

Bioresources:

Price Control Design – for discussion

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8 April 2021

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Purpose and objectives of the today

- Set out the PR19 approach to setting the bioresources price control and some potential issues with this approach
- Share our thinking on what the current situation and desired future situation might be
- Get your thoughts on whether our view is right and what options we might have going forward



Agenda

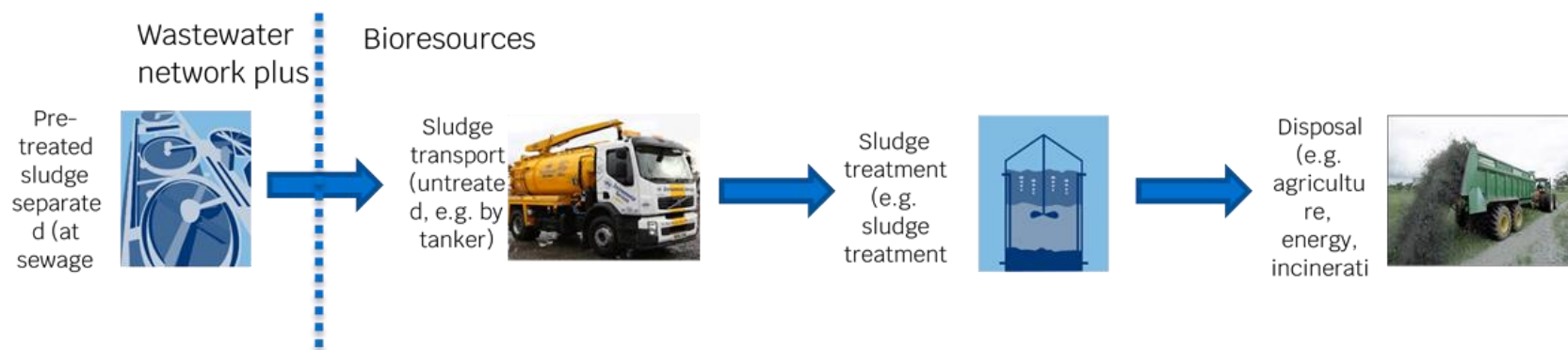
- Background to PR19 price controls
- Clarification questions
- Breakout groups
- Feedback to the group
- Close



Background (1) – We introduced a bioresources price control

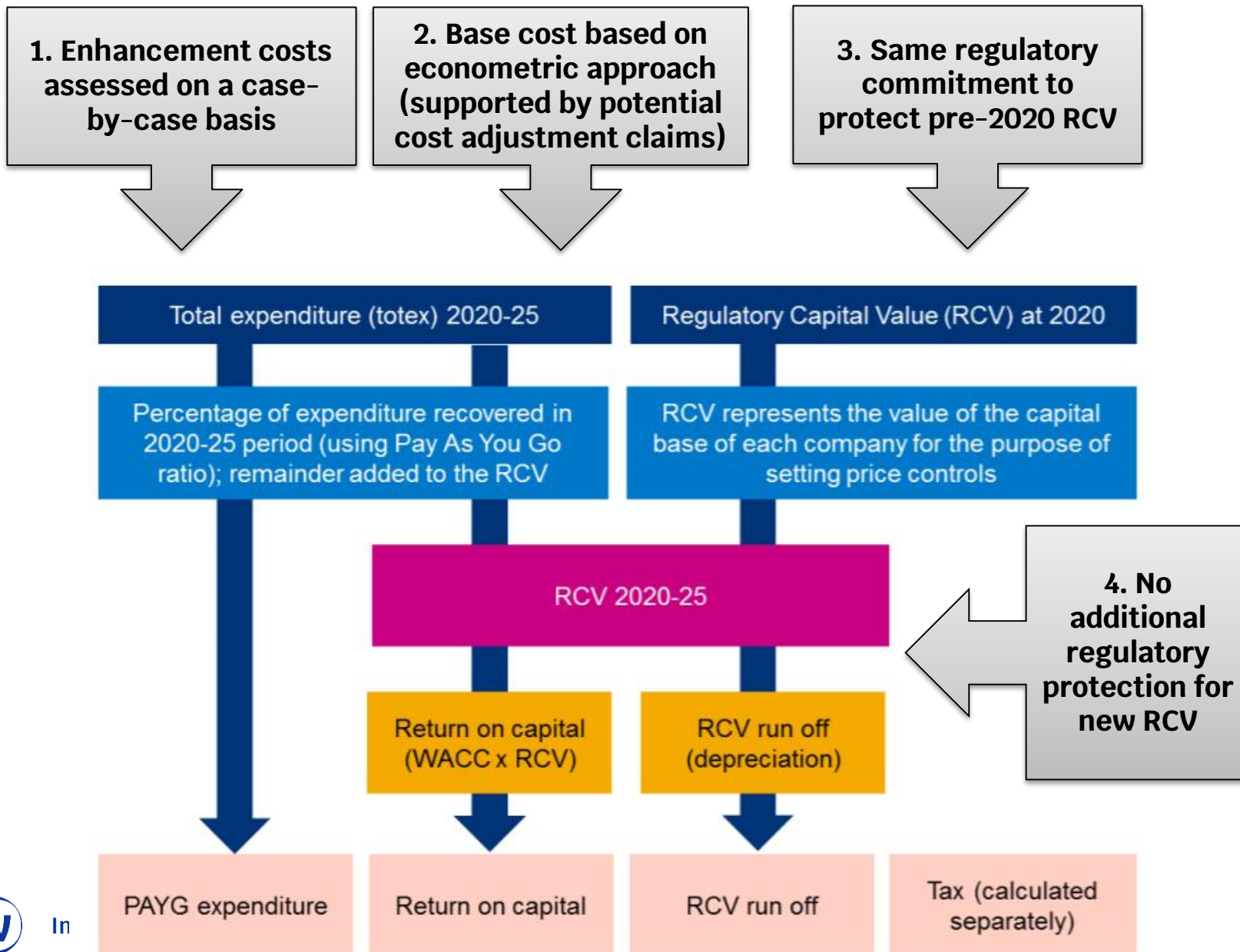
Old wastewater control split into: wastewater network-plus and bioresources

Bioresources control covers transport, treatment and disposal (recycling)



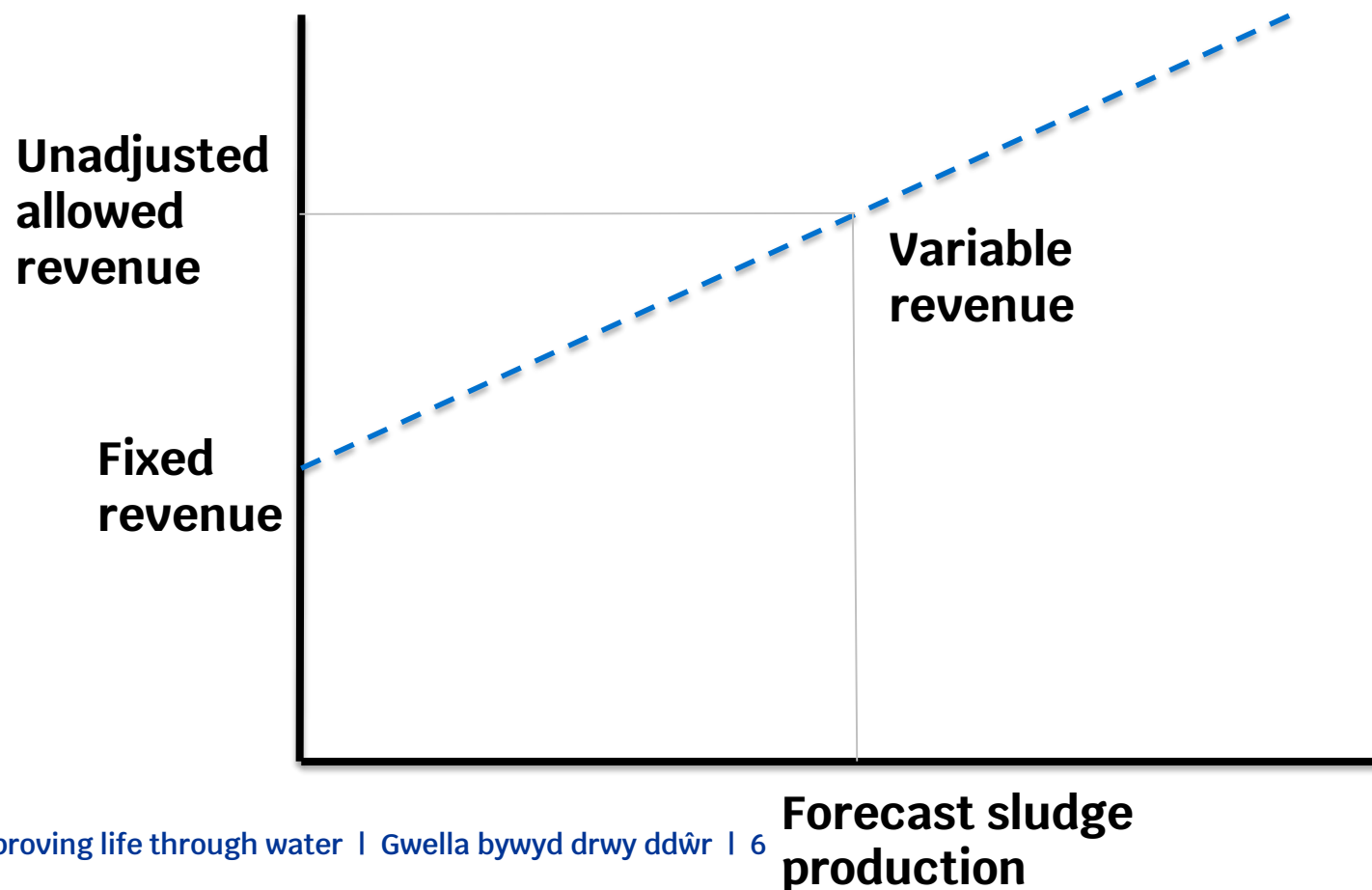
- At PR19 we introduced a new bioresources control
- This involved defining the relevant activities and allocating Regulatory Capital Value (RCV).
- This helps shine a light on these costs, increase management focus and support the bioresources market.

Background (2) – Allowed revenue based on ‘building blocks’



Background (3) – Modified Average revenue control

- Allowed revenue is based on forecast sludge production.
- Allowed revenue is adjusted though if actual production is higher or lower than forecast as shown in the figure below. (Other factors can also affect allowed revenue which are not shown below.)
- We introduced a forecasting incentive to encourage accurate forecasts.



How does this compare to Residential Retail?

In comparison, for residential retail:

- no RCV
- uses an econometric approach, supported by potential cost adjustment claims, for all costs (there are no enhancement costs)
- costs are translated into per-customer cost
- allowed revenue is based purely on the number of customers

This approach is:

- much simpler;
- generates a cost per customer that includes fixed as well as variable costs;
- led to more rapid efficiencies than most of the other price controls;
- led to changes in market structure, e.g. outsourcing



Issues we see with the bioresources approach

The PR19 approach has a number of merits. However,

- **The approach is fundamentally different from a ‘gate price’ approach used in the wider waste market**
- **In a competitive market, procurement, cost of capital and then revenues are determined through a market process rather than a regulatory one**
- **The CMA raised concern that customers fund new capacity which companies can sell on in the market, i.e. RCV could be ‘double-funded’**
- **The ‘building-blocks’ approach could create an ‘in-house bias’ for new capex, because:**
 - it seems to generate a profile of allowed revenue that is better aligned with undertaking capital expenditure in-house, rather than through a long-term contract;
 - a long-term contract could be classed as base expenditure and so subject to benchmarking – it might therefore seem to water companies to have lower regulatory protection than an enhancement approach.



Where we want to get to? For discussion

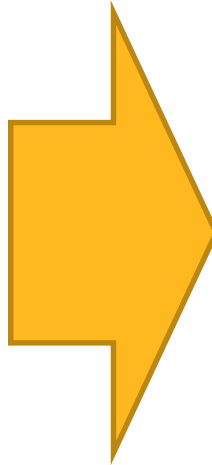
Current situation?

Short-term trades of headroom capacity

Regulator determined enhancement, cost of capital, etc.

Bilateral relationships

Water companies with low risk, customer-funded capacity



Future position?

Trading for capacity of different durations, joint production

More costs determined by market / benchmarking

Regional approach where appropriate

A more level playing field with wider waste sector

Any questions?



Breakout groups



Question for your break out groups

- Have we set out a reasonable description of the current (i.e. PR19) approach?
- Have we identified the right issues?
- Have we characterised where we are now and where we should aim to get to correctly?
- What options are there?



Next steps

- Thank you for attending this event
- We will consider your feedback
- We will consult on any proposals in May

