

Water 2020 issues paper – Summary

Topic:

Regulatory capital value (RCV) allocation

Scope:

Yorkshire Water are considering the future of the RCV and how this interacts with the aims and objectives of Ofwats programme 'Water 2020'. Particular focus is being placed on the potential (re)allocation of the RCV to parts of the service value chain, access pricing and competition. This is being examined from the impact on the key stakeholders within the industry (current and future customers, investors and companies).

The paper is a discussion paper which considers the key questions around the future of the RCV in relation to well documented challenges facing the industry. We do not conclude at this stage; rather identify areas for further research and analysis to enable the most informed decision to be made for the future of the industry.

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Introduction

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The RCV is, and will remain an important regulatory mechanism for the bulk of the regulated entity for the foreseeable future. Both companies and stakeholders place great importance on the RCV and it is important that this is recognised in any considerations on its future. This paper sets out some of the key issues associated with the RCV and the Water 2020 programme. Whilst this is not exhaustive, focus has been given to those issues that have the greatest impact on the stakeholders within the industry. In developing the paper we have considered three fundamental questions;

1. Is the RCV the most appropriate mechanism for all streams within a water company?
2. If not, what are the other alternatives?
3. For the areas where the RCV remains the most appropriate method, how should any potential (re)allocation of the current RCV be done?

We have also kept in mind the impact that (re)allocation may have on the various stakeholders within the industry (customers, investors, companies and Government/regulators). We are not making any firm conclusions, further industry research and analysis is required.

Background

It is well documented that the water industry faces a number of long term challenges, from population growth and rising customer expectations, to addressing issues associated with climate change. Upstream reform is key for the industry to address these pressures and deliver for its customers in a changing landscape.

Since privatisation in 1989, the water industry has invested significantly in protecting the environment, whilst greatly enhancing levels of service to customers and stakeholders. At privatisation, the industry was sold at a considerable discount to the modern replacement cost. The RCV therefore was (and still is) considerably smaller than the Modern Equivalent Asset Value (MEAV) terms. This is the so-called 'capital value discount' Ofwat has estimated that the regulatory value of the assets is only "12% of the total net MEAV"¹. The RCV is used to allow companies and their investors to generate revenues and returns through an appropriate cost of capital which is set for the entirety of a price control period.

Current RCV guidance

Currently the RCV has been allocated wholly to the wholesale part of the value chain. None of the RCV was allocated to retail (household or non-household). The split was made, for YW, using the RCV splits in

¹ Future access pricing in the water sector; a discussion paper, Ofwat, page 9, November 2013.

PR09 updated for the capital programme allocation in AMP5. This was then used to set the 4 price controls for the AMP. Ofwat has in its approach for PR14 adopted the following;

- closed the existing RCV to new investment from 2015;
- established a post-2015 RCV which reflects individual companies allocation of totex through slow money and the run off level which is set by the asset lives derived for the new RCV;
- allocated the current RCV to the new wholesale price limit and only allowed the wholesale area to add to the RCV (no RCV for retail).

In its consultation and final methodology statement for price setting in 2015-2020 Ofwat discussed a network plus model and its possible future introduction. This model promotes further allocation of the RCV, initially though non-binding sub limits. A key purpose of such network plus sub-limits is to delineate the charges and revenues associated with parts of the value chain that are likely to have different regulatory approaches in future.

Why is it important

Companies;

- Any allocation or change in model should aim to ensure that current and/or appropriate revenues should be able to be recovered. Any RCV (re)allocation should not be an issue as long as it becomes a zero sum game and as such is revenue neutral.
- Depending on which areas of the value chain become competitive, the treatment of the RCV will affect the market and competition within these areas, particularly regarding the future setting of access pricing for the network and assets. Establishing prices that encourage efficient entry whilst discouraging inefficient entry will be key and needs to be considered in how future value, revenues and/or RCV is apportioned.
- Any method of RCV allocation would need to consider the capital value discount which is present within the industry. The treatment of this discount and where it is apportioned will impact on either competition or the monopoly assets or both.
- The RCV allows a return on capital employed. This is appropriate for activities and parts of the value chain which are 'capital intensive', however, it does pose the question whether an RCV is the appropriate model to base returns on where the activity is capital light? The separation of non-household retail market is an example of this, where returns and revenues are not generated from the RCV model and as such no RCV has been allocated to this area.

Government and regulators;

- The ability to create an environment that has allowed long term strategic direction to be delivered has been partly afforded by the stable regulatory environment including protection of the RCV. This has allowed significant long term investment to be delivered allowing challenging national policy objectives and aspirational service improvements to be delivered for successive Governments and customers.
- The RCV has afforded assurance, whilst not legislatively backed, that long-life asset investment will be appropriately remunerated. This ensures that the industry has been able to deliver service improvements, whilst safeguarding end user affordability and the trade-off between, prices, investment and returns.

Investors;

- The RCV model has given the investment community confidence and an investment vehicle that is perceived as stable and conducive to assured long term returns. This has ensured the industry has an ability to source low cost finance to deliver long term maintenance and improvements to the network. Whilst this does not mean that alternative models aren't appropriate, any movement away from or significant amendment to, should be done so that revenues are protected and that confidence is gained or retained in new or amended models.
- The RCV provides the basis for a stable investment environment and its future treatment is a key issue for Water 2020. Without this, the industry's ability to address its pressing future challenges will be made more difficult. Allocating the RCV to different elements of the value chain is one method of facilitating competition although as outlined above with NHHR separation this can be done whilst protecting the RCV model and the confidence in this.

Customers;

- One of the potential benefits of upstream competition is to help address the long term issues being faced by the industry. Competition should reduce the industry's total costs and allow customers' bills to be minimised through increased sector efficiency.
- Detailed consideration of financing costs is needed in any approach, since this could offset or lower customer benefit. This would result if the allocation and facilitation of competition is done in a way that adversely affects the cost of financing within the sector through reduced investor confidence and a change in the perception of risk within the industry.
- Competition could in the longer term promote further efficiency gains within the industry and have a positive impact on the end bill and also negate some of the long term risks to customers' bills.

- However any (re)allocation, even if this is done in such a way that confidence is retained in the RCV model and that all changes become revenue neutral, could still have significant incidence effects on existing tariffs and their associated justifications (i.e. large user differentials).

Allocation methods

If the RCV is to be (re)allocated across the service value chain, it could be achieved by applying well known accountancy or economic methods. The method of (re)allocation which has been widely used throughout the industry is Gross MEAV (modern equivalent asset value). This has regulatory precedence and has been used in areas such as non-household tariff setting and monitoring of customer class differentials. Allocation using this method would proportionally distribute the 'capital value discount' along the service value chains. Application in this 'unfocused' way could minimise the knock on effects on non-household tariffs and associated customer class differentials.

Supplementary models

The following existing models, may have potential wider future application. Whilst they do not tackle the core issues associated with the allocation of the RCV, especially with reference to pre-existing assets, they could be employed to supplement with any allocative solution.

Non household retail (NHHR) separation

NHHR separation is an example of introducing competition whilst limiting the impact on the RCV. Retailing, as an activity, is 'capital light' and therefore none of the RCV was allocated to this area. Revenues are recovered through a margin which is applied to the cost of retailing and the wholesale side. The WACC on the wholesale side has been reduced by 15 bps to lower the revenue on the wholesale for reallocation to retail based on a 1.0% margin. A further 'risk premium' was also added to the NHHR margin of 1.5% to make the overall margin of 2.5%. This is additional to final determined WACC and as such represents a positive effect on revenues. Whilst there is no current indexation given to retail due to its capital intensity, indexation is applied to wholesale revenues which make up the greatest proportion of the retail bill. Revenues have remained broadly stable and therefore confidence in the industry from investors' remains. This method may be applicable to the abstraction element of the service value chain. This represents the only 'capital light' area which remains, with licence fees being the majority of costs incurred in this area (noting that this may require changes to the current definitions and asset allocations in the regulatory accounting guidelines).

Thames tideway tunnel (TTT)

With TTT an alternative financing model was setup to reflect the nature, activity and scale of the project. It is noted that the model is an RCV model, but one that sits outside of the established RCV for Thames. The

rate of return (WACC) was the same as that given to the majority of the industry in their Final Determinations. Essentially, this created a new company and asset which could deliver savings and reduce risk through Government guarantees to reflect the scale and complexities of the project. Whilst it remains to be seen whether this model is appropriate for wider scale use, or whether this is indeed a one off to reflect the scale and complexity of TTT, it does show that an RCV model for capital intensive projects is still an appropriate model although modification to deliver benefits and innovation can be achieved.

Summary

- In summary the industry and water companies are changing, and with it an appropriate regulatory framework needs to evolve with it.
- If the evidence and analysis suggests that the RCV should evolve then there are certain criteria that need to be achieved if a change is to be implemented without a substantial impact on the industry and its stakeholders. These are;
 - Changes to allow all current revenues to be recovered, i.e. changes are revenue neutral.
 - Confidence is retained from the investment community, such that changes will not affect historic or future returns, and that the new model or amended model will have a stable return as with the current RCV model.
 - Capital discount is apportioned 'fairly' so that competitive advantage is not provided to incumbents and that monopoly assets are able to return sufficiently to meet their long term maintenance and improvement needs.
- If reallocation is decided, to maintain confidence, the preferred option would be to limit the impacts as much as possible.
- It should be noted that although the future treatment of the RCV is an issue that is industry wide, there are noticeable differences on the challenges facing each WASC and WOC respectively. An example of this would be the greater weighting in the number of upstream assets (reservoirs) which we have in comparison to the majority of the industry.