

Cost assessment – key considerations for PR19

15 June 2017



Agenda



- 1 Key issues arising from the division of the water value chain
- 2 Cost assessment and PR19
- 3 Interaction with other components of the price control

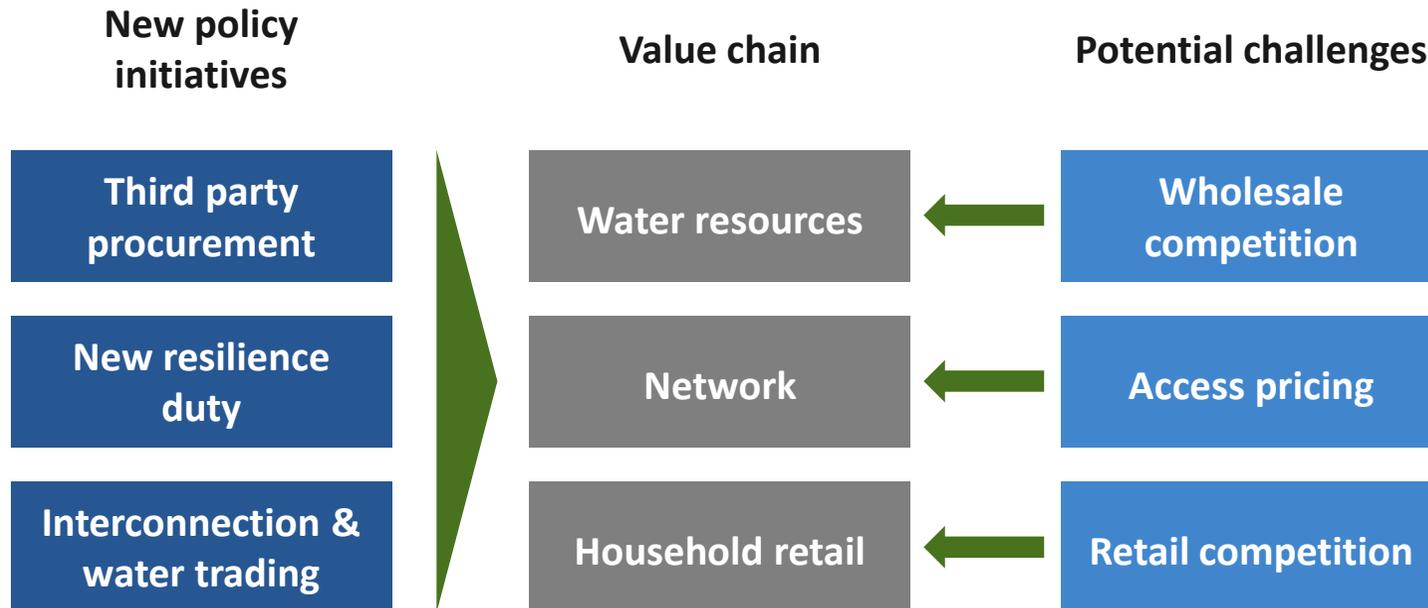


Division of the value chain



Developments and challenges

The water sector faces a number of changes that will affect the shape of the regulatory framework for PR19:



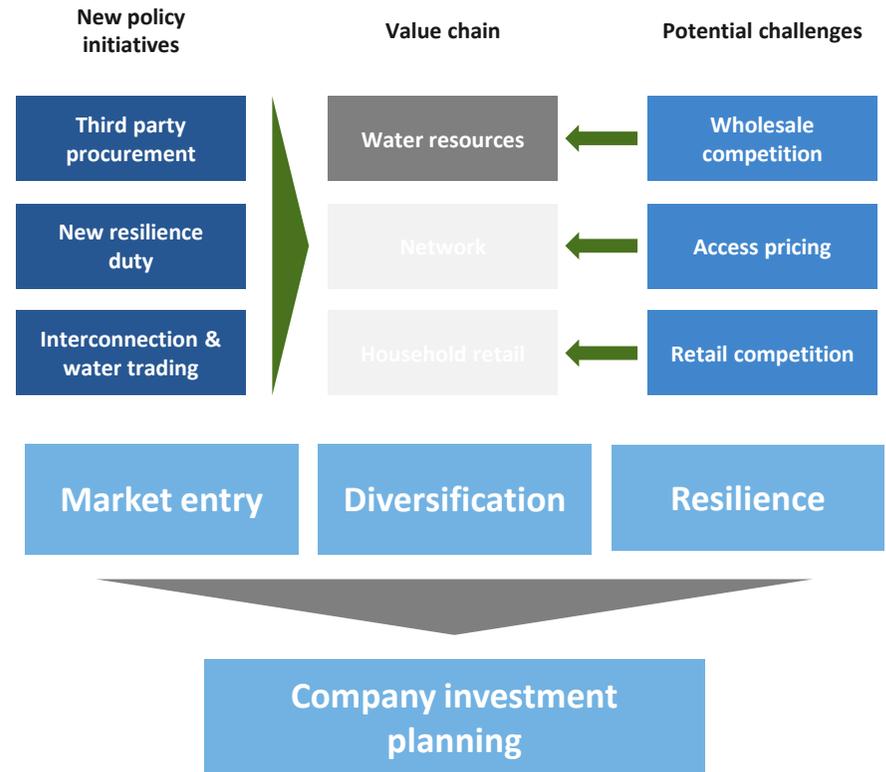
Water resources



Key challenges

Ofwat is seeking to develop a market in water resources to drive efficiencies and improve resilience:

- Separate price control sharpens focus regulatory tools.
- WoCs will bear risk of under-utilisation of water resource assets after 2020.
- Decision on what resources to develop will be scrutinise differently.
- Investment decision based on access pricing.



Changes in Water Resources presents opportunities and risks for investors and companies. Companies will need to consider how increasing contestability impacts investment planning and business risks.

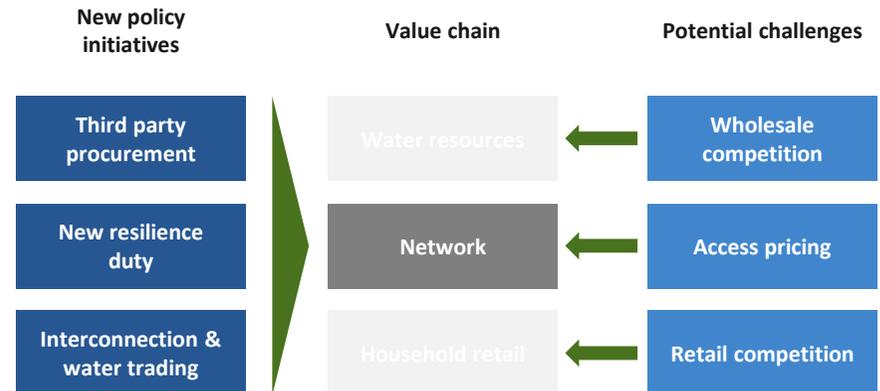




Key challenges

Network operation to remain a monopoly but network delivery to face more competition. Additional challenges from contestability in water resources.

- New access prices increasing the burden of regulation.
- New water sources, interconnections and water trading can introduce significant challenges in managing and developing the network.
- Regulatory framework can be more complex to achieve different objectives (efficiency + trading + resilience).



Significant work still to be done, including calibrating prices for quality, transportation costs and capacity utilisation while at the same time getting a well articulated PR19.



Household retail

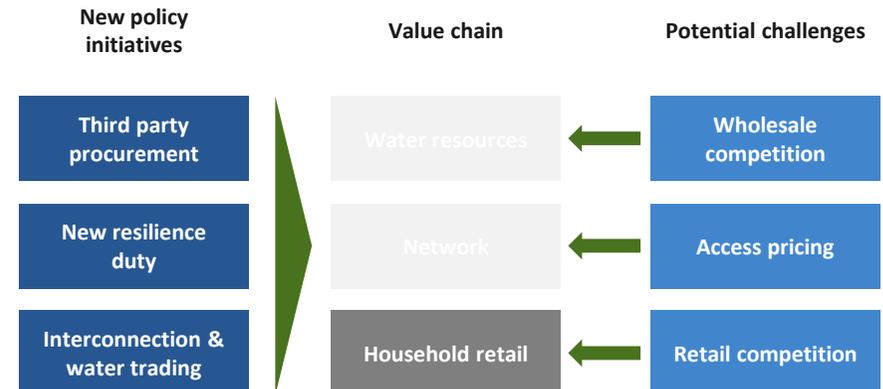


Key challenges

Ofwat believes competition in household retail would bring net benefits. Could this happen in time for PR19?

- Competition in non-household retail can hold valuable lessons for all parties, particularly companies that now compete in a multi-utility retail market.

In the interim, there are issues around dealing with setting of price controls in household retail, such as the treatment of bad debt.



Companies, Government and Ofwat should be starting to consider what can be learned from introduction in the non-household market and how they could be applied to the household sector



Cost assessment methodologies in this new framework



Ofwat's approach to cost assessment is likely to be consistent with PR14

	Water resources	Network	Retail
Econometric models	<ul style="list-style-type: none">• What costs should be included in each category?• What are the challenges Ofwat is going to face?• Does Ofwat need to introduce adjustments to account for some of the new challenges?• What is the effect of a reduction in the number of WOCs?		
Other models			
Special factors			

Challenges for cost assessment



How do you split the modelling between old/new water resources?

Can you get a better approach to enhancement costs?

What is the effect on the models of a reduced number of WOCs?

How do you account for new delivery approaches for networks?

Is it possible to do benchmarking in retail?

Potential impact of fewer comparators



Changing industry structure could influence models

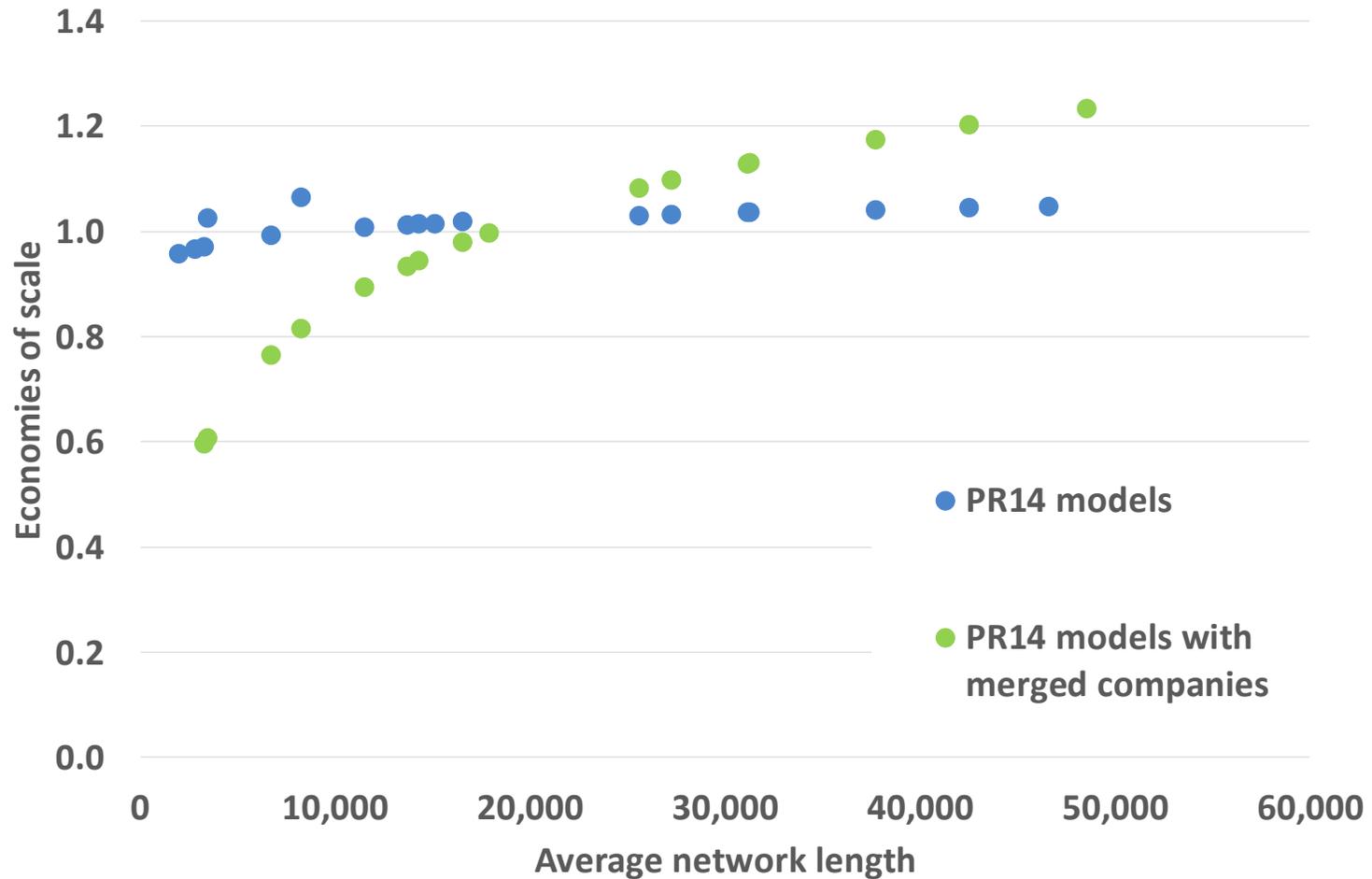
The relationship between costs and cost drivers could change, and become harder to estimate, with fewer companies. This could impact smaller companies' (WoCs in particular) efficiency estimates.

	PR14 models	PR14 (merged companies)
Network length	1.69	0.47
Property density	-2.00	-1.52
Length ²	0.01	0.12
Density ²	0.24	0.94
Length*Density	0.36	0.68
Time trend	-0.00	0.02
Regional wage	0.28	0.97
Population density	2.03	1.99
% input from river abstractions.	0.00	0.02
% input from impounding reservoirs	-0.01	0.02
Proportion of mains relined and renewed	0.06	0.08
Constant	-12.77	-8.07

Potential impact of fewer comparators



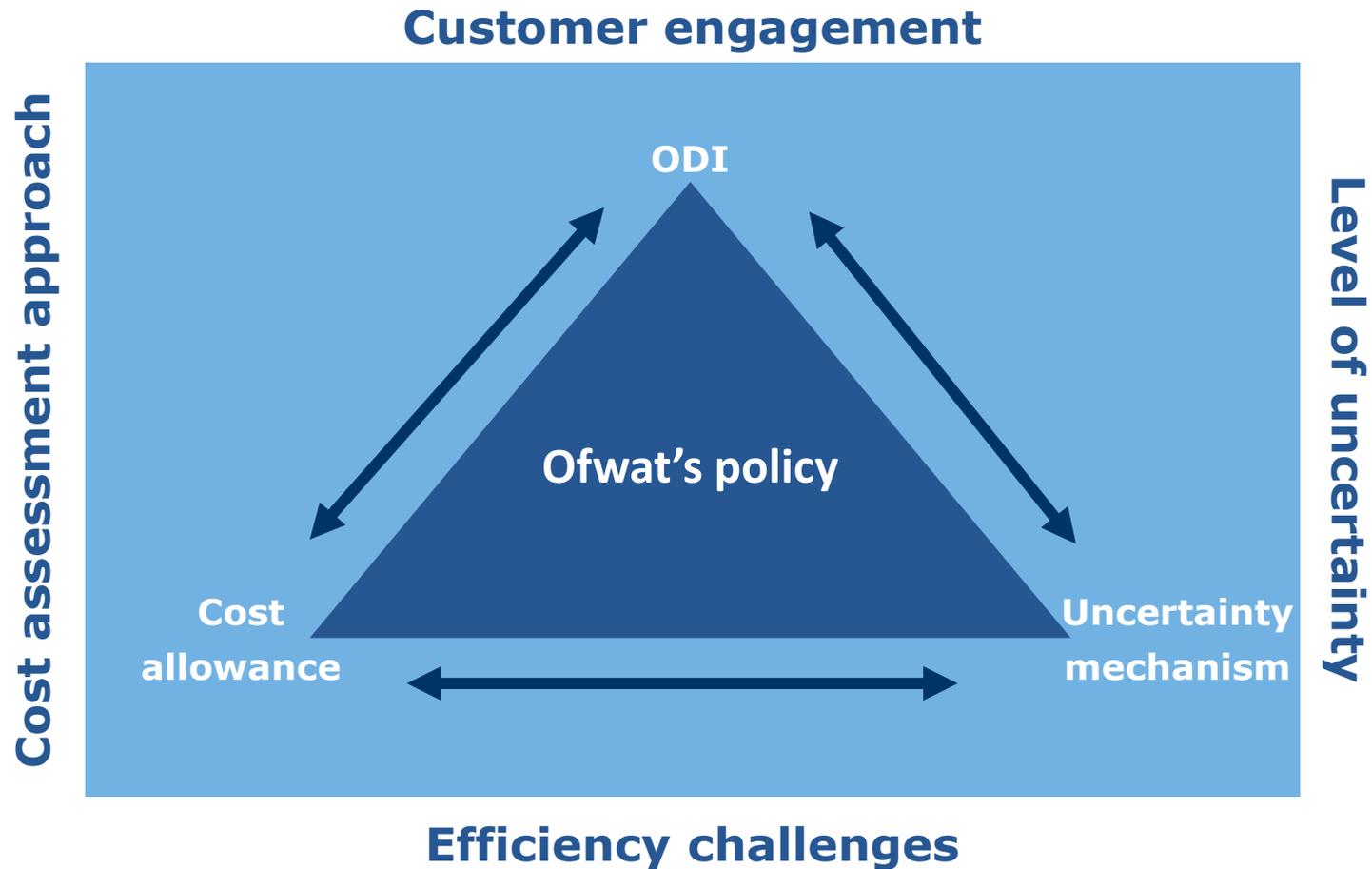
Changing industry structure could influence models



The bigger picture in the price control



There are important trade-offs between the components of the price control



The bigger picture in the price control



There are important trade-offs between the components of the price control

Cost allowance ↔ ODI	ODI ↔ Uncertainty mechanism	Cost allowance ↔ Uncertainty mechanism
<p>What is included in the models? If not,</p> <ul style="list-style-type: none">a. How certain is the project / factor?b. How robust is the case for the expenditure?c. Can it be related to a PC?d. What is Ofwat's approach to allowance of ODIs?	<p>What is included in the models? If not,</p> <ul style="list-style-type: none">a. What type of uncertainty are we considering?b. What is the size of the expenditure?c. Can it be related to a PC?d. What is Ofwat's approach to allowance of ODIs and uncertainty mechanism?	<p>What is included in the models? If not,</p> <ul style="list-style-type: none">a. What type of uncertainty are we considering?b. What is the size of the expenditure?c. What is Ofwat's approach to uncertainty mechanisms?

In practice, these are not three separate decisions but one decision on the best approach to handling special factors. These will need to be considered on a case-by-case basis.



- How do policy developments and changes in the value chain interact with your business plan?

- What special factors need to be developed, since they are likely to sit outside of Ofwat models?
- How can your business plan be tailored to help Ofwat's analysis for PR19?

How could CEPA help?



CEPA can offer a wide range of inputs for the price control

	Before September 2018	After September 2018
Division of value chain	Explaining methodology Challenging methodologies. Review consistency on BP.	Explaining changes. Challenging methodologies. Review consistency on BP.
Costs	Development of SF/ODIs/UM. Critical friend. Modelling (e.g. bad debt).	Challenging Ofwat's approach. Support on review of SF/ODIs/UM and models.
Interactions	Review decision process. Development of decision process.	Adjustments to the framework and reconsideration of ODIs and UM.



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About us



Our clients

CEPA is an economics, finance, competition and regulation advisory firm with a head office in London and an office in Sydney, Australia. Our staff and associates have extensive experience in developing and implementing regulatory frameworks in network and other regulated markets internationally, including across the UK and Europe.

We have worked with a number of private and public sector clients in the water sector, as well as regulators and regulated companies in other sectors.





Presenters



Ian Alexander is a Director at CEPA with over 25 years' experience of working on regulation and industry reform. He is an expert in regulatory regime design and evaluation, (including the use of direct procurement); and incentive design. In addition, Ian has a broad experience in the water sector where he has worked extensively with Ofwat. More generally Ian has led projects with UKWIR, CCWater, WaterUK and several of the individual companies – including Thames, Yorkshire and Severn Trent.



Rona Bar-Isaac is a Partner at Addleshaw Goddard and specialises in UK and EC competition and regulatory law, including in relation to securing merger clearances, investigations of anti-competitive agreements, abuses of market power and in the context of antitrust litigation at the Competition Appeal Tribunal, the High Court, the Administrative Court and the European Courts. Rona has particular expertise in regulated industries, including water, telecommunications and energy.



Fernando Dominguez has ten years experience as a regulation and competition economist, specialising in the water sector. Prior to joining CEPA, he worked at KPMG and before that Ofwat. At KPMG Fernando advised a number of water and sewerage companies on regulatory and assurance issues. His main areas of expertise were cost assessment and incentive design. While at Ofwat, Fernando worked on various FPL projects, including cost assessment, menus and Outcome incentives, bulk water trading, and sludge.



Ian Johnson is a Senior Consultant at CEPA working across CEPA's water, energy, and transport sectors for private and public sector clients/regulators. Ian has advised UK regulators, including Ofwat, on several issues related to price controls and cost assessment. Ian has also provided benchmarking and cost assessment advice across the energy sector and internationally, including working with Ofgem during RIIO-ED1 and advising Australian electricity companies on regulatory appeals.