted that on-going enhancement costs would be reflected in base econometric models after a period of time and so the impact may only be short-term. However the current variables in econometric models are asset based. To take account of the potential scale of NBS solutions, consideration could be given to using the scale of WINEP as a dummy variable in the models.

How do we reflect future maintenance needs in cost assessment?

Ofwat talked through our approach at PR19, what the CMA said in its redeterminations and what needs to be considered to take account of forward-looking capital maintenance.

Wessex Water then presented to the group on unit cost driven cost assessment. It highlighted that econometric models do not capture all aspects of efficiency or account for levels of services. Efficiency assessments should also consider wider social and environmental costs. An efficient allowance could incorporate an assessment of activity levels to achieve outcomes and efficient unit costs.

Questions discussed in breakout groups:

- Are there ways to supplement Wessex's proposed approach?
  - Is data available to calculate efficient costs for each asset type (PR09 cost base)?
  - How do we prevent inefficient replacement volumes?
  - How do we prevent companies making up for previous under investment?
  - How do we prevent companies from replacing the cheapest assets rather than those most in need of replacement?
- How do you manage asset replacement needs within our long-term average allowance for maintenance?
- Why would forward looking capital maintenance costs be different to those in the past?
- Are there alternative ways to reflect a forward-looking element into base cost allowances?
  - For example using forward looking costs, using new cost drivers, or continuing with PR19 approach with cost adjustment claims.
  - How can we prevent customers from paying twice if we move away from basing allowances on historical expenditure (and what are the governance requirements)?

Feedback from discussion groups

- The discussions within groups were quite wide-ranging.

- Water companies considered that a unit cost approach was most appropriate for certain assets, such as infrastructure assets. It was suggested a unit cost per outcome rather than activity could equally be appropriate. Either approach would still need to be based on econometric analysis using historical data and so would have similarity to existing approaches.
- If a unit cost of renewal approach was used there would be the difficult task of determining the efficient level of activity. The optimum rate will be different for different companies.
- Companies considered that the cost base data that would be required for this approach is largely still available.
- Any approach should be tied in with asset health and resilience to ensure that improvements were appropriately targeted. A blend of both forward and backward looking approaches may be appropriate.
- Companies suggested that any approach using unit costs would need to be triangulated with other methods of arriving at cost allowances.
- The future may be different from the past and companies suggested that there could be increasing pressure on assets because of climate change, growth etc. However, there was recognition that the risk to services under these increasing pressures is not easily comparable between companies as there are many different approaches companies use to evaluate resilience risk. Greater consistency in risk assessments would be beneficial.
- Companies suggested that it was important to incentivise the best long-term approach.

Ofwat thanked attendees for their participation in the discussions and asked for views to be included in company responses to the PR24 high level design document published on 27 May.

Future meetings and CAWG plan

Ofwat set out what we intend to cover at the next two meetings, in July and September, and asked for industry insights on the topics listed.

Ofwat presented a list of topics for future meetings and asked attendees to put forward any other issues they think should be discussed within the group.

The next meeting will be scheduled in the week beginning 12 July.