

**From:** David Young

**Sent:** 07 November 2017 12:56

**To:** David Young

**Cc:** Cost Assessment; Kevin Ridout; Paul Martin; Jennie Seymour; Salim Lorgat

**Subject:** Update on Cost Assessment 07.11.17

Dear Colleagues

We hope you are all well.

As you will be aware the Cost Assessment team has been reviewing the company July 2017 submissions made in response to the Information Request. We are continuing this review to ensure we have a robust data set.

We would like to raise three matters:

- Resubmitting Average Pumping Head Data based on the new definitions (discussed at CAWG on 25.10.17) by **1<sup>st</sup> December**
- Allocation of costs between Base and Enhancement – your comments on Ofwat's understanding by **1<sup>st</sup> December**
- Any outstanding re-submissions of data in response to the Information Request by **1<sup>st</sup> December**

We provide further detail below.

#### **Average Pumping Head**

At the workshop on 25<sup>th</sup> October we discussed Average Pumping Head. Ofwat attaches the guidance it proposes for the 2017/18 RAGs. In light of this guidance we request that companies restate the Average Pumping Head data provided for past years (2011-12 to 2016-17). We would be grateful if companies could complete the attached table and submit by **1<sup>st</sup> December**

#### **Base and Enhancement**

We are also reviewing base and enhancement expenditure allocation. In general, our view is that ***Base expenditure*** is required to maintain the current (most recently established base) level of service to customers and ***Enhancement Expenditure*** is required to improve the level of service or increase the capacity of the asset systems. We provide more detail in the note attached.

We would be grateful if companies could review our note and provide comments. It would be useful, if you can confirm whether you agree with our understanding and if you have applied these principles in your recent submissions. We appreciate comments by **1<sup>st</sup> December**

## **Re-submissions**

At the CAWG we discussed a deadline for re-submitting data in response to the 2017 Information Requests. In light of comments made we propose a cut-off date for **1<sup>st</sup> December** for any outstanding resubmissions. If you have any concerns about this please can you let me know.

If you have any further questions about the issues raised here please do not hesitate to contact me.

Kind regards

David

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## **Base and Enhancement Expenditure**

### **Base and enhancement expenditure**

Both operating and capital expenditure can be categorised as either base or enhancement.

### **Base Expenditure**

**Base expenditure** is required to maintain the current (most recently established base) level of service to customers. Base expenditure will include costs relating to the day-to-day running of the business and expenditure on maintaining the long-term capability of assets, as well as expenditure to improve efficiency.

Base expenditure may include expenditure relating to new obligations or to comply with legislation if there is no permanent increase in the level of service to customers, for example to comply with traffic management and streetworks legislation. It may also include the 'betterment' costs of replacing life-expired assets with modern equivalent assets which comply with legally required minimum standards which are higher than those they replace, for example the current version of the Building Regulations or the IET Wiring Regulations. This is the case even if the new assets deliver a consequential improvement in the treatment quality or some other aspect of the level of service.

Companies should re-base their expenditure each AMP to take account of the new base level of service which they are now providing to customers as a consequence of the enhancement expenditure in the prior AMP. For example, if a company has upgraded a treatment works to comply with new quality obligations in AMP5 then the additional operating costs associated with the upgraded treatment processes should be treated as base in AMP6.

### **Enhancement Expenditure**

**Enhancement expenditure** is generally where there is a permanent increase or step change in the current level of service to a new "base" level and/or the provision to new customers of the current service level.

Where a new asset required for enhancement purposes is replacing an existing asset either wholly or in part, only the net additional operating costs should be allocated to enhancement. Where an enhancement scheme involves the replacement of existing assets, this will often result in the avoidance of work which would have otherwise been carried out under normal capital maintenance. In such cases, we expect companies to consider the capital maintenance benefit resulting from the provision of the new asset and proportionally allocate capital expenditure between base and enhancement accordingly.

Examples of expenditure we would expect companies to categorise as enhancements include: -

- where expenditure is required to comply with new (i.e. since the base service level was established) legally enforceable quality obligations;

- enhanced service level where expenditure provides an identifiable, measurable and permanent step change in overall level of service to existing customers above the standard previously provided; and
- expenditure to maintain the supply/demand balance where expenditure provides water and sewerage services for new customers with no net deterioration from the current level of service provided to existing customers; and/or the increased use of water by existing customers at the current level of service.