



The voice for water consumers  
Llais defnyddwyr dŵr

## **CCW's response to Consultation:**

### **Assessing base costs at PR24**

## 1. Introduction

- 1.1 CCW is the statutory consumer organisation representing water and sewerage consumers in England and Wales.
- 1.2 We welcome the opportunity to respond to Ofwat's consultation. We have responded to the individual questions below. It is not in consumers' interests for money to be spent unnecessarily, ineffectively or inefficiently. From a customer perspective, it is important that they pay only for costs that are efficiently incurred. Delivering investments efficiently is something consumers expect their company to be doing. It is right for Ofwat to apply a strong efficiency challenge on consumers' behalf.

## 2. Our response

### Principles of PR24 base cost assessment

1. Do you agree with our principles of base cost assessment?
2. Do you consider any important principles are missing?

We agree with the principles as outlined. However, while we recognise that it is still Ofwat's intention to set a high evidential bar for cost adjustment claims, we think that this ought to be grounded in the principles.

### Approach to wholesale base cost modelling at PR24 Scope of wholesale modelled base costs

3. Do you consider the scope of wholesale modelled base costs should be amended at PR24? If so, please explain how the potential amendment/s to wholesale modelled base costs can be justified based on our proposed assessment framework.

We support the framework as outlined. With regard to the tests of whether certain costs should be inside or outside of modelled base costs we think it will be important to understand how the difference in treatment could change allowed costs in totality i.e. would the efficiency challenge be greater if those costs were separately assessed or within modelled base costs.

4. Would you recommend collecting additional data in relation to growth expenditure (cost and/or cost driver data) to improve cost assessment at PR24? If so, what additional data would you recommend collecting? Please provide definitions alongside suggested data additions.

If growth expenditure is going to be separately assessed then additional data seems to be a necessity. However, in view that companies have only started reporting growth expenditure in 2020/21 means that there is no historic time series to use. If Ofwat does require companies to back cast to 2011/12 it will need to be assured of the consistency and comparability of the information that companies. We would again suggest that Ofwat considers what the overall efficiency challenge would be on the basis of separate assessment and modelled within base costs

### Sample period selection

5. Do you agree that we should utilise the full historical data series available to develop the wholesale base cost models at PR24 (from 2011-12 onwards) unless there is clear justification for using a reduced time series (e.g. structural break that cannot be addressed through other remedies)?

We agree that the full historical data series should be used.

6. Should we consider including business plan forecasts in our wholesale base cost models at PR24?

We think this is an area worth exploring. However, Ofwat would need to gauge the extent to which companies' forecasts provided at previous price reviews represented a good indicator of actuals. In the absence of this there would not seem to be much value in inclusion. If this is the route Ofwat goes down it will again be necessary to be assured of comparability and consistency of data between companies. It would also be interesting to gauge the efficiency challenge inclusive and exclusive of business plans forecasts to gauge if the cost allowance would be materially different under each approach.

### **Target modelling suite**

7. Do you agree with our proposed target wholesale base cost modelling suite at PR24?
8. Do you consider it would be worthwhile attempting to develop wholesale wastewater network plus models for PR24? If so, do you propose any potential wastewater network plus cost model specifications to consider? Cost drivers and explanatory variables

We think that if the modelling suite changes from PR19 it is important to understand how any different modelling approach changes the efficiency challenge and cost allowance in its own right.

9. Do you think we should reconsider the inclusion of APH in the wholesale water base cost models at PR24? If so, should it be a substitute for, or additional to, booster pumping stations per length of mains?

Key to this is whether the data issues and concerns about statistical significance can be overcome. If these can be overcome whether APH is a substitute for or additional to booster pumping stations depends on (a) relative strength of the cost driver (b) relative confidence in the data

10. Should we consider replacing the existing 'load treated in size band 6' variable with 'load treated in band 8 and above' in the relevant wholesale wastewater base cost models?

This decision should be dictated by whether the data limitations of this approach (no data available 2013-16) are outweighed by the ability to better account for economies of scale in sewage treatment.

11. Please provide detailed proposals for any additional / alternative cost drivers and explanatory variables we should consider at PR24, including clearly defined data requirements that would need to be collected from companies.

No comment

### **Model estimation method**

12. Do you agree that we should maintain the use of random effects to estimate our wholesale base cost models at PR24?

We think that Ofwat should use the model estimation technique that performs best on the statistical tests.

### **Model selection process**

13. Do you agree with our proposed model selection process?

We agree

### **Cost adjustment claims**

We agree that there should be a high evidential bar for companies' cost adjustment claims. As the consultation paper points out companies are incentivised to put cost adjustment claims in if they think modelled costs understate their expenditure needs. There is no such incentive should modelled costs overstate these needs. There is therefore a risk that companies could spend a disproportionate amount of time engaging with stakeholder groups and Ofwat to 'promote' and get support for cost adjustment claims that are eventually rejected due to poor evidence.

We would welcome Ofwat factoring in the quality of cost adjustment claims into its assessment of PR24 business plans.

We agree that PR24 cost adjustment claims should be symmetrical as this will protect customers from the risk of a one-sided cost adjustment claim process.

14. Do you agree that the cost adjustment claim process at PR24 should be separated between base (wholesale and residential retail) and enhancement claims?

We agree for the reasons outlined in the consultation document.

15. What base cost adjustment claims (wholesale and residential retail) would you consider submitting if the PR19 base cost models were used to assess efficient costs at PR24?

No comment

16. What additional cross-sector data should be collected to support the submission of the claims indicated in response to the previous question? Please describe and explain the rationale behind the additional data that you consider should be collected and provide a draft definition.

No comment

17. How can the cost adjustment claim guidance be enhanced to improve the quality of cost adjustment claim submissions?

No comment

18. Would an early cost adjustment claim submission be welcome at PR24?

To the extent that this is likely to improve the quality of cost adjustment claims then we agree

### **Capital maintenance and asset health**

19. Do you agree with the different elements / approaches to introducing more of a 'forward-look' into our approach to assessing capital maintenance expenditure? Are there other elements / approaches we could consider?

As the consultation indicates, the risk of a more forward looking assessment is that customers could end up paying twice for maintenance. Any forward looking approach should guard against this.

As the consultation paper notes, companies have found it difficult to evidence why historic spend is not a good indicator of future spend requirements. Where ongoing maintenance needs represent a stepped change from historic levels we feel that companies must persuade Ofwat that this is the case.

It seems to us that a pre-requisite for forward looking approach is that companies' business plan forecasts represent efficient costs. If companies' costs are inflated to any degree this could have a distortive impact on the efficiency challenge.

20. Do you have any comments on the proposed long list of asset health measures in Table 5, particularly in relation to their suitability and how feasible they are to collect? Please include any reporting or definition changes you would like us to consider and provide suggestions for other measures not included in this list.

While companies are better placed to address the technical data they would need to gather, the range of asset health measures proposed in the paper is comprehensive. The availability of company data for these metrics could provide a transparent picture of the condition and reliability of water and wastewater assets. We welcome the inclusion of new maintenance activity measures as this would provide greater transparency of what companies are delivering in return for their base cost allowances.

Ofwat should use its Outcomes Working Group to consult companies and other stakeholders further on the suitability of the asset health measures. Consideration of what these measures mean to customers as an overall package is required. While these are mainly technical measures, they could inform 'plain English' reporting to customers about how well companies' assets are serving customers, which companies need to improve, and to what extent companies are keeping their commitments to maintain assets.

The Group also needs to consider how the asset health measures work alongside other common Performance Commitments that Ofwat is considering (for example, asset health measures correlate to PCs on sewer flooding and water supply interruptions).

Additionally, the use of Outcome Delivery Incentives for all common PCs risks customers paying rewards twice for the same activity. For example, if a company achieves its targets on asset health measures and earns a reward, it may also earn an additional reward for reducing supply interruptions or sewer flooding. This must be avoided.

### **Cost-service link**

21. Do you agree with the high-level approach to determine 'what base buys'? Can you define any additional analysis or information that could support this process?

We welcome any attempt to draw a more explicit link between cost allowances and performance levels. We agree that the approach as outlined represents a pragmatic and proportionate way forward. We do question how many PCs will lend themselves to this approach where a common

performance level is set. It may be that different levels of performance are merited. We are unclear if this could be factored into the approach as outlined.

We see merit in the banded approach to historic performance improvement. This effectively recognises diminishing returns so companies at the frontier of performance would be expected to have more limited scope to improve than those in the bottom quartile.

22. Do you consider it would be feasible to assess the 'efficient' baseline performance level for each company for individual PCs such as leakage and PCC through econometric modelling? Are there any other PCs where you consider this could feasibly be attempted?

Where econometrics is likely to elicit the efficient baseline performance then we agree this should be explored. As the consultation paper makes clear, it will be imperative for consistency of approach through robust definitions. However, where those performance commitments involve emotive topics such as leakage or could conceivably seek to change customer behaviour such as per capita consumption we question whether econometrics can accommodate these aspects. Any approach should not lose sight of the customer view of acceptable performance.

23. The need to collect further granular data to elucidate the cost-service relationship was highlighted by companies in response to our PR24 May consultation. Can you propose any data it would be proportionate to collect to support the high-level approach outlined in this chapter?

No comment

24. What are your views on attempting to use of a composite variable to investigate the cost-service relationship, in the context of the methodological issues and complexities we outlined?

To the extent that any composite variable does not risk masking performance of individual elements that matter to customers we think that this could be explored. However, the paper recognises that within each composite variable there would be a need to assign weightings to each individual element. It may prove difficult to capture appropriate weightings if there is considerable variability between companies. We wonder whether it would be worthwhile exploring what customers think of appropriate weightings in this regard.

25. Do you have any proposals for how to make adjustments where a performance commitment level differs from that expected to be delivered from base costs?

It may be more appropriate to take this into account in the up front cost allowance rather than through ODIs. Our research has consistently found that customers value stability of bills so where there is explicit customer support for performance that is greater or lower than that funded by base then pricing this in at the outset could avoid unnecessary bill volatility further down the line. Where any up front allowance is made, we would expect the ODI regime to be calibrated so customers are protected from any incremental cost between base and enhancement in the event of underperformance against targets. We would welcome the opportunity to explore the pros and cons of this further.

## **Residential retail cost assessment**

26. Do you have any comments regarding our proposal to ask companies to separate out the part of their provision of bad debt costs to do with Covid-19 that was made outside of their standard methodology in the PR24 business plan tables?

In view of the different approaches adopted by companies concerning Covid-related costs and the feeling that provision for doubtful debt as an indicator of bad debt costs has reduced we agree with Ofwat's approach to separate out provisions for Covid outside of the standard methodology. Whilst companies increased provision for bad debt because of Covid, with regard to their actual costs companies have reported relative stability and no significant escalation in debt. This confirms the disjoint between provision for and actual bad debt costs

27. What guidance would aid companies to provide appropriate data related to the provision of bad debt costs to do with Covid-19?

No comment

## **Enquiries**

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