

Regulating for efficient investment and asset management

...developments in the Common Framework for Capital Maintenance Planning [CMPCF]

CIWEM conference -
Issues arising from the Periodic Review process
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Overview

- **Background on the development of the ‘common framework’ used in the water industry 2004 periodic review**
- **What are the lessons from PR04? What can be improved?**
- **What are the issues for Ofwat to address in the run up to PR09?**
- **Efficiency and incentives issues**

Development of common framework for capital maintenance planning

- **Supported by Ofwat, DWI, EA, WICS, Defra & industry**
 - framework developed collaboratively
 - broad consensus for PR04
- **Forward-looking risk-based approach**
- **Service & customer focus**

Common Framework

Historical look

A

Historical Analysis
identify historical levels of maintenance expenditure and serviceability indicator trends

Expenditure review

Service & asset performance review

- Identify asset categories A 1.1
- Identify historical expenditure A 1.2
- Identify typical expenditure A 1.3
- Select indicators A 2.1
- Historical & current values A 2.2
- Reveal underlying trends A 2.3
- Draw conclusions A 2.4

Forward look - risk based

B

Forward-looking Analysis
identify future maintenance expenditure to meet regulatory objectives

Preparation

Service and cost forecasting

Intervention analysis

- Focus the analysis B 1.1
- Select the planning objective B 1.2
- Monitor service and failures B 1.3
- Design & initiate customer surveys (optional) B 1.4
- Identify failure modes B 2.1
- Obtain asset observations B 2.2
- Develop estimation methods for: B 2.3
 - probability of failure a
 - consequences of failure b
 - cost of failure c
- Validate estimation methods B 2.4
- Forecast service B 2.5

Is the future different?

C

Conclusions
compare and explain results of historical and forward-looking analyses; make the case for the required level of future maintenance

Compare and explain

Assess scope for further efficiencies

Present the case

- Identify intervention options B 3.1
- Estimate impact of interventions B 3.2
- Estimate intervention costs B 3.3
- Value service changes (optional) B 3.4
- Select optimal interventions B 3.5
- Collate and categorise costs B 3.6

PR04

- **Common framework endorsed and used by all companies**
 - Ofwat assessment of quality of case
- **Companies made a good start**
 - but there is much scope for improvement
 - reduce reliance on expert judgement
 - fill in data gaps, improve risk-based analysis
- **Outcome was a 22% uplift compared with PR99**
 - no Competition Commission referrals

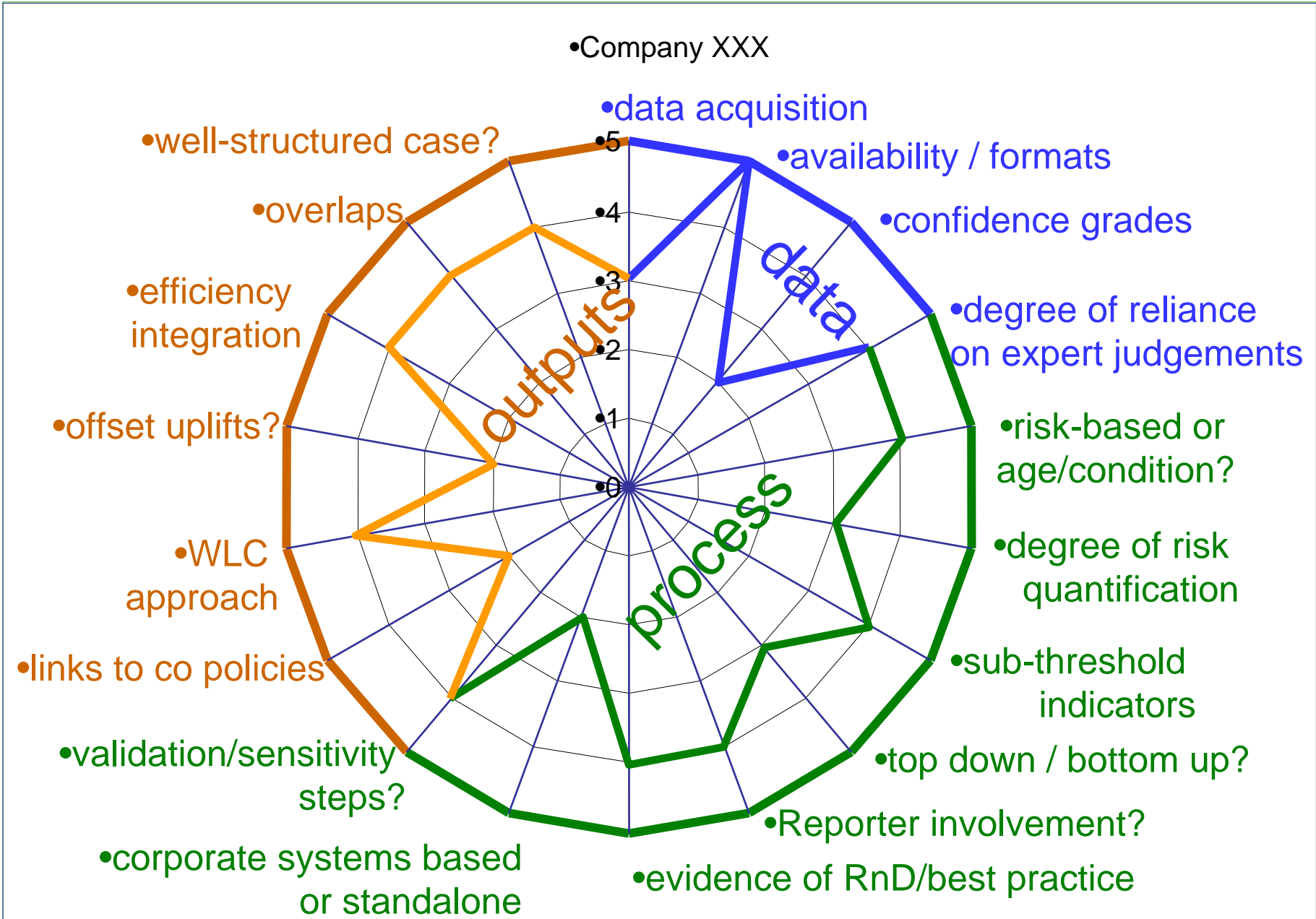
Arguably the common framework has changed the asset management landscape in the water industry....

- Growing recognition of the centrality of asset management
- Much talk of making common framework principles ‘business as usual’ - moving beyond a regulatory requirement.
- Companies already thinking ahead to PR09
 - How will they improve their data? How will they make the asset management case at PR09?
- Growing activity by consultants and software providers
- Joint industry initiatives
 - e.g. to improve understanding of sewerage infrastructure

Following PR04 a joint review of the common framework was commissioned, and will be reporting shortly...

- **Consensus on broad principles, and that extra effort worthwhile**
- ***But* scope for improvement**
 - stronger link to corporate objectives and approval
 - business as usual
 - use of more robust analytical approaches
 - focus on service impacts and economics
 - better data, reduce reliance on judgement
 - improve understanding of underground assets
 - sewerage infrastructure, where there is uncertainty over rates of deterioration
 - cost benefit planning objective (ie assess customers' willingness to pay)

Common Framework assessment - typical radar plot



Addressing the gaps: *the challenge for companies*

- **Deliver outputs, target spend, make efficiencies**
 - Focus on running the business better, not what to put in a submission to Ofwat
- **Improve analytical approaches and data quality**
 - e.g. sewerage infrastructure
 - focus on service & the economic case
 - Integration of 'lumpy' items with forward-looking analysis
- **Challenge their own processes, and demonstrate this to their reporters and Ofwat**

The review has also raised a number of challenges for Ofwat..

- **More challenge to historical levels of spend?**
 - Do companies with 'comfortable' historic levels of spend get an 'easy ride'?
 - Perverse incentives - extra revenue for companies who allow serviceability to deteriorate?
- **Better assessment of companies' plans**
 - More refined scoring and criteria
- **More to be done on opex-capex interaction**
 - Does the regulator penalise companies who propose opex-intensive, but lowest NPV, solutions?
- **Improve reporter guidance**
 - To enhance the audit of companies' approaches

Developing Ofwat's approach

- **Greater transparency acknowledged, but some aspects still criticised (e.g. use of bandings)**
- **Looking ahead to PR09...**
 - Refine our processes for assessing company plans
 - the bar will be higher
 - Greater challenge to historic spend, more emphasis on the quality of forward-looking case
- **Continue emphasis on the delivery of outputs**
 - review of serviceability measures
 - penalties for failure to deliver outputs

Regulators are always concerned with issues of efficiency and incentives. These two areas will be key themes as we develop our thinking in the run up to PR09...

On efficiency we will need to review and update our regulatory tools...

- **If companies apply the common framework in full, then can (or should) Ofwat continue to apply statistical comparative efficiency targets?**
 - Argument that common framework is how efficiencies are achieved, so further efficiency targets would be a 'double hit'
 - Can efficiency assessment play a role in challenging the historic level of spend?
- **The Baker review of PR04 also proposed a full review of Ofwat's approach to efficiency**
 - We will need to review our econometric models in the light of changing circumstances in any case
 - We will also review our cost base tool used to assess comparative efficiency via standard project costings

Ultimately the regulator wants comfort that companies have sound business planning processes, and that these underlie regulatory submissions.

So how does the regulator give incentives for this?

Incentives for good planning

- **Perverse incentives in our PR04 approach?**
 - Companies with deteriorating assets given more revenue
 - Case for Ofwat to be more explicit about how it judges output delivery and the consequences of non-delivery?
- **Scoring of the common framework has given incentives for good business planning processes**
 - But could Ofwat reinforce this by more transparency and publication of assessments?
 - Is there a way of rewarding companies that identify and ‘offer up’ savings, without encouraging short-termist risk taking?
- **Can Ofwat do more, or be more explicit, in giving incentives for long-term planning?**
 - Worries about regulatory treatment of capex-opex trade-offs

PR04 and the common framework was a major step forward in regulating water industry asset management.

But major challenges lie ahead:

- for the industry in delivering and improving its planning***
- for the incoming Water Services Regulation Authority in ensuring a balanced framework for efficiency and sound asset management.***