

April 2019

Trust in water

# **PR19 draft determinations: Our methodology for the classification of bioresources costs**

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## 1.1 Introduction

This appendix sets out the methodology we have used to classify companies' revenues as either fixed or variable. How these revenues are classified is important as it affects how Water and Sewerage Companies' (WASCs') allowed revenue varies with their sludge production.

We summarise our implementation of this methodology for each company in their draft determination, which can be found on the [draft determination webpage](#). We are also publishing the detailed calculations in the spreadsheets 'Bioresources revenue to remunerate fixed costs' for each company [here](#).

## 1.2 Background

In our PR19 Final Methodology, we set out how we would establish a separate control for bioresources. A key objective in setting this control is to ensure that companies are allowed to recover the right amount of revenue, i.e. one that reflects their costs.

We recognise that a proportion of bioresources revenues are fixed, so it would be inappropriate to set an average revenue control which did not account for this. Therefore, the form of the control we set is a 'modified average revenue' control.

The revenue control should ensure that where sludge production varies the incremental change in revenues that arises is aligned to incremental costs. Getting the alignment between incremental revenues and incremental costs right is key to ensuring that the company is correctly remunerated, if there is a difference between the sludge companies actually produce and what they had forecast.

Appendix 6 of our PR19 Final methodology published in December 2017 sets out in detail how a modified average revenue control will operate to set companies' bioresources revenue allowance.

In order to implement the modified average revenue control, we asked companies, when submitting the business plans to us in September 2018, to classify their

bioresources revenues as either fixed or variable. We also expected companies to justify their classification.

### **1.3 Our decision to intervene in companies' plans**

Our initial assessment of business plans (IAP) revealed that companies had taken inconsistent, and sometimes incorrect, approaches to classifying their bioresources revenues. We found that the proportion of revenue that companies proposed to remunerate fixed costs varied between 0% and 96.78%.

In order to better understand companies' approaches, we issued a query to all WASCs in October 2018 asking them to provide more evidence and justification. As part of their response, some companies made large changes to their cost classification. However, this still resulted in WASCs' approaches being widely inconsistent.

Although, there is a separate incentive to encourage companies to forecast their sludge production accurately, we consider that this may not be sufficient to offset the customer detriment from the significant misalignment of costs and revenues or distortions to trade.

Overall, we have concluded that there is a significant risk that we would not achieve the objectives of a separate bioresources control without further intervention. Therefore, to protect the interest of customers, we are establishing a common methodology for classifying WASC's revenues as either fixed or variable.

### **1.4 Our proposed methodology**

Our PR19 Final Methodology set out the 'building blocks' of our revenue control. These building blocks can be categorised as:

- costs related to pre- and post-2020 Regulated Capital Value (RCV), i.e. RCV run-off and return on RCV;
- Pay-as-you-go (PAYG) expenditure; and
- Other costs.

We discuss below how we have classified these categories of costs.

**Funding of the RCV** The bioresources revenue control remunerates the RCV run-off and return on investment. The revenues required to fund these costs do not vary with volumes. However, some companies discounted this key element of fixed revenues in deriving their proposed allocation between fixed and variable revenues. We are classifying the revenues associated with the RCV run-off and return as fixed.

**PAYG and other costs** We recognise that the appropriate proportion of PAYG and other costs classed as fixed costs will differ across companies depending on factors such as:

- the technological processes involved to process sludge;
- the efficiency of operations; and
- the nature of contractual relationships with third parties.

However, differences between companies were not only due to differences in the companies' characteristics, but due to how they have chosen to classify their costs.

Table 1 shows how we are intervening to determine the classification of various types of cost.

**Table 1: Proportion of PAYG and other costs classed as fixed**

Cost line	Fixed proportion
Local authority and Cumulo rates for both treatment and disposal (items 3 and 11 in Bio3)	100%
Other direct costs of treatment (item 4 in Bio3)	25%
Other direct costs of disposal (item 12 in Bio3)	0%
Other indirect cost of treatment (item 5 in Bio3)	35%
Other indirect costs of disposal (item 13 in Bio3)	35%
Pension deficit repair contributions (item 2 in Bio4)	100%
Current tax ~ wholesale wastewater bioresources (item 9 in Bio4)	0%

Our reasoning is as follows.

- Local authority rates are taxes set periodically, based on the valuation of a company's assets. These do not change with treated volumes of sludge and are therefore considered fully fixed.

- Pension deficit repair contributions also do not change with treated volumes of sludge and are considered fully fixed.
- Tax on operations is linked directly to profits, which in turn vary with volumes. We are therefore treating tax receipts as incremental.
- We have set the direct and indirect cost of treatment and disposal based on our analysis of the evidence from companies' submissions to us.

Transport costs are considered fully variable. In some cases, we apply these proportions to the efficient level of costs that we have determined, rather than the costs companies have proposed.

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