

Meeting note

Friday 21st January 2022
10:30 am to 12:15 pm

Cost assessment working group (CAWG)

Attendees

Anglian Water	Hydreace Ali
Hafren Dyfrdwy	Sindra Shaheen
NWL Northumbrian Water	Crawford Winton
Severn Trent Water	Robert Holdway
Southern Water	Kevin Wightman
South West Water	Judith Corbyn Jane O' Connor
Thames Water	Stela Bagasheva
United Utilities	Sam Crook
Welsh Water	Charlotte Beale
Wessex Water	Harriet Cutts David Peacock
Yorkshire Water	Colin Fraser Tessa Kadicheeni
Environment Agency	Mat Davis Clive Humphries
Jacobs	Zac Alexander
Ofwat	Alex Whitmarsh, Rob Lee, Tim Griffiths, Kirelle McManus, Gilda Romano, Enrico De Vivo, Daniel Mitchell, Eugenia Vela, Alexandros Maziotis

Introduction

We introduced the meeting and set out the agenda as per our slides. (These slides are published alongside this document.)

Better cost allocation

We introduced this topic as per our slide pack and asked for feedback on a selection of options. Questions for the breakout groups were:

- Do you agree with our approach?
- Is there anything else we can do to improve the consistency of historical data?

Breakout group feedback

Overall, there was general agreement with our proposed approach.

There were some concerns that adjustments for early years of the sample period may require assumptions and be less precise. It was also pointed out that companies may use different approaches to making assumptions, creating consistency issues. On the one hand, some companies suggested that earlier years of the sample could be dropped, to favour accuracy of the data over a longer time series. On the other hand, it was also noted that losing data points in the bioresources models could be problematic, given the perceived lower quality of these models compared to other wholesale base models. It was also noted that the inclusion of more years of data is important for econometric purposes because it could increase the robustness of cost assessment models.

One company suggested that, rather than dropping earlier years of the sample, the lower accuracy of adjustments for earlier years could be mitigated using a triangulated suite of models and using quality grades as part of the data request.

A company proposed the inclusion of a narrative when providing data and making data adjustments. This could make Ofwat's review easier, ensure data consistency across companies and potentially enable subsequent guidance.

One company raised a concern regarding the timescale of this work. It noted that this piece of work could be implemented more smoothly by avoiding busy period with companies' APR submissions, so requested that Ofwat issue the final version of its request as soon as reasonably possible.

Additional comments made were:

- adjustments for energy may be more accurate than adjustments for sludge liquor; and
- the adjustments should not impact wholesale water costs.

Better targeted cost assessment

We presented the proposed approach for bioresources and asked for feedback on a number of key issues.

Clarification questions

After presenting the slides, we invited clarification questions. Questions tended to focus on how financing costs would be captured in the new approach. We summarised our approach as set out in the consultation and also described potential options where the issue raised was not covered in our consultation.

We welcomed discussion in breakout groups. Our questions were:

- whether the design of the new approach, and our reasons for introducing it, are clear;
- the merits of depreciation data vs. expenditure data and how depreciation data could be best standardised and used;
- our proposed new approach to bioresources enhancements; and
- our proposed options to provide a different level of regulatory protection for pre-2020 RCV.

Breakout group feedback

General comments on the proposed modelling approach

A number of companies said they were not clear about the inputs going into the proposed model and how the efficiency challenge would be applied. We clarified the approach to depreciation for pre-2020 costs as set out in consultation document.

Some companies considered that an efficiency challenge calculated on historical data (e.g. legacy RCV) may ignore the new efficiency of a company's assets and impose an efficiency challenge on efficient costs.

One company noted that, while it understood the purpose of the new approach to assessing bioresources costs and the use of the aggregate model, the same outcome could be achieved without throwing away the building-blocks approach. We noted the points we had made in our consultation document regarding this issue and invited views for alternative approaches to removing in-house bias.

Another company noted that the model uses historical costs but forecast costs could be very different if the Environment Agency changed its rules.

A company noted that issues related to taxes had not been discussed during the workshop. We clarified that tax issues are being considered.

Depreciation vs. expenditure data

One company noted that the use of lumpy enhancement expenditure might increase data uncertainty and reduce the robustness of econometric models. We noted that our proposed approach envisages potentially using depreciation data which would tend to be smoothed.

One company expressed a preference in using capital expenditure in the model estimation instead of depreciation data. It considered that depreciation data might be inconsistently constructed across companies and over time so it might reduce the robustness of the econometric cost assessment models.

Protection of pre-2020 RCV

One company preferred the option of excluding legacy assets from the catch-up efficiency challenge (option 1). Another company considered that option 2 did not provide significant protection.

Financing costs

Some companies raised concerns about the use of financing costs as part of an aggregate model as follows.

- It seemed unclear what would happen to the 2020–2025 RCV and considered that a change could imply a retrospective change to signed contracts with investors. We noted that 2020–2025 RCV has a different level of regulatory protection and that this kind of concerns should be written down and submitted to us following the working group.
- The RCV is a key figure that investors ask for, so the move to a more complex approach would lose the simplicity of RCV, making it harder for investors to engage. We noted recent trends in bioresources RCV, how our proposed treatment of RCV was consistent with our objectives for bioresources, our intention to still make use of an asset base for bioresources and reiterated our view that our proposed approach did not tie allowed revenues to who is treating the sludge.
- It was suggested that it would be helpful if Ofwat could provide some written guidance on the RCV and the asset base, to support companies in their conversations with credit agencies.
- Ofwat's proposed approach only provides protection to the RCV ex-ante. Fluctuations in sludge volumes ex-post may create volume risk. Companies could get double remunerated on RCV if sludge is under-forecasted.

Other comments

One company proposed that econometricians from companies and Ofwat could establish a group to work together on the econometric aspects of the new design.

Data request

We invited questions regarding companies' information request. There was an initial discussion of these points. We are publishing a response to all the questions we have recently received on this topic alongside this document.

Closing remarks

We highlighted that the bioresources consultation closes on 10 February 2022. The information request regarding depreciation and net MEAV also needs to be submitted at this time. Finally, one company asked for another CAWG after the bioresources consultation closes.