South West Water

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Ofwat
Centre City Tower
7 Hill Street
Birmingham
B5 4UA

[redacted]

Dear [redacted],

RESPONSE TO METHODOLOGY CONSULTATION APPENDIX 4: BIORESOURCES CONTROL

South West Water welcomes the opportunity to comment on Ofwat's proposed methodology for funding bioresources activities at PR24. The proposals from Ofwat are far-reaching and complex and we have considered them carefully. We are supportive of Ofwat's stated objectives in this area. However, we are concerned that, in some areas, Ofwat's new approach to regulating this area may be disproportionate, given the limited and highly uncertain benefits projected.

We have included our responses to Ofwat's specific questions in Appendix 1 to this letter.

We welcome Ofwat's intention to use future, rather than historic, costs for benchmarking. The industry is likely to change significantly in the next few years, given tighter regulatory requirements and an uncertain economic outlook.

We would like to highlight the following main concerns, namely:

- South West Water faces some unique challenges and are in the unique position of serving the population of a mostly rural peninsular with a higher proportion of smaller sites serving our rural population which may naturally have a higher unit cost than large works serving densely populated areas. These characteristics should be factored into any benchmarking approaches.
- There is relatively little detail on how Ofwat proposes to allow for the significant enhancement costs likely given increasing environmental requirements. The scope of these is likely to be considerable. We are concerned that the consultation omits consideration of fundamental changes to the environmental requirements relating to bioresources activities, in particular the impact of Farming Rules for Water and IED. The approach taken by the EA restricts the time when biosolids can be recycled to land, which will require significant enhancement investment in storage and potentially in alternative

disposal methods – for example expensive landfill or incineration. Either way this means the future costs for bioresources activities will be very different to those of the past. A cost benchmarking approach using historical costs without modifications will not make appropriate allowances for the future environmental landscape.

- We consider that adopting an approach based on econometric principles could lead to revenue allowances that are too low, as some of the cost categories assessed may be inversely correlated to each other. One company may allocate much of its costs to one area, while another company allocates much of its costs to a different category. Setting an allowance based on the most efficient company in each area could lead to an insufficient allowance for both these illustrative companies when their actual activities may well be similar overall. We would welcome an assurance from Ofwat that it is aware of this point and will address it
- The approach proposed to providing certainty over a five year period does not reflect the nature of investment in bio-resources which can involve investments in one AMP period which may then not be repeated for a considerable timescale. Due to the long asset lives associated with treatment facilities, this is particularly true for bio-solids treatment. Such a timeseries should run well over 20 years

We look forward to working with Ofwat to develop the approach to setting revenue allowances for bioresources for PR24. If you have any queries, or would like any further detail, please do not hesitate to contact me.

Yours sincerely

[redacted]

Paul Boote
Chief Financial Officer
South West Water

APPENDIX 1

Q2.1: Do you have any comments on this section?

We consider that any assessment of bioresources costs which does not mention the significant increase in costs caused by a predominantly rural area, such as SWW's, is likely to be incomplete. Because a rural catchment area impacts both transport costs and the extent of liming caused by a lack of scale in local treatment requirements, Ofwat should seriously consider including a variable to adjust for this in its econometric modelling.

There are also different operational trade-off positions that companies may take which impact on which price control a cost is borne by. For example, there are legitimate choices to be made on protecting bioresources assets from the impact of rags which could mean either a fine screen on the inlet to wastewater treatment works (as part of network plus) or a sludge screen operated by the bioresources price control to remove rags that have passed through the wastewater treatment systems. Whilst this is already an issue to some extent given the differing cost sharing by control, it would be more pronounced if the approach to cost assessment diverges.

We consider that Ofwat should drive efficiency in energy consumption (rather than costs) to avoid distorted incentives that could be caused by different approaches to energy costs and recharges. We would welcome more detailed guidance from Ofwat on the transfer pricing used for recharges of energy to other parts of the business, the modelling will be impacted by variation in company assumptions. As noted in our recent response to the consultation on assessment of base costs, we consider there would be merit in Ofwat exploring the assessment of efficient energy consumption and costs separately from other base costs.

Q2.2: Do you have any further comments on our approach to a separate efficiency assessment, in particular the options we consider in section 2.4.2?

By assessing Bioresources and Wastewater Network Plus costs separately (rather than the PR19 approach of modelling them together and allocating allowances between them) it would be possible for Ofwat to "cherry pick" benchmark companies for each control creating a theoretically efficient company in wastewater services that is not observed in practice. The theoretically efficient companies could appear so due to the variation in both regional specific cost factors not captured by the model drivers, and the cost allocation assumptions made across the industry. Whilst RAG2 provides guidance, there are likely to remain differences in the allocation of direct and overhead costs across the sector. These could impact on the relative efficiency of companies, and also the efficiency benchmark used. This effect could be exacerbated by Ofwat using a different modelling approach across the two areas.

Of the three options which Ofwat considers, we believe that Option 2 (allowing companies to reallocate costs between wholesale controls) is better than Option 1 as it would enable companies, within the Regulatory Accounting Guidelines (RAGs), to address legacy cost allocation issues. Also it would enable companies to take into account necessary changes in cost allocation going forward, again as long as these changes are consistent with the RAGs.

Q3.1: Do you have any comments on this section?

In addition to the comments we make on the individual questions below, we consider that the significant extra administrative burden imposed by the proposals could be disproportionate to the limited and uncertain future gains to customers. We would welcome an assurance from Ofwat that it has considered this trade off rigorously.

We also consider that, in general, Ofwat should give far more consideration to the cost challenges that individual companies face in this area. For example, a company whose customers are predominantly rural will face different pressures from one whose customers are mostly urban.

Simply benchmarking seventeen companies and setting revenue allowances without allowing for such differences through explanatory variables could lead to such allowances being inappropriate. However, including too many such variables could undermine the purpose of benchmarking at all.

Q3.2: Do you have any further comments on the draft methodology proposals which we propose to retain from our December document and our reasons for doing so?

We consider that the draft methodology proposals continue to show insufficient consideration of cost implications of changes in environmental regulation (e.g. on land sludge disposal and IED). The cost implications of these changes in the next decade are likely to be very considerable, and almost entirely outside of companies' control.

In addition, the costs of these changes are not only substantial but also constantly changing, as environmental regulation is itself changing. The public's expectations of water companies and their environmental performance are constantly increasing. While this is understandable, it causes considerable uncertainty for investment planning.

We consider that it is appropriate for Ofwat to make explicit allowances for efficient changes in such costs. Not to do so could seriously endanger companies' financial viability. In so doing, Ofwat should bear in mind that different companies are likely to face different levels of efficient costs in these areas, because of regional factors or legacy issues.

Q3.3: Do you have any suggestions on how our approach to PR24 quality enhancements could be implemented in a way that achieves our objectives whilst addressing the concerns raised by stakeholders?

The industry is at a turning point, where significantly more investment is needed to improve various elements of the quality of service. Companies will need to invest significant amounts of money to improve their service standards. Such enhancement expenditure is likely to be significant, and we welcome Ofwat's moves towards providing some degree of certainty for such expenditure. It must also be correct that customers should not pay for inefficiently incurred expenditure. We consider that the current system of price regulation provides a good balance between these two objectives.

We consider that Ofwat's stated preference to provide allowances for enhancement expenditure one regulatory period at a time will not provide sufficient comfort for investment. While we appreciate that no regulator can bind its successors completely to any measure, providing certainty that companies can recover a return on efficiently incurred investment and associated depreciation decades into the future is likely to reduce the cost of capital for the industry as a whole.

With this background, we do not understand Ofwat's reluctance to commit to enabling companies to achieve a rate of return on efficiently incurred enhancement expenditure in bioresources over the long term, rather than simply over the next five years. Such reluctance is likely to increase uncertainty in the industry as a whole, through raising the cost of capital. Accordingly, we consider that Ofwat should take as long a view as possible of investment expenditure, and commit to remunerating it, if efficiently incurred. This would be in line with Ofwat's overall methodology for PR24.

Q3.4: Do you agree with, or have any comments on, the degree of regulatory protection we propose for pre-2020 RCV? Do you agree with our proposal to implement option 1 to achieve this?

As we stated in our response to Ofwat's December 2021 consultation, we agree with its proposal to protect the pre-2020 RCV, and consider that Option 1 (excluding legacy assets from the efficiency challenge) is likely to achieve this end.

We consider that Option 2 is unnecessarily complicated, and would reduce, rather than increase, the degree of regulatory uncertainty. Its implications for companies' financing costs would mean that customers would be unlikely to see any significant reduction in their bills, and could see an increase, from its implementation.

Q3.5: Do you agree with, or have any comments on, our updated proposals for modelling financing costs in our benchmarking models?

We agree that it is appropriate to allow financing costs for the Bioresources RCV, and to base its estimation on forward-looking variables. Given that the outlook for financial markets in general, and real interest rates in particular, seem to be changing significantly at the moment, the relatively low cost of finance of the last decade is unlikely to continue for much longer. However, we do not underestimate the difficulty of arriving at a forecast, given the volatile environment.

We agree with Ofwat that the rate of return used at PR24 is likely to be as appropriate as good as any. Estimating a separate rate of return for bioresources could enable Ofwat to tailor the estimate to the characteristics of this market. However, there are so few comparators, and the uncertainty attached to the estimate is likely to be so great, that any number derived from this approach is unlikely to be robust. However, if the overall rate of return is used for any part of the business, we consider that Ofwat should use it for all parts of the business.

While this debate will doubtless continue elsewhere, we consider that indexing different elements of the rate of return could provide certainty for investors, and hence reduce the real cost of capital. This is likely to be particularly important in bioresources, where Ofwat intends to increase revenue risk by facilitating competition in the market.

Q3.6: Do you agree with, or have any comments on, our proposals in relation to managing volume risk? Do you agree with our preferred option, that is, option 2?

We consider that the use of forecast data is likely to ensure that Ofwat considers some elements of future cost pressures. Of course, as the future is uncertain, there will likely be significant surprises. One obvious example of this in the current price control period was the COVID-19 pandemic. This seems to have increased the demand for water and sewerage services in our region significantly, through more domestic holidays and increased population growth. Therefore, it will be necessary to adopt a relatively cautious approach to forecasting future costs.

In addition, we consider that it will be challenging to ensure that forecast cost data is comparable across companies. It may be necessary for Ofwat to provide guidance on individual components of data forecasting, where anomalies or misunderstandings are most likely to occur.

Of Ofwat's options for the correction of forecast errors, we prefer Option 3, the cap and collar mechanism. We consider that this would be most likely to reduce the risk of inaccurate forecasting, and it would therefore have the least impact on financing costs. The other two options would force companies to bear an inappropriate share of the inevitable risk in forecasting volumes, and if either are implemented, it would seem appropriate to increase the rate of return in this area accordingly.

Q3.7: Do you agree with, or have any comments on, our proposals to make a separate adjustment for tax?

We agree with Ofwat's proposal for a post-tax approach to allowed return on capital. Tax is a separate expense from other estimates of the cost of capital, and we consider that Ofwat should treat it as such. In addition, we consider that it will be appropriate for Ofwat to calculate a tax building block revenue requirement in the financial model in principle. In practice, the difficulties in this area are likely to be in the detail.

We consider that allowances for R&D tax credits should be estimated separately. Ofwat has stated its intention to encourage innovation in the sector, and indeed has allocated significant attention and funding to this end. While estimating R&D credits separately increases the complexity of an already elaborate control, failure to do so could hamper this important activity.

Q3.8: Do you agree with, or have any comments on, our proposal to continue to refer to the post-2020 asset base as RCV?

The protection of the RCV is perhaps the most important way in which Ofwat can fulfil its statutory duty to ensure that the markets finance the sector at the lowest possible cost. We consider that removing RCV protection for new investment and exposing it to competitive pressure would increase cost risk and result in a higher cost of capital for bioresources. In addition, if new investment is not subject to the same regulatory protections, then this could adversely affect the ratings agencies' view of financeability.

Accordingly, we welcome Ofwat's proposal to continue to include it in the RCV to avoid jeopardising debt covenants. Failure to do so would be likely to increase the cost of capital materially. Given the size of the industry's RCV, this is likely to have a significant effect on customers' bills. It would also be likely to jeopardise investors' willingness to finance the significant increase in investment likely to be needed to meet additional environmental regulation.

Q3.9: Do you have any comments on our option assessment in the annex?

We consider that Ofwat's assessment of the various proposed methodologies in the Annex is broadly appropriate. However, we would suggest that Ofwat consider the following additional points:

- Efficiency challenge and cost allocation. In Options 2 and 3, Ofwat plans to include a separate efficiency challenge for bioresources. However, as Ofwat noted in its December document, it was unable to set such a challenge in PR19. We remain of the view that, while Regulatory Accounting Guideline 2.09 provides guidance, there are likely to remain differences in the allocation of direct and overhead costs which could affect our efficiency assessment.
- Impact of changes to environmental regulations. We would welcome an explicit assurance from Ofwat that it will take into account the impact of announced and future changes to environmental regulations in its revenue assessments, and in particular, that it will be mindful that some companies will be significantly more affected than others in some areas, such as farming.
- Proportionality. Ofwat is proposing significantly to increase the administrative burden in an already extremely complex set of price controls. Given its commitment to proportionality in its economic regulation, Ofwat should consider whether the relatively small and uncertain savings projected offset the extra expense.