

Meeting note

Tuesday 1 November 2016
 Centre City Tower, 7 Hill Street, Birmingham B5 4UA
 10.30 am to 3.00 pm

Water resources working group meeting – Fourth meeting

Attendees	
Tim Charlesworth - Affinity Water	Tom Hall - Wessex Water
Jerry Bryan - Albion Water	David Darley - Yorkshire Water
Andrew Snelson - Anglian Water	Darren Leftley - Canal and River Trust
Leonie Mackenzie - Bournemouth Water & South West Water	Peter Thorn - Coal Authority
Liz Cornwell - Bristol Water	Owen Turpin - The Environment Agency
Liz Franks - Dee Valley	Paul Harrison - Welsh Government (Items 2-4)
Sian Leek - Dŵr Cymru	Andrew Chesworth - Ofwat (Item 5)
Crawford Winton - Northumbrian Water	Colin Green - Ofwat
Steve Morley - Portsmouth Water	Freddie Levett - Ofwat
William MacKveley - Severn Trent	Gordon Hutcheson - Ofwat (Item 5)
Nikki Deeley - Southern Water	Iain McGuffog - Ofwat (Item 2)
Nagi Suzuki - South Staffordshire Cambridge	Ian Pemberton - Ofwat
Lester Sonden - Sutton & East Surrey	Khaled Diaw - Ofwat
Phillip Dixon - Thames Water	Peter Hetherington - Ofwat
Frank Grimshaw - United Utilities	Simon Harrow - Ofwat

Meeting purpose

Several topics were covered at the meeting:

- The working group discussed four different approaches for to allocating the RCV for water resources and what Ofwat's guidance to companies should and should not include;

- Ofwat provided project updates on the water resources boundary discussed at the last working group in September, access pricing for bilateral markets in England and licencing;
- There was a discussion on the approach to water resources utilisation risk, which covered the rationale, potential drawbacks and how this can be implemented in practice; and
- Areas for discussion at future meetings and how these topics would be presented.

Action	By Whom	Deadline
Minutes: Ofwat to circulate the minutes to group members for comment. Comments should be sent to Freddie Levett	Ofwat, Group members	11 November for comments from group members
RCV allocation for water resources: United Utilities and Yorkshire Water to circulate the analysis used to produce the graphs in their RCV allocation options presentation to group members	United Utilities and Yorkshire Water	11 November
RCV allocation for water resources: Ofwat to circulate the report produced by PWC for Ofwat on the “Balance of risk: Risk and reward across the water and sewerage value chain” which looks at cost of capital implications. <i>The report is available here</i>	Ofwat	Closed
RCV allocation for water resources: Ofwat is keen to understand company views on when the guidance for water resources RCV allocation should be issued. That is earlier than the sludge guidance or aligned with it? Please send your views on this to Peter Hetherington and Iain McGuffog	Ofwat	11 November
Project updates – Access pricing for bilateral markets in England: Sub group to provide an update on the four key questions set out and supplement this with a short briefing on the relevant implications of the Water Industry Act 2014 to help facilitate the discussion at the next working group in December	Ofwat, Access pricing sub group	Next working group (13 December)
Approach to water resources utilisation risk: Southern Water to circulate their report on utilisation risk to group members when it is published	Southern Water	When published, by end of 2016
Approach to water resources utilisation risk: Ofwat is happy to work with companies on a 1 to 1 basis to explore how they intend to develop mechanisms for this	Companies	Ongoing

Please contact Peter Hetherington to discuss this further		
<p>Presentations for future working groups: Group members were invited to take the lead on presenting their thoughts on topics to forum to encourage a richer discussion and inclusive debate. Among others topics available include:</p> <ul style="list-style-type: none"> • Form of control; • Regulatory treatment of interconnection; • Risk based review • Market information database • Bid assessment framework; and • Resilience <p>If you are interested in these or other topics please contact Peter Hetherington</p>	Group members	11 November for the December meeting, otherwise ongoing
<p>Working group feedback: Group members were invited to provide feedback on their experience of group meetings and provide suggestions on how to potentially improve them going forward in addition to a feedback form completed on the day. Please contact Colin Green with comments</p>	Group members	18 November

Note of the meeting

1. Welcome and introductions

Ofwat welcomed the attendees and thanked group members for their continued support. Ofwat noted that the future of the group after December was still to be decided as there had been no feedback on how to take it forward from group members. Group members were encouraged to share their views on how best to use this forum in the future and to actively contribute to topics at future meetings. To help this process a feedback form was provided to group members.

An update was then provided on the actions from the last meeting:

- The minutes have been updated with comments from members and have been published alongside the slides on the [Ofwat website](#);
- Respondents were also thanked for their feedback regarding the update to the water resources boundary discussed at the last group meeting. An update on this work was provided during the session (item 3.2);
- It was noted that members had been active in being willing to contribute to the group and this was reflected in the company presentations on the agenda.

2. RCV allocation for water resources

Ofwat gave a presentation about RCV allocation for water resources covering what the RCV is, key decisions set out in the [Water 2020 May decision document](#) (see section 5.8), why RCV is important and what RCV allocation is and is not.

The following key points were raised in discussion:

- The treatment of new investment was raised and how this would be allocated in future under the binding price controls. Ofwat noted that further thought is required on this and that its position for the treatment of post 2020 expenditure would be set out in the Methodology consultation.
- It was queried whether it was inconsistent for Ofwat to suggest that the process will be company-led by suggesting in May that companies should use PR09 MEAV data to inform their decision. Ofwat explained that the PR09 data was very much seen as a starting point and was not intended to be prospective or binding on companies' approach.
- It was queried whether Ofwat would have issues if companies came back with very different RCV allocations? Ofwat explained that each company would need to provide a robust explanation for its allocation and as long as this was the case and evidence was provided then in principle there would be no issue in this. Nevertheless this was identified as something that should be explored as part of this session and in thinking about the different approaches.
- The impact of RCV allocation on creating a level playing field was discussed, it was noted that it will only create a level-playing field for the supply of raw water, as opposed to treated water, which is arguably where the market is. It was noted that this is consistent with the May decision document and that there are linkages to access pricing for bilateral markets in England which is designed to ensure a level playing field.
- The Weighted Average Cost of Capital (WACC) at PR19 was discussed and whether it would be consistent across the separate price controls. Ofwat noted that this will be decided following the July 2017 Methodology consultation. However, for more information Ofwat suggested that group members consider the PWC report "[Balance of risk: Risk and reward across the water and sewerage value chain](#)" produced for Ofwat for the December 2015 Water 2020 consultation.

United Utilities and Yorkshire Water then gave a joint presentation that reflected on the Ofwat May decision document and set out four potential options (Asset value, Expenditure, Hybrid, Long run marginal cost (LRMC)) for RCV allocation for water resources. This was supplemented by analysis (where available) of the results of the different approaches across the industry (on an anonymised basis) using 2014-15

data. It was agreed that the data used to produce the analysis would be shared with group members. The group then split into four groups and each group was asked to consider the advantages and disadvantages of one of the approaches:

- **Asset value approaches:** The group noted that this approach had the largest range between company's allocations reflecting different assets across companies and potentially different approaches taken at PR09 to the MEAV exercise. A repeat of the MEAV valuation could be difficult as few water resources assets have been built recently (e.g. reservoirs) making it difficult to produce accurate figures. The group suggested that a large range is not necessarily an issue if the approaches taken are justifiable and consistent. The main positives of this approach were seen to be objectivity and that this could potentially be done at low cost quickly using PR09 data. The main negatives of this approach were seen to be that there may be a need for a costly revaluation exercise and that given the potential issues with PR09 valuation this approach should not be adopted without considering other options. Updates to allocation of assets to price control units in Regulatory Accounting Guidelines may also be significant.
- **Expenditure basis:** The group suggested that the method of RCV allocation was not as important as ensuring that Ofwat is encouraging the right behaviours (i.e. companies taking a justifiable approach which will not negatively impact customers). In the wider discussion it was noted that the expenditure basis appears to produce a narrower range of allocations across companies, especially when compared with the asset value approaches. It was also noted that capital maintenance had been suggested as a allocator in a previous Ofwat report "[Ofwat's review of competition in the water and sewerage industries: Part II](#)", May 2008.
- **Hybrid approaches:** The group noted that the national average approach would have the benefit of being quite easy but is limited by not being representative of company's individual positions. The group suggested that closest to the national average suffered from similar issues. Overall the group preferred the triangulation approach as this reflects differences between companies, does not rely too heavily on one approach and references both economic and engineering approaches in coming to an allocation. It was also suggested that a triangulation approach may be seen more favourably by competition appeals bodies compared with single approaches.
- **LRMC approach:** The group agreed that this approach would not be the best to take forward. In part this was due to complexity and high data requirements and as it was not suitable for companies where LRMC is above average cost for water resources. That said the group agreed that conceptually this approach would most likely be the most effective approach for encouraging markets in water resources.

The groups were then asked to consider, based on the discussion of the different approaches, what the implications were for the upcoming Ofwat guidance to companies on RCV allocation for water resources.

The following key points were raised in discussion of these principles:

- It was suggested that approaches that looked at the RCV build up using data from privatisation onwards would be a good starting point although in practice this may be difficult to produce.
- Reflecting Ofwat's encouragement of markets for water resources, the guidance could include a reference to competition law.
- Companies should ensure where possible that there are not large incidence effects, including those on wholesale tariffs, and if there are that they can be justified.
- It was suggested that companies could be told the national average figure and would need to justify moving away from this. This approach could be limited by companies needing a good knowledge of other companies' assets to justify moving away.
- As Ofwat has been clear that this guidance will not be prescriptive (i.e. set an approach), the guidance could require companies to consider a range of approaches and justify its eventual choice. It was also suggested that this should include the consideration of a MEAV approach, which can be rejected but if it is it should be explained.
- Similar to the above it was suggested that companies could use a weighted triangulation approach where the company averages multiple approaches and justify placing more weight on particular approaches (e.g. could remove outliers).

In terms of next steps, Ofwat noted that it had indicated that in May it would publish guidance by the end of 2016 for RCV allocation for water resources, but there was discussion over whether it should be linked to the work on sludge and published in Spring 2017. Ofwat was keen to understand companies' preferences here.

3. Ofwat project updates

3.1. Water resources boundary

Ofwat provided an update on the boundary definition change which was discussed at the last working group in September. Following this discussion and positive feedback from the industry, the proposed addition to the water resources boundary definition ('15 day rule') to capture raw water storage reservoirs that serve a predominantly water resources function has been added to the updated [Regulatory Accounting](#)

Guidelines (RAGs). This includes revised examples to support the application of the guidelines.

3.2. Access pricing for bilateral markets in England

Ofwat provided an update on the last meeting of the access pricing sub-group. The sub-group has agreed to present to the working group in December focusing on the key questions that they have been working on based on Ofwat's May decisions. In the discussion it was noted that to help the discussion it would be helpful if this was supplemented with a short briefing on the relevant implications of the Water Industry Act 2014.

3.3. Licensing

Ofwat provided an update on the current round of licence changes taking place to implement the May decision document. In water resources this captures changes required to implement a separate price control and the market information platform. A formal consultation on the proposed licence changes will be issued later in November.

4. Lunch

5. Approach to Water resources utilisation risk

Ofwat gave a presentation to outline its approach to utilisation risk, this touched on the position in May decision document, a further explanation of why this has been proposed and key considerations that must be taken into account in determining the level of risk sharing with customers. Ofwat also presented an example of how demand risk is managed in other sectors using a cross border electricity transmission example from Ofgem.

In the presentation Ofwat set out that customers bear much of the risk for new investment and that some form of risk sharing would seem appropriate with respect to market-wide water resources utilisation risk. There was a discussion that companies could influence some of these risks and are likely best placed to manage them. Ofwat confirmed that it would expect water companies' business plans to include some utilisation risk sharing mechanism in relation to significant investment in new, or enhanced, water resources schemes. Ofwat also set out that it is happy to work with companies on a 1 to 1 basis to explore how they intend to develop mechanisms.

Southern Water then gave a presentation on the company's perspective on utilisation risk based on work it had commissioned from Economic Insight,

particularly focusing on the potential issues with exposing companies to this risk, before considering if there is another way to achieve the same outcome. The paper will be circulated to group members and published on the Water UK marketplace of ideas.

In the discussion across these two presentations it was noted that:

- Developing a mechanism to determine the correct level of risk sharing is likely to be challenging due to the lack of clarity around measuring utilisation.
- It was noted that there is a substantial risk of unintended consequences in trying to address this. For example, there was a debate over whether this could lead to under-investment, which could be more costly than over-investment if it meant companies were not able to maintain security of supply.
- It was suggested that Ofwat should consider the potential implications that a competitive business, and potentially residential market, could have on various approaches to sharing utilisation risk.
- In developing a risk sharing mechanism it is important to consider that investment in water resources is linked to ensuring that assets can be utilised under a range of stresses (i.e. resilience to infrequent events is important, not just year on year use). The point was made that there could be metrics around the level of resilience, based on different return periods.
- Some group members expressed a view that uncertainties around utilisation are linked to factors outside of companies control, although risk could be influenced.
- The water resources management plan (WRMP) process evaluates the key risks to customers and derives plans based on benefits. It was suggested that it was for the Secretary of State to determine the resources needed and Ofwat's role is to ensure it is delivered efficiently.
- There was discussion around why existing regulatory tools were potentially insufficient, which was uncertain given the lack of clarity around what Ofwat is seeking to achieve.
- It was noted that customers are involved in considering investment decisions throughout the WRMP, not just at the statutory consultation stage. A recent Thames Water event was cited as an example of this.
- In respect to the Ofgem example it was noted that as the water sector has multiple regulators (Ofwat, EA, NRW, and DWI) developing a solution could be more difficult in water than in energy as more parties are involved. It was also noted that the example was for a network asset which has different characteristics to water resources assets.

Albion Water then gave a presentation highlighting the potential value of demand-side measures which could avoid the need for significant new investment in water resources and enhance resilience. Specifically, this referred to demand-side benefits

for new housing, particularly focusing on the benefits that separate non-potable supply to customers could potentially bring in terms of managing utilisation risk. Using provisional results from Albion's Rissington site, it was suggested that third-parties can offer demand-side benefits for housing developments by installing a dual-system with both potable and non-potable supplies. It was noted that the use of non-potable supplies for gardening significantly reduces volatility in potable demand. In the discussion it was noted that these systems are not cost-effective at a household level but instead are community level systems for new developments.

6. Actions and agenda for next meeting

Ofwat thanked the group for its contribution to the day. Group members were reminded that Ofwat was seeking feedback on their experiences to inform future engagement. Group members were also encouraged to volunteer to lead the presentations on topics for forthcoming meetings and it was noted that at the next working group resilience, access pricing for bilateral markets in England and the bid assessment framework were confirmed agenda items.