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Your Ref:

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Dear Ronan

Special factors and atypical cost allowance

In reference to the issue mentioned above, I enclose two reports reflecting the likely determination of the Regulator on NI Water's special factor and atypical cost claims. The reports highlight the reasoning behind our position and the methodology of calculation. This information will assist both NI Water and the Regulator in the calculation of efficiency gaps and in establishing robust target setting for the PC10 period.

Special Factors

In summary, the findings of the Regulator are as follows and are presented in greater detail under Annex A attached:

| Special Factor | Value Claimed (£m) | Proposed Allowance (£m) |
|---|--------------------|-------------------------|
| Water Distribution Econometric model | £22m | £7.22m |
| Power Costs | £3.9m | £2.67m |
| Travel Costs for Wastewater Treatment operations | £0.3m | £0m |
| Meter Penetration Scope Adjustment | -£1.7m | Not Required |
| Regional Wage Scope Adjustment | No Claim | -£5.6m |
| TOTAL | £24.5m | £4.29m |

- Water Distribution Costs** – The Regulator considers some of the arguments to be valid so is minded to award a special factor allowance. The reduced amount of our award reflects the fact that other cost drivers exist and our belief that there are significant inefficiencies in this area. Concerns have also been raised about the validity of using a unit cost per km of main approach and the uncertainty about the materiality of the rural impact. We intend examining the potential for an alternative model as part of our overall triangulation of efficiency targets.

- **Power Costs** – There is recognition of unavoidable electricity cost differentials between NI and the UK. Consequently, the Regulator is prepared to make some special factor allowance. The reduction reflects the fact that NI Water costs are outside the typical range (as established by the CBI) and our belief that more could be done to reduce electricity consumption.
- **Travel Costs** - No allowance is proposed as the claim is not material and will not have a significant impact on our efficiency analysis.
- **Metering Penetration** - No allowance is likely as we are minded to exclude the business activity models from our COLS analysis. This is being considered given the continued deferral of domestic charging and the resultant fact that NI Water's costs are artificially lower than would otherwise be the case.
- **Regional Wages** - The Utility Regulator has endeavoured to undertake a negative scope adjustment to reflect the fact that NI Water benefits from a low wage economy in comparison with the rest of the UK.

Atypical Costs

For the purpose of the efficiency analysis, the Regulator has determined the following atypical cost allowance which are explained in greater detail in Annex B attached:

| Atypical | Amount Claimed | Amount Allowed |
|------------------------------------|----------------|----------------|
| Increase in River Strule provision | £2.3m | £0m |
| Increase in Carmoney provision | £0.25m | £0m |
| Increase in Ballinacor provision | £0.8m | £0m |
| Increase in flooding provision | £0.17m | £0.17m |
| Business improvement programme | £8.1m | £8.1m |
| Voluntary Early Retirement (VER) | £4.56m | £4.56m |
| TOTAL | £16.18m | £12.83m |

- **River Strule Provision** - It is the Regulator's view that no amount of this expenditure should be considered atypical as this pollution incident was within management control and could have been prevented.

- **Carmoney Provision** - The same reasoning applies to this decision as to the River Strule incident. The Regulator is not aware of any mitigating circumstances and cannot treat such costs as atypical as doing so would provide less of an incentive to reduce such incidents.
- **Ballinacor Provision** - The Regulator does not consider this atypical as it is a normal part of business activities, although a relatively rare occurrence.
- **Flooding Costs** - The Regulator considers this to be an unavoidable exceptional expense, so will allow the full claim.
- **Business Improvement Programme** - The Regulator will follow the WICS approach and treat these costs as atypical for the duration of the SBP period, when the majority of costs will be incurred. Acceptance of the BIP as atypical is conditional upon binding milestones for delivery and a strict level of scrutiny on the cost and benefit monitoring of the programme to avoid consumers (and taxpayers) paying twice for the same improvements.
- **Voluntary Early Retirement** - The same reasoning applies to VER costs as BIP expenditure. It may be easier to agree binding milestones for VER since a reduced headcount provides discrete measurement of efficiency delivery. For the purpose of the efficiency assessment, these costs will only be treated as atypical during the SBP period at the end of which benefits should outweigh costs.

Conclusions

The Regulator welcomes the efforts of NI Water in undertaking the special factor and atypical claim process. The analysis should allow for a more robust approach to calculating efficiency targets for PC10 and indicative targets for PC13. In addition, the process helps to promote a better understanding of the nature of the business and associated problems faced by NI Water.

This provision may fall dramatically depending on the nature of information submitted in relation to BIP and VER spend. For the purposes of excluding these costs the Regulator requires evidence of the expected outputs, performance-to-date both in terms of non-monetary and monetary targets upon submission of the PC10 Business Plan on 1st June 2009. Upon satisfactory provision, NIAUR may then be minded to allocate all BIP and VER expenditure as atypical for the purposes of efficiency modelling.

Whether the Regulator at PC10 determines these costs as an allowed expenditure not subject to efficiency savings depends on whether NI Water can offer convincing argument that such costs remain designed to improve their overall efficiency and are:-

- ring fenced for the remainder of their duration ie they will expire during the PC10 period;
- their continuation into the PC10 period has been entirely due to unavoidable delay(s) outside the control of management; and,
- such costs are material.

The Regulator will also consider a further company response in relation to our regional wage scope adjustment and any further representation, on any of the matters outlined above or detailed within the Annexes, should be included in your PC10 Business Plan submission on 1st June 2009.

Yours sincerely



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