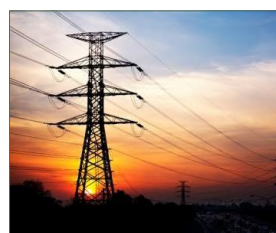


Water & Sewerage Services Price Control 2015-21

Final Determination – Annex V
Draft Determination Consultation Report
December 2014



Contents page

Water and Sewerage Services

Price Control 2015-21

Final Determination Annex V

Draft Determination Consultation Report

1.0	Introduction.....	1
2.0	Consultation Reponses	2
3.0	Consultation Issues – Our Response.....	3

1.0 Introduction

- 1.1.1 The Utility Regulator undertook a public consultation on the draft determination for PC15 which was published on 10 July 2014.
- 1.1.2 The purpose of the consultation was to seek feedback on the proposals set out in our draft determination to inform and shape the final determination.
- 1.1.3 This annex to the PC15 final determination provides a summary of the feedback given in response to the consultation.
- 1.1.4 Much of the detailed technical response was provided by NI Water which challenged a wide range of the assessments and proposals contained in our draft determination. This report includes a high level response to the issues raised by NI Water, with more information included in the technical annexes to address specific issues where appropriate.
- 1.1.5 The feedback provided by other respondents has been grouped under key themes for each respondent and our commentary indicates how we have addressed the issues raised.
- 1.1.6 The remainder of this report is set out in the following sections:
 - Section 2 provides a summary of the responses received; and
 - Section 3 summarises the key issues raised and our response.

2.0 Consultation Responses

- 2.1.1 NI Water provided a detailed response to the assessments and proposals which were set out in our draft determination. The company responded with a report supported by 27 annexes which included detailed responses to key issues and additional data submissions.
- 2.1.2 Responses were received from 6 other parties as follows:
- Consumer Council for Northern Ireland (CCNI);
 - Drinking Water Inspectorate (DWI);
 - Federation of Small Businesses (FSB);
 - Minister for Regional Development;
 - Northern Ireland Environment Agency (NIEA); and
 - Ulster Farmers union (UFU).
- 2.1.3 In our draft determination we noted that we would publish all consultation responses unless respondents requested otherwise. As no respondent asked us not to publish their response, we have published all the responses received on our web-site, excluding the detailed technical annexes provided by NI Water which include information which could be commercially sensitive.
- 2.1.4 The Utility Regulator is grateful to all those who participated in the consultation process.

3.0 Consultation Issues – Our Response

- 3.1.1 In this section we summarise the key issues raised in response to the draft determination consultation and indicate how we have addressed the issues in the final determination.
- 3.1.2 We have not responded to feedback which broadly supported our approach and determination or that touches on the roles and responsibility of the respondent themselves. Nor have we provided commentary on wider policy issues which are not directly influenced by the outcome of the final determination.
- 3.1.3 A summary of responses from a number of stakeholders excluding NI Water is included in Table 3.1.
- 3.1.4 The NI Water response and our high level views is included in Table 3.2. More detailed information is included in the detailed technical annexes to address specific issues where appropriate.

Table 3.1 - Comments from respondents other than NI Water

Ref	Organisation	Section	Comment	Our response
1	Consumer Council for Northern Ireland	Consumer views and priorities	CCNI noted the collaborative work undertaken through the Consumer Engagement Oversight Group (CEOG) to elicit and respond to consumer views during the development of the PC15 price control and emphasised the advantages of this work continuing during the delivery of PC15.	The UR agrees with the advantages of continuing to work collaboratively on consumer views and the delivery of consumer priorities. The continuing work of CEOG to develop customer satisfaction measures is highlighted in the final determination. The company's proposals to integrate consumer feedback into the prioritisation of capital investment are a further example of where the CEOG could deliver value.

Ref	Organisation	Section	Comment	Our response
		Affordability	CCNI welcomed the negative price limits in the draft determination and noted that, while it was regrettable that any charges increased, they understood why unmeasured charges will increase.	<p>We acknowledge that any increase in bills is regrettable and will receive negative consumer reaction.</p> <p>While we take all reasonable steps to set challenging but achievable efficiency targets to minimise bills, we must also ensure that NIW can finance its functions and that we do not discriminate between different types of users in the way charges are levied.</p> <p>The increase in unmeasured bills over PC15 takes account of improved estimates of consumption and reflects an equitable distribution of costs.</p>
		Affordability	CCNI asked that we consider smoothing the K factor for trade effluent to lessen the potential impact of the +5.4% increase in year one.	Further smoothing of tariffs has been completed in the final determination including trade effluent.
		Outputs and consumer benefits	CCNI noted that the consumer research concluded that services should be maintained at current levels and noted the need to keep this promise of no deterioration or retrograde service delivery.	The outputs and levels of funding in the final determination start from the basis that there will be no deterioration from current levels. In some service measures we have introduced tramlines rather than absolute measures to reflect the natural variability of service in the short term and the need to judge performance over the medium term.
		Outputs and consumer benefits	CCNI noted that no output measure has been included for sewer flooding to external areas and suggested that one be included.	<p>At this point we do not have a sufficiently robust measure of external flooding to introduce an output. We also recognise that there is no funding available to deliver reductions in external flooding.</p> <p>We have concluded that this is an area for future consideration as more meaningful consumer measures are developed.</p>

Ref	Organisation	Section	Comment	Our response
		Outputs and consumer benefits	CCNI suggested that sewer failure and sewer blockage should also be considered as indicators of sewer condition and maintenance and requirement / response.	<p>We have included sewer collapse and sewer blockage as serviceability indicators to monitor asset maintenance.</p> <p>We began collecting information on the time taken to clear sewer blockages from 2012-13. Collecting this information and the focus on sewer blockages which accompanies it will provide a basis for considering response time targets as additional consumer measures at the mid-term review.</p>
		Profile of consumer benefits	CCNI noted that in some areas outputs accelerate towards the later end of PC15.	We have reviewed the profile of outputs and set out a more even profile of output delivery where this is practical. In particular, we have reviewed the proposals for improvement for flooding outputs proposed by the company and accelerated these.

Ref	Organisation	Section	Comment	Our response
		Profile of consumer benefits	CCNI noted that NI Water had questions over the targets for sewerage pollution incidents.	<p>Pollution incidents contribute to targets in three ways:</p> <ul style="list-style-type: none"> • An output target for high and medium incidents; • Sewerage pollution incidents as a serviceability indicator; and • As a component of the OPA. <p>The company has generally accepted the enhanced starting position we proposed for PC15 in all areas based on current performance. The company challenged the rate of improvement we proposed. We have accepted the company's argument in part for the output measure but have maintained our position on the serviceability and OPA measures. More detailed information can be found in the relevant annexes to the determination.</p>
		Increased visibility and understandable impacts	CCNI noted that it looked forward to seeing the steps NI Water can take to mitigate the risk of flooding pending funding of the required major strategic drainage solutions.	NI Water has noted that proposals for a Homeowner Flood Protection Grant Scheme being considered would be funded by the Northern Ireland Executive. The company has proposed a further set of measures to add non-return valves on laterals and on landscaping / flood water diversion where which would be beneficial. Further information is provided in Annex F.
		Increased visibility and understandable impacts	CCNI noted a preference for clear local service level outputs that show the impact of investment on the service experienced.	The PC15 determination is based on NI level outputs within which the company must prioritise investment in the most effective way. We have not defined service level outputs for individual areas.

Ref	Organisation	Section	Comment	Our response
		Operational expenditure	CCNI noted that NI Water had expressed concerns that operational efficiencies proposed in the draft determination risks the company being stretched too tight and noted questions raised by NI Water on the calculation of efficiencies.	We have reviewed the additional material provided by the company in response to the draft determination. Our detailed response is included in the relevant annexes. While we made adjustments to the targets where this was justified, the overall impact has been limited. We believe that the final determination strikes the right balance between efficiency and any risk to service delivery.
		Capital investment	CCNI noted that they were aware of questions raised by NI Water in respect of the proposed capital efficiency and noted that the final determination should include clear responses to these additional factors.	Our response to the issues raised by NI Water in respect of capital efficiency is set out in Annex L – Cost Base Efficiency Analysis. In response to the company's representations, we have opted for a lower level of capital efficiency.
		Performance tramlines	CCNI supported the use of tramlines for monitoring performance and serviceability, but noted that upper tramlines must not be taken as acceptance of declining consumer service.	We agree that performance tramlines should not be taken as an acceptance of declining consumer service. We have introduced tramlines for output measures where external factors or sample techniques introduce variability into performance which is not necessarily related to NI Water's performance. In the past, output measures were set at the lower end of these performance ranges. Our approach indicates that we expect the company to out-perform these levels. When we assess serviceability we expect the company to perform at or around the reference level. Performance which is consistently close to the upper bound (particularly that of the primary measures) would be deemed to be marginal or declining.

Ref	Organisation	Section	Comment	Our response
		Financial aspects	CCNI noted the benefit of examining more closely the potential to develop a local price effect model to adjust for capital inflation.	Following detailed engagement with NI Water, it has not been possible to identify a set of indices specific to NI Water which would provide a robust Real Price Effects measure of capital inflation. We have therefore decided to adopt the 'minded to' approach signalled in the draft determination and use RPI to adjust for capital inflation in PC15.
		Financial aspects	CCNI noted that consumers should be protected against or compensated for a failure to deliver outputs and noted that the mid-term review offered an opportunity to do so.	We already have processes in place to log up or log down expenditure if outputs are not delivered. This is applied retrospectively at the next price control. We have set out the issues we would consider during a mid-term review should a financial determination be triggered. We may consider failure to deliver at a mid-term review if a financial determination was triggered for other reasons. However, we would be cautious about judging output delivery for a 6 year price control after three years unless it was clear that there was a material failure to deliver which could not be recovered in subsequent years.
		Financial aspects	Regulatory capital value (RCV). CCNI noted that future decisions on governance structure, funding arrangements and business model may impact on the RCV going forward and noted that the Consumer Council considers that RCV is not yet a fixed policy assumption.	We have set out a similar view in the past and this continues to be our opinion. The PC15 final determination is based on the current governance arrangements and funding model and we have determined that the existing RCV should continue to be extended in these circumstances. We would consider the appropriate level of RCV should these circumstances change in the future.

Ref	Organisation	Section	Comment	Our response
2	Drinking Water Inspectorate	Compliance with drinking water standards	DWI noted that it expects NI Water to deliver its statutory drinking water quality requirements including giving due regard to the need for public water supplies to be safe, clean and compliant with regulatory standards.	Working with DWI, in conjunction with other stakeholders, to prioritise investment for PC15 it has been accepted that an element of compromise is necessary. The final determination takes account of that prioritisation of outputs. An Output Review Group and Change Control Protocol are in place to address significant non-compliance with the regulations over and above those identified at the time of the final determination.
		Asset maintenance	DWI noted the need for a sustainable level of asset maintenance investment to maintain confidence in drinking water quality. The drivers for this should be both risk based and proactive.	We agree with the need for a sustainable level of asset maintenance and that this should be both risk based and proactive. While noting the progress made by NI Water in developing its asset maintenance capability, we concluded that this was not sufficient to underpin a determination of investment for PC15. Instead, we have determined a reasonable level of investment based on comparisons with other water and sewerage service providers and NI Water's historic spend. Our determination is not dissimilar to the amount of funding requested by the company. We also require the company to develop its Plan for Asset Maintenance which should set out how it will assess and prioritise in the future including risk based and proactive techniques.

Ref	Organisation	Section	Comment	Our response
			<p>DWI noted that a process had been implemented to allow NI Water to provide information to DWI to enable it to assess and, if appropriate, support schemes to improve drinking water quality in PC15. It is DWI's opinion that there was insufficient evidence in the regulatory risk assessment and insufficient detail in 'Annex A' returns to allow DWI to provide technical support for the schemes proposed by NI Water in its Business Plan. DWI has been unable to support any of the nine water treatment nominated outputs included in the draft determination.</p>	<p>In the absence of DWI's support for any of the nominated outputs included in the draft determination, we could have taken the decision to remove these outputs from the final determination, releasing funding for other priority outputs. However we are aware that, subsequent to the receipt of consultation responses, there has been further engagement between DWI and the company in relation to ongoing and emerging risks. We have therefore concluded that, in the light of the potential risks identified by both parties and the plans to undertake further treatability studies, it would be appropriate to retain some of the enhancement investment proposed by the company pending completion of the studies and further risk assessments. We would expect NI Water to set out a clear programme for the completion of these studies and the submission of Annex A returns (or undertakings if enforcement action is considered) to support investment proposals in its PC15 Monitoring Plan.</p>

Ref	Organisation	Section	Comment	Our response
		Water quality compliance	<p>DWI expressed concerns that three water quality output measures proposed in the draft determination which indicate performance ranges fall short of meeting statutory obligations for water quality and that setting such targets may inadvertently promote a failure tolerant focus on surrogate standards. DWI expressed a view that these targets should be set in the context of a direction of travel to fully meet statutory obligations at a pace consistent with protecting public health, maintaining public confidence and the views of consumers on affordability.</p>	<p>The ranges proposed for the output measures reflect the statistical reality of the sampling regime used to determine water quality compliance. At current levels of performance the range of likely outcomes for a given background level of performance is relatively wide and our output measures reflect this. In this context, the risk that the output measures may inadvertently promote a failure tolerant focus on surrogate standards is relatively low. In part, this is because individual output measures are not considered in isolation. Key improvements in performance will be delivered by other activity and nominated output measures (such as lead pipe replacement, water mains rehabilitation, treatment works enhancement and asset maintenance). Prioritizing these activity measures effectively will be a key to successful delivery in PC15 and the objective of improving water quality which we share.</p>
			<p>DWI highlighted the need for NI Water to appropriately reflect the interests of consumers, particularly their concerns and experiences relating to discoloured appearance of their water supply when prioritising water mains investment.</p>	<p>We agree that NI Water should reflect the interest of consumers when prioritising investment including water mains investment. The company has developed its water mains prioritisation methodology and it has promised a further update of the methodology and weightings to reflect the outcome of consumer engagement for PC15. We agree that this should take account of discoloured water complaints.</p>

Ref	Organisation	Section	Comment	Our response
3	DRD Minister	General	The Minister noted the Executive's PFG Commitment to no additional water charges during the current Assembly Mandate means that the hybrid status of NI Water will continue into at least the early stages of PC15, which means that NI Water remains within the public expenditure regime.	The final determination assumes that current arrangements of governance and funding will continue.
		Operational costs and efficiency	The Minister noted that NI Water's operational targets form part of the DRD budget and sought assurance that NI Water can deliver the efficiency targets set out in the final determination without detriment to service delivery and without creating budgetary pressures.	In the final determination we have maintained our approach to benchmarking NI Water against water and sewerage companies in England and Wales and to set a realistic rate of catch up to close the efficiency gap. The determination also includes an allowance for return on equity and reserves. Our view is that effective management would allow NI Water to meet or out-perform these targets. However, the company may be subject to cost shocks in individual years and, within a public expenditure regime, it may not be able to utilise the financial reserves on its balance sheet. It is a matter for the Department as shareholder to manage these issues.

Ref	Organisation	Section	Comment	Our response
		Business Improvement	The Minister noted the statement in the draft determination that we would not support NI Water's claim for extra BI funding in PC15 either in revenue or PE terms and highlighted that this could result in the need to advise DFP that some bids for PE funding were not supported by the Regulator's position on PC15.	<p>The final determination notes that we remain supportive of NI Water continuing to improve its business and reduce its staffing numbers through VER/VS to further close the efficiency gap. Likewise, we support the continued transformation of NI Water through its BI programme. Any new PE bids for additional BI throughout PC15 are supported in principle.</p> <p>We expect such bids to continue to be subject to the normal departmental approvals process. This being the case, such additional BI is quite properly a matter for DRD, as shareholder, and the company.</p> <p>The UR can assist, in any early quality assurance of BI projects and business cases, if NI Water considers this may expedite the process of business case approval.</p>
		PPP Savings	The Minister noted that the draft determination included 'savings' which assumed that historic levels of under-performance on PPP contracts and associated penalty payments would continue into the future, and noted that this anticipated and accepted poor performance in this area.	<p>For the final determination, whilst not wishing to set an allowable failure rate, we consider it appropriate to recognise that such issues will occur in all likelihood. We therefore do not believe it right that the consumer should carry the cost risk, which would effectively occur if the UR gave an allowance that assumed no performance deductions. If performance deductions do materialise during the six years of PC15, customers effectively pay for a level of service not received.</p> <p>While it is impossible to predict with certainty on issues such as PPP performance deductions we have assumed half of the historic run-rate.</p>

Ref	Organisation	Section	Comment	Our response
		Rates	The Minister noted the proposed increase in NI Water's rates bill and asked that, in view of the continued uncertainty in relation to this expenditure, the UR considers whether it would be possible to account for these costs separately in the final determination such that they are not included for the purpose of calculating efficiencies for NI Water.	<p>We have updated the assessment of additional water and sewerage rates for the final determination based on latest best estimates from LPS and DRD.</p> <p>We have continued to include rates in the opex we apply our efficiency discount. This approach is consistent with best practice regulation adopted by the Competition Commission in its recent determination for NIE and consistent with our previous approaches at PC10 and PC13. Full cost pass-through would expose consumers to missed opportunities for cost reduction.</p>
		Governance	The Minister expressed surprise that the draft determination made no allowance for the additional costs imposed by the current governance arrangements.	<p>We accept that the current governance arrangements can result in additional costs not experienced by the companies we use to benchmark costs. Equally, NI Water does not experience costs incurred by these companies, for example, raising finance and meeting parent company requirements.</p> <p>Given such offsetting factors and uncertainty around the quantum of avoided costs, no allowance is made. This is based on the view that the claim, whilst valid, falls below the materiality threshold. NI Water has failed to adequately provide evidence of the offsets as required by our acceptance criteria for special factors.</p>

Ref	Organisation	Section	Comment	Our response
4	Federation of Small Businesses	Price Limits and Efficiency	FSB highlighted the need to lessen the cost of doing business including water and sewerage costs. It agreed with the proposal to lessen the 23% efficiency gap between NI Water and similar companies in England & Wales, despite differences in the ownership model. However, it highlighted the increase in bills for unmeasured business customers, who represent around 11% of all billed customers. It noted that NI Water and the UR should be under no illusion that an increase in bills for this group will have a negative impact on the success of those businesses.	In the final determination we have maintained our approach to benchmarking NI Water against water and sewerage companies in England and Wales and to set a realistic rate of catch up to close the efficiency gap over time. We recognise the impact the increase in bills can have on any consumer. However, our duty is to ensure that we do not discriminate between different types of users in the way charges are levied. The increase in unmeasured bills over PC15 takes account of improved estimates of consumption and reflects an equitable distribution of costs.

Ref	Organisation	Section	Comment	Our response
		Mid-term review	FSB stated that NI Water must be ready to pass on any savings they make during this price control period to their customers. The UR should look closely at this throughout PC15 and it should be the main focus within the mid-term review where a decision will be made on whether a financial determination is necessary.	<p>We have set out a financial determination for PC15 which is challenging and will deliver real long term savings to all consumers. However, we are conscious that change is likely to occur over a 6 year price control and we have made provision for a mid-term review to allow outputs to be revised and, if necessary, a change to the financial determination to be made.</p> <p>However, it is not our intention that the mid term review would become another price control which would require a substantive effort from all parties. In the draft determination we itemised the issues which would be taken into account in a financial determination at the mid-term review.</p> <p>We decided to exclude changes in operational cost efficiency, capital cost efficiency, return on capital and general changes in operational expenditure such as unit rates for power or changes in labour or contractor costs.</p> <p>The risks and benefits of these changes remain with the company and its shareholder DRD who are best placed to manage them.</p>
5	Northern Ireland Environment Agency	Capital funding	NIEA expressed its disappointment at the allocation of funding towards the prioritised enhancement of water and sewerage services for the PC15 period.	The PC15 programme has been developed within overall funding constraints determined by the Executive. Within this funding envelope, the outputs to be delivered have been prioritised by the Principal Stakeholders. We acknowledge that NI Water could deliver additional beneficial investment if additional funding was available.

Ref	Organisation	Section	Comment	Our response
		Operational efficiency	<p>NIEA noted the efficiency targets proposed for operational costs and considered that this represented an additional risk to environmental compliance.</p> <p>NIEA noted that NI Water has a greater number of wastewater treatment works under its control relative to its consumer base than other companies.</p>	<p>We determine efficiency targets by benchmarking NI Water against water and sewerage companies in England and Wales and set a realistic rate of catch up to close the efficiency gap. Our view is that effective management would allow NI Water to meet or out-perform these efficiency targets.</p> <p>The econometric modelling we apply to determine efficiency takes account of the asset base of the company. We asked the company to draw to our attention any special factors which may influence the efficiency position indicated by econometric modelling such as electricity prices.</p> <p>A further submission concerns the company's use of a specialist technology for wastewater treatment, which the company drew to our attention following the draft determination. We have made an assessment of this in our final determination. Annex P provides further details.</p>
		Funding for the Belfast catchment	NIEA noted its disappointment with the limited funding set aside for the Belfast catchment, while recognising the wider strategic assessment of improvements required to reduce adverse environmental impacts on Belfast Lough.	The final determination retains the funding necessary to complete an integrated assessment of the impact of discharges on Belfast Lough with a view to identifying sustainable solutions which could be delivered in PC21, subject to the availability of funding.

Ref	Organisation	Section	Comment	Our response
		Compliance with the PPC/IED regulations	NIEA sought further clarity on work to deliver compliance with the PPC/IED directive and noted the need for NI Water and the Utility Regulator to recognise the need to sufficiently resource efforts to achieve compliance.	We have not made any significant progress on this area for the final determination. The company has included funding for PPC / IED compliance in its Business Plan and this is included in the determination. We have asked the company to provide a plan for PCC/IED work and report progress on delivering that plan.
		Plans for storm water separation and infiltration reduction	NIEA sought further clarity on the intended number of appraisals for storm water separation and infiltration reduction.	In the draft determination, we asked the company to provide more detailed information on its plans for storm water separation. The company replied in general terms and did not provide specific information. We have maintained the funding for storm water separation in the final determination and have asked the company to provide its plan for storm water separation and report progress on delivering that plan.

Ref	Organisation	Section	Comment	Our response
		Compliance targets	NIEA noted that the compliance targets set by the Utility Regulator are challenging.	<p>NI Water also made representations about the compliance targets, specifically the pollution incident targets. In view of the concerns set by the company we have reduced the pollution incident target for high and medium incidents and introduced an indicative performance range.</p> <p>We agree that the wastewater treatment compliance targets set are challenging. However, having reviewed our assessment, believe that they are achievable. We believe that the targets reflect the minimum level of performance we could reasonably expect and we have indicated a likely range of performance above these lower limits.</p>
6	Ulster Farmers Union	Price Limits	The UFU have long called for the metering of all properties in Northern Ireland and hopes that the increase in bills for unmeasured customers will see a move towards the metering of all properties.	PC15 continues to fund meter installation on existing properties, although at a reduced rate than previously. While progress will be made on meter installation, it is unlikely that NI Water will be able to meter all existing non-domestic properties at reasonable cost.
		Price Limits	The UFU has been calling for water charges to be brought in for domestic water users, believing that this will result in much greater efficiency and a more responsible attitude towards water use.	Any decision on the future of domestic water charges is a matter for the Executive. The final determination assumes that current arrangements of governance and funding will continue.

Ref	Organisation	Section	Comment	Our response
		General	UFU highlighted NI Water's practice of backdating charges for up to 6 years when it discovers an error in a previous bill and highlight the impact that such a consolidated bill can have on a business. UFU observed that there was no good reason why NI Water cannot have a bill with each customer within a year of the usage of water and would like the company to make a commitment that no-one will be faced with an unreasonable bill.	We recognise the impact a backdated bill can have on any consumer. It is our understanding that NI Water agrees individual payment terms in these cases to minimise impact on affect customers.
		Outputs and outcomes	UFU asked that the goal of reductions in leakage surpassing 159Mld should focus on unmetered and unbilled consumers to reflect the efforts made by metered consumers to reduce leakage.	The calculation of water charges takes account of the estimated level of leakage on supply pipes (between the boundary where a meter would be located and the premises served) when allocating water volumes and revenue between different classes of users. Because supply pipe leakage is already included in measured consumption, no further adjustment is made to measured users bills.

Table 3.2 - Comments from NI Water

Ref	Organisation	Section	Comment	Our response
7	NI Water	Operational Costs	<u>Insurance costs</u>	On further evidence from NI Water we determine an amount above that originally submitted by the company. Having excluded all provision movements, the resultant increase in our final allowance run rate is far closer to NI Water's recent experience across the PC13 period.
			<u>Communications</u>	Communications remain neither a new nor an exogenous cost. In the absence of alternative evidence, the company is adequately funded for these activities within base opex.
			<u>Carbon Reduction Commitment (CRC Scheme)</u>	Our Real Price Effects include the latest forecast power price increases from DECC. These electricity estimates include all non-avoidable taxes and duties (including estimated average rates of the Climate Change Levy and the cost of CRC allowance purchases for future years). Funding this part of claimed additional opex would amount to double funding.
			<u>Capitalisation</u>	Our partial allowance reflects a disallowance of the proposed new staff. However we have accepted the company's additional capitalisation of existing staff or current costs. Subsequent to the company's response to the draft determination we agreed our treatment of opex in this regard is correct. The company maintains our treatment of the consequences for capex ought to mean an increase in corresponding capex.

Ref	Organisation	Section	Comment	Our response
			<u>Additional Resource Requirement</u>	Not a new or exogenous cost. The company is already funded to undertake these activities.
			<u>Rates Revaluation</u>	<p>NI Water is undergoing a rates revaluation through Land & Property Services (Dept of Finance & Personnel) or 'LPS'. This is estimated to raise the company's total rates charge. At the time of the draft determination, NI Water had submitted an estimate for its water rates only.</p> <p>Since then we have engaged extensively with the company, DRD and LPS. In the interim period the valuation of water assets has reduced. We therefore used the company's latest submitted estimate to inform our final determination.</p> <p>An estimated increase in the total sewerage charge from £6.6m (in 2012-13) to over £10m has been re-worked around a new NAV (Net Annual Value) for NI Water's sewerage estate. The result is an additional allowance of £3.7m p.a.</p> <p>The net effect across water and sewerage is an increase of £1.7m p.a. above the £10.6m p.a. allowance from our draft determination.</p> <p>We do not consider the option to set aside NI Water's increase in rates for a future Relevant Items application as available.</p> <p>If DRD wish to fund the increase in rates bills through a Relevant Item bid this is a matter that can be considered outside the FD.</p>

Ref	Organisation	Section	Comment	Our response
			<u>Consultancy Support</u>	<p>NI Water's claim included additional consultancy support for both the potential mid-term review, as well as the bulk of their claim for the years leading to our next price control or PC21. We have included the latter due to there being little evidence of a similar consultancy support within the 2012-13 baseline that applies across PC15.</p> <p>We are not convinced of the requirement for similar operational consultancy support for any mid-term review in PC15. Such activities will be focused upon the delivery of more informed business cases to justify additional investment through the latter half of PC15.</p>
			<u>Transformation Costs</u>	<p>The final determination notes that we remain supportive of NI Water continuing to improve its business and reduce its staffing numbers through VER/VS to further close the efficiency gap. Likewise, we support the continued transformation of NI Water through its BI programme. Any new PE bids for additional BI throughout PC15 are supported in principle.</p> <p>We expect such bids to continue to be subject to the normal departmental approvals process. This being the case, such additional BI is quite properly a matter for DRD as shareholder and the company.</p> <p>The UR can assist, in any early quality assurance of BI projects and business cases, if NI Water considers this may expedite the process of business case approval.</p>

Ref	Organisation	Section	Comment	Our response
			<p><u>PPP Performance Deductions</u></p>	<p>For the final determination, whilst not wishing to set an allowable failure rate, we think it appropriate to recognise that such issues will occur in all likelihood. We therefore do not believe it right that the consumer should carry the cost risk, which would effectively occur if the UR gave an allowance that assumed no performance deductions. If performance deductions do materialise during the six years of PC15, customers effectively pay for a level of service not received.</p> <p>While it is impossible to predict with certainty on issues such as PPP performance deductions we have assumed half of the historic run-rate.</p>

Ref	Organisation	Section	Comment	Our response
		Operational Cost Efficiency	<u>Assessment of the Efficiency Gap</u>	<p>The company response to our draft determination included a late submission of their alternative to our COLS modelling. We have examined the company models and data in extensive detail and have determined to remain with our broad approach for the time being.</p> <p>The efficiency gap has however fallen due to an increase in the special factor allowance. We have further changed the allowance for exceptional costs associated with business activities.</p> <p>We are however convinced that continued dialogue and engagement with the company will offer the opportunity to develop a new set of models. Such a new alternative modelling approach will use up to date data to produce robust efficiency gap estimates. These will inform our annual reporting of NI Water's progress during PC15.</p> <p>We would hope to develop such a new approach to at least inform our next price control of NI Water at PC21. Ideally this would be in place by next year's Cost and Performance Report.</p>

Ref	Organisation	Section	Comment	Our response
			<u>Special Factors</u>	<p>We have applied four criteria when assessing the company's special factor claims. These were previously set down in our PC15 Reporting Requirements. They allow the discretion to calculate whether to allow any proportion of the company's claims in our determinations.</p> <p>Compared to the £12.80m special factor claimed by NI Water (including their late claim concerning specialised wastewater technology) the Regulator has determined a partial allowance of £6.78m, equivalent to 53%. This materially reduces the estimate of the 2012-13 efficiency gap.</p>
			<u>Frontier Shift</u>	<p>Our frontier shift assumptions include consideration of our productivity assumption and the real price effects (RPE) which an efficient company is likely to face across the PC15 period.</p> <p>The approach we have taken is comparable to that used in NIE's RP5 price control. This approach was subject to a referral to the Competition Commission which then validated the UR methodology as part of their determination of RP5.</p>

Ref	Organisation	Section	Comment	Our response
		Plan for Asset Maintenance	<p>A key requirement of our Price Control process was the provision of a Plan for Asset Maintenance which would set out how the company planned to close the gaps identified in its asset maintenance capability assessment.</p> <p>As part of its response to the draft determination, the company provided an update on its Plan for Asset Maintenance which identified some of the key approaches it might apply and an indicative timescale.</p>	<p>In the final determination we have reiterated our requirement for the company to complete a plan to address the gaps identified in its asset maintenance planning capability assessment.</p> <p>The plan should set out the desired outcome, the scope of activities required to achieve that outcome, the timescale over which these activities will be delivered and the cost if these activities.</p>
		Capital Investment and efficiency	<p><u>Capital Investment Outturn for PC13</u></p> <p>NI Water stated that it understood the assessment of logging up and logging down in Annex I of the draft determination and noted that it would need to be reassessed for the final determination based on the latest information available at that time.</p>	<p>The Utility Regulator has updated the PC13 out-turn report based on the latest best estimate of actual and projected expenditure for PC13 provided by NI Water in October 2014.</p>

Ref	Organisation	Section	Comment	Our response
			<p><u>Capital Inflation</u></p> <p>NI Water noted the discussion in the draft determination of alternative approaches to capital inflation to replace the Construction Output Price Index (COP) which was previously used to adjust for capital inflation in our price controls for NI Water and the indication from the UR that it was minded to use RPI in PC15.</p> <p>NI Water suggested that it would prefer an approach based on Real Price Effects and proposed that NI Water and the Utility Regulator worked together to develop an agreed approach prior to the final determination.</p>	<p>Following detailed engagement with NI Water, it has not been possible to identify a set of indices specific to NI Water which would provide a robust Real Price Effects measure of capital inflation. We have therefore decided to adopt the 'minded to' approach signalled in the draft determination and use RPI to adjust for capital inflation in PC15.</p>
			<p><u>Additional Income</u></p> <p>NI Water expressed concern about the approach taken to estimate capital income for the draft determination which was based on average levels of income received and indicated a higher level of income in PC15 than the company estimated. However, the company also reviewed and revised its estimates upwards and provided a latest best estimate of capital income in PC13.</p>	<p>We remain convinced that an average level of historic income over a reasonable period is a reasonable methodology for estimating future income when the estimated level of development remains constant. For the final determination, we have maintained our approach and adjusted the projected capital income upwards based on the latest best estimate of income for PC13.</p>

Ref	Organisation	Section	Comment	Our response
			<p><u>Capital Maintenance Assessment</u></p> <p>The company challenged the application of an on-going efficiency adjustment of 0.6% to capital maintenance investment on the basis that the general productivity improvements underpinning this adjustment are already inherent in the subsequent adjustments made for capital inflation.</p>	<p>The approach we have taken to apply our on-going efficiency adjustment is comparable to that used in NIE's RP5 price control. This approach was subject to a referral to the Competition Commission which then validated the UR methodology as part of their determination of RP5.</p> <p>The approach identifies Real Price Effects (assumptions around capital cost inflation) separately from productivity movement (ongoing efficiencies).</p> <p>Catch-up efficiencies are already implicitly allowed for in our forecast / prediction of capital maintenance since we modelled using upper quartile performance.</p>
			<p><u>Capital Efficiency Challenge</u></p> <p>In response to the capital efficiency challenge set out in the draft determination, the company commissioned a review of capital efficiency which concluded that the maximum level of capital efficiency which could be achieved was 7% phased in over the PC15 period, to give average capital efficiency over PC15 of 5.4%.</p>	<p>Following engagement with the company and a review of the level of efficiency proposed by water and sewerage companies in GB we have reviewed our triangulation of a range of efficiency assessments and concluded that 7% capital efficiency is appropriate.</p>

Ref	Organisation	Section	Comment	Our response
		Outputs and Outcomes	<p><u>Pollution Incidents</u></p> <p>The company accepted the initial level and rate of improvement included in the URs targets for PC15, including those inherent in the OPA target and used for serviceability. The company proposed alternative targets and rates of improvement.</p>	<p>While the company was concerned by the targets and rates of improvement we proposed, it was not able to provide an evidence based assessment of future performance which would support targets for PC15. In view of the company's concerns and in the absence of supporting information, we have:</p> <ul style="list-style-type: none"> • Maintained our position in respect of OPA score and serviceability targets; • Revised our target for high to medium pollution incidents, providing a range we would expect the company to perform in; and • Reserved the right to amend the high and medium pollution incident target at the mid-term review.

Ref	Organisation	Section	Comment	Our response
			<p><u>Serviceability</u></p> <p>NI Water reviewed the serviceability reference and control levels in the draft determination and proposed alternative levels.</p> <p>NI Water challenged the primary indicator for sewage non-infrastructure in the draft determination and asked that the UR revert to the primary indicator set out in its original approach.</p>	<p>We have review the serviceability reference and control levels for the final determination and made some adjustments to reflect better information. We have not adopted changes by the company which readjust the upper serviceability to include historic data which does not reflect the improvements already delivered by investment.</p> <p>For the final determination we have adopted the primary indicator for sewage non infrastructure set out in our original approach (percentage works compliant with number consents). We reserve the option of moving to a new primary indicator in the future.</p>
		Allowed Revenue and Financial Model	<p><u>Allowed Return on RCV</u></p> <p>The company feel the change to apply the rate of return to the mid-year RCV simply adds to the current pressures on financeability and in particular cash related ratios.</p>	<p>The change in calculation was made to align with other price control decisions within the UR. We also note the company have said they recognise the reasons for the change and do not fundamentally disagree with it.</p>
			<p><u>Financial Sustainability</u></p> <p>The company has concerns that the continued funding of capital maintenance on a cash basis may act to increase reliance on debt funding and gearing.</p>	<p>We believe the current method of funding is appropriate to the governance framework within which NI Water operates.</p> <p>We also note the company state the issues that this approach raises are of a secondary nature unless there is a change in governance structure.</p>

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			<p><u>Taxation</u></p> <p>The company noted a number of points in relation to the tax calculation and timing of submissions to HMRC.</p>	<p>We have engaged extensively with the company on taxation issues throughout the PC15 determination.</p> <p>The magnitude, liability and timing of cash tax becoming payable remain too uncertain and we have therefore excluded it from revenue considerations.</p> <p>Should cash tax become payable, we will consider adjusting price limits at the mid-term review to take account of the additional payment.</p>
			<p><u>Depreciation</u></p> <p>The company provided updated depreciation forecasts.</p>	<p>In addition to the consultation response, NI Water has provided further detail in response to UR queries and changes have been incorporated in the final determination.</p>

Ref	Organisation	Section	Comment	Our response
			<p><u>Financial Model - Tariff differentials</u> The company noted a tariff differential was not calculated on the same basis as the Annual Information Return.</p> <p><u>Financial Model - Customer Contributions</u> The company noted a minor inconsistency in relation to the deferred element of infrastructure charges not included in projections.</p>	<p>The UR has calculated sewerage tariff differentials for the final determination on the same basis as that included in the Annual Information Return and therefore included Supply Pipe Leakage (SPL). The UR acknowledges that Supply Pipe Leakage is not included for sewerage customers within NI Water's current revenue allocation workings.</p> <p>This has been corrected for the final determination.</p>
			<p><u>Revenue Smoothing</u> The company suggested further smoothing of revenue to cover measured non household and trade effluent customers.</p>	<p>Further smoothing of tariffs has been included in the final determination.</p>
			<p><u>Customer Data Projections</u> The company noted it was continuing to assess customer billing trends and would provide an update including revenue allocations if necessary.</p>	<p>The UR met with the company and received updated customer data projections which have been included in the final determination.</p>
		Management of Risks and Uncertainty	<p><u>Memorandum of Understanding</u> The company have restated part of the MOU between the Regulator and DRD. This states that mitigation measures normally available under regulation cannot be used and the agreement for relevant items outside the determination should be made.</p>	<p>It has not been possible to agree funding with DRD for relevant items due to the continuing uncertainty and pressure on existing PE budgets.</p>

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			<p><u>Consequent Written Agreement</u></p> <p>The company have noted the bid for relevant items during the 2014-15 year was not approved.</p>	<p>It is our understanding the bid for 2014-15 relevant items was withdrawn. In any event circumstances have now changed for 2014-15 as result of PE budget cuts.</p>
			<p><u>PC15 Relevant Items</u></p> <p>The company had serious concerns that the draft determination made no provision for relevant items.</p> <p>The company have gone on to say that references to established processes are not relevant if they are not funded and that they will not be able to accept a regulatory contract with no headroom to manage risk to cost and service.</p>	<p>It has not been possible to agree funding with DRD for relevant items due to the continuing uncertainty and pressure on existing PE budgets.</p> <p>Established processes have generally worked well during the first two price controls. However we are aware that there is currently a review of government funding for many key services. In the event of public expenditure reductions for water and sewerage services we will work with NI Water to ensure that it delivers the best possible package of business plan outputs within the final PE allocation.</p>
			<p><u>Inflation Pressures</u></p> <p>The company have noted a risk to PE if inflation is significantly higher than originally forecast.</p>	<p>We are aware of this issue as the company has brought it to our attention in the past. We have updated our inflation assumptions from the draft determination with the latest forecasts published by HM Treasury.</p>

Ref	Organisation	Section	Comment	Our response
			<p><u>Mid-Term Review</u></p> <p>The company have generally welcomed the regulators proposals for a mid-term review.</p>	<p>We have reiterated our general approach to the mid-term review in the final determination. Further work with the company will be required in this area and we have highlighted this within our Forward Work Programme for next year which is currently out for consultation.</p>