



The opportunities for a more coherent regulatory approach for Ofwat's funding of base expenditure and enhancements

Reckon LLP - Summary to project report - 1 September 2022

Ofwat's approach to wholesale cost assessment has evolved in a way that has led to a lack of coherence between the assessment of base expenditure, the assessment of enhancement expenditure and the setting of performance commitments.

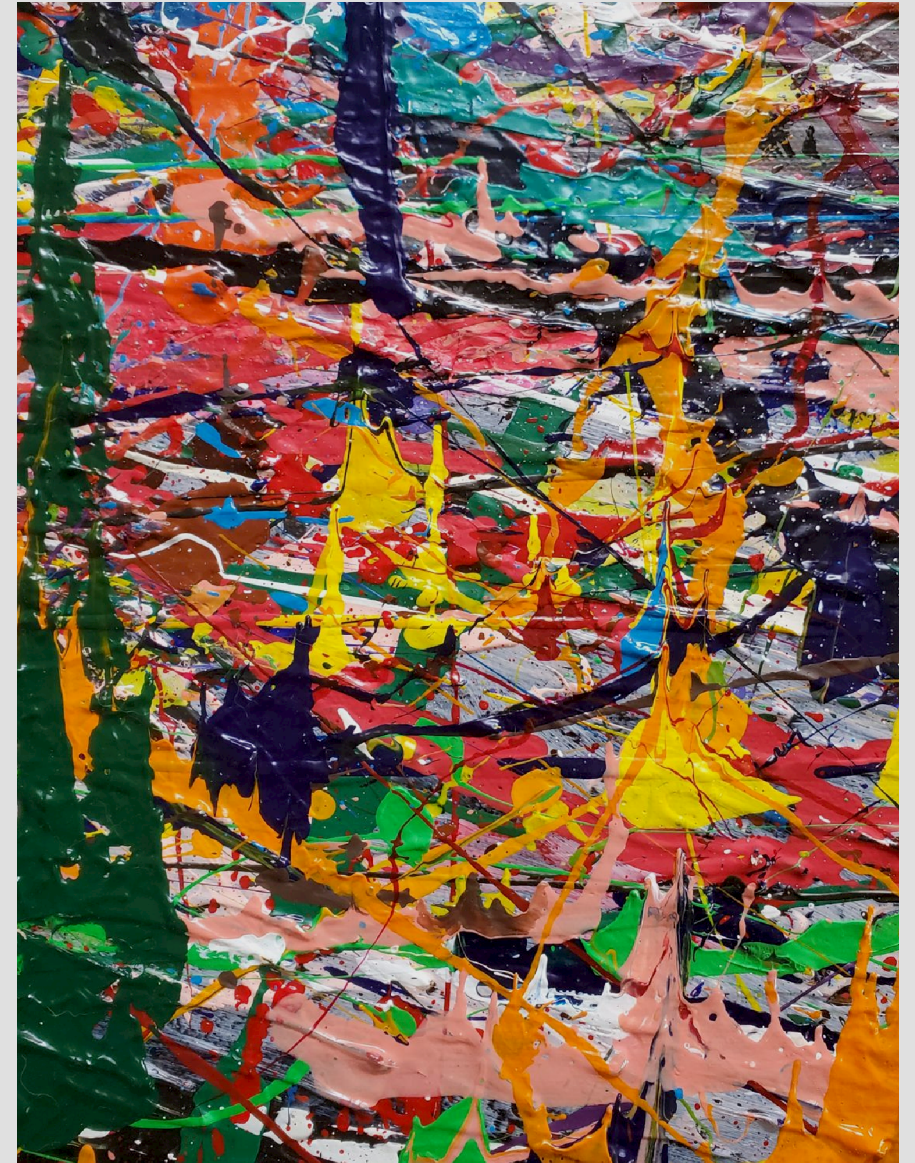
Tensions have arisen as the regulatory framework has gradually come to place greater emphasis on cross-company benchmarking, while retaining legacy elements of company-specific assessments that developed in a different context.

These tensions give rise to a range of concerns about the incentives faced by water companies and their remuneration under the regulatory framework.

Some - but not all - of these concerns are recognised by Ofwat in its PR24 draft methodology.

Reckon was commissioned by Anglian Water, United Utilities and Wessex Water to provide a deeper analysis of the problems arising from the underlying tensions and to develop practical options for tackling them.

[Click here](#) for the full report.



The project explored six key concerns with the approach at PR19

Inefficient capex bias for enhancements

Risks of a capex bias for enhancements, arising from disadvantageous and more uncertain price control funding for the ongoing opex from enhancements, in areas for which Ofwat determines explicit enhancement allowances.

Industry-wide improvements over time

Concerns about the scale of improvement that Ofwat requires companies to achieve via funding from base-plus allowances - which reflects the complexities around what performance levels are funded by such allowances.

Double counting allowances for enhancement expenditure

Risks of excessive remuneration in some cases from combined funding across: (a) explicit enhancement expenditure allowances; (b) allowances derived from base-plus models; and (c) financial ODIs.

Capital maintenance from past enhancements

Concerns that, across the industry, the capital maintenance expenditure requirements from past capital enhancements may not be fully remunerated over time.

Opex arising from past enhancements

An unreasonable exclusion of enhancement operating expenditure from the data feeding into base-plus models, which tends to under-fund the costs of maintaining existing levels of performance.

Under-funding good performance

Risks of under-funding better-performing companies, where such companies are required to maintain (or improve upon) relatively high levels of performance without the costs of this being factored in to the available funding channels.

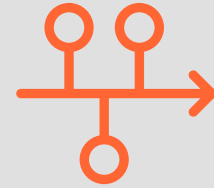
We organise our key suggestions for improvements from the project into three main themes



Groundwork: laying the foundations for a more coherent and better-functioning regulatory approach



Measures targeted at reducing the capex bias for enhancements, including a new multi-amp funding approach for enhancement opex



Measures to help reflect the evolution of efficient expenditure over time, given the impacts of past enhancements and ongoing improvements



Groundwork



We have set out four main proposals as part of what we see as groundwork



A sound conceptual framework relating to base expenditure, enhancement expenditure, and their interactions with performance.



A need to recognise two different types of enhancement operating expenditure, and to treat these differently for cost assessment purposes.



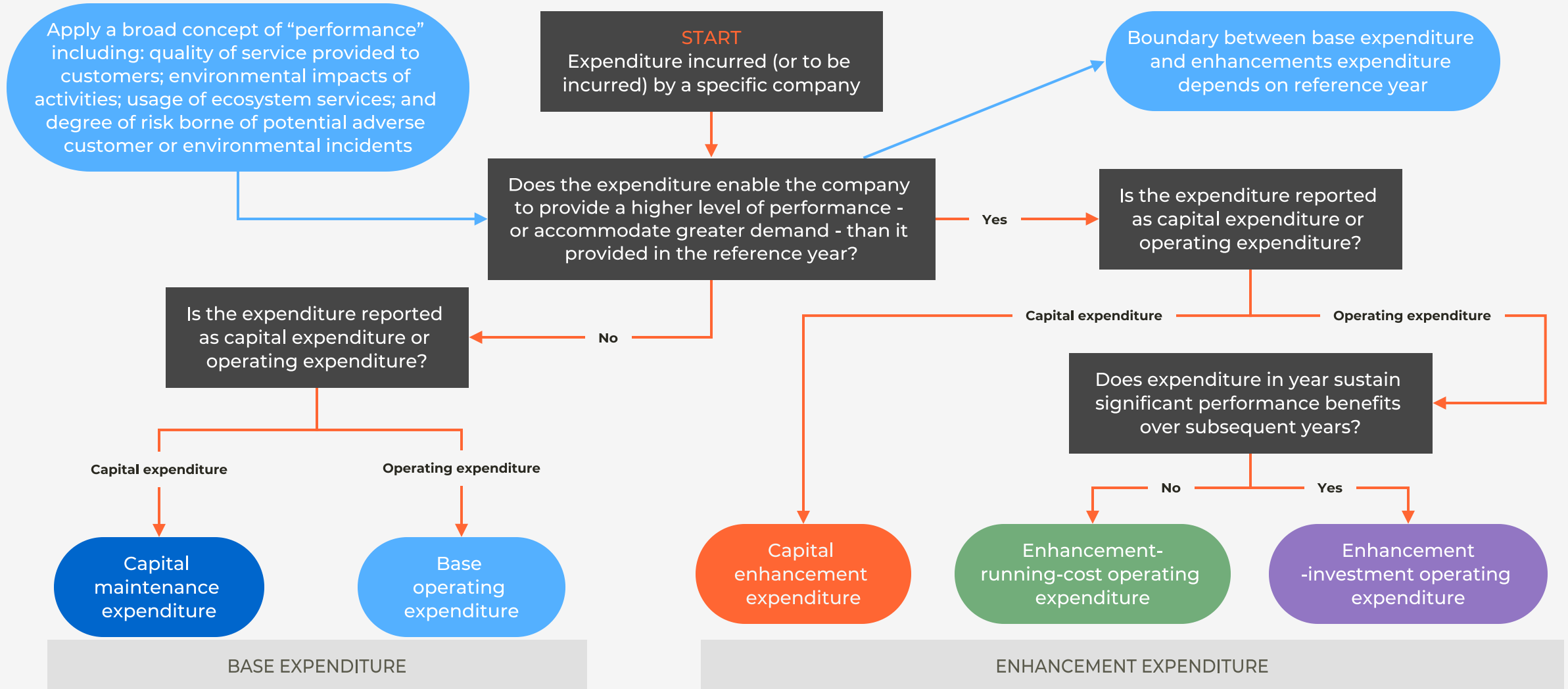
A mapping exercise to better understand and expose the relationships between specific enhancement categories and specific aspects of performance/outcomes.



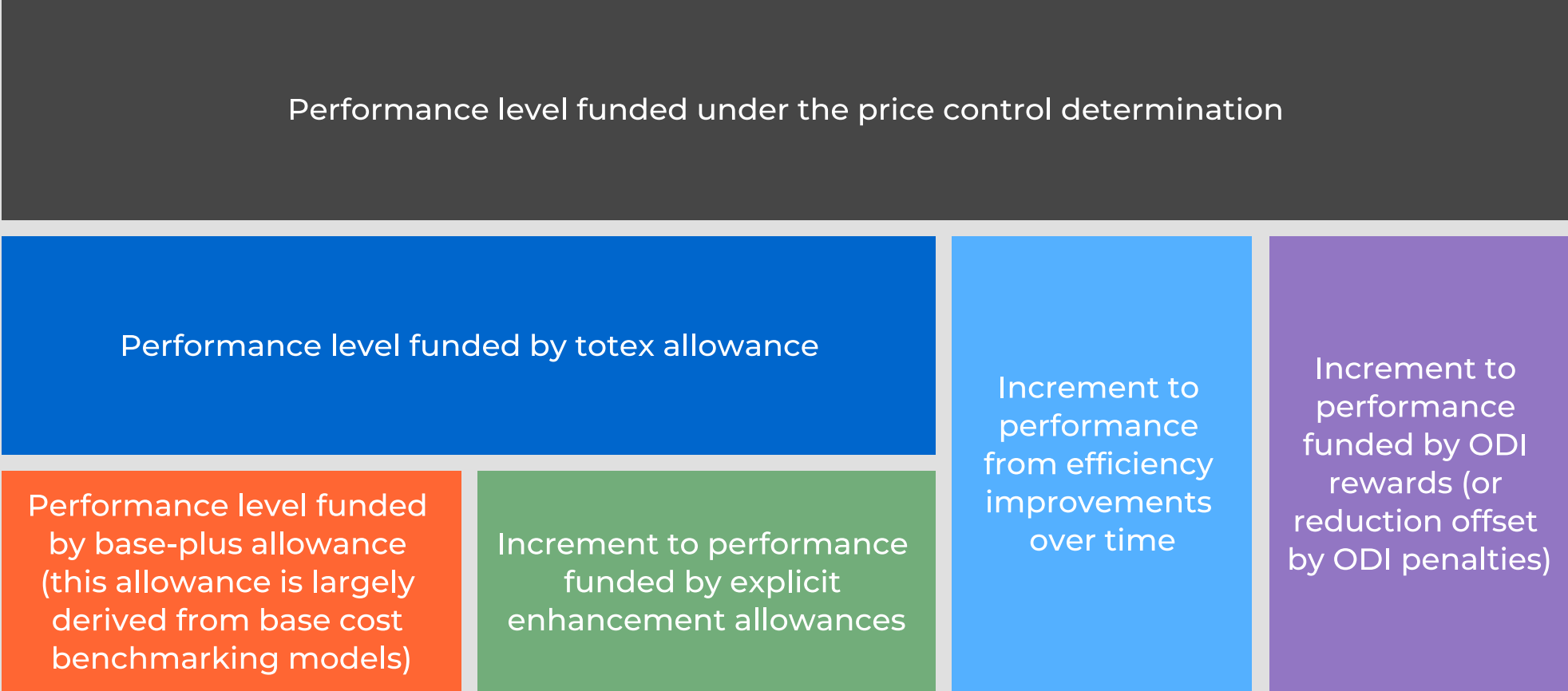
Refinements to regulatory reporting arrangements to better align with the conceptual framework and provide greater insight for future reviews.

The basis for an improved conceptual framework is provided in the project report. In the next few slides we briefly highlight a few important elements of this.

We suggest refinements to definitions of base and enhancement expenditure



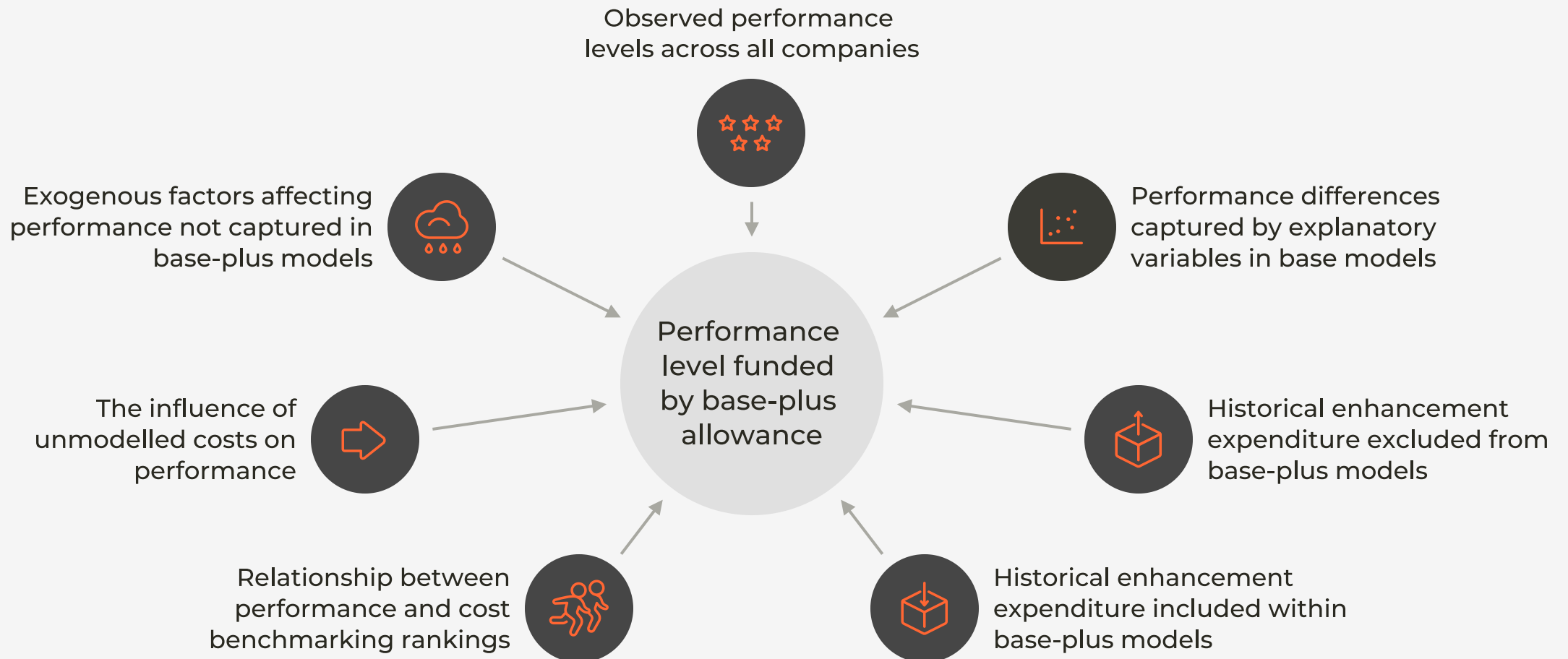
We distinguish four main price control funding channels for enhancement expenditure and performance improvements





The **base expenditure allowance** set for a company does *not* represent funding consistent with its efficient **base expenditure requirements** - or its own performance levels

We identify a range of factors that influence the performance levels funded by each company's base-plus allowance





Tackling the capex bias

Price control remuneration of efficient costs is more uncertain and less adequate for those enhancement initiatives involving a relatively high proportion of opex

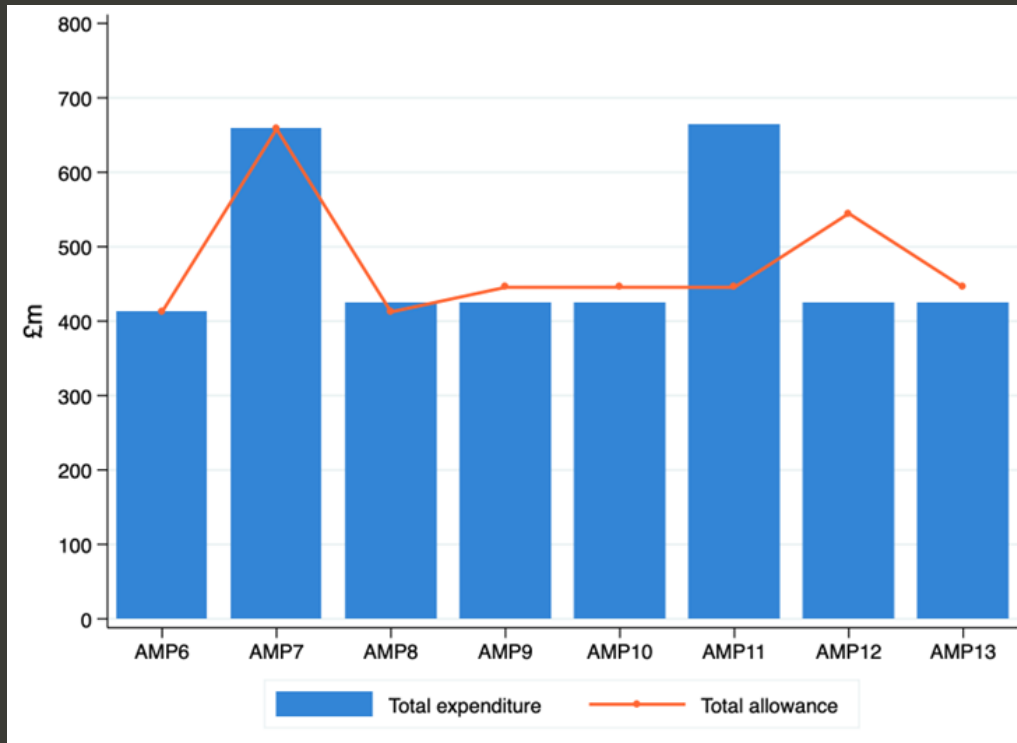


Capex-intensive enhancements?

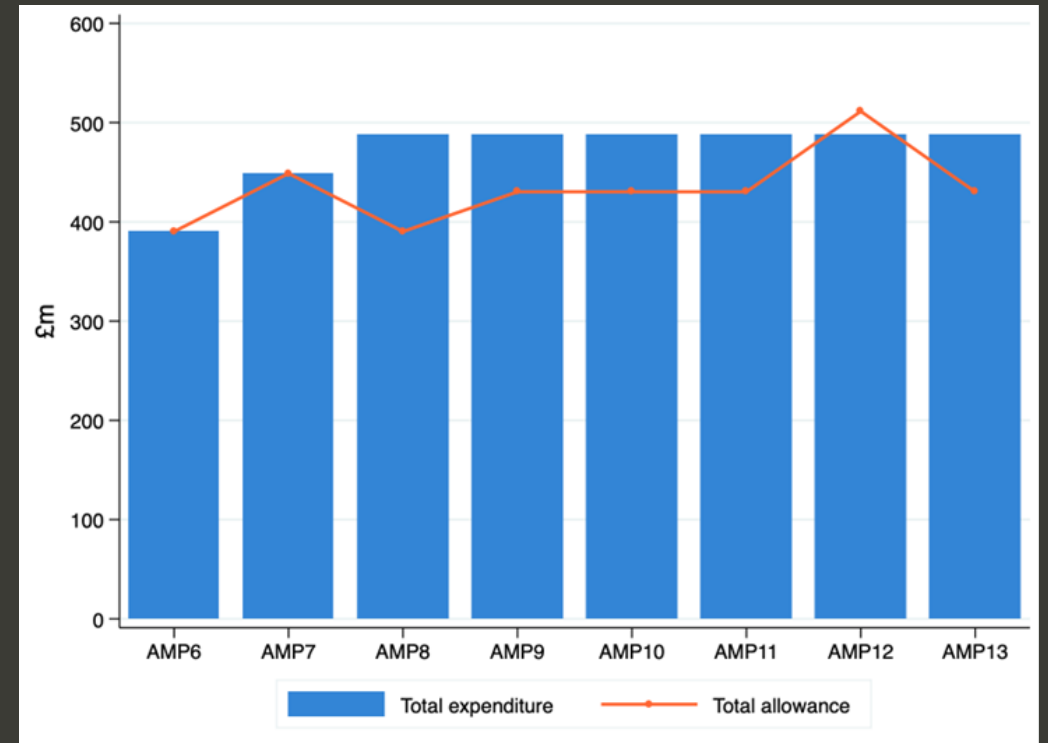


Opex-intensive enhancements?

Our simulation analysis provides insight on funding differences across capex-intensive and opex-intensive enhancements



Hypothetical scenario for companies using capex-intensive solutions in AMP7 (when others do opex-intensive ones)



Hypothetical scenario for companies using opex-intensive solutions in AMP7 (when others do capex-intensive ones)

The project considered a range of different approaches to help tackle the capex bias for enhancements

Tackling the capex bias

Concerns about the risks of a capex bias for enhancement solutions are now well recognised. This risk arises where Ofwat sets explicit enhancement allowances. Multiple factors contribute to the risk.

The project report describes and reviews a range of different options to help tackle this problem. These include an approach suggested by water companies which would involve an NPV of a long-term forecast of future enhancement operating expenditure being added to a company's RCV, and an alternative suggested by Ofwat in its PR24 draft methodology involving a 10-year funding allowance for enhancement operating expenditure being provided at PR24.

We gave particular attention to what we refer to as the adaptable multi-amp enhancement funding approach. We consider this to be a highly promising option for PR24: see box opposite.

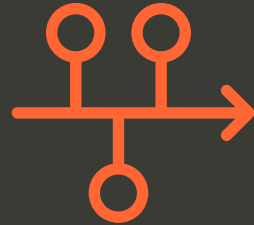
Adaptable multi-amp funding

- Ofwat determines the scale of enhancement benefits to be funded by explicit enhancement allowances - linked to PCDs / PCs.
- Ofwat determines default period of time those benefit should be funded for - taking account of the *implicit* funding duration from its established approach to capex-based enhancements (e.g. 20 years).
- Ofwat calculates a *provisional* long-term multi-amp allowance at PR24 (in £m) which can be adjusted in pre-defined ways - recorded, but not added to RCV.
- Ofwat can carry out updated cost assessment for unit costs at each price review - not locked in long-term.
- Ofwat would have early termination rights in certain circumstances.
- Approach does not eliminate risk of bias, but substantially reduces the scale of funding disadvantage for opex-based initiatives.

We contrast some alternative price control funding options for enhancement expenditure, with darker blue showing greater certainty of efficient costs in each AMP being recovered

	AMP8	AMP9	AMP10	AMP11
PR19 approach for enhancement capex	Dark Blue	Dark Blue	Dark Blue	Dark Blue
PR19 approach for enhancement opex	Dark Blue	Light Blue	Light Blue	Light Blue
10-year funding for enhancement opex	Dark Blue	Dark Blue	Light Blue	Light Blue
RCV-based remuneration of NPV forecast future opex	Dark Blue	Dark Blue	Dark Blue	Dark Blue
Adaptable multi-amp enhancement funding	Dark Blue	Light Blue	Light Blue	Light Blue

For this comparison, we assume that for the relevant enhancement category, the established and most common solution is investment in a capital asset with 20-year economic life, and treat depreciation and cost of capital on that investment as costs arising in subsequent AMPs. We then contrast remuneration under alternative options for providing allowances for enhancement operating expenditure, with greater certainty of efficient costs being recovered marked as darker blue.



Reflecting the evolution of
efficient expenditure over time

Adjustment mechanism for industry-wide expenditure

The project report describes a new type of regulatory adjustment mechanism (or uncertainty mechanism) which could help respond to several of the concerns with Ofwat's approach at PR19 and its proposals for PR24.

The mechanism could cover base expenditure and selected areas of enhancement spend and would adjust allowances in light of outturn industry-wide expenditure and net ODI performance. A focus on an industry-wide adjustment preserves efficiency incentives on companies.

This would help tackle concerns about industry-wide under-funding of the capital maintenance expenditure arising from past enhancements.

It would offer a potential funding channel for enhancement requirements that are not funded via base-plus models and are broadly similar across the industry (or where differences can be managed via ODIs around common PCs). This funding channel would help reduce the bias in favour of capex-intensive enhancements.

It could also help tackle concerns about the scale of industry-wide performance improvements over time which Ofwat treats as being funded by allowances from base models - for which there is considerable uncertainty and complexity.

The next slide highlights some of the benefits and drawbacks of this mechanism relative to some other options we have seen.



High-level comparison of some options to help tackle concerns relating to the evolution of industry-wide funding over time

	Robustness to uncertainty and complexity in setting totex and PCLs	Reliability of data used to set allowances	Predictability of allowances after final determinations	Implementation effort required
PR19 approach without any further adjustments	Red	Green	Green	Green
Uplift to base-plus allowances for forward-looking costs	Yellow	Yellow	Green	Green
Use forecast expenditure data as input to base-plus models	Yellow	Red	Green	Green
Adjustment mechanism for industry-wide expenditure	Green	Green	Yellow	Yellow

This high-level comparison is intended to convey some of the key differences between these options and is not a comprehensive assessment. The colours indicate benefits and drawbacks in relative terms across these options only, not in any absolute sense.

