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Our Ref:W/029/Eff/COLS/JA/326

Your Ref:

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Dear Ronan

NIAUR Approach to Operational Efficiency Targets

Some weeks previous we issued our methodological note on how we might set capital efficiency targets based upon the Cost Base. This was part of the Regulators on-going commitment in relation to transparency. In similar vein, we have endeavoured to set out the various approaches and assumptions we consider likely to be used in the calculation of operational efficiency targets.

Our primary modelling approach we intend to use to inform our triangulated approach to setting operational efficiency targets is COLS (corrected ordinary least squares) allied to use of a “top-down” approach to inform the likely maximum target range based upon precedent within regulated industries. This approach and our considered alternatives (panel data modelling and Stochastic Frontier Analysis) are outlined in the attached Annex A.

We shall continue using our triangulated approach to setting efficiency targets as we remain convinced there is no single approach to efficiency modelling capable of producing a single point estimate for target setting purposes.

Compared to the range of assumptions available to us for the Cost Base, the choices we face when undertaking our COLS efficiency modelling are more extensive and include:-

- **Re-specification of the water distribution model** (see Section 10.3, page 19) - whether or not to seek an alternative water distribution model rather than use the new Ofwat version, since NI Water figures represent a significant outlier in terms of the explanatory variable;
- **Adjusted or unadjusted modelling** (see Section 10.4, page 20) – we are minded to continue efficiency modelling using an unadjusted COLS approach;
- **Special factors & atypical expenditure adjustment** (see Section 10.5, page 21) – we have analysed NI Water’s recent re-submission in light of the new water distribution model published by Ofwat and our initial decisions are the subject to separate reports already forwarded to you on 21st April 2009 (“Determination of NI Water’s Special Factors Claim” and “Determination of NI Water’s Atypical Expenditure Claim”);
- **Discounts and efficiency bands** (see Section 10.6, page 22) – we intend to model using both Ofwat and Cubbin’s discounts and triangulate around a central estimate of efficiency as in previous years. We reserve judgement on whether to adopt an efficiency banding approach until determination stages;
- **Choice of benchmark** (see Section 10.7, page 25) – we intend triangulating around the available options including taking NI Water to the industry frontier or the celtic fringe. We do so in recognition of early analysis which indicates that for NI Water a significant efficiency challenge remains;
- **Continuing efficiency or frontier shift** (see Section 10.8, page 26) – we are minded to adopt the same considerations as Ofwat published recently, namely 0 per cent relative to the RPI for both water and sewerage services. Our view may alter if we decide to materially uplift NI Water’s allowed operating expenditure across PC10 for likely cost pressures;
- **Controllable/uncontrollable costs** (see Section 11.7, page 29) – once we have derived our efficiency targets we are minded to apply these to all of NI Water’s PC10 operating expenditure. There may be some scope for NI Water to argue the exclusion of BIP and VER costs from PC10 efficiencies on an exceptional basis, based on our interpretation of an existing WICS precedent and subject to the constraints outlined in our “Determination of NI Water’s Atypical Expenditure Claim” paper;
- **Excluded models** (see Section 11.8, page 30) – given continuing deferral of domestic charging we are minded to exclude both water and sewerage business activities models from our COLS efficiency modelling to ensure robust and “like for like” comparison of NI Water to the E&W industry;
- **Treatment of PPPs** (see Section 11.9, page 31) – our analysis is predicated upon AIR08 data, pre-dating the Alpha and Omega contracts. We are minded to allow NI Water to use the widely anticipated savings from these PPPs to meet or even outperform new operational efficiency targets going forward; and,

- **Rate of catch-up** (see Section 12, page 32) – we are minded to apply a high catch-up rate rather than at a level comparable to Ofwat's.

Such a wide availability in assumptions is based primarily upon best regulatory practice and experience elsewhere, alongside specialist advice we obtained from our consultants NERA. Whilst no final determination has been decided we consider it prudent to have taken this opportunity to advise NI Water of the likely approach we are minded to adopt, and in particular to have done so in advance of the company's PC10 Business Plan.

I would welcome any comments or representation you might wish to make up to the date of submission and/or included within NI Water's PC10 Business Plan submission on 1st June 2009.

Yours sincerely



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Director of Water Regulation

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