

Economic asset valuation for bio-resources RCV allocation at PR19

Overview

At its next review of price controls in 2019 (PR19), Ofwat has said it intends to set separate price controls for different elements of the wholesale water and wastewater value chain. For the wastewater service it will set binding price controls for bio-resources and network plus (encompassing sewer networks and wastewater treatment works).

The Regulatory Capital Value (RCV) is one of the 'building blocks' of price controls, representing the value of accumulated investment in the services. Currently the RCV is only split between the water and wastewater service. In order to set additional price controls it is necessary to allocate the RCV between the controls.

To facilitate the development of a separate price control for bio-resources, Ofwat has asked all water and sewerage companies to propose an initial view of the allocation of the wastewater RCV to bio-resources by 29 September 2017.

This note sets out our approach and initial allocation.

Methodology

In allocating the RCV Ofwat has asked companies to adopt a 'focused' approach. This means that the full value of the bio-resources assets are deducted from the RCV, with the remaining value being attributed to the wastewater network plus control. Ofwat has specified that the approach should represent the economic value of the assets, as at 31 March 2020. Ofwat has provided companies with detailed guidance on how to derive such an economic value.

We have followed Ofwat’s guidance to estimate the economic value of our bio-resources service. In summary, this amounted to carrying out the following steps:

- Step 1: Define the modern equivalent asset – define a hypothetical set of assets a new entrant would build to deliver the bio-resources service we currently provide
- Step 2: Estimate how much it would cost to build the hypothetical set of assets
- Step 3: Reflect the existing assets – make adjustments for differences between the hypothetical and our existing assets for age, energy and bio-solids revenue, and ongoing costs
- Step 4: Consider alternative approaches – make comparisons with alternative approaches, including a roll forward of the PR09 approach
- Step 5: Propose and explain approach

Following this approach has resulted in the following valuation.

Table 1. Proposed RCV allocation

Overall gross economic valuation of bio-resources assets	£775m
Net economic value of bio-resources assets	£292m
Proposed RCV allocation to bio-resources	7.8%

Assurance

The RCV allocation is an important part of the setting of price controls. It is therefore important that Ofwat, stakeholders and customers can have confidence in the reliability of the values used.

To provide this confidence, Ofwat has asked each company’s Board to provide written assurance that the values are appropriate and consistent with the guidance published by Ofwat.

To enable our Board to provide this assurance, we commissioned an independent external review of our submission. Reflecting the complex nature of the allocation, we used three independent assurers for different aspects of our submission.

- Jacobs - to assure the non-financial information, including asset data and our estimation of the gross economic value of our bio-resources service.
- Oxera - to assure the calculation of the economic value was appropriate and consistent with the guidance.
- Deloitte LLP to assure the underlying financial information that we included in the spreadsheet.

Each of the assurers provided a written assurance report to the Board, allowing them to sign off our proposed allocation for submission to Ofwat.