

# UK Water Industry's Five Yearly Price Review demystifying the regulatory matrix

by Dylan Davies & Richard Dowers.

**A**ll water companies have recently been compiling the statistical data and information from all aspects of their businesses to comply with the forthcoming 'Price Review' (PRO4). Almost everyone within a water company will have somehow been affected by the flurry of activity to compile the data. This information will be used by OFWAT in setting prices for the five year period commencing in April 2005. The aim of this article is to provide an understanding of the reasons for the requirement, the consequences of providing poor quality information and to give a brief background to the reasons behind the regulation of the water industry.

As part of the privatisation initiative in 1989, the UK Government decided that the privatised water businesses would require tough and effective regulation.

OFWAT was established as an independent government body and the economic regulator headed by the Director General of Water Services (DGWS), who represents the interests of water consumers. The DGWS' role is to establish customer water bills, protect service standards, promote competition, and ensure that the water companies provide a high level service while securing a reasonable rate of return on their capital.

The DGWS carries out a price review every five years in order to set price limits that will allow each company to finance its statutory functions as well as protecting the interests of customers. The current price limits were set in 1999. Price limits will be set again in November 2004.

The water industry's price cap mechanism comprises the retail price index (RPI) and the "K" factor. The "K" factor reflects how much a company needs to amend its charges relative to the RPI to finance its services and meet its legal obligations. The DGWS sets "K" separately for each water company.

To help determine the "K" factor, comparisons are made between water companies and with other sectors. Company comparisons are used in a monopolistic industry as they ensure that the companies are exposed to competition and challenge.

OFWAT collects a substantial amount of cost and performance information from the water companies. Whilst much of the information is used for performance comparisons (league tables) to effect service improvements through benchmarking, other strands focus on delivery of outputs and compliance with investment assumptions. A third strand assembles relevant cost and performance data in readiness for future price reviews.

A central component of the price review is the assessment of the water companies capital efficiency. This is done by comparing a company's estimated capital works unit costs for a range of standardised projects to obtain standard costs. These standard costs are then used for company comparisons. By collecting a sufficient sample of standard costs, a view can be taken of the relative efficiency of each company. The standard costs are stylised cost models which are designed to be similar to the actual works in the likely capital investment programme with site specific information removed to provide a comparison on a like for like basis. Land purchase, site preparation, and difficult ground conditions are excluded from the standard costs. If a company's standard costs are high compared to its peers, then this is taken as an indication that there is scope for delivering the capital works programme in that company for less

than the forecast.

For the Cost Base submission and for completion of their Business Plans, companies will need to carry out an exercise to determine the content of their future investment and hence decide on which cost models they need to produce. A review of past projects will also be required in order to establish appropriate types of work to use as data points.

To ensure uniformity, companies are required to have their cost base and business plan submissions independently audited. OFWAT appoints 'Reporters', who are independent consultants to provide confirmation that companies have complied with the data reporting requirements.

During the last Price Review, the following deficiencies were reported:

- \* weaknesses in companies information systems;
- \* data derived from the 1994 Price Review without the inclusion of adequate deficiencies;
- \* models based on a small sample of projects;
- \* over reliance on notional models;
- \* lack of actual and company specific historical data..

Companies have to ensure that the estimates provided are within  $\pm 30\%$  of the likely actual cost of undertaking a standardised project. If companies have a large sample of historical projects with adequate data capture systems used for the preparation of standard costs, a higher judgement grade is awarded by the reporter.

Water companies will submit their draft business plans for the period 2005-10 in early August 2003 and their final business plans in April 2004. These plans will set out the capital programmes each company considers will be necessary for it to fulfil its functions. The DGWS will review these submissions before deciding appropriate price levels. The amounts ultimately allowed in the price limit determination must represent value for money to both current and future customers.

Since the introduction of cost based reporting, the methodology has been refined a number of times. For each of the standard costs there is now a detailed specification and a checklist of items to be included or excluded in their calculation. There is also a general specification for each of the areas of water and sewage infrastructure and non-infrastructure.

Depending on the data available, for preparing unit cost models, companies may either use a top down approach; taking data from actual completed projects, or a bottom up approach; building up standard costs from schedule of rates. Both approaches require companies to comply with the OFWAT specifications. The bottom

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up approach will generally yield a lower standard cost and it is easier to satisfy the requirements of the Reporters audit using this method. The methodology used will have a direct bearing on the end results. OFWAT will compare companies standard costs and make an informed judgement on the level of efficiency to apply to the individual companies future capital programmes.

Despite the improvements and enhancements to the standard cost specifications companies continue to have a number of concerns about the process.

There are still many areas where companies can interpret the specifications in different ways and with different 'Reporters' auditing the various companies there is concern over consistency. This is evident with unduly large variances seen in the published standard cost comparison tables.

With the confidence grade of the benchmark costs being  $\pm 30\%$ , in many instances a company whose standard cost is say 20% higher may be assessed as being able to deliver 15% efficiencies on its future capital programme. Bearing in mind that the company is already within the tolerance limit of the benchmark cost it can be viewed as unfair or even unjustified applying any efficiency targets at all.

Companies are required to demonstrate to OFWAT that they have used the same base data to formulate their investment programmes as they have used to compile their standard costs.

Although there are over 100 standard costs, it is said that these do

not adequately reflect the total content of the companies investment programmes. Many contend that the OFWAT methodology that derives efficiency targets for the whole programme needs further review.

OFWAT is being lobbied to make improvements to the cost based process to attain a more consistent approach.

It is fundamental to the profitability of each company to not only get the cost base exercise right but also to properly forecast the cost of future investment programmes. Most companies carry out the necessary analysis and data capture once every five years. This leads to a flurry of activity that detracts from the day to day running of the business. A better approach is an ongoing mechanism to capture actual project costs at the appropriate level for analysis. This will ensure that a catalogue of costs models can be developed and continually updated. In this way, companies will always have up to date cost information which will enable them to satisfy the data requirements of OFWAT provide accurate estimates of future projects and programmes of work and monitor true efficiencies over time.

*ChandlerKBS* has been advising various water companies on their regulatory and statutory reporting requirements for many years. In particular, *ChandlerKBS* is currently providing advice on appropriate data capture techniques with the objective of optimising the accuracy of regulatory returns. ■

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