



# Response to Leakage Enhancement Totex Allowances – working paper

## 1. Summary

1. Although we agree with much of the overall approach that the CMA has set out in the Leakage Enhancement Totex Allowance working paper, we disagree with the conclusion. There are inconsistencies and material flaws in the analysis.
2. We note the proposal for Bristol Water is a marginal difference given the £4.833m included in our Statement of Case (and also allowed by Ofwat in the PR19 Final Determination), and the £4.69m calculated by the CMA as an average of the top down and bottom up assessments in the working paper.
3. The CMA does not appear to have recognised that our £4.833m allowance was not our bottom up unit costs, but was post our efficiency challenge including frontier shift. We amended our plans to replicate Ofwat’s PR19 assessment approach. We made clear that any assessment of efficiency that the CMA undertook must start from our £5.66m gross enhancement cost estimate. We provided sufficient data for the CMA to assess this, but it has failed to do so.
4. In our previous submissions we set out that any efficiency analysis undertaken by the CMA should consider, in the round, that we had set ourselves a challenging target of £4.833m for enhancement spend. A CMA assessment above this level (starting from £5.66m), could in the round result in an allowance of £4.833m with our support. It is incorrect though to just apply challenges to our lower (post efficiency) starting point of cost. Applying marginal efficiency assumptions to our post efficiency plan value is incorrect.
5. Given the low unit costs and excellent leakage performance of Bristol Water, this is unreasonable, particularly given the very low level of further adjustment applied. The CMA states this comes from a bottom up efficiency assessment. We can find no evidence of this. In the working paper we can only find a cross-reference to Ofwat’s statement that they apply a standard 5% “deep dive” assessment (although Ofwat did not take this approach to leakage<sup>1</sup>). Ofwat did not use this challenge in their response to the Provisional Findings (PFs). Instead Ofwat backsolved to the CMA Provisional Findings value for Bristol Water. This is not an appropriate, rational and unbiased approach to a regulatory determination.
6. At face value, whilst there is bottom up assessment for Anglian and Yorkshire, and a separate consideration for Northumbrian, the CMA appears not to have completed a bottom up assessment for Bristol Water, perhaps because the amount of totex involved is not seen as material, although this is not stated as a reason. If there was an assessment, no comments or reasoning is supplied. We have expressed similar concerns in responding to the other recent working papers, which in the round cause us to question whether the CMA is adequately considering the Bristol Water redetermination, given the difference in size between ourselves and the other three Disputing Companies. It cannot be consistent

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<sup>1</sup> CMA (2021), ‘Leakage Enhancement Totex Allowances – Working Paper’, paragraph 91



with the principles of regulatory best practice for the CMA to give lesser consideration to Bristol Water’s case than it does to the cases made by other Disputing Companies.

7. Although we make a number of technical points highlighting issues with the analysis in the working paper, we have kept our response as short as possible. It should be proportionate to the value in dispute. However, leakage is an important topic to Bristol Water and its customers, something the CMA had some insight to during our hearings and at the virtual site visit. The CMA consistently states it will look at the evidence in the round. We believe the CMA should look through the layers of calculation methodologies, and for leakage enhancement ask whether there is sufficient evidence to move away from the company plan (as recognised in Ofwat’s original determination). Given the very marginal (but fundamentally flawed) adjustments suggested in the consultation, we think a fixed allowance of £4.833m in the CMA’s Final Determination would be in the interests of effective regulation. This would be an appropriate, bespoke, approach to Bristol Water.
  
8. Although the consultation did not request comments on the approach to base costs, we observe that the CMA appears to have set out a conclusion without considering the evidence we put forward in our response to the Provisional Findings, in particular that the cost models, by definition, can only allow for the cost of a median level of performance. When you consider the increase in water service base costs in AMP6, and the improvement in performance, setting an allowance based on the gap to the upper quartile rather than median performance is not an adequate adjustment for high performing companies such as Bristol Water. As we set out in our Response to the CMA Provisional Findings, the CMA’s Final Determination should set our base cost allowance in respect of leakage in relation to the gap between Bristol Water’s performance and the median level of industry leakage performance.<sup>2</sup>

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<sup>2</sup> Bristol Water (2020), ‘Response to CMA Provisional Findings’, paragraphs 183 – 196.



## 2. Comments on the CMA assessment approach

9. We agree with the overall CMA taking a bespoke, company specific, approach. This is a rational conclusion, given the clear evidence of two companies with low existing levels of leakage (Anglian & Bristol Water) and two companies with low enhancement unit costs (Bristol & Northumbrian Water).
10. The CMA has also accepted the principle of an increasing marginal cost of leakage enhancement at lower levels of leakage. Given that Bristol Water clearly has low leakage and low enhancement unit costs, and is in a unique position in this regards, it is puzzling that the CMA makes any adjustment to Bristol Water's requested costs, based on the evidence presented.

### Top down options

11. We support the use of Option 1 (top down) as set out in the working paper. Table 13 states that this results in a totex allowance of £4.8m top-down. We consider that Option 2 and Option 4 in the consultation have not been calculated correctly in any case.
12. In Option 4 (page 15), the CMA adjusts a three year average of 40.7MI/d against a PR14 average of 39.5MI/d.
13. Our view is that the target should not be pro-rated in this way between the PR14 and PR19 leakage methodologies. Weather impacts affect the difference between the PR14 and PR19 leakage methodology (the difference reflects whether technical data changes are taken into account, not an impact on customers of the higher leakage reported under the PR14 methodology). Our target on the PR19 basis (*a priori* before technical data changes) was a 41MI/d three year average to 2019/20. Other differences between the PR14 and PR19 target reflect the weather impacts, not a change in target.
14. It is worth noting that the PR14 ODI for Bristol Water was applied on average over 2015-20 and leakage therefore managed over the five-year period. It was translated for reporting purposes into annual measures, but this is not appropriate for measuring ODI performance until the end of the period. Therefore, the difference in ODI performance over the five year average is 0.2MI/d (45.6MI/d vs 45.4MI/d target). Given the nature of the PR14 ODI, which allowed averaging over five years in calculating rewards/penalties, it is unreasonable to retrospectively apply adjustments to the PR19 approach as set out in Option 4. The adjustment should only be 0.1MI/d.
15. In addition as this is an adjustment to the three year average calculation based on the PR14 vs PR19 definition data changes, it should be adjusted to the value in Option 1 (8.7MI/d) based on the three-year average in 2019/20, rather than Option 2 (5.0MI/d) based on the 2019/20 single year performance.
16. Therefore we believe Option 4 understates the value of AMP7 leakage reduction targets, and should be 8.5MI/d (8.7MI/d – 0.2MI/d).
17. If the CMA did not agree with the 0.2MI/d adjustment, in any case, Option 4 should be 6.5MI/d (8.7MI/d - 1.2MI/d). Note this is the same as the Water Resource Management Plan 2019/20 to 2024/25 target reduction, so has some logic.
18. This wide variation in possible calculations under this approach (3.8MI/d CMA view to 8.5MI/d corrected view) provides further support to the CMAs decision not to use Option 4.



## Bottom up assessment

19. The Bottom up approach set out in paragraph 72 and Table 9 of the working paper is problematic. The CMA appears to have taken the results of Ofwat’s assessment for three companies, including Bristol Water, and only applied its own assessment for Anglian.
20. The CMA states *“Our reasoning for these adjustments to the calculation and our decision on whether to use this to determine allowances is explained in the Company Specific sections of this Working Paper.”*<sup>3</sup>
21. No comments are made for Bristol Water in the section headed *“Overall Leakage Enhancement assessment”* on page 20.
22. The bottom up assessment in paragraph 91 merely states *“For Bristol’s bottom-up assessment, we have mirrored Ofwat’s analysis, applying a 5% efficiency that yields an allowance of £4.59m. This was the only adjustment applied.”*
23. This is not a reasoning for adjustments. There is no analysis or explanation of the CMA’s proposed approach. It is impossible for Bristol Water to effectively respond to a working paper which does not fully explain the CMA’s reasoning for its proposed approach. Therefore, the approach is fundamentally flawed and inconsistent with the principles of best regulatory practice.
24. The CMAs reference to the Ofwat bottom up *“position”* in the consultation is incorrect in any case, which will have limited the ability of respondents less familiar with the extensive documents in the process to understand the bottom up assessment. It should have referenced Ofwat’s Response to the Provisional Findings responses, rather than the response to the Provisional Findings.  
  
*“Ofwat’s bottom-up position for Bristol is shown in Ofwat’s response to the provisional findings – costs and outcomes, Table A3.5 on page 74”*<sup>4</sup>
25. This context is important as companies have not had a direct opportunity to respond to this late Ofwat submission in detail. This Ofwat late response, reflects that Ofwat did not provide comments as originally requested to in RFI018a, or in their response to the Provisional Findings. Bristol Water made a substantive response to RFI018a which was carried out in advance of the Provisional Findings deadline, but Ofwat did not complete their assessment at that point. We would also observe that other than the Isle Utilities further assurance, none of the information we provided was different to the original Bristol Water business plan in September 2018.
26. The CMA reference is to table A3.5 on page 75, where Ofwat states *“These are applied consistently with the approach used by the CMA in ‘Leakage totex calcs tables 8-2 & 8-3 PFs’. We have retained the CMAs efficiency challenge and recognise the CMA may revise this specifically for leakage on the basis of the further information it has received. We consider any challenge applied should be a minimum of 5% on the basis of the challenge applied in PR19 deep dive assessments where we found insufficient evidence of efficient costs.”*<sup>5</sup>

<sup>3</sup> CMA (2021), ‘Leakage Enhancement Totex Allowances – Working Paper’, paragraph 72

<sup>4</sup> CMA (2021), ‘Leakage Enhancement Totex Allowances – Working Paper’, footnote 42

<sup>5</sup> Ofwat (2020), ‘Response to provisional findings responses – costs and outcomes’, page 74



27. This is Ofwat merely stating that it agrees with the CMA assessment of Bristol Water enhancement allowance in the Provisional Findings (because in combination with base leakage allowances it was overall in line with Ofwat’s Final Determination). Ofwat therefore carried out no bottom up assessment themselves, merely stating the policy that would have applied if they had carried out an assessment. They carried out no such assessment for Bristol Water during PR19, because our unit costs were efficient, and we had aligned our leakage enhancement efficiency request to Ofwat’s methodology (hence £4.833m rather than £5.66m, as stated in the overview).
28. We note Ofwat’s challenge to the CMA in section A3.17 of its response to the provisional findings – costs and outcomes.
- “Leakage was a key headline policy area for us in PR19 and **unless we have further adequate consultation on this area we consider this would be a significant flaw in the CMA’s decision making**; as a result we consider the CMA’s approach to determining efficient leakage reduction costs requires proper consultation before the CMA makes its final decision.”<sup>6</sup>
29. We do not consider the CMA bottom up assessment to be adequate further consultation, as it merely appears from the information provided to be an application of Ofwat’s deep dive minimum adjustment, which Ofwat did not even assess or apply in the first place. This is significant flaw and does not allow for proper consultation.
30. Furthermore, Ofwat’s response (nor based on the information published, the CMAs working paper) does not consider our response to the Provisional Findings, and we can see no evidence that the evidence in section 16 of our response to the Provisional Findings, alongside RFIs and the Isle Utilities report has been considered in the bottom up assessment. Although and because the numbers are small, applying an Ofwat challenge, that reduces the expenditure allowance from Ofwat’s FD and our plan, is unwarranted and inappropriate.
31. At face value, whilst there is bottom up assessment for Anglian and Yorkshire, and a separate consideration for Northumbrian, the CMA appears not to have bothered for Bristol Water, perhaps because this is not seen as material, although this is not stated as a reason. We have express similar concerns in responding to the other recent working papers, which in the round cause us to question whether the CMA is adequately considering the Bristol Water redetermination, given the difference in size between ourselves and the other three appellants. While this may be understandable, it is also wrong.
32. Beyond the CMA’s failure to carry out an adequate bottom up assessment (which it applies in equal proportion to the top down assessment in its consultation position), we reviewed what Ofwat’s 5% efficiency analysis was based on. Ofwat did not use a 5% efficiency challenge, rather proposing back-solving to the CMA’s Provisional Findings allowance for Bristol Water.
33. We can see no evidence of a bottom up assessment for Bristol Water, other than applying Ofwat’s minimum / standard 5% “deep dive” assessment, which Ofwat did not assess or apply at any point for Bristol Water. We do not consider the CMA or Ofwat have presented any evidence whatsoever of a bottom up assessment, given the efficiency challenge of c15% we had already incorporated into our business plan proposals.

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<sup>6</sup> Ofwat (2020), ‘Response to provisional findings – costs and outcomes’, paragraph A3.17