Response to CMA 2019/20 data for base cost models – Working Paper

20 January 2021

1. Response to 'CMA 2019/20 data for base cost models – Working Paper'

1.1 Thank you for issuing the recent 2019/20 Data Working Paper[1] on the use of 2019/20 costs in the base cost models and providing us with the opportunity to comment on the current proposal.

1.2 We are deeply concerned that the CMA has excluded the updated 2019/20 cost data from its analysis. The primary piece of evidence that the CMA relies upon – an analysis of "brought forward" investment – is exceptionally weak and does not bear the weight attributed to it. This leaves the CMA to rely instead on anecdotal evidence and vague concerns that inclusion of the data in question would upwardly bias the costs assessment. In fact, what the evidence indisputably shows is that **omission of the 2019/20 cost data would downwardly bias YWS's cost allowance**. Accordingly, YWS requests that the CMA revisit its reasoning and decision making on this point in its Final Determination.

1.3 We have further set out our concerns on the technical validity of the analysis supporting the 2019/20 Data Working Paper in summary below, and in full in Annex 1 prepared by Oxera.[2]

1.4 The decision to exclude the actual 2019/20 costs represents a divergence both from the CMA's stated principle to "*use the most up to date information available*"[3] and from the outcomes presented in the Provisional Findings. Reneging on the fundamental principle of using the best available factual evidence sets a dangerous precedent and should only be considered if there is compelling evidence that this will result in a better outcome for the redetermination process. This is plainly not the case in this circumstance.

1.5 Since the Provisional Findings, the CMA has been consulting on possible changes to its position, notably on WACC and the level of enhancement expenditure for leakage.[4] Were the positions set out in these recent

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1 CMA, Water Redeterminations 2020 – 2019/20 data for base cost models – Working Paper (13 January 2021) **(2019/20 Data Working Paper)**.

2 Oxera, 'Response to the CMA's Working Paper on the use of 2019/20 data in base cost modelling', (January 2021).

3 CMA's Provisional Findings, (29 September 2020), paragraph 3.53.

4 CMA, Water Redeterminations 2020 – Leakage Enhancement Totex Allowances – Working Paper (15 January 2021); CMA, Water Redeterminations 2020 – Cost of Capital – Working Papers Executive Summary (8 January 2021); CMA, Water Redeterminations 2020 – Choosing a point estimate for the Cost of Capital – Working Paper (8 January 2021); and CMA, Water

Working Papers to be adopted in the CMA's Final Determination, the combined effect would be to significantly shift the balance of risk and return beyond a reasonable range for YWS. Given this overall position, it is not possible to overlook the deficiencies in the CMA analysis leading to the exclusion of the 2019/20 costs. Based on the reasoning set out in the 2019/20 Data Working Paper and its companion pieces, neither the "means" nor the "end" are justified.

1.6 We would draw to the CMA's attention our previous arguments on the relationship between performance and expenditure.[5] The Provisional Findings did not meaningfully engage with the arguments set out by disputing companies about the structural link between performance improvements and costs. Instead, they only considered the specific service variables proposed by companies to illustrate the analytical link between performance and expenditure, and the viability of integration of the two, as cost drivers in the base models (e.g. SELL, Leakage, Water Quality Contacts). The position in the 2019/20 Data Working Paper is in direct contradiction to this approach, an inconsistency for which no explanation is provided.

1.7 Instead, the 2019/20 Data Working Paper relies on evidence that companies are spending more than predicted in 2019/20, in anticipation of the challenging performance requirements required from 2020. Indeed, the 2019/20 Data Working Paper sets out that one of the main reasons for ignoring the actual 2019/20 costs is that the "*additional spending would increase the dependent variable of our models, creating an increase in costs that is not explained by changes in the explanatory variables*."[6] These two positions are mutually exclusive – either the required service improvements are explained by the models, or they are not.

1.8 We elaborate on this point further in Annex 1 to this response as it is simply bad practice to <u>select the data to fit a model</u> (i.e. blame the data) rather than to <u>select a model to fit the data</u> (and acknowledge the general limitations of the model, such as the disconnect between cost and service performance) and this has led to errors of assessment in this case. We would encourage the CMA to revisit this position so that

Redeterminations 2020 – Cost of Debt – Working Paper (8 January 2021) (together with the 2019/20 Data Working Paper, the **Working Papers**).

5 See, for example, YWS's Statement of Case (2 April 2020), paragraphs 135-215 and YWS's Response to Ofwat Reply (27 May 2020), section 5.1.1 et seq.

6 2019/20 Data Working Paper, paragraph 31.

expenditure for service improvements can be appropriately captured in the cost assessment process.

1.9 Annex 1 also highlights further discrepancies with the conceptual approach and evidential basis for the CMA's provisional exclusion of the 2019/20 actual costs. Specifically, we examine the following issues:

(a) *Modelling over a complete AMP cycle*. Failing to include the updated 2019/20 actual costs results in the CMA models not being able to consider a complete five-year regulatory period. The CMA assumes that companies have "overspen[t]" in the final two years of AMP6, without any consideration of whether "underspend" occurred in the preceding three years.[7] Of more concern, the analysis takes no account at all of companies' expenditure compared to the regulatory cost allowance for the AMP. Effectively, the CMA appears to be suggesting companies have "overspent" in the last year of the AMP even when they are efficient compared to the regulatory allowance for the full five years.

(b) *Estimating Efficiency*. The efficiency scores are directly affected by which years are chosen for the benchmark period. By failing to update the 2019/20 data, the CMA has estimated efficiency scores over an incomplete AMP. Therefore, the estimated efficiency is not representative of the latest and complete planning cycle and leads to a significant bias in YWS's estimated cost allowance.

(c) *Nature of expenditure*. The CMA has based much of the argument for disregarding 2019/20 expenditure on anecdotal evidence that companies have "brought forward" expenditure in anticipation of AMP7.[8] It is not clear from the company commentaries if this investment is base expenditure or enhancement expenditure, or even if it relates to water or wastewater expenditure. For YWS, we have sought to improve our leakage performance in 2019/20 and have consequently incurred higher costs. These capital costs have been accounted for as enhancement expenditure in the APR and so will not be relevant for the base cost models.

1.10 Indeed, the CMA seems to assume that base expenditure can be readily transferred from one time period to another, when it is in fact obviously the case that much of a company's base operating expenditure such as

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7 2019/20 Data Working Paper, paragraphs 40-44.

8 2019/20 Data Working Paper, paragraphs 45-51.

power, labour and chemicals can only be incurred "in-period". It is only enhancement, growth and some aspects of maintenance and renewals expenditure that can be realistically "brought forward".

1.11 Notwithstanding the technical and conceptual problems, we would also like to encourage the CMA to consider the longer-term incentive properties that the proposed approach to excluding the 2019/20 costs will have on the sector. Essentially, were the approach in the 2019/20 Data Working Paper to be replicated in the CMA's Final Determination, it would be apparent to companies and investors that investment "brought forward" ahead of the start of the new regulatory period is at risk of being excluded from the cost models. This is very different to the message Ofwat actively promoted to companies throughout the PR19 process by encouraging them to "*act now to get ahead of the game*."[9] This evident contradiction creates perverse investment incentives and is, in any event, unreasonable on the evidence.

1.12 We note that one of the stated benefits of Ofwat's IAP and Fast Track Determinations was to provide regulatory certainty for some companies and allow an early start to the next AMP. Indeed, the commentaries provided by Ofwat in the 2019/20 Data Working Paper include explicit reference to this by Severn Trent.[10]

1.13 Similarly, YWS invested ODI and totex outperformance from years 1 to 3 of AMP6 into years 4 and 5 to get an early start on the challenging performance requirements for AMP7.[11] The early start programme was necessary to allow sufficient time for delivery programmes to be initiated, designed, evaluated, implemented and operationalised. The "in-period" ODI framework introduced by Ofwat for AMP7 requires companies to make step changes in performance annually, but significant lead-in time is obviously required for asset intensive measures.

1.14 For leakage, Ofwat signalled a clear policy change in both the draft and final PR19 methodologies that "step changes" in performance were expected and that targets would no longer be set with reference to the "sustainable economic level of leakage." The expectation to shift to upper

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9 Ofwat, 'Cathryn Ross speaking notes, 'Future of Utilities – Water 2017'', (21 November 2017), page 4, available from: https://www.ofwat.gov.uk/wp-content/uploads/2017/11/Cathryn-Ross-speaking-notes-Future-of-Utilities-Water-2017-21-November-2017-FINAL.pdf

10 2019/20 Data Working Paper, paragraph 10.

11 For example, the expected c.70% step up in performance between the year 5 target in AMP6 and the year 1 target in AMP7 in internal sewer flooding.

quartile performance, or make 15% improvements, from year 1 of the AMP would have been impossible without early capital enhancement investment and planning.

1.15 The decision to re-invest outperformance into the service improvements ahead of AMP7 was consulted on by our Yorkshire Forum for Water Customers, who agreed that this would provide customers with a greater benefit early (as opposed to a share in outperformance through bill reductions). It also allowed additional time for learning and innovation to be trialled and potentially shared with the industry. It became increasingly apparent as the price review progressed and the performance expectations tightened significantly throughout the process that early preparation and investment was necessary.

1.16 Were this approach to be carried into the CMA's Final Determination, it would jeopardise our understanding that the true costs of service delivery would be reflected in the cost models where we wished, for good customer and operational reasons, to make an early start. In the future, we simply will not risk investing ahead of the next AMP period if those costs will potentially not be recognised by the regulator.

1.17 We are firmly of the view that the 2019/20 actual costs should be included in the models, a position supported by the wider industry through Water UK.[12] That said, there are potentially several ways in which the CMA could address its concerns about potential accelerated costs in 2019/20. While we do not consider adjustments to 2019/20 data necessary, a partial inclusion of the costs[13] would represent a better outcome than the current approach of fully disregarding the actual data.

1.18 For example:

(a) Adjusting 2019/20 costs in specific areas of expenditure areas for individual companies where there is clear and robust evidence that a company has incurred increased costs as a direct result of "brought forward" investment.

(b) Where this is not possible, adjustments to actual costs (i.e. to retain the 2019/20 forecasts) could be made to specific

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12 Water UK, 'Water UK response to CMA consultation on use of 2019/20 data for base cost models', (January 2021).

13 We note that caution must be exercised when making any adjustments to the data. The need for, and approach to, any adjustment must be robustly evidenced. In this regard, we do not consider that the CMA has provided sufficient to justify any adjustment to the 2019/20 data, let alone its complete omission.

expenditure areas where it is most plausible that costs have been "brought forward". Annex 1 further discusses this approach.

(c) Alternatively, the CMA could "triangulate" between parallel models that separately use forecast and actual 2019/20 costs separately. At the very least, this approach would allow for the 2019/20 costs to be included in setting the efficiency benchmark and address the concerns outlined in Annex 1.

1.19 We also consider that similar considerations may be necessary for other years in the data sample (i.e. the low-cost years) to achieve a balanced view. We are pleased to note that the CMA has sought views on three methodological issues, should the 2019/20 actual data be included. On these issues, we agree that frontier shift should only be applied to actual data rather than forecast (and so would only apply from 2020/21 onwards), and that the same approach to setting the efficiency benchmark is adopted, just updated for the 2019/20 data. We have set out further views on the treatment of the merger between Severn Trent and Dee Valley in Annex 1.

1.20 In conclusion, it is our view that the evidence presented in the 2019/20 Data Working Paper is neither clear nor compelling and does not justify the exceptional step of excluding actual cost data from the cost assessment process. Consequently, the approach proposed in the 2019/20 Data Working Paper results in biased cost allowances for YWS and sets a dangerous precedent for regulators to disregard actual expenditure in favour of inaccurate forecast data. Such unreasonable departure from established regulatory good practice would influence our behaviour in the future and may have wider implications beyond the confines of this redetermination.