northern ireland water

# PC13

## The NI Water Response to the PC13 Draft Determination

**November 2012**

PC13 Prioritising Customers

# Contents



# Annexes

# 1 EXECUTIVE SUMMARY

## 1.1 INTRODUCTION

1.1.1 We welcome the opportunity to respond to the Utility Regulator's Draft Determination (the Draft Determination) for the two year Price Control period from April 2013 to March 2015 (PC13), issued by the Utility Regulator on 13 September 2012. The Board at Northern Ireland Water (NI Water) has carefully considered the Utility Regulator's Draft Determination in terms of pace of change, inter-dependencies, risks and consequences, sustainability of service and cost efficiencies. Our response is intended to inform the Utility Regulator in making a Final Determination in December 2012 that will allow NI Water to continue to improve its performance and efficiency for customers.

1.1.2 The Response addresses in detail the Utility Regulator's Draft Determination and, as requested by the Utility Regulator, sets out detailed analysis and evidence to support our response and to allow the Utility Regulator to reach a balanced Final Determination.

## 1.2 KEY CONCERNS WITH THE UTILITY REGULATOR'S PROPOSALS

1.2.1 Price Controls for our comparator companies in England & Wales typically span a five year period. PC13 is a deliberately short two year price control proposed by the Utility Regulator and agreed with stakeholders. We believe that this shorter price control period can be used to put in place a really effective and robust framework for PC15 in which issues such as the valuation of the regulatory asset base, cost of capital, arrangements for greater managerial independence, flexibility over the timing of capital spend profiles and the valid basis for realistic efficiency comparisons can all be properly established.

1.2.2 The NI Water Board has carefully considered the Draft Determination. Our over-riding view of the Draft Determination is that it is not appropriately balanced and creates too much risk to deliver. The pace of opex efficiencies proposed by the Utility Regulator for the two years to March 2015 does not adequately recognise the restrictions of the present NI Water governance model. The efficiency comparisons that compare NI Water against privatised companies and organisations with greater operating flexibility do not compare like with like. The consequential increased pace of efficiency catch-up to a notional frontier company combined with the disallowance in our cost base of the toolsets to deliver the efficiencies combines to create a Draft Determination which puts an unacceptable risk of failure on to:

- Customers;
- NI Water; and
- The Department for Regional Development (DRD).

**NI Water Governance and Funding**

1.2.3 While the Utility Regulator acknowledges our dual status (Government owned Company (GoCo) and Non Departmental Public Body (NDPB)) is not optimal, we do not believe its impact has been properly understood or adequately reflected in the overall Determination. This is particularly evident in consideration of operational costs and efficiency.

1.2.4 The Draft Determination assumes that the main consequence of our dual status is to add additional cost to our model and as a result should be treated as a special factor estimated at 12 Full Time Equivalent (FTE) staff. This reveals a fundamental misunderstanding of the impact that NDPB status has across the whole of the company. The main consequence of NDPB status is that it reduces our agility to respond to change, slows the pace at which we are able to drive transformation, inhibits our capital expenditure planning, makes us more risk averse and contributes to bureaucratic inefficiency.

**NI Water's Performance in PC10**

1.2.5 We are pleased the Utility Regulator has acknowledged our progress to date. We continue to strive to achieve the targets set for the PC10 period. However whilst some of these improvements will be sustained others have been tactical in nature, one-off in impact and in some cases as a result of external factors beyond our control which have provided positive (if unexpected) benefits. It is important for this to be understood in approaching PC13.

1.2.6 The Utility Regulator has assumed that Public Expenditure (PE) monies surrendered in the October 2012 monitoring round can all be classified as sustainable operating cost efficiencies in PC13 and beyond. We have provided evidence in our response to show that this is incorrect and request that the position be accurately reflected in the Final Determination.

**Operating Costs**

1.2.7 We welcome that the Utility Regulator has allowed some new and additional operating costs. However, the proposed allowance falls £14 million short of the funding the Business Plan requires for NI Water to operate its regulated business during PC13.

1.2.8 We are particularly concerned with the disallowance of the toolsets to deliver efficiencies i.e. Voluntary Early Retirement / Voluntary Severance (VER/VS) and Business Improvement (BI) projects. We disagree with the view that these items cannot be funded in PC13 since they have previously been funded. The Draft Determination argues that to allow costs for these items in PC13 results in customers *'paying twice"* due to underspends in these categories during PC10. However this is too simplistic a view and account needs to be taken of other unfunded cost pressures and revenue shortfalls.

1.2.9 Funding that we did not use during PC10, but which is required to deliver future efficiencies, has not been retained by NI Water but has been surrendered to the Department on an annual basis. We recommend that transformation funding is built into the costs allowed in the Final

Determination since we will need this in order to effect the efficiencies in PC13 and PC15. We have set out in full details on this area in section 5.6.

**Operating Cost Efficiencies**

1.2.10 NI Water has provided evidence that the efficiency calculation used by the Utility Regulator is not sufficiently robust to support the 72.5% over five years catch-up assumption. We summarise relevant regulatory evidence which demonstrates that the Utility Regulator's proposed efficiency target sits at the top of the range experienced by utilities in Great Britain and that English & Welsh (E&W) companies have not generally exceeded the 60% catch-up figure set by Ofwat. This shows that the proposed efficiency targets would be unfounded even if we had the flexibility of management available to the companies with which the comparisons are made, which is of course not the case.

1.2.11 Based on the evidence provided, we are of the view that the proposed catch-up target is unreasonable, disproportionate and is not justified. Increasing the catch-up target in this manner would represent a move away from incentive based regulation. Incentive based regulation has a proven track record of providing positive outcomes for both the customer and the company. NI Water believes that rather than increase the 'stick' in the manner proposed, the Utility Regulator should seek to strengthen existing reputational incentives and consider additional meaningful incentives to facilitate on-going out-performance.

1.2.12 Within a PE environment, operating cost efficiency targets which exceed those set across the rest of the UK private water sector which NI Water will likely find impossible to achieve is unreasonable, disproportionate and could compromise the interests of consumers and effective service delivery.

1.2.13 The Utility Regulator states that efficiency targets should be achievable. We agree in principle, but do not believe that the scale of the proposed efficiency improvements is achievable, particularly under our governance model and in

the short two year price control period which is less than five months away. This is further hindered by the disallowance of BI and VER/VS funding.

**Capital Investment Programme**

1.2.14 We welcome that the Utility Regulatory has, in the main, agreed and accepted our proposals for capital investment and the need to continue investment in our infrastructure. The Draft Determination requires NI Water to deliver £11.5m of additional outputs with the PE funding. We disagree with the rationale for this. The clarifications and additional information provided by NI Water in this document now require the Utility Regulator to reconsider certain elements of its conclusions. It is clear that the lack of flexibility between year ends and the inability to carry forward investment funds year to year reduces efficiency of infrastructure delivery.

**Outputs**

1.2.15 We welcome that the Utility Regulatory has, in the main, agreed and accepted our proposals for outputs, which are linked to our capital investment and improvement programmes. However it should be noted that the outputs we propose in our Business Plan form part of a package which will need to be reassessed in light of the risks created by the removal of elements of funding in the Draft Determination.

**Allowed Revenue and Financial Sustainability**

1.2.16 We note that the Draft Determination's projections result in NI Water failing many of the Ofwat targeted financial ratio values. The Utility Regulator considers that these values are appropriate for the governance framework within which we operate. Whilst we understand this approach, we have some concerns that in the event of a change in our funding or governance model, this approach could have significant implications for financial sustainability and tariffs.

**Management of Risk and Uncertainty**

1.2.17 We acknowledge that the Draft Determination contains a mechanism to manage risk and uncertainty ('relevant items' under the Consequent Written

Agreement (CWA)) and £5m per annum has been proposed by the Utility Regulator. While we have reservations about the mechanics of the 'relevant items' process we have serious concerns that the proposed £5m per annum of PE funding will not be available to DRD to meet 'relevant item' bids.

1.2.18 Funding for VER/VS, BI subject matter experts and possible power price increases if they materialise, might utilise this funding, even before any unforeseen cost pressures.

1.2.19 The PE allowance is inadequate in the context of the risk allocated to NI Water. This could lead to a failure of the public sector model used to deliver water services in Northern Ireland. Services may well be impacted when risk money is required by NI Water and the DRD is not able to request and hold money which it cannot guarantee will be spent.

1.2.20 NI Water is keen to ensure that collectively, in the context of our shared Water Stakeholders Steering Group (WSSG) objective, stakeholders provide adequate headroom in the hybrid (dual status) model to absorb cost shocks.

## 1.3 CONCLUSIONS

1.3.1 The NI Water PC13 Business Plan proposed by us in May 2012 seeks to balance service delivery and consumer interests with continuing efficiency, while maintaining stability and minimising risks within the NDPB structure.

1.3.2 In summary, it is our view that the Draft Determination does not balance risks for customers with a realistic pace of change taking into account our current hybrid model. We cannot see how the gap between the reasonable operating costs required in the Business Plan and operating costs proposed in the Draft Determination can be bridged. This introduces an unacceptable level of risk to both customers and service delivery.

1.3.3 We acknowledge that the primary role of the Utility Regulator in the water industry in Northern Ireland is to protect the interests of consumers, both

today and in future and we are supportive of that. However we have concerns that the Draft Determination proposals will actually have an adverse effect on the interests of consumers, both present and future.

1.3.4 Accordingly, the Draft Determination, as it stands, will not serve customers' best interests nor protect service delivery and therefore cannot be acceptable to NI Water. NI Water hopes that, by providing additional information and highlighting the contextual and factual misunderstandings, the Utility Regulator is in a position to produce a Final Determination which recognises these inter-dependencies and demonstrates a realistic and proportionate assessment of risk, pace of change and our governance context within a ten year programme across PC10, PC13 and PC15.

1.3.5 NI Water provides evidence to support this position in the remainder of this Response. The NI Water Board hope that the company's Response will assist the Utility Regulator in arriving at a Final Determination that takes account of the current governance arrangement and will be deliverable by NI Water and acceptable to the wider water stakeholder group.

# 2 INTRODUCTION

## 2.1 STRUCTURE OF THE RESPONSE

2.1.1 This chapter outlines the structure of NI Water's Response to the Utility Regulator's proposals.

2.1.2 Subsequent chapters deal with the following matters:

- Chapter 3 deals with NI Water governance and funding ;
- Chapter 4 deals with NI Water's performance in PC10;
- Chapter 5 responds to the Utility Regulator's proposals with respect to operating costs i.e. the allowance for operating costs;
- Chapter 6 responds to the proposed operational efficiency challenge;
- Chapter 7 deals with the capital investment programme;
- Chapter 8 deals with outputs;
- Chapter 9 deals with allowed revenue and financial sustainability;
- Chapter 10 responds on management of risk and uncertainty; and
- Chapter 11 outlines the next steps in the PC13 process.

2.1.3 The relationship between the chapters of this Response and the corresponding sections of the Draft Determination is shown in the table below:

**Table R.1: Response References in Relation to the Draft Determination**

| Chapter | NI Water's Response | Draft Determination |
|---|---|---|
| **1** | Executive Summary | |
| **2** | Introduction | Introduction |
| **3** | NI Water Governance and Funding | Introduction |
| **4** | NI Water's Performance in PC10 | Operational Costs and Efficiency |
| **5** | Operating Costs | Operational Costs and Efficiency |
| **6** | Operating Cost Efficiencies | Operational Costs and Efficiency |
| **7** | Capital Investment Programme | The Investment Programme |
| **8** | Outputs | Outputs |
| **9** | Allowed Revenue and Financial Sustainability | Price Limits for PC13 |
| **10** | Management of Risk and Uncertainty | Price Limits for PC13 |
| **11** | Next Steps | Conclusion |

2.1.4 In order to focus on the main themes, this Response does not attempt to answer every point raised by the Utility Regulator in its Draft Determination. Annex 05 Consolidated Table of Responses endeavours to respond to other matters raised by the Utility Regulator in the Draft Determination.

2.1.5 Additional supporting material is provided in the annexes which accompany this document.

## 2.2 PRICE BASE

2.2.1 In line with the Draft Determination, all costs referred to in this Response are in 2010/11 prices unless otherwise stated.

## 2.3 BACKGROUND

2.3.1 NI Water is responsible for the delivery of water and sewerage services in Northern Ireland. We employ approximately 1,330 people who work to

provide our customers with a vital service which supports the health, environment and local economy of the areas we serve.

2.3.2 We deliver clean, safe drinking water to approximately 753,400 households and businesses. We supply customers with approximately 585 million litres per day of good quality drinking water through approximately 26,500 km of water mains.

2.3.3 We collect approximately 320 million litres per day of wastewater from around 614,000 households and organisations connected to the sewerage system and transport it through approximately 15,000 km of sewers to works where it is treated and disposed of safely.

2.3.4 We submitted our PC13 Business Plan to the Utility Regulator on 21 May 2012. The PC13 Business Plan sets out our intentions to continue to improve the service to customers today and to continue to invest to safeguard services for future customers. It supports key elements of the current Programme for Government for Northern Ireland in delivering necessary infrastructure and wider strategic aims. Our Business Plan balances investment and improvements in customer service outputs and delivery with continued efficiency whilst seeking to maintain stability and grow confidence with customers and our stakeholders. It seeks to minimise risks within the parameters of our structure as both a licenced water and wastewater company and a NDPB.

# 3 NI WATER GOVERNANCE AND FUNDING

**SUMMARY**

This chapter sets out the governance and funding model of NI Water. Whilst we recognise that the Draft Determination begins to acknowledge that the governance framework is 'not optimal' it remains clear that all of the consequences of the model are generally not well understood.

While the 'dual status' model undoubtedly adds some specific administrative cost, the main consequence is that it reduces our agility to respond to change, slows the pace at which we are able to drive transformation and contributes to bureaucratic inefficiency.

The Utility Regulator has not adequately recognised our dual status in the PC13 Draft Determination proposals.

## 3.1 REGULATED GOVERNMENT COMPANY

3.1.1 NI Water was formed as a GoCo in April 2007 with the DRD as the sole shareholder. The Company was established through the Water and Sewerage Services (NI) Order 2006 and appointed as the water and sewerage undertaker under Articles 13, 18 and 19 of the Order. The constitution of NI Water is set out in the company's Articles of Association.

3.1.2 NI Water is subject to economic regulation by the Utility Regulator, under the provisions of an Instrument of Appointment (the Licence). The Utility Regulator is responsible for safeguarding customer interests through securing value and quality outcomes for customers whilst ensuring that NI Water can finance its activities.

## 3.2 NON DEPARTMENTAL PUBLIC BODY STATUS

3.2.1 NI Water was designated as a NDPB for public expenditure purposes in March 2009. This followed the decision by the NI Assembly to defer the introduction of direct domestic charges. DRD provides a public expenditure subsidy to replace the revenue that would otherwise have come from domestic customer billing. Water and sewerage charges are levied on non-domestic customers.

3.2.2 As a NDPB, NI Water is subject to the full suite of public sector governance and compliance measures which directly affect what we do, how we do it and the time it takes to get it done. Broadly these fall under two categories:

**Financial Management**

3.2.3 The financial management regime of NI Water is fundamentally different from other Utility companies in England and Wales. As a NDPB, NI Water is subject to the annual government budgetary cycle and in-year monitoring rounds. Financial management is made more complex by the need to comply with, and be audited against, government accounting standards, as well as regulatory and statutory accounting standards.

3.2.4 Utility companies in England and Wales benefit from significant financial and budgetary freedoms by comparison. They have access to distributable reserves which act as a buffer from unforeseen cost shocks and facilitate the achievement of 'out-performance'. Such a regime promotes a less risk-averse approach to cost reduction.

3.2.5 Given the emphasis PE funding places on meeting budgets, NI Water might be less inclined to consider opportunities for cost reduction which have an element of uncertainty.

**Governance**

3.2.6 'The Public Accounts Committee (PAC) report on Procurement and Governance requires <u>full compliance</u> with Managing Public Money Northern

Ireland (MPMNI) which sets out the management and governance arrangements for public sector bodies. NI Water's originating Governance Letter required adherence to the principles of MPMNI. The Governance Letters have since been replaced by a Management Statement and Financial Memorandum (MSFM) with effect from 1 April 2012.

3.2.7 The MSFM sets out how MPMNI is applied to NI Water and requires full compliance with all guidance issued by the Department of Finance and Personnel (DFP).

3.2.8 The adoption of the MSFM has brought the company closer towards central government oversight and further away from the commercial freedoms of the regulated English & Welsh models. As a result, there is a requirement for the company wide application of MPMNI principles, policies and practice which inevitably impacts on the time, resources and costs needed to fulfil procurement, administrative and governance functions.

3.2.9 The scale of the impact is such that the MSFM identifies over 130 areas across NI Water where business practice needs to be monitored to ensure alignment with the MSFM. The MSFM is embedded into the administrative culture of the organisation with all of our policies and practices aligned to relevant public service standards, protocols and approvals.

## 3.3 DAY TO DAY IMPACT OF OUR DUAL STATUS

3.3.1 Working as both a GoCo and a NDPB creates strain on both delivery models. Compared to the companies in England and Wales, we face more uncertainty over long term investment planning, resulting in a sub-optimum capital investment delivery model, and have less commercial freedoms to restructure and make decisions. Limitations on decision making include key areas such as procuring external support for business restructuring, staff remuneration and incentivisation.

3.3.2 These limitations reduce our agility to respond to change, slow the pace at which we are able to drive transformation and contribute to bureaucratic inefficiency.

3.3.3 The Chairman of NI Water wrote to the Chairman of the Utility Regulator in August 2012 setting out specific examples of how the NI Water governance model provides additional challenges to the organisation and limits the pace of change for delivering improvements and efficiencies. We attach a copy of this letter and the earlier letter to the previous Chairman of the Utility Regulator in Annex 01. Some examples are given below:

**Access to Consultancy**

NI Water has no authority to approve any non-engineering based consultancy spend. There is no *de minimis* limit for this requirement. If consultancy spend is required it has to be approved by DRD and ultimately by the DRD Minister.

It is not unusual for the internal and external approvals for relatively modest consulting expenditure to take 3-4 months to obtain and involve senior management time up to CEO level. There is also the associated resource time tied up dealing with queries.

Such lack of flexibility does not support an organisation which is seeking to deliver continued improvements in efficiency through a major restructuring programme.

**Staff Pay and Conditions**

NI Water has little opportunity to vary employment terms, which for the most part are still based on NI Civil Service terms and conditions for most staff.

NI Water has limited control over employee terms and conditions with limited authority to vary pay or provide an incentive mechanism for staff. For example, the modest employee bonus directly linked to corporate KPIs was not allowed to continue as a NDPB. In contrast, incentive schemes for staff are in place in all the GB water companies.

This lack of flexibility does not support an organisation which is seeking to motivate staff to deliver continued improvements through a major restructuring programme.

**Commercial Flexibility**

MPMNI restricts NI Water's ability to enter into commercial partnerships with suppliers to deliver efficiencies in goods, services and capital expenditure. This is in contrast to the companies in England & Wales which can take advantage of 'strategic alliances' with suppliers.

This lack of flexibility does not support an organisation which is seeking to deliver continued improvements in efficiency across its cost base.

**Inflexibility in the Capital Programme**

The PE funding model removes the End of Year Flexibility for capital investment. The capital funding allowed, as adjusted during the year, must be spent exactly within the financial year allocated. Any underspend is therefore lost to the company and any overspend may result in an appearance in front of the Public Accounts Committee (PAC).

This generates a short termism in capital planning and a conservative approach to capital programming with a surety of spending. The result is the delivery of capital projects where there is forecast certainty, such as trunk mains with small projects to balance the remaining spend. However innovative projects, or projects which require planning permission (e.g. wastewater treatment works (WwTWs), big pumping stations) or major projects which have variable start dates (tunnels, outfalls) add risk to in-year delivery. Much staff time is therefore absorbed in continually managing and re-profiling the programme. It is also important that a suitable procurement delivery vehicle is available but this provides its own challenges. This is not an efficient procurement and delivery mechanism.

## 3.4 RECOGNITION OF OUR DUAL STATUS IN THE DRAFT DETERMINATION.

3.4.1 Recognising the dual status of NI Water is essential to understanding the context for PC13 and setting realistic objectives for NI Water.

3.4.2 We welcome the fact that the Draft Determination acknowledges the following issues arising from our governance framework:

- No 'end of year flexibility' within the funding model;
- Uncertainty of public expenditure budget;
- Unpredictability of the profile of public expenditure;
- Operational expenditure and [lack of] incentives; and
- Management of risk.

3.4.3 While the Utility Regulator frequently acknowledges our dual status in the text of the Draft Determination, we do not believe it has been adequately reflected in the overall determination. This is particularly evident in consideration of operational costs and efficiency.

3.4.4 The PC13 Draft Determination has included a special factor of £480k[1] estimated at 12 FTE staff. To consider that the impact of NDPB status

> *"takes the form of answering Assembly Questions, FOI requests and returns to the DRD and Regional Development Committee[2]"*

is to misunderstand the operating environment imposed upon the organisation by NDPB status.

3.4.5 In our view, the Draft Determination has failed to grasp the impact of the NDPB status on the company. Whilst dual status does add cost, more importantly it places restrictions on how cost reduction and transformation activity can be undertaken.

3.4.6 The Utility Regulator has dismissed NI Water's assessment of the impact our status has on pace and imposed a higher catch-up factor than it would have done if the organisation was not subject to Departmental public expenditure controls.

[1] £530k was the determined assessment but this reduced by almost 10% to exclude business activity related costs
[2] Draft Determination Annex A, paragraph 4.3.3

3.4.7 NI Water has consistently maintained that the efficiency targets in PC13 must reflect our unique status. In the PC13 Business Plan, NI Water proposed closing 60% of the efficiency gap to the frontier companies, which we assessed as 34.1% in the base year, over a ten year period. We explained that the longer catch-up period was necessary because our governance framework restricts the pace at which efficiencies can be delivered.

## 3.5 POSSIBLE INCENTIVES

3.5.1 NI Water agrees that the NDPB status provides challenges in terms of incentivising and delivering efficiency savings. However, the solution to this problem is not to impose higher, and unrealistic, targets, but instead to work to introduce meaningful and effective incentives.

3.5.2 There are a number of options for introducing stronger incentives into a publicly owned utility, even with the constraints imposed by the NDPB model. Some of these options are briefly set out below.

- Opportunity for out-performance to be channelled into discretionary activities. Another option would be to introduce a mechanism that would allow additional cost savings to be diverted to discretionary projects that provide additional benefits to customers;
- Rebates for customers. An alternative or complement to the discretionary spending would be a mechanism that allows a share of any savings to be returned to non-household customers through a form of annual customer rebates;
- Reputational incentives. Another option would be for the Utility Regulator to enhance existing reputational incentives to provide a motivation to the company to achieve and beat the targets that are set; and
- Incentives for staff. A well-designed incentive system that rewards staff based on performance and efficiency and funded from out-performance. This has been a feature of the incentives put in place for Scottish Water, Welsh Water and Network Rail.

# 4 NI WATER PC10 PERFORMANCE

**SUMMARY**

This chapter sets out the performance of NI Water in PC10. Whilst NI Water is currently projecting a modest out-performance of the PC10 Final Determination, our analysis demonstrates that some of the savings achieved have been short term in nature, one-off in impact and in some cases as a result of external factors beyond our control which have provided positive (if unexpected) benefits. Our analysis shows a significant slowdown of the efficiency performance in 2012/13. There is no evidence to suggest this trend will not continue through PC13.

The Utility Regulator has assumed that PE monies surrendered in the October 2012 monitoring round can all be classified as sustainable operating cost efficiencies in PC13 and beyond. We have provided evidence in our Response to show that this is incorrect and request that the position be accurately reflected in the Final Determination.

## 4.1 OUTCOMES FROM PC10

4.1.1 The Draft Determination acknowledges NI Water's strong performance during the PC10 period. In particular:

- Out-performed operational efficiency challenge in first two years of PC10;
- Narrowed the operational efficiency gap to the companies in England and Wales;
- Improved the Overall Performance Assessment (OPA) score from 98 in 2007/08 to 184 in 2011/12; and
- Achieved capital efficiency targets, delivering outputs to the value of the £504m (nominal) funding made available [at the time of writing].

4.1.2 In the Draft Determination the Utility Regulator uses NI Water's efficiency performance in this period to:

- Assess the extent of the efficiency catch-up which remains to be achieved in PC13; and
- Justify a higher operating cost efficiency catch-up target during PC13.

It is therefore important that our performance during PC10 is properly understood and accurately reflected in the PC13 projections.

## 4.2 PC10 FINAL DETERMINATION v ACTUAL/FORECAST EXPENDITURE

4.2.1 Our latest assessment (based on 2010/11 and 2011/12 out-turn costs and 2012 October monitoring round projections) of total operational expenditure for the three year period ending in March 2013 is £562.8m (in 2010/11 prices). This is £54.8m less than the determined opex in the PC10 Final Determination. As can be seen in Table R.2 this variance is made up of underspends on Public Private Partnership (PPP) and a-typical costs and out-performance of underlying opex efficiency targets.

**Table R.2: Variations between PC10 FD and Expenditure**

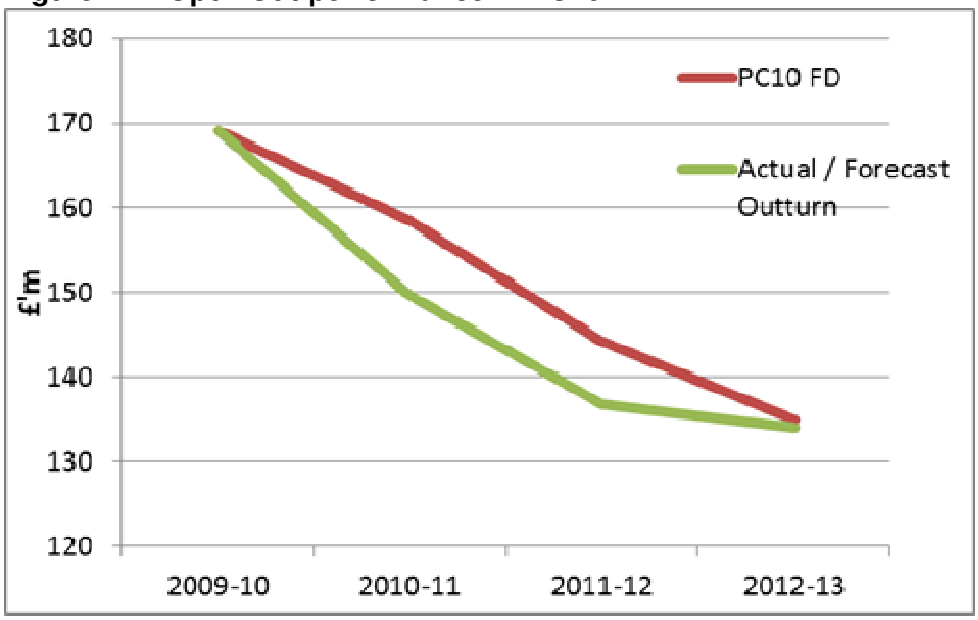
| Category | FD £m | Actual / Forecast £m | Over / (Under) £m |
|---|---|---|---|
| Underlying opex | 437.6 | 420.3 | (17.3) |
| A-typical factors (VER/VS, BI, Freeze Thaw) | 40.8 | 14.8 | (26.0) |
| PPP Unitary Payment | 139.0 | 127.5 | (11.5) |
| **Total Opex** | **617.5** | **562.6** | **(54.8)** |

4.2.2 The out-performance in underlying opex is projected to be £17.3m. It is worth noting that this analysis is based on the same methodology used by the Utility Regulator in previous Cost and Performance reports. However, it does not adjust for certain elements of our opex, outside of the a-typical categories noted above. These are classified by the Utility Regulator as either one-off in nature or are additional to that funded in the period. Examples would include

a significant rates credit in 2010/11 relating to previous years or Carbon Reduction Commitment (CRC) costs incurred during the period which were not funded in the PC10 Final Determination.

4.2.3 Figure R.1 below shows how underlying opex is performing during the PC10 period.

**Figure R.1: Opex Out-performance in PC10**




4.2.4 The analysis above shows that £9m of the out-performance was achieved in 2010/11, £7m in 2011/12 and £1m is projected in 2012/13. This analysis provides evidence of a significant slowdown in efficiency performance in the current year (2012/13) when compared with the two previous years.

4.2.5 This slowdown in the pace of efficiency delivery was anticipated and there is no evidence to suggest the pace can increase significantly in PC13 which will commence in less than five months' time.

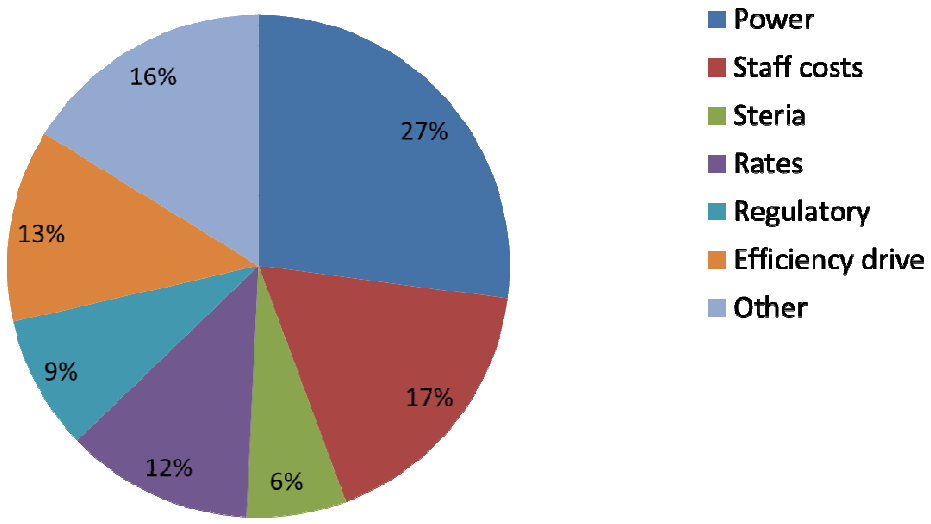
## 4.3 CAN PC10 PERFORMANCE BE REPEATED?

4.3.1 Given the reliance the Utility Regulator places upon NI Water's efficiency performance in PC10 to justify efficiency targets in PC13, it is important to

understand the underlying reasons for this achievement in order to assess how much is repeatable.

4.3.2 In order to ascertain where and how savings were achieved we have analysed the annual opex budgetary variances. The pie-chart below analyses a variance of budget to actual / forecast expenditure for underlying opex for the PC10 period.

**Figure R.2: Out-performance against Budget in PC10**




*Note: 'Steria' refers to the one-off settlement credit from the cancellation of the contract to provide customer services support*

4.3.3 Much of the out-performance cannot be assumed to be repeatable due to the following factors:

- Out-performance in the power price is linked to market volatility – this cannot be relied on going forward and requires a suitable risk allowance to be in place due to this largely uncontrollable major cost;
- Out-performance in staff costs is due to an externally driven two year pay freeze which cannot be sustained indefinitely. In addition we had a pension credit following actuarial valuation which is linked to market volatility and cannot be relied on going forward;
- We have seen reductions in regulatory costs in the current financial year based on receiving a credit from regulators for unused funding previously paid by us – we have had no commitment / indication from our regulators

that these can be sustained particularly as we move into a more strategic PC15;

- Land and Property Service (LPS) costs continue to be reviewed but rates are largely outside our control; and
- We have seen efficiencies in consultants, materials and chemicals, some of which should be able to be sustained, but the scope for further efficiencies in these areas is much diminished.

4.3.4 In our PC10 Business Plan we stated that Year 3 would be the most challenging of the three years, which is proving to be the case. We are achieving the targets but the evidence is that the scope for delivering further efficiencies is much reduced. Significant initiatives to deliver efficiencies have been completed, such as the rationalisation of operational depots and consolidation of accommodation at Belfast, Altnagelvin and Ballymena to NI Water owned sites. Initiatives of this scale are not readily repeatable. As indicated in our PC13 Business Plan, the drive to further efficiency should be through consolidation of previous gains and further tactical gains, while planning for structural changes to be delivered in PC15.

## 4.4 2012/13 EFFICIENCY SAVINGS OVER-ESTIMATED BY THE UTILITY REGULATOR

4.4.1 In the PC13 Draft Determination, a £5.2m opex reduction which was surrendered to the Department in the October 2012 monitoring round has been classified as efficiency savings. This would suggest the opex reduction is repeatable in the PC13 years. We do not agree with this view.

4.4.2 The table below shows our analysis of the £5.2m reduction and includes our assessment of our ability to carry forward these savings into PC13.

**Table R.3: Analysis of £5.2m opex reduction**

| Expenditure | Total | Description |
|---|---|---|
| | £m | |
| **Power** | 1.4 | Consists of a rate variance £0.8m and a volumetric variance £0.6m.<br><br>*It is our opinion that the rate element of power should be classified as a temporary reduction and the volumetric taken as efficiency. This is on the basis that movements in network charges and forecast power price rate are largely outside of management control.*<br><br>*We note that within the PC10 Final Determination, the Utility Regulator intended to de-risk NI Water through an indexation mechanism and leave consumption risk with NI Water. NI Water would welcome this approach and given that power represents a very significant proportion of our costs for PC13 we would be keen to engage with the Utility Regulator on this subject prior to the Final Determination.* |
| **PPP** | 0.7 | Release of accruals and disputed performance deductions from the Balance Sheet, £0.6m relate to the prior year and earlier.<br><br>This adjustment largely relates to over accruals and performance reductions in prior years which are held on the balance sheet until agreed. These are not to be seen as repeatable. |
| **Regulatory Costs** | 0.7 | Comprises a £0.7m reduction from budget due to a large credit on the Utility Regulator invoice (relating to prior year) and release of reporter accrual £0.1m.<br><br>*NI Water would view both these reductions as one-off in nature, unless the Utility Regulator can guarantee to repeat them.* |
| **Pension Credit** | 1.4 | Pension credit of £1.4m consists of a finance credit of £0.8m and a cash contribution vs. current service cost credit of £0.6m. The full £1.4m credit is taken within the operating costs in the October monitoring for reporting to Government purposes. In statutory and in particular regulatory terms, the £0.8m finance cost will be transferred to finance costs at year end.<br><br>*We are content with the cash contribution vs. current service cost credit of £0.6m to be taken as a reduction on the basis the Utility Regulator allowed a related cost in the opening baseline. It is our opinion that the finance credit explained above should not be assumed as a permanent reduction in our operating cost baseline.* |
| **Other** | 1.0 | Various<br><br>*We estimate that 70% of this reduction relates to releases of accruals from prior periods or delay of expenditure in 2012/13 due to procurement delays and delays in capital IT projects which have a resulting delay in the requirement of maintenance contracts. We would contend that none of which should be classified as on-going reduction in our cost base for future periods.* |
| **Total** | 5.2 | |

4.4.3 From the analysis above, it is NI Water's opinion that at least £3.7m of the £5.2m should be classified as one-off in nature and should be re-instated within the PC13 operating cost projections. We accept that up to £1.5m of the opex reduction could be classified as efficiency.

**Rates**

4.4.4 Through the Draft Determination query process, we have revised our rates projections with no significant difference to the PC10 projections contained within the Draft Determination. This revision includes a correction to the base year of £2.5m, relating to a significant credit received from LPS for overpayment in previous years. In the Draft Determination, this was reduced by £0.9m on the basis that the charge in the following year, 2011/12, did not show an increase of £2.5m. We do not agree with this approach and it is inconsistent with the Utility Regulator's Cost and Performance report for 2010/11 where £2.7m was accepted as a valid figure for the rates credit and was deducted when calculating outperformance for the year. This has been discussed with the Utility Regulator in a meeting on 17 October 2012.

4.4.5 In the PC13 Business Plan, we had included a further reduction in rates in 2013/14 which was accepted within the Draft Determination. On reflection we no longer feel this is appropriate. The reduction shown in the Business Plan was an objective, not something on which we could rely. Whilst we are hopeful of delivering this reduction this should be classified as part of the efficiency we aim to deliver in PC13. Given the assumed efficiency is applied to all costs including rates; we feel that inclusion of any targeted reduction in PC13 would be double-counting. We have previously outlined our view on this matter in our response to Query 037.

**Power**

4.4.6 Within a query subsequent to the Draft Determination, NI Water identified an error in the Business Plan which effectively overstated the efficiency delivered in power during PC10 by c.£2.5m. This resubmission could not have been taken into account within the Draft Determination, meaning that the opex baseline feeding into PC13 within the Draft Determination is c.£2.5m lower.

This was discussed with the Utility Regulator in a meeting on 17 October 2012.

4.4.7 The amendments noted above are summarised in the table below.

**Table R.4: Summary of Amendments to opex**

| All figures in 2010/11 prices | 2011/12 (£m) | 2012/13 (£m) |
|---|---|---|
| October monitoring round reductions which are not efficiencies | - | £3.4 |
| Rates | -£0.1 | £0.1 |
| Power | £1.5 | £2.5 |
| Total | £1.4 | £6.0 |

4.4.8 NI Water has revised the PC10 opex projections to reflect the amendments noted above. The table below summarises the adjustments and the impact on efficiencies delivered in 2011/12 and 2012/13.

4.4.9 **Table R.5: Impact of Opex Revisions on Efficiency Targets**

| All figures in 2010/11 prices | PC10 | | |
|---|---|---|---|
| | 2010/11 | 2011/12 | 2012/13 |
| **Total DD Opex** | **196.8** | **187.3** | **193.4** |
| Efficiency savings £'m | 0.0 | -11.8 | -20.8 |
| Efficiency savings % | 0.0 | 7.5% | 5.8% |
| **Net DD Opex** | **196.8** | **175.6** | **172.5** |
| | | | |
| Additions (reductions) to baseline | - | -1.4 | -2.6 |
| A-typicals and one offs | - | - | -3.4 |
| **Total Revised Opex** | **196.8** | **185.9** | **187.4** |
| **Revised efficiency profile** | | | |
| Efficiency savings £'m | 0.0 | -10.4 | -14.8 |
| Efficiency savings % | 0.0 | 6.7% | 2.7% |
| **Net Revised Opex** | **196.8** | **175.6** | **172.5** |

4.4.10 Note that the efficiencies delivered in 2011/12 and 2012/13 have been reduced from 7.5% and 5.8% in the Draft Determination to 6.7% and 2.7%.

4.4.11 This is a significant and important point as, when setting catch-up targets for PC13, the Utility Regulator takes account of efficiencies delivered in the intervening period between the base-year and the start of the price control period. Therefore the better the performance in the intervening period, the lower the target in the price control period.

# 5 OPERATIONAL COSTS

**SUMMARY**

This chapter responds to the Utility Regulator's proposals with respect to operating costs i.e. the allowance for operating costs before efficiencies. Our response to the Utility Regulator's proposals for operating cost efficiencies are presented in Chapter 6.

The Utility Regulator has proposed an allowance for operating costs (before efficiencies) in PC13 which falls £14m short of the funding NI Water requires to operate its regulated business during PC13.

An area of particular concern is that the toolsets to deliver efficiencies have been removed and the alternative options proposed to fund transformation activity are unsatisfactory.

## 5.1 INTRODUCTION

5.1.1 We welcome the acceptance by the Utility Regulator of £5.5m of proposed additions to the baseline in relation to CRC, Regulator and Reporter costs, Membrane Bio-Reactor cleaning, Integrated Pollution Prevention and Control Regulations and PC15 Consultancy Support.

5.1.2 The Utility Regulator's proposed opex allowance falls short of NI Water's forecast costs by £14m over the PC13 period. Table R.6 below sets out NI Water's submitted figures and the shortfall against the Utility Regulator's proposed allowance.

**Table R.6: Variance in Opex Prediction and Allowance**

| | NI Water Prediction (£m) | Utility Regulator Allowed (£m) | Variance (£m) |
|---|---|---|---|
| Power Price Increase | 3.10(Note 1) | 0 | 3.10 |
| Opex from Capex | 6.80 | 4.60 | 2.20 |
| Transformation - Business Improvement | 4.78 | 1.60 | 3.18 |
| Transformation - VER/VS | 5.56 | 0 | 5.56 |
| **Total** | **20.24** | **6.20** | **14.04** |

(Note 1: Based on subsequent PC13 query)

5.1.3 The following sections deal with each of these aspects in more detail.

## 5.2 POWER PRICE INCREASE

5.2.1 Power cost increases submitted by NI Water to the Utility Regulator, in the PC13 Business Plan submission, were predominantly made up of power price increases and a small increase to kilowatt hour (kWh) usage through degradation. The total additional funding requested in 2013/14 and 2014/15 was £7.6m. In a subsequent query, NI Water reduced this to a £3.1m request for funding in the same period, as a result of translating the average price per unit into 2010/11 prices as they had been submitted in 2012/13 prices.

5.2.2 The Utility Regulator has disallowed any increase, either in price or for degradation. The premise for this decision is that:

> *"The frontier shift analysis factors in a general allowance for real price effects "affecting an average WaSC", over and above the general rate of forecast RPI inflation. As such, no further price adjustment on power is required."*

5.2.3 Annex D to the Draft Determination: *'The Rate of Frontier Shift Affecting Water Industry Costs'* sets out the calculation of the frontier shift and implies a price rise of 4% per annum is applied to energy costs. We have reviewed the calculation and note that the proportion of power costs to total opex for an average water and sewerage companies (WaSC) is assumed as 12.5%

compared to an actual figure of 23% calculated from our 2012 October monitoring round position.

5.2.4 It is also worth noting that Department of Energy and Climate Change (DECC) recently (October 2012) updated their assumptions on retail energy prices and are now forecasting a 38% increase in the period 2011-2015 as shown in the table below. This increase is significantly higher than that assumed in Annex D and compares to DECC's previous forecast in October 2011 of a 13% rise over the same period.

**Table R.7: DECC Retail Energy Price Forecast - Central Commercial / Public Sector (real 2012 pence/kilowatt hour)**

| | 2011 | 2012 | 2013 | 2014 | 2015 |
|---|---|---|---|---|---|
| **Commercial/ Public sector** | 8.48 | 8.75 | 9.93 | 11.14 | 11.70 |
| ***Increase from 2011*** | | *3%* | *17%* | *31%* | *38%* |

Source: DECC Toolkit for guidance on the valuation of energy use and Greenhouse Gas (October 2012) Table 4.

5.2.5 We can see some logic in an increase in power price over and above Retail Price Index (RPI) being a cost pressure that we would seek to cover through 'relevant items' since the power market is subject to volatility. However the starting point should be based on the latest DECC forecasts, and we have some concerns regarding the adequacy of the 'relevant items' in the PC13 period. We explain this in more detail in Chapter 10.

5.2.6 We note in the PC10 Final Determination that the Utility Regulator intended to develop a methodology for indexing the price element of the energy component of the end-user price to de-risk the company. The need for such a mechanism is more relevant now than ever and we would welcome the opportunity to work with the Utility Regulator to agree this for PC13 and beyond.

## 5.3 OPEX FROM CAPEX

5.3.1 In the PC13 Business Plan, NI Water claimed opex from capex of £6.8m over the PC13 period. The Draft Determination has disallowed £2.2m of this. NI

Water sought further clarification from the Utility Regulator on this and the matter was discussed at a workshop between NI Water and the Utility Regulator on 17 October 2012.

5.3.2 Approximately £1.5m of the disallowed amount related to Management and General (M&G) opex from capex which was due to a misunderstanding. The rest relates to another misunderstanding over the treatment of indexation and to the allocation of power increases in certain Capital Works Projects (CWP). This is summarised in the table below.

**Table R.8: Summary of the NI Water Response to opex from capex**

| | Accept reduction | UR to review | Total |
|---|---|---|---|
| | £m | £m | £m |
| **Misunderstandings** | | | |
| Management & General (M&G) | - | 1.51 | 1.51 |
| Indexation | - | 0.27 | 0.27 |
| **Further information on disallowed items** | | | |
| Castor Bay to Belfast | - | 0.27 | 0.27 |
| Ballydougan to Newry | 0.06 | 0.00 | 0.06 |
| Killyhevlin | 0.07 | 0.00 | 0.07 |
| | **0.13** | **2.05** | **2.2** |

5.3.3 Further details can be found in Annex 04. Further to our discussion at the workshop on 17 October 2012, we ask the Utility Regulator to reconsider the disallowance.

## 5.4 TRANSFORMATION COSTS

5.4.1 Voluntary Early Retirement / Voluntary Severance and Business Improvement are our core toolsets to deliver efficiencies in PC13 and PC15. The Draft Determination has disallowed VER/VS of £5.6m and BI Subject Matter Experts of £3.2m. Each is considered briefly below.

**VER/VS**

5.4.2 During 2010/11 and 2011/12 NI Water has continued to offer a VER/VS scheme to aid the delivery of efficiency in the organisation. The level of formal applications for the schemes has been lower than anticipated during

these years, as the volunteers have often been from areas of the business which have been deemed to be business critical.

**Table R.9: Actual and Planned Level of VER/VS**

| £m (2010/11 prices) | 2010/11 | 2011/12 | 2012/13 | 2013/14 | 2014/15 |
|---|---|---|---|---|---|
| Actual/planned VER/VS | 35 | 28 | 26 | 37 | 37 |
| Average cost £k | 74,280 | 71,430 | 75,000 | 75,700 | 75,700 |
| **Total cost** | **2.6** | **1.9** | **1.8** | **2.8** | **2.8** |

5.4.3 The planned level of VER/VS uptake in the remainder of the PC13 is based on the levels of uptake in 2010/11 and 2011/12. It is expected that these levels will continue to be difficult to achieve without a major re-structuring programme which identifies the efficiencies and subsequent manpower reductions to be targeted, however they are necessary.

**Business Improvement**

5.4.4 At the start of 2012, NI Water's Executive Committee anticipated that efficiency savings in the PC13 period would be largely tactical across both headcount and non-headcount areas, supported by targeted budget cuts. Headcount reductions will require VER/VS funding identified above.

5.4.5 Foreseeing a limit to the savings that can be obtained from this approach, a Future Organisation Model (FOM) Business Case proposed how the next wave of strategic change could be planned during PC13 (2013-15). Put another way, NI Water will have greatly reduced its scope for tactical cost reductions by the end of PC13 and now needs to start to plan strategic change if it is to realise any significant benefits during PC15 (2015-2020).

5.4.6 Anticipating approval to complete the design phase during 2012/13 with assistance of subject matter experts, the PC13 Business Plan requested BI funding of a further £3.2m for relevant subject matter expertise through the PC13 period to accelerate the delivery of benefits from the start of PC15.

5.4.7 At the time of writing, approval by DRD to complete the design phase in 2012/13 with assistance of subject matter experts has yet to be given. Since

the timetable has slipped, it is now unlikely that NI Water will be capable of investing £3.2m to complete the work necessary in the PC13 period. This slippage on engaging subject matter experts is itself an example of the very real impact of additional workload and delay resulting from the present governance structures. As a result it is recommended that the Final Determination includes provision for £1.5m of funding for subject matter expertise (feasibility & delivery) during the PC13 period.

5.4.8 We note that the Utility Regulator does not anticipate that transformation costs will be treated as a-typical in the next price review. We would have concerns with this proposal since these costs relate to on-going transformation and restructuring activity and cannot be considered as part of the on-going business cost base.

## 5.5 DRAFT DETERMINATION APPROACH TO FUNDING

5.5.1 The Draft Determination proposes that transformation in PC13 should be funded through out-performance or if necessary through PE funding via 'relevant items' in order to avoid double-funding.

5.5.2 NI Water does not have access to any out-performance funding in PC10. Under PE rules, out-performance funding is handed back each year. Our argument in relation to 'double-funding' is explained in more detail in section 5.6 below.

5.5.3 The alternative option offered in the Draft Determination is that funding for these items can be sought via relevant items. We have some concerns regarding the adequacy of the 'relevant items' in the PC13 period. We explain this in more detail in Chapter 10. We also have concerns around lapsed time involved in relevant item bids.

5.5.4 It is our recommendation that transformation funding is built into the Final Determination since we will need it in order to effect the efficiencies in PC13 and PC15.

## 5.6 '**DOUBLE-FUNDING**'

5.6.1 Within the Draft Determination, the Utility Regulator has disallowed NI Water's bids for BI and VER/VS funding in PC13. The Utility Regulator argues that to allow these costs in PC13 would result in customers 'paying twice' due to underspends in these cost categories in PC10 (see section 4.2 above).

5.6.2 NI Water believes that to retrospectively ring-fence two cost categories in this manner is unfair. We also believe it is not consistent with the treatment agreed in the CWA which underpins the Memorandum of Understanding (MoU) between the Department and the Utility Regulator. For convenience we have reproduced the relevant CWA section below:

> ***"Section 1 PC10 Agreed Approaches***
>
> *The Department and the Regulator agree the following assumptions in respect of a determination.*
>
> - *RPI – The existing approach contained in the licence and for the use in the Scheme of charges will be maintained. RPI will also be taken into account in any bid for additional funding.*
> - *Construction Outputs Price Index (COPI) – The impact of COPI will be noted and monitored but no account taken of it until PC13 unless NI Water bring a bid forward for additional funding.*
> - *Correction Factor – No correction factor mechanism will be used during the PC10 period. For clarity, this means there will be no carry forward of under or over recoveries between years or into the PC13 period. There will also be no correction factor brought forward from the Strategic Business Plan (SBP)[3] period.*
> - *Ring-fencing – The Regulator agrees that there will be no ring fencing of operational expenditure during the PC10 period. This applies specifically to (a) the Business Improvement Programme (BIP) (b) the Voluntary Early Retirement/Voluntary Severance (VER/VS) and (c) PPP operating costs. Thus, out-performance in these areas can be applied against under-performance in other areas when measuring delivery against overall opex efficiency targets."*

5.6.3 Rather than isolating particular cost categories in the manner proposed by the Utility Regulator, we believe that a more comprehensive approach should be adopted. This means that consideration must also be given to additional costs incurred on previously 'unfunded' items as well as any income shortfall experienced by NI Water and variances in other revenue building blocks.

[3] Strategic Business Plan 2007-10

Such an approach would be in line with PE funding limits which we are currently subject to.

5.6.4 Analysis carried out previously in this document (section 4.2) shows that operational expenditure in PC10 is forecast to be £55m lower than Utility Regulator allowed in the PC10. This 'underspend' is summarised in Table R.10.

**Table R.10: PC10 Variance in Opex**

| PC10 Variance in Opex | Total £m |
|---|---|
| VER/VS | 23 |
| Business Improvement (BI) | 6 |
| Freeze / Thaw | (3) |
| CRC | (4) |
| PPP | 12 |
| **Subtotal** | **34** |
| Outperformance on underlying opex | 21 |
| **Total** | **55** |

5.6.5 The analysis shows that a £41m underspend on VER/VS, BI and PPP offset by £7m of unfunded costs (Freeze / Thaw and CRC costs) results in a net underspend of £34m. We are also forecasting an out-performance of PC10 Final Determination underlying opex targets of £21m (including CRC costs). This equates to a total projected underspend in PC10 of £55m.

5.6.6 When assessing the extent to which customers may be 'paying twice', variations in revenue recovered must also be considered. Table R.11 below demonstrates that in the same period NI Water's customer revenue was £33m lower than that assumed in the PC10 Final Determination.

**Table R.11: PC10 Variance in Income**

| | 2010/11 £m | 2011/12 £m | 2012/13 £m | Total £m |
|---|---|---|---|---|
| Total appointed income (FD revised RPI) | 351.0 | 350.9 | 357.8 | 1,104.5 |
| Total appointed income received | 345.7 | 338.6 | 342.4 | 1,069.7 |
| **Shortfall** | **5.2** | **12.4** | **15.5** | **33.1** |
| **Breakdown of variance** | | | | |
| Subsidy | -4.6 | 2.2 | 2.8 | 0.5 |
| Non-Domestic | 10.2 | 9.5 | 12.3 | 31.9 |
| Miscellaneous | -0.4 | 0.6 | 0.4 | 0.7 |
| **Total** | **5.2** | **12.4** | **15.5** | **33.1** |

5.6.7 The analysis shows that in PC10 we will under recover c.£32m of revenue from non-domestic customers. This shortfall arose because of a significant drop in non-domestic customer demand and a decision by the company not to pass on the full price increase to customers. A reduction in non-domestic income creates pressure on PE and NI Water has absorbed this pressure throughout the PC10 period through a reduction in operating expenditure, meaning no additional PE funding was necessary.

5.6.8 Revenue building blocks also include capital related allowances. During PC10 NI Water's capital programme was reduced by approximately £70m. In August 2011 the Utility Regulator (having considered both financial and non financial implications of the reduction to the capital programme) indicated that the impact on revenue of the variation between original and revised capital maintenance programmes would be considered by them when setting K factors for PC13[4]. At that time the Utility Regulator indicated an uplift of c.£10m to revenue would be appropriate.

[4] Water and Sewerage Service Price Control 2010-2013 – Capital budget change control August 2011 section 2 'Impact on revenue and price limits'.

5.6.9 NI Water believes the Utility Regulator's approach is not consistent with the approach agreed in the CWA. We also believe that revenue shortfalls and the impact of the revisions to PC10 capital must be considered when determining double funding and would also make the following points:

- NI Water is carrying c.2.5% unused K out of PC10. This equates to c.£15m in revenue over the period;
- The CWA for PC10 also prevented NI Water carrying forward and claiming the correction factor for the SBP period. At the time this was forecast at c.£15m; and
- There is no regulatory mechanism in place to deal with operational expenditure underspends or out-performance, unlike in E&W and Scotland.

5.6.10 It is our recommendation that transformation funding is built into the Final Determination since we will need it in order to effect the efficiencies in PC13 and PC15. NI Water would strongly urge the Utility Regulator to introduce an appropriate revenue adjustment mechanism similar to that in place in E&W and Scotland.

# 6 OPERATIONAL COST EFFICIENCY

**SUMMARY**

This chapter responds to the Utility Regulator's proposals with respect to operational efficiencies. In it we demonstrate how the efficiency calculation used by the Utility Regulator is not of sufficient robustness to support the catch up assumption. We also summarise relevant regulatory evidence which demonstrates that the Utility Regulator's proposed efficiency target sits at the top of the range experienced by GB utilities and that England and Wales comparator companies have not generally exceeded the 60% catch-up figure.

Based on the evidence provided, we have concluded that increasing the catch up target is unreasonable and is not justified. This represents a move away from incentive based regulation. Incentive based regulation has a proven track record of providing positive outcomes for both the customer and the company. NI Water believes that rather than increase the 'stick' in the manner proposed, the Utility Regulator should seek to strengthen existing reputational incentives and consider meaningful incentives to facilitate on-going out-performance.

The Utility Regulator states that efficiency targets should be achievable. We have concerns that the scale of the efficiency is not achievable in our governance model and in the short two year price control period which is less than just five months away. This is not assisted by the disallowance of transformation enabling funding.

## 6.1 INTRODUCTION

6.1.1 In the PC13 Business Plan NI Water proposed closing 60% of the efficiency gap to the frontier companies, which we assessed as 34.1% in the base year, over a ten year period. We explained that the longer catch-up period was necessary because our governance framework restricts the pace at which efficiencies can be delivered. In order to demonstrate this, we provided

specific examples (in both the Business Plan and in a follow up letter to the Utility Regulator Chairman) of how as a NDPB our financial and governance framework differs from that of other comparator companies and how this constrains the pace at which we can make sustainable cost savings.

6.1.2 In the Draft Determination the Utility Regulator has assessed the efficiency gap at 38.1% and set targets based on an assumption that NI Water could close 72.5% of the gap over a five year period. The Utility Regulator has chosen to ignore our arguments for a longer catch-up period and instead uses NI Water's NDPB status and the impediment to out-performance that this causes, as justification for the increase in catch-up.

6.1.3 With the assistance of Frontier Economics, we have analysed the Utility Regulator's assessment of the efficiency gap and the validity of the assumptions made in coming to this assessment. We have also considered the regulatory precedents cited by the Utility Regulator and other relevant evidence. From this we have concluded that the efficiency targets set are unreasonable and cannot be justified for the following reasons:

- We have significant concerns regarding the robustness of the efficiency modelling results and strongly believe they do not support a catch-up assumption greater than that previously applied by the Utility Regulator for PC10 or by Ofwat;
- The efficiency gap is overstated as a result of the Utility Regulator's approach to the allocation of special factors and a-typical costs;
- Empirical evidence demonstrates that the Utility Regulator's proposed efficiency target sits at the top of the range experienced by GB utilities;
- Empirical evidence demonstrates that E&W comparator companies have not generally exceeded the 60% catch-up figure;
- The Utility Regulator has not properly taken account of our dual status and the very real impact this has on the pace at which we can deliver sustainable cost reductions;
- The Utility Regulator's argument that it should apply a tougher catch-up target to NI Water because the company is a NDPB is flawed. NI Water would instead propose that existing reputational incentives are

strengthened and further meaningful incentives be considered to facilitate on-going out-performance;

- The Draft Determination materially overstates the level of efficiency savings which NI Water will achieve by the end of the PC10 period and thus understates the actual efficiency challenge in PC13. In order to meet the catch-up target in the Draft Determination, NI Water would have to achieve year-on-year efficiency savings of 7.3% on the whole of the cost base;
- The Draft Determination makes no allowance for the shortness of the PC13 period which will commence in less than five months; and
- The Draft Determination does not allow sufficient transformation enabling expenditure required by NI Water to make sustainable reductions.

6.1.4 In the remainder of this chapter we present evidence which supports our conclusions.

## 6.2 ROBUSTNESS OF EFFICIENCY MODELLING

6.2.1 Frontier Economics have concluded that there are a number of factors that indicate that the Utility Regulator's assessment of NI Water's relative efficiency is less robust and precise when compared to the assessment's made by Ofwat and the Water Industry Commission for Scotland (WICS). Frontier's paper is attached at Annex 03, however their findings are summarised below:

**Scale and Uncertainty over Special Factors**

6.2.2 The efficiency gap is calculated using Ofwat efficiency models which only use one or two variables to model NI Waters cost. As cost is driven by many factors, omitted variables can skew results and whilst the inclusion of special factors does adjust for some omitted variables, there is a risk that the remaining cost difference is not all genuine inefficiency. For NI Water, the scale of total special factors is higher than for any other E&W water and sewerage company. This indicates that the efficiency models are less suited to NI Water than to E&W companies. In addition, there is significant

uncertainty over the estimation of the water distribution special factor - the most material of the special factors claimed. Indeed the Utility Regulator agrees that further investigation is required in this area. Furthermore, NI Water strongly believes there are other special factors which have yet to be determined, a point which was acknowledged by the Utility Regulator in the Draft Determination. For example, there could be a case for a significant special factor in relation to sewerage network opex. This claim is borne out of the modelling results which show that actual expenditure in this area is 159% higher than that predicted by the econometric model.

**Modelling Process is Less Robust**

6.2.3 The efficiency models used by the Utility Regulator, which were developed by Ofwat, have not been updated since 2008/09. Whilst the Utility Regulator has re-estimated the models using available 2010/11 data, they have not replicated the data validation and refinement process used by Ofwat. This introduces the risk that the models are increasingly out of date and are less robust at predicting real efficiency. In this regard, it is worth noting that the model coefficients estimated by the Utility Regulator have in some cases deviated materially from those used by Ofwat in 2007/08. In addition, the sample size for the water models has also reduced from 22 to 21 companies. Frontier Economics have concluded that it would therefore be appropriate to apply a greater degree of caution when applying the efficiency models.

**Modelling Adjustments**

6.2.4 The Utility Regulator has based its efficiency targets on modelling results that exclude the results of the business activity models. The Utility Regulator has also chosen to reduce the special factor and a-typical claims to reflect this exclusion. Table R.12 demonstrates the impact of the exclusion of these models.

**Table R.12: Impact of Business Activity Model on the Efficiency Gap**

| | Water | Sewerage | Total |
|---|---|---|---|
| **Business Activity model included** | | | |
| Modelled Cost £m | 74.07 | 65.31 | 139.38 |
| Frontier Predicted costs £m | 53.13 | 45.37 | 98.49 |
| Efficiency Gap to frontier % | 28.27% | 30.54% | **29.33%** |
| **Business Activity model excluded** | | | |
| Modelled Cost £m | 66.64 | 59.70 | 126.33 |
| Frontier Predicted costs £m | 41.38 | 36.89 | 78.18 |
| Efficiency Gap to frontier % | 37.90% | 38.36% | **38.12%** |

6.2.5 By excluding the business activity model the efficiency gap increases from 29.3% to 38.1%. This has a significant impact on the efficiency target.

6.2.6 Whilst the Utility Regulator may have legitimate concerns about the validity of the business activity modelling results for NI Water, there are aspects of the Utility Regulator's approach which raise concerns for us:

- Essentially the Utility Regulator is excluding a model where there is a factor that operates in NI Water's favour. However, there may be factors in the other models that act in the other direction e.g. sewerage networks. This introduces the risk that the Utility Regulator's approach is perceived to be one-sided. Exclusion of this model also means NI Water has not benefitted from the significant reductions in business activity costs resulting from management's decision to in-source the customer billing back office function.
- A more direct concern is that the Utility Regulator has estimated the efficiency target based on the models excluding business activities but has then applied the targets to operating expenditure including business activities. The Utility Regulator is implicitly assuming that NI Water's underlying efficiency in business activities is the same as its measured efficiency in the other models. This is a dubious assumption that does not appear to be supported by any evidence. In fact, the analysis in Table R.13 shows that business activity expenditure has nearly halved since 2008/09.

**Table R.13: Business Activities Cost Since 2007-08 (Out-turn Prices)**

| | 2007/08 (£m) | 2008/09 (£m) | 2009/10 (£m) | 2010/11 (£m) | 2011/12 (£m) |
|---|---|---|---|---|---|
| **Business activities costs** | £24.07 | £26.59 | £25.52 | £14.97 | £13.25 |

- The Utility Regulator has also chosen to apply a reduction to allowed special factors and a-typical claims. This reduction was based on the proportion of business activity expenditure to total modelled expenditure. This approach assumes that the same proportion of special factor and a-typical costs also relate to business activities. We have carried out an analysis of these costs which provides a more accurate basis for making this adjustment. Table R.14 and R.15 demonstrate that the actual adjustment is significantly lower than that applied in the Draft Determination.

**Table R.14: Special factor adjustment to reflect exclusion of business activities**

| Special Factor | DD adjustment (£m) | Actual costs allocated (£m) |
|---|---|---|
| Water Distribution Econometric Model | -0.9 | 0.00 |
| Electricity prices | -0.5 | -0.01 |
| Regional Wages | 0.2 | 0.00 |
| NDPB status | -0.05 | -0.05 |
| **Total adjustment to Special Factor** | **-1.2** | **-0.06** |

**Table R.15: A-typical cost adjustment to reflect exclusion of business activities**

| A-typical costs | DD adjustment £m | Actual costs allocated £m |
|---|---|---|
| Business Improvement Programme | -0.2 | -0.03 |
| VER/VS | -0.2 | 0.00 |
| Freeze / Thaw | -0.5 | -0.56 |
| Staff Costs | -0.1 | -0.11 |
| Operational Contractors | 0.1 | 0.00 |
| Outsourcing | 0.2 | 2.40 |
| Legal & Professional | -0.1 | -0.80 |
| Bad Debts | 0.0 | 0.00 |
| Various | 0.1 | 0.00 |
| **Total adjustment to A-typical costs** | **-0.7** | **0.90** |

Reflecting this 'actuals based' adjustment in the Utility Regulators assessment of the efficiency gap would reduce it to 36.7%.

6.2.7 Frontier Economics have demonstrated that a number of aspects of the Utility Regulator's approach raise significant concerns regarding its robustness. We have therefore concluded that the Utility Regulator is not justified in applying the higher catch-up factor of 72.5%. This is a view supported by the Competition Commission recently when they concluded there was a clear link between the scale of the catch-up factor and the degree of confidence in the modelling results.

> *"We also emphasize that the main justification for having the 60 per cent catch-up rate over a five-year period is that there is noise in Ofwat's efficiency estimates. If it were not for this noise, a 100 per cent catch-up over a five-year period would not be an unreasonable target, especially for opex expenditure."*[5]

6.2.8 It is also worth contrasting the Utility Regulator's approach with that of WICS at SR02, when they set a catch-up target of 80% over five years. Whilst the overall catch-up was higher than that proposed by the Utility Regulator, there were a number of aspects of their approach which suggests their approach was more cautious, namely:

- 80% catch-up was predicated upon both the merger of the three water authorities going ahead and a spend to save allocation of £200m being made available to Scottish Water over the period;
- WICS assessment of the efficiency gap was based on three comparable companies from the E&W industry, not the frontier companies. In fact WICS assessment of the efficiency gap was based on the lowest ranked of the comparator companies, thus reducing the size of the efficiency gap further;
- WICS carried out an alternative assessment of the efficiency gap to validate the efficiency modelling results;
- WICS made a number of adjustments to Ofwat models to better reflect local issues. For example they amended explanatory factors in the water resource and treatment model (WICS included different source types) and in the small wastewater treatment works model (WICS extended banding

[5] Competition Commission 2010 Determination of charges for Bristol Water"

to include many small WwTW in Scotland and gave these works a higher unit cost); and

- Benchmarking included the full costs incurred by the companies for leakage targets, domestic metering and other imposed costs not faced in Scotland.

## 6.3 REGULATORY PRECEDENTS – A REVIEW OF RELEVANT EVIDENCE

6.3.1 NI Water asked Frontier Economics to assess whether available evidence supports the proposed catch-up efficiency target. Frontier Economics paper is attached at Annex 03. We have summarised their main findings.

### Competition Commission - Bristol Water Determination 2010

6.3.2 As part of this Determination, the Competition Commission considered whether E&W comparator companies have managed to achieve the 60% catch-up assumption that Ofwat has applied at successive price controls. The Competition Commission's analysis revealed the following:

- In the majority of cases (two-thirds) the company did not achieve the target based on 60% catch-up; and
- This result did not vary depending on the starting point. In other words, companies with a high degree of assessed inefficiency were just as likely to fail to achieve the target.

6.3.3 The Competition Commission concluded that the majority (two thirds) of companies do not achieve their catch-up targets.

### Reckon (2008)

6.3.4 In 2008 Reckon[6] undertook a study on the econometric models for UK Water Industry Research (UKWIR). They concluded that 65% represented an upper bound for the efficiency catch-up factor. However, this conclusion was based on the assumption that the cost differences identified by the models were genuine inefficiencies. This is an unrealistic assumption because not all

[6] Review of the Approach to Efficiency Assessment in the Regulation of the UK Water Industry, Reckon 2008

systematic cost differences have been accounted for and which, if relaxed, implies a lower catch-up factor.

**Water Industry Commissioner for Scotland – Scottish Water Final Determination 2002**

6.3.5 In 2002 the WICS imposed a catch-up factor of 80% applied over a five year period from 2001/02 to 2005/06. We have already highlighted a number of aspects of their Determination which, when compared with that of the Utility Regulator, demonstrate a more cautious approach on the part of WICS.

6.3.6 It is also worth noting the extent of the catch-up was dependent on the merger of the three water authorities that went to form Scottish Water. WICS also identified that the scale of catch-up would have been lower (50% as opposed to 80%), if the merger had not been a factor.

6.3.7 WICS allowed £200m of 'spend to save' funding. These allowances were profiled to match the profile of efficiency savings. WICS states that the catch-up targets were predicated on the availability of this spend to save investment funding.

6.3.8 These factors are important in understanding the context of the 80% catch-up target imposed by WICS in 2002. It is therefore not directly comparable to the approach adopted by the Utility Regulator in the PC13 Draft Determination.

6.3.9 WICS have reported that while Scottish Water managed to reduce operational expenditure by c.£160m, or 40%, by the end of SR02 period, it should be noted that these savings include merger savings. WICS estimated that the potential for merger savings ranged from a minimum of £36m to £52m. Therefore, it would be reasonable to assume that up to one third of total savings delivered in this period could be attributed directly to the merger of the three authorities.

**Office of Rail Regulator (ORR) - Network Rail determination 2008**

6.3.10 In the 2008 Price Control for Network Rail, the ORR applied a 66% catch-up factor over a five year period. This was based on catch-up to the upper quartile performance.

6.3.11 The relevant features of this approach are as follows.

- The efficiency target was set as a catch-up towards the upper quartile performance as opposed to the frontier performance;
- ORR identified the relevant efficiency benchmarks based on an extensive analysis considering a variety of sources of evidence. This included top-down and bottom-up assessments of efficiency, separate studies for different components of operating and maintenance expenditure. This focus on multiple sources of evidence would help to improve the reliability of the efficiency assessment; and
- The efficiency target imposed by ORR on Network Rail was 4.9% per year, compared to NI Water's Draft Determination target of 6% per year. The assessed efficiency gap of 35% was broadly similar to the Utility Regulator's assessed gap for NI Water of 38%.

6.3.12 Frontier Economics have concluded that regulatory precedent does not support a catch-up target of more than 60% catch-up to an efficiency frontier. Where higher catch-ups than 60% have been implied they involve specific characteristics that distinguish them from the Draft Determination. The specific characteristics include a situation where the savings are based on merger savings (WICS 2002) or are applied as catch-up to the upper quartile performance rather than the frontier performance (WICS 2010 or ORR 2008).

6.3.13 The analysis undertaken by the Competition Commission in the Bristol Water Determination illustrated that the E&W companies have typically not exceeded Ofwat's 60% catch-up assumption.

## 6.4 **IMPACT OF NDPB STATUS**

6.4.1 It is worth highlighting the way in which the Utility Regulator has treated NI Water's status as a NDPB when it comes to setting efficiency targets. Page 54 and Annex A of the Draft Determination set out the Utility Regulator's thinking:

> *"Annex A: 4.2.1 The Utility Regulator recognises that the operational model in which NI Water works is not typical. It is evident that they incur extra costs which private companies would not. A corporate structure which complies with government and regulatory rules will have extra compliance costs.*
>
> *5.9.11 As a NDPB subject to Departmental public expenditure (PE) controls, NI Water is incentivised to "spend to budget" (see Section 1.2 Governance Framework above). This means that the setting of the budget becomes all important as NI Water has less incentive to outperform than in the Ofwat regime. There is not the same imperative to incentivise NI Water to the extent that its efficiency target is calibrated upon 60% catch-up to frontier performance, with the remaining 40% available as potential outperformance.*
>
> *5.9.12 If NI Water outperforms its efficiency targets and delivers up, for example, 70% catch-up to frontier performance there is every likelihood such under spend would be required to be handed back to the Department.*
>
> *5.9.13 A critical success factor for NI Water, operating as it does within a public expenditure context, is for the company to reduce its operational expenditure within its PE funding envelope. NI Water's PE budget and its operational expenditure should reflect what is therefore achievable.*
>
> *5.9.14 We have therefore targeted a higher level of catch-up to frontier than we might otherwise have determined, reflecting the interests of consumers (and taxpayers)."*

6.4.2 The implication, as summarised in the final paragraph, is that the Utility Regulator imposed a higher catch-up factor than it would have done if NI

Water was not subject to Departmental public expenditure controls. There are a number of flaws in this 'tough' approach that the Utility Regulator has adopted.

**The Draft Determination does not properly take account of the impact NDPB status has on the pace of change**

6.4.3 The PC13 Draft Determination has included a special factor of £480k[7]. Whilst dual status does add cost, more importantly it places restrictions upon how cost reduction and transformation activity can be undertaken.

6.4.4 The Utility Regulator has not made any other allowance in the Draft Determination but rather used the lack of out-performance incentives inherent within the current PE budgetary regime, to justify increasing the efficiency catch-up target from 60% to 72.5%.

6.4.5 NI Water has consistently maintained that the efficiency targets in PC13 must reflect our unique status. In the PC13 Business Plan NI Water proposed closing 60% of the efficiency gap to the frontier companies, which we assessed as 34.1% in the base year, over a ten year period. We explained that the longer catch-up period was necessary because our governance framework restrict the pace at which efficiencies can be delivered.

6.4.6 NI Water have already provided evidence, both in the Business Plan, and in a follow up letter to the Utility Regulator Chairman, which clearly demonstrates how our financial and governance framework impacts our agility and removes a number of transformation options available to comparator companies. Chapter 3 of this document re-iterates our views on this issue

**The Utility Regulator Mis-understands Ofwat's position with regard to out-performance.**

6.4.7 The Utility Regulator's approach assumes that the 60% catch-up figure used by Ofwat is based on a view that the E&W companies can, on average,

[7] £530k was the determined assessment but this reduced by almost 10% to exclude business activity related costs

achieve more than the 60% but that the additional element is left as out-performance for shareholders. This view of Ofwat's approach is not supported by regulatory precedent. The Ofwat approach clearly allows the companies to retain a share of any additional efficiency beyond the 60%, in the same way that the companies would have to absorb the impact if they fail to achieve the 60% catch-up. However, the Ofwat approach is not based on an expectation that companies will achieve more than 60%. There is no basis for this in Ofwat's price control documentation.

6.4.8 Furthermore, in the Bristol Water Determination the Competition Commission was clear that the 60% catch-up figure is appropriate in terms of the 'statistical noise' in the econometric modelling. This view is supported by the Competition Commission finding that most companies do not exceed the 60% catch-up figure.

**The Utility Regulator's Approach is Not the Best Solution**

6.4.9 Overall, setting an efficiency target above the level that can realistically be achieved is not the appropriate solution to any incentive problems caused by the NDPB status.

6.4.10 NI Water agrees that the NDPB status provides challenges in terms of incentivising and delivering efficiency savings. However, the solution to this problem is not to impose higher, and unrealistic, targets, but instead to work to introduce meaningful and effective incentives.

6.4.11 There are a number of options for introducing stronger incentives into a publicly owned utility, even with the constraints imposed by the NDPB model. We have previously outlined these options in section 3.5 of this document.

## 6.5 ASSESSMENT OF PERFORMANCE IN PC10

6.5.1 When setting catch-up targets for PC13, the Utility Regulator takes account of efficiencies delivered in the intervening period between the base-year and the

start of the price control period. Therefore the better the performance in the intervening period, the lower the target in the price control period.

6.5.2 In their Draft Determination, the Utility Regulator made a number of adjustments to opex in the PC10 period. Most significantly they classified as efficiency savings, a £5.2m opex reduction surrendered as part of the 2012 October monitoring round. We have presented evidence to the Utility Regulator which demonstrates that this reduction was largely made up of a number of one-off type reductions and therefore cannot be classified as efficiency. NI Water has also revised the power projections contained within the Business Plan.

6.5.3 Chapter 4 provides analysis of outturn and forecast expenditure in PC10 and the impact on efficiencies. Table R.16 below summarises NI Waters view on the efficiencies we expect to achieve in PC10 and the impact this will have on PC13 targets.

**Table R.16: Impact of Opex Revisions on Efficiency Targets**

| | PC10 | | PC13 | | |
|---|---|---|---|---|---|
| | 2011/12 BY+1 | 2012/13 BY+2 | 2013/14 BY+3 | 2014/15 BY+4 | BY+5 |
| Catch-up (annual) - DD | 7.5% | 5.8% | 6.0% | 6.0% | 6.0% |
| **Catch-up (cumm.) - DD** | **7.5%** | **12.9%** | **18.1%** | **23.0%** | **27.6%** |
| | | | | | |
| Catch-up (annual) - PC10 Revised | 6.7% | 2.7% | 7.3% | 7.3% | 7.3% |
| **Catch-up (cumm.) - PC10 Revised** | **6.7%** | **9.2%** | **15.8%** | **21.9%** | **27.6%** |

6.5.4 In the Draft Determination, the Utility Regulator assumes that NI Water will deliver 12.9% cumulative efficiencies by 2012/13. However, this reduces to 9.2% when we re-categorise the reduction in 2012/13 to predominately 'one-off' in nature. Therefore, if we adopt the same catch-up target proposed in the Draft Determination, the actual efficiency challenge in PC13 would increase from 6% to 7.3% per annum.

## 6.6 ACHIEVEABILITY

6.6.1 NI Water has concerns about the achievability of the efficiencies proposed by the Utility Regulator. There is a direct correlation between the scope for achieving savings from operational cost and the extent to which it can be deemed controllable in the short to medium term. In our Business Plan we presented a categorisation of our opex cost base as proportion of 2012/13 budget as follows:

**Table R.17: Analysis of NI Water's cost base**

| Category | Comprises | Proportion |
|---|---|---|
| Headcount | • Wages<br>• Salaries<br>• Cap sals<br>• Overtime<br>• VER/VS | 25% |
| Controllable | • Contractors<br>• Materials<br>• Chemicals<br>• Vehicle & Plant<br>• Office & Computer<br>• Power [60%] | 38% |
| Non-controllable | • PPP<br>• Rates<br>• Bad Debt<br>• Regulatory<br>• Power [40%] | 37% |

6.6.2 Whilst there is an element of subjectivity regarding the categorisation of costs between controllable and non-controllable, it is the case that NI Water has little or no control over legacy PPP contracts, rates costs and costs charged by our various regulatory stakeholders. In addition, 40% of power is estimated to be non-controllable.

6.6.3 Working on the basis that the £15.7m efficiency in the PC13 Determination (£7.9m in 2013/14 and £7.8m in year 2) will need to be effected in the headcount and controllable cost pools, the proportionate split would look as follows:

**Table R.18: Possible allocation of efficiency**

| Category | Proportion | % | 2013/14 (£m) | 2014/15 (£m) | Total (£m) |
|---|---|---|---|---|---|
| Headcount | 25% | 40% | 3.2 | 3.1 | 6.3 |
| Controllable | 38% | 60% | 4.7 | 4.7 | 9.4 |
| Non-controllable | 37% | Assume very limited scope for efficiencies in these categories | | | |
| **Totals** | **100%** | **100%** | **7.9** | **7.8** | **15.7** |

6.6.4 Assuming an average staff cost of £40k, the Draft Determination efficiency equates to almost 160 headcount reductions in the two-year period of which 80 would be required in 2013/14. This equates to a 12% reduction in staff numbers within 18 months, just to deliver this element of the required opex efficiency. Our PC13 Business Plan projected a headcount reduction of 75 over the two year period, which we regarded a challenge to achieve.

6.6.5 In addition, the Draft Determination efficiency equates to a further £5.9m in controllable costs. This amounts to over a 12% reduction in controllable costs in the 2012/13 budget.

6.6.6 We cannot see how the scale of the efficiency proposed in the Draft Determination can be achieved in our governance model without excessive risk, and in the short two year price control period which is less than just five months away. This is further undermined by disallowance of BI and VER/VS monies.

## 6.7 OTHER RELATED MATTERS

### Special Factors

6.7.1 We have reviewed the special factor Draft Determination and would make the following points:

#### a) Water distribution

Whilst there is agreement that a special factor adjustment is required it is clear there is not yet a clear definitive approach. NI Water welcomes the

Utility Regulator's acknowledgement that further investigation is required to better predict distribution opex and efficiency for PC15. For PC13 the Utility Regulator has derived the special factor using a composite scale variables (CSV) approach which uses the length of main, connected properties, (winter) population and distribution input as explanatory variables for Distribution Opex.

We have a number of issues with the manner in which the Utility Regulator has implemented the CSV approach:

- Whilst the Utility Regulator notes correctly that all these variables are highly correlated, they partially dismiss length of main because the simple correlation to opex is not as high as with the others. This is used as the basis for setting the weights in favour of connected properties and winter population (the variables that give the lowest estimate). We would have concerns with using the highest simple correlation to attribute causality.
- We would question whether the connected properties and winter population variables capture different attributes of the network configuration. If not the CSV would be assigning a weight of 60% to the lowest possible estimate.
- The sample size is still 21 and even with only one regressor, the standard error is fairly high.

**b) NDPB status**

The PC13 Draft Determination has included a special factor of £480k. Whilst dual status does add cost, more importantly it places restrictions upon how cost reduction and transformation activity can be undertaken.

**c) Additional special factors**

NI Water strongly believes there are other special factors which have yet to be determined, a point which was acknowledged by the Utility Regulator in the Draft Determination.

**Frontier Shift**

6.7.2 We have reviewed the approach to assessing frontier shift in the First Economics report for the Utility Regulator. We believe the approach adopted is broadly reasonable but would make the following observations:

**a) Input price inflation**

The assessment of input price inflation is based on an industry standard input mix. We believe NI Water's mix is materially different for several cost categories. Table R.19 below compares the assumed mix with NI Waters actual (calculated from our 2012/13 October monitoring round position). It is worth highlighting that the proportion of power costs to total opex for an average WaSC is assumed as 12.5% compared to an actual figure of 23%. NI Water would recommend the actual input mix is used in the Final Determination.

**Table R.19: Input price mix**

| Category | Proportion Draft Determination | Proportion NI Water Actual |
|---|---|---|
| Labour | 50.0% | 50.2% |
| Materials | 10.0% | 3.8% |
| Chemicals | 2.5% | 2.8% |
| Power | 12.5% | 23.0% |
| Rates | 10.0% | 9.3% |
| EA charges | 5.0% | 2.5% |
| Bad debt | 5.0% | 0.6% |
| Other | 5.0% | 7.8% |
| **Totals** | 100.0% | 100.0% |

**b) Productivity growth**

We have reviewed the approach to Total Factor Productivity (TFP) and note that it is the same as that adopted by Cambridge Economic Policy Associates (CEPA) and Reckon for ORR and applied by the Competition Commission to Bristol Water. However it does not appear that First Economics used a time period that represents a full economic cycle For example CEPA, in its

analysis for ORR, used a period 1997-2006. It is not clear what the impact of these different time periods is. We note that the CEPA study estimates that the whole economic TFP for the period 1997-2006 was 0.1%. The whole economy TFP for the First Economics period 1990-2007 was 0.07%. This might suggest the First Economics have overstated the TFP improvements.

# 7 THE INVESTMENT PROGRAMME

**SUMMARY**

This chapter deals with the Utility Regulator's proposals in relation to the Capital Investment Programme for PC13. NI Water acknowledges that the Utility Regulator has, in the main, agreed with and accepted our proposals for capital investment and the need to continue investment in our infrastructure.

Our revised capital submission reflects the two PE Revisions advised by DRD in May 2012 and September 2012 and is constrained by the level of PE available.

The Utility Regulator has proposed additional outputs of £11.5m. There are a number of areas where we have challenged the Draft Determination findings in relation to the scope for additional outputs and through the provision of clarifications or additional information we ask the Utility Regulator to reconsider its conclusions.

## 7.1 CAPITAL INVESTMENT OUT-TURN FOR PC10

7.1.1 We welcome the conclusion of the Draft Determination that the company has delivered the capital efficiency challenge set out in the PC10 Final Determination. This is a significant achievement, considering the governance and delivery framework in which we operate

7.1.2 We understand the assessment of logging up and logging down in Annex J. We note that this will need to be reassessed in due course following recent adjustments to PE funding availability.

## 7.2 CAPITAL INVESTMENT IN PC13

7.2.1 NI Water notes the re-profile of the capital funding in the Draft Determination which provided a more uniform expenditure profile and would have assisted with efficient delivery. Since the Draft Determination a further change to available PE has been made and this has been incorporated into our Draft Determination response. Unfortunately this returns the funding to a saw-tooth profile which will increase the challenge on efficient delivery.

7.2.2 A summary of the capital funding presented in the PC13 Business Plan, the subsequent PE revisions and the resultant capital funding presented in the Draft Determination response is provided below.

**Table R.20: Capital Programme Re-profile**

| | 2012/13 (£m) | 2013/14 (£m) | 2014/15 (£m) | PC13 Total (£m) |
|---|---|---|---|---|
| PC13 BP | 147.6 | 151.3 | 180.0 | 331.3 |
| PE Revision 1 | | +15.0 | (15.0) | - |
| PC13 DD | 147.6 | 166.3 | 165.0 | 331.3 |
| PE Revision 2 | +12.0 | - | (12.0) | (12.0) |
| PC13 DD Response | 159.6 | 166.3 | 153.0 | 319.3 |
| PC13 DD Response (Nominal)* | 162.3 | 168.0 | 155.9 | 323.9 |

*Nominal, gross, adjusted for additional £0.9m capital income identified in Draft Determination and agreed by NI Water.

7.2.3 A summary of how these PE revisions impact the sub-programmes in 2012/13 and the PC13 years is presented below.

**Table R.21: Revised Capital Profile**

| Sub-Prog | Title | Business Plan (£m) | | DD Response (Re-profiled) (£m) | | DDR-BP Variance (£m) | |
|---|---|---|---|---|---|---|---|
| | | 2012/13 | Total PC13 | 2012/13 | Total PC13 | 2012/13 | Total PC13 |
| 0 | Staff salaries and on-costs | 10.57 | 21.20 | 10.50 | 21.17 | -0.06 | -0.03 |
| 1 | Base maintenance (Water) | 4.45 | 5.10 | 4.06 | 8.18 | -0.38 | 3.08 |
| 2 | Base maintenance (Sewerage) | 11.58 | 26.60 | 16.25 | 19.14 | 4.67 | -7.47 |
| 3 | Water resources | 5.36 | 1.60 | 3.80 | 2.04 | -1.56 | 0.44 |
| 4 | Water treatment works | 0.45 | 3.80 | -0.14 | 4.16 | -0.59 | 0.36 |
| 5 | Water trunk mains | 4.35 | 28.80 | 3.82 | 27.41 | -0.53 | -1.39 |
| 6 | Service reservoirs & clear water tanks | 1.10 | 1.60 | 1.15 | 2.05 | 0.05 | 0.45 |
| 7 | Service reservoir rehab | 0.50 | 8.30 | 0.63 | 8.25 | 0.13 | -0.05 |
| 8 | Water mains rehabilitation | 31.71 | 53.50 | 33.19 | 54.20 | 1.48 | 0.69 |
| 23 | Water Mains new and replacement | 0.26 | 6.80 | 0.23 | 6.10 | -0.03 | -0.70 |
| 11 | Named Sewerage Projects | 0.12 | 0.00 | 0.06 | 0.00 | -0.06 | 0.00 |
| 12 | Sewerage Maintenance, Flooding and DG5 | 13.22 | 49.30 | 19.49 | 40.78 | 6.27 | -8.52 |
| 24 | Sewerage - Development and ad-hoc repairs | 3.12 | 6.10 | 4.79 | 7.71 | 1.68 | 1.61 |
| 15 | Wastewater treatment (carry over projects) | 4.92 | 0.90 | 3.48 | 3.10 | -1.44 | 2.20 |
| 16 | Wastewater treatment (new starts) | 21.16 | 46.60 | 21.50 | 43.23 | 0.34 | -3.37 |
| 17 | Small wastewater treatment works | 1.00 | 7.50 | 2.47 | 7.41 | 1.47 | -0.09 |
| 9 | Leakage | 3.09 | 6.10 | 3.06 | 6.09 | -0.03 | -0.01 |
| 10 | Ops capital Water (Base) | 7.98 | 16.00 | 7.91 | 16.02 | -0.06 | 0.02 |
| 18 | Ops Capital Sewerage (base) | 7.29 | 15.70 | 7.17 | 15.70 | -0.12 | 0.00 |
| 19 | Metering | 2.32 | 4.60 | 2.21 | 4.63 | -0.11 | 0.03 |
| 20 | M&G | 15.29 | 24.70 | 16.30 | 26.50 | 1.01 | 1.80 |
| 25 | Additional Outputs | 0.00 | 0.00 | 0.36 | 0.00 | 0.36 | 0.00 |
| | **Total** | **149.82** | **334.80** | **162.30** | **323.85** | **12.48** | **-10.95** |

Note: All prices in this table are nominal

7.2.4 The key reasons for variances in the sub-programmes is provided in Annex 06 along with a revised Table 3.3 (Proposed Expenditure by Project or Sub-Programme) reflecting both the programme re-profile and PE alterations.

7.2.5 At the time of drafting this response, we understand that another PE revision may require an additional £5m investment in 2012/13. This has not been factored into the above summary nor into the revised Table 3.3 in Annex 06 as the outcome of the 2012 October monitoring round, has not been announced. This is a current example of PE funding constraints.

## 7.3 APPLICATION OF INVESTMENT

7.3.1 The Utility Regulator's guidance for PC13 stated that the existing Social and Environmental Guidance as structured for PC10 would remain during PC13. It was indicated that the revisions for PC13 should not be limited by the Base / Enhancement proportions providing there was alignment over the combined PC10/PC13 period.

7.3.2 NI Water has complied with the Social and Environmental Guidance by allocating budgets across service and purpose streams in similar proportions. An outcome has been achieved that gives reasonable alignment.

7.3.3 An overview of the 16-box models for PC10, PC13 and a combined PC10/13 is provided below.

**Table R.22: PC10 Projected 16-Box Model**

| PC10 | Quality Enhancement | Base service provision | Enhanced service levels | Supply Demand Balance | Totals |
|---|---|---|---|---|---|
| Water Infrastructure | 5.51% | 13.60% | 1.96% | 8.98% | 30.05% |
| Water Non-infrastructure | 1.30% | 9.98% | 0.55% | 3.29% | 15.12% |
| Sewerage Infrastructure | 5.89% | 5.11% | 1.96% | 3.97% | 16.92% |
| Sewerage Non-infrastructure | 9.21% | 20.35% | 0.98% | 7.38% | 37.91% |
| Totals | 21.90% | 49.04% | 5.44% | 23.61% | 100.00% |

**Table R.23: PC13 Projected 16-Box Model**

| PC13 | Quality Enhancement | Base service provision | Enhanced service levels | Supply Demand Balance | Totals |
|---|---|---|---|---|---|
| Water Infrastructure | 6.55% | 14.92% | 1.02% | 10.88% | 33.37% |
| Water Non-infrastructure | 0.31% | 11.51% | 1.12% | 3.79% | 16.73% |
| Sewerage Infrastructure | 5.90% | 6.13% | 2.22% | 2.66% | 16.91% |
| Sewerage Non-infrastructure | 8.37% | 18.54% | 1.16% | 4.92% | 33.00% |
| Totals | 21.13% | 51.10% | 5.53% | 22.24% | 100.00% |

**Table R.24: PC10/PC13 Composite 16-Box Model**

| PC10/PC13 Composite | Quality Enhancement | Base service provision | Enhanced service levels | Supply Demand Balance | Totals |
|---|---|---|---|---|---|
| Water Infrastructure | 5.91% | 14.11% | 1.60% | 9.71% | 31.33% |
| Water Non-infrastructure | 0.92% | 10.57% | 0.77% | 3.48% | 15.74% |
| Sewerage Infrastructure | 5.89% | 5.50% | 2.06% | 3.46% | 16.91% |
| Sewerage Non-infrastructure | 8.88% | 19.66% | 1.05% | 6.43% | 36.02% |
| Totals | 21.61% | 49.83% | 5.48% | 23.08% | 100.00% |

7.3.4 NI Water has strived to ensure the apportionment of allocations remain similar to that originally scoped at PC10 which are generally accepted to reflect the Social and Environmental Guidance developed by DRD.

7.3.5 The budget re-profile has necessitated changes in the programme from the original Business Plan submission but these have been managed to minimise impact on nominated outputs:

- The Ardglass WwTW project has been deferred to PC13 and construction of the Ballycastle WwTW has been re-programmed into PC15 to allow for the relevant sites to be procured;
- The M1 Trunk main project has been reprogrammed to PC15; and
- A number of Unsatisfactory Intermittent Discharges (UID)'s have been moved out of PC13. This has been done with the agreement of the NIEA

after consideration of budgetary constraints and priorities. These UIDs are identified as Ballysally UID Coleraine, East Belfast Screens and Hunters Mill, Downpatrick.

## 7.4 SCOPE FOR ADDITIONAL OUTPUTS

7.4.1 The Draft Determination proposes £11.5m of adjustments to the capital programme, as summarised in the table below. The rationale for each of these adjustments is discussed in subsequent sections.

**Table R.25: Capital Adjustments proposed in the Draft Determination**

| | PC13 DD Adjustment (£m) |
|---|---|
| Additional capital income | 0.9 |
| Continuing efficiency | 4.6 |
| Unit cost & scope challenge | 5.9 |
| Total adjustment | 11.5 |

### Additional Capital Income

7.4.2 NI Water accepts that an adjustment should be made in this element of the Business Plan and agrees that an additional £0.9m should be included.

### Continuing Capital Efficiency

7.4.3 In Section 3.5.4 of the Draft Determination the Utility Regulator states:

> *"it would only be appropriate to extend the continuing efficiency adjustment of 0.4% a year into PC13, assuming 2010/11 as the price base for cost estimates in the company's Business Plan".*

7.4.4 This efficiency adjustment requires NI Water to reduce the cost of planned outputs by £4.6m. This is stated by the Utility Regulator as the *"frontier shift"* element of capex efficiency.

7.4.5 NI Water challenges the Utility Regulator's assessment that £4.6m should be assigned to efficiency.

There are two major areas of contention:

a) It appears that a cumulative efficiency of 0.4% per annum has been applied to all PC13 capex from year one of PC10 rather than year one of PC13. Since PC13 cost estimates are based on unit rates at the end of PC10 (i.e. post-PC10 efficiencies), this is unreasonable. Efficiencies should be applied as 0.4% in year 1 and 0.8% in year 2 (rather than 1.6% and 2.0%); and

b) It also appears that this cumulative efficiency has been applied to the entire PC13 capital programme, even though many projects have already started on-site, been awarded, tendered or are otherwise committed. There is no opportunity for NI Water to deliver further efficiencies from these projects.

7.4.6 In Section 3.5.3 of the Draft Determination the Utility Regulator acknowledges that much of the work in PC13 is already committed, is in procurement, will be delivered through existing framework contracts or is based on well-developed scopes of work estimated using recent tender costs. Whilst accepting the established frontier shift efficiencies within capex from the PC10 period derived from the tested Ofwat model, there are a number of issues which NI Water wishes to raise with the Utility Regulator on the calculation of capital efficiency:

**Application of Frontier Shift from 2010/11**

7.4.7 In section 3.3.7 of the Draft Determination the Utility Regulator concluded:

> *"Taking account of the fact that the logging up and logging down process does not credit the company for material omissions in its PC10 business plan, we have concluded that the company has delivered the capital efficiency challenge set in the PC10 final determination."*

7.4.8 This efficiency delivery includes the frontier shift efficiency across both the base and enhancement programmes for the whole of the PC10 period. The application of frontier shift from the start of PC10 to the entire PC13 programme effectively doubles the efficiency on the frontier shift already delivered by NI Water in the PC10 period. This improvement in efficiency is

already incorporated in the contracted project costs and estimated project costs within the programme for PC13.

7.4.9 NI Water contends that the application of the frontier shift should be from the start of the PC13 period (for only those projects not already committed), not back dating the efficiency to the start of the PC10 period. This proposed approach for PC13 replicates the accepted approach used in PC10 on frontier shift efficiency targets.

**The Elements of the PC13 Programme Available to Deliver Frontier Shift Efficiencies**

7.4.10 Projects carrying over from PC10 into PC13 will be committed prior to the start of the PC13 period as recognised in Section 3.5.3 of the Draft Determination. This means that NI Water is unable to deliver additional frontier efficiency above that delivered for PC10 for projects started prior to the PC13 period. The frontier shift efficiency should only be applied to those projects and programmes starting in PC13 and should be applied from the start of the PC13 period for the two years of the period.

**NDPB Status and the Impact of Public Expenditure**

7.4.11 The change in the capital programme profile reduces expenditure in the final year of the PC13 period. This should reduce the efficiency demanded by frontier shift. Smooth spend profiles have been shown to correlate with efficient delivery in a recent study of the water industry as shown in the Treasury report *"Smoothing investment cycles in the water sector"*. The current NI Water PE process does not provide smooth controllable spend profiles essential for efficient delivery in any utility. NDPB status also reduces the ability to take risks, both in delivering innovative solutions and in developing long-term industry leading partnership arrangements.

7.4.12 NI Water asks the Utility Regulator to consider the cumulative effect of PE funding changes and NDPB status on NI Water's ability to deliver frontier shift efficiency improvements.

**Impact of Indexation**

7.4.13 The Utility Regulator should also consider that the Construction Output Price Index (COPI) itself, at the component project level includes the UK construction programme's delivery of frontier shift across the construction industry through the monitoring of outputs. In indexing projects to the 2010/11 year the Utility Regulator has effectively applied the output frontier shift for the UK construction industry to the prices and then duplicated the application to the whole PC13 period.

7.4.14 The majority of prices within the PC13 Business Plan were presented as nominal costs linked to Table 3.3. These costs fell into three main types:

a. Tendered costs for PC10/PC13 carryover, with tendered costs for the PC13 period from Capital Programme Monitoring and Reporting (CPMR) system and these are nominal costs;
b. Estimated costs for projects with a defined scope drawn from the CPMR system and these are therefore nominal costs for the year of insertion; and
c. Project and programme estimates based on current costings in 2011/12 prices and using COPI to inflate costs for insertion in Table 3.3.

7.4.15 Frontier shift for 2013/14 and 2014/15 can only truly be applied to the projects and programmes in category 'c' which have not started in PC10 and are therefore in a position to deliver frontier shift.

**Duration of the PC13 Price Control Period**

7.4.16 The two year duration of the PC13 price control period limits the ability to deliver the innovations in capital delivery and capital solutions chosen. The delivery of frontier shift within a capital programme is usually delivered across the five year period in UK water and sewerage companies. The profile of frontier shift delivery is not smooth. Normally projects in the later part of the programme, using the benefit of development and innovation, deliver the frontier shift.

In a two year price control period NI Water can only be expected to continue to deliver elements of frontier shift carrying forward from PC10 in 2013/14 and 2014/15 within the limitation of NI Water's status.

**Impact of Efficiency on Projects Outside the Capital Works Programme (CWP)**

7.4.17 Retaining the existing level of efficiency with the duplication of the PC10 frontier shift efficiency means that since the majority of committed projects lie within the CWP, the proposed efficiencies will have to be found, disproportionately, from M&G and Operations Capital. Particularly if this level of efficiency has to be derived from M&G projects it will limit NI Water's ability to transform the business and to deliver continuing sustained efficiencies.

7.4.18 In addition, M&G investment is 60% base maintenance while Operations Capital is nearly 100% base maintenance with very limited enhancement allocation. The proposed efficiency will therefore also have a disproportionate impact on the base maintenance allowance.

7.4.19 In PC10 the Utility Regulator excluded committed projects from the delivery of frontier efficiency, and NI Water has delivered the frontier shift for those elements of the programme subject to this efficiency.

7.4.20 NI Water has prepared a revised efficiency calculation for PC13 based on the capital available to deliver the frontier shift, as summarised in Table R.26 below.

**Table R.26: Revised Capital Efficiency**

| | Carryover Funding within programme 2013/14 (£m) | Carryover Funding within Programme 2014/15 (£m) |
|---|---|---|
| Total of projects already "committed" | 77.15 | 20.24 |
| Total Capex | 167.97 | 155.88 |
| Total available to deliver required efficiency | 90.82 | 135.64 |
| Required efficiency (based on 0.4% per annum) | 0.4% | 0.8% |
| Efficiency to be derived from available capex | £0.36 | £1.09 |
| Total efficiency | | £1.45 |

7.4.21 This analysis is based on contracts within projects with an approved A3 status (the contract award point) on the 18 October 2012 within the NI Water capital approval system CAPTRAX[8].

7.4.22 In summary NI Water has limited opportunity to deliver frontier efficiency across the entire capital programme and consider that a total of £1.45m is the most correct catch-up for frontier shift efficiency.

**Unit Cost and Scope Challenge**

7.4.23 NI Water acknowledges the positive comments on the progress made to improve the quality of the information provided in our business cases.

7.4.24 The Draft Determination has proposed unit cost and scope challenge of £5.9m as summarised in the table below. The rationale for each of these adjustments is reviewed in subsequent sections.

[8] Part of the CPMR system that monitors the Capital Works Programme.

**Table R.27: Unit Cost & Scope Challenge**

| | PC13 DD Adjustment (£m) |
|---|---|
| Capitalised salaries and on-costs | 1.8 |
| Water main unit rates | 2.1 |
| WwTW options | 2.0 |
| Total challenge | 5.9 |

## 7.5 CAPITALISED SALARIES AND ON-COSTS

7.5.1 In the PC13 Business Plan, a reduction of £1.1m was made to the NI Water opex baseline. This reflected the reduction in opex resulting from the capitalisation of staff time involved in capital delivery across the business. This was then capitalised within the capitalised salaries (capsals) and on-costs sub-programme as part of the £1.1m per annum increase in this programme in PC10.

7.5.2 The Draft Determination applied a "scope challenge" of £0.9m per annum to the company's capsals and on-costs, effectively removing the funding for all of the additional capsals identified in the PC13 process.

7.5.3 The Utility Regulator's proposal to remove all of the additional capsals from the capital investment plan is far more severe than the opex efficiency which would have been applied had it been left as opex (100% efficiency as capex versus 23% as opex).

7.5.4 This approach would act as a major disincentive for the company to review its capitalisation policy and ensure direct comparability with water companies in E&W. It appears to penalise rather than incentivise NI Water. We suggest that a proportionate approach would be to apply (as an absolute maximum) the equivalent opex efficiency to the additional capsals, i.e. c.£400k rather than £1.8m.

7.5.5 We acknowledge that the inclusion of additional capsals has an effect on the cost base efficiency analysis. However, in assessing the scope for the capsals challenge, the Utility Regulator has applied the PC10 capsals percentage allocations. When these allocations were derived, NI Water was not subject to NDPB end-of-year inflexibility constraints. Therefore, it is inappropriate to use the same percentages to recalculate capsals' requirements based on the PC13 capital programme.

7.5.6 Generally, the Utility Regulator assumes that a reduced capital programme will result in reduced in-house project management requirements and, thereby, the ability to reassign resources to reduce external project management costs. As noted in NI Water's PC13 Business Case for Sub-Programme 00, capsals associated with the delivery of the capital works programme have been reduced in PC10, reflecting the lower spend profile (see table below). Since the capital spend in PC13 remains at levels similar to those at the end of PC10, the Utility Regulator's assumption of additional reductions is unwarranted.

**Table R.28: Comparison of 2010/11 Against 2012/13 Budget – based on revised capitalisation policy**

| | 2010/11 Actual | | 2012/13 Budget | | Variance 2010/11 to 2012/13 | |
|---|---|---|---|---|---|---|
| **Directorate** | **(£m)** | **FTE** | **(£m)** | **FTE** | **(£m)** | **FTE** |
| CWP | 3.6 | 79 | 3.1 | 66.2 | 0.5 | -12.8 |
| M&G | 2.8 | 61.76 | 4.0 | 80.1 | 1.3 | 18.74 |
| Operations | 0.9 | 21.55 | 2.3 | 60.7 | 1.4 | 39.15 |
| **Total** | **7.3** | **162.31** | **9.5** | **207** | **2.2** | **45.09** |

7.5.7 In addition, due to the lack of year-end flexibility and frequent in-year changes to capital budgets, managing the capital works programme to deliver out-turn spend precisely on target imposes an additional project management burden. Reductions in budget require project delivery to be "slowed", whilst additional in-year funding requires delivery to be accelerated – all of which must be managed without recourse to additional external resources.

## 7.6 WATER MAINS UNIT RATES

7.6.1 Having reviewed the latest correspondence from the Utility Regulator[9] and after careful consideration, NI Water accepts the logic and rationale contained within the above response document but wishes to comment on the calculation provided.

7.6.2 The response to Query 003 provides a derivation of the overall unit rate from the PC13 information submitted and includes an estimated uplift for polyethylene pipe of 4%. This has since been updated and revised to 4.7%, based on the most recent paper presented to the NI Water Capital Investment Panel for approval.

7.6.3 In summary, the programme increases from the Draft Determination of £51,388k to a revised figure of £51,717k.

7.6.4 NI Water considers the enforcement of a methodology for tracking rural and urban activity will provide the Utility Regulator with better visibility of how the programme is performing against the assumptions and estimates made when submitting the original Business Case and further opportunity to scrutinise unit costs as PC13 progresses. We note that currently we are in negotiations with the two water mains rehabilitation contractors who are reluctant to take on work in urban areas at current rates. This demonstrates that in a time of severe recession in the construction industry, these rates are very challenging for contractors.

## 7.7 WwTW OPTIONS

*7.7.1* The Utility Regulator has proposed Unit Cost and scope challenges to WwTWs in the Draft Determination on the basis that estimates are not fully developed and therefore will be subject to change, i.e. reduced costs:

[9] Utility Regulator's Response to NI Water Draft Determination Query 003 – 3 October 2012.

*"The company has only considered single options for some schemes. Consideration of a range of options offers the opportunity for further efficiency".*

7.7.2 At the time of preparing the Business Case for Sub-Programme 16 (Wastewater Treatment New Starts) a spreadsheet was presented, tabulating the preferred option for each site and giving a high level cost estimate for delivery of each solution.

7.7.3 In the background, NI Water's consultants were progressing through the Stage 1 and Stage 2 appraisal process identifying options and developing robust cost estimates using NI Water specific data from recently completed projects of a similar size and nature. Since the Business Plan was submitted the first set of three project cost estimates / appraisal studies (as listed below) have been issued to NI Water.

7.7.4 The information gives visibility of the progression through the appraisal process and the results indicate that not only have a number of options been investigated for each site but the latest costs are consistent with the original costs presented in the Business Plan. Table R.29 below summarises the current cost estimate while Table R.30 summarises the current approval status of each project. The costs presented in Stage 2 reports and CIP papers have been adjusted for COPI[10] to 2013/14 prices from 2011/12 estimates.

**Table R.29: Current Cost Estimates**

| Code | WwTW Site | Business Plan Estimate (£'k) | Current / A1 Estimate (£'k) | Variance |
|---|---|---|---|---|
| KP668 | Lisnarrick | 1, 240 | 1,356 | +9.41% |
| KL394 | Drumsurn | 1,679 | 1,646 | -1.76% |
| KL386 | Gortnahey | 1,617 | 1,588 | -2.00% |

[10] Construction Output Price Index

**Table R.30: Additional Information Provided to the Utility Regulator**

| Code | WwTW Site | Stage 1 Appraisal | Stage 2 Appraisal | A1 Approved |
|---|---|---|---|---|
| KP668 | Lisnarrick | ✓ | Draft | |
| KL394 | Drumsurn | Composite Report Stage 1 and Stage 2 | | ✓ |
| KL386 | Gortnahey | Composite Report Stage 1 and Stage 2 | | ✓ |

7.7.5 The Appraisal Reports for Lisnarrick, Drumsurn and Gortnahey are attached as Annex 02.

## 7.8 CONTINUITY OF INVESTMENT

7.8.1 In Annex K of the Draft Determination the Utility Regulator asked NI Water to:

a) *"Set out a plan for managing the continuity of investment"…*and

b) *"Identify the work it [NI Water] will carry out in PC13 to develop the evidence base for sustainable development of water services…"*

7.8.2 We set out these plans in Annex 08.

## 7.9 CONCLUSION

7.9.1 As discussed above, the evidence does not support all aspects of the Utility Regulator's assessment of the potential adjustment (additional £11.5m of outputs). Nevertheless, as required by the Draft Determination, a list of potential projects have been identified within a newly defined Sub-Programme 25 (Identified Efficiency Outputs) and include projects postponed as a result of funding changes and additional projects which could be progressed.

7.9.2 The list of projects is shown in the table below.

**Table R.31: Projects within Sub-Programme 25**

| | Project Title | CIDA |
|---|---|---|
| KG140 | Waringfield SPS Upgrade | Growth |
| KG180 | Knockshane WWPS, Lurgan Upgrade. | Growth |
| JR462 | M1 Crossing Replacement Belfast. | Base maintenance |
| JC385 | Monaclogh SR Capacity Extension | Growth |
| KC415 | Ballysally CSO Coleraine - Works Package | Quality – UID |
| KS374 | Hunter's Mill Storm Attenuation and Network Improvements, Downpatrick | Quality – UID |
| KS842 | Kilkeel DAP Phase 1 | Quality – UID |
| KL504 | Londonderry DAP : Buncrana Road Work Package, Stage 2 | Quality – UID |
| KC302 | Ballintoy WwTW | Quality |
| JI999 | Service Reservoir Enhanced Security Phase 2 - Acceleration | Quality – completion of programme in Ji038 in PC13 period. |

# 8 OUTPUTS

**SUMMARY**

This chapter deals with the Utility Regulator's proposals in relation to the outputs. NI Water acknowledges that the Utility Regulator has, in the main, agreed with and accepted our proposals for outputs, which are linked to our capital investment programme. This chapter provides some further information on our position and also provides a response to the Draft Determination.

However it should be noted that the outputs we propose in our Business Plan form part of a package which will need to be reassessed in light of the risks created by the removal of elements of funding in the Draft Determination.

## 8.1 DEFINITION OF OUTPUTS

8.1.1 NI Water notes and agrees with the general statement of principles in the definition of outputs.

## 8.2 NOMINATED OUTPUTS

8.2.1 The Utility Regulator has provided NI Water with the table of nominated outputs as understood for the Draft Determination. Following the revisions required to the capital programme as a result of changes to PE, NI Water has revised the table of nominated outputs. This is included in Annex 09 *'Table 4.4 – Outputs delivered by PC13 Capital Projects and Programmes of Work'.*

8.2.2 Where the Utility Regulator has asked NI Water to provide additional clarification on scope of outputs, these have also been provided in Annex 09.

**Water mains**

8.2.3 NI Water is currently developing a more robust process for identifying areas of investment based on a bottom up approach emphasising customer needs that

will be firmly established for PC15. NI Water has proposed two methodologies for definition of urban and rural which have been shared with the Utility Regulator. NI Water welcomes the proposed PC13 engagement to develop and agree the definitions that will be used to establish targets and monitoring performance for PC15.

## 8.3 COMPLIANCE STANDARDS VARIABILITY

8.3.1 As part of the Draft Determination Query response process, NI Water has provided additional information on compliance standards variability. NI Water notes the comments provided in the Draft Determination and will continue to work with key stakeholders to improve the calculation of KPI's including the integration of 50 to 250 Population Equivalent (pe) WwTWs as noted in Annex K of the Draft Determination, during PC13 to inform PC15.

## 8.4 LEAKAGE TARGETS

8.4.1 We note that the Utility Regulator has not defined a target level of leakage for PC13, but has set a target for leakage reduction in PC13 of 5 million litres per day (Ml/d) per year using the new leakage software. To achieve this, the PC13 Draft Determination has included a level of capital funding for leakage reduction consistent with that included in PC10 of circa £3.0m per annum.

8.4.2 However, PC10 is a 3-year period whereas PC13 will be a 2-year period. NI Water would therefore contend that the adoption of a similar conversion factor for the PC13 period as was used in PC10 would result in a leakage reduction target of 4Ml/d per annum.

8.4.3 The rationale for this conclusion is that the PC10 target was for a reduction of 11 Ml/d over three years. The PC13 Draft Determination sets the target for leakage reduction at 5 Ml/d per year, i.e. 10 Ml/d over the PC13 period.

8.4.4 The Utility Regulator has indicated that NI Water has delivered a leakage reduction of 8 Ml/d /year over the last three years. This is based on the out-

turn figure for 2008/09 of 180.93 Ml/d plus 2.0 Ml/d (volume of leakage attributable to the hour to day factor) and the out-turn figure for 2011/12 of 168.23 Ml/d less 9.0 Ml/d (volume of leakage attributable to the introduction of revised property numbers). This would be an overall reduction of 23.7 Ml/d over 3 years and is 7.9 Ml/d per year (rounded to 8.0 Ml/d).

8.4.5 The Utility Regulator recognised within the Draft Determination that the years between 2008/09 and 2011/12 were not typical in relation to the weather conditions experienced in Northern Ireland. In 2009/10 there was a 1:30 freeze thaw event and in 2010/11 there was a 1:100 year freeze thaw event. However the Utility Regulator did not recognise that these two exceptionally cold winters were followed with a very mild winter in 2011/12. The milder winter in 2011/12 provided the opportunity to maximise leakage reduction in this year and would not have been typical of a previous or normal winters. The out-turn figure should be adjusted to take account of the mild winter. An average winter would equate to be between 3 to 7 Ml/d. If a figure of 5.0 Ml/d is used then the reduction over three years would be 18.7 Ml/d which is 6.2 Ml/d per year (rounded to 6 Ml/d).

8.4.6 As per the Draft Determination, the Utility Regulator recognised that it becomes more difficult to achieve reductions at lower levels of leakage and using a similar conversion factor the proposed target would be 3.9 Ml/d (rounded to 4.0 Ml/d) per year of PC13. A yearly target of 4.0 Ml/d would in effect be higher than the PC10 average yearly targets but yet with a similar level of annual capital funding to PC13.

8.4.7 At the time of writing, a meeting has been scheduled for 6 November 2012 to update the Utility Regulator on progress on reporting leakage using Netbase[11]. This update and the Reporter audit of same which will further inform the Utility Regulator for the Final Determination.

[11] NI Water's leakage management software package

## 8.5 SEWER FLOODING

8.5.1 We will continue to work with the Utility Regulator and other key stakeholders in refining the register for out-of-sewer flooding (DG5 Register) and proposed solutions. The DG5 Register holds properties at risk of internal flooding due to hydraulic incapacity. NI Water acknowledges the significant progress which has been made in this area and the relatively low level of out-of-sewer flooding in Northern Ireland.

8.5.2 Since the Draft Determination NI Water has further defined the work to be undertaken on the DG5 Register and an updated spread sheet is attached in Annex 10. The spread sheet indicates the proposed delivery period for removal of properties and NI Water would intend ranking the DG5 properties, prioritising their removal where possible in the following order:-

- 2 in 10 properties[12];
- 1 in 10 properties;
- 1 in 20 properties;
    - Hospitals, schools;
    - Any properties on the NI Water Critical Care Register; and
    - Ranked in order of least cost per property.

8.5.3 Annex 10 indicates seven properties on the 2 in 10 and 1 in 10 registers are to be delivered in PC15. NI Water will endeavour to advance these seven properties into PC13 (at the expense of seven of the 1 in 20 properties).

8.5.4 NI Water is in the process of completing a number of feasibility studies which will confirm the likely frequency of flooding (2 in 10, 1 in 10 or 1 in 20) of the properties which are on the DG5 Register but remain to be categorised. These feasibility studies are due to be completed by mid-November 2012 and the output can be made available to the Utility Regulator at that time.

[12] Properties which are likely to be affected by out-of-sewer flooding twice in ten years or more often.

8.5.5 During the PC10 period NI Water has worked to improve the accuracy of information relating to DG5 properties. During the period a number of properties, designated as 1 in 20 have been removed by company action and, subject to the prioritisation outlined above we intend to continue to remove these properties. A paper outlining this approach was submitted to the Outputs Review Group (ORG) in June. The issue of removal of 1 in 20 properties will be further explored again with ORG at the November meeting.

## 8.6 POLLUTION INCIDENTS

8.6.1 As part of the Draft Determination Query response process NI Water has provided additional information on pollution incidents[13]. The processes affecting pollution incident performance are multi-factorial and linking outputs to additional investment is not straightforward. However NI Water will continue to work with key stakeholders to improve the processes linking incident reduction to investment during PC13 to inform PC15.

## 8.7 CASTOR BAY TO BELFAST TRUNK MAIN

8.7.1 This project was identified in the Water Resource Strategy (WRS-2007) for completion in PC10 and subsequently incorporated into the assessments during development of the Water Resource Management Plan (2012) with substantive consultation and acceptance by all stakeholders. NI Water consulted with the Utility Regulator on this singular issue in February 2012 as part of the endorsement of the Water Resource Management Plan. The Utility Regulator in its document *"The Utility Regulator's report into the Freeze/Thaw incident 2010/11"* makes reference under Para. 4.30:

> *'The hydraulic capacity of the transfer mains was tested by an extended period of operation at the peak capacity of the treatment works and this exposed some hydraulic restrictions in the system. Some of the key restrictions identified (the supplies to Dungannon, Newry and Belfast from Castor Bay) already form part of the PC10 programme. NI Water is developing a hydraulic model of its trunk main*

[13] Query 025 – Utility Regulator issues date 29/06/12 and NI Water return date of 17/07/12.

*system as part of its on-going work on water resources. We expect the company to take account of any weaknesses exposed by the 2010/11 freeze thaw incident in its analysis and identify any necessary investment for the next price control.'*

8.7.2 From a corporate risk perspective, developing from the Freeze / Thaw events of 2009/10, 2010/11 and previous needs analysis through the Water Resource Strategy (WRS) and the Water Resource Management Plan (WRMP), NI Water remains of the opinion that the provision of the main is an important part of the PC13 Business Plan to comply with the WRMP and improve resilience in the event of another Freeze / Thaw.

8.7.3 Abandoning the project at this stage would have an adverse effect on OPA and the Security of Supply Index (SOSI) and a knock on effect on resilience of the network in any future Freeze/ Thaw incident by reducing the opportunity for additional flexibility.

8.7.4 In respect of the Utility Regulator's concerns towards the proposed programme and clarity of need, at a meeting with the Utility Regulator on 18 October, NI Water has committed to providing a detailed overview of the project covering design considerations, security of supply, quality and operational impact during November 2012. The overview will also include the interdependencies with other trunk main projects such as the Cross Town Main upgrade.

## 8.8 MANAGEMENT & GENERAL

8.8.1 The PC13 Business Case for M&G capital expenditure outlined the link to the Ministerial Social and Environmental Guidance. In addition to addressing priorities set out in the Social and Environmental Guidance, M&G projects also link to broader company strategy by developing the key themes of the business through the balanced score card approach (key themes are Customer, Compliance, Cash and Colleagues). This information was provided in the Sub-Programme Business Case and detailed in the

spreadsheet provided to the Reporter for M&G projects. The individual business cases which comprise the M&G programme are at varying stages of progress through the procurement procedure. The definition of benefits improves as the projects progress through the various procurement gateways culminating at A3[14] stage. Detailed business cases will progress to A3 to suit delivery requirements and could be provided to the Utility Regulator on a summary basis on approvals and benefits within the Capital Investment Monitoring cycle.

## 8.9 SERVICEABILITY

8.9.1 We note the long list of serviceability indicators provided in Annex K upon which the Utility Regulator has indicated it will base formal serviceability monitoring. NI Water would wish to build on the positive engagement to date with Utility Regulator on serviceability indicators to agree a basket (short list) of indicators for each service area. In addition NI Water would welcome further engagement on the processes for determining trends and triggers for serviceability assessment.

## 8.10 DG3 - INTERRUPTION TO SUPPLY

8.10.1 NI Water operates a watermains network of almost 27,000km and is currently upgrading approximately 300km of the network per annum. This represents a replacement rate of 1.1% per annum. Individual business cases for Water Mains Rehab Programme work packages contain detailed information on expected outputs and provide indications of the improvement in DG3 interruptions to supply within the work package area. However given the very low rate of replacement linking individual work package investment to global improvements in DG3 is not clearly demonstrable as the remaining 98.9% of the network not subject to rehabilitation is deteriorating at varying rates. The individual business cases outlining the link between investment and the DG3 beneficial outputs can be made available to the Utility Regulator. In its submission, NI Water provided detail on overall serviceability for water

[14] The Contract Award Point in the procurement cycle

infrastructure and while not all indicators were consistent NI Water indicated a stable level of serviceability. The serviceability assessments were shared with the Utility Regulator as part of the submission. During the PC13 period therefore capital investment will at best only maintain global DG3 performance. Improvements in DG3 performance will be driven by improved operational performance. A revised approach to identifying and prioritising water mains rehabilitation is under development and among other things will provide clear linkages between investment and beneficial outputs. The revised approach will be available to inform the development of the PC15 Business Plan, providing high level assessments for the draft capex programme in June 2013 and detailed plans for the Business Plan submission in March 2014.

## 8.11 OVERALL PERFORMANCE ASSESSMENT (OPA)

### Drinking Water Quality

8.11.1 The Utility Regulator has proposed OPA scores based on targets for aluminium, manganese and e-coli., which are higher than the levels needed to achieve the PC13 target for Mean Zonal Compliance. In light of up-to-date compliance data, we are concerned that the Utility Regulator's view may be unrealistic.

8.11.2 Many of the components of the OPA drinking water quality scores are impacted by the water distribution system's poor condition and, combined with the regulatory monitoring regime this can result in highly variable compliance levels. For example, we already believe that the 2012 projected levels of compliance for iron and turbidity will not be met. Therefore, over-performance in relation to the remaining parameters will be necessary simply to maintain our forecast OPA scores.

8.11.3 With respect to the increased OPA target for e-coli., it should be noted that 2012 compliance (as at the end of August) will not meet NI Water projected compliance levels. Compliance for Trihalomethanes (THMs) is also below projected levels at the end of August 2012. This demonstrates the difficulty in

projecting e-coli compliance levels, due to the constant requirement to achieve a balance between e-coli levels (controlled by chlorine disinfection) and disinfection by-products (THMs).

8.11.4 In summary, we believe that the Utility Regulator's proposed OPA scores for drinking water quality present an unrealistic target and introduce an unreasonably high risk of failure. We would be pleased to explain this further to avoid setting a water quality target which NI Water will fail.

**Wastewater Treatment Works Consents Compliance**

8.11.5 The Draft Determination set OPA scores for WwTW % non-compliance based on the Utility Regulator's projection of passing / failing works.

8.11.6 Additional information is included in Annex 07 which supports a revised projection which we believe to be more realistic, as summarised below:

**Table R.32: WwTW % Non-Compliance**

| | 2013 | 2014 |
|---|---|---|
| NI Water Business Plan | 2.80% | 2.22% |
| Revised OPA (NI Water) | 2.56% | 1.97% |
| Utility Regulator Draft Determination Projection | 2.42% | 1.82% |

## 8.12 OPA PARAMETERS

8.12.1 In Annex E of the Draft Determination, the Utility Regulator anticipates that PC15 will examine the possibility of introducing additional measures to the OPA.

8.12.2 NI Water encourages the Utility Regulator to include four additional OPA measures in PC13, namely:

1. Sewer Flooding (overload);
2. Sewer Flooding (other causes);
3. Security of Supply (absolute performance); and
4. Security of Supply (performance against target).

8.12.3 We accept that the on-going development of the flooding (DG5) at-risk registers (which requires clear differentiation of 1 in 20, 1 in 10 and 2 in 10 year registers) prohibits the inclusion of the "Sewer Flooding (at risk)" OPA measure in PC13. However, we see no reason for the exclusion of the above four measures.

8.12.4 In Annex E, the Utility Regulator notes the high confidence grades (A2) for the Security of Supply measures – suggesting that these should now be included in the OPA. We note that the confidence grades cited for the flooding measures are comparable with many of the current 11 OPA measures, and that the latest confidence grades (as presented in AIR12) are higher than those cited by the Utility Regulator. Also, the "accuracy" component of the confidence grades quoted are broadly in line with, or better than, the "E&W Low" comparators – again suggesting that it is now appropriate to include these measures in the OPA.

8.12.5 Therefore, in the interests of improving the relevance and comprehensiveness of OPA, we advocate its further enhancement by the inclusion of these four additional parameters in the PC13 period.

# 9 ALLOWED REVENUE AND FINANCIAL SUSTAINABILITY

**SUMMARY**

This chapter responds to the Utility Regulator's proposals in relation to the overall revenue allowance for PC13.

In the main, the revenue allowance is the product of preceding chapters so we do not repeat the arguments in this chapter. However we do draw the Utility Regulator's attention to a few areas that we consider merit attention:

- Roll forward of Regulatory Capital Value;
- Allowed Rate of Return;
- Financial Sustainability;
- Deferred Tax; and
- Customer Data Projections

## 9.1 ROLL-FORWARD OF REGULATORY CAPITAL VALUE

9.1.1 NI Water disagrees with the opening RCV used by the Utility Regulator for the PC10 period which is different to that used by NI Water in the PC13 Business Plan and the 2010/11 Regulatory Accounts. The figure used by the Utility Regulator (£1,386m) is a forecast used by NI Water in our PC10 Business Plan submitted in June 2009. This was adopted by the Utility Regulator in the PC10 Final Determination. Since then through the SBP period (2007-2009), the RCV has been tracked in our annual regulatory accounts using actual expenditure. This gives a figure of £1,421m at 31 March 2010. As no agreed methodology was in place for the roll forward of the RCV through the SBP period, it is NI Water's view that this figure, incorporating actual expenditure, is an appropriate starting point for PC10.

9.1.2 NI Water is content with the methodology applied by the Utility Regulator for rolling forward the RCV within the PC10 period which largely aligns with that adopted by NI Water in the PC13 Business Plan.

9.1.3 We would urge the Utility Regulator to put in place an agreed method for rolling forward the RCV for future price controls.

## 9.2 ALLOWED RATE OF RETURN

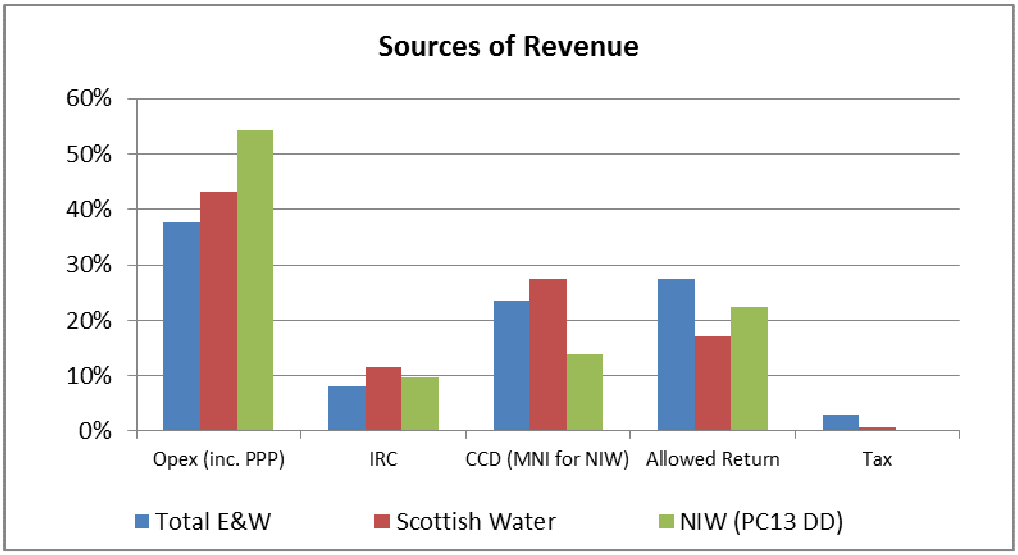
9.2.1 The Utility Regulator has determined a Weighted Average Cost of Capital (WACC) of 4.0%, which is lower than NI Water's proposed WACC of 4.5%. In calculating overall WACC, the Utility Regulator has reflected a reduction in the cost of equity. Whilst the Utility Regulator has recognised in their projections, the correlation between cost of equity and dividend paid, we are uncertain how acceptable a lower dividend might be to our Shareholder (DRD). We also note the slightly lower cost of new debt adopted by the Utility Regulator and we welcome the Utility Regulator's acknowledgement of the prevailing uncertainty and their proposal to continue to monitor gilt yields prior to the Final Determination.

## 9.3 FINANCIAL SUSTAINABILITY

9.3.1 NI Water is currently funded for capital maintenance on a cash basis given the lack of a robust Modern Equivalent Asset Valuation (MEAV) rather than Current Cost Depreciation (CCD) as is the case in England, Wales and Scotland. Whilst there are valid reasons for adopting this approach, NI Water does have concerns that the continued funding of capital maintenance using this approach may act to increase the reliance on debt funding and therefore gearing.

9.3.2 The graph below compares NI Water's revenue building blocks with England, Wales and Scotland. On the CCD line it shows that, proportionally, NI Water receives much less revenue from this source than our counterparts, which in turn increases the proportion of opex.

**Figure R.4: Comparisons of Revenue Building Blocks**




*Source: Ofwat & WICs 2010-15 Final Determinations vs. UR PC13 Draft Determinations*

9.3.3 Debt funding available to NI Water in the period to 2013/14 was agreed in 2006/07 with covenants put in place to restrict the amount of borrowing allowed by NI Water to certain percentages of capital spend. These covenants were based on the SBP model where NI Water was expected to self-fund a much larger proportion of the capital expenditure than is proposed in the Draft Determination. The Utility Regulator's cash approach to funding depreciation and capital maintenance has resulted in significantly increased debt funding requirements through the PC13 period, greatly reducing any headroom currently held by NI Water on these covenants.

9.3.4 We note that the Draft Determination projections result in NI Water failing many of the Ofwat targeted financial ratio values. The Utility Regulator believes that these values are appropriate for the Governance framework within which we operate. It is NI Water's view that in our current model the issues that this approach raises are of a secondary nature, however in the event of a change in our governance model, which is currently under review, the continuation of this approach could have significant implications.

## 9.4 DEFERRED TAX

9.4.1 NI Water has adopted International Financial Reporting Standards (IFRS) as the basis of our tax charge and included this within our Business Plan. The Utility Regulator's financial model adopts a UK Generally Accepted Accounting Practice (GAAP) basis which significantly understates the tax charge.

9.4.2 Whilst these deferred tax estimates do not affect the financial ratios, which are more 'cash based', NI Water questions the use of UK GAAP projections which will significantly overstate actual profitability in the period.

## 9.5 CUSTOMER DATA PROJECTIONS

9.5.1 NI Water made a PC13 customer data resubmission to the Utility Regulator on 03 August 2012 with revisions to the customer demand projections contained in the PC13 Business Plan. In a letter to NI Water on 16 August, the Utility Regulator stated that further changes to customer data should be submitted with the draft principal statement on 28 September and no further updates could be considered beyond that date for inclusion in the Final Determination.

9.5.2 In the draft principal statement submission we concluded that, following an assessment of prevailing customer billing trends, there was no evidence to support a further revision at that time. However in our covering letter we highlighted the fact that the economic situation remains extremely volatile and undertook to update the Utility Regulator if our assessment changed.

9.5.3 Since the draft principal statement submission, NI Water has made a number of adjustments to 2012/13 reported income. The majority of these adjustments are one-off and retrospective in nature and therefore will not impact our underlying PC13 consumption projections, however analysis of the adjustment in relation to test meters consumption indicates that some of this is recurrent. We estimate that metered water and measured sewerage

consumption should be reduced by 270K $m^3$ and 70K $m^3$ respectively in both years of PC13.

9.5.4 In order to ensure that price limits accurately reflect customer projections, we recommend that the Utility Regulator reflects this adjustment in the Final Determination. NI Water would offer to meet with the Utility Regulator to discuss this matter further if necessary.

# 10 MANAGEMENT OF RISK AND UNCERTAINTY

**SUMMARY**

This chapter discusses the issues of managing risk and uncertainty, in particular our concerns relating to Relevant Items and the level of 'headroom' within the funding constraints.

While we have reservations about the mechanics of the 'relevant items' process we have serious concerns that the proposed £5m per annum of PE funding will not be available to DRD to meet 'relevant item' bids.

## 10.1 MEMORANDUM OF UNDERSTANDING

10.1.1 In order to provide a framework for PC10 to be accepted and future price controls to be managed, the Utility Regulator and the Department have developed a MoU to set out how the regulatory regime works alongside the public expenditure regime.

## 10.2 CONSEQUENT WRITTEN AGREEMENT

10.2.1 The CWA details the processes and assumption that will apply at each price control.

10.2.2 It acknowledges that NI Water has no access to reserves and provides for an interim determination process. This allows the company to submit a bid under 'relevant items' for additional funding to both the Utility Regulator and the Department. A joint decision must be made in consideration of the company's net financial position. Such expenditure may be allocated to public expenditure only or to charges.

## 10.3 PC10 RELEVANT ITEMS

10.3.1 During PC10, NI Water was required to make two relevant items bids. Both were required in order to obtain approval for the annual budget – one for

2011/12 and one for 2012/13 - in the main, to obtain PE cover for items such as Clear Line of Sight (CLoS) and IFRS which are not relevant in the regulatory regime.

10.3.2 In summary they were not used in the true sense of managing risk and uncertainty. While the second bid ran more smoothly than the first bid we have some reservations about the mechanics of the process.

## 10.4 PC13 RELEVANT ITEMS

10.4.1 To facilitate the management of risk and for the interim determination process to operate, the Draft Determination states that a public expenditure allowance of £5m will be provided in each year of the price control.

10.4.2 While we have reservations about the mechanics of the 'relevant items' process we have serious concerns that the proposed £5m per annum of PE funding will not be available to DRD to meet 'relevant item' bids.

10.4.3 The Draft Determination makes reference to 'relevant items' on a number of occasions, specifically in relation to:

- Power price;
- VER/VS; and
- BI.

10.4.4 In addition, there may be a requirement for PE cover for a CLoS provision payment over and above that assumed in the Draft Determination.

10.4.5 The sum of these items will exceed the £10m currently available for 'relevant items' cover which will leave little or no cover for real unforeseen cost pressures that may arise in the period, which 'relevant items' was originally intended to mitigate against.

## 10.5 INFLATION PRESSURES

10.5.1 It is worth noting that whilst the RPI-K mechanism provides a hedge against inflationary cost pressures in a normal regulatory regime, this is not the case for NI Water operating as it does within both a regulatory and public expenditure funding regime. Whilst revenues are uplifted annually to reflect actual RPI, only non-domestic revenues (20% of total revenue) score against PE which means NI Water has to absorb significant inflation pressures.

## 10.6 PUBLIC EXPENDITURE HEADROOM

10.6.1 Table R.33 shows a summary of the PE funding limit currently available and the Resource Departmental Expenditure Limit (DEL) forecast by the Utility Regulator through their PC10 Final Determination and PC13 Draft Determination. The Resource limit currently available for PC13 is based on projections made in the PC10 Final Determination in February 2010. This limit was subsequently reduced to reflect inter-departmental transfers to cover tuition fees.

**Table R.33: Summary of PE Funding and Draft Determination**

| **Cash shown as £m** | | **DRD Funding** | | | **UR Determination** | | |
|---|---|---|---|---|---|---|---|
| | | **2012/13** | **2013/14** | **2014/15** | **2012/13** | **2013/14** | **2014/15** |
| Operating Costs | *a* | 216.8 | 216.8 | 216.3 | 191.3 | 185.8 | 181.5 |
| Depn & Capital Costs | *b* | 60.4 | 60.4 | 60.4 | 71.5 | 55.6 | 58.6 |
| Income | *c* | (83.0) | (83.0) | (83.0) | (82.7) | (67.4) | (64.1) |
| DRD costs / tuition fees | *d* | (3.2) | (4.3) | (5.1) | 0.0 | 0.0 | 0.0 |
| **Resource DEL** | | **191.0** | **189.9** | **188.6** | **180.1** | **174.0** | **176.0** |
| | | | | | | | |
| CASH | *a+c+d* | 130.6 | 129.5 | 128.2 | 108.6 | 118.4 | 117.4 |
| less: UR determination | | (108.6) | (118.4) | (117.4) | | | |
| **HEADROOM (CASH)** | | **22.0** | **11.1** | **10.8** | | | |

10.6.2 Headroom has been calculated as the difference between DRD cash funding held and the requirement within the Utility Regulator Determination for that

period. From 2012/13 to 2014/15 headroom has fallen from £22m to £10.8m, a drop of over 50%.

10.6.3 This reduction is as a result of a number of unavoidable pressures experienced by NI Water for which there was no commensurate increase in Resource limits. These additional cost pressures have been set out in the table below which reconciles the overall movement in headroom calculated above:

**Table R.34: Overall Movement in Headroom**

| | £m |
|---|---|
| **Headroom in 2012/13 / £m** | **22.0** |
| IFRS adjustment | -1.0 |
| CRC | -2.0 |
| Other cost increases (allowed in PC13 DD) | -1.4 |
| Increase in tuition fees (2012/13 to 2014/15) | -1.9 |
| Reduction in Non-domestic revenue | -18.6 |
| Offset by reduction in opex | +13.7 |
| **Headroom in 2014/15 / £m** | **10.8** |

10.6.4 The major change above is the drop in non-domestic income which is forecast in the Draft Determination to be c.£19m lower in 2014/15 than assumed within the DRD funding line. This has been somewhat offset by reduced costs but the overall result is a 50% drop in headroom available to NI Water.

10.6.5 Given the above movements, we have significant concerns over the level of PE funding during the PC13 period and the significant reduction in headroom available to NI Water over the period. This response to the Draft Determination includes a number of reasons why we believe the net opex allowance within the Draft Determination is not sufficient. Should these arguments be accepted, the headroom calculated above will be reduced further, exacerbating the pressures and risks on NI Water. In addition, the analysis does not include any additional requirement for payment of provisions, i.e. CLoS accounting, nor the Utility Regulator's suggestion that VER/VS requirements (£5.6m) could be funded through PE as a relevant item.

**UNUSED K**

10.6.6 We welcome that the Draft Determination acknowledges that NI Water is permitted to carry forward unused K.

# 11 NEXT STEPS

11.1 NI Water has submitted this response on 8 November 2012 in accordance with the PC13 Overall Approach document.

11.2 In our Response, we have raised a number of concerns in respect of the Draft Determination. We appreciate that in considering our Response, the Utility Regulator may wish to seek further clarification. NI Water would wish to assure the Utility Regulator that we will be happy to engage further with the Utility Regulator to provide further clarification.

11.3 It is our expectation that the Utility Regulator will issue a Final Determination on 14 December 2012.

11.4 NI Water will carefully consider the Final Determination and give the Company decision to the Utility Regulator no later than 14 February 2013.