

Meeting note

Tuesday 17 January, 10:30am to 3.00 pm
Centre City Tower, 7 Hill Street, Birmingham B5 4UA

Bioresources form of control workshop

Attendees	
Andrew Snelson	Anglian Water
Gagan Gulati	Anglian Water
Crawford Winton	Northumbrian Water
Eleanor Taylor	Severn Trent Water
James McLaughlin	Severn Trent Water
Kim Williams	South West Water
Leonie MacKenzie	South West Water
Kevin Wightman	Southern Water
Peter Trafford	Thames Water
Rhianna Rawlins	Thames Water
Jon Latore	United Utilities
Annie Sconce	United Utilities
Daniel Davis	Welsh Water
Paul Edwards	Welsh Water
Matt Greenfield	Wessex Water
Matt Wheeldon	Wessex Water
Dave Musco	Yorkshire Water
Sarah Shaw	Yorkshire Water

Ofwat attendees	
Khaled Diaw	Colin Green
Alison Fergusson	Peter Jordan
Iain McGuffog	David Young
Jill Marsal	Rob Lee
Kevin Ridout	

Reckon attendee (morning only)	
Nicholas Francis	

Meeting purpose

The purpose of this meeting was to discuss:

- Bioresources RCV allocation
- Bioresources form of control: volume measure
- Bioresources form of control – other issues arising

Action	By whom	Deadline
Include definition of Tonnes Dry Solids to sludge working group agenda	Ofwat	30 January

Note of Meeting

Introductions

Ofwat introduced the workshop in the context of a time of open discussion over the first few months of 2017 before the price review methodology consultation in the summer. The material presented at today's meeting was not settled and decided Ofwat policy and may indeed be deliberately provocative in order to explore the issues around the form of the bioresources price control.

RCV allocation

Introduction (Ofwat)

Ofwat introduced the background and main reasons behind the RCV allocation, and reminded the audience that an Information Notice (IN17/01) had been published setting out that companies would be required to carry out a valuation of their sludge assets to inform their focussed allocation of the historical RCV at PR19 this year.

Key points made were:

- Review of why Ofwat was undertaking a focussed allocation including: Ensuring a level playing field between incumbents and new entrants; protecting the interests of customers; avoiding over-recovery; and Maintaining consistency between charges and cost recovery
- Ofwat stated that it was important that companies gave appropriate allocations of RCV to the bioresources control
- Ofwat recapped on the key points from October 2016 workshop – including points on the valuation approach and trade-offs between precision and simplicity
- Ofwat stated that the context of this valuation was different to the valuation companies undertook at PR09.
- Ofwat recapped on the Information Notice issued earlier in January stating the key dates, the use of RAG 4.06 for definitions and the valuation date being for 31 March 2020. Ofwat also stated that the final RCV allocation would form part of the PR19 Final Determinations
- One company raised a question about what type of feedback Ofwat would provide to them following the submission of valuation information in September 2017. Ofwat replied that the form of the feedback would depend on the information that companies provided, but the intention was to raise any concerns so companies could address these for their PR19 business plans.

- Another question concerned the format of the guidance on bioresources RCV allocation. Ofwat will consult on this guidance and set out expectations on companies, with the Reckon document providing more explanation of the key issues for companies to consider in their approach

Reckon Presentation

Reckon explained the work they are doing to explore concepts and high level methodologies, which will ultimately lead to guidance for companies to consider when carrying out the valuation. They explained the economic value concept that the project was working with. Key points were:

- In addressing the “Why are we doing this” Reckon stated this was for a separate price control and it was different to the past MEAV valuations (which were more driven by establishing current cost depreciation)
- Ofwat was undertaking a focused approach to the valuation which mean that we were focussing the RCV Discount to MEAVs on the Network Plus part of the wastewater business. To establish the historical RCV allocation to bioresources given the PR19 context a forward looking concept to valuation considering economic value was appropriate.
- Reckon explained the benefits of the this approach: (1) helping ensure a level playing field for competition in markets; (2) sending the right price signals to service providers and ensuring commercial opportunities ; and (3) protecting against the risk of transferring value to investors from customers
- Reckon discussed the Economic Value (EV) Concept:
 - EV is the value that can be generated by using assets
 - For bioresources it was noted that this included treatment and disposal of sludge as well as Energy Generation and biosolids
 - Reckon eluded to the potential circularity inherent in the concept in the absence of market prices – an RCV value is needed to set a price control revenue stream, which in turn sets regulated prices but these prices determine economic value of the assets.
- Reckon discussed how sludge asset values could consider economic value in practice:
 - The approach envisaged understanding what the company would build as a hypothetical new entrant, and to understand the costs and revenue stream that this would deliver. Adjustments would be made to reflect the economic life, cost and revenue generating capabilities of the actual assets in order to arrive at the economic value.
 - The approach is similar to the approach Ofwat described in RAG 1.05 in calculating Net MEAVs, after taking into account the change in context.

- Reckon envisaged there would be an industry wide template to support the calculation of economic value which would help ensure comparability and consistency. However they emphasised this was a company led process reflecting the diversity of locations and existing approaches to bioresources.
- Reckon discussed some of the practical issues that needed to be considered still. These included (1) Costing of the new build assets (eg how do you value land); and (2) adjustment for differences between the hypothetical assets and actual ones

One delegate asked if the approach was for a bottom up asset-by-asset valuation. Reckon explained that it was more at a process level. The meaning of process level was explored in their work and it was acknowledged that there is a trade-off between level of granularity and simplicity.

Ofwat Follow Up presentation and Discussion Groups

Ofwat gave a follow on presentation about how the approach could be applied. Key points:

- Ofwat recapped on one of its objectives – to achieve a consistent approach with companies retaining ownership of the valuation.
- Ofwat outlined a 5 step process for the approach being considered for the guidance of the consultation:
 - Step 1: Define the Modern Equivalent Asset that the company considers they would use build as a hypothetical new entrant
 - Step 2: Establish the economic value of this asset
 - Step 3: Adjust the value to reflect the current assets
 - Step 4: Consider cross checks
 - Step 5: Explain proposed focused valuation of RCV at 31 March 2020

Discussion focused on cross checks, particularly if they revealed a difference between historical values and economic values caused by changes in sludge strategy. One delegate asked if the valuation needed to account for different levels of supply and demand in different regions. Ofwat explained that guidance would be provided on how to select the capacity for the hypothetical assets.

Another delegate asked if the methodology for adjustments due to age, technology differences etc. would be provided by the project. It was confirmed that the exact methods would be left to companies with the intention that the calculation steps provided in the guidance would aid consistency in approach across companies and allow cross industry comparisons to be made on new build costs, asset life assumptions etc.

Feedback from break-out groups

The audience was then broken up into 3 discussion groups. The key points from the discussion are summarised below:

- The concept of hypothetical new entrant asset costs: The obligations of a new entrant may be different to the incumbent – they can take a certain capacity and no more, whereas the incumbent has to treat all sludge arising. A new entrant may also have different contracting risk, asset standards, capacity and headroom assumptions. Companies should in general assume they would reflect the current sites and capacities for the hypothetical asset unless there was convincing evidence for a different assumption. Companies would need clear reasons to suppose that a new entrant, that had all the same obligations to deliver the regulated sludge service at a site, would choose to invest in different assets to the company on a greenfield site.
- If there is strict reconciliation expected it could undermine the concept of economic value. Including the energy revenue generation makes reconciliation and cross checks difficult as it is not part of PR09 asset valuation methods for example. The discussion emphasised that companies should consider what overall valuation is appropriate and why they believe this is the case.
- Do companies need to take account of the site of existing facilities, and make different assumptions if they are close to company borders, for example? Some comments were also raised that geographical location affected value with the potential for greater cross border trades. Energy generation geographical location effected energy revenues given grid capacity at regions.
- The approaches to considering spare capacity were discussed.
- It was important that the cross checks were used to decide on an appropriate RCV allocation, rather than all be stringently applied. Which cross checks are most appropriate may depend on the particular circumstances of a company.

Ofwat encouraged companies to email rcv.allocation@ofwat.gsi.gov.uk if they had any further comments on the preliminary thoughts for discussion that were presented at the meeting, to inform the forthcoming consultation on the bioresources RCV allocation guidance.

Volume measure: tonnes of dry solids – (TDS)

Ofwat explained the issues of variability with and lack of a consistent industry approach to sludge volume measurement. One delegate asked if measurement is mandated from 2020 whether installing instrumentation could be part of an “early start” programme.

During the break out sessions one group considered the best place to measure TDS and the definition of the TDS measure.

The group suggested we stick with pragmatic approach of measuring at both the tanker/truck imports point and at the process feed in point. From the sludge producers' side this would mean potentially relying on meters owned and maintained by others for a regulatory measure of their own sludge production. This would require contractual commitments on calibration, independent accreditation and access to logger and meter data.

It was suggested that the issue of who owns which measurement assets could be included in the RAGs definition of the boundary between N+ and sludge. It was suggested that the principle should apply that those providing the service own the assets. This would mean biosolids owning the TDS measurement and Network plus owning liquor measurement.

Data accuracy and confidence grades may be of use in understanding progress in measurement.

The group considered the draft definition of tonnes of dry solids for the revenue control.

Suggested alterations to the definition of TDS are shown in track changes below:

Sludge production in tonnes dry solids for the average revenue price control:

- is a measure of untreated sludge (primary, secondary and tertiary) produced by in-area wastewater treatment processes in a year;
- does not include the grit and screenings removed through preliminary wastewater treatment processes, ~~but is likely in some cases to include some screenings from smaller wastewater treatment works without inlet screens. Such screenings may be removed as part of the sludge treatment process, for example through pre-digestion or imported sludge screens;~~
- is ~~as direct as possible~~ directly measured rather than deemed and ~~so~~ follows these principles by preference:
 - Measured - compulsory after 2020 for both flow and dry solids (rather than calculated);
 - ~~Continuously~~ measured by instrumentation rather than composite sampling, but composite sampling rather than spot sampling.

It was suggested that a short discussion on the definition could be included at the next sludge working group meeting, allowing company delegates to confer with colleagues before the definition was finalised.

The other breakout group considered the issue of reliability of forecasts at PR19, incentivising accurate forecasting, and the pros and cons of the different options for adjustments due to variations between forecast and actual sludge volumes.

Delegates noted that one option for producing forecasts at PR19 is a two-stage process. The first stage would consist in making adjustments to historical data to make it consistent with the RAG 4.06 boundary and as close as possible to what measurements on that basis would yield. In a second stage, forecasts would be produced based on the adjusted data.

Improvements in data accuracy through adopting additional measurement equipment would create challenges to differentiate between genuine volume variance and variation arising from data quality improvement. The point was made that companies should not be penalised or, equally, gain if significant variances between actual and forecast volumes were the result of improved measurement. It was therefore suggested some form of adjustment mechanism might be necessary.

It was suggested that materiality of variation and the impact of adjusting for it on customer bills needs to be considered before developing a complex adjustment process. It was suggested that there are already several incentives and adjustment mechanisms and creating additional ones would increase complexity, especially given how little variability there is in sludge volumes. This would also possibly make all the mechanisms less effective in achieving their objectives. One delegate noted the benefit of a common simple incentive mechanism (eg WRFIM) to drive accurate forecasting. There needs to be internal consistency across wholesale when considering volumes limiting scope for gaming. One delegate noted that the reputational incentive on companies to accurately forecast should not be understated.

Some delegates suggested that a total revenue control could be adopted initially at the beginning of the control period (e.g. two years) to enable the collection of accurate measurements over that period so that a reliable average revenue control could be set for the remaining of the control period.

Issues on form of control

Welsh Water and Thames Water presented some slides to invite discussion on other form of control issues, particularly thinking about post 2020 investment in sludge

assets, and the adjustments that could be made either through the price control period or at the end of the five years.

There was some discussion about RCV protection beyond 2025. Ofwat reiterated that, regarding pre-2020 RCV, (a) this would be protected; (b) for the 2020-25 control period, we did not consider an explicit guarantee mechanism to be necessary as there was no risk of asset stranding; (c) was such risk to arise (e.g. at PR24), this would be reconsidered but, because we do not know the form of control for the price review in 2024, we cannot elaborate on this now. It was suggested that it may require an explicit mechanism, unlike the implicit protection for 2020-2025.

Regarding post-2020 investment, Ofwat reiterated there was no guarantee on that investment. One delegate suggested that such lack of guarantee would stop investors from investing in bioresource assets, unless they were rewarded with a high cost of capital. Another delegate suggested post-2020 investment should not be called RCV.

It was acknowledged that PR19 could be a “transitional” price control as we move from a purely regulated position to a more market-based approach to bioresources services provision.

There was some discussion about the difference between a “strictly” binding price control (with charges between network plus and bioresources), and a more “soft” binding price control, allowing matters such as RCV protection or end of period true ups to apply to network plus rather than bioresources.