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

Meeting note

Tuesday 12 October 2021
11:00 am to 1:00 pm

Cost assessment working group (CAWG)

Attendees

Anglian Water	Iain Amis Richard Goodwin
Dŵr Cymru	Charlotte Beale
Hafren Dyfrdwy	Kristinn Mason
Northumbrian Water	Crawford Winton
Severn Trent Water	Robert Holdway
South West Water	Judith Corbyn Jane O'Connor
Southern Water	Michael Kearns
Thames Water	Carlos Pineda Bermudez Carl Smith
United Utilities	Sam Crook
Wessex Water	Harriet Cutts
Yorkshire Water	Daniel Chubb
Affinity Water	Martin Hall
Bristol Water	George Clarke James Holman
Portsmouth Water	Jamie Jones
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, Phillip Dixon.

Introduction

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

- Background on PR19 growth cost assessment and looking ahead, Ofwat;
- Growth cost assessment at PR24, Anglian Water;
- Nutrient neutrality, Ofwat;
- Closing remarks.

Ofwat said at the end of the session there would be a poll to gather views on future Cost Assessment Working Groups (CAWG), with questions having been circulated a day in advance to allow companies to consider their response in advance of the session.

Background on PR19 growth cost assessment and looking ahead

Ofwat clarified that the scope of the presentation would exclude broader aspects related to the regulation of developer services and its evolution at PR24, as the focus of the session was on the cost assessment of growth expenditure.

Ofwat presented a recap on the evolution of the PR19 approach to setting cost allowances in this area, with regards to: the modelling approach; the forecast of growth adopted; the separate unit cost adjustment; the deep dives; and the end-of-period reconciliation mechanism (DSRA). Ofwat discussed the challenges faced in relation to cost allocation of growth expenditure at PR19. It also set out the conclusions the CMA reached during the PR19 appeals, which substantially agreed with our PR19 approach to assessing growth expenditure. The minor changes made by the CMA in relation to the growth unit cost adjustment and the scope of the DSRA were recapped to ensure common understanding of the changes ahead of the breakout room discussions.

Ofwat moved on to summarise the work undertaken since PR19 and the feedback received from stakeholders in response to the PR24 May 2021 consultation 'PR24 and beyond: Creating tomorrow, together'. As part of their consultation feedback, a number of companies flagged the assessment of growth expenditure as a key area to prioritise at PR24, and indicated that growth expenditure should be removed from base costs and assessed separately at PR24. Ofwat also recapped the changes made to the definition of growth expenditure in 2020-21 Regulatory Accounting Guidelines (RAGs).

Ofwat concluded its introduction by setting out the outstanding questions related to cost allocation issues and the key questions on the cost assessment approach at PR24.

Growth cost assessment at PR24

Anglian Water presented a discussion on the assessment of growth expenditure at PR24.

It set out a distinction between standard and strategic growth, whereby the former is standard and repeatable, and the latter is more complex and lumpy. It discussed the drivers of both types of expenditure, suggesting the former could be modelled relatively simply, while the latter may require a more nuanced assessment. To exemplify the challenges related to location, asset headroom and timing of strategic growth, it presented a short case study on one of its long-standing development projects (Alconbury Weald / Huntingdon).

Anglian Water went on to outline potential areas for additional data collection to inform PR24 and PR29 assessment of growth-related expenditure. It also put forward some suggestions for how assessment of strategic growth expenditure could be improved:

- Using company spatial planning to determine forward growth enabling programme of infrastructure and treatment capacity.
- Using planning data to forecast development level requirements with trigger points for investment.
- Considering the timespan of the plots enabled through investment within cost assessment.
- Infrastructure charges to fund investment from developer customers over longer period to allow fairness of charges between AMPs.
- Reconciliation of growth enabled due to prevailing housing market activity.

Questions for the breakout groups were:

1. Do you think we should consider different cost assessment approaches for “standard” growth (i.e. site specific) and “strategic” growth (i.e. network reinforcement and wider growth)?
2. Which approaches would be more suitable to each area?
    a. Remain in base costs
    b. Standalone benchmarking model(s) [backwards and/or forwards looking]
    c. Shallow/deep dive
    d. Other
3. What data do you currently capture on “strategic” growth costs and drivers? Would it be proportionate to report this additional data?
4. Is there evidence that the DSRA should be changed at PR24 (e.g. adopt the CMA approach)?
5. The changes to reporting requirements in 2020-21 APRs should have improved cost allocation issues:
    a. Will the changes (e.g., new split of “standard” growth - tables 4N and 4O) enable better cost assessment?

b. Are there outstanding concerns over cost allocation between growth, maintenance and other enhancement lines (e.g. SDB)? If so, how can these be mitigated?
c. Are there concerns over the allocation of overheads? If so, how can these be mitigated?

Feedback from the discussion groups

Q1) Do you think we should consider different cost assessment approaches for "standard" growth (i.e. site specific) and "strategic" growth (i.e. network reinforcement and wider growth)?

Generally, companies considered that it may be appropriate to model growth expenditure outside of the base cost econometric models (i.e., assess growth separately) if it is possible to develop robust standalone growth models,. Comments made included:

- Separating growth costs into 'standard' and 'strategic' may help to compare growth costs on a consistent basis across the industry. Particularly as lumpy growth-related investments tend to stand out more for smaller companies compared to larger companies (i.e., relatively large proportion of total expenditure).
- But there is a question on where to draw a line between standard and strategic growth and which activities to include under each category. Particularly when many new developments are likely to lead to standard and strategic growth costs being incurred.
- It was suggested that a different split between standard and strategic growth may be appropriate, based on what developers contribute to (e.g., site specific and network reinforcement) and don't contribute to (e.g., treatment works enhancements; water resource enhancements; etc.). This approach would also ensure alignment to developer charges.
- The boundary between growth related costs and capital maintenance was highlighted as a potential issue that will need to be considered if growth related costs are assessed separately from base costs, as well as the allocation of cost overheads.
- It was suggested that Ofwat could ask companies how well the current definition of developer services maps to standard and strategic growth.

Q2) Which approaches would be more suitable to each area? a. Remain in base costs; b. standalone benchmarking model(s) [backwards and/or forwards looking]; c. shallow/deep dive; d. Other

In relation to the cost assessment of standard growth, points made included:

- Standard growth should be more suitable for standalone modelling as the activities are more standardised/uniform, which would enable for comparative benchmarking. Unit cost comparisons may also provide a good starting point.
- But it was also recognised that this will not be a trivial task as there are many different drivers of site-specific developer services costs (e.g., services required; household versus non-household; level of contestability) and there are also likely to be cost allocation issues.
- The additional developer services data collection should support the assessment, as well as the changes made to the 2020-21 RAGs. But it was noted that only two or three years of data in the current format will be available by PR24.
- Local planning data could be used, as it is outside companies' control. But it was also recognised that local planning data forecasts tends to be 'aspirational' and may therefore overestimate housing growth.

In relation to the assessment of strategic growth costs, companies recognised it will be more challenging than the assessment of standard growth. Points made included:

- Strategic growth can be site/area specific and relatively bespoke to each company. There are many localised strategic growth drivers, including treatment capacity headroom and local authority growth rates. It could therefore be difficult to develop a one-size-fits-all approach (e.g., econometric model) to assess strategic growth costs.
- Treating strategic growth like other enhancement areas may be appropriate, including a mix of benchmarking analysis (e.g., unit cost and/or econometric benchmarking analysis) and deep dives / cost adjustment claims.
- There was a recognition that deep dives would be resource intensive for Ofwat and the importance of developing an independent benchmark was acknowledged – it was suggested that, even if the modelling was not perfect, it would be important to create a process that is amenable to an adjustment (e.g., cost adjustment claim or reconciliation mechanism).
- Unit cost benchmarking for strategic mains (i.e., per km of main) and additional treatment capacity (i.e., per Ml/d of additional capacity) may be worth considering.
- An assessment based on whole life costs could be considered given that strategic growth may not fit with the 5-year investment cycle.
- Alternatively, standard and strategic growth could be assessed collectively, with cost adjustment claims raised for strategic growth not sufficiently allowed for through the cost assessment approach.
- If strategic growth was retained in the base cost models, capacity and population growth could be considered as additional cost drivers (the endogeneity of capacity was noted).
- The intrinsic link between growth related costs, long term strategic plans, Water Resource Management Plans (WRMPs), and Drainage and Wastewater Management Plans (DWMPs) must be considered when companies produce their business plans and Ofwat assess efficient costs.

- It was said it would be helpful to have clear guidance on how Ofwat will assess strategic growth (and any deep dives).

It was noted that there are three strands of data: pre-2021, 2021-2024 and forecasts. Recent historic and forecast data may be the most useful. Appropriate weights may need to be applied to the three periods of data.

Concerns were raised on the use of the Office for National Statistics' (ONS) household projections to forecast growth, which are backwards looking. It was said it would be helpful if Ofwat could set out its thoughts on the topic to ensure business plans are developed in line with Ofwat's growth forecast. However, it was also noted that a reconciliation mechanism (whether in-period or end-of-period) would mitigate any discrepancy between companies' and Ofwat's forecast of growth. It was noted that companies should clearly set out the assumptions applied to develop their business plans.

It was also noted that site-specific activities (subject to competition) could be entirely taken out of the price control, which appears to be one of the options being considered for future regulation of developer services.

Q3) What data do you currently capture on "strategic" growth costs and drivers? Would it be proportionate to report this additional data?

Overall, companies considered the variables proposed by Anglian Water should be relatively straightforward to provide. But they would need to confirm this with engineers and data specialists. Ensuring data consistency between companies will be the biggest challenge. It was also noted that big projects, such as the Huntingdon example presented by Anglian Water, tend to be carried out by NAVs now, and incumbent companies would not have such granular data available.

It was noted that treatment capacity headroom may be an interesting factor to report on. But it would need to be reported at a zonal level, which may be challenging to provide in a robust and consistent way (e.g., treatment of assets on the boundary). An additional complexity is that strategic growth investments can take place far away from where the growth happens. Reporting net additional capacity requirements as a result of big new development projects (such as Anglian Water's Huntingdon) may be helpful. But another company noted its growth is driven by infills rather than mega developments.

Before adding any additional data to the Annual Performance Reports, Ofwat could test any future data requirements in relation to strategic growth through a data request like the one on developer services site-specific data. But it was noted that recasting historical data is likely to be challenging.

Q4) Is there evidence that the DSRA should be changed at PR24 (e.g. adopt the CMA approach)?

Companies recognised that the introduction of the DSRA at PR19 is an improvement from PR14, although it was noted it is difficult to evaluate the impact with just one year of data. It was noted that ONS projections appear to be below outturn growth for most companies even during the year impacted by Covid, and this could lead to quite a large adjustment at the end of the period.

The general view was that it is difficult to comment on whether the DSRA should be changed at PR24 prior to knowing what the regulation of developer services is going to be. For example, a revenue adjustment mechanism may not be required if site-specific developer services are taken outside of the price control.

Additional comments made were that it could be made an in-period (rather than end-of-period) adjustment.

Q5) The changes to reporting requirements in 2020-21 APRs should have improved cost allocation issues: a. will the changes (e.g., new split of "standard" growth - tables 4N and 4O) enable better cost assessment? b. are there outstanding concerns over cost allocation between growth, maintenance and other enhancement lines (e.g. SDB)? If so, how can these be mitigated? c. are there concerns over the allocation of overheads? If so, how can these be mitigated?

In terms of the allocation between growth, maintenance and supply demand balance (SDB), there were no conclusive comments made. It was noted this may be more of an issue for the reporting of strategic growth (e.g., overlap between growth at treatment works and maintenance), and in any deep dives it may be appropriate to ask a question about cost allocation.

Companies noted that overhead costs are often allocated using a top-down approach rather than at the project level. It was noted is difficult to know the level of alignment between companies. Companies said that the sector could do a lot of work on standardising overheads but it is unclear to what extent this would drive the assessment of growth expenditure forward. Ofwat noted the RAGs 2021-22 set out improved guidance on the allocation of overhead costs, including allocation of overheads for developer services.[1]

One company noted the line between risk of sewer flooding and resilience is potentially a blurred one, as it is difficult to understand the definitions.

---

[1] Ofwat, ' IN 21/03 Regulatory accounting guidelines 2021-22', October 2021, p. 3.

Written responses were asked by COP 22nd October where this question was not discussed or there were additional comments to be made.

Nutrient neutrality

A short discussion was held on the issue of 'nutrient neutrality'. Ofwat recapped the background and said this is a fast-moving policy area. It asked the group for reflections on whether nutrient neutrality will require changes to the cost assessment approach and/or the regulatory framework at PR24.

Anglian Water noted that the current structure of developer services charges does not allow to charge developers for treatment expenditure. It said it will provide a written response on the issue.

Closing remarks

Ofwat asked companies to send written responses on the topics discussed by COP 22nd October.

Ofwat noted no further CAWG sessions are planned in the year. It opened two polls to collect feedback from the group on future CAWG session.

The first poll asked whether companies would welcome a CAWG session on cost adjustment claims in November. The majority of respondents (89%) said they would welcome such a session.

The second poll asked for any other areas where companies wish to present on in future CAWG sessions. The following topics were suggested:

- Average pumping head as a power cost driver
- Disaggregation of large treatment works
- Enhancement modelling (WINEP)
- Forecasts of cost drivers
- Calculation of the catch-up efficiency challenge
- Econometric cost assessment methodologies – dynamic panels
- Bioresources cost assessment
- Productivity assumptions (frontier shift)
- A meeting for Ofwat to present key points from the December consultation, perhaps with responses from companies on specific points
- Splitting out water complexity bands
- Water resources cost assessment and allocation.

Ofwat noted that sessions have already been held on some of the topics mentioned above, including average pumping head, water resources and bioresources.[2] [3]

Ofwat set out a window of two weeks for volunteers to come forward about presenting at a November session on cost adjustment claims.

Ofwat also noted that future sessions would depend on the need for a cross company discussion (for example to take account of new information), the willingness of companies to present at future sessions and the level of engagement of companies in the discussions. We stated that at present we are focused on our consultation on base models in December and would consider the need for a session on enhancement costs in the new year.

[2] PR24 cost assessment working groups.
[3] Review of the bioresources market.