

1 NORTHUMBRIAN WATER RESPONSE TO THE CMA WORKING PAPER ON LEAKAGE

1.1 SUMMARY

- (1) On 15 January 2021 the CMA published a Working Paper on the approach to leakage (**Leakage Working Paper**). This is Northumbrian Water's (**NWL's**) response to that Working Paper.
- (2) As a starting point, we agree with the CMA's provisional conclusions that "*it is reasonable that some of the companies may need to incur additional enhancement spend to move from the AMP6 targets based on SELL assessments, to the new targets of 15% or more below previous levels*" and that it is appropriate to allocate "*an allowance for the efficient costs of these enhancements*".¹
- (3) It is, when seen in that context, extremely disappointing that the CMA has not applied these points of principle on an equivalent basis to NWL and instead provisionally concludes that we should not be allocated an enhancement allowance for leakage. This is despite us having clearly demonstrated that, like the other companies, we will incur these enhancement costs in AMP 7 and that our costs are efficient.²
- (4) We disagree, therefore, with the CMA's provisional conclusion that it is reasonable to limit the application of that principle to those "*companies whose business plans identified that further enhancement allowances were needed to meet the ambitious leakage PCs*" – the effect of which is to apply this adjustment to all Disputing Companies with the exception of NWL. The CMA's primary rationale for this position appears to be that to do otherwise would be "*inconsistent with the business plan process*" and that what it considers to be our business plan view, that the PC improvements could be funded from base expenditure, remains "*realistic*" such that a 'reclassification' of expenditure as enhancement is "*not compelling*".³
- (5) This provisional conclusion is unreasonable and results in an unjustifiable and discriminatory outcome for NWL compared to the other Disputing Companies.
- (6) As we set out in this response, we consider that it would be appropriate for the CMA to make an enhancement allowance for NWL consistent with the basis for which one is being made for the other Disputing Companies:
 - we will incur enhancement expenditure of c.£15.57m during AMP7 to achieve our target leakage reductions – and this has always been the case;
 - our presentation of those costs in our business plan, and subsequently in our Statement of Case (**SoC**) must be seen in the context of the PR19 regulatory framework which was very clear that all leakage costs should be treated as base costs (with very limited exceptions for enhancement costs for upper quartile performers) and our PR19 proposals as an overall package;
 - our response to the CMA's emerging thinking on the treatment of leakage costs in the PFs was reasonable and proportionate in light of the evolution from Ofwat's FD19 policy and methodology and is based on cogent evidence and reasoning as to the

¹ CMA Leakage Working Paper, para. 39.

² NWL Response to PFs, Section 6; NWL Reply to PFs Responses, Section 4.4; NWL response to RFI012; NWL Response to RFI018A; and NWL Response to RFI020.

³ CMA Leakage Working Paper, para. 96.

existence of our efficient enhancement costs. It should not be characterised as inappropriately “*opportunistic*” as Ofwat has inferred;⁴

- we have previously challenged the assessment that our leakage levels are “*relatively high*”⁵ and our PC levels are slightly lower⁶ and do not agree with that characterisation, but regardless this should not be a reason for excluding the enhancement allowance based on the CMA’s approach to Yorkshire Water which has similar features;
- the fact that our proposed costs are relatively low is similarly not a reasonable justification for not making an allowance. Such an approach would simply punish efficient companies, the exact opposite of what the CMA should be trying to achieve;
- this is a full redetermination, meaning that the CMA can and should take decisions on matters not raised by the parties themselves;
- where the CMA makes important methodological and policy changes from Ofwat’s final determination that are not company-specific those should be applied on an equivalent basis to all Disputing Companies; and
- even allowing for the CMA’s statement that its approach has been tailored to each company’s individual circumstances,⁷ the fact that the enhancement costs were not explicitly included in our business plan is not a sound basis on which to draw such a significant distinction and is inconsistent with the principles of best regulatory practice.

(7) The CMA’s leakage methodology should, therefore, be applied to all Disputing Companies that can demonstrate that they meet the relevant substantive criteria: i.e. that they will incur additional enhancement expenditure to deliver the AMP 7 reductions; and that the associated costs are efficient. We consider that these tests are met for all four Disputing Companies, including NWL.

(8) Should the CMA conclude that it would be appropriate to make an enhancement allowance for NWL, we note that:

- in light of the arguments put forward, including those in relation to AMP6 cost outperformance overall (despite NWL overspending against the water price control⁸), we can accept the principle of CMA’s position set out in “Option 3”⁹ that funding should only be allowed for leakage reductions below the lowest levels recently achieved by companies, which for us was in 2013/14. **Based on the CMA’s calculations this would result in an allowance for NWL of £10.8m;**¹⁰
- we do not support the use of CMA’s top down approach as set out in Option 2.¹¹ It is perverse and inappropriate to measure leakage reductions using a different measurement basis for the start and finish points; and
- the justification for the CMA’s view of an appropriate “bottom up” allowance for NWL of £6.27m does not properly reflect the recent evidence we have submitted on our costs - it is not clear that this, and indeed other evidence we submitted to the CMA elsewhere has been read and considered.

(9) We note that as the CMA recognises in its consultation¹² and as we have stated elsewhere,¹³ were our cost gap of c.£85m to be met by other means then we would not seek further

⁴ For example in Ofwat’s “Reference of the PR19 final determinations: Costs and Outcomes –response to provisional findings responses” Para A3.4

⁵ NWL response to PFs section 6.2.1.

⁶ CMA Leakage Working Paper, para. 96 2nd bullet.

⁷ CMA Leakage Working Paper, para. 7.

⁸ As set out in the data supporting Ofwat’s 2019/20 Service Delivery Report – water expenditure of £1378m vs allowance of £1302m

⁹ As per CMA Leakage Working Paper, para. 53.

¹⁰ As per CMA Leakage Working Paper, para. 53: $17.5\text{Mld}/25.3\text{MLD} \times £15.6\text{m} = £10.8\text{m}.$

¹¹ As per CMA Leakage Working Paper, para 52.

¹² As per CMA Leakage Working Paper, para. 97

¹³ NWL Post PFs Hearing Presentation, Slide 7

funding from customers for leakage or any other cost pressure. Clearly the consultation is on a single area of the redetermination and that means that we cannot yet see the extent to which the CMA will address that overall cost gap. We set out a stretching business plan package for our customers at PR19: our decision to seek a redetermination was motivated entirely by our desire to get back to that plan and never to seek allowances beyond it.

- (10) Finally on the subject of leakage, as referred to in our PFs hearing, we would like to take this opportunity to remind CMA of an outstanding point regarding the precise definition of our bespoke PC for responding to visible leaks.¹⁴ We welcome a conclusion from CMA on this in its final redetermination.

1.2 RELEVANCE OF THIS BEING A FULL REDETERMINATION

- (11) It is well established that if a water company challenges its price control settlement from Ofwat and a referral is made to the CMA, the CMA carries out a full redetermination. In practice, this means that the CMA makes a completely fresh determination on the merits and, whilst it must comply with the same statutory duties as Ofwat, it is not bound in any way by Ofwat’s methodology or conclusions.

- (12) Similarly, the CMA is not limited to consideration of the issues highlighted as areas of concern by either the disputing company or Ofwat. It is free to give consideration to issues raised by third parties, or to issues raised by no-one but identified as areas for intervention by the CMA itself:

*"The scope of our determinations extends to **all aspects of the price control and not just the issues raised by the Main Parties**. We were also conscious that the redeterminations should not be construed as processes that would necessarily lead to an outcome for the Disputing Companies better than the Ofwat determination. **We did not limit our assessment to the specific issues raised by the companies in their statements of case** and considered whether the allowances set by Ofwat were too generous. We also **considered other areas of significance to the outcome not raised by the parties**, and invited third parties to tell us if there were any other areas they thought we should consider."¹⁵ (Emphasis added)*

- (13) As a point of principle we consider that the fact that the CMA is not limited in the scope of its redetermination by the issues we have presented in our SoC should work both ways: just as it does not prevent the CMA from opening areas we have not raised where it concludes that the FD allowance is too generous, nor should it preclude the CMA from increasing our allowance in areas that we have not raised where it concludes that Ofwat’s allowance was insufficient to fund efficient costs.

- (14) A corollary of this is that the CMA is also required to take appropriate account of “*information, views and evidence produced and provided to us by the Main Parties **in the course of the redeterminations***”.¹⁶ Where the CMA itself has developed and presented new methodologies as part of its provisional redetermination, it is only proper that we should be able to respond and adapt our position accordingly.

- (15) One novel aspect of this particular process is that four companies rejected FD19 and their redeterminations have been run by the CMA in parallel. Recognising the potential for the read-across of issues, in its statement on its approach to the redeterminations the CMA confirmed that:

*"Within our redeterminations, **our consideration within an area of the price controls is not driven solely by the issues raised by the Main Parties** (although this is an important*

¹⁴ Full details in NWL letter to CMA (Sarah Fox) dated 13th July “Ofwat Pr19 corrections and clarifications”.

¹⁵ PFs, para. 3.9.

¹⁶ PFs, para. 3.8

*part of the evidence we will be considering). We will also be considering issues raised and evidence provided by Third Parties. In addition, **our decisions on issues raised by each Main Party, unless the issue is a solely company-specific matter, will be likely to have relevance for the redeterminations for the other companies.***¹⁷ (emphasis added)

- (16) This statement is both clear and consistent with the principle of this being a full redetermination in which the CMA is not constrained by the issues on which the parties themselves have focused. If a decision of the CMA is not company-specific and has broader relevance for all the Disputing Companies, it is right and proper that it should not limit its application to the party that raised the point. Indeed, the CMA's s2(4) WIA 1991 duty to comply with the principles of best regulatory practice requires it to be proportionate and consistent in its interventions.
- (17) Where, as in the case of a sector-wide issue such as leakage, the CMA has responded to issues raised by some of the parties and has materially changed the methodology as applied by Ofwat in its FD19, to limit the application of that change to a subset of disputing companies, solely by reference to who raised the point in the first instance, seems unreasonable, inconsistent and disproportionate – both as a matter of principle and by reference to the underlying circumstances.
- (18) In these circumstances, the onus should not reasonably be on the disputing company to give “*cogent evidence and reasoning*” to support a perceived “*change of view*”¹⁸ but instead on the CMA to justify why it is limiting the application of the methodology in this way and effectively discriminating against NWL vis-a-vis the other Disputing Companies. As we set out in the following sections, the CMA's apparent justifications for doing just that are insufficiently robust.

1.3 CONTEXT FOR OUR LEAKAGE CLAIMS

1.3.1 Our Business Plan approach

- (19) As the CMA has accepted, Ofwat's PR19 leakage reduction targets are a step change for the sector, particularly when seen in the context of the previous approach that was driven by SELL. Our detailed plan to deliver those reductions, as provided to the CMA in response to RFI018, was developed to complement our most recent Water Resources Management Plan (**WRMP**), which we consulted on in 2018 and published in 2019.¹⁹ The WRMPs focus on the detail of how we planned to achieve the reductions, but as is the nature of WRMPs, did not publicly address any associated costs.
- (20) Those costs were, however, assessed as part of our internal business planning. As set out in our original delivery plan, it was always the case that we expected the enhancements required to deliver the necessary reductions to cost in the region of c.£16m.²⁰
- (21) As we explained in previous submissions, our approach to these leakage reduction costs in our business plan was heavily influenced by Ofwat's stated policy and methodology:
- “*we expect an efficient company to be able to deliver our performance commitment levels through our base allowance*”²¹ and, as a matter of principle, Ofwat stated as part

¹⁷ CMA's PR19: Approach to the redeterminations, 11 June 2020, para. 27.

¹⁸ CMA Working Paper, para 97

¹⁹ See our WRMPs for NW and ESW, Sections 5.3.5: <https://www.nwg.co.uk/responsibility/environment/wrmp/current-wrmp-2015-2020/>

²⁰ See NWL Response to RFI018A Question 2(B) and NWL RFI018A-001 Appendix 1 – Summary of interventions and costs.

²¹ SOC417 PR19 FD Securing Cost Efficiency Technical Appendix, p.61

of its Initial Assessment (IAP) in January 2019 “*rejected requests for enhancement costs related to the funding of one of our common performance commitments*”;²²

- the one exception to this general principle was for “*leakage reduction, where we are allowing enhancement funding for companies who plan a greater than 15% reduction or performance beyond upper quartile*”.²³ As our plans were based on 15% reduction in NW, and 17.5% in ESW (only slightly exceeding the 15% benchmark) and our metrics did not pass the upper quartile (UQ) test we did not qualify for any material enhancement costs under Ofwat’s approach. In contrast, both Anglian Water and Bristol Water are UQ for these purposes and requested, and were granted, an enhancement allowance; and
- cost adjustment claims were reserved for “*unique or atypical*” costs.²⁴ As all companies had been given the same 15% leakage reduction challenge, in our view associated costs could not be described as “*unique*”. We note that Yorkshire Water did make a cost adjustment claim for leakage but on the basis that its costs were “*atypically large*”.²⁵ As Yorkshire Water’s claimed costs are substantially higher than ours (£94.7m compared to our c.£16m), the difference in approach is understandable - Yorkshire Water’s costs do appear to meet the criteria whereas ours did not.

(22) During Ofwat’s PR19 process it was clear, therefore, that we were not eligible for either an enhancement allowance or a cost adjustment claim, so the only possible FD19 outcome would be an assumption that our leakage reduction costs be funded from our overall totex allowance, or other resources.²⁶

(23) It is also relevant that had we included a claim for these costs in our business plan despite the clear steer from Ofwat that it would not be supported, this could have had implications for the assessment of our efficiency, and our chances of being granted fast track status, at the IAP. We also note that if, at IAP, Ofwat considered costs the companies had classed as enhancement “*to be part of the normal running of the business*”, as it had explicitly stated for leakage costs, it would “*consider that such costs are included in our base allowance and make no further adjustment*”.²⁷

(24) It is correct, therefore, that we did not explicitly signal in our business plan the additional enhancement costs that we knew we would incur to deliver the AMP 7 leakage reductions. However, this decision must be seen in the context of Ofwat’s prevailing methodology and what was legitimately achievable in terms of movement during that PR19 process. Given that the CMA’s approach to this same issue has fundamentally shifted away from that taken by Ofwat, to refuse to apply its new methodology and policy simply on the basis that these costs were not explicitly identified in our business plan appears unduly punitive and disproportionate.

1.3.2 Our approach to the SoC

(25) When compiling our SoC we remained mindful of Ofwat’s PR19 regulatory methodology: we focused our arguments on aspects of our determination where we had either previously raised concerns with Ofwat or where the Final Determination made changes in policy that we disagreed with and could not previously have challenged. As we had not sought an enhancement allowance or a cost adjustment from Ofwat under its prevailing methodology, we did not consider it would have been appropriate to include such a claim in our SoC.

²² SOC205 Ofwat IAP19 Technical Appendix 2, p.18

²³ SOC205 Ofwat IAP19 Technical Appendix 2, p.19

²⁴ Ofwat Final Methodology for PR19 (December 2017) section 9.4.5 / p. 148.

²⁵ Yorkshire Water PR19 Business Plan, Table 8a.

²⁶ In its PFs the CMA recognises that this was a clear policy position taken by Ofwat: PFs, para, 8.52.

²⁷ SOC205 Ofwat IAP19 Technical Appendix 2, p.18

- (26) We were clear in our SoC, however, that our overall totex allowance was insufficient when looking at the package in the round, with an estimated cost gap of c.£85m.²⁸ As the CMA acknowledged in its PFs in the context of its consideration of leakage funding,²⁹ we also expressly stated our view that FD19 had not provided sufficient funding to deliver the leakage reductions and that this imbalance in the package needed to be addressed:

*“These stretching targets **have not been accompanied by the additional funding for the investment required to deliver them.** This undermines our ability to meet the targets, despite our customers having demonstrated a willingness to pay for the investments as we engaged with them to develop our BP19 (see section **Error! Reference source not found.**). Combined with the impact on incentives to reduce leakage, **a change is required in this area to put the price control back into balance.**”³⁰*

- (27) We also reserved the right to submit additional information in the event that the CMA opted to take a detailed look at areas outside those covered in our SoC.³¹ In our response to RFI012 which pre-dated the PFs we noted that we had not sought a specific allowance for our enhancement costs but noted that *“the CMA may be considering a different approach to funding leakage targets. Should you choose to do so, a consistent approach would be appropriate”*.³²

1.3.3 Our response to the CMA’s PF’s position on leakage

- (28) The CMA helpfully acknowledges in its Working Paper that it is acceptable for a company to change its view on issues during the course of a redetermination.³³ As noted above in Section 1.2, in setting out its approach to the redeterminations the CMA had made it clear that its *“decisions on issues raised by each Main Party, unless the issue is a solely company-specific matter, will be likely to have relevance for the redeterminations for the other companies”*.³⁴

- (29) In the PFs the CMA introduced some significant changes to Ofwat’s policy and methodology for leakage:

“We provisionally agree that there will be an additional cost associated with this level of leakage reduction. The Leakage PC target represents a step change in expectations compared to the last decades. Therefore, it cannot be said that the Disputing Companies can achieve this leakage reduction goal by following the same practices to address leakage performance as during the eight-year period considered by our base cost models. They will have to do substantially more. This may also include exploring and adopting new approaches to reduce leakage. We expect that this will mean additional cost and our engineering advisors confirmed that this was likely to be the case.”³⁵

“We have provisionally decided that there is not sufficient evidence to disallow non-upper quartile performers (Yorkshire and Northumbrian) from recovering the costs of achieving leakage reductions.”³⁶

“We have not seen any evidence that the Disputing Companies, specifically, profited by underperforming their leakage targets, or by obtaining excessively generous funding for those targets.”³⁷

²⁸ NWL SoC, Section 5.2.2.

²⁹ Provisional Findings, Para 8.33.

³⁰ NWL SoC Para 540.

³¹ NWL SoC Para 18.

³² NWL Response to RFI012, para. 15.

³³ CMA Leakage Working Paper, para. 97.

³⁴ CMA’s PR19: Approach to the redeterminations, 11 June 2020, para. 27.

³⁵ PFs, para. 8.57.

³⁶ PFs, para. 8.62.

³⁷ PFs, para. 8.63.

- (30) Under this new methodology we considered that we met the CMA’s criteria for making an allowance for efficient enhancement costs.
- (31) In our response to the PFs we have demonstrated that the cost gap arising from FD19 as presented in our SoC remained materially unchanged under the PFs and that analysis of the newly available 2019/20 data gave additional weight to the existence and scale of that gap.³⁸
- (32) Our decision to respond to the PFs by making a claim for our leakage enhancement costs took account of:
- our stated concern in the SoC that funding for leakage reductions was out of balance and that we would have to find other means to fund the shortfall;
 - the persisting gap between our view of our efficient totex requirements and our allowance;
 - the materially new methodology for leakage set out in the PFs (including the specific reference to NWL) which meant that an enhancement claim was now a viable option;
 - the regulatory framework for redeterminations;
 - the CMA’s duty to act in accordance with the principles of best regulatory practice; and
 - our clear position that at no point were we asking the CMA to allow more totex at an aggregate level than had been sought in our BP19.³⁹
- (33) We consider that this is a cogent and reasonable basis on which to have adapted our position during the redetermination. Indeed, there are other instances identified in our Response to the PFs where we have accepted the CMA’s PFs reasoning and no longer seek specific adjustments in its final determination.⁴⁰ The fact, therefore, that it has triggered a request for an adjustment, as opposed to leading us to drop such a claim, should not undermine the position that it is legitimate for us to react to the CMA’s PFs approach to leakage and to adapt our case accordingly.
- (34) In support of that claim we have provided detailed and robust evidence with regards to the activities we will carry out and the associated efficient costs.⁴¹
- (35) Regarding the suggestion that we have reclassified our costs as enhancement, we note that in the PFs the CMA commented that our estimates for achieving the new targets had not distinguished between base and enhancement expenditure required to achieve the incremental reduction.⁴² This reference to our response to RFI012 shows a misunderstanding of the costs we presented. As we stated in that response, the c.£16m costs detailed in Table 1 thereof were distinct from our base cost requirements to maintain leakage at current levels and related entirely to *“the additional costs of meeting the leakage reductions in the performance commitments”*.⁴³
- (36) We also note that Yorkshire Water originally sought additional funding as a base cost allowance adjustment claim as it did not satisfy Ofwat’s UQ criteria for enhancement funding, yet the CMA has proceeded with its consideration of those costs as enhancement and has made an allowance in accordance with its preferred methodology:
- “Yorkshire’s performance on leakage was not upper quartile, so it did not qualify under Ofwat’s approach for consideration for additional leakage enhancement expenditure. Yorkshire told the CMA it needed £94.7 million of enhancement Totex for leakage.”*

³⁸ NWL Response to the PFs, Section 2.3.

³⁹ NWL Post PFs Hearing Presentation, Slide 7

⁴⁰ For example, we accepted the CMA’s provisional position on: cost sharing rates (Response to PFs, Section 3.8); the application of a UQ efficiency challenge to WINEP costs (Response to PFs, Section 4.5); and the application of frontier shift to enhancement spend (Response to PFs, Section 4.6).

⁴¹ NWL Response to RFI018A; NWL Response to RFI020.

⁴² PFs, para. 8.70.

⁴³ NWL Response to RFI012, para. 14.

- (37) The CMA has not raised any concerns about reclassification of expenditure from base to enhancement for Yorkshire Water, rightly recognising that companies’ presentation of these costs during the PR19 process were inevitably guided by the prevailing methodology. The reality for us, as it is for Yorkshire Water, is that these are enhancement costs that we will incur to meet the increased targets for leakage reduction in AMP 7. Our original business plan approach was not driven primarily by a view that we could fund the improvements from our base expenditure, but instead by a recognition that any claim to the contrary would be rejected by Ofwat.

1.3.4 Conclusions on the legitimacy of our claim for an enhancement allowance

- (38) In light of the context outlined above, including in particular the significant shift in the overarching methodology from Ofwat’s PR19 guidance to the CMA’s PFs, we do not consider it is legitimate to suggest that our decision, following the PFs, to request an allowance for our leakage enhancement costs is “*inconsistent with the business plan process that requires companies to identify a single and internally coherent business plan*”.⁴⁴
- (39) As such we do not consider that it is reasonable to disapply the CMA’s leakage methodology to us simply because our original business plan did not include an explicit claim for these costs when all other aspects of the CMA’s methodology to support an enhancement allowance are clearly met.

1.4 OUR LEAKAGE LEVELS ARE NOT ‘RELATIVELY HIGH’ BUT THIS IS IRRELEVANT ANYWAY

- (40) Another factor used by the CMA to justify its decision not to make an enhancement allowance is that “*Northumbrian’s leakage levels are relatively high*”.⁴⁵
- (41) We have previously set out evidence supporting our assessment of our leakage performance, in particular demonstrating that:
- our ESW region is in fact a strong performer on leakage, and performs better than UQ when assessed on the basis of leakage per property served, or leakage as a % of distribution input;
 - leakage levels are higher in our NW operating area, but this is on the basis of Ofwat’s SELL approach combined with a very strong water resource position as a result of Kielder reservoir; and
 - with the exception of a ‘minor blip’ due to extreme weather in 2017/18, we have consistently met our leakage targets, as set by Ofwat.⁴⁶
- (42) However even on the basis of CMA’s comparative analysis, given its PFs statement that “*there is not sufficient evidence to disallow non-upper quartile performers (Yorkshire and Northumbrian) from recovering the costs of achieving leakage reductions*”⁴⁷ this does not appear a reasonable justification for not making an allowance. We also note that this does not seem to have been a barrier to making an allowance for Yorkshire Water.⁴⁸
- (43) The CMA also observes that our “*PC is lower than that indicated in the PR19 methodology at 12.9%*”.⁴⁹ This figure equates to a reduction in 3-year average terms. As we have previously explained, when measured in Annual Average terms our PCs equate to reductions

⁴⁴ CMA Leakage Working Paper, para. 96, 1st bullet.

⁴⁵ CMA Leakage Working Paper, para. 96, 2nd bullet.

⁴⁶ NWL response to PFs section 6.2.1.

⁴⁷ PFs, para. 8.62.

⁴⁸ As set out in the CMA Leakage Working Paper Annex 1, Figures 2 and 3, Northumbrian’s relative performance is significantly ahead of Yorkshire’s.

⁴⁹ CMA Leakage Working Paper, para. 96, 2nd bullet.

of 15% (NW) and 17.5% (ESW) by 2024/25.⁵⁰ This is consistent with the methodology as confirmed by Ofwat’s position in the FD that “*All companies accepted the challenge and proposed at least a 15% reduction on an annual average basis*”.⁵¹ As such this statement is incorrect and an invalid reason on which to base the CMA’s decision.

1.5 THE FACT THAT OUR LEAKAGE COSTS ARE RELATIVELY LOW IS IRRELEVANT

- (44) Another factor cited by the CMA in justifying its decision not to grant us an allowance for our leakage enhancement costs is that “*Northumbrian’s level of proposed costs are low by comparison to the other companies*” which it considers supports the proposition that we should “*be able to meet these performance targets from base*”.⁵²
- (45) Not only do we not consider this not to be a valid justification for not making an enhancement allowance, such a view has the potential to create a dangerous precedent that:
- undermines the incentives for companies to submit efficient costs; and
 - penalises us for our efforts to create an efficient leakage reduction plan
- (46) We consider that it is also worth noting that in responding to the CMA’s emerging thinking on leakage and opting to submit details of our plan and associated costs in response to non-mandatory RFIs (e.g. RFI018A) we have provided the CMA with additional data points against which it has been able to assess the other companies’ plans. This includes substantiating the UQ benchmark for efficient leakage costs and, at a more granular level, tightening efficiency benchmarks for individual leakage reduction activities. Consequently, the CMA has used this as evidence to justify a lower allowance for other Disputing Companies.⁵³ It seems likely (although we are unable to confirm this without seeing the CMA’s detailed calculations) that even if an enhancement allowance is made for our leakage costs, our submission in this regard will have resulted in lower costs being granted for the industry as a whole.

1.6 CMA’S TOP DOWN CALCULATIONS AND ASSOCIATED OPTIONS

- (47) Regarding the CMA’s top down method for the estimation of costs outlined in the Working Paper, we cannot support the use of CMA’s Option 2 as set out.⁵⁴
- (48) To address the CMA’s concern regarding early progress in 2019/20, this option proposes that companies should only be funded for leakage reductions as measured between annual performance in 2019/20 and 3 year average performance in 2024/25.
- (49) It is simply not appropriate to assess improvements on any metric using a different measurement basis for the start and end points – this makes no mathematical sense.
- (50) Improvements in 2019/20 are already reflected in the 2019/20 three year rolling average baseline as set out in CMA’s Table 4⁵⁵ which appropriately assesses improvements measured between 2019/20 three year average and 2024/25 three year average performance. This ought to be sufficient to address the CMA’s observation regarding the need to account for early progress in leakage reduction in 2019/20.
- (51) Alternatively, if the CMA remains unduly concerned about early progress in 2019/20, it could assess reductions as measured between annual performance in 2019/20 and annual

⁵⁰ Letter from NWL to CMA, 6th June 2020 – NWL Response to Ofwat’s Response to RFI002

⁵¹ As set out on p12 of Ofwat’s Final Determination Policy Summary

⁵² CMA Leakage Working Paper, para. 96, 2nd bullet.

⁵³ For example, CMA Leakage Working Paper, para. 107.

⁵⁴ CMA Leakage Working Paper, para 52.

⁵⁵ The 2019/20 3 year average figures in CMA’s table 4 already correctly reflect 2019/20 improvements i.e. they reflect 2019/20 actuals as confirmed in response to RFI025, as opposed to 2019/20 forecasts. .

performance in 2024/25. We do not support this option, however, as annual leakage figures are more susceptible to weather related volatility.

1.7 CALCULATION OF CMA'S 'BOTTOM UP' ALLOWANCE

- (52) In the Working Paper the CMA has expressed its view on a 'bottom up' allowance for NWL of £6.27m⁵⁶ which matches Ofwat's bottom up calculation.⁵⁷
- (53) As the CMA has not made any allowance for us this figure is not discussed in any more detail in the company specific section of the Working Paper. As such, we are unclear how the CMA has accounted for the further evidence we shared in support of our own bottom up costs for pressure management⁵⁸ (noting that Ofwat's equivalent bottom up figure includes a £4.4m reduction in relation to pressure management costs), nor how CMA rationalises this reduction against our view of efficient costs given that it has used them as an efficiency benchmark against which to assess the other companies' costs.⁵⁹

⁵⁶ CMA Leakage Working Paper, Table 9.

⁵⁷ As set out in Ofwat's Reference of the PR19 final determinations: Costs and Outcomes –response to provisional findings responses Table A3.1.

⁵⁸ NWL Post PFs Hearing Submission, para. 67.

⁵⁹ For example CMA Leakage Working Paper, para. 105.