Annex L - PC21 Efficiency Modelling - Final Determination

Northern Ireland Utility Regulator

31 March 2021

FINAL REPORT

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1. EXECUTIVE SUMMARY

CEPA has been engaged to support the Northern Ireland Utility Regulator (UR) in assessing the relative efficiency of Northern Ireland Water's (NI Water) operating expenditure (opex) and capital maintenance expenditure for PC21.[2] As we consider relative efficiency, we compare NI Water to water and sewerage companies operating in England and Wales (E&W) using data collected by Ofwat, the economic regulator of the water sector in E&W.[3]

The objective of this study was to develop wholesale water and sewerage opex and capital maintenance econometric benchmarking cost models and use these to assess the relative efficiency of NI Water's opex and capital maintenance expenditure relative to a notional efficient company.

1.1. Changes made between draft and final determination

This report is a revised and updated version of our previous PC21 efficiency modelling report, which the UR published alongside its draft determination (DD).[4]

The econometric benchmarking models were developed collaboratively with NI Water and its advisers through Cost Assessment Working Groups (CAWGs), and there is general agreement amongst all parties that the selected models perform well against our model selection criteria.

As a result, NI Water's DD response raised no concerns on the selected econometric models. Instead, the comments focused on specific issues related to the calculation of the wholesale sewerage catch-up efficiency challenge and special cost factors (SCFs). The latter are applied as post modelling adjustments to reflect that not all cost drivers are adequately captured in the econometric models.

We outline the changes we have made following consideration of NI Water's DD response below.

1.1.1. Calculation of wholesale sewerage catch-up efficiency challenge

The wholesale sewerage catch-up efficiency challenge is calculated based on the last three years in the sample period (2016/17 to 2018/19). This represents a change from our DD report, where the efficiency challenge was based on the full sample period (2012/13 to 2018/19). We have made this change in response to arguments made by NI Water that it has steadily improved its wholesale sewerage opex efficiency gap over the sample period.

1.1.2. Electricity price SCF

This electricity price SCF accounts for the energy price differential between Northern Ireland and the rest of the UK. NI Water questioned the data that was used to estimate the electricity price SCF at DD. More specifically, it questioned the approach we applied to calculate average electricity prices for each financial year based on data that is available for each half of the calendar year (e.g., January to June and July to December), and considered a different approach would be more appropriate, as illustrated below.

Table 1.1: Approach to calculating average electricity prices for each financial year

Financial year	CEPA DD approach	NI Water approach
2018/19	An unweighted average of the second half of 2018 (July to December) and the first half of 2019 (January to June).	An unweighted average of the first half of 2018 (January to June) and the second half of 2018 (July to December).

[2] The price control for NI Water from 2021.

[3] Source: https://www.ofwat.gov.uk/regulated-companies/price-review/2019-price-review/data-tables-models/. Files 'Cost Assessment FM_WW1 with APR 2018-19 data' and 'Cost Assessment FM_WWW1 with APR 2018-19 data'.

[4] Source: CEPA, 2020. PC21 efficiency modelling. Available here.

For FD, we calculate the electricity price SCF by taking an unweighted average of the approach we applied at draft determination and the approach suggested by NI Water, which avoids the risk of cherry picking.

1.1.3. Regional wage SCF

We apply a regional wage SCF to NI Water's opex to reflect the advantage NI Water obtains from operating in a lower wage cost region of the UK. NI Water commented on several key aspects of the regional wage SCF, which we summarise below alongside our FD approach.

Table 1.2: Summary of key methodological decisions for the regional wage SCF

Aspect	Draft Determination	NI Water proposal	Final Determination
'All employees' versus 'full-time employees only'	All employees	Full-time employees only	All employees
Comparison to UK average or UQ firms	UK average	UQ firms	UK average
Notional versus actual labour share of opex	Notional	Actual (direct labour only)	Notional
ONS ASHE data	ASHE 2019 provisional data set	ASHE 2020 provisional data set	ASHE 2019 revised data set

1.1.4. Capital maintenance Regional Price Adjustment (RPA) SCF

We apply an RPA SCF to NI Water's capital maintenance costs to take into account regional price differences between a typical water company in Northern Ireland and the rest of the UK that are not captured in the capital maintenance econometric models. The RPA is made up of labour, plant & equipment, and materials components.

We update the labour RPA to reflect the updated ONS ASHE 2019 data series but have made no changes to the plant & equipment RPA.

NI Water raised a concern that the calculation of the materials RPA did not explicitly consider Mechanical, Electrical, Instrumentation, Control and Automation (MEICA), which they consider is an important issue given that the costs for some MEICA components can be more expensive in Northern Ireland than in Great Britain (according to NI Water). But we have not changed our approach to determining the materials RPA at FD given the change proposed by NI Water has a minimal impact on the overall RPA, and further disaggregation of the materials RPA risks decreasing the accuracy of the RPA.

1.2. Key findings

We identified scale, density, water treatment complexity and network complexity / topography as the most important drivers of wholesale water opex and capital maintenance based on the data available. We identified scale, density, economies of scale in sewage treatment, and age of the network as the most important drivers of wholesale sewerage opex and capital maintenance based on the data available. These findings are supported by engineering rationale, and are reflected in the models selected, which include explanatory variables to capture each of these cost drivers.

We also recognise that no econometric model perfectly captures all factors that drive differences in costs; the results will inevitably include a degree of inaccuracy. It can be justifiable to adjust results for factors that are not adequately captured in the models (i.e., SCFs). Based on the approach taken in previous price controls, discussions at CAWGs, and UR's PC21 information requirements document[5], we quantified three SCFs that we consider when assessing NI Water's relative efficiency – electricity prices, regional wages, and capital maintenance

[5] PC21 Information Requirements. Chapter 2 – Operational Costs and Efficiency (issued 15 March 2019 – Version 02).

RPA. We assess the relative efficiency of NI Water both before and after the application of SCFs based on an upper quartile (UQ) benchmark.

A relevant consideration is that accounting standards followed by E&W companies changed in 2015/16, which led to the abolition of renewals accounting.[6] This caused a significant shift in the classification of expenditure from capital maintenance to opex. We included a dummy variable in the models to capture the impact of accounting change on opex and capital maintenance, but it does not perfectly capture company reactions to it. Overall, however, we are satisfied that the dummy variable performs well enough to enable the model results to be utilised by the UR when setting NI Water's allowances but recommend they are not applied mechanistically. Instead, we suggest that the UR triangulate between the results presented in this report and other analysis.

The efficiency results are summarised below based on the weighted average efficiency gap. The weighted average efficiency gap is calculated based on the full sample period for wholesale water opex and capital maintenance, and sewerage capital maintenance. But the wholesale sewerage opex weighted average efficiency gap is calculated based on the last three years of the sample period (2016/17 to 2018/19) to recognise that NI Water has steadily improved its wholesale sewerage opex efficiency gap in recent years.

Overall, the efficiency results are mixed across the wholesale water and sewerage models, with NI Water appearing relatively more efficient in wholesale water than sewerage.

1.2.1. Efficiency results before SCF adjustments

Opex[7]

Table 1.3: NI Water wholesale water weighted average efficiency gap to upper quartile, before SCFs, opex

	Model 1	Model 2	Model 3
Final Determination	5.5%	0.6%	-2.2%
Draft Determination	Same as DD	Same as DD	Same as DD

Table 1.4: NI Water wholesale sewerage weighted average efficiency gap to upper quartile, before SCFs, opex

	Model 1	Model 2
Final Determination	-1.0%	-1.4%
Draft Determination	-7.3%	-7.0%

Capital maintenance[8]

Table 1.5: NI Water wholesale water weighted average efficiency gap to upper quartile, before SCFs, capital maintenance

	Model 1	Model 2	Model 3	Model 4
Final Determination	1.6%	2.8%	0.9%	-0.9%
Draft Determination	Same as DD	Same as DD	Same as DD	Same as DD

[6] Source: https://www.ofwat.gov.uk/wp-content/uploads/2017/04/RAG-1.08-Principles-and-guidelines-for-regulatory-reporting-under-the-new-UK-GAAP-regime.pdf

[7] For illustration purposes only:

- NI Water's wholesale (water plus sewerage) opex weighted average efficiency gap to the UQ would be 0.2% if equal weights were applied to each opex model (before SCF adjustments).

[8] For illustration purposes only:

- NI Water's wholesale (water plus sewerage) capital maintenance weighted average efficiency gap to the UQ would be -1.7% if equal weights were applied to each capital maintenance model (before SCF adjustments).

Table 1.6: NI Water wholesale sewerage weighted average efficiency gap to upper quartile, before SCFs, capital maintenance

	Model 1	Model 2
Final Determination	-5.2%	-2.6%
Draft Determination	Same as DD	Same as DD

1.2.2. Efficiency results after SCF adjustments

Opex[9]

Table 1.7: NI Water wholesale water weighted average efficiency gap to upper quartile, after SCFs, opex

	Model 1	Model 2	Model 3
Final Determination	0.3%	-2.8%	-8.1%
Draft Determination	0.2%	-3.0%	-8.3%

Table 1.8: NI Water wholesale sewerage weighted average efficiency gap to upper quartile, after SCFs, opex

	Model 1	Model 2
Final Determination	-7.8%	-8.9%
Draft Determination	-12.8%	-12.5%

Capital maintenance[10]

Table 1.9: NI Water wholesale water weighted average efficiency gap to upper quartile, after SCFs, capital maintenance

	Model 1	Model 2	Model 3	Model 4
Final Determination	-2.7%	-2.3%	-3.2%	-7.7%
Draft Determination	-2.6%	-2.3%	-3.1%	-7.6%

Table 1.10: NI Water wholesale sewerage weighted average efficiency gap to upper quartile, after SCFs, capital maintenance

	Model 1	Model 2
Final Determination	-13.9%	-11.7%
Draft Determination	-13.8%	-11.6%

[9] For illustration purposes only:

- NI Water's wholesale (water plus sewerage) opex weighted average efficiency gap to the UQ would be -5.7% if equal weights were applied to each opex model (after SCF adjustments).

[10] For illustration purposes only:

- NI Water's wholesale (water plus sewerage) capital maintenance weighted average efficiency gap to the UQ would be -9.0% if equal weights were applied to each capital maintenance model (after SCF adjustments).

2. INTRODUCTION

CEPA has been engaged to support the Northern Ireland Utility Regulator (UR) in assessing the relative efficiency of Northern Ireland Water's (NI Water) operating expenditure (opex) and capital maintenance expenditure for PC21.[11] As we consider relative efficiency, we compare NI Water to water and sewerage companies operating in England and Wales (E&W) using data collected by Ofwat, the economic regulator of the water sector in E&W.[12]

The objective of this report is to present the wholesale water and sewerage econometric benchmarking models developed to assess the relative efficiency of NI Water's opex and capital maintenance expenditure and the results of the relative efficiency analysis.

This report is a revised and updated version of our previous PC21 efficiency modelling report, which the UR published alongside its draft determination (DD).[13] NI Water's DD response includes comments on specific issues related to our DD efficiency modelling report, which we consider throughout this report. The NI Water DD response documents that we have reviewed are:

- NI Water's core response to the Draft Determination[14] – referred to as the **Main Response**;
- Economic Insight's analysis of Labour-related SCFs[15] – referred to as **Annex 4.1**; and
- NI Water and Chandler KBS' analysis of Regional Price Adjustments (RPA) [16] – referred to as **Annex 5.22**.

All monetary values presented in this report have been adjusted to a 2017/18 price base using the RPI All Items Index published by the Office for National Statistics (ONS).[17] [18]

The structure for the remainder of this report is as follows:

- Section 2 presents a summary of our approach to modelling, which includes our modelling strategy and model assessment criteria.
- Section 3 presents key data analysis that was conducted ahead of modelling.
- Section 4 presents the selected wholesale water econometric model results.
- Section 5 presents the selected wholesale sewerage econometric model results.
- Section 6 presents relative efficiency analysis based on the selected econometric models before adjustments for Special Cost Factors (SCFs).
- Section 7 presents analysis of SCFs that are quantifiable and their impact on model results.
- Section 8 concludes.

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[11] The price control for NI Water from 2021.

[12] Source: https://www.ofwat.gov.uk/regulated-companies/price-review/2019-price-review/data-tables-models/. Files 'Cost Assessment FM_WW1 with APR 2018-19 data' and 'Cost Assessment FM_WWW1 with APR 2018-19 data'.

[13] Source: CEPA, 2020. PC21 efficiency modelling. Available here.

[14] NI Water (Dec 2020), 'NI Water Response to the PC21 Draft Determination: Main Report'.

[15] Economic Insight (Dec 2020), 'PC21 Labour-related SCFs', provided as 'Annex 4.1 - Labour Related SCF(Economic Insight)' of the NI Water Response.

[16] ChandlerKBS (Nov 2020), 'PC21 Regional Price Adjustment' is provided as Appendix A of 'Annex 5.22 - Annex J RPA PC21 (CEPA)' of the NI Water Response.

[17] Source: Office for National Statistics (16th October 2019). RPI All Items Index.

[18] A multiplier of 1.0306 would need to be applied to convert costs from a 2017/18 price base to a 2018/19 price base.

3. APPROACH TO MODELLING

To ensure the process of model development and selection was objective and transparent, we developed a separate paper describing our a priori assumptions for explanatory variables[19] (based on economic and technical rationale) and provided this to UR before model development commenced. We also produced two short papers setting out in further detail our modelling strategy[20] and model assessment criteria.[21] We summarise these papers in the sections below.

The model development process has also been complemented by Cost Assessment Working Groups (CAWGs) between CEPA, UR and NI Water that took place throughout 2019. The first econometric modelling results were presented in February 2019 at CAWG#5 and the models have since been refined, culminating in the final set of opex and capital maintenance that were presented in December 2019 at CAWG#9.[22]

3.1. Modelling strategy

To develop our modelling strategy, we sought where possible to follow current best practice in the sector, drawing for example on Ofwat's work at PR19. Where necessary or proportionate we have adapted our approach. For example, after evaluating the data collected by UR, we concluded it was only possible to develop models at a high degree of aggregation because it would have been challenging to obtain (robust) more granular data and it was not clear to us that a proportionate approach would warrant such an intensive data collection strategy.

The table below summarises the key points of the strategy used to develop cost assessment models for PC21. Further details are provided in our published opex efficiency modelling strategy paper.

Table 3.1: Summary of model development strategy

Category	Approach
Target modelling suite	We concluded it would be best to focus on developing top-down water and wastewater models. We decided to develop sewerage models that exclude bioresources to control for differences in sludge treatment and disposal between NI Water and England and Wales companies.
Data adjustments	We excluded a number of costs from the models, including business rates, pension deficit repair costs, Traffic Management Act (TMA) costs and atypical costs. No pre-modelling adjustments were made to the data to cover regional price differentials. Instead these are dealt with through a special factor process if the UR deems it appropriate to do so.
Functional form	We aimed to develop simple models. If the data suggested that more complex relationships exist, we considered whether these can be captured by other explanatory variables and whether higher order terms (i.e. quadratic terms) add sufficient explanatory power to the models to justify the additional complexity and reduction in degrees of freedom.
Estimation method and assumptions on efficiency	There are several different estimation methods available, each with different implications for how model residuals and company efficiency are calculated. Transparency is a key UR priority for PC21. Therefore, we focused on pooled ordinary least squares (OLS) as it is easy to replicate and understand compared with other modelling approaches. As part of

[19] CEPA (March 2018), '*CEPA cost assessment report*', available at https://www.ofwat.gov.uk/wp-content/uploads/2018/03/CEPA-cost-assessment-report.pdf

[20] CEPA (January 2019), '*Opex Efficiency Modelling Strategy*', available at https://www.uregni.gov.uk/sites/uregni/files/media-files/PC21%20CEPA%20Opex%20Efficiency%20Modelling%20Strategy%20Short%20Paper.pdf

[21] CEPA (January 2019), '*Opex Model Assessment Criteria*', available at https://www.uregni.gov.uk/sites/uregni/files/media-files/PC21%20CEPA%20Opex%20Model%20Assessment%20Criteria%20Short%20Paper.pdf

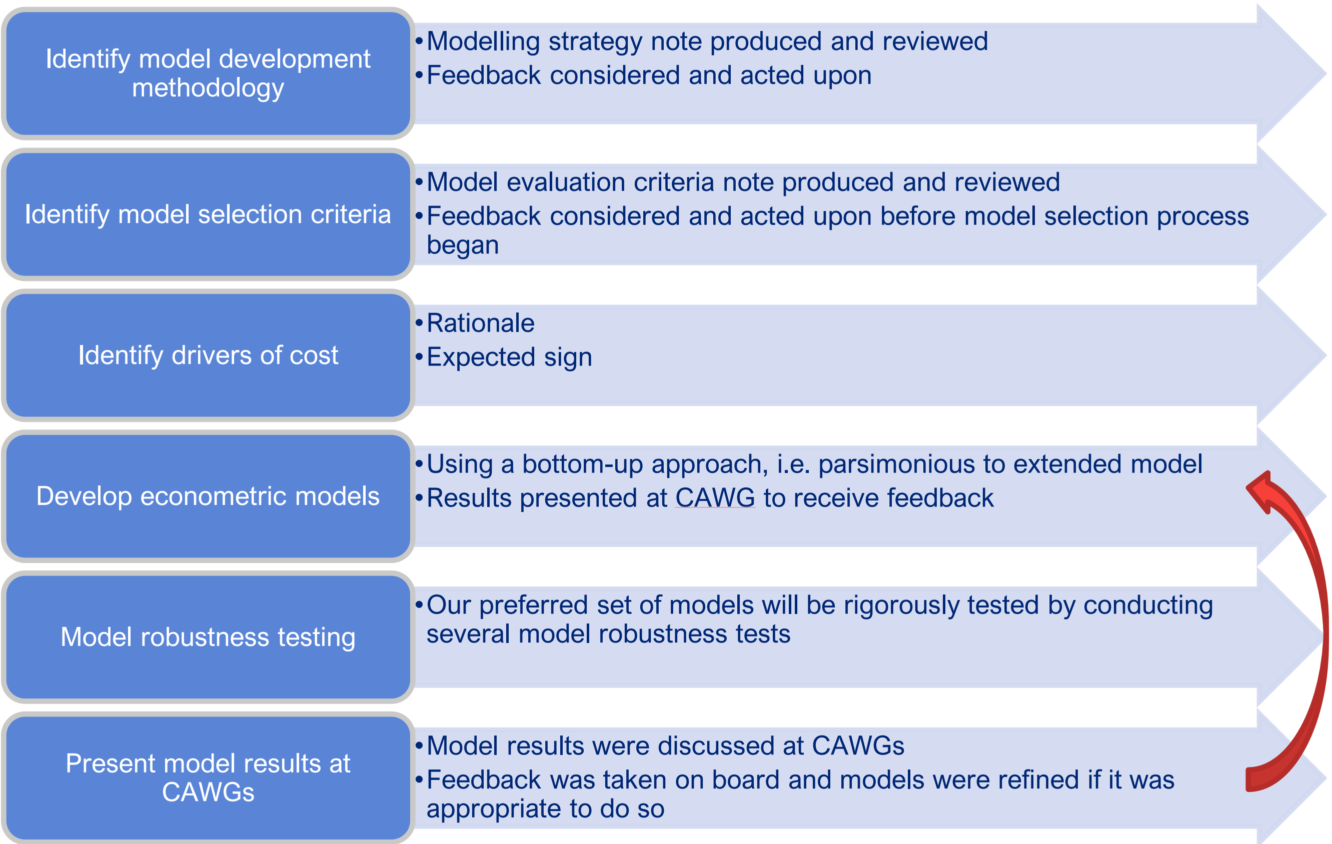
[22] NI Water made some minor data changes following CAWG#9, which have been reflected in the modelling results presented in this report.

Category	Approach
	our sensitivity testing, we examined whether other panel data models, such as random effects, provided additional value.
Explanatory variables[23]	Our work for Ofwat for PR19 identified a number of explanatory variables that could be used in the modelling and categorised them into five 'cost driver' groups.[24] The models we developed were based on a subset of these variables, subject to data availability and other factors. We note that some of the variables we use are transformations or combinations of the variables we set out in this report.

Source: CEPA

CEPA's modelling process is summarised in the figure below highlighting the transparent approach we have followed. Development has been iterative as models have been reassessed and refined to reflect feedback made during the CAWGs.

Figure 3.1: CEPA modelling process



Source: CEPA

3.2. Model assessment criteria

In advance of model development it is important to establish a clear process that allows for proper evaluation of model robustness. Our high-level selection criteria are summarised in the figure below and formed the basis of

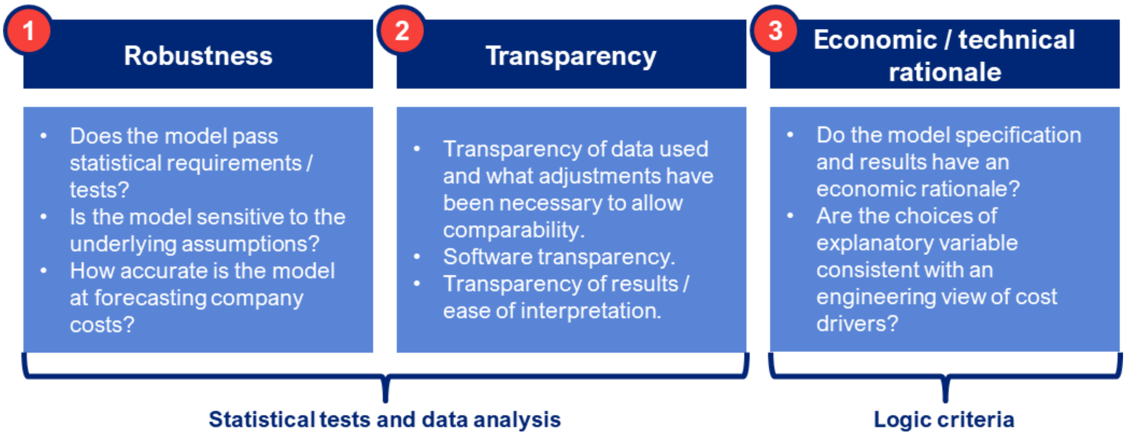
[23] Throughout this report, we use the term 'driver of cost'. To be clear, the explanatory variables used for modelling purposes are proxies for companies' underlying cost drivers. While we expect some explanatory variables may have a very strong relationship with underlying drivers of cost (for example, length of mains), the use of a given explanatory variable as a proxy does not preclude alternatives.

[24] CEPA (March 2018). '*CEPA cost assessment report*''

decisions on whether any given model was sufficiently robust to use in UR's opex and capital maintenance efficiency assessment for PC21.

The criteria applied are consistent with those used by Ofwat, UR and other regulators in developing cost assessment models. They apply specifically to the econometric models.

Figure 3.2: Model selection criteria



Source: CEPA

When developing models, we placed most weight on their economic and technical rationale. We considered whether:

1. the selected explanatory variables were line with our a priori expectations of what would be important explanatory variables?
2. the estimated model coefficients were consistent with a priori expectations in terms of magnitude and sign?
3. the selected models were consistent with policy in other areas of the price control?

Ideally, final selected models would pass all model robustness tests they are submitted to. However, setting such a high standard could make it very difficult to develop any models at all. As a result, as part of this work it was important to understand what a model failing a test meant for its potential use in PC21. Trade-offs between test results are an inherent part of model development, meaning that a failure of one test will not necessarily result in the rejection of the model. Nevertheless, where we identified significant concerns which meant a particular model was not robust, we went back through our iterative process and considered model alterations.

The table below provides a summary of the tests conducted within the model selection criteria. Further detail is provided in Appendix A.

CEPA economics matters

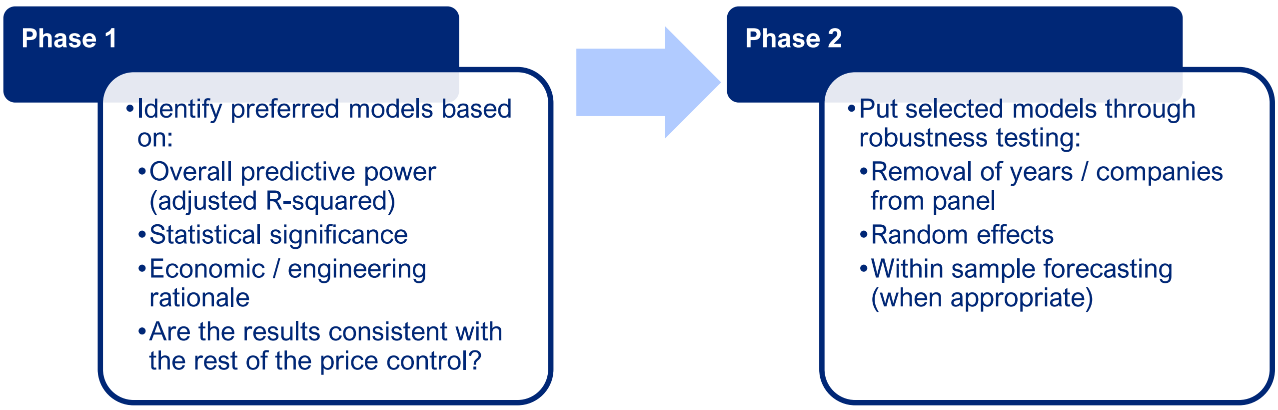
Table 3.2: PC21 model selection criteria summary – tests

Level of importance	Definition
Very high	• Jointly statistically significant (F-test) • Overall goodness of fit / predictive power (Adjusted R-squared) • Consistency with policy in other parts of the price control
High	• Consistency with a priori expectations of magnitude and signs of estimated coefficients • Stability of efficiency rankings • Stability of inefficiency range • Transparency of results and ease of interpretation
Medium	• Sensitivity to: o removal or addition of a year o the removal of the most or least efficient company o introduction of quadratic terms • Statistical significance of individual parameters (t-test) • Pooling test • Within-sample forecasting power
Low	• Multicollinearity tests • Linearity • Homoscedasticity • Normality • Test of pooled OLS versus random effects (Breusch-Pagan test) • Hausman test for fixed effects

Source: CEPA

We carried out our analysis in two phases. In a first phase, we identified those models that met the minimum characteristics required for a model to be considered further. In a second phase, those models that were selected in Phase 1 were evaluated further by running the remaining set of robustness tests discussed above. This is summarised in the figure below:

Figure 3.3: Model development stages



Phase 1

Phase 1 of our analysis started by running a simple model including a constant and a scale explanatory variable and then expanding them to add explanatory variables in order of importance (See Section 4.3 below) until all explanatory variables have been tested in the models. This process allowed us to generate a set of preferred models based on the data available that could be stress tested during Phase 2.

The models selected at the end of Phase 1 were those that met the following minimum conditions:

- All coefficients were consistent with our a priori expectations based on economic and engineering rationale.
- The overall predictive power of the model (as indicated by the adjusted R-squared) was 80% or higher.
- The coefficients were consistent with the rest of the price control (e.g. models where leakage would grant higher allowances for companies would be excluded).
- No two variables were correlated by more than 90%. Exceptions are made for variables that are transformations of other explanatory variables included in the model (e.g. quadratic terms).
- All explanatory variables are statistically significant at least at the 20% confidence level. Exceptions are sometimes made for variables that do not make this threshold but reflect relationships that are well set in engineering and/or economic literature and meet all other minimum conditions listed above.

Phase 2

The models selected through Phase 1 analysis were then put through a series of robustness tests to determine whether a model is sufficiently robust to be considered by the UR when setting NI Water's PC21 allowances. Further details on the robustness tests conducted are presented in Appendix A.

4. DATA ANALYSIS

As is the case in any modelling activity, the quality of econometric model outputs depend on the quality of the model inputs. Therefore, before conducting econometric analysis it is important to assure the quality of the data inputs that are being used. In this section, we summarise the actions taken to ensure the data provided was in a form that could be used to develop our econometric models. We clarify the definitions of the variables we have used, including the range of cost drivers considered, and note the change in Ofwat's regulatory accounting guidelines from 2015/16 onwards.

Data for E&W water companies was published by Ofwat, which means the focus of our data analysis and assurance has been on NI Water data as we assumed that the England and Wales data had been assured by Ofwat. That said, we also examined each set for consistency with each other.

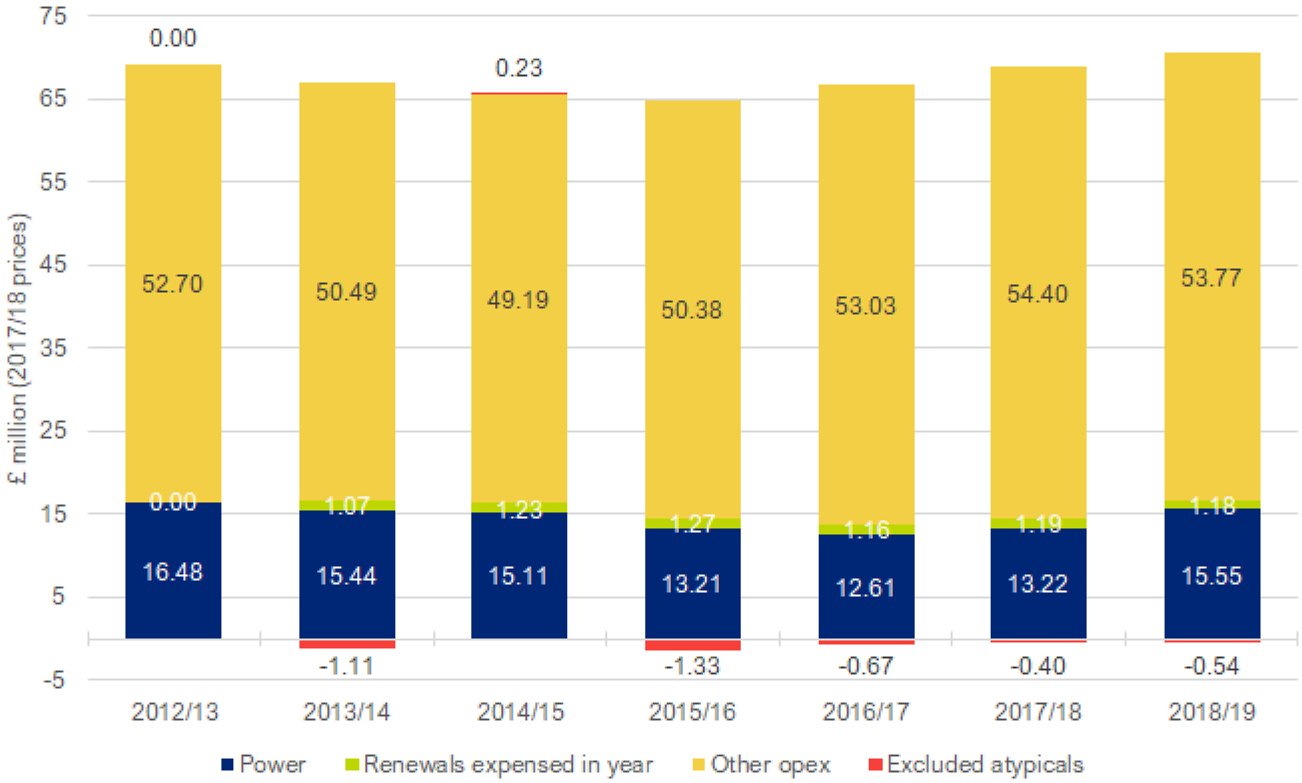
4.1. Opex analysis

The value of operating expenditure, used as the dependent variable in our modelling, comprises a number of different components. The box below describes the composition of modelled opex for wholesale water and sewerage:

Modelled wholesale water opex	=	Power + Bulk supply + Renewals expensed in year (infrastructure & non-infrastructure) + Other opex - Atypical expenditure
Modelled wholesale sewerage opex	=	Power + Discharge consents + Bulk Discharge + Renewals expensed in year (infrastructure & non-infrastructure) + Other opex - Atypical expenditure

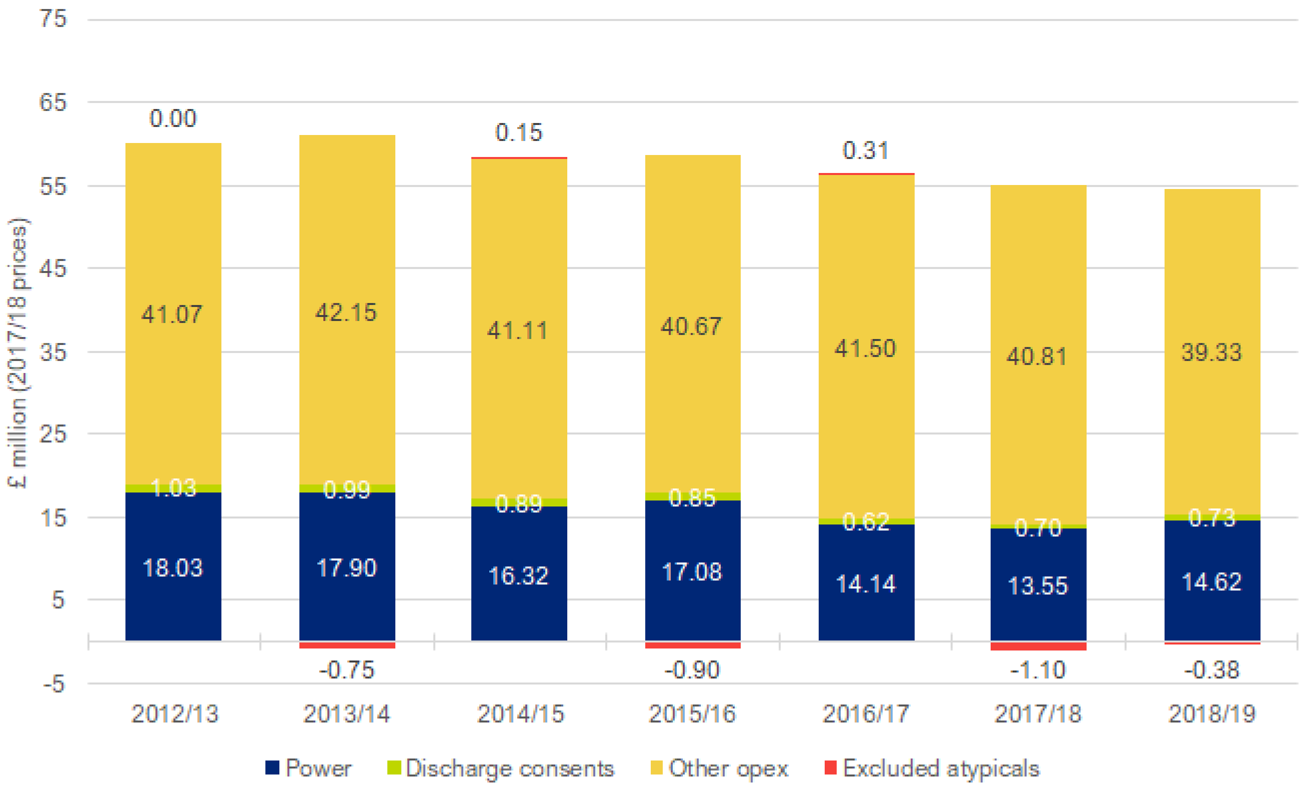
Figure 4.1 and Figure 4.2 summarise these components between 2012/13 to 2018/19. NI Water allocates a relatively large proportion of opex into 'other opex'. We have been assured by NI Water through discussions at CAWGs that data has been reported in line with the definitions followed by E&W companies and additional assurance has been provided by the Reporter. As a result, we are satisfied that the quality of the opex data reported by NI Water is sufficiently good to be used within comparative econometric benchmarking analysis alongside E&W companies' data.

Figure 4.1: NI Water wholesale water modelled opex



Source: CEPA analysis of NI Water data

Figure 4.2: NI Water wholesale sewerage modelled opex



Source: CEPA analysis of NI Water data

Atypical costs can be defined as exogenous costs (i.e. outside the control of the company) that were incurred in PC15 but are not expected to be incurred in PC21 (i.e. one-off costs). In this case, historical information is not a good reflection of future expenditure and it is sensible to exclude these costs from the modelling.

NI Water identified a number of costs items they consider to be atypical. Following discussions at CAWGs, costs related to (i) industrial action, (ii) holiday pay backdate, (iii) extreme weather, and (iv) Project Clear (for wholesale water) were excluded from the modelling. NI Water also proposed excluding costs related to voluntary early retirement (VER), business improvement (BI), consultancy and legal costs for Omega renegotiation. But these were rejected by the UR as they were either not deemed to be atypical in nature (e.g. VER and BI costs are ongoing costs incurred by NI Water) and/or were costs that were incurred as a result of NI Water's own actions (e.g. legal costs for Omega renegotiation).[25]

Details of the atypical expenditure excluded from the modelling are provided in Table 4.1 below.

Table 4.1: Atypical expenditure excluded from modelled opex, £ million (2017/18 prices)

Opex category	2012/13	2013/14	2014/15	2015/16	2016/17	2017/18	2018/19
Wholesale water							
Industrial action	0.00	1.11	-0.30	0.00	0.00	0.00	0.00
Project Clear	0.00	0.00	0.00	0.00	0.67	0.40	0.00
Extreme weather	0.00	0.00	0.00	0.00	0.00	0.00	0.54
Holiday pay backdate	0.00	0.00	0.00	1.33	0.00	0.00	0.00
Wholesale wastewater							
Industrial action	0.00	0.75	-0.15	0.00	0.00	0.00	0.00
Extreme weather	0.00	0.00	0.00	0.00	0.00	1.10	0.38
Holiday pay backdate	0.00	0.00	0.00	0.90	-0.31	0.00	0.00

Source: CEPA analysis of NI Water data

4.2. Capital maintenance analysis

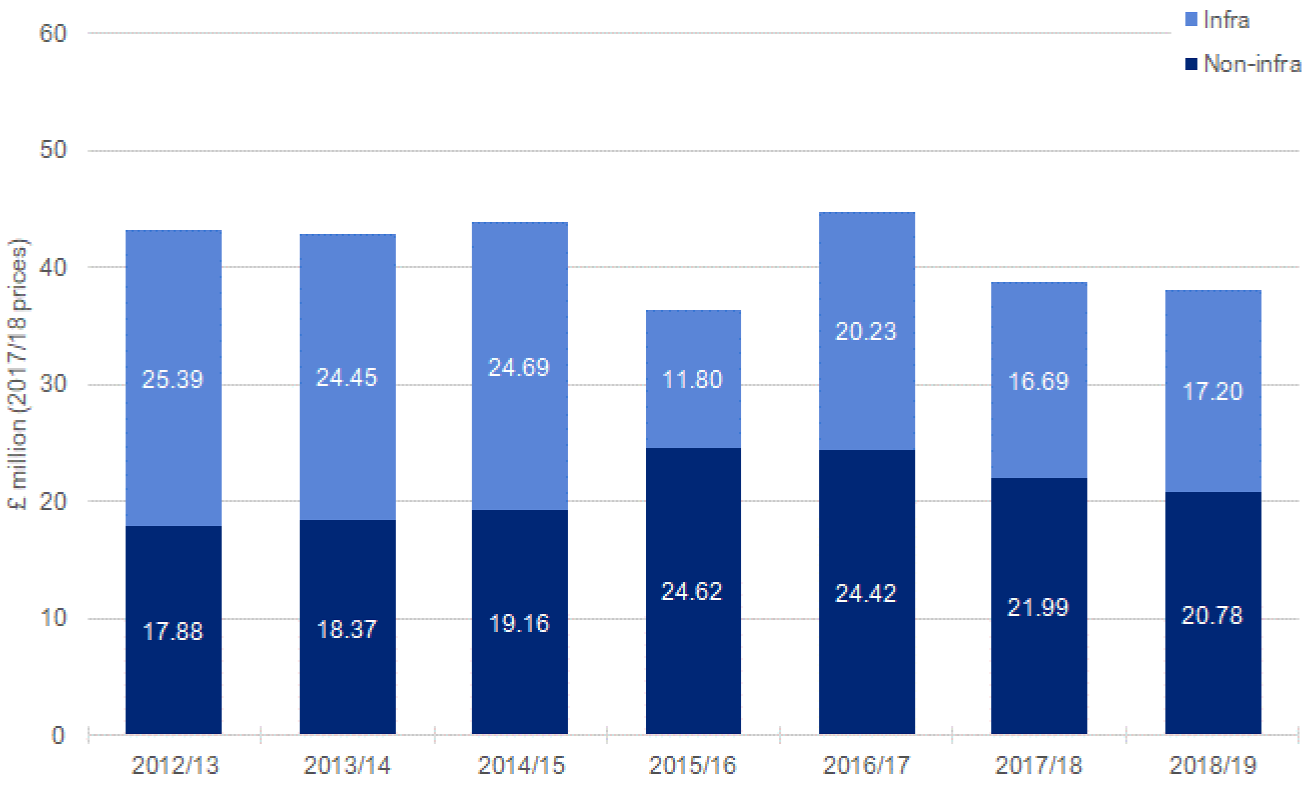
The value of capital maintenance expenditure, used as the dependent variable in our modelling, is comprised of activities that maintain the existing service level. The box below describes the composition of modelled capital maintenance for both wholesale water and sewerage:

Modelled wholesale water maintenance	=	Maintaining the long-term capability of the assets (infrastructure) + Maintaining the long-term capability of the assets (non-infrastructure)
Modelled wholesale sewerage maintenance	=	Maintaining the long-term capability of the assets (infrastructure) + Maintaining the long-term capability of the assets (non-infrastructure) [excluding sludge / bio resources]

Figure 4.3 and Figure 4.4 summarise these components between 2012/13 to 2018/19. Infrastructure capital maintenance costs largely relate to planned maintenance of underground pipes and distribution networks. Non-infrastructure capital maintenance costs largely relate to water and wastewater treatment works and processes.

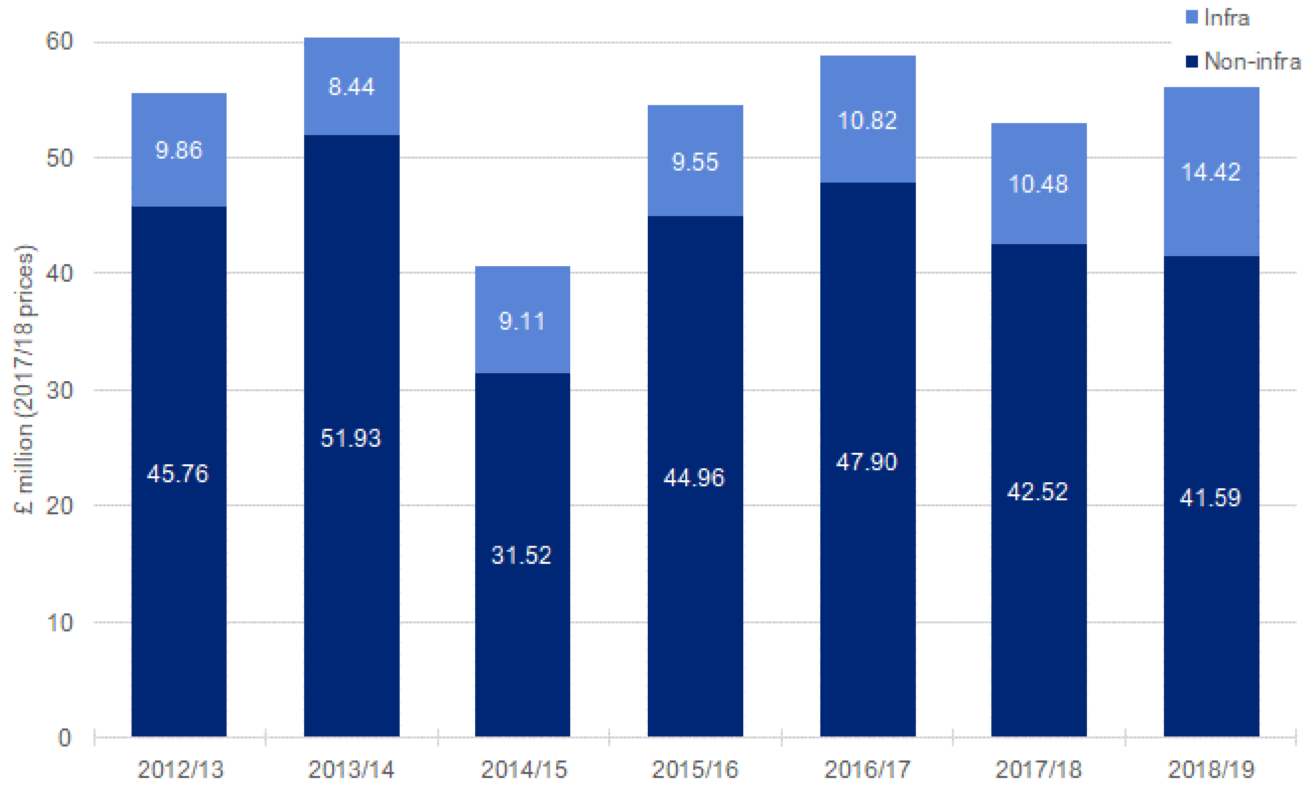
[25] Reconciliation adjustments for industrial action (in 2014/15) and holiday pay backdate (for sewerage in 2016/17) means there is a minor addition to the modelled expenditure in these two years.

Figure 4.3: NI Water wholesale water modelled maintenance.



Source: CEPA analysis of NI Water data

Figure 4.4: NI Water wholesale sewerage modelled maintenance.



Source: CEPA analysis of NI Water data

Capital maintenance expenditure is generally lumpier than opex, which makes it relatively more difficult than opex to model as the costs incurred may not move directly in line with the drivers of cost. This is reflected in the figures above. However, this concern can be mitigated by conducting efficiency analysis over a period of time (e.g. average efficiency gap over the period 2012/13 to 2018/19) rather than selecting any one year. This is reflected in Sections 7 and 8 below.

We note a switch in expenditure from infrastructure capital maintenance solutions (e.g. underground pipes and distribution networks) to non-infrastructure solutions (e.g. water and wastewater treatment works and processes) from 2015/16 onwards when looking at wholesale water. However, we do not consider this to be an issue as they are assessed at an aggregate level.

4.3. Explanatory variables

In advance of model development, we identified five major drivers of cost based on engineering and economic rationale: scale, density, system characteristics, activity level and quality. The rationale behind each cost driver is provided in the table below.

Table 4.2: Major drivers of wholesale water and sewerage costs

Cost driver	Rationale
Scale	The scale of the activities being undertaken by the company is expected to be the most important driver of total costs.
Density	It is often suggested that there is a u-shape relationship between density and costs incurred by a water company. For example, • Companies in sparse areas may have to travel longer distances for maintenance and/or may be forced to treat water using many smaller treatment works meaning they are unable to benefit from economies of scale in water treatment. • Companies in highly dense urban areas may face additional costs related to traffic congestion, traffic management and cooperation with other utilities.
System characteristics	The characteristics of the assets and systems operated by the company could also lead to differences in total costs between companies. Examples include network complexity / topography, economies of scale in water and sewage treatment, water and sewage treatment complexity and the age of the network.
Activity level	Cost differences between companies could reflect that some companies need to deliver a higher but efficient amount of activity to deliver specific outputs. For example, some companies may have a higher number of new connections, increasing the level of maintenance required.
Quality	Increasing the quality of the service delivered by companies can have an ambiguous effect on costs. The company may need to invest to provide the higher level of quality but may also benefit from cost decreases in other areas. For example, investment to reduce the level of leakage may reduce costs associated with fixing leaks on the network as well as reduced costs associated with answering customer calls when reporting supply issues.

Source: CEPA

Based on data available, we identified explanatory variables that could be used to proxy these cost drivers. For example, the total length of mains is a proxy for the scale of a water company.

Table 4.3 and Table 4.4 set out the set of available explanatory variables that we identified for each cost driver based on the data available and their expected sign. Explanatory variables were added into the models in order of the importance assigned to the underlying cost driver based on economic and engineering rationale. For example, scale explanatory variables were added first and quality explanatory variables were added last.

Table 4.3: Wholesale water explanatory variables

Cost driver		Explanatory variable	Expected sign
Scale		Total connections	Positive
		Total length of mains	
Density		Connections per length of mains	Ambiguous
		Ofwat weighted density measure[26]	
System characteristics	Network complexity / topography	Number of booster pumping stations, service reservoirs and water towers	Positive
		Number of booster pumping stations per length of mains	
	Economies of scale in water abstraction	Number of sources	Positive
		Distribution input per source	Negative
	Water treatment complexity	% of water input from different water sources	Depends
		% of water treated in complexity bands 4 to 6	Positive
		Ofwat weighted complexity variable	
	Economies of scale in water treatment	% of water treated in treatment works sizes 7 to 8	Negative
		% of water treated in treatment works sizes 1 to 2	Positive
		Number of water treatment works	Positive
	Age of network	% of mains installed post-1981	Negative
Activity level		% mains refurbished, relined, or renewed	Positive
		New connections	
Quality		Leakage	Negative

Source: CEPA

[26] See section4.5.

Table 4.4: Wholesale sewerage explanatory variables

Cost driver		Explanatory variable	Expected sign
Scale		Total connections	Positive
		Total length of sewers	
		Total load	
		Volume of wastewater	
Density		Connections per length of sewers	Ambiguous
		Ofwat density measure	
System characteristics	Economies of scale in sewage treatment	% of load treated in size bands 1 to 3	Positive
		% of load treated in size bands 6	Negative
		Number of sewage treatment works	Positive
		Number of sewage treatment works per length of sewer	
	Network complexity / topography	Number of network pumping stations	Positive
		Number of network pumping stations per length of sewers	
	Sewerage treatment complexity	Volume of trade effluent as a % of volume of wastewater	Positive
		% wastewater subject to tertiary treatment	Positive
		% of load with ammonia consents <=3mg/l	Positive
	Age of network	Total length of sewer laid or structurally refurbished post-2001	Negative
		% sewer laid or structurally refurbished post-2001	
Activity		New connections	Positive
Quality		Number of sewer blockages	Depends
		Number of gravity sewer collapses	
		Number of sewer rising main bursts / collapses	

Source: CEPA

The selection of explanatory variables is partially driven by data availability. For example, NI Water were unable to provide pumping station capacity, which was used by Ofwat in the wastewater botex models for PR19 as a proxy for network complexity.[27] In addition, data limitations also meant that we were only able to develop wholesale water models using 2013/14 to 2018/19 data, whereas sewerage models were developed using 2012/13 to 2018/19 data. However, we do not consider that these data limitations have affected the quality of the results.

NI Water also assigned confidence grades to the underlying data of each explanatory variable and identified '% of mains installed post-1981' and 'total length of sewer laid or structurally refurbished post-2001' as variables they had the least confidence in. This was because the data had to be manually computed rather than directly extracted from its data systems. We reviewed the data provided and concluded it was sufficiently good to be used within the econometric analysis as both data series followed a trend that looked sensible when compared against E&W company data.

[27] See Ofwat's initial assessment of plans, supplementary technical appendix: econometric approach, available at: https://www.ofwat.gov.uk/publication/supplementary-technical-appendix-econometric-approach/

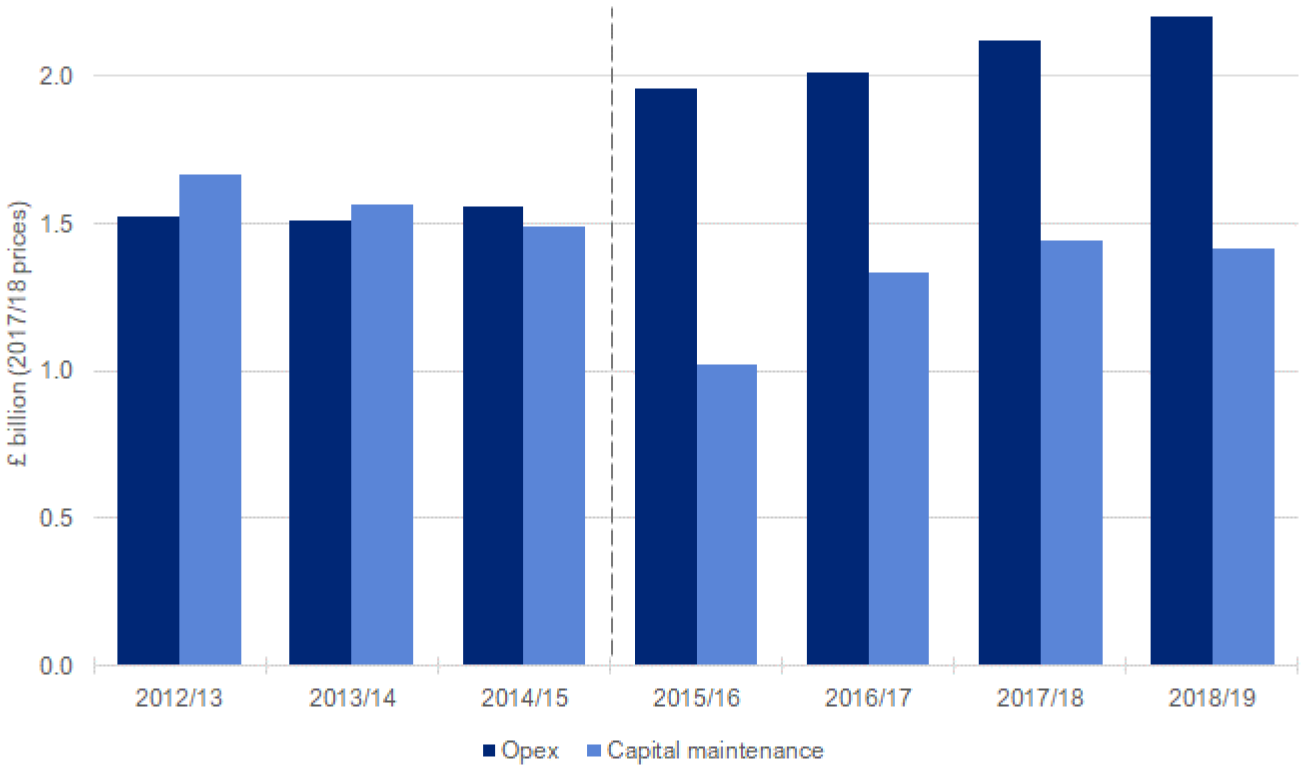
Overall, the data provided by NI Water for modelling purposes has gone through multiple iterations and quality assurance through the CAWGs, and the same data has also been used as part of NI Water's PC21 business plan submission. We are therefore confident that the data provided by NI Water is robust.

4.4. Accounting change

The accounting standards followed by E&W companies changed in 2015/16, which led to the abolition of renewals accounting.[28] The impact of this change is that infrastructure renewals expenditure (IRE) may now be all or partly recorded as opex rather than capital maintenance.

As shown in Figure 4.5 and Figure 4.6, this led to a significant shift in the classification of expenditure. For a number of E&W companies there is a step change in the level of opex and maintenance from 2015/16 onwards.

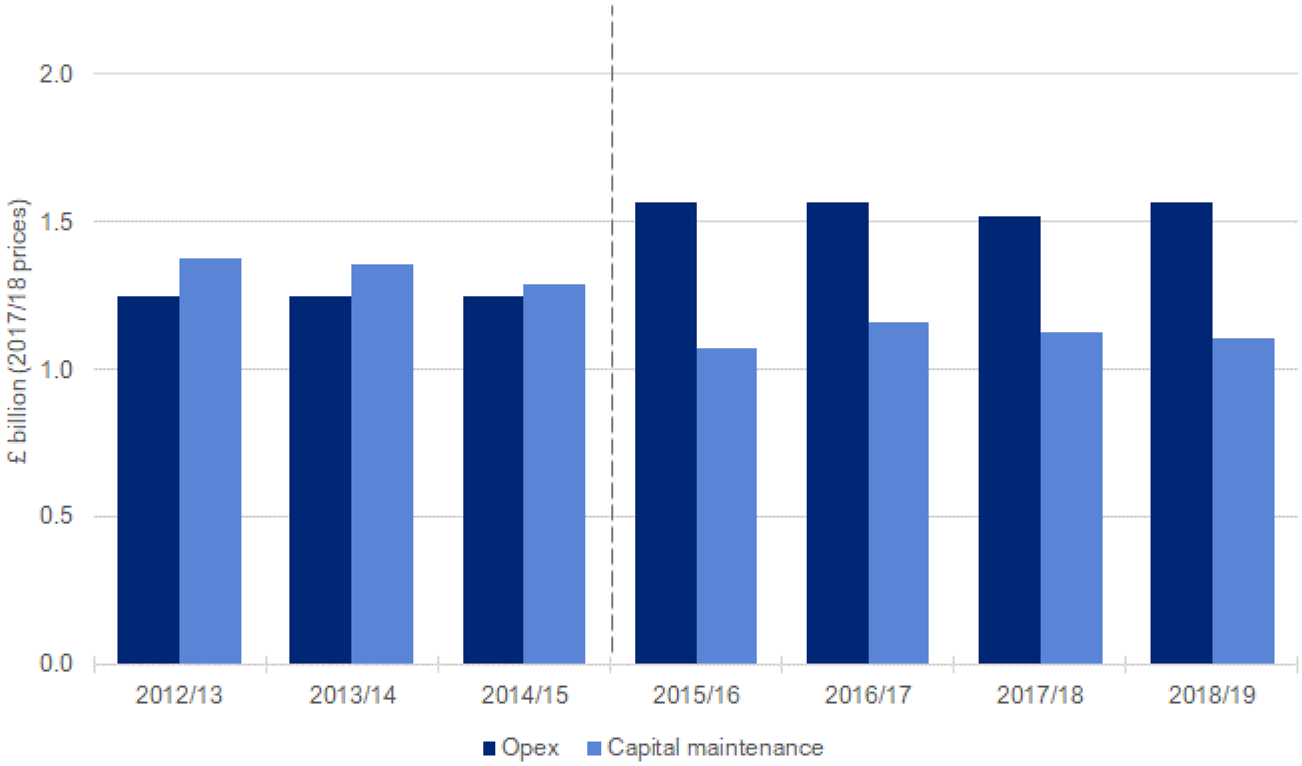
Figure 4.5: England & Wales wholesale water opex and capital maintenance expenditure



Source: CEPA analysis of Ofwat data

[28] Source: https://www.ofwat.gov.uk/wp-content/uploads/2017/04/RAG-1.08-Principles-and-guidelines-for-regulatory-reporting-under-the-new-UK-GAAP-regime.pdf

Figure 4.6: England & Wales wholesale sewerage opex and capital maintenance expenditure



Source: CEPA analysis of Ofwat data

NI Water were not required to implement the change in accounting standards at the same time as E&W companies and as a result did not experience a shift in the classification of expenditure in 2015/16. Accounting procedures at NI Water have now been realigned for the most recent year of data available; 2018/19. However, NI Water's response to the change differs from the majority of E&W companies with only a minor reclassification of expenditure from maintenance to opex reported in 2018/19.

This change in accounting procedures within the modelling period makes it more difficult to compare expenditure between companies in the four most recent years. In order to account for this in our modelling, we include an accounting dummy variable that is zero prior to 2015/16 and one otherwise for England and Wales companies.[29] The effect of this is to isolate the impact of the accounting change on opex and capital maintenance within the model rather than in the model residuals, which reduces the risk that the difference in relative efficiency between companies is caused by the accounting change.

Given that companies have applied the accounting change differently, the dummy variable does not perfectly capture companies' reactions to the accounting change as it only captures an average effect. We tested a range of alternative options but were unable to identify a better solution:

- Models that were estimated excluding the dummy variable performed significantly worse with large unexplained variances in efficiency scores.

[29] The dummy variable is always equal to zero for NI Water as their costs are not affected by the accounting change in England and Wales. This includes 2018/19 given that the reclassification of NI Water costs between opex and maintenance in 2018/19 was very marginal and would be significantly overestimated by the dummy variable.

- Testing alternative specifications for the dummy variable (e.g. grouping companies based on how they responded to the accounting change) had minimal impact on model results and used up degrees of freedom.
- Botex models address the accounting change issue (by definition) but fail to improve the overall robustness and clarity of the results. For example, there were large variances in efficiency scores across botex model specifications and between different years.

Overall, we are satisfied that the accounting dummy variable captures companies' reactions to the accounting change well enough to enable the model results presented in this report to be used by the UR when considering NI Water's PC21 opex and capital maintenance allowances. This judgment was supported by NI Water and their consultants, Economic Insight, who also agreed that the use of a dummy variable was the best option available to address this issue.

To provide an additional level of confidence to our results, we cross-check our opex and capital maintenance model results against botex model results. For example, one may expect that the botex efficiency results fall in between the opex and maintenance efficiency results providing the model specifications being compared are like-for-like. Botex model results are presented in Appendix B.

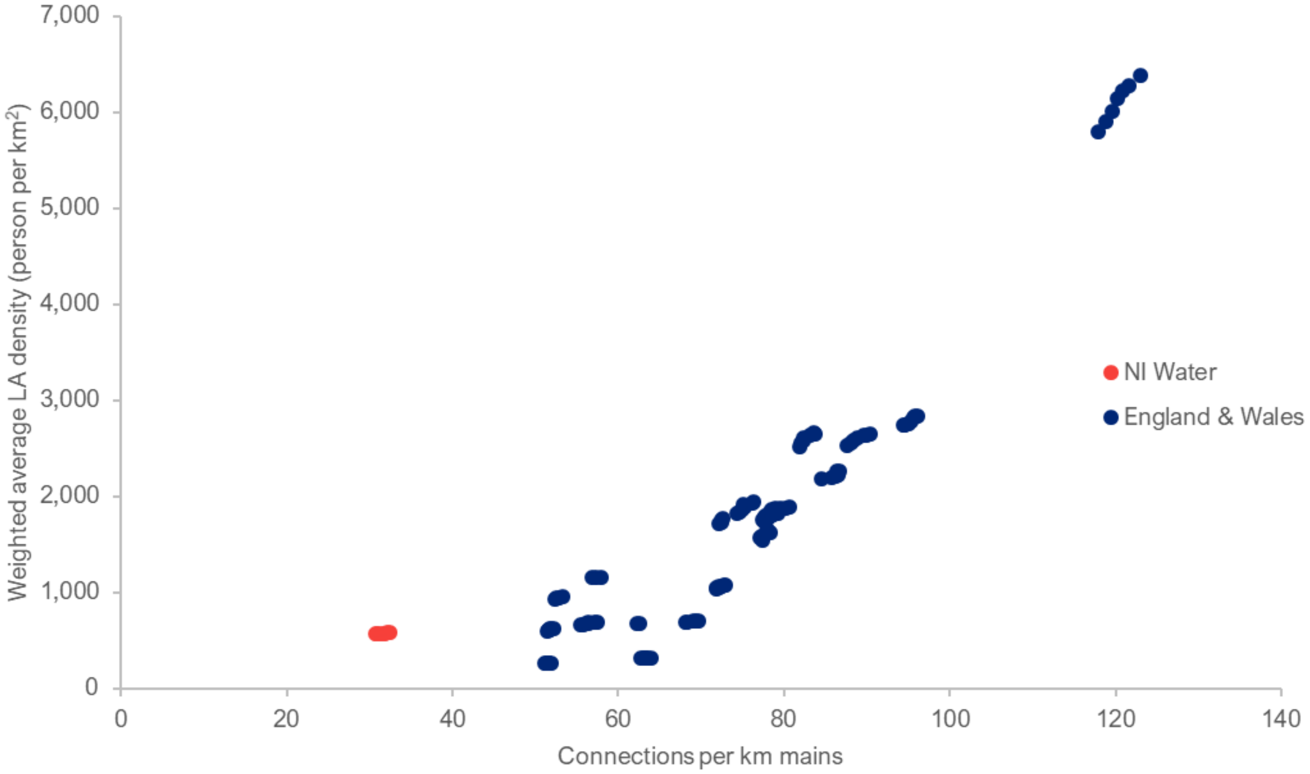
4.5. Density measure

Ofwat employed its own weighted average density measure within their PR19 econometric cost models. This was calculated by taking population density (people per km squared) at a local authority level and weighting by the population in each local authority served by the company in question.

We examined the correlation between Ofwat's weighted average density measure, based on population density at a local authority level, and the conventional connections per length of mains measure. The results indicate that Ofwat's measure may be less suitable in the context of NI Water's network.

Figure 4.7 shows that the broadly linear relationship between the two measures among England and Wales companies begins to break down below roughly 70 connections per km of water mains. As a result, Ofwat's weighted average density measure does not appear to accurately capture the sparsity of NI Water's network given its population density is around 30 connections per km. This was also reflected in our initial model development, which showed that the inclusion of the Ofwat weighted average density measure produced unrealistic efficiency results for NI Water. Therefore, we developed models that used the conventional measure for the effect of density on costs. This approach was agreed with the UR and NI Water within the CAWGs.

Figure 4.7: Comparison of density measures



Source: CEPA analysis

5. WHOLESALE WATER MODELLING RESULTS

This section presents the wholesale water opex and capital maintenance model results. As described previously, we conducted our model development in two phases.

A larger range of models were selected following Phase 1 of the model development process (e.g. models that only include explanatory variables to capture scale and density). But to ensure that this report is digestible for the reader, the tables below focus on the models selected following Phase 2 of the model development process and subsequent further shortlisting following feedback from CAWGs.

A number of considerations and decisions were made in order to reach the final wholesale water model selection:

- **Scale, density, water treatment complexity and network complexity / topography were identified as the most important drivers of wholesale water opex and capital maintenance** based on the data available; a finding supported by engineering rationale. This is reflected in the models selected, which include explanatory variables to capture each of these cost drivers.

- **Age of the network is also an important driver of wholesale water capital maintenance.** As expected, older networks incur additional maintenance costs which are reflected in the model results. However, the UR may want to consider whether there are any perverse incentives associated with age explanatory variables, when deciding how to use the model results. For example, all else being equal, having an older network leads to higher predicted costs from the models, which may not provide an incentive to NI Water to maintain / replace its network. The UR may also want to note that NI Water has **less confidence in the data underlying the age explanatory variable** (% of mains after 1981) as it is not captured within their data reporting systems and has been manually constructed to inform CAWG.

- Our analysis indicates that there is a **u-shape relationship between density and wholesale water opex**. This finding is in line with Ofwat's PR19 econometric cost models and supports the hypothesis that operating costs are higher both for companies operating in very sparse areas and companies operating in highly dense urban areas. The evidence is not as clear for wholesale water capital maintenance as the explanatory variable used to capture the u-shape relationship (connections per length of mains squared) is not individually statistically significant. However, 'connections per length of mains' and 'connections per length of mains squared' are jointly statistically significant (see Appendix B).

- **We identified three different explanatory variables which capture the effect of water treatment complexity on costs**: (i) % of water treated in complexity bands 4 (single stage complex treatment) to 6 (works with one or more very high cost processes); (ii) Ofwat's weighted average treatment complexity; and (iii) % water from pumped reservoirs. All three variables performed well in the opex models, which is reflected in the models selected. However, concerns have been raised by NI Water and their contractor, Economic Insight, during CAWG meetings on the weights applied to the different complexity bands by Ofwat when calculating the weighted average treatment complexity variable. The UR may want to take this into account when deciding how to use the model results to assess the relative efficiency of NI Water's wholesale water opex (e.g. by placing relatively less weight on opex model 2). The capital maintenance models only include '% water treated in complexity bands 4 to 6' to capture water treatment complexity, because this variable performed better during the model development process.

- **Total number of connected properties was also tested as a scale explanatory variable** within the model development process, but the models selected all include length of mains in preference to connected properties. This decision reflects the fact that all three model specifications include 'connections per length of mains' to capture the effect of density on costs. Use of 'connections per length of mains' captures both the total number of connected properties and length of mains. This means that using the total number of connected properties instead of length of mains as the scale cost driver would lead to the same efficiency results.

The following tables present wholesale water model results and include the full names of the variables to facilitate presentation. However, it should be noted that the models are developed in logs (except for percentage variables that have been modelled using levels). The full results of our model robustness assessment, including additional models excluded from the final selection, are available in full in Appendix B.

5.1. Opex models

Table 5.1: Main model results, wholesale water opex

Variables	Model 1	Model 2	Model 3
Length of mains	1.006***	0.970***	1.000***
Number of booster pumping stations per length of mains	0.306**	0.290*	0.216
% of water treated in complexity bands 4 to 6	0.004***		
Weighted average treatment complexity		0.396**	
% of water input from pumped reservoirs			0.004***
Connections per length of mains	-3.238*	-4.000**	-2.742**
Connections per length of mains squared	0.490**	0.586***	0.425**
Post-2014/15 UK GAAP accounting treatment	0.187***	0.193***	0.196***
Constant	0.402	1.843	-0.647
Overall predictive power	97.0%	96.8%	97.1%
Number of observations	111	111	109

*Source: CEPA analysis. Note: Significant at the * 10% level, ** 5% level, *** 1% level.*

5.2. Capital maintenance models

Table 5.2: Main model results, wholesale water capital maintenance

Variables	Model 1	Model 2	Model 3	Model 4
Length of mains	1.190***	1.244***	1.191***	1.249***
Number of booster pumping stations per length of mains	0.528*	0.339	0.525*	0.305
% of water treated in complexity bands 4 to 6	0.011**	0.011**	0.011**	0.011***
% of mains after 1981		-0.019***		-0.019***
Connections per length of mains	0.943***	0.637**	1.076	1.992
Connections per length of mains squared			-0.016	-0.166
Post-2014/15 UK GAAP accounting treatment	-0.209**	-0.173*	-0.210*	-0.179*
Constant	-9.962***	-9.302***	-10.248	-12.244
Overall predictive power	88.6%	90.0%	88.5%	89.9%
Number of observations	111	109	111	109

*Source: CEPA analysis. Note: Significant at the * 10% level, ** 5% level, *** 1% level.*

5.3. Discussion

Overall, the selected wholesale water opex and capital maintenance models presented above perform well against our assessment criteria. A summary of the findings is as follows:

- The estimated coefficients on the explanatory variables all have a plausible sign and magnitude. In addition, most explanatory variables are individually statistically significant at a 10 percent significance level. The exceptions being:
    - The number of booster pumping stations per length of mains in opex model 3 and capital maintenance models 2 and 4. However, these models are included in our final model selection because network complexity / topography is an important driver of wholesale water opex and capital maintenance from an engineering perspective, and the estimated coefficients are sensible in terms of sign and magnitude.
    - 'Connections per length of mains' and 'connections per length of mains squared' are not individually significant in capital maintenance models 3 and 4. However, we include these models in our final selection as these variables capture the u-shape relationship between density and costs, which NI Water has stressed is important given the sparsity of its network. These variables are also jointly statistically significant (see Appendix B).
- All the models perform well in terms of goodness of fit, with an adjusted R-squared of at least 88.5%. The opex models also satisfy the within sample forecasting test, which indicates that these models could be used to predict wholesale water opex allowances. However, capital maintenance Model 1 fails this test, which means that caution should be applied if capital maintenance Model 1 is used to predict allowances.
- Efficiency results are stable across the different model specifications. All models for both opex and capital maintenance satisfy the ranking and score stability tests.
- The opex models fail the linearity test (RESET), which may indicate that a different functional form could perform better. However, more complex functional forms increase complexity whilst not always producing better results. In the case of the models tested here, we are not convinced that the added complexity of alternative functional forms is warranted given relatively good performance on other tests and lack of clarity regarding which alternative functional forms would be objectively justifiable.
- Where a quadratic variable has not been included, the models have a max and mean variance inflation factor (VIF) of less than 10, indicating a low risk of multicollinearity. Where the test is failed, it is driven by the inclusion of a quadratic variable, which is necessarily closely related to the linear density variable. As mentioned, the quadratic density variable is included to capture the u-shape relationship between opex and density.
- The models perform well in other tests. All models pass the Chow / Pooling test, which suggests that the inclusion of the accounting dummy variable sufficiently captures the accounting change that was faced by E&W companies in 2015/16 (see Section 4.4). The models are also consistent with a priori expectations and price control incentives. Two opex models fail the normality test but we place a low level of importance on this test result as it does not distort the estimated coefficients.
- NI Water agreed that the selected wholesale water opex and capital maintenance models perform well against our assessment criteria, and recognised the collaborative approach taken to develop the models through the CAWGs in its draft determination response.

6. WHOLESALE SEWERAGE MODELLING RESULTS

As with the previous section, this section presents the wholesale sewerage opex and capital maintenance models selected following Phase 2 of the model development process and subsequent further shortlisting following feedback from CAWGs.

A number of considerations and decisions were made to reach the final wholesale sewerage model selection:

- **Scale, density, economies of scale in sewage treatment, and age of the network were identified as the most important drivers of wholesale sewerage opex and capital maintenance** based on the data available. This finding is supported by engineering rationale and is reflected in the models selected, which include explanatory variables to capture each of these cost drivers.
- The UR may want to consider whether there are any **perverse incentives associated with age explanatory variables** when deciding how to use the model results. For example, all else being equal, having an older network leads to higher predicted costs from the models, which may not provide an incentive to NI Water to maintain / replace its network. The UR may also want to note that NI Water has **less confidence in the data underlying the age explanatory variable** (% sewer laid or structurally refurbished post 2001) as it is not captured within its data reporting systems and has been developed based on assumptions.
- Our analysis indicates that there is a **u-shape relationship between density and wholesale sewerage opex and capital maintenance**. Identification of this relationship supports the hypothesis that operating costs are higher for companies operating in very sparse areas but are also higher for companies operating in highly dense urban areas. This is reflected in the final selection of sewerage opex and capital maintenance models, which all contain 'connections per length of mains' and 'connections per length of mains squared' explanatory variables to capture this relationship.
- **All selected wholesale sewerage models contain length of sewer as the scale cost driver.** Total number of connected properties was also tested as a scale explanatory variable but is not included in the final model selection due to the same reasons given in Section 5. We also tested models with load as the scale cost driver, but significant concerns were raised during CAWG meetings with this variable, which led to models including load being excluded from the final model selection. The concerns related to significantly higher load per connected property in Northern Ireland compared to E&W companies, which may be driven by a combination of the use of an incinerator by NI Water; a relatively high household occupation rate in Northern Ireland; and/or differing underlying assumptions being used by companies to calculate load.

The following tables present wholesale sewerage model results and include the full names of the variables to facilitate presentation. However, it should be noted that the models are developed in logs (except for percentage variables that have been modelled using levels). The full results of our model robustness assessment, including additional models excluded from the final selection, are available in full in Appendix B.

6.1. Opex models

Table 6.1: Main model results, wholesale sewerage opex

Variables	Model 1	Model 2
Total length of sewers	1.017***	0.978***
% of load treated in size bands 1 to 3	0.072***	0.063***
% sewer laid or structurally refurbished post-2001		-0.009***
Connections per length of mains	-11.858*	-10.687**
Connections per length of mains squared	1.550*	1.393**
Post-2014/15 UK GAAP accounting treatment	0.167***	0.180***
Constant	16.351	14.726
Overall predictive power	94.8%	96.4%
Number of observations	77	76

*Source: CEPA analysis. Note: Significant at the * 10% level, ** 5% level, *** 1% level.*

6.2. Capital maintenance models

Table 6.2: Main model results, wholesale sewerage capital maintenance

Variables	Model 1	Model 2
Total length of sewers	0.695***	0.693***
% sewer laid or structurally refurbished post-2001		-0.008
Connections per length of sewers	-21.988***	-21.776***
Connections per length of mains squared	2.796***	2.763***
Post-2014/15 UK GAAP accounting treatment	-0.196**	-0.178**
Constant	40.455***	40.248***
Overall predictive power	82.4%	84.2%
Number of observations	77	76

*Source: CEPA analysis. Note: Significant at the * 10% level, ** 5% level, *** 1% level.*

6.3. Discussion

The selected wholesale sewerage opex models perform well against our assessment criteria, with a high overall goodness of fit, and satisfy most sensitivity tests:

- The estimated coefficients on the explanatory variables all have a plausible sign and magnitude and are all statistically significant at the 10 percent significance level.
- The models perform well in terms of goodness of fit, with an adjusted R-squared well over 90%. They all also satisfy the various robustness tests, with results broadly remaining stable after including or excluding different data points.
- Efficiency results are stable across the different model specifications. However, Model 2 does not satisfy the within sample forecasting test, which means that caution should be applied if Model 2 is used to predict allowances.
- The models perform well in all other tests, which all pass with the exception of the test for normality for Model 2. But we place a low level of importance on this test result as it does not distort the estimated coefficients.

The selected capital maintenance models have a lower overall goodness of fit and do not perform as well as the opex models. This is expected given that maintenance expenditure is more variable than opex. The models satisfy the majority of our assessment criteria, with model 1 performing slightly better than model 2:

- The estimated coefficients on the explanatory variables are all consistent with a priori expectations. All coefficients, except for the network age variable, are consistently significant at a 10% level. While the network age variable is not significant at the 10% level in the capital maintenance model it is statistically significant at the 20% level and does increase the overall goodness of fit as measured by the adjusted R-squared.
- Overall goodness of fit is above 80% when measured by adjusted R-squared. While these models are the most robust achievable with the data available, they achieve only our minimum threshold in terms of predictive power.
- Both models satisfy tests assessing the stability of results to the removal of different data points. Model 1 satisfies both the within-sample forecasting test and the stability of efficiency scores, while model 2 does not. The models broadly perform well in the other tests, such as normality and homoscedasticity.

We note that NI Water agreed that the selected wholesale sewerage opex and capital maintenance models generally perform well against our assessment criteria, and recognised the collaborative approach taken to develop the models through the CAWGs in its draft determination response.

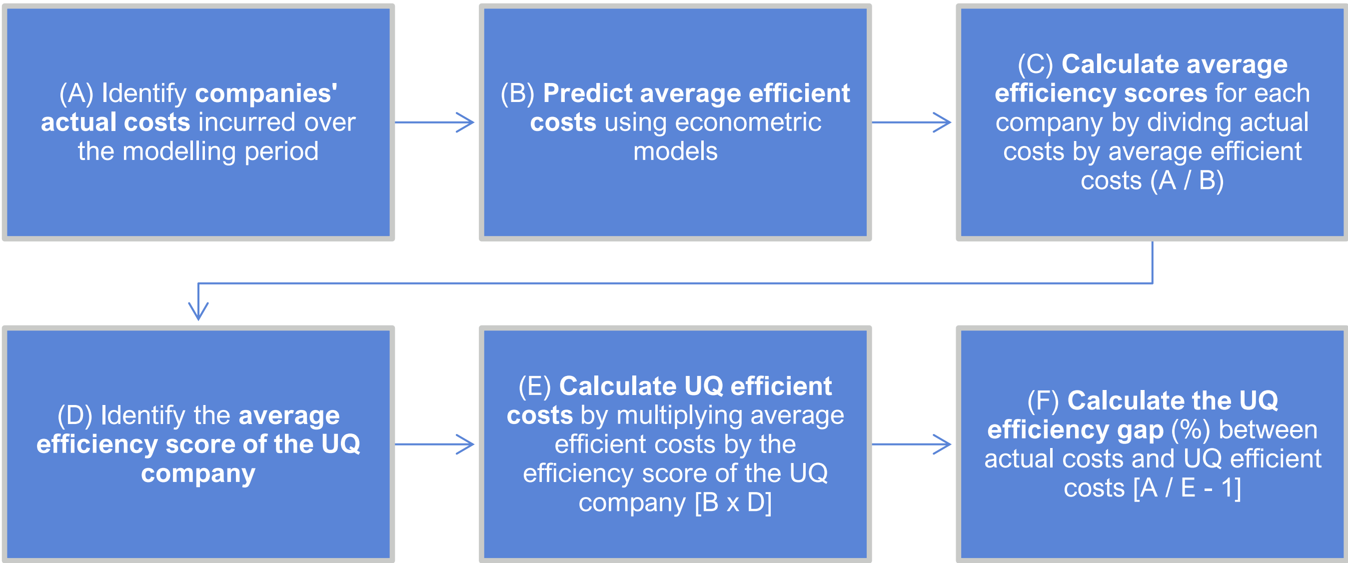
7. EFFICIENCY ANALYSIS BEFORE APPLICATION OF SPECIAL COST FACTORS

The tables and figures below summarise NI Water's efficiency results based on the econometric benchmarking models described in the sections above. In the context of this report, we define an efficiency gap as the expenditure distance between upper quartile (UQ) efficient company and NI Water in percentage terms.[30] In other words, we define the amount to which NI Water would need to reduce or increase its costs to reach the UQ efficient company.

We apply the UQ benchmark as it has been used by UK regulators such as the UR, Ofwat and Ofgem when conducting relative efficiency analysis in recent price controls.

The upper quartile efficiency gap is calculated as follows:

Figure 7.1: Efficiency gap calculation before application of special cost factors



This means that an efficiency gap of 5% would indicate that NI Water's costs are 5% lower than the costs that would have been incurred by the UQ efficient company. Conversely, a gap of -5% would indicate the company's costs are 5% higher than the UQ efficient company.

An illustrative example is provided in Table 7.1 to show how NI Water's UQ efficiency gap has been calculated for each model. In this example, the efficiency gap is -15%, which means that the company would need to reduce its costs by 15% to reach a similar performance level to the UQ company. We have not accounted for special cost factors when conducting the efficiency gap analysis presented in this section. Special cost factors and the resulting adjusted efficiency gaps are considered in section 8.

[30] The upper quartile is equivalent to the company placed 5.25 out of 18 wholesale water companies in the weighted average efficiency gap calculations. The upper quartile is equivalent to the company placed 3.5 out of 11 wholesale sewerage companies in the weighted average efficiency gap calculations.

Table 7.1: Illustrative efficiency gap calculation before special cost factors

Column	Item	Calculation	Example
A	Actual Cost (excluding atypical costs)		£100m
B	Predicted Average		£89.5m
C	Efficiency Score of UQ Company		0.95
D	UQ Predicted Costs (before special cost factors)	B * C	£85m
E	**Efficiency Gap to UQ (£m)**	**D – A**	**- £15m**
F	**Efficiency Gap to UQ (%)**	**E / A**	**- 15%**

Source: CEPA analysis

7.1. Wholesale water efficiency results

The tables below present, by model, the efficiency gap results from the wholesale water models.[31]

Opex efficiency

Table 7.2: NI Water wholesale water efficiency gap to upper quartile, opex

	Model 1	Model 2	Model 3
2013/14	0.6%	2.1%	-3.2%
2014/15	0.4%	1.1%	-0.3%
2015/16	2.7%	-1.5%	-2.6%
2016/17	0.8%	-1.0%	-6.1%
2017/18	-3.0%	-3.7%	-8.8%
2018/19	-2.1%	0.4%	-3.2%
Weighted Average (2013/14 to 2018/19)	5.5%	0.6%	-2.2%

Source: CEPA analysis

Capital maintenance efficiency

Table 7.3: NI Water wholesale water efficiency gap to upper quartile, capital maintenance

	Model 1	Model 2	Model 3	Model 4
2013/14	-3.0%	0.4%	-3.7%	-0.2%
2014/15	-16.3%	-12.5%	-16.8%	-17.8%
2015/16	-10.2%	-14.1%	-10.4%	-18.6%
2016/17	-9.6%	-11.8%	-9.8%	-15.8%
2017/18	16.7%	11.2%	16.2%	5.8%
2018/19	14.1%	13.0%	13.7%	8.8%
Weighted Average (2013/14 to 2018/19)	1.6%	2.8%	0.9%	-0.9%

Source: CEPA analysis

We focus our analysis on the weighted average efficiency gap over the full sample period (2013/14 to 2018/19) rather than the yearly efficiency gap results as it is less likely to be affected by regulatory cycle and accounting

[31] NI Water's upper quartile efficient costs that are used to calculate the efficiency gaps are provided in Appendix D.

differences between NI Water and E&W companies. This mirrors the approach taken by Ofwat at PR19 to calculate efficiency gaps, which is calculated based on the sum of actual and predicted costs over the modelling period. NI Water agreed with this approach in its draft determination response given there is no discernible efficiency trend observed over the sample period for wholesale water opex and capital maintenance.

NI Water's wholesale water opex efficiency gap to the UQ ranges from **-2.2% to 5.5%** based on a weighted average calculation and appears more efficient than an UQ company in two out of three models. Across the three models there does not appear to be a clear indication of whether NI Water are becoming more or less efficient over time.

NI Water's wholesale water capital maintenance efficiency gap to the UQ ranges from **-0.9% to 2.8%** based on a weighted average calculation and it appears more efficient than an UQ company in three out of four models. There is some evidence that NI Water is becoming more efficient over time with respect to capital maintenance, which the UR may want to consider when assessing whether NI Water's wholesale water opex expenditure is efficient.

7.2. Wholesale sewerage efficiency results

The tables below present the efficiency gap results for the selected wholesale sewerage models.[32]

Opex efficiency

Table 7.4: NI Water wholesale sewerage efficiency gap to upper quartile, opex

	Model 1	Model 2
2012/13	-15.2%	-13.2%
2013/14	-15.7%	-16.8%
2014/15	-11.2%	-10.4%
2015/16	-3.8%	-6.3%
2016/17	-1.4%	-3.1%
2017/18	-3.5%	-3.8%
2018/19	1.8%	3.5%
Weighted Average (2016/17 to 2018/19)	-1.0%	-1.4%

Source: CEPA analysis.

[32] NI Water's upper quartile efficient costs that are used to calculate the efficiency gaps are provided in Appendix D.

Capital maintenance efficiency

Table 7.5: NI Water wholesale sewerage efficiency gap to upper quartile, capital maintenance

	Model 1	Model 2
2012/13	-10.3%	-7.5%
2013/14	-22.9%	-19.6%
2014/15	-3.7%	0.1%
2015/16	-13.2%	-11.2%
2016/17	-12.2%	-9.6%
2017/18	-2.6%	-3.5%
2018/19	-13.7%	-13.1%
Weighted Average (2012/13 to 2018/19)	-5.2%	-2.6%

Source: CEPA analysis

As above, we focus our analysis on the weighted average rather than the yearly efficiency gap results as it is less likely to be affected by regulatory cycle and accounting differences between NI Water and E&W companies.

For wholesale sewerage capital maintenance, the weighted average efficiency gap is calculated based on the full sample (2012/13 to 2018/19) given there is no discernible efficiency trend observed over the sample period. This leads to NI Water's wholesale sewerage capital maintenance efficiency gap to the UQ ranging from **-5.2% to -2.6%** It is less efficient than the UQ company in both models.

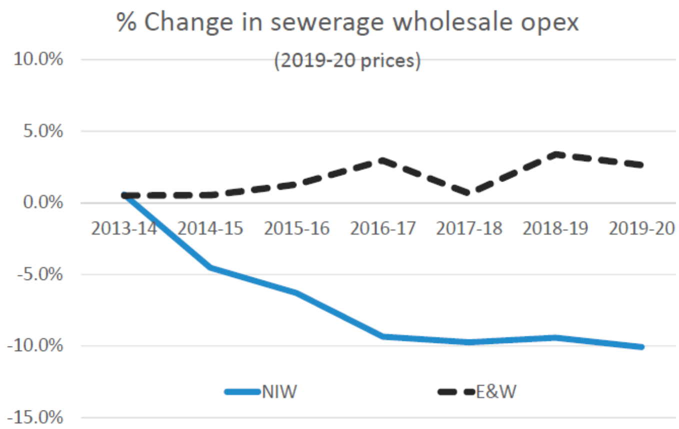
But for wholesale sewerage opex, the weighted average efficiency gap is calculated based on the last three years in the sample period (2016/17 to 2018/19). This represents a change from our DD report and has been made in response to arguments made by NI Water that it has steadily improved its wholesale sewerage opex efficiency gap over the sample period, as shown in Table 6.4 above.

In CAWG#10, the company provided further evidence to explain what has driven the improvements in relative sewerage opex efficiency:

- NI Water has reduced its wholesale sewerage opex by 10% since 2012/13 because of cost reduction initiatives such as:
    - organisation re-design (e.g., moved to production lines);
    - optimised its insource / outsource balance;
    - reduced emergency call outs (e.g., sewer blockages);
    - better procurement; and
    - reduced energy usage
- There has been a 3% increase in sewerage opex amongst E&W companies over the same period.

These factors are illustrated in the figure below.

Figure 7.2: percentage change in wholesale sewerage opex



Source: NI Water

NI Water therefore proposed that more weight should be given to recent years in the sample period (i.e., last 3 years) We recognise that NI Water has made a conscious effort to deliver wholesale sewerage opex efficiency savings in recent years. This is reflected in NI Water's wholesale sewerage efficiency gap to the upper quartile benchmark for the two selected wholesale sewerage opex models, which reduces over the period 2012/13 to 2018/19.

The table below shows how the weighted average sewerage opex efficiency gap decreases as more weight is placed on recent performance.

Table 7.6: NI Water wholesale sewerage efficiency gap to upper quartile (before SCFs), opex

Weighted average sample	Model 1	Model 2
2012/13 to 2018/19	-7.3%	-7.0%
2013/14 to 2018/19	-6.1%	-5.9%
2014/15 to 2018/19	-3.7%	-3.6%
2015/16 to 2018/19	-1.9%	-2.5%
2016/17 to 2018/19	-1.0%	-1.4%
2017/18 to 2018/19	0.6%	0.7%

Source: CEPA analysis

Overall, we consider that NI Water's proposal strikes an appropriate balance between placing more weight on recent performance whilst recognising that the efficiency gap in any one year may not be an accurate reflection of NI Water's relative efficiency.

Based on this approach, NI Water's wholesale sewerage opex weighted average efficiency gap to the UQ reduces to **-1.4% to -1.0%** i.e., it remains less efficient than the UQ company in both models but by a smaller margin.

However, the final decision whether to place more weight on recent years will ultimately require the UR to apply it regulatory judgement as there are arguments in both directions. Calculating the efficiency gap based on the full sample helps to account for regulatory cycle impacts and accounting differences between NI Water and E&W companies. Whereas a focus on the last three years of results arguably provides a better reflection of NI Water's relative efficiency at this point in time.

8. SPECIAL COST FACTOR ANALYSIS

The econometric models presented in this report are intended to capture the key drivers of costs for a water and sewerage company. The models are then used to assess the relative efficiency of NI Water with water and sewerage companies in England and Wales.

However, no econometric model perfectly captures all factors that drive differences in costs; the results will include a degree of inaccuracy. It may therefore be justifiable to adjust results for factors that are not adequately captured in the models – we define these as Special Cost Factors (SCFs). In this context, SCFs are variables that are:

- outside management control;
- have not been adequately captured in the modelling; and
- have a material impact in that ignoring them would result in NI Water having materially higher or lower costs than the predicted costs from the model.

Based on the approach taken in previous price controls, discussions as part of CAWG meetings, and UR's PC21 information requirements document[33], we identified three SCFs that potentially meet the criteria listed above and are quantifiable. These are:

- **Electricity prices.** Power prices have historically been higher in Northern Ireland when compared to the rest of the UK. NI Water has previously cited the lack of supplier competition locally compared to E&W dependence on gas, a lack of indigenous fuels and regulated charges and tariff structures as some of the reasons for the difference. We apply an electricity price SCF adjustment to wholesale water and sewerage modelled opex.
- **Regional wages.** Companies operating in Northern Ireland typically find themselves with an advantage over England and Wales water companies because they operate in a lower wage economy. Our regional price adjustment (RPA) analysis found that median hourly wages (excluding overtime) for a water company operating in Northern Ireland was around 12% lower than a typical water company operating in the UK.[34] We apply a regional wage SCF adjustment to wholesale water and sewerage modelled opex.
- **Capital maintenance regional price adjustment (RPA).** A SCF adjustment is made to take into account regional price differences in capital maintenance between a typical water company in Northern Ireland and the rest of the UK that are not captured in the econometric models.

We note this is not an exhaustive list of SCFs; we have focused our analysis on factors that are clearly not captured in the modelling and can be quantified. This approach is in line with the approach taken by NI Water, which considers that the suite of econometric cost models developed by CEPA for this price control remove certain factors which resulted in SCF adjustments previously (e.g., rurality)[35].

SCFs that have not been explicitly identified in this report could have a positive or negative impact on NI Water's opex and/or capital maintenance efficiency gap. For example, the Northern Ireland Environment Agency (NIEA) plans to transition to a Mature Wastewater Compliance Model, which will align the reporting of wastewater compliance at the treatment works and in the sewer network with the rest of the UK. This will be delivered through a significant programme spanning both PC21 and PC27 and will capture operational policy changes to both consenting discharges and the assessment of compliance. NI Water has estimated that the transition to the mature

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[33] PC21 Information Requirements. Chapter 2 – Operational Costs and Efficiency (issued 15 March 2019 – Version 02). The intended approach to PC21 by the UR is largely unchanged from their PC15 approach, which in turn is based upon their regulatory letter "WR18" issued at PC13, following in general terms their approach at PC10.

[34] Source: CEPA (2020). PC21 Regional Price Adjustment.

[35] Source: NI Water (January 2020). NI Water PC21 Business Plan. Chapter 5 Annex 2.2 Special Factors and Atypicals.

compliance model will lead to an increase in opex during PC21. Arguably, this could be applied as a negative special cost factor as these are costs that are required to align wastewater compliance with England and Wales water companies, which implies that NI Water is currently incurring lower wastewater compliance costs relative to a comparable company in England and Wales. We take a conservative view and do not apply wastewater compliance as a negative special cost factor because there may be water companies in England and Wales who are also non-compliant.

As briefly discussed in section 7, we apply the SCF adjustments by making post-modelling adjustments to the predicted costs from the models (i.e., after the econometric models have been estimated). A negative (positive) adjustment reduces (increases) NI Water's predicted costs from the models, which reflects the fact that the SCF is expected to make the operation of NI Water less (more) costly relative to the average water and sewerage company in the sample.

NI Water has commented on the approach we applied to estimate the SCFs in our DD efficiency modelling report as part of its response to the UR's DD we reflect on its points in the subsections below.

The remainder of this section is organised as follows:

- Electricity price SCF
- Regional wage SCF
- Regional price adjustment SCF
- Summary of changes to SCFs at FD
- Efficiency results after special cost factors

8.1. Electricity price SCF

Box 1: Electricity Price SCF

Power prices have historically been higher in Northern Ireland when compared to the rest of the UK. NI Water has previously cited the lack of supplier competition locally compared to E&W, dependence on gas, a lack of indigenous fuels and regulated charges and tariff structures as reasons for the difference. We therefore apply an electricity price SCF adjustment to NI Water's wholesale water and sewerage modelled opex.

8.1.1. DD position

We adopted a consistent approach to that used by the UR in PC15 to estimate the electricity price SCF, which seeks to reflect electricity price differences between NI Water and a comparable company in England and Wales. The analysis was based on the following data:

- Power consumption data from NI Water's PC21 business plan, broken down by Industrial and Commercial (I&C) consumption bands.
- Electricity prices for Northern Ireland and the UK, as published in the UR's Annual Transparency Reports, broken down by I&C consumption bands. Data is provided for each half of the calendar year (e.g., January to June and July to December), which we combined to arrive at an average electricity price for each financial year to align with the efficiency modelling analysis. For example, to obtain the electricity price for 2018/19, we calculated an unweighted average of the second half (H2) of 2018 (July to December) and the first half (H1) of 2019 (January to June).

Our analysis, based on the data described above, led to the following electricity price SCF adjustments which were reported as part of the regulator's DD:

- Wholesale water opex SCF adjustment ranging from -£1.8 million in 2016/17 to £2.8 million in 2012/13.

- Wholesale sewerage opex SCF adjustment ranging from -£2.0 million in 2016/17 to £3.1 million in 2012/13.

8.1.2. NI Water DD response

NI Water's response recognised that the approach taken by CEPA to estimate the electricity price SCF was very close to the approach it had taken within its business plan. But it raised a question regarding the data that was used to estimate the electricity price SCF. More specifically, it questioned the approach we applied to calculate average electricity prices for each financial year and considered a different approach would be more appropriate, as illustrated below.

Table 8.1: Approach to calculating average electricity prices for each financial year

Financial year	CEPA approach	NI Water approach
2018/19	An unweighted average of the second half of 2018 (July to December) and the first half of 2019 (January to June).	An unweighted average of the first half of 2018 (January to June) and the second half of 2018 (July to December).

8.1.3. FD position

The financial year starts with the second quarter of the calendar year. We therefore consider there is equal justification for using our DD approach and NI Water's approach to estimated electricity prices in a financial year. To avoid the risk of cherry picking, we therefore propose to take an unweighted average of the two approaches.

This results in the following electricity price SCF adjustments:

- Wholesale water opex SCF adjustment ranging from -£1.8 million in 2016/17 to £2.9 million in 2012/13.
- Wholesale sewerage opex SCF adjustment ranging from -£2.0 million in 2016/17 to £3.2 million in 2012/13.

Table 8.2 sets out the changes in the estimated electricity price differential between our draft and final determination advice.

Table 8.2: Electricity price differential, Northern Ireland relative to the UK – DD versus FD

Consumption size band	2012/13	2013/14	2014/15	2015/16	2016/17	2017/18	2018/19
Electricity price differential, Northern Ireland relative to the UK - DD							
Very small	12.0%	10.6%	-1.4%	3.7%	-5.0%	-7.0%	0.9%
Small	17.2%	14.9%	-1.6%	0.8%	-2.1%	0.8%	-3.6%
Small / medium	21.2%	15.1%	6.9%	0.5%	-2.8%	2.1%	1.5%
Medium	17.3%	10.7%	0.0%	-9.3%	-15.8%	-11.7%	-7.1%
Large & very large	14.4%	6.2%	-11.0%	-27.8%	-33.1%	-25.6%	-15.0%
Electricity price differential, Northern Ireland relative to the UK - FD							
Very small	13.5%	10.5%	-0.2%	5.6%	-4.3%	-6.8%	-0.7%
Small	18.6%	15.7%	0.8%	2.2%	-1.9%	0.0%	-2.0%
Small / medium	21.3%	17.5%	8.5%	2.4%	-3.3%	1.5%	2.3%
Medium	17.4%	13.1%	2.5%	-6.5%	-15.4%	-12.9%	-7.5%
Large & very large	15.1%	9.5%	-7.5%	-23.4%	-33.5%	-28.7%	-15.1%

Source: CEPA analysis

Table 8.3 sets out the changes in the estimated electricity price SCF between our draft and final determination advice.

Table 8.3: Updated Electricity price SCF opex adjustment, £ million (2017/18 prices)

	2012/13	2013/14	2014/15	2015/16	2016/17	2017/18	2018/19
SCF adjustment – DD (£m)							
Wholesale water	2.8	1.8	-0.1	-1.2	-1.8	-1.2	-0.9
Wholesale sewerage	3.1	2.1	-0.1	-1.6	-2.0	-1.2	-0.8
SCF adjustment – NI Water proposal (£m)							
Wholesale water	3.0	2.6	0.6	-0.5	-1.8	-1.6	-0.8
Wholesale sewerage	3.3	3.0	0.7	-0.6	-2.1	-1.6	-0.7
SCF adjustment – FD (£m)							
Wholesale water	2.9	2.2	0.3	-0.8	-1.8	-1.4	-0.8
Wholesale sewerage	3.2	2.5	0.3	-1.1	-2.0	-1.4	-0.8

Source: CEPA analysis

Box 2: Electricity price SCF

For FD, we propose to calculate the electricity price SCF by taking an unweighted average of the approach we applied at draft determination and the approach suggested by NI Water, which avoids the risk of cherry picking.

We assess the impact of applying the updated electricity price SCF on NI Water's opex efficiency gap in Section 8.5 below.

8.2. Regional wage SCF

Box 3: Regional wage SCF

Labour costs in Northern Ireland are typically lower than in the rest of the UK. We therefore apply a regional wage SCF to NI Water's modelled opex to reflect the advantage NI Water obtains from operating in a lower wage cost region of the UK.

8.2.1. DD position

For our DD advice, we adopted a similar approach to that used by the UR in PC15 to estimate the magnitude of the SCF, adjusted to ensure the methodology remained consistent with the approach taken in our Regional Price Adjustment (RPA) report[36].

The approach involves calculating the regional wage differential between a water company operating in Northern Ireland compared with a typical water company operating in the UK using data from the Annual Survey of Hours and Earnings (ASHE). The regional wage SCF is then calculated based on the regional wage differential between Northern Ireland and the UK and the proportion of opex attributable to labour costs.

Hence, the regional wage adjustment SCF is calculated in two steps:

- Calculation of regional wage adjustment factors between Northern Ireland and the UK; and
- Calculation of the regional wage SCF adjustment.

Each step is discussed in further detail below.

[36] CEPA (July 2020). 'Annex J Regional Price Adjustments PC21 (CEPA)'.

Regional wage adjustment factors

The table below highlights the key methodological decisions / assumption we applied to calculate the RWA factors, and compares against the approach taken by NI Water in its PC21 business plan:

Table 8.4: Summary of key methodological decisions for regional wage adjustment factor

Aspect	Comparison to NI Water BP	Justification given at DD
Hourly vs weekly wages	Same approach	We used hourly wages since weekly wages may capture other elements of company policy, such as differences in working hours both within and between different regions.
Median vs mean wages	Same approach	We used median rather than mean wages to calculate the regional wage adjustment as they are less likely to be affected by extreme values.
All employees vs full-time employee wages	Different approach	We used all employees. Companies employ a mix of full-time and part-time staff and any bias that may be introduced from part-time staff working fewer hours is mitigated by using hourly wages.
SOC code level	N/A	We use 2-digit SOC codes rather than the more detailed 3-digit and 4-digit categories. These are more reliable than more granular occupational data given their larger sample size.
Calculation of wage differential	Different approach	We did not consider it necessary to exclude London and Scotland from the calculation given that our adjustment is based on labour costs incurred by a typical water company rather than based on labour costs incurred in the whole economy. This was the approach taken at PC15.

Source: CEPA

Based on our DD assumptions, the overall wage differential between NI Water and other water companies operating in the UK was between 10.6% and 12.0% over the period 2012/13 to 2018/19.

Table 8.5: Wage differential between NI Water and other UK water companies

	2012/13	2013/14	2014/15	2015/16	2016/17	2017/18	2018/19
RWA	-12.0%	-14.5%	-11.5%	-11.7%	-11.8%	-10.6%	-11.7%

Source: CEPA analysis

Regional wage SCF adjustment

The regional wage SCF was calculated based on the wage differential between Northern Ireland and the UK and the proportion of opex attributable to labour costs. We assumed a labour share of opex of 47%, which was provided by the UR to ensure consistency with the notional input mix used in its frontier shift analysis and which represents the labour share of opex for a typical water company.

For the DD, we estimated the RWA SCF based on NI Water's wholesale water and sewerage modelled opex for each year of the sample period, which led to the following estimates:

- The wholesale water regional wage SCF adjustment ranges from £3.4 million to £4.5 million over the period 2012/13 to 2018/19.
- The wholesale sewerage regional wage SCF adjustment ranges from £2.7 million to £4.1 million over the period 2012/13 to 2018/19.

8.2.2. NI Water DD response

NI Water provided responses to our DD position in their Main Response and through their advisors Economic Insight and Chandler KBS.

Economic Insight offer three key challenges to the DD position, two of which relate to the calculation of the RWA and one which relates to the labour share of opex to which the RWA is applied to calculate the SCF:

- The RWA should use **full-time** employees rather than **all employee** ASHE data. Economic Insight argue that by using the 'all employee' ASHE data we implicitly assume that full-time employees account for 72% of NI Water's labour. As a result, they consider this approach places too much emphasis on part-time employees as almost all staff at NI Water are full-time employees, averaging 97% between 2017 and 2020.
- The RWA should be calculated **with respect to the regions in which upper quartile firms are based** rather than relative to the **whole of the UK**. Economic Insight consider that our approach to estimating the labour RPA, which involves comparing wages in Northern Ireland to the rest of the UK, is inconsistent with the efficiency benchmarking process, whereby NI Water is compared to the Upper Quartile (UQ) firm.
- The labour share of opex used at DD (47%) is **not sufficiently justified** and should be based on NI Water's **input mix** and/or NI Water's **actual labour costs**. Economic Insight's approach, which is based on NI Water's share of labour costs, leads to a labour share of opex of 33%.

NI Water's RPA analysis in Annex 5.22 also included an estimation of the RWA. The approach taken to estimate the RWA was largely consistent with the approach taken in our DD RPA report with the exception that **NI Water updated the analysis to reflect the revised 2019 ASHE data and the provisional 2020 ASHE data** released in November 2020. Our DD position was based on provisional 2019 ASHE data because of the date at which the analysis was undertaken. The accompanying Chandler KBS RPA report also assessed the labour RPA and largely agreed with assumptions used in our DD RPA report.

8.2.3. FD position

We structure our response below in line with the five main points raised by NI Water and its advisors in relation to the RWA and labour RPA:

- 'All employees' versus 'full time employees only'
- Comparison to UK average or UQ firms
- Notional versus actual labour share
- Using the latest ONS ASHE data available
- Adjustment for labour sources from outside the local region

We reiterate that our approach to determining the RWA and labour RPA is not trying to perfectly reflect NI water's organisational structure. Rather, we are basing our comparison and estimate on a 'notional' water company, which is standard regulatory practice. This is important to keep in mind when considering the issues listed above.

We also note there are some inconsistencies present in NI Water's response. NI Water and Chandler KBS largely agreed with our approach to estimating the labour RPA, but NI Water and Economic Insight disagreed with our approach to estimating the RWA, despite the fact we applied the same approach to estimating the RWA and the labour RPA. This has made it more challenging to address the points raised in NI Water's DD response in a structured way.

'All employees' versus 'full-time employees only'

The RWA is designed to reflect the price differences between a typical water and sewerage company in Northern Ireland and the rest of the UK, as stated throughout our DD reports. This is not necessarily the same as the actual price differences faced by NI Water. For example, our RPA report stated the following with regards to the mix of labour resources used in NI Water's activities:

> *"NI Water is the only water and sewerage company in Northern Ireland. Therefore, we do not consider it suitable to calculate an RPA based on the labour cost differentials in the water supply, sewerage and*

waste management sector only because we would expect NI Water's own labour costs to bias the differential of this category." (CEPA RPA report, pg. 12)

Similarly, while it may be the case that NI Water has a high proportion of full-time employees, NI Water has not provided any evidence as to why an efficient water and sewerage company would expect their employee mix to differ significantly from the employee mix implied by the ASHE data. In other words, no evidence has been provided as to why NI Water's decision to employ a high proportion of full-time employees is efficient.

Any bias that may be introduced from part-time staff working fewer hours should also be mitigated by using hourly instead of weekly wages. Chandler KBS agreed with this approach in its advice to NI Water on the labour RPA:

"CEPA has favoured the All Employee, Median Hourly excluding overtime wage rates for labour RPA analysis. This is consistent with the labour RPA assessment for NI and we agree that this is the most relevant wage category to use from the ASHE labour data." (Chandler KBS RPA report, pg. 11)

The decision to use 'all-employees' ASHE data is also supported by most recent decisions taken by the UR and other utility regulators in the UK, as shown in the table below. The exception being the use of full-time employees at GD17, but this was largely because of the UR's decision to use weekly wages to determine the RWA in this case.

Table 8.6: Recent regulatory precedent on all versus full-time employee ASHE data[37]

Regulator (price control)	All versus full-time employees
CEPA (PC21 DD position)	All employees
Ofgem (RIIO-GD2)	All employees
UR (RP6)	All employees
UR (GD17)	Full-time employees
UR (PC15)	All & full-time employees
Ofgem (RIIO-ED1)	All employees

Source: CEPA review of published sources

Overall, we consider our decision to use 'all employees' ASHE is well justified. We therefore continue to use 'all employee' ASHE data to estimate the RWA / labour RPA. For completeness, we show the impact of using 'full-time employees' data, with other RWA assumptions unchanged in the table below.

Table 8.7: RWA sensitivity analysis – 'full-time employees'

Description	2012/13	2013/14	2014/15	2015/16	2016/17	2017/18	2018/19
Regional wage SCF adjustment: all employees							
Wholesale water	-3.9	-4.5	-3.5	-3.5	-3.7	-3.4	-3.8
Wholesale sewerage	-3.4	-4.1	-3.1	-3.2	-3.1	-2.7	-3.0
Regional wage SCF adjustment: full-time employees							
Wholesale water	-4.0	-4.7	-3.7	-3.5	-3.9	-3.4	-3.9
Wholesale sewerage	-3.4	-4.3	-3.2	-3.2	-3.3	-2.7	-3.0

Source: CEPA

The table above shows the decision to use 'all employees' only has a marginal impact on the RWA, and slightly favours NI Water based on the sample period.

[37] Ofwat did not apply

Box 4: All employee versus full-time employee ASHE data
We continue to use 'all employee' ASHE data to estimate the RWA / labour RPA.

Comparison to UK average or UQ firms

We estimated the RWA and labour RPA based on the wage differential between Northern Ireland and the UK average in our DD analysis. But NI Water and Economic Insight consider the comparison should be made between Northern Ireland and the UQ (E&W) firms based on the efficiency benchmarking analysis.

The point made by NI Water and Economic Insight potentially reflects a misunderstanding of how SCFs have been applied in the efficiency benchmarking process. As noted in Figure 8.1 below, SCFs are applied to adjust average efficient costs (step C) before the UQ company is identified (step E). As such, we do not consider it is necessary to make the adjustment relative to the UQ company.

The approach taken by Economic Insight may also lead to the risk of cherry-picking given that the estimation of the RWA depends on the econometric model selection process (the benchmark company differs between models) and the benchmark (e.g., upper quartile). For example, the benchmark company could operate in a relatively high-cost area of the UK, which would increase the RWA. Calculating the RWA based on the differential between Northern Ireland and the UK average therefore reduces the risk of cherry picking at PC21 and in future price controls.

This is demonstrated in Table 8.8 below, which shows how the company closest to the upper quartile (5th placed wholesale water company and 4th placed wholesale sewerage company) changes across models based on the weighted average efficiency score across the sample period.

Table 8.8: Upper quartile company for each opex model after application of special cost factors

Wholesale water opex			Wholesale sewerage opex	
Model 1	Model 2	Model 3	Model 1	Model 2
NIW	NES	SSC	SWB	SWB

Source: CEPA analysis

Overall, we consider our decision to estimate the RWA based on the differential between Northern Ireland and UK average wages is well justified and therefore do not change our approach for final determination.

Box 5: Comparison to UK average or UQ firms
We continue to estimate the RWA based on the differential between Northern Ireland and UK average wages.

Notional versus actual labour share of opex

There are two options to calculating the quantum of opex that the RWA is applied to:

- using a notional labour share of opex; or
- using actual NI Water labour costs to determine the labour share of opex.

We assumed a notional labour share of opex of 47% when applying the regional wage SCF, which was provided by the UR to ensure consistency with the notional input mix used in its frontier shift analysis. A notional labour weighting has frequently been used by regulators within regional wage analyses rather than actual company labour costs to reduce the risk of potential errors and bias in the information submitted by individual companies. Examples include Ofgem at RIIO-2 and RIIO-1, the UR and RP6 and GD17 and the Competition Commission at RP5.

We do not address in detail here any comments about the approach taken by the UR to arrive at the 47% parameter, except to reiterate that we believe ensuring consistency between different aspects of analyses is important. Further detail on how the UR's internal frontier shift modelling – including how they updated the assumed opex input mix – is available in Annex K of the Draft Determination.[38]

NI Water consider it would be more appropriate to calculate the labour share of opex based on NI Water's own cost data. Based on this approach, they conclude that NI Water's labour costs account for an average of 31% of total opex costs over the past five years, which they divide by their labour RPA (0.93) to arrive at a labour share of opex of 33%. NI Water therefore suggest that CEPA has overestimated the labour share of opex (Annex 4.1, pg. 13).

However, on review of these calculations, it is apparent that the 33% figure only accounts for direct labour (i.e., directly employed staff). NI Water's calculation also included business rates, which is incorrect as business rates were excluded from the benchmarking analysis.

The table below presents a comparison of the notional labour share of opex (47%) versus alternative assumptions based on NI Water's own cost data over the period 2012/13 to 2018/19 (excluding business rates):

- **UR notional labour share of opex**.
- **NI Water's direct labour share of opex**: direct labour only.
- **NI Water's direct + contractor labour share of opex**: direct labour plus contractor labour.

Table 8.9: Labour share of wholesale opex (excluding bioresources)

	2012/13	2013/14	2014/15	2015/16	2016/17	2017/18	2018/19	Average
UR notional labour share	47%	47%	47%	47%	47%	47%	47%	47%
Direct labour costs	33%	35%	35%	36%	36%	37%	36%	36%
Direct labour costs + contractors	47%	48%	49%	48%	49%	51%	50%	49%

Source: CEPA analysis of NI Water data

Data provided by NI Water would suggest around 49% of wholesale opex (excluding bioresources) is related to labour if contracted labour is included in the calculation. We have not been provided with any evidence to explain why the RWA should not be applied to contractors. This suggests that the notional labour weighting of 47% used within our analysis is broadly in line with NI Water's own cost data, and could be considered a conservative estimate rather than an overestimate.

Finally, we note that the Chandler KBS RPA report identified the labour share of capital costs (capex) to be 42.51% based on NI Water's PC21 IPAC report[39]. In our view, it is reasonable to expect that the labour share of NI Water's opex should be higher than the labour share of NI Water's capex.

Overall, we have not seen any convincing evidence that would lead to a change in the labour share of opex used within our analysis. For completeness, however, we have calculated the regional wage SCF adjustment based on different labour share of opex assumptions using NI Water's opex data, as presented in Table 8.10 below. A 33% labour share of opex (as suggested by NI Water) would lead to a 30% decrease in the regional wage SCF adjustment.

[38] UR (Sep 2020), *'Draft determination - Annex K: Opex and Capex Frontier Shift'*

[39] Chandler KBS (November 2020). 'PC21 Regional Price Adjustment', Table 4.

Table 8.10: Regional wage SCF adjustment - different labour share of opex assumptions, £ million (2017/18 prices)

Description	2012/13	2013/14	2014/15	2015/16	2016/17	2017/18	2018/19
Selected regional wage SCF adjustment: 47% labour share of opex assumption							
Wholesale water	-3.9	-4.5	-3.5	-3.5	-3.7	-3.4	-3.8
Wholesale sewerage	-3.4	-4.1	-3.1	-3.2	-3.1	-2.7	-3.0
Sensitivities							
Sensitivity 1: NI Water's 33% labour share of opex assumption							
Wholesale water	-2.7	-3.2	-2.5	-2.5	-2.6	-2.4	-2.7
Wholesale sewerage	-2.4	-2.9	-2.2	-2.2	-2.2	-1.9	-2.1
Sensitivity 2: 49% labour share of opex assumption (staff costs plus contractor costs)							
Wholesale water	-4.1	-4.7	-3.7	-3.6	-3.8	-3.5	-4.0
Wholesale sewerage	-3.5	-4.3	-3.3	-3.3	-3.3	-2.8	-3.1

Source: CEPA analysis

Box 6: Notional versus actual labour share of opex

We continue to assume a labour share of opex of 47% when applying the regional wage SCF, which ensures consistency with the notional input mix used in the UR's frontier shift analysis and avoids the regional wage SCF being affected by potential errors or bias in NI Water's labour cost data.

Using the latest ONS ASHE data available

The analysis conducted by NI Water and Chandler KBS in Annex 5.22 used the revised ASHE 2019 release and the provisional ASHE 2020 release. Whereas our DD analysis was based on the provisional ASHE 2019 release reflecting the date at which the analysis was conducted.

Firstly, we do not consider it would be appropriate to use the provisional ASHE 2020 release to estimate the regional wage SCF as the econometric benchmarking analysis was conducted using data up to 2018/19.

We recognise however that our DD analysis used the provisional rather than revised 2019 ASHE data and have updated our analysis accordingly[40]. As expected, the changes to the 2018/19 RWA is minor, increasing marginally from -11.7% to -12.0%, as presented in the table below.

Table 8.11: 2018/19 Regional wage SCF based on provisional and revised ONS ASHE data

	Provisional 2019 ASHE data		Revised 2019 ASHE data	
	RWA factor	Regional Wage SCF adjustment (£m, 2017/18 prices)	RWA factor	Regional Wage SCF adjustment (£m, 2017/18 prices)
Wholesale Water	-11.7%	-3.8	-12.0%	-3.9
Wholesale Sewerage	-11.7%	-3.0	-12.0%	-3.0

Source: CEPA analysis

[40] We also use the revised 2019 ASHE data to calculate the labour component of the capital maintenance RPA discussed below.

Box 7: Using the latest ONS ASHE data available

We update our regional wage SCF analysis to reflect the revised 2019 ASHE data.

We assess the impact of applying the updated regional wage SCF on NI Water's opex efficiency gap in Section 8.5 below.

8.3. Capital maintenance RPA SCF

Box 8: Capital maintenance RPA SCF

A SCF adjustment is applied to NI Water's capital maintenance costs to take into account regional price differences between a typical water company in Northern Ireland and the rest of the UK that are not captured in the capital maintenance econometric models.

8.3.1. DD position

As detailed in our separate Regional Price Adjustment (RPA) report[41], we developed a model to estimate regional price differences in capital expenditure (capex) between a typical water company in Northern Ireland and the rest of the UK. We estimated individual RPAs for the key resource categories of labour, materials, and plant & equipment:

- Labour RPA: discussed in the section above (i.e., the RWA).
- Materials RPA: comprised of individual RPAs for six subcategories of materials likely to be used in capex projects - concrete, rebar, pipes, meter, disposal and other. The chosen level of disaggregation ensured that the available data was used effectively and avoided a level of detail for which reliable data cannot be obtained. Even if data could be obtained at a more granular level, this would not necessarily improve the RPA estimates as data quality can be reduced. In addition, a carefully constructed high-level RPA estimate is applicable across a broad range of management decisions and is less likely to interfere with operational decisions of the regulated company (i.e., cherry picking).
- Plant & equipment RPA: we found no strong evidence for a plant & equipment RPA, and therefore assumed that Northern Ireland plant and equipment costs are equivalent to the rest of the UK.

The individual labour, materials, and plant & equipment RPAs were then aggregated to a single adjustment to be applied across all capex with a weighting of 40%, 20% and 20%, respectively.

The baseline aggregated RPA adjustment suggested that the overall price differential between NI Water and other UK companies was 8% for wholesale water and 9% for wholesale sewerage, as shown in the table below. We then estimated a capital maintenance RPA SCF based on NI Water's wholesale water and sewerage capital maintenance for each year of the modelling sample period, which led to the following estimates:

- The wholesale water capital maintenance RPA SCF adjustment ranged from £3.1 million to £3.8 million over the period 2012/13 to 2018/19.
- The wholesale sewerage capital maintenance RPA SCF adjustment ranged from £3.8 million to £5.6 million over the period 2012/13 to 2018/19.

[41] CEPA (July 2020). 'Annex J Regional Price Adjustments PC21 (CEPA)'.

CEPA economics matters

Table 8-12: Capital maintenance RPA SCF – Draft Determination, £ million (2017/18 prices)

Description	Column	Calculation	2012/13	2013/14	2014/15	2015/16	2016/17	2017/18	2018/19
Wholesale Water RPA	A		-8%	-8%	-8%	-8%	-8%	-8%	-8%
Wholesale Sewerage RPA	B		-9%	-9%	-9%	-9%	-9%	-9%	-9%
Wholesale water capital maintenance	C		43.3	42.8	43.9	36.4	44.7	38.7	38.0
Wholesale sewerage capital maintenance	D		55.6	60.4	40.6	54.5	58.7	53.0	56.0
Wholesale water	E	C x A	-3.7	-3.6	-3.7	-3.1	-3.8	-3.3	-3.2
Wholesale sewerage	F	D x B	-5.2	-5.6	-3.8	-5.1	-5.5	-4.9	-5.2

Source: CEPA analysis

8.3.2. NI Water DD response

We addressed comments on the labour RWA component in Section 8.2, and NI Water did not challenge the plant & equipment components of our RPA analysis published as part of DD.

In relation to materials, NI Water raised a concern around the absence of Mechanical, Electrical, Instrumentation, Control and Automation (MEICA) costs from the materials mix, which they consider have a significant contribution to Non-Infrastructure projects.[42] NI Water consider that this is an important issue given that the costs for some MEICA components can be more expensive in Northern Ireland with elements of cost being up to 10% greater than in Great Britain (according to NI Water). NI Water say that this part of the programme would be nationally or internationally sourced and will cost more in Northern Ireland due to transport and handling costs, with many MEICA items imported from the Republic of Ireland. They therefore decided to apply an RPA of 105% for imported MEICA materials, which NI Water said was informed by some MEICA contractors who said that some MEICA activities are lower in cost in NI.

NI Water adjusted the material weightings to take account of the MEICA plant but it has a minimal impact on the materials RPA, as shown in the table below.

Table 8.13: Materials RPA comparisons

	CEPA PC21 DD	NI Water based on Table 4.2 material weightings
Materials RPA	89.5%	90.3%

Source: CEPA analysis and Annex 5.22 of NI Water's PC21 DD response

However, the materials RPA is only one component of the RPA and NI Water's materials RPA adjustment only has a minimal impact on the overall RPA, as shown in the table below.

Table 8.14: Overall RPA comparisons

	CEPA PC21 DD	Based on NI Water's revised materials RPA
Overall RPA	91.1%	91.4%

Source: CEPA analysis and Annex 5.22 of NI Water's PC21 DD response

The subsequent impact on the capital maintenance RPA SCF of adopting NI Water's materials RPA is correspondingly small, as shown in the table below.

[42] NI Water (December 2020). PC21 Draft Determination NI Water Response, Annex 5.22, pg. 9.

Table 8.15: Capital maintenance RPA SCF, £ million (2017/18 prices)

Description	2012/13	2013/14	2014/15	2015/16	2016/17	2017/18	2018/19
Capital maintenance RPA SCF: CEPA PC21 DD							
Wholesale water	-3.7	-3.6	-3.7	-3.1	-3.8	-3.3	-3.2
Wholesale sewerage	-5.2	-5.6	-3.8	-5.1	-5.5	-4.9	-5.2
Capital maintenance RPA SCF: based on NI Water's revised materials RPA (all else equal)							
Wholesale water	-3.5	-3.5	-3.6	-3.0	-3.6	-3.2	-3.1
Wholesale sewerage	-5.0	-5.4	-3.6	-4.9	-5.3	-4.7	-5.0

Source: CEPA analysis

8.3.3. FD position

The labour component of the capital maintenance RPA has been updated to reflect the revised 2019 ASHE dataset, as discussed in Section 7.2 above. The plant & equipment component of the RPA remains unchanged from DD.

Turning to materials, NI Water has argued that MEICA materials should be captured explicitly in the materials mix. But it has also shown the explicit identification of MEICA materials in the materials mix has a minimal impact on the overall materials RPA. In addition, further disaggregation of the materials RPA risks decreasing the accuracy of the RPA. This is demonstrated by the fact that NI Water has not presented compelling evidence to demonstrate how it arrived at an RPA of 105% for imported MEICA materials. For these reasons, we do not consider it is necessary or appropriate to change our approach to determining the materials RPA, which is consistent with the approach taken at PC15.

The updated baseline aggregated RPA to reflect the revised 2019 ASHE data is presented below.

Table 8-16: Capital maintenance RPA SCF – Final Determination, £ million (2017/18 prices)

Description	Column	Calculation	2012/13	2013/14	2014/15	2015/16	2016/17	2017/18	2018/19
Wholesale Water RPA	A		-9%	-9%	-9%	-9%	-9%	-9%	-9%
Wholesale Sewerage RPA	B		-9%	-9%	-9%	-9%	-9%	-9%	-9%
Wholesale water capital maintenance	C		43.3	42.8	43.9	36.4	44.7	38.7	38.0
Wholesale sewerage capital maintenance	D		55.6	60.4	40.6	54.5	58.7	53.0	56.0
Wholesale water	E	C x A	-3.7	-3.7	-3.8	-3.1	-3.8	-3.3	-3.3
Wholesale sewerage	F	D x B	-5.2	-5.7	-3.8	-5.1	-5.5	-5.0	-5.3

Source: CEPA analysis

Box 9: RPA SCF – explicit inclusion of MEICA in materials mix

We do not consider it is necessary or appropriate to change our approach to determining the materials RPA.

We assess the impact of applying the updated capital maintenance RPA SCF on NI Water's opex efficiency gap in Section 8.5 below.

8.4. Summary of changes to SCFs at FD

We summarise the changes we have made to the SCFs following consideration of NI Water's DD response below.

CEPA economics matters

Electricity price SCF

This electricity price SCF accounts for the energy price differential between Northern Ireland and the rest of the UK. NI Water questioned the data that was used to estimate the electricity price SCF at DD. More specifically, it questioned the approach we applied to calculate average electricity prices for each financial year based on data that is available for each half of the calendar year (e.g., January to June and July to December), and considered a different approach would be more appropriate, as illustrated below.

Table 8.17: Approach to calculating average electricity prices for each financial year

Financial year	CEPA DD approach	NI Water approach
2018/19	An unweighted average of the second half of 2018 (July to December) and the first half of 2019 (January to June).	An unweighted average of the first half of 2018 (January to June) and the second half of 2018 (July to December).

For FD, we calculate the electricity price SCF by taking an unweighted average of the approach we applied at draft determination and the approach suggested by NI Water, which avoids the risk of cherry picking.

Regional wage SCF

We apply a regional wage SCF to NI Water's opex to reflect the advantage NI Water obtains from operating in a lower wage cost region of the UK. NI Water commented on several key aspects of the regional wage SCF, which we summarise below alongside our FD approach.

Table 8.18: Summary of key methodological decisions for the regional wage SCF

Aspect	Draft Determination	NI Water proposal	Final Determination
'All employees' versus 'full-time employees only'	All employees	Full-time employees only	All employees
Comparison to UK average or UQ firms	UK average	UQ firms	UK average
Notional versus actual labour share of opex	Notional	Actual (direct labour only)	Notional
ONS ASHE data	ASHE 2019 provisional data set	ASHE 2020 provisional data set	ASHE 2019 revised data set

Source: CEPA

Capital maintenance RPA SCF

We apply an RPA SCF to NI Water's capital maintenance costs to take into account regional price differences between a typical water company in Northern Ireland and the rest of the UK that are not captured in the capital maintenance econometric models. The RPA is made up of labour, plant & equipment, and materials components.

We update the labour RPA to reflect the updated ONS ASHE 2019 data series but have made no changes to the plant & equipment RPA.

NI Water raised a concern that the calculation of the materials RPA did not explicitly consider Mechanical, Electrical, Instrumentation, Control and Automation (MEICA), which they consider is an important issue given that the costs for some MEICA components can be more expensive in Northern Ireland than in Great Britain (according to NI Water). But we have not changed our approach to determining the materials RPA at FD given the change proposed by NI Water has a minimal impact on the overall RPA, and further disaggregation of the materials RPA risks decreasing the accuracy of the RPA.

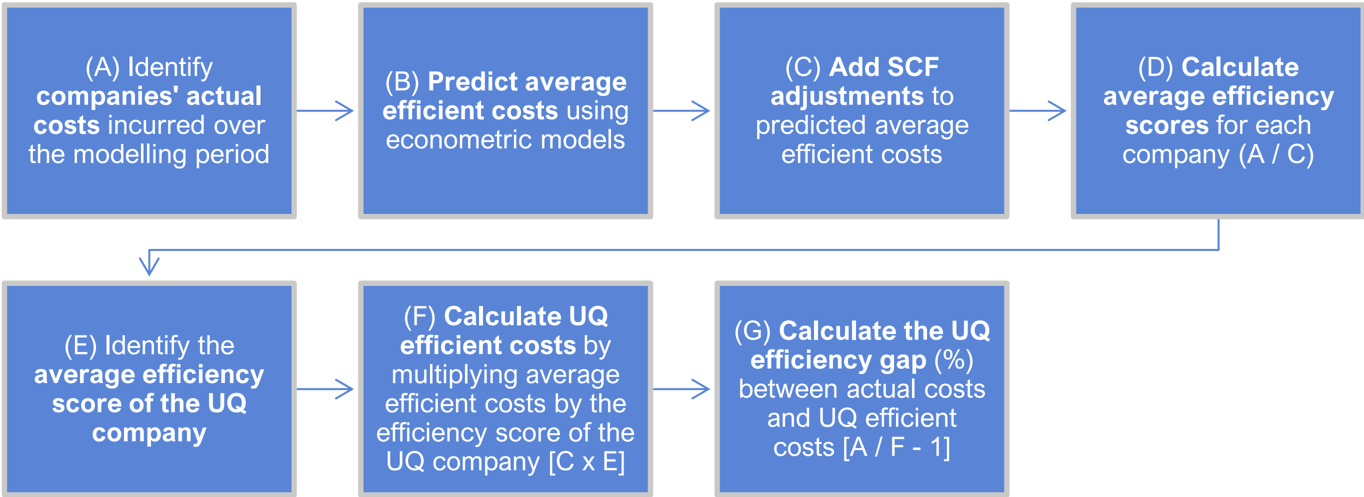
8.5. Efficiency results after special cost factors

The tables below summarise NI Water's efficiency results after application of the three updated special cost factors discussed above – electricity price SCF, regional wage SCF, and RPA SCF.[43]

As discussed in Section 7, we define the efficiency gap as the distance (in terms of expenditure) between upper quartile (UQ) efficient company and NI Water in percentage terms.

The upper quartile efficiency gap after application of SCFs is calculated as follows:

Figure 8.1: Efficiency gap calculation after application of SCFs



This means that an efficiency gap of 5% would indicate that NI Water's costs are 5% lower than the costs that would have been incurred by the UQ efficient company. Conversely, a gap of -5% would indicate the company's costs are 5% higher than the UQ efficient company.

An illustrative example is provided in Table 7.1 to show how NI Water's UQ efficiency gap has been calculated for each model after the application of special cost factors. In this illustrative example, the efficiency gap is -9.8%, which means that the company would need to reduce their costs by 9.8% to reach the UQ company. But the efficiency gap has reduced from -15% (see Table 7.1) to -9.8% after taking into account the SCFs.

Table 8.19: Illustrative efficiency gap calculation after special cost factors

Column	Item	Calculation	Example One
A	Actual Cost (excluding atypicals)		£100m
B	Predicted Average		£89.5m
C	Special Cost Factors (SCFs)		£5.5m
D	Predicted Average + SCFs	B + C	£95.0m
E	Efficiency Score of UQ Company		0.95
F	UQ Predicted Costs (after SCFs)	D * E	£90.2m
G	**Efficiency Gap to UQ (£m)**	**F – A**	**- £9.8m**
F	**Efficiency Gap to UQ (%)**	**G / A**	**- 9.8%**

Source: CEPA analysis

[43] NI Water's upper quartile efficient costs that are used to calculate the efficiency gaps are provided in Appendix D.

Wholesale water opex efficiency results (after SCFs)

Table 8.20 presents NI Water's wholesale water efficiency gap to the upper quartile benchmark for the wholesale water opex models presented in Section 5 after taking into account the SCFs.

The SCF adjustments are negative (i.e., the environment NI Water operates in allows for lower efficient costs compared to the typical company in E&W). This leads to a widening of NI Water's efficiency gap compared to the unadjusted calculations presented in Section 7.

NI Water's wholesale water opex efficiency gap to the UQ after taking into account the updated SCFs ranges from **-8.1% to 0.3%** based on a weighted average calculation and appears less efficient than an UQ company in two out of three models. This compares to a wholesale water opex efficiency gap range of between -2.2% and 5.5% before application of SCFs.

Table 8.20: NI Water wholesale water efficiency gap to upper quartile (after SCFs), opex

	Model 1	Model 2	Model 3
2013/14	-0.6%	-0.6%	-6.5%
2014/15	-2.7%	-0.1%	-4.5%
2015/16	-2.5%	-6.4%	-8.7%
2016/17	-4.9%	-8.5%	-13.5%
2017/18	-8.7%	-10.0%	-15.1%
2018/19	-6.8%	-5.2%	-9.8%
Weighted Average (2013/14 to 2018/19)	0.3%[44]	-2.8%	-8.1%

Source: CEPA analysis

Table 8.21 below compares the wholesale water opex weighted average efficiency gap between DD and FD after taking into account of SCFs. Overall, the SCF changes made at FD (as discussed above) only have a minor impact on the wholesale water opex efficiency results.

Table 8.21: NI Water wholesale water weighted average efficiency gap to upper quartile (after SCFs), opex, FD versus DD

	Model 1	Model 2	Model 3
Weighted Average (2013/14 to 2018/19) – FD	0.3%	-2.8%	-8.1%
Weighted Average (2013/14 to 2018/19) – DD	0.2%	-3.0%	-8.3%

Source: CEPA analysis

Wholesale water capital maintenance efficiency results (after SCFs)

Table 8.22 presents NI Water's wholesale water efficiency gap to the upper quartile benchmark for the wholesale water capital maintenance models presented in Section 5 after taking into account the SCFs.

For wholesale water capital maintenance, the RPA SCF adjustment is negative, which leads to a widening of NI Water's wholesale water capital maintenance efficiency gap.

NI Water's wholesale water capital maintenance efficiency gap to the UQ after applying the RPA SCF ranges from **-7.7% to -2.3%** based on a weighted average calculation and it appears less efficient than the UQ company in all

[44] The weighted average efficiency gap is positive because the catch-up efficiency challenge that is applied is much lower than on a year-by-year basis. This may be because of different spending patterns between water companies (e.g. high and low spending years may differ between water companies).

four models. This compares to a wholesale water capital maintenance efficiency gap range of between -0.9% and 2.8% before application of the RPA SCF.

Table 8.22: NI Water wholesale water efficiency gap to upper quartile (after SCFs), capital maintenance

	Model 1	Model 2	Model 3	Model 4
2013/14	-10.6%	-5.6%	-11.3%	-8.2%
2014/15	-22.9%	-19.5%	-23.4%	-24.7%
2015/16	-15.8%	-19.6%	-16.1%	-24.1%
2016/17	-16.3%	-18.6%	-16.6%	-22.6%
2017/18	9.3%	3.7%	8.8%	0.0%
2018/19	7.1%	6.2%	6.8%	2.7%
Weighted Average (2013/14 to 2018/19)	-2.7%	-2.3%	-3.2%	-7.7%

Source: CEPA analysis

Table 8.23 below compares the wholesale water capital maintenance weighted average efficiency gap between DD and FD after taking into account of the RPA SCF. Overall, the RPA SCF change made at FD (as discussed above) only have a minor impact on the wholesale water capital maintenance efficiency results.

Table 8.23: NI Water wholesale water weighted average efficiency gap to upper quartile (after SCFs), capital maintenance, FD versus DD

	Model 1	Model 2	Model 3	Model 4
Weighted Average (2013/14 to 2018/19) – FD	-2.7%	-2.3%	-3.2%	-7.7%
Weighted Average (2013/14 to 2018/19) – DD	-2.6%	-2.3%	-3.1%	-7.6%

Source: CEPA analysis

Wholesale sewerage opex efficiency results (after SCFs)

Table 8.24 presents NI Water's wholesale sewerage efficiency gap to the upper quartile benchmark for the wholesale sewerage opex models presented in Section 6 after taking into account the SCFs.

We note that the weighted average efficiency gap has been calculated based on the last three years of the sample period rather than the full sample period to reflect that NI Water has steadily improved its wholesale sewerage opex efficiency gap over the sample period (as discussed in Section 7.2).

The SCF adjustments applied to NI Water's wholesale sewerage opex are negative overall. Hence, application of the SCFs widens NI Water's efficiency gap to an UQ company.

NI Water's wholesale sewerage weighted average opex efficiency gap to the UQ after applying the SCFs ranges from **-8.9% to -7.8%**, meaning that NI Water appears less efficient than the UQ company in both wholesale sewerage opex models. This compares to a wholesale sewerage opex efficiency gap range of between -1.4% and 1.0% before application of SCFs.

Table 8.24: NI Water wholesale sewerage efficiency gap to upper quartile (after SCFs), opex

	Model 1	Model 2
2012/13	-15.5%	-13.6%
2013/14	-18.1%	-19.2%
2014/15	-15.7%	-15.0%
2015/16	-11.0%	-13.4%
2016/17	-9.7%	-12.0%

	Model 1	Model 2
2017/18	-10.5%	-10.8%
2018/19	-1.5%	-1.1%
Weighted Average (2016/17 to 2018/19)	-7.8%	-8.9%

Source: CEPA analysis.

Table 8.25 below compares the wholesale sewerage opex weighted average efficiency gap between DD and FD after taking into account of the RPA SCF. Overall, the changes made at FD (i.e., by placing more weight on recent years in the sample to calculate the weighted average efficiency gap (i.e., 2016/17 to 2018/19) and updated SCFs) lead to a substantial reduction of NI Water's wholesale sewerage weighted average opex efficiency gap.

Table 8.25: NI Water wholesale water weighted average efficiency gap to upper quartile (after SCFs), capital maintenance, FD versus DD

	Model 1	Model 2
Weighted Average (2016/17 to 2018/19) – FD	-7.8%	-8.9%
Weighted Average (2013/14 to 2018/19) – DD	-12.8%	-12.5%

Source: CEPA analysis

Wholesale sewerage capital maintenance efficiency results (after SCFs)

Table 8.26 presents NI Water's wholesale sewerage efficiency gap to the upper quartile benchmark for the wholesale sewerage capital maintenance models presented in Section 6 after taking into account the SCFs.

The RPA SCF adjustment applied to NI Water's wholesale sewerage capital maintenance is also negative. Hence, application of the SCF widens NI Water's efficiency gap to an UQ company.

NI Water's wholesale sewerage capital maintenance efficiency gap to the UQ after applying the RPA SCF ranges from **-13.9% to -11.7%**, meaning that NI Water appears less efficient than the UQ company in both wholesale sewerage capital maintenance models. This compares to a wholesale sewerage capital maintenance efficiency gap range of between -5.2% and -2.6% before application of the RPA SCF.

Table 8.26: NI Water wholesale sewerage efficiency gap to upper quartile (after SCFs), capital maintenance

	Model 1	Model 2
2012/13	-18.9%	-16.3%
2013/14	-30.9%	-28.0%
2014/15	-6.9%	-3.4%
2015/16	-21.2%	-19.5%
2016/17	-20.9%	-18.7%
2017/18	-10.9%	-12.4%
2018/19	-21.9%	-21.6%
Weighted Average (2012/13 to 2018/19)	-13.9%	-11.7%

Source: CEPA analysis.

Table 8.27 below compares the wholesale sewerage capital maintenance weighted average efficiency gap between DD and FD after taking into account of the RPA SCF. Overall, the RPA SCF change made at FD (as discussed above) only have a minor impact on the wholesale sewerage capital maintenance efficiency results.

Table 8.27: NI Water wholesale sewerage weighted average efficiency gap to upper quartile (after SCFs), capital maintenance, FD versus DD

	Model 1	Model 2
Weighted Average (2012/13 to 2018/19) – FD	-13.9%	-11.7%
Weighted Average (2012/13 to 2018/19) – DD	-13.8%	-11.6%

Source: CEPA analysis

9. CONCLUSION

Through this project we have developed a range of wholesale water and sewerage econometric benchmarking models, in order to assess the efficiency of NI Water's opex and capital maintenance expenditure relative to companies in England and Wales.

The econometric benchmarking models presented in this report perform well against our model selection criteria with no major concerns identified. Our opex models perform somewhat better than the capital maintenance models, reflecting the fact that the latter is inherently lumpy in nature.

The tables below compare the weighted average efficiency results before and after SCF adjustments between Draft and Final Determination. Efficiency results are mixed across the wholesale water and sewerage models, with NI Water appearing relatively more efficient in wholesale water than sewerage.

When deciding how to use these results to assist in setting opex and capital maintenance allowances the UR should note that the accounting dummy variable included in the models does not perfectly capture companies' reactions to the accounting change discussed in Section 4.4; it only captures an average effect. Overall, however, we are satisfied that the dummy variable captures companies' reactions to the accounting change well enough to enable the model results to be utilised by the UR when setting NI Water's allowances but recommend they are not applied mechanistically.

In addition, while we present the results in this report to one decimal place, we do not intend the results to be applied to that level of precision. Instead, we suggest that the UR triangulate between the results presented in this report with other analysis, such as the botex model results presented in Appendix B and Appendix C, when setting NI Water's opex and capital maintenance PC21 allowances.

9.1. Wholesale water and sewerage efficiency results before SCF adjustments

Opex[45]

Table 9.1: NI Water wholesale water weighted average efficiency gap to upper quartile, before SCFs, opex

	Model 1	Model 2	Model 3
Final Determination	5.5%	0.6%	-2.2%
Draft Determination	Same as DD	Same as DD	Same as DD

Source: CEPA analysis

Table 9.2: NI Water wholesale sewerage weighted average efficiency gap to upper quartile, before SCFs, opex

	Model 1	Model 2
Final Determination	-1.0%	-1.4%
Draft Determination	-7.3%	-7.0%

Source: CEPA analysis.

Capital maintenance[46]

Table 9.3: NI Water wholesale water weighted average efficiency gap to upper quartile, before SCFs, capital maintenance

	Model 1	Model 2	Model 3	Model 4
Final Determination	1.6%	2.8%	0.9%	-0.9%
Draft Determination	Same as DD	Same as DD	Same as DD	Same as DD

Source: CEPA analysis

Table 9.4: NI Water wholesale sewerage weighted average efficiency gap to upper quartile, before SCFs, capital maintenance

	Model 1	Model 2
Final Determination	-5.2%	-2.6%
Draft Determination	Same as DD	Same as DD

Source: CEPA analysis.

[45] For illustration purposes only:

- NI Water's wholesale (water plus sewerage) opex weighted average efficiency gap to the UQ would be 0.2% if equal weights were applied to each opex model (before SCF adjustments).

[46] For illustration purposes only:

- NI Water's wholesale (water plus sewerage) capital maintenance weighted average efficiency gap to the UQ would be -1.7% if equal weights were applied to each capital maintenance model (before SCF adjustments).

9.2. Wholesale water and sewerage efficiency results after SCF adjustments

Opex[47]

Table 9.5: NI Water wholesale water weighted average efficiency gap to upper quartile, after SCFs, opex

	Model 1	Model 2	Model 3
Final Determination	0.3%	-2.8%	-8.1%
Draft Determination	0.2%	-3.0%	-8.3%

Source: CEPA analysis

Table 9.6: NI Water wholesale sewerage weighted average efficiency gap to upper quartile, after SCFs, opex

	Model 1	Model 2
Final Determination	-7.8%	-8.9%
Draft Determination	-12.8%	-12.5%

Source: CEPA analysis.

Capital maintenance[48]

Table 9.7: NI Water wholesale water weighted average efficiency gap to upper quartile, after SCFs, capital maintenance

	Model 1	Model 2	Model 3	Model 4
Final Determination	-2.7%	-2.3%	-3.2%	-7.7%
Draft Determination	-2.6%	-2.3%	-3.1%	-7.6%

Source: CEPA analysis

Table 9.8: NI Water wholesale sewerage weighted average efficiency gap to upper quartile, after SCFs, capital maintenance

	Model 1	Model 2
Final Determination	-13.9%	-11.7%
Draft Determination	-13.8%	-11.6%

Source: CEPA analysis.

[47] For illustration purposes only:

- NI Water's wholesale (water plus sewerage) opex weighted average efficiency gap to the UQ would be -5.7% if equal weights were applied to each opex model (after SCF adjustments).

[48] For illustration purposes only:

- NI Water's wholesale (water plus sewerage) capital maintenance weighted average efficiency gap to the UQ would be -9.0% if equal weights were applied to each capital maintenance model (after SCF adjustments).

Appendix A DETAILED PC21 MODEL SELECTION CRITERIA

Description	Level of importance	Comment
Robustness of models		
Statistical significance of individual parameters (t-test)	Medium	• If one or more of the coefficients in the model fails this test, we cannot rule out that the relationship being identified between the driver of cost and costs under consideration is not spurious (i.e. the coefficient could be zero). • Parameters could fail this test because there is no relationship between the driver of cost and the costs but also due to limitations in the data. The small size and poor quality of some of the components in the sample could make it difficult, if not impossible, to identify clearly the relationship between the variables and, therefore, we are unable to reject the null hypothesis that the coefficient is significantly different from zero. • While statistical significance of the estimated parameters is important, it is also important we can capture as many of the drivers of cost as possible. This issue highlights the trade-off between parsimony and avoiding omitted variable bias, which is common in econometric modelling, but perhaps comes under greater scrutiny in the regulatory context. • As a result, it would be possible to include variables that are statistically insignificant if they reflect relationships that are well set in engineering and/or economic literature. In those cases, we can be certain that the relationship exists even when there is not enough data or of enough quality to identify it robustly enough. • Furthermore, this would need to be compared with the F-test discussed below. Even when individual variables are insignificant, it is possible that they are jointly considering relevant effects. • One topic to be considered is whether this result is caused by the existence of multi-collinearity (i.e. high correlation between explanatory variables). If that is the case, one could decide to keep both variables but recognising that they are both measuring similar effects.
Jointly statistically significant (F-test)	Very high	• If the equation fails this test, it could suggest that the joint effect of all parameters is not statistically different from zero. • Therefore, if a model fails this test, it is not possible to determine whether there is an actual relationship between explanatory variables and the dependent variable. • There are different reasons that could justify this result (e.g. poor data quality or wrong specification of the model) but they all seem to indicate that there is a lack of statistical robustness that will make the result easy to challenge.
Underlining assumptions tests		
Linearity	Low	• This test aims to determine whether one could expect a linear relationship between the driver of cost and the costs under consideration. The linear assumption might be a reasonable assumption in some cases whereas in others it may not.

Description	Level of importance	Comment
		• Failing this test seems to indicate that the data could be better fitted using a different functional form (e.g. quadratic). However, this is not to say that a linear assumption is automatically wrong but that other options could be better. The introduction of alternative functional forms, however, could increase the complexity of the models which would be linked to additional data requirements. • Given the need to develop transparent models and the limitations in the data available, the UR could still use models that fail this test. However, it will be important to consider whether additional adjustments need to be introduced in the results to account for the lack of linearity (e.g. introduction of quadratic terms or other explanatory variables).
Homoscedasticity	Low	• Ensuring that OLS is BLUE (Best Linear Unbiased Estimator) requires that the residuals of the equation are normally distributed with an average of zero and a variance equal for all of them. If this assumption is violated, the results are still unbiased although they could lose some other properties. Heteroscedasticity can be detected by inspecting the residuals in addition to formal testing procedures. • If a model fails the homoscedasticity test, it means that the variance of the errors is not equal for all observations. Different measures can be introduced to address this issue (e.g. use cluster robust standard errors). However, if the effect persists, the model could still be used as the results are robust.
Normality	Low	• The impact of non-normality only has implications in small samples. As the sample size increases, the sampling distributions are approximately normally distributed. This means we can apply standard inference based on asymptotic approximations, and as a result normality is not a great concern.[49]
Multicollinearity	Low	• When two or more explanatory factors are closely linearly related and used in the same model, it can cause estimates for the impact of those variables to be very imprecise. When variables are perfectly collinear, it is impossible to linearly estimate the model in question. • CEPA considers a variable inflation factor (VIF) of greater than 10 to indicate a high degree of multicollinearity. While in this case the estimates of some parameters may be less precise, they remain unbiased. Where a variable and its squared term are both included in a model this will inherently generate a degree of multicollinearity, and so failing this test is even less of a concern.
Tests of pooled OLS versus random effects models - Breusch-Pagan	Medium	• Both OLS and Random Effects assume that the individual firm effect is uncorrelated with the regressors. Thus, the main difference between OLS and a Random Effect estimation is the assumptions that are made about the structure of the error term. • If the model fails this test, then OLS is unbiased but not the most efficient estimator assuming the aforementioned assumption holds (i.e. larger standard errors compared to other estimators). In other words, in these circumstances

[49] Even in small samples, the lack of normality only has implications for the inference of t- and F-test statistics and not the unbiasedness and consistency of parameter estimates.

Description	Level of importance	Comment
LM test for random effects		Random Effects is more likely to produce a more accurate estimate. However, we can still use OLS to produce unbiased parameter estimates.[50]
Hausman test for fixed effects	Medium	• If the unobserved fixed effects are uncorrelated with the regressors then both OLS and Random Effects estimation produce unbiased results. However, if the unobserved fixed effects are correlated with the regressors only Fixed Effects estimation produce unbiased results. • The Hausman test can be used to test whether the unobserved fixed effects are correlated with the regressors. If the difference in the estimated coefficients between Fixed and Random Effects estimation is statistically significant, this is evidence that the regressors are correlated with the unobserved fixed effects. In this case we will need to consider whether fixed effects estimation is more appropriate and/or whether there are any omitted but available time invariant explanatory variables we could test in the random effects model. • Nevertheless, while Fixed Effects estimation has useful statistical properties it is rarely used in efficiency analysis because of two reasons. Firstly, it is difficult to distinguish between inefficiency and company heterogeneity. Secondly, due to the relatively small datasets, fixed effects estimation tends to produce very wide standard errors. As a result, OLS or random effects estimation, while biased, is often preferred to fixed effects estimation within an efficiency analysis exercise.
Sensitivity of results		
Chow test - Sensitivity to removal / addition of a year / company	Medium	• This test would consider whether there is any data that does not fit with the rest of the data set (i.e. a company or a year presenting different characteristics than the rest of the data set). There are several reasons that could justify this distinction such as structural break in the data (different across years) or the presence of an outlier in the data. • Therefore, before taking a specific decision it will be important to evaluate the rationale that could justify these differences. For example, if a company has a very different cost structure than the rivals for, for example, historic reasons outside of the control of the company, it could require that that company is excluded from the analysis.
Sensitivity to inclusion / exclusion of explanatory variables	Medium	• A key part of our model development approach is deciding the most appropriate explanatory variables to include or exclude. When considering the merits of a given variable, we consider the potential effect on the efficiency rankings for a company or group of companies of including/excluding an explanatory variable. This allows us to identify whether the model produces consistent efficiency rankings/scores. • There are reasons that could justify these changes in efficiency rankings/scores. Therefore, the impact of inclusion / exclusion will need to be carefully evaluated.

[50] Assuming the individual fixed effects are not correlated with the regressors.

Description	Level of importance	Comment
Predictive Power		
Overall goodness of fit (Adjusted R-squared)	Very high	• If a model fails to explain a significant variation in the costs of the industry, it would be inappropriate to use it for the estimation of the costs going forward (for models in log-terms the R-squared relates to the log of costs). Therefore, we would expect that only models with a high explanatory power should be used as the base of the cost assessment methodology (e.g. above 80%).
Within sample forecast power of the models	Medium	• Similarly, if a particular model does not have significant forecasting power this would also be a concern. We have tested this by evaluating whether a selected model estimated using only 5 years of historical data (2012/13 – 2016/17) for wholesale water models, or only 4 years (2013/14 – 2016/17) for wholesale sewerage models, has sufficient power to accurately forecast 2017/18 expenditure.
Transparency		
Transparency of results / ease of interpretation	High	• To facilitate their use during PC21, the models should be understandable and intuitive. However, there would need to be a balance between simplicity and complexity if the latter brings a significant improvement in the performance of the model.
Data availability	High	• To ensure that NI Water can challenge the models, it is important that they have access to the data used in developing the models. • To reduce this risk CEPA propose that the final consolidated data set could be shared with NI Water.
Software transparency	Very High	• We use Stata to conduct our econometric analysis, which is an internationally recognised standard software for applied econometrics analysis. • In addition, our final model selection is replicated in Excel to ensure that the UR can re-run the analysis on an annual basis.
Economic and technical rationale		
Are any important explanatory variables omitted?	Medium	• By omitting important explanatory variables, the model would fail to incorporate some of the drivers into the analysis. In some cases, it will not be possible to incorporate these variables as the model already includes a significant number of drivers of cost given the data available, or no robust variable has been found to cover this specific cost driver. • Engineering and econometric experts will be used to minimise this risk. However, if it were to arise this would be flagged and potential off-model adjustments would need to be incorporated into the results to account for these effects.
Consistency with a priori expectations of magnitude and	High	• Ahead of running a regression CEPA will have an expected sign for the coefficients. In some cases, the economic and technical literature will also be able to offer an expected size for the parameter. • Estimated coefficients that significantly differ from our a priori expectations of magnitude and signs could be a cause for concern. However, there are good reasons that could justify this effect. For example, the variable could be picking up

Description	Level of importance	Comment
signs of estimated coefficients		some additional effect for which the explanatory variable is only an imperfect proxy. if any variable would fail this test, it would need to be considered carefully and a good explanation developed before putting forward the model.
Consistency with policy in other parts of the price control	Very high	• Models that produce coefficients that are inconsistent with policy in other parts of the price control would be automatically rejected, e.g. inclusion of costs that are dealt with in other parts of the price control.
Stability of relative efficiency		
Stability of efficiency gap	High	• CEPA will conclude that a model fails to provide a consistent efficiency range if the efficiency gap for NI Water is outside of a range of +/- 5 percentage points around the average efficiency gap for NI Water when considering all the selected models.

Source: CEPA

Appendix B SENSITIVITY TESTING

In this appendix we present the full results of our sensitivity and robustness testing. For completeness, we also present analysis for additional model specifications that were considered but were not included in our final model selection. Note that the analysis in this appendix does not include any consideration of special cost factors.

In addition to the opex and capital maintenance models, we also present wholesale water and sewerage 'botex' models. These models use the combination of opex and capital maintenance and the dependent variable. This means we do not need to include a dummy variable for the accounting change.

B.1. Wholesale water sensitivity results

B.1.1. Opex sensitivity results

Table B.1: Wholesale water sensitivity results, opex

	Model 1	Model 2	Model 3
Length of mains	1.006***	0.970***	1.000***
Number of booster pumping stations per length of mains	0.306**	0.290*	0.216
% of water treated in complexity bands 4 to 6	0.004***		
Weighted average treatment complexity		0.396**	
% of water input from pumped reservoirs			0.004***
Connections per length of mains	-3.238*	-4.000**	-2.742**
Connections per length of mains squared	0.490**	0.586***	0.425**
Post-2014/15 UK GAAP accounting treatment	0.187***	0.193***	0.196***
Constant	0.402	1.843	-0.647
Overall predictive power	97.0%	96.8%	97.1%
Number of observations	111	111	109
Model robustness tests[51]	**Model 1**	**Model 2**	**Model 3**
Jointly statistically significant (F-test)	✓	✓	✓
Linearity	×	×	×
Homoscedasticity	✓	✓	✓
Normality	×	×	✓
Chow / Pooling test	✓	✓	✓
Test of pooled OLS versus RE	RE	RE	RE
Hausman test for FE	RE	RE	RE
Consistency with a priori expectations of magnitude / signs	✓	✓	✓
Consistency with other parts of the price control	✓	✓	✓
Is the mean VIF less than 10?	×	×	×
Is the max VIF less than 10?	×	×	×
Joint significance of quadratic term	✓	✓	✓

[51] Unless otherwise stated (see Appendix A), statistical robustness tests are assessed at the 1% significance level

	Model 1	Model 2	Model 3
Sensitivity of estimated coefficients to removal of least efficient company	✓	✓	✓
Sensitivity of estimated coefficients to removal of most efficient company	✓	✓	✓
Sensitivity of estimated coefficients to removal of individual years	✓	✓	✓
Within sample forecasting power	✓	✓	✓
Stability of NIW efficiency score	✓	✓	✓
Efficiency gaps	**Model 1**	**Model 2**	**Model 2**
2013/14	0.6%	2.1%	-3.2%
2014/15	0.4%	1.1%	-0.3%
2015/16	2.7%	-1.5%	-2.6%
2016/17	0.8%	-1.0%	-6.1%
2017/18	-3.0%	-3.7%	-8.8%
2018/19	-2.1%	0.4%	-3.2%

*Note: Significant at the * 10% level, ** 5% level, *** 1% level. Ticks (crosses) indicate that the model passes (fails) that specific model robustness test.*

B.1.2. Capital maintenance sensitivity results

Table B.2: Wholesale water sensitivity results, capital maintenance

	Model 1	Model 2	Model 3	Model 4
Length of mains	1.190***	1.244***	1.191***	1.249***
Number of booster pumping stations per length of mains	0.528*	0.339	0.525*	0.305
% of water treated in complexity bands 4 to 6	0.011**	0.011**	0.011**	0.011***
% of mains after 1981		-0.019***		-0.019***
Connections per length of mains	0.943***	0.637**	1.076	1.992
Connections per length of mains squared			-0.016	-0.166
Post-2014/15 UK GAAP accounting treatment	-0.209**	-0.173*	-0.210*	-0.179*
Constant	-9.962***	-9.302***	-10.248	-12.244
Overall predictive power	88.6%	90.0%	88.5%	89.9%
Number of observations	111	109	111	109
Model robustness tests	**Model 1**	**Model 2**	**Model 3**	**Model 4**
Jointly statistically significant (F-test)	✓	✓	✓	✓
Linearity	✓	✓	✓	✓
Homoscedasticity	×	×	×	✓
Normality	✓	✓	✓	✓
Chow / Pooling test	✓	✓	✓	✓
Test of pooled OLS versus RE	RE	RE	RE	RE
Hausman test for FE	RE	RE	RE	RE
Consistency with a priori expectations of magnitude / signs	✓	✓	✓	✓
Consistency with other parts of the price control	✓	✓	✓	✓
Is the mean VIF less than 10?	✓	✓	×	×
Is the max VIF less than 10?	✓	✓	×	×
Joint significance of quadratic term	N/A	N/A	✓	✓
Sensitivity of estimated coefficients to removal of least efficient company	✓	✓	×	✓
Sensitivity of estimated coefficients to removal of most efficient company	✓	✓	✓	✓
Sensitivity of estimated coefficients to removal of individual years	✓	✓	✓	✓
Within sample forecasting power	×	✓	✓	✓
Stability of NIW efficiency score	✓	✓	✓	✓
Efficiency gaps	**Model 1**	**Model 2**	**Model 3**	**Model 4**
2013/14	-3.0%	0.4%	-3.7%	-0.2%
2014/15	-16.3%	-12.5%	-16.8%	-17.8%
2015/16	-10.2%	-14.1%	-10.4%	-18.6%
2016/17	-9.6%	-11.8%	-9.8%	-15.8%

	Model 1	Model 2	Model 3	Model 4
2017/18	16.7%	11.2%	16.2%	5.8%
2018/19	14.1%	13.0%	13.7%	8.8%

*Note: Significant at the * 10% level, ** 5% level, *** 1% level. Ticks (crosses) indicate that the model passes (fails) that specific model robustness test.*

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B.1.3. Botex sensitivity results

Table B.3: Wholesale water sensitivity results, botex

	Model 1	Model 2	Model 3	Model 4	Model 5	Model 6	Model 7	Model 8
Length of mains	1.073***	1.095***	1.065***	1.087***	1.052***	1.017***	1.044***	1.004***
Number of booster pumping stations per length of mains	0.334**	0.265*	0.400**	0.325**	0.226	0.301**	0.306*	0.408***
% of water treated in complexity bands 4 to 6	0.006***	0.006***	0.006***	0.006***				
Weighted average treatment complexity						0.719***		0.758***
% of mains after 1981		-0.007*		-0.006*				
Connections per length of mains	0.903***	0.803***	-1.684	-1.393	0.956***	0.950***	-2.051	-2.944
Connections per length of mains squared			0.316	0.269			0.367	0.475*
Constant	-8.321***	-8.152***	-2.699	-3.381	-8.382***	-8.819***	-1.847	-0.382
Overall predictive power	96.6%	96.8%	96.8%	96.9%	95.5%	96.7%	95.6%	97.0%
Number of observations	111	109	111	109	111	111	111	111
Model robustness tests	**Model 1**	**Model 2**	**Model 3**	**Model 4**	**Model 5**	**Model 6**	**Model 7**	**Model 8**
Jointly statistically significant (F-test)	✓	✓	✓	✓	✓	✓	✓	✓
Linearity	✓	×	✓	×	✓	×	✓	×
Homoscedasticity	✓	✓	✓	✓	✓	✓	×	✓
Normality	✓	✓	✓	✓	✓	✓	✓	✓
Chow / Pooling test	✓	✓	✓	✓	✓	✓	✓	✓
Test of pooled OLS versus RE	RE	RE	RE	RE	RE	RE	RE	RE
Hausman test for FE	FE	FE	FE	FE	FE	FE	FE	FE
Consistency with a priori expectations of magnitude / signs	✓	✓	✓	✓	✓	✓	✓	✓
Consistency with other parts of the price control	✓	✓	✓	✓	✓	✓	✓	✓
Is the mean VIF less than 10?	✓	✓	×	×	✓	✓	×	×
Is the max VIF less than 10?	✓	✓	×	×	✓	✓	×	×
Joint significance of quadratic term	N/A	N/A	✓	✓	N/A	N/A	✓	✓
Sensitivity of estimated coefficients to removal of least efficient company	✓	✓	×	✓	✓	✓	×	✓
Sensitivity of estimated coefficients to removal of most efficient company	✓	✓	✓	✓	✓	✓	✓	✓

	Model 1	Model 2	Model 3	Model 4	Model 5	Model 6	Model 7	Model 8
Sensitivity of estimated coefficients to removal of individual years	✓	✓	✓	✓	✓	✓	✓	✓
Within sample forecasting power	✓	✓	✓	✓	✓	✓	✓	✓
Stability of NIW efficiency score	×	×	✓	✓	✓	✓	×	×
Efficiency gaps	**Model 1**	**Model 2**	**Model 3**	**Model 4**	**Model 5**	**Model 6**	**Model 7**	**Model 8**
2013/14	-13.1%	-12.4%	-3.1%	-3.7%	0.1%	-0.4%	-13.9%	-15.9%
2014/15	-16.9%	-18.4%	-7.2%	-8.2%	-6.5%	-3.0%	-19.2%	-19.6%
2015/16	-6.0%	-9.3%	1.0%	0.2%	-2.8%	-1.3%	-14.0%	-15.0%
2016/17	-7.3%	-10.5%	0.1%	-1.3%	-3.1%	-3.0%	-12.4%	-15.8%
2017/18	0.4%	1.5%	9.2%	10.6%	9.1%	4.1%	-2.8%	-6.7%
2018/19	2.2%	1.4%	10.6%	7.1%	1.5%	2.3%	-4.3%	-4.8%

*Note: Significant at the * 10% level, ** 5% level, *** 1% level. Ticks (crosses) indicate that the model passes (fails) that specific model robustness test.*

B.2. Wholesale sewerage sensitivity results

B.2.1. Opex sensitivity results

Table B.4: Wholesale sewerage sensitivity results, opex

	Model 1	Model 2	Model 3	Model 4	Model 5	Model 6	Model 7	Model 8
Total length of sewers	1.017***	0.978***	0.900***	0.875***				
Total load					0.963***	0.927***	0.861***	0.835***
% of load treated in complexity bands 1 to 3	0.072***	0.063***			0.060***	0.056***		
% sewer laid or structurally refurbished post-2001		-0.009***		-0.011***		-0.009***		-0.010***
Connections per length of mains	-11.858*	-10.687**	-11.097	-10.445				
Connections per length of mains squared	1.550*	1.393**	1.429	1.339				
Post-2014/15 UK GAAP accounting treatment	0.167***	0.180***	0.166***	0.180***	0.181***	0.186***	0.168***	0.175***
Constant	16.351	14.726	17.579	16.748	-7.718***	-7.156***	-5.480***	-5.054***
Overall predictive power	94.8%	96.4%	91.7%	94.2%	96.0%	97.6%	93.5%	95.7%
Number of observations	77	76	77	76	77	76	77	76
Model robustness tests	**Model 1**	**Model 2**	**Model 3**	**Model 4**	**Model 5**	**Model 6**	**Model 7**	**Model 8**
Jointly statistically significant (F-test)	✓	✓	✓	✓	✓	✓	✓	✓
Linearity	✓	✓	✓	×	✓	✓	✓	×
Homoscedasticity	✓	✓	✓	✓	✓	✓	✓	✓
Normality	✓	×	✓	✓	✓	✓	✓	✓
Chow / Pooling test	✓	✓	✓	✓	✓	✓	✓	✓
Test of pooled OLS versus RE	RE	RE	RE	RE	RE	FE	RE	RE
Hausman test for FE	RE	RE	RE	RE	FE	FE	FE	FE
Consistency with a priori expectations of magnitude / signs	✓	✓	✓	✓	✓	✓	✓	✓
Consistency with other parts of the price control	✓	✓	✓	✓	✓	✓	✓	✓
Is the mean VIF less than 10?	×	×	×	×	✓	✓	✓	✓
Is the max VIF less than 10?	×	×	×	×	✓	✓	✓	✓
Joint significance of quadratic term	✓	✓	×	×	N/A	N/A	N/A	N/A
Sensitivity of estimated coefficients to removal of least efficient company	✓	×	✓	×	✓	✓	✓	✓

	Model 1	Model 2	Model 3	Model 4	Model 5	Model 6	Model 7	Model 8
Sensitivity of estimated coefficients to removal of most efficient company	✓	✓	✓	✓	✓	✓	✓	✓
Sensitivity of estimated coefficients to removal of individual years	✓	✓	✓	✓	✓	✓	✓	✓
Within sample forecasting power	✓	×	×	×	✓	✓	✓	×
Stability of NIW efficiency score	✓	✓	✓	✓	✓	✓	✓	×
Efficiency gaps	**Model 1**	**Model 2**	**Model 3**	**Model 4**	**Model 5**	**Model 6**	**Model 7**	**Model 8**
2012/13	-15.2%	-13.2%	-13.2%	-15.5%	-9.9%	-10.5%	-15.6%	-20.2%
2013/14	-15.7%	-16.8%	-13.9%	-15.2%	-8.9%	-11.2%	-13.6%	-17.6%
2014/15	-11.2%	-10.4%	-9.8%	-10.1%	-7.7%	-10.0%	-14.2%	-16.4%
2015/16	-3.8%	-6.3%	-7.2%	-11.9%	-2.9%	-5.6%	-4.8%	-10.3%
2016/17	-1.4%	-3.1%	-2.7%	-7.5%	-0.5%	-4.6%	-5.6%	-11.2%
2017/18	-3.5%	-3.8%	-3.5%	-5.3%	-2.7%	-4.0%	-4.6%	-8.7%
2018/19	1.8%	3.5%	1.3%	-1.5%	-2.7%	-7.3%	-5.4%	-11.9%

*Note: Significant at the * 10% level, ** 5% level, *** 1% level. Ticks (crosses) indicate that the model passes (fails) that specific model robustness test.*

B.2.2. Capital maintenance sensitivity results

Table B.5: Wholesale sewerage sensitivity results, capital maintenance

	Model 1	Model 2	Model 3	Model 4	Model 5	Model 6	Model 7	Model 8
Total length of sewers	0.695***	0.693***	0.695***					0.842***
Total load				0.676***	0.665***	0.661***	0.796***	
% sewer laid / structurally refurbished post-2001 per km sewers		-0.008				-0.007	-0.005	-0.006
% of load treated in complexity bands 1 to 3							0.049	0.052
Connections per length of sewers	-21.988***	-21.776***	1.100**	0.555	-18.115**	-17.939***	-23.266***	-28.189***
Connections per length of mains squared	2.796***	2.763***			2.263**	2.236***	2.911***	3.585***
Post-2014/15 UK GAAP accounting treatment	-0.196**	-0.178**	-0.229***	-0.215**	-0.189**	-0.172**	-0.178**	-0.186**
Constant	40.455***	40.248***	-7.051***	-6.167***	32.341**	32.214**	40.699***	50.870***
Overall predictive power	82.4%	84.2%	77.5%	79.3%	82.5%	84.1%	85.6%	86.0%
Number of observations	77	76	77	77	77	76	76	76
Model robustness tests	**Model 1**	**Model 2**	**Model 3**	**Model 4**	**Model 5**	**Model 6**	**Model 7**	**Model 8**
Jointly statistically significant (F-test)	✓	✓	✓	✓	✓	✓	✓	✓
Linearity	✓	×	×	✓	×	×	×	✓
Homoscedasticity	✓	✓	✓	✓	✓	✓	✓	✓
Normality	✓	✓	✓	✓	✓	✓	✓	✓
Chow / Pooling test	✓	✓	✓	✓	✓	✓	✓	✓
Test of pooled OLS versus RE	RE	RE	RE	RE	RE	RE	RE	RE
Hausman test for FE	RE	RE	RE	RE	RE	RE	RE	RE
Consistency with a priori expectations of magnitude / signs	✓	✓	✓	✓	✓	✓	✓	✓
Consistency with other parts of the price control	✓	✓	✓	✓	✓	✓	✓	✓
Is the mean VIF less than 10?	×	×	✓	✓	×	×	×	×
Is the max VIF less than 10?	×	×	✓	✓	×	×	×	×
Joint significance of quadratic term	✓	✓	N/A	N/A	✓	✓	✓	✓
Sensitivity of estimated coefficients to removal of least efficient company	✓	✓	✓	✓	✓	✓	✓	✓

	Model 1	Model 2	Model 3	Model 4	Model 5	Model 6	Model 7	Model 8
Sensitivity of estimated coefficients to removal of most efficient company	✓	✓	✓	✓	✓	✓	✓	✓
Sensitivity of estimated coefficients to removal of individual years	✓	✓	✓	✓	✓	✓	✓	✓
Within sample forecasting power	✓	×	✓	✓	×	×	×	×
Stability of NIW efficiency score	✓	×	×	×	×	×	✓	✓
Efficiency gaps	**Model 1**	**Model 2**	**Model 3**	**Model 4**	**Model 5**	**Model 6**	**Model 7**	**Model 8**
2012/13	-10.3%	-7.5%	-22.2%	-18.7%	-4.9%	-2.3%	-9.9%	-11.6%
2013/14	-22.9%	-19.6%	-37.0%	-32.2%	-20.4%	-16.0%	-16.6%	-18.8%
2014/15	-3.7%	0.1%	-17.4%	-11.6%	-2.7%	1.7%	4.4%	1.5%
2015/16	-13.2%	-11.2%	-33.2%	-30.4%	-15.6%	-14.1%	-8.9%	-13.8%
2016/17	-12.2%	-9.6%	-33.5%	-28.1%	-12.2%	-10.0%	-17.4%	-15.0%
2017/18	-2.6%	-3.5%	-13.5%	-15.2%	-6.1%	-7.2%	-10.3%	-11.0%
2018/19	-13.7%	-13.1%	-29.4%	-31.0%	-18.9%	-16.5%	-16.8%	-14.0%

*Note: Significant at the * 10% level, ** 5% level, *** 1% level. Ticks (crosses) indicate that the model passes (fails) that specific model robustness test.*

B.2.3. Botex sensitivity results

Table B.6: Wholesale sewerage sensitivity results, botex

	Model 1	Model 2	Model 3	Model 4	Model 5	Model 6
Total length of sewers	0.947***	0.920***			0.835***	0.946***
Total load			0.905***	0.878***		
% of load treated in complexity bands 1 to 3	0.066***	0.059***	0.065***	0.058***	0.029	0.084***
% sewer laid or structurally refurbished post-2001		-0.008*		-0.007*	-0.009*	-0.004
Volume of trade effluent as a % of volume of wastewater						0.073***
Connections per length of mains	-20.175***	-19.007***	-14.646***	-13.678***	0.895**	2.507***
Connections per length of mains squared	2.591***	2.438***	1.834***	1.709***		
Constant	34.308***	32.489***	22.754***	21.351***	-6.963***	-15.487***
Overall predictive power	94.6%	96.1%	95.2%	96.4%	92.5%	96.0%
Number of observations	77	76	77	76	76	76
Model robustness tests	**Model 1**	**Model 2**	**Model 3**	**Model 4**	**Model 5**	**Model 6**
Jointly statistically significant (F-test)	✓	✓	✓	✓	✓	✓
Linearity	×	×	×	×	×	×
Homoscedasticity	×	✓	✓	✓	✓	✓
Normality	✓	✓	✓	✓	✓	✓
Chow / Pooling test	✓	✓	✓	✓	✓	✓
Test of pooled OLS versus RE	RE	RE	RE	RE	RE	RE
Hausman test for FE	RE	RE	RE	RE	RE	FE
Consistency with a priori expectations of magnitude / signs	✓	✓	✓	✓	✓	✓
Consistency with other parts of the price control	✓	✓	✓	✓	✓	✓
Is the mean VIF less than 10?	×	×	×	×	✓	✓
Is the max VIF less than 10?	×	×	×	×	✓	×
Joint significance of quadratic term	✓	✓	✓	✓	N/A	N/A
Sensitivity of estimated coefficients to removal of least efficient company	✓	✓	✓	✓	×	✓
Sensitivity of estimated coefficients to removal of most efficient company	✓	✓	✓	✓	✓	✓
Sensitivity of estimated coefficients to removal of individual years	✓	✓	✓	✓	✓	✓
Within sample forecasting power	✓	✓	✓	✓	×	✓
Stability of NIW efficiency score	✓	✓	✓	✓	×	✓
Efficiency gaps	**Model 1**	**Model 2**	**Model 3**	**Model 4**	**Model 5**	**Model 6**
2012/13	-6.9%	-9.9%	-4.9%	-6.3%	-21.3%	-27.4%
2013/14	-14.3%	-15.4%	-10.1%	-11.6%	-28.9%	-19.6%

	Model 1	Model 2	Model 3	Model 4	Model 5	Model 6
2014/15	0.0%	-0.2%	1.1%	2.8%	-17.9%	1.0%
2015/16	-7.8%	-8.3%	-5.7%	-4.7%	-25.6%	-5.4%
2016/17	-7.8%	-7.0%	-8.1%	-5.5%	-23.9%	-4.7%
2017/18	0.3%	-1.5%	-2.4%	-0.3%	-18.7%	5.5%
2018/19	-0.9%	0.4%	-8.1%	-6.2%	-12.1%	0.0%

*Note: Significant at the * 10% level, ** 5% level, *** 1% level. Ticks (crosses) indicate that the model passes (fails) that specific model robustness test.*

Appendix C FURTHER BOTEX ANALYSIS

In the previous appendix we introduced botex modelling which combines both opex and capital maintenance expenditure as the dependent variable and is used as a cross-check sensitivity for the more disaggregated models.

In this appendix we provide further discussion of the botex results; compare the output of the botex models (e.g. model predicted costs) with the output from the separate opex and capital maintenance models; and compare the wholesale water botex model results with Ofwat's PR19 econometric cost models.

Based on the analysis presented, we conclude that the botex model results support the separate opex and capital maintenance model results discussed in the main report. However, the botex model results do not perform as well against the model sensitivity tests relative to the separate opex and capital maintenance models, and the wholesale water botex models have a larger efficiency score range relative to Ofwat's PR19 wholesale water botex models. For these reasons, we consider that the UR should focus on the separate opex and capital maintenance model results presented in the main report when setting NI Water's PC21 wholesale opex and capital maintenance allowances.

The remainder of this appendix is set out as follows:

- Botex model discussion
- Comparison to disaggregated models
- Comparison to Ofwat's PR19 modelling

C.1. BOTEX MODEL DISCUSSION

Overall, the wholesale water botex models presented in Table B.3 above perform well against our assessment criteria. But they do not perform as well against the model sensitivity tests relative to the separate opex and capital maintenance models. A summary of the findings is as follows:

- Botex models 1 to 4 broadly reflect the specifications of the preferred opex and capital maintenance models. Models 5 to 8 provide alternative sensitivities that consider complexity variables. The botex models do not include a dummy to reflect the accounting change as this is captured via the combination of opex and capital maintenance.
- The estimated coefficients on the explanatory variables all have a plausible sign and magnitude. Where an explanatory variable is included in both opex and capital maintenance models, the estimated magnitude in the botex models is generally within the range estimated by the disaggregated models. For example, the unweighted average magnitude for length of mains is 0.992 in the opex models, 1.219 in the capital maintenance models, and 1.055 across the botex models.
- Most explanatory variables are individually significant at least at the 10 percent significance level. The exceptions generally follow those discussed in section 5.3 i.e.:
    - The number of booster pumping stations per length of mains in Model 5.
    - 'Connections per length of mains' and 'connections per length of mains squared' are not individually significant when both included in a model (except in Model 8 where the squared term is individually significant at the 10% level). However, in all cases the variables are jointly statistically significant.
- All the models perform well in terms of goodness of fit, with an adjusted R-squared of over 95%. Most models also satisfy the within sample forecasting test, indicating the models could reasonably be used to predict wholesale botex allowances.

- However, the models do not perform as well against the sensitivity tests relative to the standalone opex and maintenance models. For example, two models are sensitive to the removal of the least efficient company, and efficiency results are unstable in four out of eight models.
- Models 2, 4, 6, and 8 fail the linearity test (RESET), which may indicate that a different functional form could perform better. For example, this may mean there is a more complicated relationship between botex and the age of the network. However, more complex functional forms increase complexity whilst not always producing better results.
- The models generally perform well against other tests, most of which we place low emphasis on. For example, all the models satisfy normality and pooling assumptions, and only Model 6 does not satisfy the homoscedasticity test.

Similarly, the wholesale wastewater botex models presented in Table B.6 generally perform well against our assessment criteria.

A summary of the findings is as follows:

- Botex models 1 to 2 broadly reflect the specifications of the preferred opex and capital maintenance models. Models 3 to 6 are sensitivities that consider a different possible volume variable or remove the quadratic term.
- The estimated coefficients on the explanatory variables all have a plausible sign and magnitude. They are all statistically significant to at least the 10% level, with the exceptions of the complexity variable in Model 5 and the network age variable in Model 6.
- The models perform well in terms of goodness of fit, with an adjusted R-squared consistently well over 90%, and as expected generally fall in between the goodness of fit of the opex and capital maintenance models.
- The models perform well against tests assessing the stability of results. All models except for Model 5 are stable to the removal of data points, satisfy within sample forecasting expectations and have efficiency scores that are stable in most models.
- The models generally perform well in the other tests. All pass the normality and pooling tests and only Model 1 fails to satisfy the homoscedasticity assumption. However, all models do not pass the linearity test, which may indicate that a different functional form could perform better. However, as discussed in the main report more complex functional forms increase complexity whilst not always producing better results.

C.2. COMPARISON TO DISAGGREGATED MODELS

Figure C.1 and Figure C.2 consider how similar the outputs of the two modelling approaches are to each other in terms of predicted costs. The darker blue bar reflects the sum of predicted average costs from the opex and capital maintenance models, while the lighter blue bar is the average expenditure the botex models predict for a typical water and wastewater company with NI Water's characteristics.[52] The red line reflects NI Water's actual expenditure in a given year.

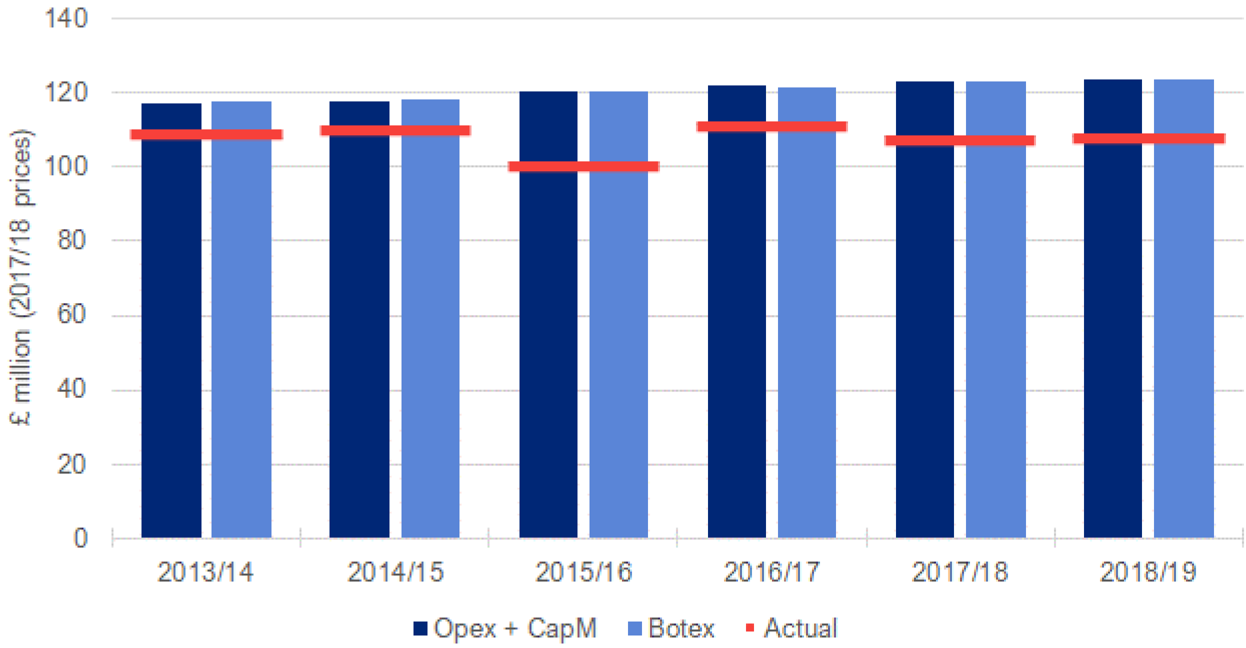
The figures show that the two approaches result in very similar final predicted costs. The figure also reflects the results found in Section 7 of the main report, which showed that NI Water generally appear more efficient in wholesale water than wholesale sewerage.

A comparison of the efficiency gaps implied by the different modelling approaches is challenging to do in a simple and consistent manner. Reasons for this include:

- botex model specifications are not always aligned with the opex and capital maintenance model specifications as each has been developed independently according to our model development process;
- the relative weight of opex and capital maintenance efficiency gaps must account for the changing levels of associated expenditure over time; and
- efficiency rankings may differ between opex, capital maintenance and botex models, leading to differences in the upper quartile company between the disaggregated modelling approach (i.e. separate opex and capital maintenance models) and botex modelling approach.

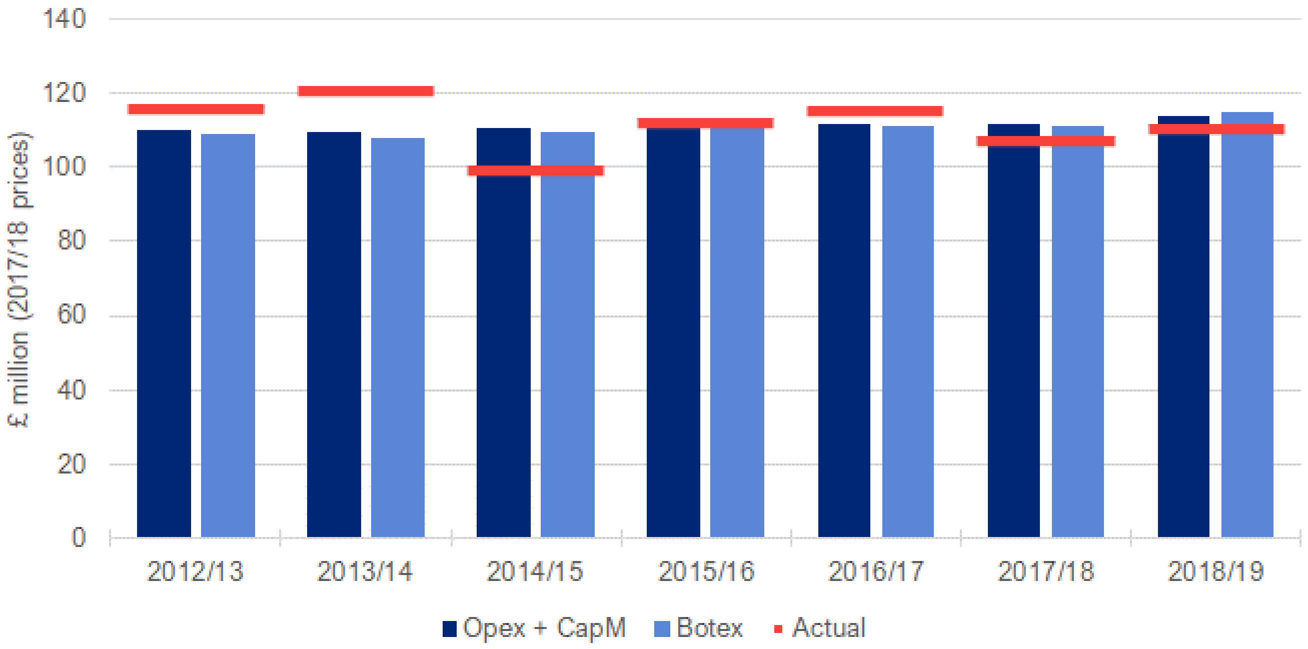
Overall, however, we believe the similarity in average predicted costs between the two approaches is sufficient to support the conclusion that the disaggregated opex and capital maintenance models are consistent with the botex model results.

Figure C.1: Comparison of disaggregated and botex models, wholesale water



[52] For illustration purposes only, we apply an equal weight to each selected opex, capital maintenance and botex model in order to compare results. We focus on average predicted costs rather than upper quartile predicted costs because the upper quartile benchmark may differ between the opex, capital maintenance and botex model results, which would make comparisons challenging.

Figure C.2: Comparison of disaggregated and botex models, wholesale sewerage



C.3. Comparison to Ofwat PR19 cost modelling

It is challenging to make comparisons with Ofwat's PR19 cost modelling for several reasons:

- **Ofwat developed models at different levels of cost disaggregation**. For example, Ofwat did not develop combined sewage treatment and collection cost models. This means it is not possible to compare our botex sewerage model results with Ofwat's PR19 cost model results.
- **Ofwat included growth related enhancement capex** in their econometric base cost models for draft and final determinations. Whereas, growth related enhancement capex is not included in our botex models.
- **Model specifications are not always aligned**, which means it is not possible to make direct comparisons between results.
- **Different underlying time periods**. For example, our wholesale water botex models for PC21 were developed using data from 2013/14 to 2018/19. Whereas, Ofwat's PR19 botex models at the initial assessment of plans were developed using data from 2011/12 to 2017/18.
- **Data amendments**. Data amendments have been made since Ofwat published its initial assessment of business plans (IAP) econometric cost models.

We focus the comparison on the wholesale water botex models 3 and 8 presented in this report and Ofwat's IAP wholesale water botex models as we consider these make for the most meaningful comparison because the model specifications are reasonably comparable and the Ofwat IAP models exclude growth related enhancement capex. However, comparisons remain difficult to make due to some of the reasons listed above.

Table 9.9 presents selected CEPA PC21 wholesale water botex results and *Table 9.10 presents Ofwat's PR19 IAP wholesale water botex models. We include the econometric model results and average efficiency scores (actual costs divided by predicted costs) for the water companies included in the sample.*

Overall, there are some material differences between the two sets of results:

- The Ofwat IAP wholesale water models have a higher explanatory power and include explanatory variables that generally appear more statistically significant.
- The Ofwat IAP wholesale water models have a lower spread of average efficiency scores. For example, the largest efficiency score across both Ofwat wholesale water botex models is 1.17 (i.e. 17% less efficient that the average efficient company). This compares to the largest efficiency score across CEPA PC21 wholesale water botex models of 1.29 (i.e. 29% less efficient that the average efficient company).

If it is difficult to say with any confidence whether the differences between the two sets of results identified above are caused by the inclusion of NI Water into the dataset. However, there is some limited evidence that the inclusion of NI Water in the sample has widened the spread of efficiency scores between companies.

Table 9.9: Selected CEPA PC21 wholesale water botex results

	Model 3	Model 8
Length of mains	1.065***	1.004***
Number of booster pumping stations per length of mains	0.400**	0.408***
% of water treated in complexity bands 4 to 6	0.006***	
Weighted average treatment complexity		0.758***
Connections per length of mains	-1.684	-2.944
Connections per length of mains squared	0.316	0.475*
Constant	-2.699	-0.382
Overall predictive power	96.8%	97.0%
Number of observations	111	111
Actual Costs / Predicted Costs (2013/14 to 2018/19)		
Northern Ireland Water (NIW)	0.93	0.96
Affinity Water (AFW)	0.95	0.95
Anglian Water (ANH)	0.97	1.01
Bristol Water (BRL)	1.04	0.99
Dee Valley Water (DVW)	0.98	1.00
Northumbrian Water (NES)	0.86	0.94
United Utilities (NWT)	1.06	1.02
Portsmouth Water (PRT)	0.84	0.89
SES Water (SES)	1.20	1.18
South East Water (SEW)	0.97	0.93
Southern Water (SRN)	0.90	0.91
South Staffs Water (SSC)	0.87	0.88
Severn Trent Water (SVT)	0.93	1.08
South West Water (SWB)	1.08	0.97
Thames Water (TMS)	1.26	1.19
Dwr Cymru (WSH)	1.25	1.18
Wessex Water (WSX)	1.21	1.29
Yorkshire Water (YKY)	0.93	0.86

Source: CEPA analysis

Table 9.10: Ofwat PR19 initial assessment of plans wholesale water botex models

	Model 3	Model 8
Number of properties	0.993***	0.984***
Number of booster pumping stations per length of mains	0.515***	0.517***
% of water treated in complexity bands 3 to 6	0.003***	
Weighted average treatment complexity		0.371***
Connections per length of mains	-1.711***	-1.473***
Connections per length of mains squared	0.126***	0.109***
Constant	-1.273	-2.267**
Overall predictive power	98%	98%
Number of observations	124	124
Actual Costs / Predicted Costs (2011/12 to 2017/18)		
Affinity Water (AFW)	1.01	0.99
Anglian Water (ANH)	1.07	1.03
Bristol Water (BRL)	1.02	0.97
Dee Valley Water (DVW)	0.82	0.84
Northumbrian Water (NES)	0.97	0.96
United Utilities (NWT)	1.06	1.06
Portsmouth Water (PRT)	0.82	0.85
SES Water (SES)	1.11	1.11
South East Water (SEW)	1.01	1.01
Southern Water (SRN)	0.94	0.94
South Staffs Water (SSC)	0.99	0.97
Severn Trent Water (SVT)	1.00	1.02
South West Water (SWB)	0.98	0.99
Thames Water (TMS)	1.03	1.03
Dwr Cymru (WSH)	1.17	1.17
Wessex Water (WSX)	0.96	0.95
Yorkshire Water (YKY)	0.81	0.82

Source: Ofwat (https://www.ofwat.gov.uk/initial-assessment-of-business-plans-cost-assessment-models/)

Appendix D UPPER QUARTILE PREDICTED COSTS

This appendix presents NI Water's modelled upper quartile efficient costs (2017/18 prices) which are used to estimate NI Water's catch-up efficiency gap in Section 7 (before application of special cost factors) and Section 8.5 (after application of special cost factors).[53] In other words, this is our prediction of what NI Water's costs would be if the company were operating at the upper quartile benchmark.

An illustrative example is provided in Table 9.11 to show how we have calculated NI Water's UQ predicted costs for each model **before consideration of special cost factors (SCFs)**.

Table 9.11: Illustrative upper quartile predicted costs calculation before SCFs

Column	Item	Formula	Example
A	Actual Cost (excluding atypical costs)		£100m
B	Predicted Average Modelled Costs		£89.5m
C	Efficiency Score of UQ Company		0.95
D	Predicted UQ Modelled Costs (before SCFs)	B * C	£85m

Source: CEPA analysis

An illustrative example is provided in Table 9.12 to show how we have calculated NI Water's UQ predicted costs for each model **after consideration of SCFs**.

Table 9.12: Illustrative upper quartile predicted costs calculation after SCFs

Column	Item	Formula	Example
A	Actual Cost (excluding atypicals)		£100m
B	Predicted Average Modelled Costs		£89.5m
C	SCFs adjustment		£5.5m
D	Predicted Average Modelled Costs + SCFs	B + C	£95.0m
E	Efficiency Score of UQ Company		0.95
F	Predicted UQ Modelled Costs (after SCFs)	D * E	£90.2m

Source: CEPA analysis

[53] A multiplier of 1.0306 would need to be applied to convert costs from a 2017/18 price base to a 2018/19 price base.

D.1. Upper quartile predicted costs (before SCFs)

D.1.1. Wholesale water opex

Table 9.13: NI Water wholesale water UQ predicted costs £m 2017/18 prices – opex (before SCFs)

	Model 1	Model 2	Model 3
2013/14	66.3	67.3	63.8
2014/15	66.0	66.5	65.6
2015/16	65.2	62.6	61.9
2016/17	66.7	65.4	62.1
2017/18	66.4	65.9	62.4
2018/19	68.5	70.2	67.7
Weighted Average (2013/14 to 2018/19)	70.3	67.0	65.1

Source: CEPA analysis

D.1.2. Wholesale water capital maintenance

Table 9.14: NI Water wholesale water UQ predicted costs £m 2017/18 prices - capital maintenance (before SCFs)

	Model 1	Model 2	Model 3	Model 4
2013/14	41.5	43.0	41.3	42.7
2014/15	36.7	38.4	36.5	36.1
2015/16	32.7	31.3	32.6	29.6
2016/17	40.4	39.4	40.3	37.6
2017/18	45.1	43.0	44.9	40.9
2018/19	43.3	42.9	43.2	41.3
Weighted Average (2013/14 to 2018/19)	41.4	41.9	41.1	40.4

Source: CEPA analysis

D.1.3. Wholesale sewerage opex

Table 9.15: NI Water wholesale sewerage UQ predicted costs £m 2017/18 prices - opex (before SCFs)

	Model 1	Model 2
2012/13	51.0	52.2
2013/14	50.8	50.2
2014/15	51.9	52.4
2015/16	55.5	54.1
2016/17	55.8	54.8
2017/18	52.0	51.9
2018/19	55.3	56.2
Weighted Average (2016/17 to 2018/19)	54.4	54.2

Source: CEPA analysis.

D.1.4. Wholesale sewerage capital maintenance

Table 9.16: NI Water wholesale sewerage UQ predicted costs £m 2017/18 prices - capital maintenance (before SCFs)

	Model 1	Model 2
2012/13	49.9	51.4
2013/14	46.5	48.5
2014/15	39.1	40.7
2015/16	47.3	48.4
2016/17	51.6	53.1
2017/18	51.6	51.1
2018/19	48.3	48.7
Weighted Average (2012/13 to 2018/19)	51.3	52.7

Source: CEPA analysis.

D.2. Upper quartile predicted costs (after special cost factors)

D.2.1. Wholesale water opex

Table 9.17: NI Water wholesale water UQ predicted costs £m 2017/18 prices – opex (after SCFs)

	Model 1	Model 2	Model 3
2013/14	65.5	65.5	61.6
2014/15	64.0	65.7	62.8
2015/16	61.9	59.5	58.0
2016/17	62.9	60.5	57.2
2017/18	62.5	61.5	58.1
2018/19	65.2	66.3	63.1
Weighted Average (2013/14 to 2018/19)	66.8	64.7	61.2

Source: CEPA analysis

D.2.2. Wholesale water capital maintenance

Table 9.18: NI Water wholesale water UQ predicted costs £m 2017/18 prices - capital maintenance (after SCFs)

	Model 1	Model 2	Model 3	Model 4
2013/14	38.3	40.4	38.0	39.3
2014/15	33.8	35.3	33.6	33.0
2015/16	30.7	29.3	30.6	27.6
2016/17	37.4	36.3	37.2	34.5
2017/18	42.3	40.1	42.1	38.7
2018/19	40.7	40.3	40.5	39.0
Weighted Average (2013/14 to 2018/19)	39.6	39.8	39.4	37.6

Source: CEPA analysis

D.2.3. Wholesale sewerage opex

Table 9.19: NI Water wholesale sewerage UQ predicted costs £m 2017/18 prices - opex (after SCFs)

	Model 1	Model 2
2012/13	50.8	52.0
2013/14	49.4	48.7
2014/15	49.3	49.7
2015/16	51.3	50.0
2016/17	51.1	49.8
2017/18	48.3	48.1
2018/19	53.5	53.7
Weighted Average (2016/17 to 2018/19)	50.7	50.0

Source: CEPA analysis.

D.2.4. Wholesale sewerage capital maintenance

Table 9.20: NI Water wholesale sewerage UQ predicted costs £m 2017/18 prices - capital maintenance (after SCFs)

	Model 1	Model 2
2012/13	45.1	46.5
2013/14	41.7	43.5
2014/15	37.8	39.3
2015/16	42.9	43.9
2016/17	46.4	47.8
2017/18	47.2	46.4
2018/19	43.8	43.9
Weighted Average (2012/13 to 2018/19)	46.6	47.8

Source: CEPA analysis.

CEPA
economics matters

UK

Queens House

55-56 Lincoln's Inn Fields

London WC2A 3LJ

T. **+44 (0)20 7269 0210**

E. **info@cepa.co.uk**

www.cepa.co.uk

Australia

Level 20, Tower 2 Darling Park

201 Sussex St

Sydney NSW2000

T. **+61 2 9006 1307**

E. **info@cepa.net.au**

www.cepa.net.au

in cepa-ltd @cepaltd