Cost Assessment Working Group – Bioresources

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Our objectives for this session

In April 2021 we discussed a potential new price control design. In May 2021 we consulted on options to address barriers to market development, including issues around cost allocation and cost assessment. We are now consulting on Our proposed approach to funding bioresources activities at PR24. This takes forward these workstreams.

Our objectives for today are to provide:

1. clarification of our proposals and information request regarding depreciation and net MEAV to help inform your consultation responses; and

2. a chance to discuss some of the proposals.

We suggest that the session today focuses on the proposals in the current consultation, rather than those in earlier consultations.

In the interests of time, we suggest we do not focus on the draft information request, regarding the reallocation of costs between controls today. However, we would be happy to discuss any questions you have regarding this separately.

Agenda

Welcome

Introduction and background to this work

Better cost allocation
Summary of our proposals and draft data request
Clarification questions
Breakout group

Better targeted cost assessment
Summary of our proposals regarding:
- a more market-based approach to setting costs and revenues;
- implementing the new bioresources control

Clarification questions
Breakout groups

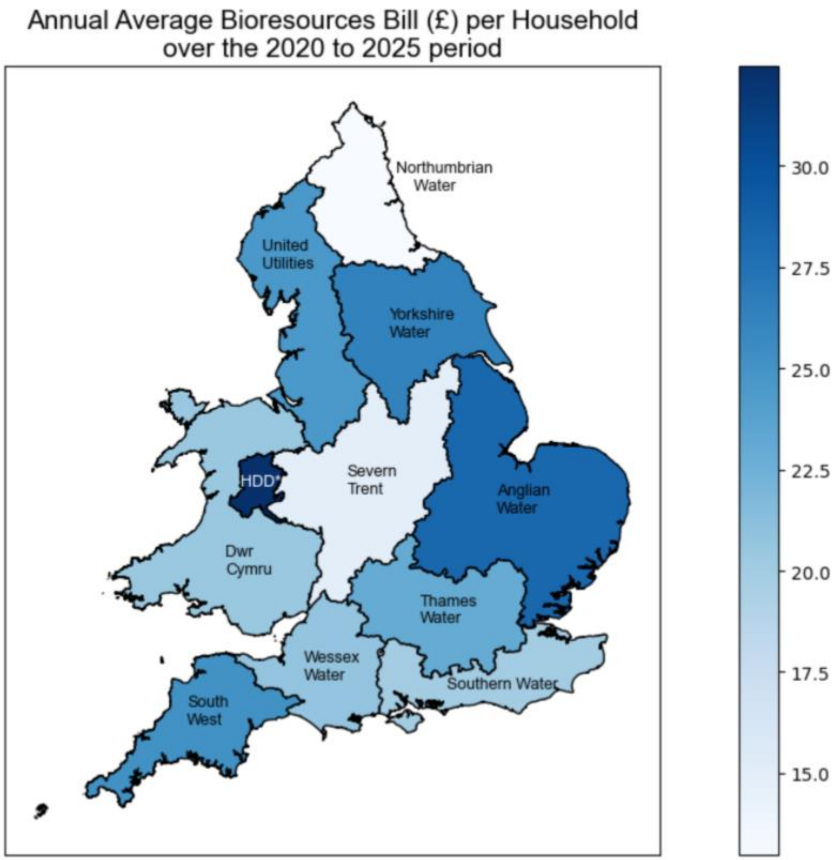
Depreciation and net MEAV data request
Summary of our data request
Clarification questions

Close

Introduction

Background

- Bioresources activities comprise around £3 billion (6%) of companies' allowed revenue for the 2020-25 period.
- The yearly cost to customers can vary significantly between companies' areas – ranging from as low as around £13 to over £32 for a typical household customer.
- With the right conditions, bioresources activities could help to create greater economic and environmental value. A well-functioning bioresources market could help achieve this.
- Several reviews have found there to be potential benefits from competition in bioresources.



*HDD = Hafren Dyfrdwy

Our review of the bioresources market

In recent years, we have introduced a number of changes to facilitate the bioresources market such as a separate price control, information remedies and transfer pricing guidance.

After identifying potential issues with the operation of the bioresources market, we launched our 'Review of the bioresources market' in October 2020. We published the draft findings of our review in May 2021. We have already implemented some proposals.

After our recent [market monitoring report](#) we remain concerned about the operation of the bioresources market.

In May 2021 we [consulted](#) on a number of potential proposals to address the barriers we identified. These included measures to address:

- cost allocation issues; and
- cost assessment issues.

We are now [consulting](#) on proposals to address these issues.

The pillars of our bioresources strategy

Better cost allocation

Background

We introduced a separate bioresources price control at PR19. A separate price control helps to shine a light on the costs of bioresources, focuses management attention on driving efficiency and enables targeted regulation. Where costs are comparable between companies, they help the sector to better identify relative levels of efficiency and help to inform trades.

However, there were a number of outstanding issues regarding the allocation of costs between the wastewater network plus and bioresources control. Therefore, we recently produced guidance on the allocation of costs for:
sludge liquors;

- energy; and
- overheads.

We consider that a separate efficiency challenge for bioresources would be more transparent and more likely to achieve a stretching, targeted efficiency challenge for these activities. However, the previous cost allocation issues prevented us from achieving this at PR19.

Our assessment

We want to set a separate efficiency challenge for bioresources at PR24. To achieve this, we need appropriate data. Companies will shadow report on the basis of all the improved cost allocation guidance for the first time this summer.

We are considering a number of options:

- **Option 1: Only use data from 2020-21 onwards**
- **Option 2: Use uncorrected historical data before companies' new reporting requirements took effect**
- **Option 3: Ofwat adjusted historical data**
- **Option 4: Company adjusted historical data.**

We prefer option 4. We consider this is more likely to provide accurate data and is consistent with companies taking ownership of their data.

We therefore propose that companies provide the additional historical data alongside their APRs in the summer. In our consultation, we provided a draft information request to implement this.

Breakout groups

Do you agree with our approach?

Is there anything else we can do to improve the consistency of historical data?

A more market-based approach to setting costs and revenues

Background

At PR19, our approach to determine bioresources funding was through:

- a separate process for assessing base costs (which used econometric models) and enhancement costs (which were assessed more on a case-by-case basis);
- financing costs based on a cost of capital applied to a regulatory asset base; and
- a modified average revenue control.

In our bioresources market review, we identified a number of issues with our approach at PR19:

- it was more regulatory, rather than market, based approach;
- assessing different costs through different processes could create potential distortions; and
- the way the building blocks approach was applied could lead to an ‘in-house bias’ for new investment.

At PR19, we said:

- a different degree of regulatory protection would apply to pre-2020 RCV and new investment after that date; and
- we intended to explore setting price limits based on ‘gate fees’.

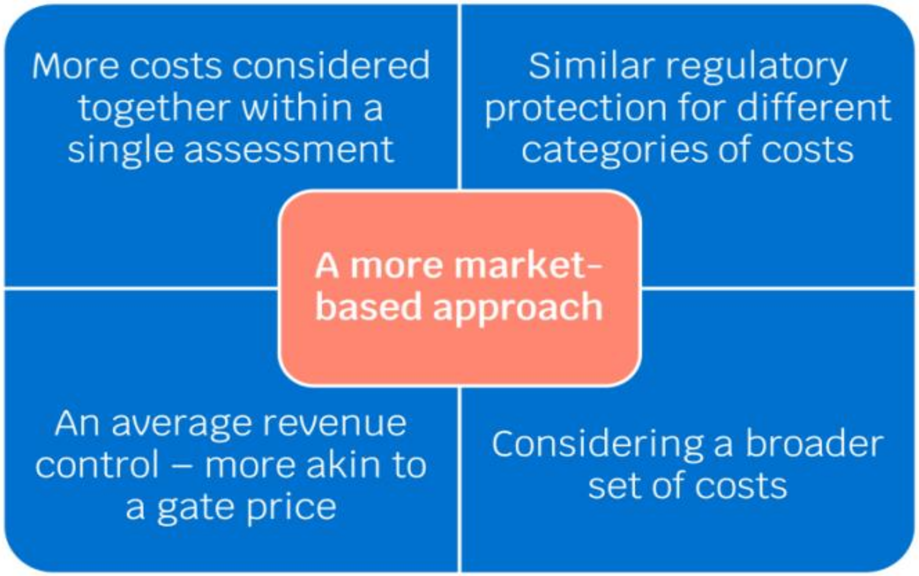
We therefore consulted on an approach based on:

- benchmarking companies’ average revenue requirements;
- using supplementary approaches to cost assessment, such as benchmarking against the wider waste market; and
- providing a level of protection for pre-2020 RCV.

Overview of our proposed approach

To address these issues we put forward a more market-based approach based on the four principles below.

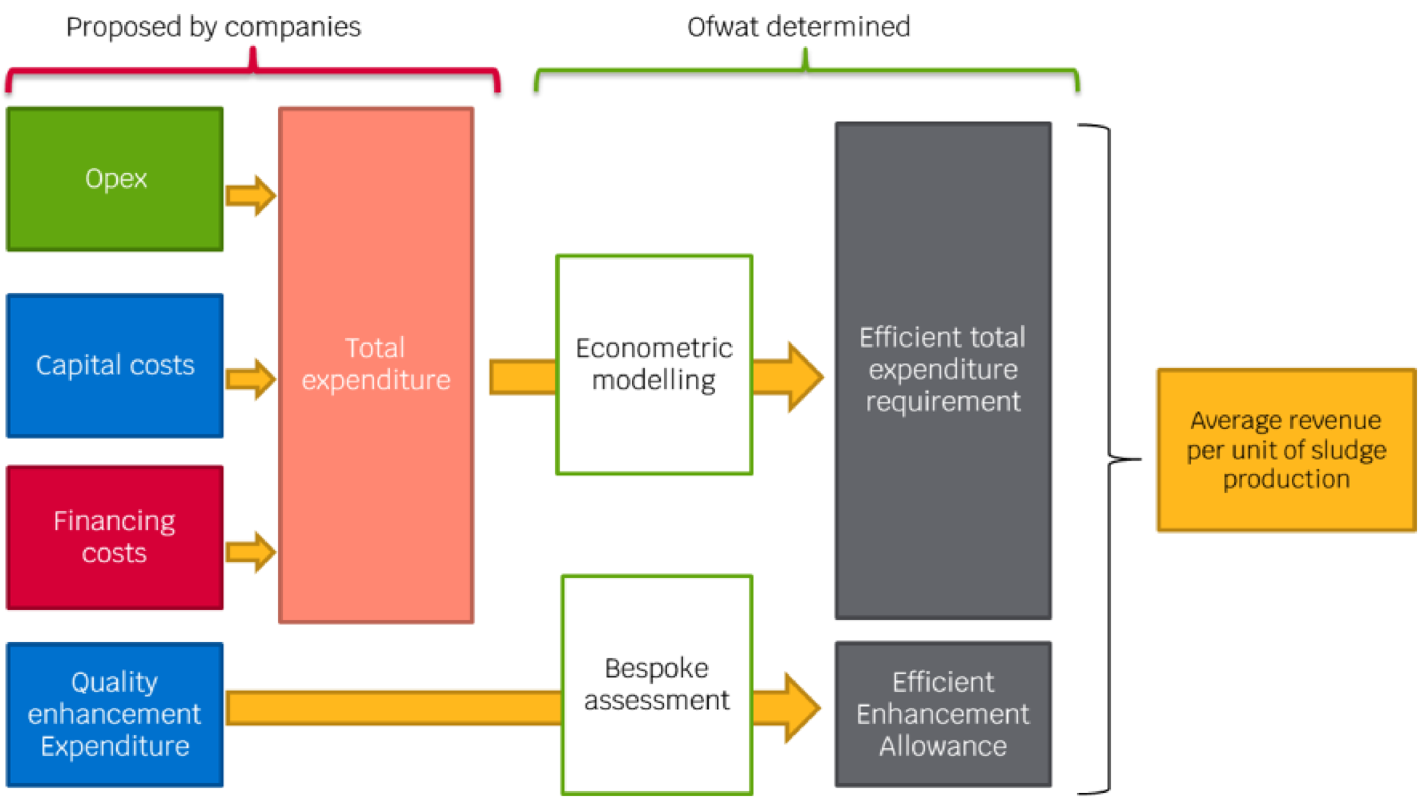
Principles for our proposed approach



Overview of our new approach

Our proposed approach is based on:

- including financing costs and more enhancement costs within our econometric models;
- exploring using depreciation data, rather than expenditure data, in our econometric models.



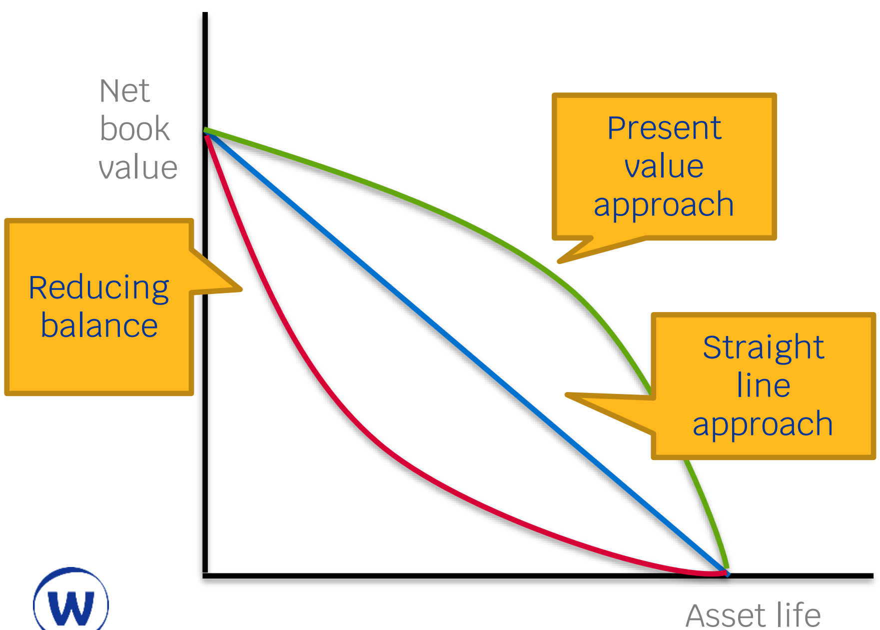
A standardised approach to capital costs to pre-2020 depreciation

At PR19 we used expenditure data when assessing bioresources costs. We want to explore using depreciation data instead at PR24 – this data could also be used to implement the different level of protection for pre-2020 RCV.

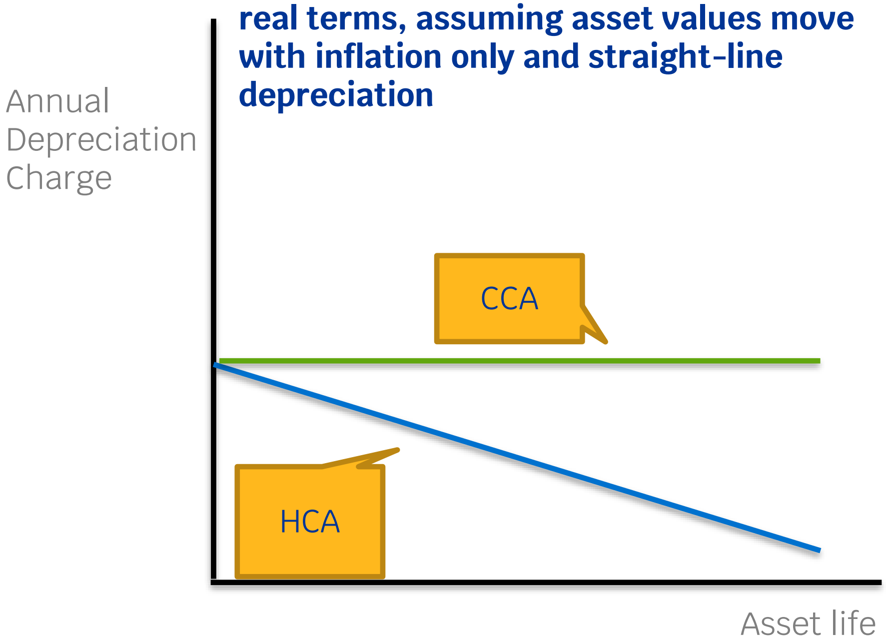
Our preferred option is to use:

- a straight-line approach to depreciation – this strikes a balance between the two alternative approaches considered; and
- light-touch current cost accounting (CCA) – this should provide sufficiently accurate and consistent data.

Alternative depreciation profiles



Annual depreciation profile of an asset, in real terms, assuming asset values move with inflation only and straight-line depreciation



Approach to depreciation over the 2020-25 period

Over this period, we already have companies' RCV and RCV run-off data that we can draw on.

Companies generally choose the reducing balance method to run off their bioresources RCV over this period. Although, we didn't enforce a strict standardisation of RCV run off, companies were required to set this at the 'natural rate'.

If we applied the standardised approach to depreciation (see previous slide) over this period then there would be a divergence between the data we use in our modelling and companies' RCV and RCV-run off. In light of this, we considered two options:

- **Option 1: Apply the standardised approach with a subsequent adjustment**
- **Option 2: Use the PR19 bioresources RCV and run off (with no adjustment)**

We prefer option 2. We consider that this should provide appropriate data for our analysis, may not be significantly different from the standardised approach and would avoid the need for complicated adjustments. However, we will review our position in light of companies' data.

Approach to financing costs

We propose including financing costs within our econometric cost benchmarking models for bioresources. This would incentivise companies to seek efficiencies across their entire cost base, reduce potential distortions created by taking different approaches for different categories of cost and come closer to a market process where efficient costs are reflected in the service's price.

The asset base would be consistent with our approach to depreciation, i.e.

- before 2020, take account of additions net of depreciation; and
- over the 2020-2025 period, be equal to the RCV.

Our preferred approach is for financing costs to be based on 'notional' financing costs. We would use the allowed return from previous final determinations to estimate companies' historical financing costs and apply this rate to the bioresources asset base corresponding to the relevant control period.

This approach would be consistent with our longstanding approach of setting companies' allowed return based on a notional basis and would protect customers from bearing increased costs due to their company's financing structure decisions. The approach would also be more transparent and less data intensive than using 'actual' financing costs.

Approach to enhancements

Under our proposed approach, we envisage more enhancement expenditure being funded through our econometric models.

Growth enhancement

We consider that there should be **no cost adjustment claims for growth expenditure.** We would envisage our econometric models to incorporate capital costs and include a scale driver. Furthermore, companies would be funded through an average revenue control.

New quality enhancement

We consider three options on how we would treat new quality enhancement claims at PR24.

- **Option 1: Provide an allowance for one regulatory period.**
- **Option 2: Provide an allowance for two regulatory periods.**
- **Option 3: Provide an allowance for all efficient expenditure.**

In terms of capital costs, options 1 and 2 would provide for the depreciation costs over the respective periods, rather than capital expenditure as in option 3.

We prefer option 1 as this best meets our objective of more costs being assessed through our econometric models. This is because this approach would allow the full costs of the enhancement expenditure to be captured in our models more quickly as the enhancement costs would appear in the input data for the econometric models in subsequent periods.

Implementing the new bioresources control

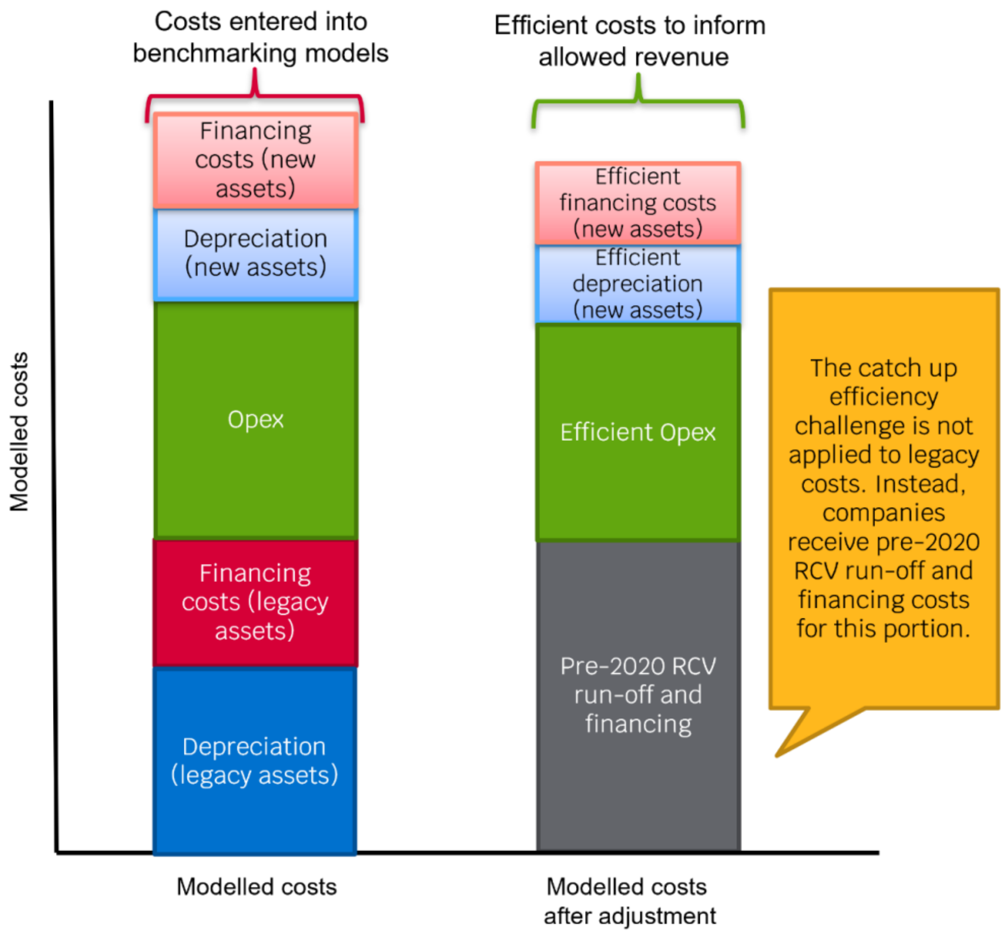
Approach to pre-2020 RCV (1)

In our bioresources market review, we said we would take account of the different regulatory protection for pre-2020 RCV.

Under both the options we consider, we would first undertake our efficiency challenge using our proposed approach, discussed in earlier slides.

In option 1, 'legacy' depreciation and financing costs would be excluded from the efficiency challenge. Instead, we would fund the run-off and financing costs for pre-2020 RCV.

Option 1: Excluding legacy assets from the catch-up efficiency challenge



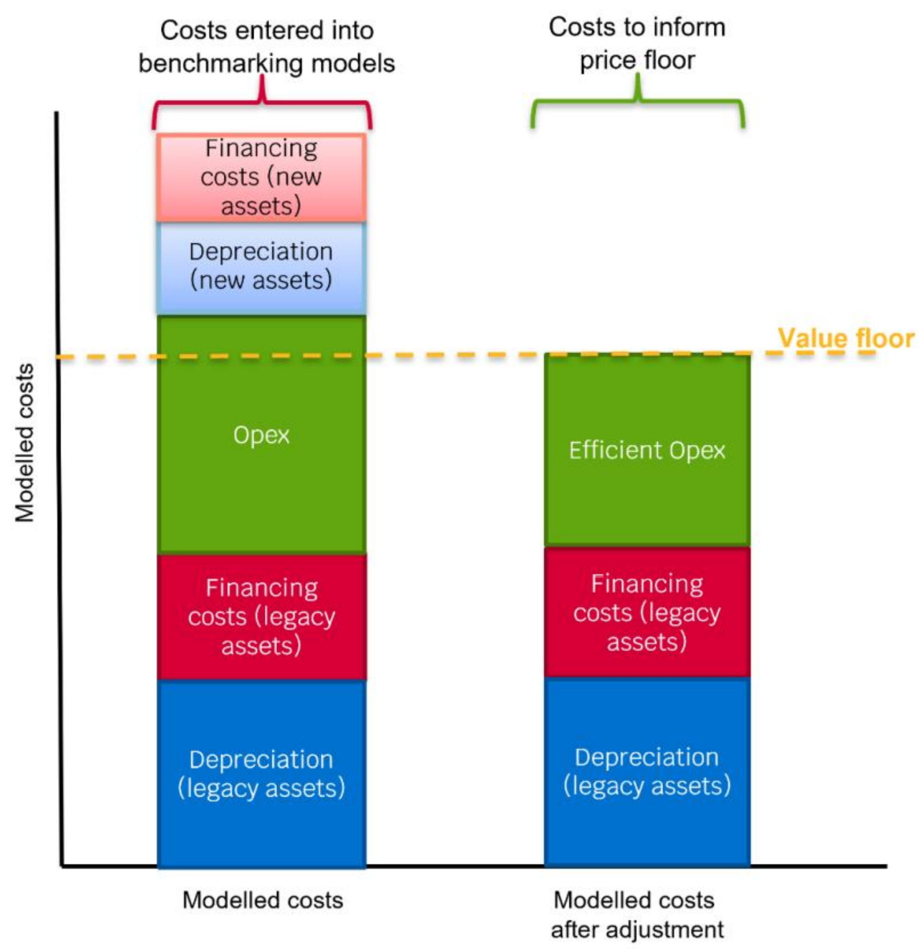
Approach to pre-2020 RCV (2)

Under option 2, we would set a value floor such that the cost of new investment (i.e. depreciation and financing costs) would not receive additional regulatory protection and an efficiency challenge is applied to operating costs.

The floor would ensure that the capital costs of legacy assets and efficient operating costs could be recovered.

We do not have a preferred option at this stage and wish to consider feedback. We consider that option 1 would provide symmetric protection in the sense that companies can neither gain nor lose from our efficiency assessment regarding their costs for legacy assets. Option 2 is 'asymmetric' in this sense (as it only provides protection to companies) but the value floor is likely to have an effect in only limited circumstances.

Option 2: Value floor



Assessment of cost risk

We consider that there will be **no increase in the risk of asset stranding**. We consider that companies' allowed revenue should continue to be based on the amount of sludge produced and would not depend on whether the company or a third party treats the sludge. Companies face no new threat of direct competitive entry under our proposed approach.

Although our new approach would set a cost challenge in a new way, **we consider that our proposed approach will not necessarily increase the cost risk**. That said, we will get a better sense of this when we have undertaken quantitative analysis.

An **average revenue control will lead to a modest increase in volume risk**. We consider that a degree of volume risk is acceptable and note that prior to 2010, companies were exposed to volume risk across all price controls. However, we would review whether mechanisms such a cap and collar on allowed revenue and how a forecasting incentive could be applied at PR24.

We therefore consider that there will not be a significant increase in risk faced by companies.

Breakout groups

We would welcome discussion regarding:

- whether the design of the new approach, and our reasons for introducing it, are clear;
- the merits of depreciation data vs. expenditure data and how depreciation data could be best standardised and used;
- our proposed new approach to bioresources enhancements; and
- our proposed options to provide a different level of regulatory protection for pre-2020 RCV.

RCV and nMEAV data request

RCV and nMEAV data request

We recently issued a data request focused on nMEAV values for Bioresources. The data request is intended to give us some additional data on depreciation that we can use to model our proposed approach for PR24.

Structure of the request

- Tab 1 requires the gross MEAV and asset life information split by upstream service as collected at PR19. We expect that the nMEAV equals the OFWAT determined RCV used at PR19 such that the validation check gives a zero or near-zero difference.
- Tabs 2 and 3 require the site data – similar to the PR19 request but with less detail.
- Tabs 4 and 5 are for data equivalent to that reported in the APR for additions and [historic cost] depreciation.
- Tabs 6-10 are entirely calculated and so no inputs are required – they give a straight-line deprecation forecast based on the additions and asset life data provided. This provides a sense check on the inputs.

Issues: We note that tab1 uses a simplistic straight-line approach to calculate the nMEAV using GMEAV and asset life inputs. We accept that, in practice, an alternative approach was used at PR19 which gave a materially different nMEAV than that which could have been calculated within the data request.

We are therefore happy for companies to over-write the calculations in that tab where necessary.

Any questions?

Next steps

Our consultation closes on 10 February 2022.

The information request regarding depreciation and net MEAV also needs to be submitted at this time.

After considering your response regarding the draft information request (regarding the reallocation of costs between controls), we will seek the relevant information to be submitted alongside your Annual Performance Reports in the summer.