


# Water and Sewerage Service Price Control 2013-2015

PC13 Annex B  
Atypical Costs - Final Determination

December 2012



# Water and Sewerage Service Price Control 2013-15

## PC13 One-offs and Atypicals

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## Executive Summary

As part of their Business Plan submission for PC13, NI Water is required to detail atypical expenditure or one-off costs. Atypical expenditure is defined as costs (or reductions) which are not repeatable and are exceptional in nature.

The purpose of identifying these costs / reductions is two-fold:

1. Atypicals are excluded from the efficiency gap analysis. The regressions are designed to model cost in a 'typical' year. One-off spend will distort results so are excluded from the analysis.
2. Consideration needs to be given to one-offs when establishing the opex baseline. NI Water has made a number of baseline adjustments to account for the reasons why 2010-11 was not typical.

The Utility Regulator must determine whether these claims are reasonable and justified. For the purpose of the efficiency analysis, NI Water has made the following cost claims:

**Table A – Claimed atypical cost for efficiency analysis**

Atypical Cost	NI Water Claimed Atypical Cost	Rationale
Business Improvement Programme (BIP)	£2.0m	Restructuring costs incurred in transforming the business.
Voluntary Early Retirement / Severance (VER/VS)	£2.6m	Restructuring costs incurred in transforming the business.
Freeze / Thaw	£5.1m	Costs of dealing with an extreme climatic event.
<b>Total Atypical Cost</b>	<b>£9.7m</b>	

NI Water believes their opex in 2010-11 to be £9.7m above what they would typically spend. The company are of the opinion that these costs should be removed from the efficiency analysis in order to get a 'true' view of the efficiency gap.

The Business Plan also provides an assessment of one-off adjustments in order to establish an appropriate baseline. There is a disjoint in PC13 by virtue of the efficiency and baseline adjustments being different.

NI Water is of the opinion that the baseline adjustments represent one-off costs and should be amended accordingly. However, the company has not undertaken the same adjustments for the baseline as for the efficiency analysis.

The table below details the atypical adjustments for the baseline.

**Table B – Claimed atypical cost for base lining opex**

Atypical Cost	NI Water Claimed Atypical Cost	Rationale
Business Improvement Programme (BIP)	£2.0m	Restructuring costs incurred in transforming the business.
Voluntary Early Retirement / Severance (VER/VS)	£2.6m	Restructuring costs incurred in transforming the business.
Freeze / Thaw	£5.1m	Costs of dealing with an extreme climatic event.
Staff costs	£1.9m	Cost of equal pay claim and pensions.
Operational Contractors	-£1.3m	Accrual release associated with sludge and septic tank emptying.
Outsourcing	-£2.4m	Accrual release resulting from the settlement of the Steria contract termination.
Legal and Professional	£1.2m	Additional legal costs from Steria dispute and reclassified of capex.
Rates	-£2.5m	A credit from Land and Property Services (LPS) due to reassessment of rateable properties and values.
Bad Debts	£1.1m	An increase in provision due to downward trend in the economy.
Various	-£0.6m	Primarily release of accruals from prior years in consultancy and audit.
<b>Total Atypical Cost</b>	<b>£7.1m</b>	

The Utility Regulator does not consider there to be any difference between one-off and atypical costs. Consequently, the baseline adjustments should mirror those made in the efficiency analysis. This ensures that an appropriate and consistent challenge is placed on the correct baseline expenditure.

The one exception is rates. The efficiency analysis does not take any account of rates. It is reasonable therefore to include this as a baseline change but not an efficiency cost adjustment, if considered to be atypical.

A summary of the allowed atypicals is provided in Table C.

**Table C – Allowed atypical cost**

<b>Atypical Cost</b>	<b>NI Water Claimed Atypical Cost</b>	<b>UR Allowance for Atypical Costs</b>
Business Improvement Programme (BIP)	£2.0m	£2.0m
Voluntary Early Retirement / Severance (VER/VS)	£2.6m	£2.6m
Freeze / Thaw	£5.1m	£5.1m
Staff costs	£1.9m	£1.2m
Operational Contractors	-£1.3m	-£1.3m
Outsourcing	-£2.4m	-£2.4m
Legal and Professional	£1.2m	£0.8m
Rates	-£2.5m	-£2.5m
Bad Debts	£1.1m	£0.0m
Various	-£0.6m	-£0.6m
<b>Total Atypical Cost (Baseline)</b>	<b>£7.1m</b>	<b>£4.9m</b>
<b>Total Atypical Cost (Efficiency Analysis)</b>	<b>£9.7m</b>	<b>£7.4m</b>

The Utility Regulator has made a couple of minor adjustments to the allowances. Disallowed costs generally reflect the fact that expenditure areas are normal operational activities rather than exceptional events.

The outworking of the analysis has two impacts.

- a) The atypical allowance for the efficiency analysis has decreased. This results in a marginally higher relative gap and opex efficiency target.
- b) Baseline cost adjustment has decreased. This results in a higher baseline allowance than that submitted by NI Water.

Full explanation of the Utility Regulator's decisions are provided in the main report.

# 1 Atypical Costs Claimed

## 1.1 Background

- 1.1.1 As part of the PC13 Business Plan, NI Water is required to submit a claim for atypical costs. Atypicals are those which are one-off or exceptional in nature and unlikely to be repeated.
- 1.1.2 The purpose of assessing atypical costs is twofold.
  - a) Atypicals are excluded from the efficiency gap analysis. The regressions are designed to model cost in a 'typical' year. One-off spend will distort results so are excluded from the analysis.
  - b) Consideration needs to be given to one-offs when establishing the opex baseline. NI Water has made a number of baseline adjustments to account for the reasons why 2010-11 was not typical.
- 1.1.3 The Utility Regulator must determine on these atypical costs. Their acceptance or not will impact on the relative efficiency gap, efficiency targets and the opex baseline allowance for PC13.

## 1.2 Interdependency

- 1.2.1 The atypical cost allowance has an important interdependency between the baseline and the efficiency gap. A company must consider carefully what it considers to be atypical.
- 1.2.2 The higher the atypical cost claimed the lower 'typical' costs will be if accepted. The result will be a lower relative gap and smaller efficiency targets. However, the company will have a reduced base opex allowance as a result of lower 'typical' costs.
- 1.2.3 Alternatively, the company can choose to make a low atypical cost claim. This will result in tougher efficiency targets but applied to a higher base expenditure level.

## 1.3 Business Plan Claim

- 1.3.1 In the PC13 Business Plan there appeared to be a disjoint in the approach to atypicals. NI Water claimed only three atypical categories (BIP, VER/VS and freeze/thaw) for the purpose of efficiency comparisons. This mirrored the atypicals identified in the Annual Information Return.

- 1.3.2 For the 2010-11 baselining exercise the company undertook these three plus seven other adjustments, both positive and negative. NI Water has reasoned that some of the baseline adjustments are one-off but not atypical. They should not therefore form part of the efficiency analysis.
- 1.3.3 The Utility Regulator does not distinguish between one-off and atypical costs. Any appropriate changes to the efficiency analysis should also be made to base opex. Adopting such an approach means that the efficiency challenge corresponds with the appropriate baseline.
- 1.3.4 The exception to this rule is rates (or third party services). Rate costs do not form part of the efficiency analysis. If atypical expenditure is incurred in this area, a baseline adjustment will be required. However, this would not transfer into a change in the efficiency analysis atypical provision.
- 1.3.5 The table below details the cost areas claimed by NI Water as atypical for both the efficiency analysis and the baseline.

**Table 1.1 – Claimed atypical cost for efficiency analysis and baseline**

Atypical Cost	NI Water Claimed Atypical Cost for Efficiency Analysis	NI Water Claimed Atypical Cost for Baselining
Business Improvement Programme (BIP)	£2.0m	£2.0m
Voluntary Early Retirement / Severance (VER/VS)	£2.6m	£2.6m
Freeze / Thaw	£5.1m	£5.1m
Staff costs		£1.9m
Operational Contractors		-£1.3m
Outsourcing		-£2.4m
Legal and Professional		£1.2m
Rates		-£2.5m
Bad Debts		£1.1m
Various		-£0.6m
<b>Total Atypical Cost (Efficiency Analysis)</b>	<b>£9.7m</b>	
<b>Total Atypical Cost (Baseline)</b>		<b>£7.1m</b>

- 1.3.6 Detail behind the rationale for each claim and the Utility Regulator's determination is provided in Chapter Two.

## 2 Atypical Costs Allowed

### 2.1 Determined Costs

2.1.1 The Utility Regulator has made the following determination with respect to atypicals.

**Table 2.1 – Claimed and allowed atypical cost**

Atypical Cost	NI Water Claimed Atypical Cost	UR Allowance for Atypical Costs
Business Improvement Programme (BIP)	£2.0m	£2.0m
Voluntary Early Retirement / Severance (VER/VS)	£2.6m	£2.6m
Freeze / Thaw	£5.1m	£5.1m
Staff costs	£1.9m	£1.2m
Operational Contractors	-£1.3m	-£1.3m
Outsourcing	-£2.4m	-£2.4m
Legal and Professional	£1.2m	£0.8m
Rates	-£2.5m	-£2.5m
Bad Debts	£1.1m	£0.0m
Various	-£0.6m	-£0.6m
<b>Total Atypical Cost (Baseline)</b>	<b>£7.1m</b>	<b>£4.9m</b>
<b>Total Atypical Cost (Efficiency Analysis)</b>	<b>£9.7m</b>	<b>£7.4m</b>

2.1.2 Most costs have been accepted. Some adjustments have been undertaken by the Utility Regulator. The result is a lower atypical allowance for the efficiency analysis and for the baseline.

2.1.3 This means NI Water will have a slightly tougher efficiency challenge but a higher level of base opex. The rationale for the company claim and the Utility Regulator's decisions are provided below.

2.1.4 Each category of opex is considered individually.



## 2.2 Business Improvement Programme

- 2.2.1 This expenditure represents funds to transform, modernise or restructure the business. BIP is not strictly an atypical cost. It is repeatable opex as it has been funded since 2007-08.
- 2.2.2 Due to significant transformation costs being incurred at the outset of NI Water, the Utility Regulator agreed that it would treat the spend as atypical. This remained the case for PC10 so the full allowance in 2010-11 has been accepted.
- 2.2.3 The Utility Regulator is of the opinion that this atypical status should cease for the PC15 assessment. The company has now had adequate time and funding to make major changes. Whilst there may be a need for future BIP funding, the Utility Regulator believes no special dispensation should be made in the efficiency analysis. This reflects a more generous approach than Scotland where the Invest-to-Save programme was restricted to only one price control.

## 2.3 Voluntary Early Retirement / Voluntary Severance

- 2.3.1 VER/VS falls into the same category as business improvement. The costs are not strictly atypical but have been treated as such. This is due to NI Water's immaturity as a company and the need to transform from being a civil service agency. Consequently the full £2.6m has been accepted.
- 2.3.2 The Utility Regulator believes this atypical status should also cease for the PC15 review. The company has had reasonable opportunity to make significant changes. Any further spend should be classified as normal business operations.

## 2.4 Freeze/ Thaw

- 2.4.1 During December 2010 and January 2011 NI Water incurred an extreme weather event. Temperatures dropped to the coldest in 100 years. This was followed by a rapid thaw which resulted in significant levels of bursts and interruptions to supply. Approximately 450,000 consumers were affected.
- 2.4.2 NI Water made a provision of £5.1m to deal with the event. This has been claimed as an atypical due to the exceptional nature of the incident. The Utility Regulator accepts that these costs do not represent typical expenditure. The entire £5.1m freeze/thaw claim has been accepted.

## 2.5 Staff Costs

- 2.5.1 The company have claimed £1.2m extra cost in 2010-11 due to an equal pay claim following the civil service settlement. This is a legacy of certain staff that transferred from the civil service being eligible for a lump sum payment. NI Water

claims the costs to be atypical as they are *“deemed to be not pertinent to the underlying 2010-11 costs.”*

- 2.5.2 NI Water has also added a claim of £0.7m for pension costs. The argument is that the pension charge is uncertain as it is decided by actuaries.
- 2.5.3 The Utility Regulator agrees that the £1.2m equal pay claim is atypical. The lump sum payment is one-off in nature. Costs are exceptional as the issue is a legacy from the civil service.
- 2.5.4 Pension costs are not considered atypical. Whilst the charge is uncertain and decided by actuaries, the cost reflects a usual business operation. No atypical allowance has been granted for this element of staff costs.

## 2.6 Operational Contractors

- 2.6.1 NI Water made an atypical claim for a cost reduction of £1.3m in the base year. The company stated that costs were lower in 2010-11 as a result of an accrual release for sludge and septic tank emptying. Costs proved lower than the 2009-10 provision which resulted in the one-off release.
- 2.6.2 The Utility Regulator is inclined to accept this claim. Whilst the activity is not strictly atypical, the release of the accrual is lowering base opex beyond normal levels. An adjustment is therefore required.

## 2.7 Outsourcing

- 2.7.1 A £2.4m atypical cost reduction was identified by NI Water for outsourcing. This relates to the settlement with Steria regarding a termination of contract. The amount awarded was less than provided for in 2009-10. This resulted in the release of an accrual in the base year.
- 2.7.2 There is acceptance that this cost reduction is atypical. The accrual release is exceptional due to the nature and size of the contract and the unanticipated circumstances around the postponement of domestic charges. As a result, full allowance for this cost has been provided.

## 2.8 Legal and Professional Services

- 2.8.1 NI Water has argued for an atypical of £1.2m for legal and professional services. This is made up of £0.8m legal expenses incurred during the Steria dispute. An additional £0.4m is claimed for the reclassification of capex projects.

- 2.8.2 The Utility Regulator accepts that the Steria dispute was exceptional. However, there does not appear to be justification for treating the capital projects transfer as atypical. A £0.8m provision has been allowed.

## 2.9 Rates

- 2.9.1 The company has identified a £2.5m atypical cost reduction for rates. This was the consequence of a credit resulting from new bills issued from Land and Property Services (LPS). More accurate bills were produced based on further assessments of rateable properties and values.
- 2.9.2 It is accepted that this claim is atypical. The credit is exceptional in nature and unlikely to be repeated. However, the scale of the claim is open to some debate.
- 2.9.3 The negative atypical is indicating that the rates bill is £2.5m below what it would be in a normal year. It would then be expected that actual costs would rise by a similar amount in the next year. In 2011-12 rates are only £1.7m higher. Converting to 2010-11 prices would mean an increase of £1.6m.
- 2.9.4 The calculations suggest that the atypical is overestimated. This may be the result of the credit reflecting changes to bills over a number of years.
- 2.9.5 The Utility Regulator in its final determination has allowed the full atypical claim of minus £2.5m. This is based on the fact that NI Water has made the appropriate negative cost claims for rates in the additional opex section of their revised Business Plan figures.

## 2.10 Bad Debts

- 2.10.1 Given the current economic difficulties, NI Water reviewed their bad debt provision. The result was a one-off increase of £1.1m. The company considers this cost to be atypical and non-repeatable.
- 2.10.2 There does not appear to be any justification for treating this as atypical. Dealing with bad debt is a normal part of the regulated business. Moreover, the economic downturn has been prevalent for some years and is likely to continue in the near future. The Utility Regulator does not consider this cost to be exceptional so has made no allowance.

## 2.11 Various Items

- 2.11.1 The final claim is for a cost reduction of £0.6m. This relates to accrual release from prior years provisions for consultancy and audit spend. NI Water considers this atypical as the reduction is non-repeatable.

2.11.2 The Utility Regulator has accepted the claim in full. The activity is not strictly atypical in nature but the reduction is non-repeatable.

## 3 Conclusions

### 3.1 Outcomes

- 3.1.1 The outworking of the analysis has produced some minor changes to opex figures. The atypical allowance for efficiency benchmarking has decreased slightly (from £9.7m to £7.4m). This results in a change in the efficiency gap and opex targets.
- 3.1.2 Atypical provision for baseline opex has decreased from £7.1m claimed to £4.9m allowed. This means that the Utility Regulator considers the baseline to be £154.5m rather than the initial £152.2m submitted in the Business Plan.
- 3.1.3 The amendments are not material and do not make a huge impact on the overall opex allowance. Perhaps the most important outcome is the setting of the principle that efficiency and baseline atypical adjustments should not differentiate except for costs which are excluded from the efficiency models (e.g. rates and third party services).

