

31 March 2017

Water 2020
Ofwat
Centre City Tower
7 Hill Street
Birmingham B5 4UA

By email: rcv.allocation@ofwat.gsi.gov.uk

Dear Sirs,

CONSULTATION ON ECONOMIC ASSET VALUATION FOR THE BIO-RESOURCES RCV ALLOCATION AT PR19

We welcome the opportunity to respond to the consultation on the proposed asset valuation to allocate the bio-resources regulatory capital value (RCV).

We are supportive of the development of new markets and Ofwat's direction of travel in this respect. However, due to the significance of the regulatory framework changes proposed we need to make sure there is opportunity to debate and engage further on the approach to ensure that any unintended consequences or potential imbalances between the sludge and network plus RCV are fully understood. At this stage we believe there is more work to do and more evidence required before a decision can be made on any new approach.

There is increasing focus in the water sector on long term resilience, with climate change, population growth, and changes in consumer behaviour increasing pressure on companies. Long term investor confidence, facilitating long-term investment, and planning is essential to secure the resilience of water and wastewater services. Protection against unintended consequences to the network plus and overall wastewater business is therefore essential.

We agree that whatever the approach taken there needs to be consistency in approach. This is vital as we need to ensure that the eventual approach works for all operating circumstances.

As Ofwat are aware, South West Water's (SWW) sludge strategy is heavily reliant upon recycling high quality bio-resources to agriculture, guided by the Safe Sludge Matrix and the needs of the EU Sludge Directive. As a result, the environmental obligations and duties placed upon the wholesale business must not be compromised by any of the proposed changes.

The proposed approach includes a significant level of complexity that has been developed since the initial high level discussions which considered whether a focused or unfocused approach for RCV allocation was most appropriate. This increased complexity adds risk and uncertainty of unintended consequences. Further consideration is therefore needed of potential impacts on the remaining economic framework and network plus business before a final approach could be agreed.

We also consider that additional customer and broader stakeholder engagement is needed on such a complex and significant change in approach.

As a result we are not convinced at this stage that there is sufficient analysis and testing to agree to the detailed proposals and would welcome the opportunity for further engagement.

Detailed answers to the specific questions raised in the consultation are included in the Appendix to this letter.

Please do not hesitate to contact me if you would like to discuss this further.

Yours faithfully,

A handwritten signature in black ink, appearing to be 'S. Bird', written over a horizontal line that extends to the right.

Stephen Bird

Managing Director

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APPENDIX

Proposed approach - economic value

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

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.

As discussed in our covering letter we are not convinced at this stage that there is sufficient analysis and testing to agree to the detailed proposals and would welcome the opportunity for further engagement.

In addition we have identified a number of assumptions that would be needed which are inherently uncertain and could impact the valuation, including:

- future wholesale energy prices and the impact of government strategy for renewable subsidies
- forecast operating costs (including transportation) and assessment of potential efficiencies of new technologies
- interaction of non appointed activities.

We also note that the approach does not consider expected returns within this area which does not therefore reflect the nature of the new market.

Finally, we note that the potential impact of the bio-resources allocation on the remaining RCV is not considered.

Cross checks on RCV allocation

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?

Yes we would agree that, should an allocation result in an outcome that was clearly detrimental to customers and left them facing significantly higher bills, we would revisit this.

Ofwat has previously stated that the RCV of pre-2020 assets is implicitly protected. A check / adjustment would therefore be needed to ensure no undue stranding risk for pre-2020 assets.

We note that unintended consequences on RCV, returns, and financeability of the network plus businesses should be also considered.

Step 1 – Define the Modern Equivalent

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.

One of the areas of significant uncertainty in such an economic approach is the pricing assumption on electricity generated.

In our response to Ofwat's consultation on regulatory reporting on 21 June 2016 we highlighted additional guidance needed in relation to the allocation of energy generation benefits to the bio-resources business unit. For example, where energy generated by the bio-resources business unit is used by the network plus business (for sewerage wastewater treatment) we consider that additional guidance is needed to ensure consistency in the approach to deriving the unit price for this energy. Energy prices are complex and subject to frequent change such that the valuation method needs to be carefully considered in order that the calculation itself is not unnecessarily complex (such as any assumptions on future wholesale price, environmental taxation / levies, distribution charges, transmission charges and system charges).

Step 3 – Reflect the current assets

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 have no specific comments on the assumptions in table 4.2.

Step 4 – Consider alternative approaches

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?

We agree that substantive cross checks should be made when proposing the value of bio-resource RCV allocation. Specifically checks to ensure there are no unintended consequences to the network plus business or stranding of pre 2020 assets.

Timetable

Q6 Do you have any comments on our timetable?

Q7 Do you have any comments on our assurance expectations?

We are supportive of Ofwat's intention to finalise the bio-resources RCV allocation in advance of the submission of PR19 Business Plans and the process steps establishing the RCV allocations.

We recognise the importance of ensuring robust assurance when seeking consistency across the industry. SWW has a well established assurance and Board approval framework which we apply to all external submissions. We will continue with this approach for the RCV submission.

The timetable is challenging with assurance and Board approval activities required over the summer period, however SWW started considering its bio-resources RCV following the January 2017 workshop in anticipation of further guidance and timetables being published.

Publication of information (I)

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

As acknowledged by Ofwat, publication of information that is commercially sensitive may damage the bio-resources market. Companies may be reluctant to highlight new technologies or operational approaches if this means sharing with potential competitors detailed scheme and cost information.

Publication of information (II)

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?

Despite reservations in publishing all the RCV and bio-resource data required, it should be possible to publish some summary information that helps with the development of the market while preserving innovation incentives.

Data tables

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 do not have any specific comments regarding the draft tables at this time but would suggest that during the completion of the tables there is a forum for issues to be raised with Ofwat and clarification to be sought.

