

Meeting note

Thursday 11 November 2021
11:00 am to 1:00 pm

Cost assessment working group (CAWG)

Attendees

Anglian Water	Richard Goodwin Andrew Snelson
Dŵr Cymru	Charlotte Beale
Hafren Dyfrdwy	Kristinn Mason Nathaniel Sear
Northumbrian Water	Geoffrey Randall Crawford Winton
Severn Trent Water	Robert Holdway Kay Orsi
South West Water	Judith Corbyn Jane O'Connor
Southern Water	Michael Kearns Kevin Wightman
Thames Water	Carlos Pineda Bermudez Michele Zarri
United Utilities	Sam Crook
Wessex Water	Harriet Cutts
Yorkshire Water	Daniel Chubb Alex Starling
Affinity Water	Martin Hall
Bristol Water	George Clarke
Portsmouth Water	Caroline Jemphrey
SES Water	Van Dang
South East Water	Matt Hersey
South Staffs Water	Daniel Haire
Ofwat	Tim Griffiths, Daniel Mitchell, Gilda Romano, Paul Martin, Simon Harrow, Rebecca Paterson, Shivani Lad, Sarah Watson, David Watson, Alex Whitmarsh.

Introduction

Ofwat opened the meeting, introduced the team and set out the agenda:

- Background on PR19 cost adjustment claims and looking ahead, Ofwat
- Cost adjustment claims, Severn Trent
- Band 6 sewage treatment works disaggregation, Anglian Water
- Closing remarks

Background on PR19 cost adjustment claims and looking ahead

Ofwat recapped the process for assessing cost adjustment claims at PR19, including the scope of the process, the gates used to assess claims, the materiality thresholds, and the implicit allowance. Ofwat noted that the need for adjustment is the most important gate for base cost adjustment claims, and where it is rejected the claim is failed.

Ofwat noted that the cost adjustment claim process was one-sided at PR19, as companies have an incentive to make claims where the models are underestimating their allowance but not in areas where the allowance is overestimated. This could lead to customers not being adequately protected from cases where the models overestimate companies' expenditure requirements.

Ofwat gave a high-level summary of the cost claims received at PR19 on base costs, growth expenditure and enhancement costs. This review indicated that base cost claims at PR19 related to factors that are not 'unique' to the company (eg density, economies of scale), and, if appropriate for an adjustment to be made, would lend themselves well to symmetrical cost adjustments at PR24.

Ofwat provided some initial considerations on improvements to the cost adjustment claim process at PR24. These related to:

- separating the cost claim process between base and enhancement, with enhancement claims being submitted to the relevant enhancement area;
- base cost adjustment claims being symmetrical by default at PR24, with companies expected to set out in their submission how an adjustment to the company would impact the rest of the sector;
- identifying new industry-wide data collection requirements early on in the process, to enable the data to be collected and high-quality cost claims to be submitted;
- where a claim wasn't submitted or was rejected at PR19, the company would need to clearly set out the evidence of a material change in circumstances since PR19;
- the oversight of the PR19 base models should improve the quality of the claims, which would be considered as part of the assessment of PR24 business plans; and

- improvements on the visibility of the calculation of the implicit allowance, such as a separate gate distinct from the need for adjustment.

Cost adjustment claims, Severn Trent

Severn Trent provided its reflections on the cost adjustment claims process ahead of PR24. It recapped the premise for cost adjustments and provided a potential categorisation of different types of claims: atypical base costs (related to factors relevant for few companies); typical base costs (related to factors relevant for the industry); enhancement unmodelled claims (deep dives); and enhancement modelled claims. It suggested that clarity over the assessment approach of the different types of claims would help (eg flow diagram).

Severn Trent suggested that improved oversight of the models and clarity on the implicit allowance would improve submission of cost claims. It noted that at PR19 it was hard to replicate approaches taken to calculate the implicit allowance, and repeatability and visibility could be enhanced at PR24. It also noted that claims could either fall in a zero, partial or full implicit allowance scenario, and that where base costs have been incurred in the past the implicit allowance would always be greater than zero. It suggested that improved clarity over the interaction with the need for adjustment gate would also be beneficial.

Severn Trent indicated that an improved data collection process could be desirable for a more robust assessment process of cost claims and to make adjustments. It proposed some examples of areas where new or improved data could be collected on base costs at PR24.

Band 6 sewage treatment works disaggregation, Anglian Water

Anglian Water presented its analysis on the disaggregation of the 'band 6 and above' sewage treatment works. It recapped the data availability for this area, with key missing data years being 2013-14, 2014-15, and 2015-16.

Anglian Water indicated that, according to 2020-21 data, band 6+ accounts for a large share of the industry treated load, and it could be split up into smaller bands to better account for economies of scale at the larger treatment works. It proposed a split of band 6+ in smaller bands (6-10), but said that the precise point for disaggregation of bands was still open for consideration.

Anglian Water showed that its analysis of unit costs indicated the presence of declining unit costs, ie economies of scale. It suggested the current approach could disadvantage companies without very large works, such as Anglian Water.

Questions for the breakout groups covered the three presentations:

1. Do you agree that cost adjustment claims should focus on base costs at PR24?

2. Assuming the PR19 wholesale base cost models are used to assess efficient base costs at PR24, what cost adjustment claims would you consider submitting?
3. What additional industry data would need to be collected to support the submission of well evidenced cost claims and allow companies and Ofwat to assess cross sector impacts of any adjustment?
4. Do you consider there is a case for breaking down band 6 sewage treatment works along the lines suggested by Anglian Water? Could this be implemented as a symmetrical adjustment?
5. What modifications/clarifications to guidance and approach would help you to improve the quality and reduce the number of cost adjustment claims submitted?

Feedback from the discussion groups

Q1) Do you agree that cost adjustment claims should focus on base costs at PR24?

Around half of the companies agreed that the cost claim process could be split between base and enhancement, with cost claims focused on base. Comments made included:

- support for separating out the adjustment process across base and enhancement;
- support for more visibility of the implicit allowance calculation and a separate gate distinct from the need for adjustment;
- early sight of the base models may reduce cost claims;
- a flow chart or decision tree may be helpful, to clarify where/how each investment is assessed; and
- if cost claims were symmetrical, companies may need the right to respond to other claims.

However, concerns were expressed by some companies around enhancement claims. Companies noted that an adjustment process would be needed for enhancement expenditure too, although the lack of sight of the enhancement models (which are based on forecast expenditure and therefore will not be known until the business plan submissions) may make it challenging for companies to identify cost claim requirements. Ofwat clarified that enhancement expenditure would need to be justified within the relevant business plan line, as the enhancement models are unlikely to be known in advance.

In addition, although companies acknowledged that the majority of claims are either on base or enhancement, it was flagged there may be instances of cross-over, which may be difficult to fit in if the process was too siloed.

One company noted that at PR19 there were instances where part of the reason given for rejecting the claim was because the company was already receiving a higher base cost allowance than requested. The company considered that claims should be looked at

independently of allowances, otherwise this may not incentivise companies to stretching business plan submissions. Ofwat acknowledged the point made but noted that it is important to consider allowances in the round given the information asymmetry between itself and companies. This is why it was important that companies explained why allowances, in the round, would be insufficient to accommodate special factors without a claim when it submitted evidence against the 'need for cost adjustment' assessment gate at PR19.

Q2) Assuming the PR19 wholesale base cost models are used to assess efficient base costs at PR24, what cost adjustment claims would you consider submitting?

Table 1 below summarises the potential areas companies indicated in their initial feedback on PR24 base cost adjustment claims.

Table 1: Areas for potential base cost adjustment claims at PR24

Company	Initial considerations on PR24 base cost adjustment claims
Anglian Water	Growth; capital maintenance; sewage treatment bands disaggregation.
Dŵr Cymru	Sparsity/density; income deprivation for residential retail.
Hafren Dyfrdwy	Tightening consent at sewage treatment works; particularly phosphorus.
Northumbrian Water	N/A
Severn Trent	Nature-based solutions.
Southern Water	At PR19 the company submitted mainly enhancement claims. Going forward it could consider claims on large sewage treatment works, p-removal (unless addressed by the base models), maybe growth.
South West Water	Density (variation within regions and variation in population levels during the year, such as tourist peaks); UV treatment.
Thames Water	London network age and condition (particularly mains replacement).
United Utilities	Not different from areas indicated in Ofwat's presentation, unless there was a change in circumstances.
Wessex Water	N/A
Yorkshire Water	Increased opex due to p-removal programme (potential for a p-complexity variable in the base models).
Affinity Water	Soil resistivity (geological impacts on mains); water treatment technologies (different technology across bands).
Bristol Water	Canal and River Trust cost claim.
Portsmouth Water	N/A
SES Water	Topography (average pumping head); leakage reduction (technology of detection); water softening; residential retail (WOC cost profile not captured in the models).
South East Water	Water resources / treatment complexity (eg greensand boreholes are more expensive); growth (given uncertainty around assessment process).
South Staffs Water	Energy requirements (average pumping head); UV treatment; income deprivation.

Q3) What additional industry data would need to be collected to support the submission of well evidenced cost claims and allow companies and Ofwat to assess cross sector impacts of any adjustment?

High-level areas where further data requirements may be needed were indicated as growth, density, and water treatment complexity. In relation to the London network, potential areas were indicated as pipe material, repair rate, volumes, number of joints, traffic loading. Average pumping head was indicated as an area where improved data would be beneficial, with work having already started through the cost assessment working group.

One company said it would be helpful to collect information on the additional costs of nature-based solutions, similarly to the data companies have to provide in relation to green recovery schemes.

One company noted there may need to be further guidance on how many years of historical data would be enough to build a strong enough case. It also noted that the old serviceability metrics may be helpful to collect historical data as several companies should still report these metrics, and they could be more amenable to industry data collection.

It was flagged that additional data requirements could increase the data burden on top of the Annual Performance Report process, and additional areas for collection may have to be focused.

Q4) Do you consider there is a case for breaking down band 6 sewage treatment works along the lines suggested by Anglian Water? Could this be implemented as a symmetrical adjustment?

Some companies expressed support for disaggregating band 6 sewage treatment works. It was suggested capex data also could be looked at to better understand the picture given that Anglian Water's analysis focused on opex.

However, other companies expressed the concern that disaggregating the band may be appropriate for Anglian Water but not other companies, and that using higher bands may lead to a range of big outliers. One company noted that the charts shown in Anglian Water's presentation do not appear to show significant economies of scale above band 6.

Companies noted that the choice of thresholds should be driven by engineering logic, otherwise there is a potential risk that the selected thresholds could be subjective (parallels were drawn to the high density/sparsity variables developed at PR19, which were ultimately not used due to the high degree of subjectivity of the thresholds used).

It was suggested that the bands could be weighted, similarly to the approach taken for the water treatment complexity variable. Ofwat asked Anglian Water for suggestions on how the bands could be weighted.

One company suggested a similar assessment could be carried out on the water treatment work bands too. Ofwat invited this feedback to be put forward in response to the paper being published in December on base costs.

Q5) What modifications/clarifications to guidance and approach would help you to improve the quality and reduce the number of cost adjustment claims submitted?

Improvements suggested related to:

- early sight of the base models;
- improved data quality;
- improved guidance on the implicit allowance calculation (eg pre or post efficiency);
- improved template to present the gross and net value of the claim; and
- a cost adjustment claim early submission to allow companies to receive feedback from Ofwat and potentially to provide feedback on other companies' cost claims.

Closing remarks

Ofwat said that no further CAWG sessions have been planned for the year. Further sessions could be considered in the new year (eg on enhancement), but they should be driven by companies' work on a specific area, the benefits of a group discussion and the level of engagement of companies in the discussions.

Ofwat asked companies to come forward if there are any areas they would like to present on in the new year.