

Appendix 8h:

Approach to cost adjustment claims

Author: Yorkshire Water

Contents

Contents	2
Approach to cost adjustment claims	3
1. Executive summary	3
2. Purpose	3
3. Introduction	3
4. Our Aim	4
5. Regulatory guidance	4
6. Process	5
7. Phase 1 – High level assessment	5
8. Phase 2 - Detailed development	6
9. In the round assessment	6
10. Implicit allowance	7
11. Materiality assessment	7
12. Engagement	8
13. Timeline of submissions	9
14. Final cost adjustment claims in our PR19 plan - September	11

Approach to cost adjustment claims

1. Executive summary

We have submitted the following cost adjustment claims as part of PR19 business plan.

Table 1: Claims summary table

Claims (September)	Type	Reference	Value	Appendix
Cellared properties	Regional operating circumstances	YKY WWN+01	£105.9m	Appendix 8k: Cellared properties
Wastewater Growth	Atypically large investment	YKY WWN+04	£55.3m	Appendix 8l: Wastewater growth
Bioresources – WINEP enhancement expenditure	Atypically large investment	YKY BR-01	£60.4m	Appendix 8m: Bioresources – WINEP enhancement expenditure
Total =			£221.6m	

All these claims have been subjected to the same process in developing our finalised claims. This also applies to claims that we have explored and not submitted as part of our finalised plan. The process we have followed is set out in this document.

2. Purpose

The purpose of this document is to evidence the approach we have taken in developing our cost adjustment claims; submitted as part of our PR19 business plan. This document should be read in conjunction with the following technical appendices:

- Appendix 8i: In the round assessment of the need for cost adjustment claims, Oxera
- Cost adjustment claims - Appendix 8k: YKY WWN+01 Cellared properties
- Cost adjustment claims - Appendix 8l: YKY WWN+04 Wastewater growth
- Cost adjustment claims - Appendix 8m: YKY BR-01 Bioresources – WINEP enhancement expenditure

3. Introduction

In assessing, developing and rationalising our cost adjustment claims we have done so being mindful of the updated regulatory guidance, as well as aligning any claim with our customer priorities, in addition to the challenges that have been provided by the

Yorkshire Forum for Water Customers (YFWC). The claims have been subject to external audit by Jacobs.

We understand that the use of cost adjustment claims (formerly special cost factors) should only be applied to exceptional items and that there has been a shift in methodology from PR14 to PR19. Noting this we set ourselves a challenge to only include cost adjustment claims where absolutely necessary. This was embedded in our aim which was agreed and supported by both the YFWC and our Board.

4. Our Aim

The aim is to provide well evidenced claims, supported by customers and needed to deliver the services agreed as part of our wider business plan engagement.

5. Regulatory guidance

We have based our final cost adjustment claims, i.e. those that have been included within this plan, on the following regulatory guidance:

- Delivering Water 2020: Our final methodology for the 2019 price review (December 2017)
 - Appendix 11: Securing cost efficiency
- PR19 final methodology queries and answers (specifically 24 April 2018, query no.269)
- Information Notice: Price review early submissions on 3 May 2018 for performance commitment definitions and cost adjustment claims (18/02 March 2018)
- Information Notice: Enhancement expenditure - setting expectations for well-evidenced proposals and clarifying interaction with cost adjustment claims (IN 18/11 June 2018)

6. Process

In understanding any potential cost adjustment claims which we potentially would be submitting as part of our business plan we developed a long list of possible items. This was developed internally with our asset management and operational professionals. The list drawn up considered where there were:

- Business pressures
- Regional specific operational issues or factors
- New or atypical costs in comparison to PR14
- Significant investment requirements.

We appraised the initial long list using a two-stage approach. To support us in doing this process we commissioned Stantec and ICS through our PR19 strategic planning partner framework. This supported our assessment and development of claims utilising their asset management, regulatory, and economic expertise to ensure that we only submitted claims that were robust, well evidenced, in the interests of our customers and could meet the regulatory evidential requirements.

7. Phase 1 – High level assessment

In phase 1 we challenged ourselves to understand in more detail:

Is there a case to be made?

This initial assessment was to establish whether there is a good, strong and robust argument to be made that a cost adjustment claim is required. This considered, but was not be limited to:

- **Is there a regional circumstance for Yorkshire?** Are we materially different to other operating regions including an assessment of whether there is an evidence base to draw upon to support this.
- **Is this new expenditure not captured?** Is the base reason for the claim new and as such not evidenced in any historical core cost modelling process, such as that used to determine efficient cost baselines for companies.
- **Historical precedence** - Has a claim previously been submitted and if so what was the assessment of the claim. This was used to ensure that we were not submitting claims that have previously received a regulatory assessment that means it is an inappropriate claim.

- **Is it likely to be included for in modelling?** We considered whether the claim is atypical to any other historical or future expenditure for Yorkshire water and what is expected in the industry.

8. Phase 2 - Detailed development

In phase 2 we developed the case where we deemed there maybe one to be made. At this stage we did assume all the claims would be taken to full submission. We started developing the cases and where any limitations were observed these were discounted for our early submission in May.

Making the case for a cost adjustment claim

We split the evidence criteria into two parts, this reflected our proposal to evidence iteratively as part of our early submission in May and then develop further for the business plan submission in September.

This activity included our full assurance and board assurance occurring on our final claims limiting the cost of assurances and ensuring that the focus could be applied to those claims that were most appropriate for our circumstances and our customers.

9. In the round assessment

In developing and assessing any cost adjustment claims it is essential to consider ‘top down’ information and alongside focus on the ‘bottom up’ claim specific evidence to establish a legitimate need for any cost adjustment claims.

To ensure that our claims are required, we commissioned Oxera to undertake an independent ‘in the round’ assessment of our allowances and cost adjustment claims. The scope of the project was to assess if, based on historical outturn cost modelling, there were allowances that could predicate, or offset, the need for cost adjustment claims. The work was not intended to review or assess the evidence base for any of our claims on an individual basis, it was to assess a general theoretical need based on allowances in the round.

The full report is provided in ‘Appendix 8i: An in the round assessment of cost adjustment claims’. The conclusion reached was that, with reference to the three final claims being submitted, there was not any compelling evidence to suggest that there are allowances ‘in the round’ that could offset the need for these claims.

10. Implicit allowance

To assess whether any of our claims contained any implicit allowance we commissioned the support of Economic Insight (EI). Based on the work with EI, and the uncertainty surrounding the treatment of costs within the cost modelling process, it was determined that the best way to approach claim development was to submit all claims on an incremental basis. I.e. the part of the expenditure that is different or atypical, this ensures that there is no implicit allowance already accounted for in cost baselines. We have set out, where readily quantifiable, implicit allowances based on the PR14 approach.

11. Materiality assessment

In assessing the materiality of our potential claims, we have used the thresholds that are set out in the final methodology¹. Table 2 shows, by price control, our threshold for materiality based on the Totex values of our plan.

Table 2: materiality assessment (general)

Control	Materiality assessment		
	Business plan	Percentage	Threshold
Water resources	£226.4m*	6%	£13.6m
Water network plus	£1,797.6m*	1%	£18.0m
Wastewater network plus	£2,512.3m*	1%	£25.1m
Bioresources	£380.3m*	6%	£22.8m
Residential retail	£262.6m**	4%	£10.5m
Business retail	£38.0m**	6%	£2.3m

As a percentage of business plan (5-year) net Totex in the respective control.

*all costs expressed in 2017/18 prices including RPE consistent with the data tables WS1 and WWS1

** all costs expressed in outturn prices and IPI to be consistent with the data tables R1 and R5

We have used the above values to satisfy ourselves that the claims we are submitting as part of the business plan are material against the criteria set out in the final methodology documentation. Table 3 shows our final three claims including their value and subsequent materiality assessment as a percentage of the relevant Totex value.

¹ Delivering Water 2020: Our final methodology for the 2019 price review, Ofwat, 13 December 2017, pg149

For completeness we show the materiality gross and net of implicit allowance where we have deemed there may potentially be an allowance already accounted for in the modelling.

Table 3: materiality assessment (claims)

Claims	Materiality assessment			
	Price control	Value	Materiality (gross)	Materiality (net)
Cellared properties (WWN+01)	Wastewater Network Plus	£105.9m	4.2%	4.2%
Wastewater growth (WWN+04)	Wastewater Network Plus	£55.3m	2.2%	1.7%
Bioresources – WINEP enhancement expenditure (BR-01)	Bioresources	£60.4m	15.9%	15.9%

12. Engagement

12.1 Customers

For all of our indicative cost adjustment claims submitted as part of our early submissions in May we conducted specific customer engagement which was delivered by Qa Research. The results of this engagement for the specific claims submitted as part of our business plan are provided in each claim specific appendices.

Due to the uncertainty surrounding the Water Industry National Environment Programme (WINEP), and the impact it has on our expected sludge volumes, we did not submit claim BR-01 in May. In our covering letter we stated that we would review our WINEP3 documentation and submit a claim as part of the business plan should we deem that the impact was material and met the relevant criteria for a cost adjustment claim. Based on further analysis undertaken after May, it was deemed that a claim for the enhancement expenditure incurred because of our Phosphorus removal (P-Removal) requirements in our WINEP was appropriate and necessary.

As the claim was dependant on our ongoing engagement with DEFRA and the Environment Agency (EA) we did not include the claim BR-01 in our initial research on cost adjustment claims. However, all claims were included in our secondary research as part of our overall affordability and acceptability testing which gained overall support of 86%².

² Appendix 5a: 'PR19 Customer and Stakeholder Engagement'.

12.2 The Yorkshire Forum for Water Customers (YFWC)

We have continuously engaged with the YFWC regarding our cost adjustment claims explored for inclusion as part of our business plan. It was crucial that we involved the YFWC to enable valid challenge on an ongoing basis regarding the suitability of our claims. We have received robust and challenging engagement from the YFWC which has led to our claims being revised to reflect our final three claims submitted as part of the plan.

Challenge from the YFWC led to that our claim relating to a ‘new customer resolution management system’ not being progressed. The YFWC felt that the cost of the claim did not reflect good value for money and didn’t sufficiently represent our customers’ priorities. Additionally, the cost of our claims has been significantly reduced based on the challenges that the YFWC has lodged based on affordability to customers. Of the claims submitted in May that have progressed to full submission the costs have been revised as follows:

Table 4: Revised claim values, from early submission to final claims

Claims	Claim Value	
	May	September**
Cellared properties (WWN+01)	£150.6m	£105.9m**
Wastewater growth (WWN+04)	£54.6m	£55.3m** (£42.7m+**)
Bioresources – WINEP enhancement expenditure (BR-01)	N/a	£60.4m**

+ Net of implicit allowance

**inclusive of real price effects

13. Timeline of submissions

13.1 Before May

Prior to the submission of our indicative cost adjustment claims in May we progressed with the developing the following claims based on the process set out.

For the avoidance of doubt, we did not formally submit any of these claims at any stage whether that be early submission in May or as part of the formal business plan submission.

Table 5: All claims actively explored

Claims	Type	Reason for not progressing
HS2 Mains Diversions	Atypically large investment	Materiality - Claim assessed as being immaterial against the increased materiality thresholds set for PR19
Withernsea WWTW relocation	Regional operating circumstances	Materiality - Claim assessed as being immaterial against the increased materiality thresholds set for PR19
*IT – Customer resolution management system (CRM)	Atypically large investment	Customer Priority - Challenges from our Forum, the Yorkshire Forum for Water Customers. We did not progress the claim as it was not supported or deemed to be a priority for our customers.
Growth (water)	Atypically large investment	Materiality - Claim assessed as being immaterial against the increased materiality thresholds set for PR19
Flood resilience of YW assets	Material new costs	Need for cost adjustment – The narrative supporting how different or special our scenario is, was not strong enough. Cost could potentially be offset
WINEP Clean	Atypically large investment	Materiality - Claim assessed as being immaterial against the increased materiality thresholds set for PR19

13.2 Indicative cost adjustment claims submitted in May

As part of our early submissions in May we submitted the cost adjustment claims shown in table 6.

Table 6: Early submission claims

Claims submitted	Type	Claim reference	Value	Reason for not progressing
Cellared properties	Regional operating circumstances	WWN+01	£150.6m	N/a – progressed to full claim.
Hull and Haltemprice	Regional operating circumstances	WWN+02	£30.0m	Materiality consideration -whilst the claim is still material we have challenged ourselves to assess whether the pressure can be managed in the round.
Growth (wastewater)	Atypically large investment	WWN+04	£54.6m	N/a – progressed to full claim.
Raw water quality	Regional operating circumstances	WN+01	£73.5m	Regulatory treatment – This is efficient enhancement expenditure and as such should be remunerated outside of core cost modelling.
Leakage	Atypically large investment	WN+02	£224.7m	Regulatory treatment – This is efficient enhancement expenditure and as such should be fairly remunerated outside of core cost modelling.
Total			£533.4m	

14. Final cost adjustment claims in our PR19 plan - September

We committed to further refining and evidencing the claims identified to challenge ourselves further to only submit claims as part of the formal business plan that were absolutely necessary. The extract below is from our covering letter submitted as part of the early submission in May:

“We will continue to develop our cost adjustment claims submission between now and our business plan submission in September. This early submission represents the completed work done to date and as such our claims at this point are being considered on that basis only. Subsequent work undertaken between now and September will be considered and submitted as appropriate. Therefore, our list of cost adjustment claims (if any) as part of our formal business plan submission may differ from those outlined in this submission.

We will continue to challenge ourselves rigorously in this area to ensure that we are asking only for cost adjustment claims where necessary. Our aim for the final submission as part of our business plan in September is to provide well evidenced claims, supported by customers and needed to deliver the services agreed as part of our wider business plan engagement”³.

The output of work undertaken between May submission is that we are including three cost adjustment claims as part of our business plan submission. These are identified in table 7. Of those claims submitted in May, but not submitted as part of the final business plan we have outlined the reason for the removal in table 6 on the previous page.

Table 7: Final cost adjustment claims

Claims (September)	Type	Reference	Value
Cellared properties	Regional operating circumstances	WWN+01	£105.9m
Wastewater growth	Atypically large investment	WWN+04	£55.3m
Bioresources – WINEP enhancement expenditure	Atypically large investment	BR-01	£60.4m
Total			£221.6m

³ Early submission of cost adjustment claims for PR19, Yorkshire Water, 3 May 2018

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Yorkshire Water Services Limited, Western House, Halifax Road,
Bradford, BD6 2SZ, Registered in England and Wales No.2366682

