PR24 bioresources supplementary document
Southern Water response

September 2022

from Southern Water

Introduction

Thank you for the opportunity to respond to this consultation on the approach to regulating bioresources at PR24.

We welcome the ongoing dialogue with Ofwat as its thinking develops in this area. Despite significant concerns raised by the sector in response to its December consultation, there is almost no change to Ofwat's preferred approach in this draft methodology consultation. We would advocate for further engagement with companies in developing proposals that meet both Ofwat's objectives for bioresources and companies' aspirations in this area. We would be happy to be involved in that further work.

Due to the lack of detail with current proposals, we do not feel able to respond meaningfully to questions QS.1 and QS.2. Ofwat acknowledges that the "*models do not provide statistically significant results. This means that none of the cost drivers included in the models had a significant impact on explaining variations in company's bioresources costs. This could indicate data quality issues which affect the reliability of the results."* These proposed models aligned with Ofwat's preferred approach are not yet robust and will consequently not provide reliable outputs - rendering this approach untenable at this stage.

The modelling output demonstrates that the 'reformed' approach does not work as well as the existing totex models. We note Ofwat's suggestion that further data requests might improve the statistical significance of these proposals, however we see limited evidence for this, given that back-casting valuation data from previous periods is likely to be increasingly inaccurate. We would also question the proportionality of this exercise and impact on companies' resources given the other PR24 priorities and the relative scale of bioresources revenues.

We would urge Ofwat to consider carefully whether its proposed approach to bioresources is the most effective regulatory means of addressing the key challenges in this part of the sector, where there remain three significant issues that are not fully resolved. These are:

(i) the Farming Rules for Water legislation,
(ii) the Industrial Emissions Directive and
(iii) the renewables incentive.

We discuss each of these below.

(i) Farming rules for Water (FRfW)

Ofwat make reference to the FRfW and we understand the view that forecasting regulatory changes is too speculative to drive enhancement funding at PR24. Given that a legislative change on farming rules has the potential to drastically alter the bioresources business by making recycling to agriculture much more restricted, we propose using price control deliverables (PCDs) to control for this uncertainty.

If PCDs are able to be symmetrical (i.e. to add expenditure, rather than solely return enhancement funding to customers), then investing to meet regulatory changes brought about through farming rules for water would not have to be included in the headline funding provided in final determinations, given the guidance is to be reviewed no later than 2025.Using a PCD in this way would provide a mechanism to ensure there is appropriate funding for when/if there is a new obligation arising from regulatory guidance on FRfW.

If PCDs are restricted to only return money to customers in the event of non-delivery, we propose to include the necessary efficient enhancement funding in our business plan and would expect to be funded upfront on the basis the legislation will change and the PCDs would ensure funds would be returned to customers if the EA does not change its FRfW regulatory guidance.

(ii) The Industrial Emissions Directive (IED)

In relation to the IED, Ofwat state *"We note that the implementation of the Industrial Emission Directive is not a new obligation. Therefore, companies should already have considered how to meet the relevant requirements. We expect companies to meet existing obligations within the 2020-25 period."*

The Environment Agency first disclosed its intention to implement the IED for biological treatments of sewage sludge to water companies at the Strategic Steering Group meeting in April 2019, two months after Ofwat's initial assessment of PR19 business plans in February 2019. PR19 plans were submitted to Ofwat on 03 September 2018, and at that time no formal communication had been made as to the implementation of IED for the biological treatment of sludge and there was no inclusion or mention of possible IED requirements in the PR19 WINEP programme - at this point in time it was too speculative to drive any funding via PR19. In July 2019 we received formal notice from the Environment Agency informing us that we would need to submit IED permit applications. Given its materiality, this timeline clearly demonstrates that these new statutory obligations were not considered as part of PR19.

We understand that the Environment Agency states this is not a new directive and that the water industry has been aware of the IED plans since 2013-14 when the directive was transposed into UK regulations in 2013, but was deferred by the Environment Agency pending clarification of the possible exemption by way of the Urban Wastewater Treatment Directive. However, formal notice was only received from the Agency in July 2019, and, as we are yet to receive any conditional IED permits on our sites contingent on improvements to ensure compliance, it is unreasonable to believe there will be no spend in AMP8 for IED compliance. It is in fact likely that the majority of spend will be in AMP8, with regulatory compliance dates on permits giving appropriate time to make the necessary investment. We recommend this is discussed with the Environment Agency to ensure appropriate funding arrangements are in place in AMP8, including transitional funding in 2024-25 to meet IED permit compliance.

(iii) Renewables Incentives

We disagree with Ofwat's assessment of renewable incentives income, which directly benefits customers in lower bills for bioresources treatment (the income from the incentive is a negative cost to the company and is passed onto customers). The cessation of certain renewable incentives is outside of company control and will mean the future is different from the past; this is therefore unlikely to be picked up by the econometric modelling. Further, each company has its own bespoke profile of when incentive income reduces, leading to a disparity in the market.

Ofwat's efficiency incentives encouraged companies to apply for these incentives benefiting customers, and early adopters will be the first to experience a steep increase in net costs due to the incentives ending - those that were first to strive for efficiencies will be punished first with unachievable efficiency targets.

It should also be noted that the Green Gas Support Scheme for biomethane injection, explicitly excludes any asset that has previously produced biogas that has received an incentive.

Consultation questions

Our December proposals

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?

Ofwat suggest that a separate efficiency challenge is appropriate due to having improved cost allocation guidance such that costs are more accurately allocated to the appropriate controls in its econometric modelling. However, the improved cost allocation guidance has not resulted in econometric modelling which is reliable enough to support a robust separate efficiency challenge. Without significant improvements in the robustness of the modelling we do not believe setting a separate efficiency challenge is appropriate.

Question 3.2: 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 would reiterate the comments we made in response to the December document that we are not convinced the regulatory framework being proposed will necessarily deliver the best outcome for customers and the environment. In particular, the absence of any long-term certainty over the regulatory framework over a replacement investment cycle and the move away from the well-understood building blocks model is likely to deter investment in long-life capital assets, creating an overt opex bias, even where this may not be the most efficient outcome for customers.

Furthermore, we are unconvinced of the rationale for including financing costs within the econometric modelling as these have been confirmed to destabilise the models; including backcast MEAV data is likely to destabilise the models further. Ofwat is in any case proposing to make a post modelling adjustment to reflect the latest forward-looking view of cost of capital for the sector. So far, it has not considered model sensitivity to WACC, and this should be considered.

We believe that Ofwat needs to consider further whether its proposed 'market-based approach' is likely to deliver the best outcome for the market, for customers and the environment, including supporting delivery of the Net Zero objective.

Question 3.3: 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?

Ofwat's preferred approach is an allowance for annualised costs over one regulatory period. If the intention is to fund a long-term investment over five years this would mean much higher run-off included in AMP8 allowances than would normally be the case when depreciating assets over multiple periods. This would lead to unnecessary bill volatility. If the intention is only to fund the first five years of a long-term investment the concerns, we expressed in December about the risk of preventing necessary investment are still highly relevant.

While we are regularly seeking out trading opportunities, the scope is highly constrained. This is due to our geography and location of urban conurbations being largely spread along the south coast of England with long distances to our neighbouring companies of Thames Water and Wessex Water. There are some, albeit limited, areas where trading could be viable (e.g., near Horsham, Basingstoke, and East London) but we estimate this is less than 10% of our sludge volume. Hence the vast majority of treatment will need to be in the Southern Water area and the current framework creates a strong bias against capital investment and introduces uncertainty of investment returns. This is clearly not in line with Ofwat's wider intentions of ensuring high quality, stable service for customers and a focus on increasing renewable energy generation for Net Zero.

Ofwat's approach is likely to lead to companies being unable to invest in long-life assets where there is uncertainty over asset stranding and cost recovery. No commercial business would be able to secure financial close on an investment in an asset with a 30-year life with a revenue stream that was only secured for a five-year period. We would reiterate our view from the December consultation that "a better approach would be to allow recovery of investment over more than two regulatory periods (Option 2). This would mimic the approach in the wider waste market, where investment in long life assets would typically be underpinned by a long-term contract providing a revenue stream over the life of the asset."

Updated proposals

Question 3.4: 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?

We agree with Option 1. However, please see our response to question 3.6 in respect of volume risk.

Question 3.5: Do you agree with, or have any comments on, our updated proposals for modelling financing costs in our benchmarking models?

We are unconvinced of the rationale for including financing costs within the econometric modelling as these have been confirmed to destabilise the models - as noted on page 31 of the supplementary document Ofwat say: *"Overall, the models that include depreciation and financing costs and a long time period, i.e., 2011-12 to 2020-21, do not provide robust results."*

Question 3.6: 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 do not agree that the pre-2020 RCV should be subject to volume risk. As bioresources costs are highly site specific, any lower volumes at sites are reconciled as a reduction in revenue, even if that site had investment prior to 2020 (and hence should have been protected). The allocation of volume risk is also inappropriate. Companies cannot fully control or influence the amount of sludge produced during wastewater treatment, yet any reduction in volumes reduces revenues. The volume of sludge produced is impacted through for example, phosphorus-removal required by WINEP and macroeconomic factors such as the amount and types of trade effluent produced by businesses within our area. Ofwat need to reconsider this form of price control and set a fixed price recovery of RCV irrespective of volumes.

Question 3.7: Do you agree with, or have any comments on, our proposals to make a separate adjustment for tax?

Yes, we agree with the proposals to retain a separate adjustment for tax.

Question 3.8: Do you agree with, or have any comments on, our proposal to continue to refer to the post-2020 asset base as RCV?

We support continuing to refer to the post-2020 asset base as RCV.

Summary of potential impacts of different options

Question 3.9: Do you have any comments on our option assessment in the annex?

The option assessment highlights the direction that Ofwat would like the market to go, but without the evidence this option will give correct outputs.

QS.3: Do you agree with, or have comments on, the proposed, updated approach to calculating asset values and CCA depreciation as set out in annex 6? In particular, do you:

• Agree with, or have any comments on, our proposed approach to calculating GMEAV and the alternative approach considered?

The starting RCV position is stated at 31/3/20 supported by a list of assets constructed for PR19. This set of assets is a hypothetical set of Modern Equivalent Assets. We would then maintain these assets and add anything new in terms of growth or quality.

If you assume that the hypothetical assets are what you aspire to, then it should follow that when you replace elements you will be moving the actual position towards the hypothetical one. In such a scenario the gross replacement cost of an asset will be equal to the disposal value because you are trying to turn the actual asset into the hypothetical one. As the start point is the hypothetical position, the current value of the replaced asset must be equal to the price paid now.

The difference between Option 1 and option 2 is the current cost of the asset being disposed of. If the assumption is that the actual assets are old and inefficient the current cost of the asset being disposed will generally be higher than its efficient replacement.

Efficiency targets on maintenance should be kept to Opex only and will therefore not impact on capex.

• Agree with, or have any comments on, our proposed approach ('gradual unwinding') and alternative approach to estimate changes in the value of the NPV adjustment?

On the basis that the RCV is supported by a listing of hypothetical assets and considering comments for bullet 1 above, an unwinding is not required. More appropriate would be a regular review (say every five years) of the hypothetical assets to align to latest technological advances and use of the adjustment line for this once per AMP or in exceptional circumstances, such as a complete site rebuild. Adjustments will be step changes in this approach.

• Agree with, or have any comments on, our proposed approach ('bottom-up method) to recording CCA depreciation?

We would propose to keep separate the existing hypothetical base, balancing capital maintenance expenditure to disposals and the assets acquired for growth or quality enhancement purposes. These would likely have different asset lives.

• Agree with, or have any comments on, our proposed approach to the rules on asset life assumptions?

No comment

• Have any comments on the options to generate backcasting estimates of asset values and depreciation?

No comment