

Iain McGuffog,  
Director  
Water 2020  
Ofwat  
Centre City Tower  
7 Hill Street  
Birmingham B5 4UA

Dear Iain,

### **Consultation on economic asset valuation for the bioresources RCV allocation at PR19**

Please find attached our responses to the questions set out in your consultation "Economic Asset Valuation for the Bio-resources RCV allocation at PR19".

As you will see, we are broadly supportive of the proposals set out in the paper, and although they envisage a very considerable amount of detailed work in a fairly short period, we consider that they are achievable.

However, during the course of analysing the consultation paper and the supporting report by Reckon LLP, and subsequently in formulating our response, we have also given consideration to whether the detailed estimation of the bio-resources RCV envisaged is necessarily the best way of achieving Ofwat's PR19 objectives. In broad terms, we take these to be:

- the establishment of a vibrant and effective market for bio-resources as quickly as possible – we take "effective" to denote, amongst other things, successful treatment and management of the co-existence of appointed and non-appointed bio-resources services; and
- a "guarantee" of the RCV attributable to bio-resources as at 1<sup>st</sup> April 2020.

We support both of these objectives. Recent changes in technology and market developments have transformed sludge treatment and disposal. From a situation a few years ago where vertically-integrated wastewater monopolies looked after the whole of the "production process" through to final disposal we see a future not too far away in which wastewater treatment operators "procure" the sludge service from the open market in just the same way that they buy power or maintenance services or indeed any other input. But at the same time we firmly agree that it is important, for the reasons Ofwat has explained, that the legacy RCV as at 2020 that relates to the sludge business is preserved going forwards.

Where we are not quite so certain, perhaps, is the priority to be given to getting a "robust and accurate" valuation of sludge assets to "support the proposed RCV allocation to bio-resources". We understand the logic set out in the consultation paper, and in particular the importance of avoiding valuations that are either higher or lower than what the market would be expected to "reveal". However, attempting to "second-guess" where any market will settle is notoriously problematic because by their very nature markets bring about the disclosure and dissemination of large amounts of information that could not feasibly be discovered in advance. Therefore, hard though we and others would try to assign economic values to existing bio-resources assets, it is almost inevitable that we will "get it wrong" one way or the other, by comparison with what the market will eventually reveal.

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Further, in thinking about how the market will function, it has occurred to us that valuing assets as at April 2020 as proposed might well still leave us some way off establishing "true" economic value, especially without assessing at the same time location values and transport costs. Put bluntly, there is little point in estimating how much it would cost entrants to build a particular asset from scratch if they clearly wouldn't do so, because some alternative way of servicing market demand was obviously better. However robust and refined the estimates of economic value submitted in September, therefore, it is possible that they can never be more than well-prepared answers to what is not quite the "right" question.

We have been considering, therefore, if the main PR19 objectives might be better achieved by tackling them from a different strategic direction. We think that consideration should be given to an approach characterised, in very rough terms, by the following features:

- the responsibility to procure satisfactory treatment and disposal of sludge would sit with "network-plus", but the activities of the appointed business, as it were, would terminate at the end of the sewage treatment process;
- the focus, at the price review, would be on what price the network-plus business would face for bio-resources services, and for what quantities it needed them. That price would represent the total cost to the network-plus business of procuring the sludge service from the bio-resources "business", and would therefore feed into the price control for the network plus business as one element in the "building blocks" calculation. It could be arrived at in a number of different ways, but benchmarking would most likely play a central role. Importantly, by "agreeing" to a price, which would be made public, both buyer (the network-plus business) and seller (the sludge business) would commit to transacting at that same price or better with third parties for a set period of time thereafter;
- no sludge expenditure need therefore be directly allowed in price controls. However, all of the wastewater RCV as at 1<sup>st</sup> April 2020 would remain within the network-plus business. As with the treatment of the separation of the retail function at PR14, an adjustment to the allowed return in the network plus business to deduct projected margin earned by the sludge business would be made, in order to ensure that customers are only "paying once".

Companies would be incentivised to propose price levels that were consistent with their assessments of prospective fair market values for the sludge services. If they unduly inflated prices between the network plus and the sludge businesses they would open themselves up to greater risks of being undercut by third parties. If they unduly suppressed prices the sludge business would be open to being forced to serve third parties at a price that could be uneconomic.

It is always possible that there will be areas where incumbents enjoy a degree of market power, and can price a little higher so as to earn slightly higher returns. This should come as no surprise, as there are segments in markets that are generally thought of as being competitive where small pockets of market power enable above-average profits to be achieved. However, given the general strategy outlined above this should not be regarded as a concern: any additional margin earned in this way is netted off the allowed return on RCV in the network-plus business, so customers are no worse off as a result.

Finally, there are two other aspects of this approach that we believe should be attractive from the point of view of putting in place a set of arrangements at PR19 that achieve the main objective of getting the market to work. First, it resolves the question that the working group was grappling with last year and which remains unresolved, namely what form the "price control" takes. Also, it answers this question in a way that is simple and logical from a commercial point of view, and does not require the sorts of contrived regulatory arrangements that often involve contentious future "true-ups" and which can have unintended consequences.

Second, it effectively eliminates the set of questions regarding the interaction between appointed and non-appointed sludge business, which have been debated at the working group and elsewhere but are as yet unresolved. The interface between what is "regulated" or "price controlled" sits between the network-plus business and the bio-resources services market, rather than occupying some virtual position within individual assets or operating units. We think that this would enable far greater transparency and thereby elicit much more confidence in the market from participants and other stakeholders. We also think it would make Ofwat's job as regulator rather more straightforward.

Therefore, for the reasons set out above, we suggest that Ofwat's objectives can be met by leaving the whole legacy RCV within the Network + revenue control thus removing the requirement to undertake the bioresources economic asset valuation. If you would be interested in pursuing these suggestions further we would be happy to meet with you or your colleagues on an informal basis in the near future.

We have no objection to you publishing this letter and the answers to the consultation questions.

I am copying this letter to Colin Green, as he expressed an interest in these issues during a meeting with some of my colleagues earlier this week.

Yours sincerely



Mike Davis  
Director of Strategy & Regulation.

cc. Colin Green, Director Ofwat

Attachment  
Welsh Water response to consultation questions

## Welsh Water response to consultation questions

*Q1 Do you agree that the focused RCV allocation should be based on the economic value of assets as set out in section 3?*

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*Q2 Do you agree that companies should consider impact on customers and markets and propose an alternative RCV allocation if this will better protect customers, including by promoting a level playing field for markets?*

A: We believe that Ofwat's objectives can better be met by leaving the whole legacy RCV within the Network + revenue control. But if it is felt that an allocation of the 31<sup>st</sup> March 2020 RCV is required then we are supportive of the focussed approach suggested in the consultation basing the RCV on the economic value of the assets with the flexibility to propose an alternative allocation if appropriate cross checks reveal any issues.

*Q3 Do you agree that the assumptions in table 4.1 are appropriate for companies to use for the valuation exercise? We welcome any comments on these assumptions; suggestions of further assumptions you consider all companies should use; or requests for clarification. If you disagree that any of the above assumptions are appropriate to be used by all companies please explain why and if relevant suggest an alternative.*

&

*Q4 Do you agree that the assumptions in table 4.2 are appropriate for companies to use for the valuation exercise? We welcome any comments on these assumptions; suggestions of further assumptions you consider all companies should use; or requests for clarification. If you disagree that any of the above assumptions are appropriate to be used by all companies please explain why and if relevant suggest an alternative.*

A Yes, the assumptions look reasonable at this time. As the valuation progresses and experience with the tool and the methodology deepens it will be important to keep a channel open for queries and dissemination of issues and remedies arising. It would be useful to maintain the Sludge Working Group to facilitate this. The openness and level of engagement within the sludge working group has provided a good forum for development of the methodology for the Bioresources price control as well as a route for timely resolution of issues arising. This level of accessibility and continued dialogue will be especially important as we undertake the economic asset valuation.

*Q5 Do you have any further suggestions of potentially useful cross checks, beyond those presented in table 4.4 that companies may want to consider?*

No, not at this time.

*Q6 Do you have any comments on our timetable?*

A: We think that undertaking a draft valuation, with feedback in good time to inform the submission of the Business Plan, is sensible. The timetable for the production and submission of a fully assured submission in September 2017 is ambitious but achievable. However, a forum for the speedy resolution of any methodological issues arising over the summer will facilitate this.

*Q7 Do you have any comments on our assurance expectations?*

A: The expectations are clear. However, it would be useful for the tables to allow companies to indicate the confidence grades of the input data. There are a number of assumptions that will have to be made in order to complete the tables to the level of detail required which will affect the level of assurance that can be given. It also needs to be recognised that there is scope for movement in the level of the RCV as the methodology for the price control is finalised and also as a result of review and feedback on the draft RCV submissions. The assurance would be expected to reflect this uncertainty.

*Q8 Do you agree that companies should publish information on their websites to allow other stakeholders to comment, and when this could happen?*

*&*

*Q9 At what level of detail do you think that this information should be published at? Please comment as to what you consider the benefits or disadvantages to companies publishing information at a site level?*

A: The level of information to be published will depend on the market design and the structure of the binding price control. There will be more detail on this in the July consultation so we would suggest that the usual practice of allowing companies to propose and justify any redactions or private submissions at the time of submission would seem appropriate.

*Q10 Do you have any comments or require any clarification on the proposed tables? Where you have alternative proposals, please set out how this meets the objectives of the asset valuation for the purposes of allocating the legacy wastewater RCV to the bioresources control.*

A: We have not identified any issues at this time but would welcome a clear escalation route for issue resolution should any arise as we undertake the project to complete the tables and calculate the economic asset valuation.