PC13 Information Requirements
Chapter 2 – Operational Costs and Efficiency

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Chapter 2 - Operational Costs and Efficiency

2.1. Efficiency Improvements

Outline

2.1.1. In developing its final business plan the company should decide on the scope for it to improve its efficiency in the next price limit period. Constraints on making the maximum use of this scope should be explained.

2.1.2. The company should:

- Set out its views on the scope for improvements in efficiency and the evidence on which they are based;
- Explain how they lead to its assumptions about cost reductions from current levels that it has included in its strategy; and
- Describe how the assumed improvements have been incorporated in the business plan expenditure projections.

2.1.3. These judgements should be informed by the company's view of:

- Its expectation for improvements in efficiency which the best company could achieve year by year;
- Its relative efficiency or inefficiency to its peers within the regulated industry;
- The findings of any benchmarking studies it has carried out; and
- The pace of improvements over the period.

2.1.4. The company should refer to any benchmarking studies it has conducted and explain how these and other studies have informed the assessments.

2.1.5. We suggest that the efficiency chapter should be divided into three sections:

Table 2.1 - Approach to Efficiency Chapter

Efficiency improvements	
Section 1	Overall approach to assessing the scope for catch-up improvements in efficiency during the PC13 period.
Section 2	Assessment of frontier shift efficiency improvements.
Section 3	Scope for efficiency improvements for PPP schemes.

2.1.6. The company should make any assessments of relative efficiency using 2010-11 as the base year for both output delivery and costs incurred.

2.1.7. The company should explain how it intends to meet its efficiency assumptions including where they will be made. The company should confirm that its efficiency assumptions can be met, without increasing the risk of service or quality compliance failure.

2.1.8. The company may wish to provide details of studies undertaken both to arrive at its relative efficiency assessment and also the scope for general improvement in efficiency.

Efficiency Assessment

2.1.9. The efficiency table asks for improvements in efficiency judgements to be set down for:

- Block A: Operating expenditure efficiency (base).
- Block B: Operating expenditure efficiency (enhancements).
- Block C: Operating expenditure efficiency (PPP schemes).

2.1.10. This assessment should reflect the total efficiency assumptions i.e. for both the water and sewerage service[1].

Approach – Minimum plus catch-up judgements

2.1.11. The approach is structured around five steps. The five steps are:

[1] *Note: Improvements in efficiency should be entered as in the following example, 4.5% should be entered as 4.5, not 0.045.*

1. The view the company takes of its efficiency relative to its peers within the regulated water industry. The company is asked to band its assessment on the scale A to E as set down in the Ofwat efficiency reports 'Relative Efficiency Assessment'. This view will be informed by NIAUR's work on comparative efficiency as well as the company's own analysis.

Table 2.2 - Relative Efficiency Bandings

Relative efficiency banding	
A	Most efficient
B	Above average efficiency
C	Average efficiency
D	Below average efficiency
E	Least efficient

2. Following this view the company would be in a position to reach a conclusion on the scope for it to catch-up with the best in the industry and the proportion of this catch-up that it is prepared to include in its expenditure forecasts.

3. The company then sets down its decisions on the rate of catch-up that it has assumed over the period (either applied from 2010-11 or for PC13 only).

4. The company then makes an assessment of the minimum level of improvements in efficiency, year on year that it is reasonable to assume in price setting for even the most efficient companies. These judgements could be applied from the 2010-11 base year costs or from the first year of new price limits.

5. The final step calculates the aggregate improvement year by year from the separate judgements of minimum level of improvements (step 4) and the rate of catch-up (step 3). The particular percentage reductions in costs are compounded in the final line in each year.

Table 2.3 - Worked Example from Ofwat of Base Opex Efficiency Application

Line description		Units	Assessment AMP 4	AMP 3		AMP 4					AMP 5
				2003-04	2004-05	2005-06	2006-07	2007-08	2008-09	2009-10	2010-11
A	**OPERATING EXPENDITURE EFFICIENCY (BASE)**										
1	Assessment of relative efficiency	Band	D								
2	Assessment of scope for catch-up(base)/ assumed Profile year on year	%	30	0	0	6.9	6.9	6.9	6.9	6.9	0
3	Assumed minimum level of efficiency improvements/assumed profile year on year(base)	%	1.0	1.0	1.0	1.0	1.0	1.0	1.0	1.0	1.0
4	Opex – Overall compounded assumed profile (base)	%		1.0	2.0	9.7	16.7	23.2	29.2	34.8	35.4

Worked Example - Step-By-Step Approach

- Step 1 – The company reaches a judgement that its current performance is below average hence enters a D banding in line 1.

- Step 2 – After reviewing all the evidence the company concludes that it would need to improve its efficiency by 30% to catch-up with the best in the industry.

- Step 3 – The company considers that they will achieve this catch-up evenly over the AMP 4 period. The entries in line 2 are 6.9% p.a. for years 3 to 7, such that the 30% is shared out geometrically.

- Step 4 – The company reaches a judgement that 2% per annum improvement in efficiency is what an efficient company might reasonably be expected to achieve as a minimum. However the company considers it needs an incentive to drive through this level of improvements such that only part of this level of improvements should be assumed up front for customers in price limits set in 2004.

  The company decides to divide the scope 50/50 between customers and the company hence enters a 1% per annum improvement year on year. Of course any out-performance of this figure would be passed through to customers at the subsequent price control. The company has based its forward projections of expenditure on the 2002-03 level so the 1% p.a. applies from that base.

- Step 5 – The per annum improvements from steps 1 and 4 are compounded to produce the overall assumed cumulative improvement profile in line 4[2].

2.1.12. The following table illustrates how catch-up efficiencies would be shared on a geometric basis over 2, 4 or 5 years. The table gives the p.a. catch-up figure for each of the years.

[2] *Note: Positive figures are shown in the table as these represent improvements in efficiency. Costs would reduce by these figures to reflect the delivery of the improvements.*

Table 2.4 - Geometric Mean Calculations

Geometric Mean Calculations			
Total catch-up (%)	2 years p.a. (%)	4 years p.a. (%)	5 years p.a. (%)
3	1.5	0.8	0.6
4	2.0	1.0	0.8
6	3.0	1.5	1.2
8	4.1	2.1	1.7
9	4.6	2.3	1.9
12	6.2	3.1	2.5
16	8.3	4.3	3.4
20	10.6	5.4	4.4

2.2. Water and Sewerage Opex Expenditure Projection

Outline

2.2.1. In Block A the company is required to input the operating expenditure for 2010-11 (excluding PPP costs). This should be consistent with the relevant data reported in the Annual Information Return 2010-11.

2.2.2. In Block B the company should report the net adjustments to the Block A number that it regards as being above (positive number) or below (negative number) normal continuing expenditure for the base service. Full explanations of these adjustments should be included in the text.

2.2.3. Unusually low expenditure, for example arising from a temporary reduction in pension contributions, should also be quantified and explained. Such adjustments will generally reflect exceptional, atypical and un-appointed activities.

2.2.4. However, certain cost elements which have been excluded from the efficiency analysis should still remain part of the baseline cost in these tables as they are (at least in part) of a controllable nature. Therefore no adjustment should be made for rates, third party costs or doubtful debt.

2.2.5. Block C provides for the company adjustments (up or down) to the adjusted base year to reflect its assessment of its **base service needs** for the PC13 period.

2.2.6. The company should quantify and explain the components of these adjustments in the supporting text, providing supporting information where appropriate. NI Water should detail the base year cost (in 2010-11) for particular opex lines and provide reasons and justification for any change in PC13.

2.2.7. Block D brings forward the company assumptions on efficiency improvements from the efficiency table. This facilitates the calculation of a forecast for base service operating expenditure.

2.2.8. Block E details the costs set aside for business transformation. This includes expenditure associated with Voluntary Early Retirement / Voluntary Severance (VER/VS) packages and Business Improvement Plan projects. How these costs are allocated between tables 2.2 and 2.3 (water and sewage) is of little importance, but should be detailed in the chapter.

2.2.9. The company must provide justification for any proposed transformation expenditure, consisting of an analysis of costs and benefits. Business cases to support expenditure will be accepted if deemed appropriate for submission by the company.

2.2.10. NI Water should provide assurance that any claimed transformation expenditure does not represent double funding. VER/VS costs should be supported by details of headcount reduction, both on an individual basis and on the total company staff levels.

2.2.11. Block E includes Line 9a. This line represents the atypical adjustments made in Line 2. These costs should be added back for the **base year only** in order to provide an appropriate total opex figure for 2010-11.

2.2.12. Block F details the opex costs arising from capital expenditure throughout the PC13 period. These lines are split along the traditional enhancement allocations i.e. quality, enhanced service level and growth.

2.2.13. The company should provide detail as to how these figures have been arrived at. NI Water should further detail instances where opex costs are expected to decrease as a result of capital expenditure.

2.2.14. Block G brings forward the company assumptions on efficiency improvements from table 2.1 to calculate a forecast of enhancement operating expenditure.

2.2.15. Block H reflects the total PPP unitary charge expenditure including PPP interest and capital repayments. The PPP opex element is subject to the assumed efficiency profile as detailed in table 2.1.

2.2.16. Block I provides a sum total of all the elements of opex costs. This should align with the comparable costs in the financial model.

2.3. Total Operational Expenditure

2.3.1. The final table simply provides an overall sum of water and sewerage opex split by:

- Base opex;
- Transformation costs;
- Opex from capex;
- PPP costs; and
- Total operational expenditure.