Thursday 20October 2016, 10am to 3.30 pm

Centre City Tower, 7 Hill Street, Birmingham B5 4UA

Sludge working group – 7th meeting

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| Attendees |
| Alexander Maddan | Agrivert Ltd |
| Andrew Snelson | Anglian Water |
| Andrea Mancini | Water Industry Commission For Scotland |
| Ralph Lodge | digitrm |
| Alec Llewelyn (am) | Northumbrian Water |
| Crawford Winton (pm) | Northumbrian Water |
| Sam McGauley  | Severn Trent Water |
| Helen Richards  | South West Water |
| Kevin Wightman | Southern Water |
| Stewart Carter | Thames Water |
| Frank Grimshaw | United Utilities |
| Dave Holthofer | Welsh Water |
| Daniel Davies | Welsh Water |
| Matt Wheeldon | Wessex Water |
| Phil Wickens  | Wessex Water |
| Andrew Calvert | Yorkshire Water |
| Mat Davis | Environment Agency |
| Steven Jackson | Kelder Group |

Meeting purpose

The purpose of this meeting was to discuss:

* Non-regulated revenue: Charging and transfer pricing;
* Discuss the updated template for the physical market information database;
* Allocation of bioresources RCV
* Actions and setting future working group sessions, facilitated by Ofwat;

A list of actions arising from this workshop are detailed in the table below.

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| Action  | By whom  | Deadline |
| Delegates to provide feedback on the physical market information template. | All | 2 November 2016 |
| Delegates to contact Peter Jordan if they have any further ideas or comments on the asset valuation approach.  | All | No deadline. |
| Companies who would like to send a sludge expert to the sludge cost assessment sub-group provide nominations if they have not already done so. | WASCs | 2 November 2016 |
| Delegates to complete the form with future sludge working group topics | All | 2 November 2016 |

# Note of Meeting

## Introductions

Ofwat welcomed everyone to the working group. Colin Green, who had recently joined Ofwat as the New Design Director for Water2020 programme, provided an overview of his responsibility for the design of the form of control, market development and the risk based review.

He thanked all attendees for coming and welcomed the input from the industry. He has been encouraged by the number of organisations prepared to facilitate discussion on the design elements in this forum. It was reiterated that this forum allows an open discussion and he urged people to ask questions of clarification if needed.

Finally he welcomed any views on how to take some of these sessions forward beyond this session. He also thought that some of the issues needed to be circled once again.

## Non-regulated revenue: Charging and transfer pricing

Ofwat introduced this session and provided an overview of the issues that needed to be considered in a transfer pricing approach. A number of issues were raised by delegates, including:

* How to split common costs between appointed and non-appointed business.
* How new investment should be treated
* How transport costs should be treated?
* Which transfer pricing approach should be used. [Companies are keen to gain some certainty to enable their businss planning and investment decisions].
* Whether companies would be incentivised to maximise lowest cost treatment options. It was noted that different treatment processes have very different costs and environmental impacts. It was thought that this issue was potentially addressed through long-term cost efficiency benchmarking.

## **Cost characteristics of sludge services. Facilitated by Thames Water**

Thames water provided an overview of the issues around cost assessment for sludge. As part of this presentation it raised the following issues for discussion by the group:

1. To what extent should the different treatment technologies be reflected in the cost assessment? When modelling just sludge treatment, there was a question on whether you want to control for it.
2. To what extent is choice of treatment technology in the company control?

One delegate asked whether the costs included compliance with the Biosolids Assurance Scheme (BAS). It was considered that they probably were included.

Another delegate suggested that it could be for companies to make the case for the differences rather than control for them. Liming has very different costs to AD technology. At PR04, different treatment processes were taken into account in the opex modelling, but then it was abandoned. One delegate thought at some point treatment process would have been a decision by the company, therefore this shouldn’t be something that is taken account in cost assessment. However, it may be appropriate to take other external factors into account (e.g. land availability) that may have influenced treatment process choice. Technologies have changed so a good decision in the past might not be the best option now.

It was also noted that technologies may well change in the future and that we needed to be careful not to hinder innovation. It was thought that care should be taken on how far back the panel of cost data went. It was suggested that it would be detrimental if a model suggested companies should use lime again.

An issue was raised on the definition for the sludge price control boundary. Any changes in the boundary would impact on historical cost information. It was thought that this issue needed to be mitigated, possibly through restatement of previous information or by adjusting any model derived from data stated on a different set of activities.

A further issue that needed to be considered was liquor treatment. It was asked whether this would rely on the existing mogden approach or whether a new approach would be developed.

A point was raised about the interaction of capex and opex. It was suggested that it may be difficult to look at capex and opex separately in the models and then combine the data. It is also difficult to capture some of the individual company circumstances, such as, land availability. Does such data exist and if not, is there a proxy for it? It is important to recognise that modelling is not the end of assessment because companies may use special cost factors claims etc.

A delegate raised the issue of the relationship between the network business and bioresources business. A company might have a very inefficient bioresources because they have an apparently efficient wastewater business which transfers cost and risk to the bioresources business. Therefore these businesses can’t be looked at in isolation. However, it is difficult to see how these issues could be factored in. There are contractual tensions that can affect the quality of bioresources. An example of a similar concern was given of different compost qualities. The cost implications and the environmental implications of low quality is thought to be underestimated.

Delegates asked about the timing for developing a cost model for sludge. Ofwat’s cost assessment group are expecting to have a first discussion on the bioresource model in November, with another discussion before the end of the year.

**Basis for transfer prices. Facilitated by United Utilities**

United Utilities provided an overview for the possible bases of transfer pricing. Within the presentation the objectives for transfer pricing were discussed. It was considered that additional objective to those in the presentation should be for environmental protection.

Different pricing methods were discussed. It was considered that pricing at full average cost could deliver an inefficient outcome, although long run marginal costs (LRMC) are likely to be similar to average costs. The structure of pricing needs to be considered both for current capacity as well as new investment.

Transfer prices also need to comply with competition law. If companies do not recover short run marginal costs (SRMC) then it is clearly predatory. One delegate thought that using SRMC does not necessarily lead to price discrimination issues.

The group generally thought that there was a need to define what was meant by a short-term contract. One delegate thought that less than a year was and maybe even an AMP period of five years. Another delegate thought that a short-term contract could be defined by spare capacity. It was agreed that there was a spectrum of levels between short-run and long-run. It was considered that guidelines would probably be required around the trades in the mid-range.

It was asked whether the marginal cost was the efficient price. It was thought that consideration needs to be given to the fact that existing customers had paid for the headroom and if the headroom did not exist they would have paid less. Other considerations raised were on the right pricing going forward, and the influence that certain prices may have on capacity decisions. It was also acknowledged that one of the constraints around the pricing rules were around Ofwat duties, for example, the water act in terms of protecting customers from paying for non-appointed activity.

One delegate raised the issue of swapping sludge over company borders. This may happen because of the distances between STC and WWTW at the borders. Also raised was the possibility of moving sludge around the business to create capacity at the border which could make the service to appointed customers more expensive. It was thought that where there was significant displacement of sludge within an operating area it should not count as a short-term trade.

One delegate considered that there was already a market price between one buyer and one seller. This would be less than the full average cost otherwise transcations would not occur. It was thought that the trade price should be the SRMC plus a “significant contribution”. This was considered to be in line with competition law and with current Ofwat transfer pricing guidelines. One delegate considered that without this pricing structure that no trades would occur in the next 5 years. It was acknowledged that trading, to a limited extent, was already happening. Another delegate questioned the assumption on significant contribution and suggested that ‘customers should be no worse off (rather than benefit)’ from the trade. It was also highlighted that customers would benefit from the trades at subsequent price controls.

There needs to be some mechanism that allowed customers to share in the benefits. Ofwat’s main concern is about protecting customers, rather than setting the market price. It is thought the transfer price sets a floor to the market price. However if there was a big difference between the transfer price and the market price then that may raise concerns over customer protection.

**Wessex Water presentation: Transfer pricing and trading**

Wessex described their transfer pricing approach. During the discussion it was highlighted that one factor to consider is local pricing versus regional average pricing It was suggested that trade effluent based on regional average price could create a price distortion.

Delegates considered that companies had very reasonable knowledge of their marginal costs and they entered into negotiation with this knowledge. It was considered that the price agreed upon was between the marginal costs of both companies.

It was asked to what extent companies report trades to Ofwat. It was explained that companies report on the volume treated by a third party at a regional level. Transactions between appointed and non-appointed business is also reported at an aggregate level.

A question was raised on when the RAGs would be clarified with Ofwat’s position regarding the trading price approach. Ofwat said that it would need to consider the discussions and issues around the transfer pricing approach. A programme would be put together. There was a need to go through a consultation process.

## Sludge market: market information, facilitated United Utilities

United Utilities presented the updated physical market information database. It has tested the template, it estimated that it took two weeks to populate, the hardest element being sludge production volumes. One delegate thought the template was too complicated. Another delegate thought that having so much information would overload potential entrants.

One delegate thought that it would be difficult to put in information on the available capacity at a particular STC. This is because it is a dynamic market, they could divert sludge to other works if it made economic sense. Therefore, providing an answer to the question may not help the market. It was thought it might be more useful to give an indication on what companies are willing to put into the market. It was also suggested that it might be better to say something about the amount of indigenous sludge as it is unlikely to be economic to transfer that to other works.

Another delegate suggested it could be a yes/no question on whether sludge capacity was available. There was mixed opinion on this point. Although many delegates agreed, others thought it could be misleading.

A question was raised on whether liquor information would also be on the information platform. One delegate thought that this would form conversations going forward rather than having it explicitly on the platform. Movement of liquors has been observed in the market. This raised the question on whether you have ‘liquors to transport’ on the information platform. It was suggested that this information could also be included in the ‘other’ column.

One potential entrant said that companies are good at putting information out, although in many cases this was difficult to find. They considered that having the bigger picture would be really useful to have. This is more important on sludge cake, which can travel much greater distances compared to liquid sludge.

It was agreed that the group should have longer to review the physical market information template. [**Action:** Sludge working group members to provide feedback on the physical information template by 2 November 2016]

## Allocation of RCV

Ofwat provided an overview on the allocation of RCV for bioresources including details of its provisional timetable for developing the RCV allocation approach. Ofwat welcomed comments on the timetable. Delegates generally thought the timetable was very tight. One delegate asked whether the timetable was bioresources specific and whether there was another one for water resources. Ofwat confirmed that the timetable was bioresources specific.

**Asset valuation Approaches. Facilitated by Southern Water and United Utilities**

Southern Water presented four different asset valuation approaches:

* Roll-forward of PR09
* Asset-level valuation;
* Process-level
* Standard cost approach

They considered, excluding the roll-forward at PR09, the standard cost approach would be the least cost. A delegate thought it would be useful to have this approach, although it was likely to be difficult to do it at an asset level. Another delegate asked whether it was sufficiently granular as only 40 different costs were listed, some in large size bands. It was noted that there is a trade-off between precision and simplicity.

It was questioned what the purpose of this valuation exercise was. One delegate thought it was to get an indicative market price. An issue with this is that the valuation exercise could value technology currently used but no longer build.

It was confirmed that the RCV allocation would lead to a cash flow for Bioresources activities. This was suggested by one delegate not to matter as pre-2020 RCV is protected. However, the run off rate could have an impact on the market and is one reason for needing the remaining asset life information.

**Break-out sessions**

The group broke into two sub-group to discuss the following questions:

* What are the pros and cons of approaches? Do you agree with the pros and cons mentioned in the presentations?
* How will you provide assurance on your valuation?
* What consistency is required and how do we achieve this?
* ‘Standard cost’ approach - How granular would the standard cost matrix need to be? Is it missing material treatment / asset types? What other issues need to be considered?

Discussion Group 1 – Feedback

The group had focused on the first two questions. The group went through each of the asset approaches, going from the simplest approach to the most complex. It asked whether the benefits of going to the next more complex approach were worth the extra costs. There was a general consensus that it was more important to have consistency between the companies rather than having accuracy. The group looked at PR09 but considered that there had been too many inconsistencies between companies. The discussion focused on standard approach at the process level. It was thought that the asset level was a step too far.

Other points raised were:

* That any approach would need to be discussed at company boards. Some delegates thought boards might be more in favour of company specific rather than an industry based approach.
* Who should carry-out the valuation, the company or a third-party?
* The treatment of common assets between network plus and the bioresource business.

Discussion Group 2 – Feedback

* Most of the group considered that the process level was the right approach. The group discussed issues, including the assumptions around what is built now, the treatment of redudant assets and how resilience would be considered.
* The group revisited the objectives and agreed that the main objective was to give an indication of what the market price for bioresources services is. However, it was important to note that the asset valuation created a price for the region, rather than locally.
* It was considered that oncosts should be included and land price should be standardised.

## Actions and setting future working group sessions, facilitated by Ofwat

Ofwat updated the group on progress of the actions arising from the previous working group. One action outstanding was circulating the questionnaire on the costs and benefits of installing new equipment for sludge measurement. Delegates consider that getting robust measures of sludge volume is critical.

Ofwat also noted that it had only received some nominations from companies for the sub-group on the cost assessments. [**action:** companies who would like to nominate a sludge expert to the sludge cost assessment sub-group provide nominations if they have not already done so].

Ofwat provided companies with a form to fill out with suggestions of topics delegates thought should be discussed in future working group meetings. [**action:** companies to complete the form with future sludge working group topics by 2 November 2016].

The provisional date for the next working group session is 6 December 2016. An invite will be sent around when the session has been confirmed. [**Note that subsequent to this meeting it was decided to delay the next working group to 17 Januruary 2017**].