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Our Ref: W123/20/CS/952

Date: 15<sup>th</sup> May 2013

Dear Caroline

### **PC15 Approaches to Efficiency**

Please find attached two papers which detail our “minded to” approaches to both opex and capex efficiencies.

We have reflected further upon your response to our draft documentation in your letter and associated annexes of 1<sup>st</sup> May, following our meeting of 10<sup>th</sup> April. It is important to stress that the Regulator cannot fetter its discretion at this stage. As a result, definitive processes and efficiency targets are not stated in the accompanying papers. We have however, sought and see merit in providing you with an update on the approaches under consideration.

### ***Requests for Clarification - Opex***

You raised a number of other specific requests for clarification of the Regulator’s thinking and whilst these are responded to within the detail of our separate “minded to” papers, they are listed here for completeness, along with a brief description of our intended approach:

- treatment of BIP and VER/VS as Business as Usual rather than as atypical expenditure.

Whilst we are not minded to apply any efficiency challenge to VER/VS going forward we do not intend continuing to treat BIP as atypical expenditure when calculating NI Water’s efficiency gap.

- hierarchy of methods of deriving the Regulator’s triangulated view of opex efficiencies.

We intend adopting a triangulated view of NI Water’s opex efficiencies and intend using the 2010/11 COLS models as our principal means of identifying the new PC15 efficiency gap. That said, other alternative approaches will be examined against the criteria of (i) accuracy, (ii) reliability and (iii) robustness, to determine the extent to which we might include them when deciding upon the PC15 operational efficiency challenge.

- setting efficiency targets (both opex and capex).

Noted, and we have included specific “Setting Targets” section within each “minded to” paper.

- any allowance for deterioration in the 2010/11 based opex models and significant change in opex performance of comparator companies.

We are likely to include the use of Cubbin discounts (as at PC10) when informing our opex triangulation for PC15. The principal means of identifying the efficiency gap shall also be subject to an examination against our modelling criteria cited above.

- Concerns over our possible adoption of a CSV alternative to the existing Water Distribution model:
  - Winter population – we intend modelling a variety of cost drivers and will examine the respective modelling merits or otherwise before finalising upon a specific model for PC15. The modelling work we have thus far shared with NI Water was indicative of our general approach rather than the final choice of model;
  - Weightings of variables – we intend conducting sensitivity analysis around adoption of different weightings to further inform our PC15 analyses; and,
  - Potential non-linearity – we intend conducting further detailed research into this question, alongside the related potential for such costs to be influenced by an urban-rural dimension. Any alternative modelling approach that offers potential for improvement will be considered, including the suggested adoption of Least Absolute Deviation regression rather than OLS.

### ***Special Factors and Atypicals (Opex and CMER)***

Regarding the close proximity of the Regulator’s date for initial feedback on draft special factors and atypical expenditure of 14<sup>th</sup> February 2014, please be advised this is the latest date based on the latest date of submission on 20<sup>th</sup> December 2013.

We would like to re-emphasise our support of an earlier submission and would commit to providing earlier feedback of same to inform the development of your PC15 Business Plan.

### ***Requests for Clarification - Capex***

Our “minded to” approach paper on capex focuses upon how we might inform NI Water’s capex efficiency gap through use of the Cost Base, Frontier Shift and additional analysis of NI Water’s potential procurement efficiencies.

We further detail our approach and scope of work for Capital Maintenance and the use of the CMER dataset, before detailing how we are minded to set capex efficiency targets.

As discussed and agreed at working level, reflected in your response of 1<sup>st</sup> May, having reviewed the potential to use TR61 there would appear to be more questions raised by its use than answered and so we do not intend to pursue this option for PC15.

We also discussed the possible introduction of a procurement efficiencies workstream to inform capex efficiencies. We would expect the company to consider whether to augment their submission of the PC15 Business Plan by inclusion of same. As noted in the accompanying paper, we shall consider whether or not to conduct our own procurement efficiencies research to inform our determination (see paragraphs 2.1.6 and 2.1.7 of our PC15 Capex 'Minded To' Methodology).

### ***PC15 Information Requirements***

We have updated our PC15 Information Requirements, specifically in response to your requests for:

- further detail on our requirements for any Business Improvement Programme and VER/VS claims (see paragraphs 2.2.8 through 2.2.14 of our PC15 Information Requirements, Chapter 2 – Operational Costs and Efficiency);
- later CMER Special Factors and Atypical Expenditure submission dates (see paragraph 1.2.1 of our PC15 Information Requirements, Appendix A1 – CMER General Guidance) – we agree these can be submitted along with draft opex special factors and atypicals on Friday 20th December 2013; and,
- Confirmation of a single Cost Base (see paragraph 1.3.1 of our PC15 Information Requirements, Appendix B1 – Cost Base General Guidance), where we now refer to final Cost Base (v1.0) for submission 8<sup>th</sup> November 2013 and (v2.0) submission alongside the PC15 Business Plan 24<sup>th</sup> March 2014.

I hope the above and attached “minded to” papers provide sufficient detail to enable the development of a robust PC15 Business Plan and Cost Base (v2.0) submission. If there remain any queries please do not hesitate to contact me for further clarification.

Yours sincerely



**Caspar Swales**  
**Head of Comparative Efficiency & Performance Branch**

cc: Ronan Larkin (NI Water)  
Michael Mulholland (NI Water)  
Gordon Smyth (NI Water)  
Martin McIlwaine (NI Water)  
J Aston (UR)  
John Mills (UR)  
Alan Craig (UR)  
Roy Colville (UR)  
Roy Mitchell (UR)

**Attached Documents**

PC15 Opex 'Minded To' Methodology

PC15 Capex 'Minded To' Methodology