

Northumbrian Water response to the Ofwat consultation on economic asset valuation for the bioresources RCV allocation at PR19

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

If you disagree, please explain what variations to this approach, or alternative approach, you prefer and why it would be more desirable than our preferred approach. Please include in your explanation how it would meet the objectives of the focused allocation of pre-2020 RCV to the bioresources control.

We support a focused RCV approach for the bioresources control. We agree that this should be based on the net MEAV of the assets. We note this is in line with Ofwat's initial proposals as presented to Reckon, before the alternative economic value approach was counter-proposed by Reckon.

As Northumbrian Water's bioresources assets reflect our current bioresource strategy and have been recently built, we see few differences between our assets and processes, and those a new entrant would build. We do not envisage any difficulty in assessing an asset value for bioresources for ourselves. Indeed, on a unit cost basis, NWL has the lowest bioresources costs in the industry. This gives us an interest in importing bioresources from other areas, using our efficient position to create value through trading.

We are unclear on why, in general, the assumption of economic value could be based on hypothetical assets rather than the existing ones. This seems to us to be a possible opportunity for companies with sub-optimal processes and assets to ignore this, assume replacement with new optimal ones, and reduce the bioresources RCV allocation accordingly, knowing that the RCV balance will be attributed to the monopoly network + business. Customers of the network + business will thus be paying for the difference between recent sludge investment in inefficient processes (included in the current RCV) and the lower optimal RCV allocation to bioresources.

New entrants and efficient incumbents looking to trade will be concerned if they build efficient new bioresources assets only to find that the competitor incumbent's bioresources charges are based not on their actual inefficient assets, but on hypothetically efficient assets. Creating a market with valuations based on a starting assumption of maximum efficiency for all incumbents makes it difficult for equally efficient entrants to compete. We feel this creates an artificial and unnecessary barrier to entry.

The Reckon report states (p5):

Our approach is to assume that these prices will be constrained by price controls which are intended to proxy for the constraints on **prices that would emerge through market processes under the hypothetical assumption that there is effective competition for the treatment and disposal of wastewater sludge from new market entrants (using newly-built assets).**

This assumption of maximum efficiency for all bioresources incumbents seems to be based on the presumption that the market is one of perfect competition, where all variations in cost have been competed away and all participants are 'price takers'.

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Competition Act concerns

We draw Ofwat's attention to the final page of the Reckon report which notes the Competition Appeals Tribunal preferred to use the **actual** costs of the water company over any **hypothetical** new entrant costs:

Extract from Reckon report (p82):

Competition Appeal Tribunal, Albion Water v Water Services Regulation Authority (Shotton case), judgment of 6 October 2006 and judgement of 7 November 2008 on unfair pricing.

The judgment by the Competition Appeal Tribunal (CAT) considers the relevance of alternative costing and asset valuation approaches (including hypothetical new entrant) for the purposes of examining Ofwat's decision on allegations of excessive and unfair and pricing by a dominant water company under UK competition law.

*In its main judgment, the CAT finds that, in that context, **it was not relevant to consider the costs of a hypothetical new entrant, and that the focus should be on the actual costs of the dominant water company in providing the service:***

Extract from CAT findings on Albion v WSRA (6 October 2006):

*581. Secondly, to assess a common carriage charge on the basis of what it would cost a new entrant hypothetically to build for himself the asset to which it seeks access, **would largely defeat the whole object of the exercise.** If the common carriage price is to be calculated on a "new build" basis, the entrant might just as well replicate the system for himself. But that would imply that the new entrant should build another facility, although there is an equivalent facility already in existence. This in turn would cause a wholly unnecessary duplication of resources, leading to the stranding of the original asset: and would, it seems to us, be contrary to the policy behind common carriage and the licensing provisions of the WA03.*

It is critically important that Ofwat's guidance is in line with Competition Law. We urge Ofwat to consider carefully the Competition Appeal Tribunal findings and their implications. We suggest this approach should be checked against the equally efficient operator test, as it does only seem to allow more efficient rather than equally efficient operators to enter the market.

In conclusion, we believe that a net MEAV approach for existing assets and processes is the most appropriate way to allocate the RCV for bioresources.

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?

We agree that a cross check for unintended consequences on customer bills, charging rules and competition law will be important and should be required. As noted in Q1, we have concerns that an economic value approach could have competition law consequences.

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

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appropriate to be used by all companies please explain why and if relevant suggest an alternative.

Table 4.1 has clear and helpful guidance. We do not believe sub site processes necessarily need to be separately costed if there is a more appropriate way of costing the site assets, but we would make that clear in our submission.

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.

We generally agree with the assumptions in Table 4.2. Our only concern is over the suggestion under shared services that there should be a *proportionate allocation of other business assets that would be required by a separate sludge business.*

This appears to contradict the 'principal use' guidance for asset allocation per RAG 2.06 Section 2.2 which states: *Where possible, capital expenditures and associated depreciation should be **directly attributed to one of the price control units.** Where this is not possible as the asset is used by more than one service, it should be **reported in the service of principal use** with recharges made to the others services that use the asset reflecting the proportion of the asset used by the other services.*

On Figure 4.2, we agree that adjustments to reflect the present value of investments are valid. A new entrant with the same assets would have to recover both the financing cost and the annualised costs (depreciation) of the assets, which these calculations reflect.

The example in Table 4.3 is a useful one for illustrating our earlier point about hypothetical values. Whilst we understand most of the calculation, the inclusion of adjustment 'line h' is of concern to us:

h. Annual additional operating and maintenance costs and lower revenues from existing asset compared to hypothetical.

This adjustment illustrates our concern about moving from actual to hypothetical assets. In the example shown, if this value in 'h' is increased to £3m, the economic value of the bioresource treatment centre becomes **negative**.

We can see that the adjustment is taken from the calculation in figure 3.5. It is a consequence of setting the value of the existing asset based on the operating efficiency of the new asset. As we noted above, it is possible that the operating savings between the existing and new assets could reduce the existing asset value to an unsustainable level, **even to a negative value**. It is certainly likely that the operating savings will bring the existing asset valuation to a level below the new asset valuation, creating a possible barrier to entry for new entrants. The negative value point may be seen as extreme, but the fact that this could actually happen should alert Ofwat to the issue.

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?

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Table 4.4 covers all the potential cross checks.

Q6 Do you have any comments on our timetable?

We are unclear on the reason for the 29th September deadline. This is several months before the water resource RCV allocation, yet requires more detail. The data tables require a large amount of data with a significant level of disaggregation and analysis. A slightly later deadline of say end October would still give Ofwat 2-3 months for feedback.

The remainder of the timetable is reasonable.

Q7 Do you have any comments on our assurance expectations?

We support the approach to assurance as set out.

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

We would be happy to publish this information on our website. It may also be helpful for all stakeholders for Ofwat to hold a workshop between submission and their January 2018 feedback to discuss issues arising and initial Ofwat observations.

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?

Whilst we generally support transparency, it is important that information supplied is used for the purpose it was prepared for. The RCV allocation exercise should not be viewed as market data, it is a one-off exercise for a particular purpose. For that reason, we consider that the information should only be published at a high level.

There will be separate requirements for bioresources market information that will be assured and updated for market participants. This exercise is the more appropriate one for sharing operating costs and access prices.

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.

We agree with the detail set out for the Gross and Net MEAV along with the asset life details. We also agree that these can usefully be broken down out by sludge treatment centre and thickening plant.

We are less clear on any need for the analysis of operating costs in Tables 3 & 4. The opex information in these tables is simply aggregated in Table 5 and checked against the APR data in Table 4E, which is already published. None of the opex data feeds into the MEAV calculation or the site calculations in Tables 5 or 6.

It is this granular collection of operating costs by individual site that could provoke commercial confidentiality concerns per Q9. If Ofwat believe that opex by site is required for market information purposes, this should be clearly stated and the appropriate cost allocation carried out in a separate exercise. We do not consider that this is necessary for the purposes of bioresources RCV allocation.

Northumbrian Water, April 2017