

# Meeting note

Thursday 2 March 2017  
 Centre City Tower, 7 Hill Street, Birmingham B5 4UA  
 10.30 am to 3.15 pm

## Water resources form of control workshop

Attendees	
Jerry Bryan - Albion Water	Tom Hall - Wessex Water
Patric Bulmer - Bristol Water	David Hinton - South East Water
Joanna Campbell - SES Water	Kerstin McEwan - WICS
Polly Chancellor - The Environment Agency	Steve Morley - Portsmouth Water
Tim Charlesworth - Affinity Water	Robert Scarrot - South West Water
Nikki Deeley - Southern Water	Sarah Shaw - Yorkshire Water
Phillip Dixon - Thames Water	Pat Spain - Severn Trent Water
Paul Edwards - Welsh Water	Nagi Suzuki - South Staffordshire-Cambridge Water
Frank Grimshaw - United Utilities	Crawford Winton - Northumbrian Water
Alex Plant - Anglian Water	Colin Green – Ofwat
Peter Hetherington - Ofwat	Mathew Stalker - Ofwat
Simon Harrow - Ofwat	Iain McGuffog – Ofwat
Peter Jordan - Ofwat	David Young – Ofwat
Hanif Jetha - Ofwat	

## Meeting purpose

The purpose of this workshop was to:

- Present Ofwat’s current thinking on the different elements of the separate water resources control (to be consulted on in the July methodology consultation)

- Provide an opportunity for stakeholders to provide feedback and raise questions in advance of the consultation

The workshop was structured around six key areas:

- Background to the form of control
- RCV allocation to water resources
- The capacity measure for the water resources control
- Understanding of the link to access pricing
- The in-period bilateral entry adjustment
- Bringing it all together and exploring outstanding issues

Action	By Whom	Deadline
<b>Minutes:</b> Ofwat to circulate the minutes to group members for comment. Comments should be sent to <a href="#">Hanif Jetha</a> and <a href="#">Peter Hetherington</a> .	Ofwat; group members	17 March
<b>Capacity measure:</b> Further comments on our proposed approach (water resources yield) should be sent to <a href="#">Simon Harrow</a> and <a href="#">Peter Hetherington</a>	Group members	17 March
<b>Treatment of post-2020 expenditure:</b> Ofwat to clarify the treatment of post 2020 expenditure and the links to RCV protection Closed: See appendix 1	Ofwat	Closed
<b>In-period bilateral entry adjustment:</b> Ofwat to share the market share approach calculations presented during the in-period adjustment presentation. Closed: This has been sent round to group members alongside the draft minutes.	Ofwat	Closed
<b>WRMP pre-consultation meetings:</b> We have set out that we will have at least one pre-consultation discussion meeting with each company (before autumn 2017), focusing on the key issues for WRMP19. If not already arranged companies should contact <a href="mailto:wrmp@ofwat.gsi.gov.uk">wrmp@ofwat.gsi.gov.uk</a> to arrange their meeting	Incumbent companies	24 March

## 1. Background to form of control

Ofwat set out what the form of control is, recapped the factors that led to the decision in May and explained how the rest of the workshop would be set out. In the discussion of these slides the following points were raised:

- It was clarified that the adjustment based approach only applies to post-2020 investment in water resources e.g. not to pre-2020 water resources capacity;
- It was queried whether aligning with water resources planning should be an additional objective for the form of control for water resources;
- The issue of utilisation risk for significant new investment was raised, it was noted that as set out in the November working group this is outside the form of control and that companies should contact Ofwat to arrange a bilateral discussion on this topic;
- The treatment of maintenance expenditure for pre-2020 water resource capacity was raised and how this would be treated in the form of control. Ofwat took an action to clarify this.

## 2. RCV allocation water resources

Ofwat recapped the RCV allocation position as set out in its [May 2016 decision document](#). The [technical guidance](#) published in January 2017 was then discussed, focusing on expectations for companies as well as some issues and approaches that companies might want to consider when allocating the RCV. In the discussion the following points were raised:

- it was reinforced by Ofwat that companies have ownership of the allocation of RCV within the boundaries set by the guidance.
- the timing of RCV allocation, water resources management plans (WRMP) and tariff allocations were queried. Ofwat noted that companies should explore these issues together to ensure the potential interactions between them are understood.
- the amount of assurance needed to be supplied to Ofwat for the RCV allocation was questioned. It was noted that this will depend on how much reallocations change and that companies should provide the same assurance that they would to their own board.
- there was a discussion of the merits of a full MEAV allocation, with some attendees suggesting that it may be less difficult than has been suggested. However, other attendees questioned whether, even if it could be done easily, a full MEAV allocation would be useful.
- there was a discussion about Ofwat's ability to change the boundary for the water resources control. It was noted that in the licence there was an

envelope of activities that could be designated. Ofwat noted that this has been added to ensure flexibility in case some elements of the definition in RAGs are inappropriate. The safeguard of a potential change in allocation at PR24 was also noted here.

- Ofwat clarified that the April / May meetings with companies were to discuss companies' proposed approaches, not to identify what analysis has already been undertaken.

The workshop then broke out into four group discussions, each covering a different topic related to RCV allocation at PR19.

### **Group 1: What information should Ofwat collect?**

The group identified the following key information:

- Charges and incidence effects
- Impact of changes in accounting boundaries
- Movements from 14/15 valuation
- Proposed unfocused RCV allocation to water resources as a percentage and forecast £m of the 1 April 2020 total water RCV
- Supporting calculations of how the RCV allocation proposal has been calculated

### **Group 2: What high level check can Ofwat undertake?**

The group made the following key points:

- The overarching objective of the checks should be to ensure there is no adverse impact on customers and/or water resources markets
- Reflecting this a risk based approach should be taken, with checks focused on;
  - companies that had not followed guidance
  - companies with poor assurance
  - companies with outlying results
  - companies with outlying movements from 2014-15

### **Group 3: What limitations exist with information?**

The group discussed the following:

- Difficulties with data, in particular the changes in the RAGs over time and that MEAV estimates of reservoirs are also likely to cause problems for any MEAV revaluation.

- That any approach should be outcome focused rather than focused on the underlying theoretical correct answer. For example if there is no adverse impact on customers and/or water resources markets, but the answer is not theoretically correct, should this matter?
- Differences in approach and expectations between companies and Ofwat which might result in submissions that do not meet Ofwat's expectations. Here it was noted that it will be important to continue the open dialogue between water companies and Ofwat and that this would be facilitated by the company meetings.

#### **Group 4: What are the main issues Ofwat should consider?**

The group made the following key points:

- It was noted that the link between the WRMP and RCV allocation may not be as obvious as implied by Ofwat, as the group stated that it was unclear how trading would interact with the RCV Allocation. In the discussion it was explained that RCV Allocation determines revenue which in turn relates to prices. Further one member of the group suggested that spare capacity in Water Resources would be sold at incremental cost – and thereby the WRMP would provide a floor in the price.
- The group considered the approaches of the valuation put forward by Ofwat. There was no one single approach preferred but reference were made to a hybrid of methods. Some concern was noted about the Economic Value approach for water resources given the complexity.
- One member commented about the challenges facing new entrants and whether RCV Allocation would help this. Here it was noted that new entrants would compete against incumbent companies for new capacity, rather than existing capacity.

### **3. Water resources control capacity measure**

Ofwat used this session to explore the options for the capacity measure that it will use in the water resources price control. Ofwat explained that an ideal measure would have four characteristics, it would be: (1) within the activity envelope of the separate price control, (2) transparent, objective and practical to calculate, (3) able to capture changes in capacity over the period and (4) transferable into average demand.

Ofwat went on to explain that it considered three different capacity measures from the supply demand balance calculations which were (1) water resource yield, (2) deployable output and (3) water available for use. Based on an assessment against

the characteristics of an ideal measure, the preferred measure is **water resources yield**. In the discussion the following points were made:

- It was unclear in the examples how transfers would be accounted for in the measure. Ofwat noted that the aim would be consistent with the planning process and that this would be clarified with further guidance.
- It was noted that bilateral market entry would not count as adding resource capacity to the company's network, unless it could be relied on by the incumbent. It was explained that capacity added through the bidding market would count in this context.
- The introduction of a capacity split will result in demand management (in network plus) being incentivised over supply side options (to avoid increasing capacity). There was a discussion over whether this was intentional and what the effect would be.
- An attendee noted that abstraction reform would reduce the amount of pre-2020 capacity. It was explained that the level of capacity at 2020 is not fixed and will reduce over time. Ofwat noted that RCV associated with pre-2020 capacity was protected, but not the level of capacity itself.

The workshop then broke out into 3 discussion groups to discuss 3 different options for re-assessment of the capacity measure after 2020.

### **Group 1: Annual re-assessment**

The group felt that if the WRMP deployable output will be re-assessed annually as part of the WRMP annual review, it would be reasonable to re-assess capacity on the same basis and as part of the same process. The group noted that the WRMP annual review is fairly light touch with only large material changes being accounted for. This would mean that even with a frequent re-assessment not much would change in-period.

Reflecting this the group noted that if the adjustment was end of period rather than in-period, then having the re-assessment in line with WRMP development would make more sense.

### **Group 2: No re-assessment**

The group only found one benefit to this option over the others; that it is simple and easy to do. Though they noted that this is only true in the short term, as it may cause more work in the long run. For example, the group noted that this option would introduce risk in that the measure would be reported wrong, and would make assurance inappropriate (as the number would change through time).

In the discussion it was noted that while this is one extreme, there may be little benefit to re-assessing the figure every year unless it was used for in period adjustments to the revenue control.

### **Group 3: Limited re-assessment**

The group considered that limited re-assessment appeared to be the most sensible option. The benefits of this approach were alignment with the WRMP planning process and limiting regulatory burden (e.g. compared to assessment every year).

The group also discussed the preferred measure, and noted that it will be important to fully explore how it links to the assumptions used for water resource planning. Here, for example, the group noted that interactions with water quality should be fully understood across any potential to ensure there are no unintended consequences of introducing the measure.

## **4. The role of access pricing in the form of control**

Ofwat recapped on where the access price fits in and the key linkages to the form of control. During the presentation the following points were raised:

- There were some questions about how the access price is arrived at. In particular whether the access price should use average costs and the incremental cost (like Ofwat has set out) or if it should use the long run marginal cost. Ofwat clarified that the price is based on average cost and the incremental cost is the average of the incremental costs of all schemes proposed in the next period.
- The incentives of retailers was discussed, namely whether they would to sign long term contracts for water resources. The group had a range of views on this and the potential mismatch was compared to the long term planning focus of water resources planning was noted.
- The link to the in-period adjustment was raised. Ofwat explained that the adjustment element of the form of control is intended to stop customers from being made worse off from third party entry. It was noted that companies will need to monitor the market to make sure that they can plan for entry.
- This led to a further discussion about companies maintaining sufficient capacity (as supplier of last resort) in case large third parties leave the market or their resources fail and how this would interact with the control. Some attendees felt that this scenario is unlikely as most large supplies wouldn't simply choose to leave the market that suddenly (although some attendees disagreed). Here the Strategic Supplies framework in 66G and 66H of the Water Industry Act 1991, introduced by the Water Act 2003 was referenced.

Ofwat noted that this is not a form of control issue but a market architecture issue.

- The group discussed whether similar access pricing arrangements comprising of an average cost plus a compensation payment might also assist in facilitating treatment assets brought by entrants. Irrespectively, the access prices may need to reflect different costs of treating entrants' water of varying quality. Ofwat noted that quality-related treatment charges and distance-related transport charges were flagged in previous consultations and while no stakeholder had provided significant commentary on such charge they remain an issue for further consideration.

The workshop broke into two discussion groups to discuss a formal and informal approach to linking access prices and the form of control.

**Group 1: How could a structural link between access prices and the control work and what elements would it include? How would a structural link affect incumbents and potential alternative providers?**

The group discussed several issues related to access prices and how they will function. There was a discussion as to whether the proposal could facilitate inefficient entry and/or prevent efficient entry because the use of an average cost of new resources might not always align with the costs the incumbent faces at any one time. Yet it was noted that this second best solution might be simpler and in practice unless there is significant discrepancy between the costs of schemes incumbents are beginning in a control period any adverse impact may be limited. There was a further discussion on securing water sources in the event a third party provider is no longer able to function.

The group saw merits in both a flexible and a structural approach to linking the form of control and access prices. There was a discussion of whether the group had a deep enough understanding of all the linkages. However, several participants suggested that a structural approach might be simplest and provide greater clarity and that it could just “work when it needs to and not do anything when it isn't needed”.

**Group 2: How might we informally assess whether access prices are consistent with the costs recovered through controls? What information would companies need to submit? How would an informal assessment impact incumbents and potential alternative providers?**

The group also discussed several issues related to access prices and how they will function. The role of the WRMP process and the scenarios presented to help assess

this was a clear link identified. The group also discussed the Scottish experience of section 29E and whether lessons could be learned from this.

Reflecting the timing of the opening of the bilateral market the group felt an informal link would be the most appropriate. It was noted that the key need is transparency of data and that only once the market starts to develop will we better understand the framework and how it needs to evolve. Here one member noted that the bilateral market is a big opportunity and will require open dialogue between incumbents, regulators and third parties for it work effectively.

## **5. In-period bilateral entry adjustment**

Ofwat recapped on why an in-period bilateral entry adjustment is needed and some potential approaches to implementing the adjustment. In the discussion the following points were made:

- It was suggested that in a scenario with increasing demand, the only penalty that should be applied to an incumbent in response to bilateral entry is a recouping of the funding costs as the incumbent will have received the money slightly before they need it, as with entry the incumbent's new resources could have been deferred but would still be needed.
- There was a discussion over the risk treatment of post-2020 water resources investment. There was a concern that the split could drive inefficient decisions to 'keep patching up' pre-2020 (protected) capacity when new (post-2020, hence at-risk) capacity would be a 'better' value solution?
- The scale of entry was raised, and that any mechanism should be proportionate to this.
- There was a discussion on the two different approaches to the volume adjustment. Ofwat agreed to circulate the market share approach and noted that the capacity based approach was under development. The group also noted that here it would be helpful to have worked examples using data from WRMPs.
- There was a discussion on the potential types of revenue adjustments. Here group members felt it would not be appropriate to make an adjustment beyond revenue. It was also noted that the adjustment did not necessarily need to be one way and could be symmetric (i.e. increase revenue if actual entry is lower than forecast entry).
- Some attendees questioned this use of in-period revenue adjustments and said that Ofwat was sending mixed messages given its restricted use in outcome delivery incentives and the potential introduction of more volatility in bills.

## **6. Bringing it all together and exploring outstanding issues**

Ofwat presented the various elements of the water resource control and explored the links to the wider policy framework (see slide 58). Here the links between business plans and WRMPs were brought up and companies were reminded to arrange their WRMP pre-consultation meetings. There was also a general discussion about what else needs to be addressed before the methodology consultation to be published in July 2017. The planned group activities did not take place as the previous section overran.

## Appendix 1: Treatment of post-2020 expenditure

The table below sets out our position in May 2016 on the treatment of water resources expenditure post-2020:

Area	Ofwat position
Pre-2020 RCV	Protected
Post-2020 totex to maintain pre-2020 capacity	Not protected but also not exposed to risk at PR19 (we have introduced the distinction between pre and post 2020 capacity to ensure this)
Post-2020 investment in new capacity	Not protected. Companies in England will be explicitly exposed to market risk at PR19 from bilateral market entry (that is, if they lose market share to third parties in the bilateral market, their revenues would fall).  In May 2016 we consulted on the extent to which companies should face market wide demand risk that reflects future uncertainty (see section 4 of appendix 3). As set out in the <a href="#">November 2016 working group</a> (see slides 41 to 72) we are considering introducing this for significant new investment

Maintenance expenditure (or any part of water resources expenditure) would not be added on to the existing pre-2020 RCV. This is because:

- RCV is not directly linked to physical assets. It is a regulatory tool for ensuring sufficient financing is provided for water companies' businesses. It would be inappropriate to provide funding for maintenance of particular assets on a different basis depending on when they happen to have been built. To do so would give companies different incentives to maintain assets depending on whether they were built pre or post 2020. This could distort company decisions on how to run their businesses.
- We have introduced the distinction between pre and post 2020 capacity to ensure only post 2020 investment is exposed to market risk from bilateral market entry. Further we have a duty to secure that the companies' functions are properly carried out and that undertakers are able to finance carrying out their functions. Reflecting this we would need to provide sufficient funding to companies for them to be able to fulfil their supply obligations.
- Finally in any case, even if it was desirable, it would be very hard to define what is "normal maintenance" and what was "expenditure to maintain capability" for pre-2020 capacity. For example where would refurbishment sit and would this work across all assets? One example would be expenditure to bring a mothballed water resource back into use might feature as incremental

investment in a water resource plan, but could also be classified as maintenance.