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Trust in water

Water resources pre-2020 legacy RCV allocation at PR19 – technical guidance

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About this document

This document provides technical guidance for the appointed water companies[1] for whom we set full price controls in 2014 to consider in allocating the pre-2020 legacy Regulatory Capital Value (RCV) of the wholesale water control between water resources and network plus. As set out in the Water 2020 May decision document, we propose that companies allocate RCV on the basis of the proportion of the asset value of water resources relative to the wholesale water business. This document provides technical guidance to assist companies in proposing the allocation of the RCV between water resources and network plus controls.

We expect the relevant appointed companies to submit their proposed allocation in January 2018. We will review this and intervene in a proportionate and risk based way, with the final allocation confirmed as part of the final determination for price review 2019 (PR19).

[1] By which we mean companies holding appointments as water and / or sewerage undertakers under the Water Industry Act 1991.

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1. Background

The RCV represents the capital value of each company for regulatory purposes. We created this regulatory tool shortly after privatisation for the purposes of setting price limits. It captures the capital invested in the business and forms part of our building block approach to price controls. As part of a price review the RCV is used to assess the revenues that are required to provide a return on the capital invested in the business.

In "Water 2020: our regulatory approach for water and wastewater services in England and Wales", we confirmed that we will introduce a binding separate control for water resources. A separate control will help facilitate the setting of better targeted regulatory incentives and increase the focus (both within companies and the regulator) on specific services and activities that companies undertake. The separate control will also help to inform, enable and encourage an effective market by revealing improved information that will support company decision-making; mitigate cross-subsidy concerns; and help foster a more commercial culture within companies in relation to relevant activities.

As the control will be set using a building blocks approach we will require an explicit RCV allocation of the pre-2020 legacy RCV (which includes water resources) to determine the revenue allowance for the separate water resources control. This allocation is for the purposes of setting the separate control and the pre-2020 legacy RCV will stay within the appointed water company.

As the pre-2020 RCV is not directly linked to any specific assets, either in the case of water resources or other services, an approach to allocation of the RCV between the price controls is required. There are two broad possibilities:

- **a focused approach**, where the RCV allocation is based on the economic value of the assets employed (for example, as represented by their net Modern Equivalent Asset Valuation (MEAV)), and
- **an unfocused approach**, where RCV allocation is based on the proportion of the assets employed in the business relative to the total assets of the business.

In May, we confirmed that an **unfocused approach** is the most appropriate basis on which to allocate the RCV between the network plus and water resources price controls. This reflects our view that fully-developed markets for existing water resources are unlikely to emerge in the immediate future, given the relatively long life of water resource assets, the slow pace of technological change and the high cost of water transport. Further a focused approach would not be viable or desirable as

given the scale of the RCV discount at privatisation and the existing MEAV estimates, a focused approach could result in the entire legacy RCV being allocated to water resources for some companies – and in some cases, this would still be below the relevant MEAV.

Consistent with our wider approach to regulation, we decided in May not to impose a common allocation methodology to derive an unfocused allocation of RCV to water resources to all companies. Instead, we expect each company will have **ownership and responsibility** for how it's legacy pre-2020 RCV is allocated between water resources and network plus, consistent with an unfocused approach. This reflects our view that part of companies' existing RCV-based allowed return on capital is already (implicitly) attributable to water resources: in setting their wholesale tariffs for different types of services, companies should have an understanding of how much allowed return they are raising, or should be raising, for water resource activities relative to other wholesale activities. Company ownership of allocation will also help to avoid unintended and unnecessary impacts on wholesale tariffs and strengthens companies' ownership of their wholesale tariff structure.

This note sets out technical guidance for companies to consider in coming to their allocation and next steps.

2. Potential approaches

We expect companies to draw on, and present their proposals by reference to existing data on the balance of asset values in water resources versus network plus.

There is considerable judgement required to estimate MEAVs and in particular, difficulty applying the approach to very old assets with long lives such as the distribution networks and water resources. So, for some companies, a split based on the unfocused net MEAV may not provide the most appropriate basis for the RCV allocation. Companies can consider other approaches that retain the broad principle of an unfocused allocation that better meet the objectives for allocating the pre-2020 legacy RCV.

The table below provides an overview some potential approaches companies could take and in the next section we set out the issues we want companies to consider.

Table 1: Potential approaches to allocating the pre-2020 legacy RCV

Approach to RCV allocation	Summary of considerations
Based on net MEAVs	Companies can consider a roll forward of the 2014-15 net MEAV for water resources (based on the full revaluation of all water wholesale assets carried out at PR09). The unfocussed allocation of RCV would be based on the proportion of the net MEAV for water resources assets of the net MEAV for all water wholesale assets
Based on gross MEAVs	This would potentially be a lower allocation than an unfocussed approach on a net MEAV basis as assets existing at privatisation (including long life water resource assets such as reservoirs) would have a higher relative gross MEAV and therefore be less represented in an RCV allocation on this basis than those that have been replaced more recently
Splitting pre-privatisation assets at a discount to the RCV and post privatisation assets at full value	Companies may want to consider this as a cross check to other approaches that consider historic expenditure. However, given the changes to asset records and accounting classification since privatisation this may be difficult to calculate
Historic expenditure – e.g. proportion of past expenditure, or operating costs and accounting charges for capital expenditure, incurred on water resources	Depending on the data and the life of the assets, this may provide a good cross check or alternative approach to an allocation based on estimates of net MEAVs. The period of time that was appropriate to consider may in part be driven by the basis for the accounting charges

Approach to RCV allocation	Summary of considerations
Projected expenditure (either totex or operating costs and accounting charges for capital expenditure) – e.g. proportion of future expenditure expected on water resources	The proportion of future expenditure expected on water resources could be tested. Given the long life of water resource assets, the period of time that would need to be considered may be longer than 25 plus years of water resource management plans
Economic value	The forward looking revenue stream (net of operating costs) from prices for water resources and other aspects of water supply set on a consistent long run basis. Where companies have supply demand surpluses at a point in time, the value of this water for trading may need to be considered. The historic and future expenditure considerations associated with the access price for third party water resource providers in the bilateral water trading market in England and compensation payments could be considered with this approach, building on the Average Incremental Cost data in company Water Resource Management Plans
Averaged or hybrid approaches	In arriving at the RCV allocation, companies could consider averaging between different approaches. In doing this companies should consider the impacts on wholesale charge structures

3. Issues for companies to consider

In coming to an allocation companies should consider:

- The definition of water resources.
- Impact on wholesale tariffs.
- The links to WRMPs.
- The links to bulk supplies.
- Roll forward of historic net MEAV.
- Revaluation of net MEAV.
- Separating pre and post-privatisation RCV.
- The potential for reallocation at the 2024 price review (PR24).

The definition of water resources

Companies should base their RCV allocation for water resources on the basis of Regulatory Accounting Guidelines 4.06. Company annual performance reports and regulatory accounts for 2016-17 will be the first to reflect this and prior years will have been recorded and reported on a different basis. Companies will need to provide assurance that data used for RCV allocation has been allocated correctly, including setting out the basis for any adjustments to historical information to reflect the regulatory accounts which will be used for the control.

Impact on wholesale tariffs

The allocation of the water resources pre-2020 legacy RCV could affect the balance of wholesale tariffs for different services (for example, supplies to households versus large users and potable versus non-potable supplies). As part of their considerations we expect companies to carry out an analysis of how their proposals could affect the calculation of wholesale charges for different services and customer groups. This analysis will need to split out wholesale tariffs into water resource and network plus charges. Testing the sensitivity of the legacy RCV allocation through charging models under a range of different allocation and competition scenarios should inform this analysis. We would not expect to see significant disruption in historical tariff structures without strong supporting evidence and consideration to how to transition to any new tariff structure.

The links to WRMPs

Companies should consider their RCV allocation approach alongside their Water Resource Management Plans (WRMPs). This will allow companies to consider the impact of their legacy RCV allocation on water resource markets and wholesale tariffs. WRMPs are expected to consider the potential for water trading, as well as the cost of water resource and other options to address deficits between water supply and demand. Companies will need to consider how their calculation of water resource costs from their WRMPs are affected by their proposed RCV allocation. Average Incremental Cost (AICs) in WRMPs should not be affected by the legacy RCV allocation (as this concerns a forward looking cost for incremental investment in water resources). AICs should affect future average water resource costs and wholesale tariff structures and so will be relevant to testing the impact of the proposed RCV allocation. Companies may also need to consider consistency of RCV allocation with previous WRMPs as part of their assessment of wholesale tariff structures.

The WRMP guidelines state that pre-consultation discussions should be carried out with a range of organisations, including other water suppliers where there are existing bulk supplies or shared resources and potential water suppliers, companies or third parties where trades may occur.

The links to bulk supplies

Maintaining consistency between charges and cost recovery is a factor companies need to bear in mind when developing their RCV allocation and why we will leave ownership with companies, only intervening where there are clear risks to consumers or the development of markets. This will include cases where the incumbent water companies use appointed assets to provide bulk supplies.

Where bulk supply prices are related to average costs for components of water resource or network plus services, then the RCV allocation between water resources and network plus could have an impact on the cost associated with providing bulk supplies. Irrespective of the legacy RCV allocation, companies retain their responsibilities to comply with competition law.

Roll forward of historic net MEAV

As a starting point companies should reference their existing unfocussed allocation of water resources using net MEAV. This should be based on a roll forward of 2014-15 net MEAV (which should be based on the full revaluation of assets carried out at

PR09), consistent with the approach taken to current cost accounts set out in Ofwat Regulatory Accounting Guidelines.

- Where companies roll forward their 2014-15 net MEAV this should be to 31 March 2020, consistent with actual reported capital expenditure during 2015-17 and calculations of capital maintenance charges on water resources and forecasts consistent with their plans for 2017-18, 2018-19 and 2019-20. Companies using this approach would then be able to update this to reflect their PR19 business plans.
- Indexation of the rolled forward net MEAV should use RPI inflation consistent with the approach to current cost accounts set out in RAGs, when there was a requirement to publish this information on an annual basis.
- Because there have been changes to the allocation of assets to the water resources price control unit since 2014-15, we would expect companies to explain the impact that this has had to their roll forward of 2014-15 MEAV.
- We may use similar cross checks to those set out in this note when reviewing the appropriateness of company proposed RCV allocations for water resources.

Revaluation of net MEAV

We are not requiring companies to undertake a revaluation of net MEAV for the purposes of the allocation of legacy RCV. If companies do choose to undertake a full revaluation of their assets, they should undertake this for their entire water wholesale asset base. This is necessary for this to inform an unfocussed allocation of the RCV.

Valuing water resources are particularly challenging, in part because there are few examples of developing large scale water resources in recent years and that the landscape and natural environment significantly affect the cost.

For the purposes of the net MEAV unfocussed allocations particular issues could include:

- how land has been considered;
- the approach for water resource assets, in particular if inflated historic costs continue to be used;
- how shared infrastructure, IT and other Management & General assets have been valued and allocated to water resources; and
- the translation of cost models into current costs, including “on-costs” and overheads.

Companies should set out the cost models they have used for each asset category and the on costs. Companies should apply confidence grades to this information, setting out both the accuracy of the asset data (e.g. number or capacity of assets) and the range of confidence in any cost models used in the valuation.

Moving from gross to net MEAVs

Where a revaluation is carried out, for non-infrastructure assets it is important to also consider the remaining asset life. Where companies revise their asset life, it is good practice for the net MEAV to be calculated as:

Net MEAV = Gross MEAV * (remaining asset life / (age + remaining asset life)).

Companies should set out the average age and remaining life assumptions for each sub-category of non-infrastructure assets.

For any non-infrastructure assets the asset age and remaining life should be considered – where a full revaluation is carried out the approach should be consistent across business units.

For infrastructure assets it may be appropriate to use alternative approaches such as inflating historic gross and net values including accumulated depreciation. Cross checks are then required to compare the age, condition and maintenance expenditure to the accumulated depreciation. This emphasises why we do not think that a revaluation will be the best approach to establishing the RCV allocation for water resources.

The impact of requisition charges on a MEAV approach

If companies draw on MEAV estimates we would expect them to take account of the likelihood that, for network plus activities (principally treated water distribution), a significant element of the estimated MEAV may have already been funded through connection charges, requisitions and infrastructure charges, leaving less to be funded through wholesale tariffs. In contrast there would not normally be similar upfront funding for water resources. This may suggest that if an MEAV approach is used for an unfocused allocation, the allocation to water resources should be greater than would be implied by a simple pro rata allocation between water resources and network plus.

Separating pre and post-privatisation RCV

One potential approach is to separate the historic data on capital expenditure and depreciation since privatisation by service business unit and calculate a separate RCV pre and post privatisation. The pre-privatisation RCV (inflated by RPI) could be split based on the net MEAVs and include the full discount to the net MEAV. This approach will depend on companies having sufficient information in historic records to split water resources from other asset categories. The appropriateness of this approach may depend on the scale of enhancement investment in water resources and other long life assets since privatisation, as otherwise this approach could risk low or even negative RCV in some service business units.

The potential for reallocation at PR24

In order for the RCV allocation to provide regulatory commitment and support binding controls, the allocation of the existing wholesale RCV to the water resources control needs to be stable over time. This is also important for third party providers who need certainty about the prices they need to compete against.

However, in May we recognised that there are advantages to allowing companies to revisit the allocation of the existing wholesale RCV to water resources at the next price review if there are compelling reasons to change or evidence of misallocation at PR19. For instance, we might be prepared to accept a revised allocation if there was new information showing that the previous allocation was not appropriate.

To be clear we would expect any changes to be the exception rather than the rule and it would require compelling evidence of a misallocation, it will not be an opportunity for companies to improve their competitive position. In light of this it is important that companies make every effort and provide assurance of appropriate allocations for PR19 and so avoid the need for any reallocation at future price controls.

4. Next steps

Each company will propose its own allocation of the pre-2020 legacy RCV at 31 March 2020 to the water resources control and provide sufficient supporting evidence to enable Ofwat to carry out a review to ensure outcomes are in customers' interests.

We have set out in this technical guidance note that there are a number of issues for companies to consider. Therefore we intend to meet with companies to understand their proposed approach in response to this guidance. This will inform our expectations for the information that we need to collect from all companies on RCV allocations.

As a minimum we expect companies will need to set out:

- Their proposed unfocused RCV allocation to water resources as a percentage and forecast £m of the 1 April 2020 total water RCV.
- A comparison to the previously reported 2014-15 water resources net MEAV as a proportion of the total water wholesale net MEAV, together with an explanation of why the proposed unfocused RCV allocation varies from this.
- Supporting calculations of how the RCV allocation proposal has been calculated as well as details of the alternatives considered, together with a narrative justifying the choice.
- Explanation of how the issues set out in this technical guidance have been considered, in particular any sensitivity testing on wholesale tariffs and bulk supplies.
- Clarity on the consistency of the analysis with information within company WRMPs.
- A statement from their Board setting out the factors and assurance information they considered in support of the proposed RCV allocation.

We do not intend to collect information on company proposals for their water resource RCV allocations until after the draft Water Resource Management Plans have been developed. This will allow companies to consider fully the relationship between current and incremental water resource costs and the relationship with other services within network plus such as water treatment.

The timetable is summarised below:

April 2017 – May 2017	Meetings with companies to understand approach in response to this guidance
July 2017	Ofwat sets out the information we intend to collect alongside the Water 2020 methodology consultation
End of January 2018	Companies submit water resource RCV allocation information.
End of April 2018	Ofwat provide feedback on water resource RCV allocation to companies approach to inform their PR19 business plans
December 2019	Ofwat decision on RCV allocations as part of PR19 final determinations

Enquiries

Any requests for further information or discussion on RCV allocation should be sent to rcv.allocation@ofwat.gsi.gov.uk

Further information

Regulatory Accounting Guidelines

Water 2020 May 2016 document