

11 July 2017

Trust in water

Delivering Water 2020: consultation on PR19 methodology Appendix 8: Water resources legacy RCV allocation – initial submission

**Appendix to chapter 6:
Targeted controls,
markets and innovation:
wholesale controls**

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Contents

1. Introduction	3
2. Background	3
3. Summary of our discussions with companies	4
4. January 2018 information requirements	5
5. Assurance and submission	7

1. Introduction

This appendix sets out our expectations for companies' initial allocation of the pre-2020 legacy wholesale water regulatory capital value (RCV) between water resources and water network plus. This is important as part of the 2019 price review (PR19) we will be setting separate water resources and water network plus revenue controls on a building blocks basis where companies will receive a return and run off on their RCV.

We expect the relevant appointed companies to submit their proposed allocation by **12pm on Wednesday 31 January 2018** using the tables provided. Each company will support its proposal with appropriate information, commentary and an assurance statement. We will review company submissions and provide feedback.

Companies will need to act on this feedback and provide an updated allocation as part of their business plan in September 2018. Where companies do not take appropriate account of our feedback we will intervene in a proportionate way. We will confirm the final RCV allocation as part of the PR19 final determinations.

This document is structured in the following way.

- section 2 provides background and explains guidance we have already provided to companies;
- section 3 summarises discussions we have had with companies between February and May 2018;
- section 4 sets out the information we expect companies to provide in January 2018; and
- section 5 sets out the assurance we expect companies to provide to give us confidence in their information.

2. Background

In [Water 2020: our regulatory approach for water and wastewater services in England and Wales](#), our Water2020 decision document, we confirmed that an **unfocused approach** should be used to allocate the pre-2020 RCV between the water network plus and water resources price controls. An unfocused approach allocates the RCV based on the proportion of assets employed in the business relative to the total assets of the business.

We will not impose a common allocation methodology to derive an unfocused allocation of RCV to water resources to all companies. Instead, we expect each

company will have ownership and responsibility for how its legacy pre-2020 RCV is allocated between water resources and network plus, consistent with an unfocused approach.

We consider that part of companies' existing RCV-based allowed return on capital is already, implicitly, attributed to water resources. In setting their wholesale tariffs for different types of services, companies should have an understanding of how much allowed return they are raising, or should be raising, for water resource activities relative to other wholesale activities. Company ownership of the allocation will help to avoid unintended and unnecessary impacts on wholesale tariffs and strengthens companies' ownership of their wholesale tariff structure.

In January 2017 we published [technical guidance on water resources pre-2020 RCV allocations at PR19](#). The technical guidance sets out a number of approaches that companies could consider and a range of issues to be aware of in arriving at their RCV allocation approach.

3. Summary of our discussions with companies

We discussed the technical guidance on 28 February 2017 at our regulatory accounts working group and 2 March 2017 [water resources form of control workshop](#). We also held a series of meetings with individual companies in April and May 2017.

Our meetings with individual companies have given us confidence that the technical guidance and the scope of information we proposed that companies provide in January 2018 is appropriate. Companies are considering a range of approaches as set out in the technical guidance that are appropriate to their circumstances. Individual companies have specific challenges that affects which approaches are most useful.

We have drawn a number of conclusions from these discussions.

It is important for companies to take ownership in allocating the RCV so that they can tailor the approach they take to their individual company circumstances. For some companies the Water Resources Management Plan (WRMP) will have less relevance to their consideration of the RCV allocation. And it may simply be sufficient to test the impact of the RCV allocation on their current charges structures, particularly where companies intend to base their RCV allocation proposals on rolling forward past Modern Equivalent Asset Value (MEAV) valuations. Even so, each company will need to review its draft WRMP to demonstrate that it is not relevant to the RCV allocation.

Where companies have maintained current cost registers or undertaken a full revaluation before PR14, this is useful information for companies to consider when rolling past MEAV valuations.

In January 2018, it will be useful for all companies to provide a roll-forward from the 2014-15 net MEAV using a forecast of expenditure and capital charges up to 31 March 2020. We understand that company confidence in forecasting movements in expenditure and capital charges for water resources out to 2020 in advance of submitting their PR19 business plan will vary.

4. January 2018 information requirements

The objective of the initial submission in January 2018 is to collect common information across companies to ensure that there is no adverse impact on customers and/or water resource markets.

We have not amended the technical guidance we set out in January 2017.

As a minimum each company will need to set out the following.

- Its proposed unfocused RCV allocation to water resources as a percentage and forecast £m of the 31 March 2020 total water RCV.
- A comparison to the 2014-15 water resources net MEAV that it included in its 2015 regulatory accounts, as a proportion of the total water wholesale net MEAV, together with an explanation of why the proposed unfocused RCV allocation varies from this.
- Supporting calculations of how it has calculated its proposed RCV allocation.
- An explanation to justify the proposed RCV allocation, that includes
 - an explanation of how the issues set out in the technical guidance have been considered;
 - a narrative justifying the approaches that have been considered; and
 - how the company has considered the impact on charges including any sensitivity testing on wholesale tariffs and bulk supply charges.
- A statement setting out the consistency of the analysis with information within company Water Resource Management Plans explaining any apparent discrepancies.

The level of information companies provide should be proportionate to the factors they have considered in making their proposed RCV allocation.

We do not have any specific expectations of what companies may choose to publish on their websites at the time of submission to us. We will publish high-level information on company RCV allocation proposals as part of our feedback in April 2018.

Alongside this document we provide an [excel spreadsheet](#) with two tables for companies to present information to us in a standard format.

In **Table 1** we expect companies to set out their proposed RCV allocation and a comparison to the net MEAV as per their 2014-15 regulatory accounts.

Block A allows companies to set out the roll forward of the net MEAV from the 2014-15 regulatory accounts to 31 March 2017.

Block B allows companies to forecast how their current forecast of expenditure, depreciation and any other adjustments (such as planned disposals) would impact the roll forward their net MEAV to 31 March 2020.

Block C allows companies to set out their proposed RCV allocation, with the total for water wholesale RCV equalling the PR14 final determination water RCV for 31 March 2020, inflated to March 2017 prices.

Companies must complete Block A and Block C. It would be helpful if companies forecast 2017 to 2019 expenditure in Block B. This will assist us in providing useful feedback on the proposed RCV allocation to the company. We do not require this if it is not relevant to the company's proposed approach or suitable forecast data is not available.

For final RCV allocations we expect that the "midnight adjustment" between closing 31 March 2020 and opening 1 April 2020 RCVs will need to be allocated between water resources and water network plus. Companies do not need to complete line 18 for the initial submission, unless there is a particular issue they anticipate that they wish to highlight at this stage.

In **Table 2** we have provided a standard way to test company RCV allocation proposals. Companies may need to complete additional analysis to support their RCV allocation proposals depending on their company specific circumstances. The purpose of the table is for Ofwat to understand the sensitivity of wholesale revenues and charges to the proposed RCV allocation.

Block A allows companies to split 2016-17 actual water wholesale revenue between water resources and water network plus. The allocation of revenue in block A

between water resources and water network plus should, as far as possible, be based on current tariff structures.

Block B allows companies to estimate the impact on 2016/17 revenues if their proposed RCV allocation had been in place. Companies should assume the PR14 wholesale rate of return of 3.6% per year for both water resources and water network plus, for illustration purposes.

Block C allows companies to provide the increase in water resource capacity (yield) between 31 March 2020 to 31 March 2025, expected in the draft WRMP and the associated impact on total expenditure in this period. This will be zero if a company's draft WRMP does not have an increase.

Blocks D and E contain standard calculations of average revenue per cubic metre to illustrate the sensitivity of wholesale charges to the proposed RCV allocation.

5. Assurance and submission

We will take into account the quality of the assurance statements that companies provide and the confidence we can place in the data provided when providing feedback to companies. We seek assurance that the assumptions and any limitations in data used for the analysis have been exposed.

Companies should send completed data tables and the supporting information set out above to rcv.allocation@ofwat.gsi.gov.uk by **12pm** on **Wednesday 31 January 2018**.