24th April 2009

To Chief Executive of NIW

WR9: UR Policy Approach for Setting Price Limits for PC10

The purpose of this letter is to set out the approach the Authority is minded to take in setting price limits for the period 2010 to 2013. It sets out our expectations and informs the company of general policy approaches we are minded to deploy. Where ministerial direction or stakeholder engagement may influence policy this has been indicated. It is structured under the headings below:-

- PC10 Business Plan 2010 – 2013 - General
- Operational Expenditure
- Capital Expenditure
- Financial Considerations
- Regulatory Incentives

PC10 BUSINESS PLAN 2010 – 2013 - GENERAL

1.0. The Business Plan submission should provide a clear baseline for the PC10 period and outline the service improvements and outputs delivered between 2007 and 2010 to ensure that customers are not asked to pay for improvements previously funded.

2.0 The Business Plan should provide the necessary assurance that NI Water is delivering the right outputs at the right time and for the right cost. Individual expenditure proposals must include:

- a clearly defined time table and delivery date;
- measurable and defined outputs (including interim "milestones") against which progress can be monitored in subsequent Annual Returns;
- defined asset improvements or changes to operational practices to deliver the required outcomes;
- a statement of support from the relevant stakeholder(s) confirming the proposed outputs are consistent with Ministerial guidance and/or statutory requirements (relevant stakeholders in this context include the Environmental Agency, the DWI and Consumer Council); and,

- identified costs that the Reporter has challenged and verified.

Without the necessary assurance, it is unlikely proposals will be accepted for price capping purposes.

3.0 We are mindful that in the current environment, the company may not be able to provide clearly identified outputs against all the objectives set in the Ministerial Social and Environmental Guidance due to insufficient definition or a lack of adequate data. We are therefore minded to make provision for this type of output where:

- There is continuing support in subsequent revisions to the Ministerial Social and Environmental Guidance.
- We can determine a challenging budget for the delivery of a group of outputs based on appropriate external benchmarks and the advice of the Reporter.
- We have confidence that the outputs can be defined and delivered efficiently through the business plan period.
- The programme for delivery provides time to develop detailed proposals and agree them with relevant stakeholders including the Utility Regulator.
- We have consulted on appropriate governance arrangements with other regulators and have agreed arrangements which we can outline in our determination.

4.0 Where the efficiency targets underpinning the proposed price cap are more challenging than those envisaged by the company we will be consulting with other stakeholders how best to use the financial headroom made available within the expenditure limits set by Government. One option would be to identify and include additional outputs as part of the Final Determination. It is important however that these should reflect the principles outlined above and should not be open ended commitments. We understand the company is including an over profile to the order of 12% of capital over the period which will helpfully facilitate such an approach should we choose to adopt this option.

Logging up and down

5 .0 The scale of capital investment over the Strategic Business Plan period, 2007-2010 represents a significant challenge for NI Water. For this period we were unable to link capital projects to agreed outputs, which renders comprehensive logging up and down, (to reflect differences in cost from the SBP determination and thus the impact on charges for PC10), difficult. We have not therefore requested a formal logging report, however should our analysis of the PC10 submissions identify significant shortfalls from the SBP period we reserve the right to take action as considered appropriate.

6.0 As with any price control period, there will be projects which bridge the gap between business plan periods. We expect the company to separately identify projects contributing to the overhang into PC10.

Treatment of changes to obligations during the PC period.

7.0 Changes to obligations which arise during the PC10 period will be addressed through procedures for logging up/logging down. We are mindful of the impact which public finance limits will continue to have on the application of these procedures..

OPERATING EXPENDITURE (OPEX)

Establishing an operational baseline for PC10

8.0 We would normally expect to use the company's audited accounts for 2007/08 as the starting point for PC10 opex projections. Before we do so, however, the company will have to justify and explain the significant increase in opex which has occurred since 2004/05 (+35.2%) while inflation increased by 10.8% over the same period. This is a matter that will need to be addressed as part of the company's PC10 Business Plan submission.

9.0 Subject to this caveat, our presumption is that, to maintain existing levels of service, the company will be able to manage within current expenditure levels and that, post efficiency; base opex would otherwise decline over time. Consistent with this approach the onus of proof will lie with NI Water to justify any upward pressures on base opex over the review period. In particular it will be expected to show:

- such increases impact disproportionately on the company relative to business generally;
- all reasonable steps have been taken to mitigate the impact; and the scale and scope of the increase(s) can be assessed with reasonable certainty.

In all cases we will expect to see evidence of Reporter challenge and validation of costs to ensure the increases are unavoidable and represent value for money.

10.0 Related to the above we will also expect the company to clearly identify any changes that may distort the underlying level or trend in base opex relative to prior years. This will include changes in accounting allocation and/or adjustments for atypical costs.

Incremental Opex

11.0 Where additional opex is associated with service enhancements or improved quality standards the company will need to demonstrate these are unavoidable and cannot be absorbed within the existing base. The company will need to show:

- there is a clear linkage with additional outputs it is proposing to deliver;
- the additional outputs have the requisite stakeholder support; and
- the increased costs arise from necessary changes in operational practice which have been validated by the Reporter.

Northern Ireland Authority for Utility Regulation
Queens House, 10-14 Queen Street, BELFAST, BT1 6ER
T: +44 (0) 28 9031 1575 F: +44 (0) 28 9031 1740

12.0 With regard to the revenue consequences of capex, we will assume that the opex of refurbished capital asset will be the same or lower than before, and that the company may be expected to absorb any incremental impacts from the efficiencies normally associated with modernising and optimising existing installations.

Opex Efficiency

13.0 Our preliminary analysis suggests NI Water lags well behind the better performing water companies in the rest of the UK. Our expectation therefore is that it will be required to make significant progress in closing the efficiency gap. We recognise however that there is a limit to what can realistically be achieved over a three year period. Our current thinking is to set tough but realistic targets for the PC10 period and to serve notice of indicative targets extending beyond 2013. Commensurate with this approach we will require the company to formulate a detailed action plan as part of its PC10 output requirements. We see this as essential in ensuring progress can be sustained in closing the efficiency gap in the lead up to the PC13 review at which time the indicative targets can be reviewed.

CAPITAL EXPENDITURE (CAPEX)

Establishing a baseline capital investment programme

14.0 Establishing a clearly defined investment programme for the Strategic Business Plan period 2007 – 2010 has proved to be very protracted. Detailed definition of the baseline investment programme brings major benefits for stakeholders and customers and its lack to date has caused difficulties. It is important that this issue does not persist through the PC10 period.

15.0 We have since taking up our role, emphasised the need for a fully defined capital investment programme. At the outset and alongside our persistence in relation to the development of comprehensive Capital Investment Monitoring, we have made clear our requirement for transparency and auditability of the investment programme. The requirement to populate the relevant C5 tables was contained within the first issue (29/08/08) of the PC10 Business Plan Information Requirements. Outputs from, including prioritised projects from the technical working groups should assist in meeting this requirement. Where work is ongoing to define specific locations and projects for unsatisfactory intermittent discharges we expect NI Water to indicate the timeline for such clarity to be forthcoming.

16.0 It is important that, as well as providing a mechanism for monitoring NI Water's performance, a detailed baseline brings other benefits for consumers. Capital projects such as treatment plant upgrades or pipe renewal can have major impacts on consumers and local communities. Consumers are entitled to know about projects that will affect their locality. The existence of a detailed baseline programme will also provide clarity on NI Water's PC10 obligations.

General Comments

17.0 The Company provided a draft PC10 Capex submission to DRD in December 2008. The submission was reported on by the Independent Reporter. Following our review of the submission, we highlighted some key issues regarding the identification of outputs, scope definition and the quality of underlying cost estimates which we expect to be addressed in the company's forthcoming business plan. Specifically:

- proposed investment will be related to a clear set of outputs (including appropriate milestones) agreed with the relevant stakeholders;
- effective use will be made of existing assets in meeting quality and growth objectives before proposing full replacement of existing works;
- the cost estimates underpinning the company's plan will be fully consistent with the final cost base as amended for any fine tuning by the Reporter and/or our own consistency and comparability checks; and
- potential overlaps in the allocation of expenditure between the various purpose categories will be eliminated to ensure outputs are properly accounted for and not funded twice.

Purpose Allocation

18.0 As part of its plan submission NI Water is required to allocate its capex across the four purpose categories specified in the Regulatory Accounting Guidelines, via:

- Base Maintenance
- Quality Enhancements
- Supply: Demand Balance Enhancements
- Levels of Service Enhancements

19.0 We expect the company to rigorously follow the guidelines and we will be asking the Reporter to undertake sample audits to confirm this is the case.

Base Maintenance

20.0 With regard to base maintenance we are conscious that there is insufficient high quality data to support all aspects of the Capital Maintenance Planning Common Framework (CMPCF). Given these data constraint, we are minded to adopt a pragmatic approach for PC10. This will involve setting a reference level for base maintenance based on recent historical performance and spend tested in conjunction with the following:-

- An assessment of the maintenance proposals contained in the company's business plan, including the strength of the case presented and overlaps and synergies with other parts of the plan
- econometric modelling – using Ofwat's capital maintenance models and NI Water explanatory data to predict base maintenance expenditure.

- normalised unit cost benchmarking – using an average E&W industry unit cost (by property, customers or km of pipes, for example) applied to NI Water; and / or,

- recent IRE/MNI - use of AIR08, in absence of any material deterioration in serviceability, as likely to offer first estimate of IRE/MNI spend and base level of performance.

For the avoidance of doubt, Base Maintenance is for maintaining current levels of service. Any improvements in service that NIW wishes to propose for PC10 should be presented as enhancements.

21.0 Looking beyond PC10 we expect the company to adopt a sounder approach to long term asset management planning in line with the principles of the CMPCF. To this end we will require the company to include in its business plan a plan of action setting out the improvements in its processes, management systems and other measures needed to rectify the deficiencies noted above. We note that NI Water is using the AMPAP, (Asset Management Assessment Process[1]) to benchmark its asset management capabilities and we look forward to understanding from the company's business plan what progress has been made (eg through the Business Improvement Programme) and what further steps the company considers are required.

Enhancement

22.0 For enhancement capex we will require the company to prepare a detailed business case for each individual proposal. Consistent with the section on outputs and in addition to the criteria set out above this should include:

- clearly defined measurable outputs
- a clearly defined timetable and delivery date
- clearly defined asset improvements
- identified costs that the Reporter has challenged and verified
- a statement of support from the relevant stakeholder(s)

23.0 As with base maintenance proposals account should also be taken of other possible interventions to secure the desired outcomes.

24.0 For the avoidance of doubt, we do not expect to make additional provision in price limits under the enhancement categories for the company to maintain or regain compliance with current standards. We expect the work required to reduce the risk of non compliance to come from within the provision for base maintenance. However, where a clearly defined and longstanding shortfall in capacity that requires the construction of additional or larger assets and is recognised by the relevant statutory regulator, and a clear output has been established in line with the general principles set out above, we will make provision for additional investment in our determination which we will treat as an enhancement.

[1] UKWIR, Asset Management Planning Assessment Process, A methodology for Self Assessment, May 2007

Management & General Investment

25.0 We recognise the need for investment in the company's management systems and the general facilities and systems required to deliver an efficient service. As with other areas of investment, we expect investment in management and general to be subject to internal challenge by the company. We expect major items of investment to be supported by a business case setting out the need for investments, measurable outputs, linked to benefits to consumers and the environment. A programme for delivery should also be included, which may be subject to scrutiny by the reporter. We are minded to fund investment which is supported in this way and where the benefits, quantified both in terms of improvements in service and reductions in capital and operating costs are demonstrated to outweigh the costs of delivery.

26.0 NI Water has benefited from substantial investment in new systems and facilities through the Business Improvement Programme. We expect submissions for future investment to be based on assumptions of successful delivery of this committed investment and the company to demonstrate that its business plan reflects the realisation of the planned savings from this programme

Capex Efficiency

27.0 As in the case of opex, we will apply tough but realistic efficiency targets to the company's capex projections. These will be in 4 parts involving a combination of:

- Reporter led challenge of the company's cost estimates ,taking account of scope definition, approach to risk, investment appraisal procedures and the robustness of cost and planning information at the individual project level;
- use of normalised unit cost modelling as a basis for benchmarking, prediction at the industry "average" and recent IRE/MNI spend;
- a cost base challenge[2] to assess the relative efficiency of the company's approach to procurement and project delivery: this will be applied to all aspects of capex and will be the primary basis for setting appropriate "catch up" targets; and,
- An assumption on continuing efficiency over and above "catch up".

28.0 In setting efficiency targets, we recognise the need for a balanced approach. Setting targets which are too aggressive may jeopardise service delivery, particularly over a short time frame. Drawing on experience elsewhere in the UK, however, it would appear that companies are able to become more efficient more quickly in delivering capex enhancement projects than in changing their day to day operations or in relation to their capital maintenance requirement. We will reflect this in our approach to PC10.

29.0 With regard to sewer flooding, we recognise that the company does not have the information required to identify properties at risk of internal flooding due to hydraulic overload and that the assessment of properties at risk is highly uncertain. We understand that the company is not in a position to prepare robust estimates and prioritise investment to reduce the risk of sewer flooding which is a key priority for investment identified by customers and the Social and Environmental Guidance. We expect the company's business plan to include

[2] As indicated in our letter dated 9th Mar-09, "NIAUR Approach to Cost Base Efficiency Targets"

a clear statement of how it will develop its assessment of the risk of sewer flooding to allow it prepare and prioritise investment plans with the agreement of other stakeholders including the Utility Regulator in line with the criteria set out in 3.0 above.

Managing Stop: Go

30.0 It is important that the company manage the profile and continuity of its capex programme to realise the efficiency gains which can be obtained through forward planning and continuity of expenditure. To this end we will be sympathetic to well founded proposals that overlap the period immediately beyond 2013. This may include the funding of feasibility and design costs of schemes where outputs can be defined ahead of PC13.

FINANCIAL CONSIDERATIONS

31.0 We have constructed our financial model so that it is capable of handling both a cash based approach and a regulatory building block approach. It is our intention to utilise both approaches in the Financial Model, we will assess the financial ratios as deployed by Ofwat and WICS to inform our scenarios and process for determining the price control.

Capital Maintenance Provisions

32.0 To calculate the revenue requirement the cost of capital expenditure is spread over the life of the assets involved. The relevant charges are in two parts:

- a Current Cost Depreciation (CCD) charge in respect of above ground assets such as treatment works,
- An Infrastructure Renewals Charge (IRC) in respect of under ground assets making up the water distribution and sewerage networks

33.0 The conceptual model underpinning these charges requires comprehensive asset inventory data involving periodic revaluation (on a modern equivalent asset basis) of the company's assets. It also presupposes the availability of high quality time series data to allow a cross check of the company's maintenance provisions against the long term trend in its capital maintenance expenditure, the general presumption being that in "steady state" the two should be broadly equal. In the case of England and Wales for example, the relevant time frames are:

- For CCD; a cross check with MNI capex over the period 1997/98 to 2024/25 i.e 28 years
- For IRC; across check against forward projections over the period 2010 to 2025, or alternatively, over the period 2005 to 2020 ie five years back and ten years forward.

34.0 We are conscious that the approach adopted elsewhere in the UK has taken a number of years to evolve and that the quality of data currently available to NIW is unable to support the same level of robustness. As with maintenance capex therefore, we are minded to take a pragmatic approach for PC10 as set out below.

Current Cost Depreciation - CCD

35.0 CCD will be calculated in two parts:

- Base CCD and;
- New CCD

36.0 For base CCD we will require the company to provide a forward projection of the depreciation charge on existing assets as at March 2008. For the avoidance of doubt it should also exclude any provision for accelerated depreciation. In the absence of a robust asset revaluation we will assume the base depreciation thus calculated can be reduced in line with the catch up efficiency applied to new capex. This effectively assumes the mix of existing and new assets is the same. New CCD should be calculated on non infrastructure capex incurred after March 2008.

37.0 For Capex needed to enhance and grow the asset base we are minded to adopt a similar approach to that proposed by OFWAT for its 2009 price review. This involves using standard apportionments to split new capex into the five depreciation categories specified in the Business Plan Information Requirements and applying a set of standard asset lives to each category. This approach will help ensure the revenue requirement is not unduly influenced by the company's depreciation policies while at the same time recognising the potential impact of specific schemes.

Infrastructure Renewals Charge - IRC

38.0 The IRC represents the annualised cost of maintaining the under ground networks at their current level of operations. In the absence of reliable long term data we will consider using benchmarking to the industry “average” and recent IRE spend. Given the short timeframe involved we will need to review the extent to which any adjustments should be made for prepayments or accruals reported over the period to March 2009 relative to an industry average. To the extent the company has built up an accrual, however, we will explore the reasons for this and challenge the company as to why it should not be wound out over a suitable period.

Future Approach

39.0 Looking to the future, we expect the company to be in a position to undertake a robust revaluation of its assets ahead of the PC13 review. To this end it should include in its Business Plan a set of proposals identifying the measures necessary to update its asset register. These should be in sufficient detail to allow progress to be monitored on in subsequent Annual Reports and allow the proposals to be subject to challenge and scrutiny by the Reporter.

Cost of Capital

40.0 In the interests of regulatory consistency, we will consider precedents elsewhere in the UK to determine a risk profile appropriate to an efficiently run water company. We will then take a view on whether any adjustments are appropriate to take account of the special circumstances applying to NIW, notably its tax status and the role of Government as sole shareholder and provider of debt.

41.0 It is likely that, in setting the cost of capital, we will adopt a prudent approach to gearing consistent with our view that the company's capital structure should incorporate a buffer to protect against external shocks and limit the taxpayer's exposure to financial risk.

Financeability Testing

42.0 We will undertake a series of financeability tests to ensure the company is able to finance all reasonable debt and dividend commitments, in doing so we will have regard to the financial ratios used by other regulators such as WICS and OFWAT. We will also consider the extent to which it would be appropriate to assume the ratios should be at a level sufficient to place the company within the investment grade envelope for credit rating purposes. We will be consulting closely with DRD on this and the related question of Government's dividend expectations.

Tax

43.0 Our current understanding is that NI Water is unlikely to incur a tax liability over the PC10 period. We note NI Water is reviewing its tax position with HMRC and expect that NI Water will justify any change in this assumption within its Business Plan..

Base Revenues

44.0 We will expect NI Water to derive realistic forecasts of its base revenues based on a disaggregation that will allow the Utility Regulator to verify charge caps for each part of the tariff and non tariff basket items as detailed in the Business Plan requirements and relevant conditions of the Licence.

45.0 As with opex, we will look closely at the make up of the base year figures to ensure they are representative of annual activity.

46.0 We will also check the company's forecasts to ensure they are internally consistent with those underpinning its water resource planning and its supply/demand balance proposals. This will be complemented by external checks against other forecasts prepared by Regional and Local Government.

47.0 Additionally we will scrutinise the company's plan to ensure it has secured and continues to maintain a proper balance between domestic and non domestic charges. In this context we will expect the company to fully explain the steps it is taking to ensure all properties receiving a water and sewerage service have been properly identified and are being billed as appropriate. In the absence of a sufficient explanation we will consider adjusting the base revenue forecasts in a manner we consider fit using the information available to us.

REGULATORY INCENTIVES

Deployment of Out Performance

48.0 We would encourage Northern Ireland Water to develop a policy for the investment of out performance monies. We suggest that the company discuss this policy with the

Department and the Utility Regulator to gain their support and approval. We would expect such a policy to:

- reflect the company's view of its level of risk to shocks and therefore the level of reserves which it considers appropriate to build up and how these are to be managed;

- consider further investment which reflect ministerial and customer priorities; and

- identify appropriate arrangements for the prioritisation and efficient delivery and programme of additional investment which will allow for the agreement of the quality regulators and other stakeholders in respect of the investment delivered and the agreement of the Utility Regulator in respect of investment targets.

49.0 We will consider the risks, as outlined by the company in its business plan and the possible impact which it and is consumers may be subject to over the period. In this context we will reflect on the level of reserves which the company may require and for what purpose they might be deployed. We would expect the company to have a view on the management of risk and thereby the need for and scale of reserves. We are minded to facilitate the building of reserves with any out performance of our expectations. We will be engaging with the Department of Regional Development, Department of Finance and Personnel and other stakeholders as appropriate to discuss this issue.

Management Incentives

50.0 We consider that the interest of managers should be aligned as closely as possible to the interest of consumers. We will therefore seek to have a meaningful management bonus scheme approved by DRD, with payments transparently linked to the company's financial performance and on how well the company delivers services to consumers51.0 We will seek to reflect the incentive arrangements successfully operated across other similar regulated utilities with:-

- the assessment of financial performance being based on the generation of restricted financial reserves; and

- improved service to customers and the environment being informed by our annual assessment of the company's overall performance assessment & performance against individual measures.

We will seek ministerial support for this approach and engage with the Department Regional Development's Shareholder Unit on this matter.

Failure to Deliver

52.0 It is important that customers are not asked to pay twice for the agreed level of service funded through the Price Control. Should NI Water under perform the targets set in PC10, customers should not be expected to fund any additional costs that NI Water incur. I would therefore expect NI Water's Board to consider how such costs are to be met in such circumstances and to consider implications of same prior to approving the payment of actual dividends. Where poor management results in additional costs or failure to deliver we expect the Board to ensure that this does not result in additional costs to the consumer; the payment of bonuses and the actual dividend will again play a role here. The company should note that additional costs arising from management failures should not qualify for the utilisation of reserves.,

53.0 Where the failure arises because the output is no longer required or for reasons outside the company's control the shortfall will be logged down.

Yours sincerely

J Aston

Director of Water Regulation

NIAUR