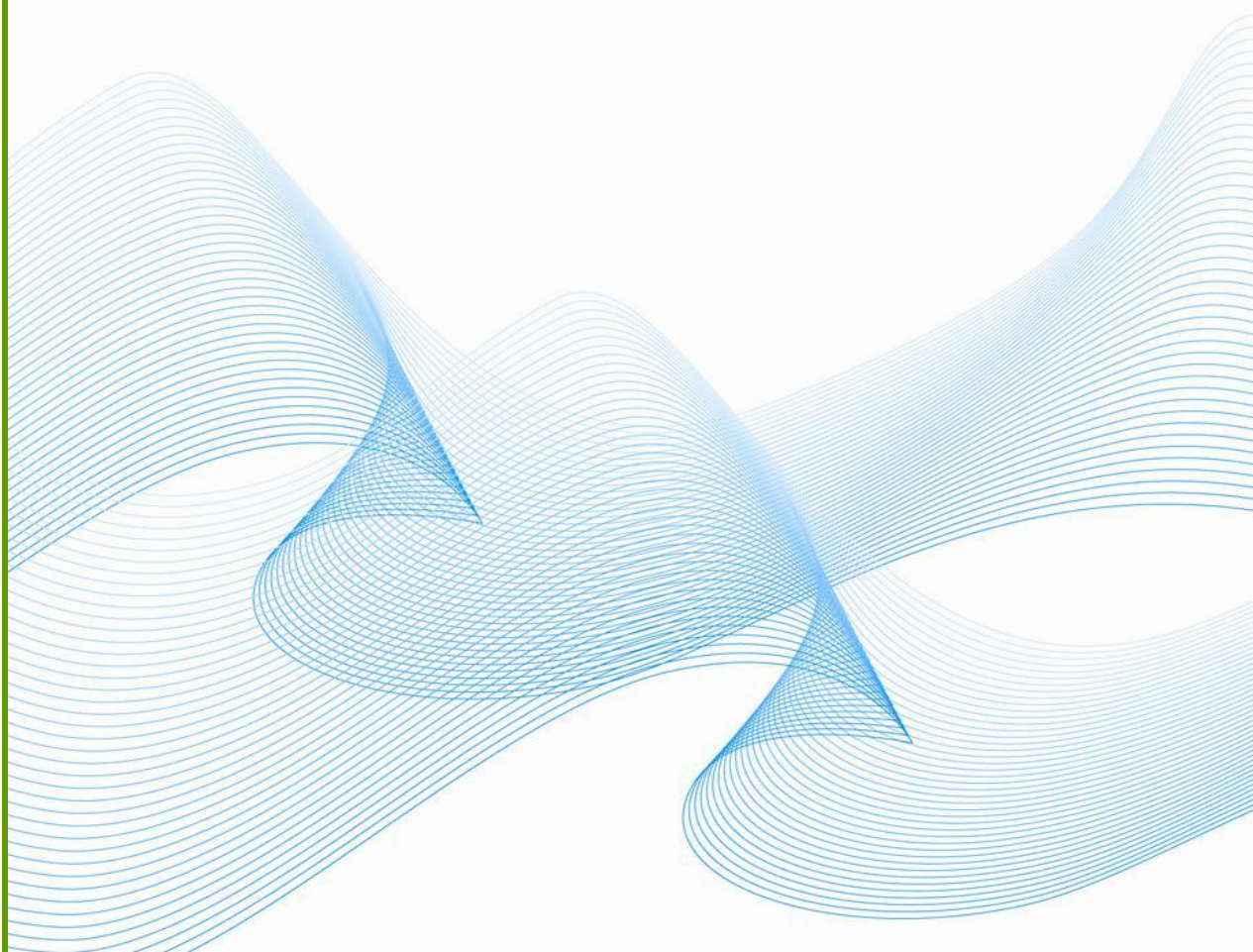




Water and Sewerage Service Price Control 2010-13

Draft Determination Main Report – Annex D3
Analysis of NI Water's Atypical Claims

September 2009



Water and Sewerage Revenue and Charges Price Control 2010-2013

Draft Determination Main Report

Annex D3 – Analysis of NI Water’s Atypical Claims

Content Note

The determination on atypical expenditure has been previously communicated to NI Water in a letter and report sent on the 21st April 2009. This annex reproduces the information produced in that initial report, so has not been reformatted to reflect the style and numbering of the main document.

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Determination of NI Water's Atypical Expenditure Claim

Background

In the Annual Information Return 2008 (AIR08) guidance, NIAUR required NI Water to identify and explain any atypical expenditure. Such expenditure could be defined as “one-off” or “exceptional” costs incurred as a result of events outside management control. Examples taken from Ofwat might include expenses associated with:-

- Extreme climatic events;
- Unusual compensation payments; and,
- Rebates of rates / service charges.

The Regulator also asked NI Water to identify any business restructuring costs associated with the Business Improvement Programme (BIP). Such costs by their nature are within management control but may be deemed exceptional as they are one-off efficiency initiatives. This cost treatment follows the £200m Spend-to-Save example of Scottish Water, whose initiatives were treated as exceptional by the Water Industry Commissioner for Scotland (WICS).

Within the AIR08 submission NI Water identified £16.18m of atypical costs divided as follows:-

Table 1: NI Water atypical expenditure claims

Atypical	Amount	Description
Increase in River Strule provision	£2.3m	An increase in claims provision associated with pollution incidents at Hunters Crescent Wastewater Treatment Works (WWTW) in Omagh between 1999 and 2004
Increase in Carmoney provision	£0.25m	An increase in claims provision associated with a serious injury sustained by a contractor who was blown from a roof following an explosion at Carmoney WWTW
Increase in Ballinacor provision	£0.8m	Extra costs associated with the clean up and desludge of lagoons at Ballinacor
Increase in flooding provision	£0.17m	A provision for legal costs as a result of any claims that might arise due to flooding on the 12 th June 2007
Business improvement programme	£8.1m	No breakdown of the exact nature of this spend has been included, although the associated projects are identified in NI Water's One Programme report
Voluntary Early Retirement (VER)	£4.56m	These are the provisional costs set aside for the redundancy package associated with the headcount reduction scheme
TOTAL	£16.18m	

The Regulator's View

As a matter of course, the Regulator must take a view on each of the claims and decide whether the costs should be excluded from normal business costs. This will make a difference to any subsequent efficiency analysis as the level of base expenditure will be smaller if all or some of the claims are accepted.

Taking the atypical costs in the order given, the Regulator has formed the view of the amount that should be allowed. This is highlighted in the table below.

Table 2: Proposed atypical expenditure allowance

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

Increase in River Strule provision

NI Water has claimed an extra £2.3m as atypical due to increased claims by the Loughs Agency for the cost of regenerating the river with fish stocks. This is as a result of pollution incidents associated with the Hunters Crescent WWTW in Omagh. NI Water may claim that this should justifiably be atypical as it is a legacy issue outside of management control, since the incidents occurred as far back as 1999. NI Water may also point to the view of the Interim Reporter (Halcrow) who felt that the 2006/07 River Strule provision was allocated correctly to atypical expenditure.

It is the view of the Regulator that no amount of this expenditure should be considered atypical. The primary reason is that this pollution incident was within management control and could have been prevented. Consequently NI Water must be liable for any claims incurred. Furthermore, the expenditure is not a "one-off" item as provision for this claim has been made in 2006/07, 2007/08 and more claims could be made in the future.

Increase in Carmoney provision

This expenditure is associated with an increased claim due to an accident that occurred at Carmoney WWTW in 2005. Using similar reasoning to the River Strule judgement, the Regulator is of the opinion that this cost is not atypical. Since accidents are generally preventable it is likely that these costs were within management control. NIAUR are not aware of any mitigating circumstances to consider otherwise. As a consequence, NI Water must be liable for any cost incurred. The Regulator has some sympathy in that NI Water is dependent on accurate claims from Central Claims Unit (CCU). However, the amount is relatively small and it is for NI Water to decide if such claim levels are realistic.

A precedent was set here by Ofwat in relation to United Utilities claim for an atypical allowance due to an Ofwat penalty. Ofwat rejected this claim as there would effectively be no punishment if the penalty was treated as atypical. Likewise, NIAUR are minded to reject atypical claims for pollution incidents or accidents. If these costs are simply classed as exceptional then there would be little incentive for NI Water to reduce their occurrences. Furthermore, in relation to public liability insurance claims, Yorkshire Water stated that, **“these costs are not to be classed as atypical as they form part of the Company’s normal trading.”**¹ NIAUR is of the same opinion.

Increase in Ballinacor provision

NI Water has claimed an atypical cost for the clean up and desludge of the lagoons at Ballinacor. The actual amount relates to the difference between the provision made and the cost of the contract awarded to Glen Water. NIAUR sees no reason why this should be classified as atypical since the cost of cleaning sludge lagoons, although rare, is a normal part of business operations and not the impact of exceptional events. Unless NI Water provide some exceptional reason why the cost of the Glen Water contract is more than provided for, the Regulator is minded not to accept this claim.

Increase in flooding provision

The Regulator is content that legal costs associated with flooding incidents were uncontrollable in this instance. As a consequence the full amount of the claim is classified as atypical.

Business improvement programme (BIP)

The costs associated with the BIP are slightly different to normal atypical allocations. Such expenditure is likely to be part of normal business costs as they are related to modernisation projects aimed at making NI Water more efficient. In the traditional use of the allocation, these costs would not really be considered atypical as they are pro-active management decisions.

¹ See Yorkshire Water Company Commentary of June Return 2006/07 (Chapter 21)

Consequently they would be self-financing in the Ofwat framework and included within base costs.

However a precedent was set by WICS who allowed a £200m (capex and opex) spend-to-save initiative to be included upfront in the regulatory revenue cap. NI Water have formulated some of their own efficiency initiatives, known as the BIP. The anticipated **operational** costs and savings of these schemes are evidenced below.

Table 3: BIP operating costs

BIP Operating costs (£m)				
	2007/08	2008/09	2009/10	Total
Capability	3.3	1.3	1.1	5.7
Legal/regulatory	1.6	2.9	1.4	5.9
Efficiency	6.1	2.4	0.7	9.2
Total	11.1	6.6	3.2	20.9

*Source: LECG – High Level Review of NI WATER's Business Improvement Programme
 (Figures may not add due to rounding)*

Table 4: BIP operational savings

BIP Operational Savings (£m)				
	2007/08	2008/09	2009/10	Total
Capability	0.3	0.5	0.5	1.3
Legal/regulatory	5.9	15.1	24.6	45.6
Efficiency	0.9	0.9	1.0	2.8
Total	7.1	16.5	26.0	49.6

Source: NI WATER – Why Northern Ireland needs the 'One Programme' (figures may not add due to rounding)

The Regulator accepts the rationale behind this claim and the level of expenditure provided. At present there are serious misgivings associated with allocating all this money as atypical. In Scotland, WICS were mindful that including spend-to-save reduced the challenge faced by Scottish Water. They also noted that no such provision was made for the Ofwat companies. In their *Costs and Performance Report 2002-03* WICS state,

“We are not aware of any precedent for such an allowance to be included upfront in a regulatory revenue cap. It is therefore of the utmost importance that we are able to monitor this allowance in detail to ensure that customers’ interests are protected.”²

² See WICS – Cost and Performance Report 2002-03

NIAUR requires this same level of assurance but are not in a position to ensure customers interests are protected, as to date little information on the performance of the schemes has been provided. Scottish Water was by contrast able to assess tangible outputs associated with this spend. In a report on the BIP³ commissioned by NIAUR from LECG the following key outputs had been readily recorded:-

1. By 2004/05 the headcount of Scottish Water was reduced by 28%;
2. In the first 3 years, Scottish Water was better able to prioritise its response to calls resulting in a 50% reduction in the number of repeat visits to individual sites to address a problem;
3. Scottish Water achieved a 141% increase in the utilisation of its field operatives by 2004/05; and,
4. By the third year since its creation, the operating costs of Scottish Water had been reduced by 29% (excluding costs for new plants).

At this stage the Regulator agrees in principle with treating the modernisation costs as atypical. This reflects the fact that NIAUR is content to mirror the WICS methodology but requires much more monitoring information. In order to provide assurance that customer interests are being protected, the Regulator would require detailed information on a project-by-project basis. This would include various factors such as:-

1. Planned level of expenditure;
2. Actual spend to date;
3. Expected Monetary and Non-Monetary Benefits;
4. Actual realisation of benefits with documented evidence; and,
5. Evidence of project governance etc.

The level of information required would reflect the example project monitoring spreadsheet which the Regulator provided to NI Water during its own Review of the BIP⁴. There would also be a need to document the evidence of benefits realisation rather than simply the provision of numbers. Regular updates on performance to date would be considered essential, either on a quarterly or bi-annual basis. Under normal circumstances this would be viewed as a form of micro-management, which both the Regulator and NI Water would wish to avoid. However, if the interests of the customers are to be adequately protected NIAUR insist this level of detail is proportionate to its duty to protect customers. At the present time inadequate assurance exists as to successful delivery of the BIP which must be addressed by NI Water if they wish BIP costs to be treated as atypical.

Following on from the WICS example, the Regulator considers it appropriate to establish a time frame for completion of the programme. In Scotland the Commissioner allowed the spend-to-

³ See LECG – High level review of NI WATER's Business Improvement Programme

⁴ NIAUR's "Review of the BIP" (27th Feb-08) was a systems and VFM audit of NI Water's planned BIP.

save project to run for the course of a price review (4 years). Since the majority of expenditure in the BIP is planned for the first three years, the Regulator considers it prudent to cease atypical allowance by PC10. NIAUR is of the opinion that three years is a sufficient juncture for the modernization process. Even though funding for the improvement programme may continue into PC10, these costs will no longer be treated as atypical for the purpose of efficiency modelling. Since planned benefits are much greater than proposed costs at this point (2009/10), this does not seem to the Regulator to be an unreasonable approach.

Whether the Regulator further determines these costs as fully allowable for the purposes of PC10 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.

Voluntary Early Retirement (VER)

The cost of early retirement and severance pay was a large proportion of the spend-to-save programme in Scotland. NI Water has identified these costs as separate from their improvement programme. In reality however, this scheme will play a major part in the restructuring of the water industry in Northern Ireland.

The Regulator does not accept that these costs are atypical as they are a direct result of management restructuring decisions. NIAUR does however realise the exceptional nature of VER payments until the business is fully restructured. In principle the Regulator is willing to accept that the totality of the claim be treated as atypical. In similar vein to the BIP schemes, the Regulator would expect to see performance indicators and other relevant information associated with such a scheme e.g. staff cuts, salary reductions etc, monitored against anticipated. The Regulator would have to receive and be satisfied that company submissions offered adequate protection of the consumer before excluding such costs from our efficiency analysis.

In a similar fashion to the BIP, VER costs will not be treated as atypical after the SBP period has elapsed. The Integrated Financial Model (IFM) assumed VER costs of £29m in the period from 2007/08 to 2013/14. Profiled as follows:-

Table 5: Profile of proposed VER costs

	VER Costs (£m)
2007/08	5.2
2008/09	10.8
2009/10	5.5
2010/11	1.8
2011/12	1.8
2012/13	1.9
Total	29.0

The table indicates that 74% of the expenditure will be incurred within the first three years by which time benefits should far exceed costs. Consequently, the expenditure incurred after 2010 will not be considered atypical for the purposes of our efficiency modelling.

As before, whether the Regulator further determines these costs as fully allowable for the purposes of PC10 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.

Conclusions

In total, the Regulator holds out the possibility that £12.83m (79.3%) will be allowed as atypical expenditure in 2007-08. This is a much higher percentage awarded to the Ofwat companies in 2007-08, although the physical amount claimed per company tended to be much less in England and Wales.

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. 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 i.e. 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.