Future approaches to the RCV

United Utilities Water
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United Utilities Water Limited
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Summary

Ofwat's Water 2020 regulatory framework consultation sets out preferred options in relation to the design of the future regulatory framework, including the role of the RCV. A key element of these proposals is the further development of RCV protection, building on the approach adopted at previous price reviews.

This short paper seeks to explore and expand upon these proposals, considering how RCV protection may work in practice, including how companies and investors may perceive incentives under various designs of the protection, and discussing some options for providing further confidence and clarity on how it might operate.

This paper expands on our main response to Ofwat's December Water 2020 consultation where, in summary, we stated that:

> *"We strongly support Ofwat's commitment to protect investment included in the RCV to 31 March 2020. Clarification as to the regulatory risk profile associated with future 'network+' investments will further reassure investors – we consider that this clarity for AMP7 investment should be given at PR19.*
>
> *However, we are keen to understand how this commitment will be met for sludge, given the volume adjustment to revenues that Ofwat is proposing for the separate sludge price control."*

We agree that a commitment to protect RCV from past investment is necessary and that it should be based on the pre 2020 RCV and associated run-off and returns. We recognise the strength of commitment Ofwat are proposing to put in place for historically incurred RCV, and welcome this.

The industry will continue to need to refinance historic investment as well as making substantial future investments in the 'network+' elements of the value chain. By introducing a strong commitment to the historic RCV we believe Ofwat will reassure investors that historic investment will be remunerated based on the risk profile as they understood it at the time investment was made and not based on a retrospective assessment.

The key remaining uncertainty around Ofwat's commitment to the pre 2020 RCV is how the RCV allocated to sludge will be remunerated given Ofwat's proposed volume adjustment to sludge revenues. The commitment to the RCV will only deliver the benefits highlighted by Ofwat if investors have confidence that it will be honoured in practice. The introduction of competition for sludge will likely be the first test of this. Whilst the element of the industry RCV associated with sludge is small, the nature and strength of the operation of the RCV commitment in the case of sludge is likely to become seen as a test of the credibility of Ofwat's protection of the rest of the RCV.

There is a significant interaction between RCV protection and the gate pricing methodology for sludge[1]. At this stage there is limited information on the likely scale and variability of gate prices for sludge, so it is difficult to determine which approach to setting gate prices is in the long term interest of customers. We recommend that Ofwat engage further with the industry in determining the best approach to pricing, and in particular consider the interactions and impacts between gate pricing methodology and RCV protection.

Finally, in the December consultation, Ofwat proposes that the 'network+' control recovers any shortfalls. Whilst this seems a fairly straightforward approach when considering price controls for the period 2020 to 2025, it does raise questions as to what happens if at some future date sludge businesses more formally separate from 'network+' regulated entities perhaps – ultimately – through legal separation. Clarity around "ownership" of the pre 2020 RCV would appear to be an important question to resolve if industry structures are to evolve.

We recommend that Ofwat consider carefully where 'ownership' of the pre 2020 RCV lies, and the longer term implications of proposals to allow for sludge revenues to be recovered through the 'network+' price control.

[1] ~~See also UU's Water 2020 consultation response document "Considerations for separate sludge price controls"~~

Introduction

We broadly welcome the preferred options set out in Ofwat's Water 2020 regulatory framework consultation in relation to the approach to the RCV. In particular, we welcome the continued roll forward of protection for spend in the most recent AMP, extending the protection to efficiently incurred investment made during the April 2015 – April 2020 period. We believe that this is an appropriate mechanism to provide ongoing confidence among investors that near term cashflows made into investments are capable of receiving returns over the long term.

In our main response to the Water 2020 consultation we made the following comments:

> *"We strongly support Ofwat's commitment to protect investment included in the RCV to 31 March 2020, specifically:-*
>
> - *The proposed protection of pre 2020 RCV is a valuable commitment that will form a strong foundation for future reform of the industry.*
> - *Clarifications from Ofwat in relation to RCV protection, including clarification as to the regulatory risk profile associated with future 'network+' investments will further reassure investors.*
>
> *However, we are keen to understand how this commitment will be met for sludge, specifically we would like to better understand:-*
>
> - *How will the volume adjustment to revenues that Ofwat is proposing for the separate sludge price control will interact with sludge gate pricing?*
> - *What are Ofwat's specific proposals in relation to the recipient price control and timing of shortfall recovery?"*

This paper seeks to expand these responses and explore the issues raised in more detail.

Support for pre 2020 RCV protection

We agree that protection for past investment as represented by the RCV is in the long term best interests of customers. Further, we support the proposal that the protection should be extended to the April 2020 RCV and associated run-off and returns. We recognise the strength of commitment Ofwat are proposing to put in place for historically incurred RCV and welcome this.

The proposed upstream reforms for the industry contained in the Water 2020 proposals are significant in scale and scope. Viewed on their own they are likely to be seen by investors as tending to increase the risk profile of the industry, as demonstrated by the comments from Moody's and S&P reports set out below.

> *"Ofwat's planned new approach to its 2019 price review… would increase credit risk for water companies if implemented. The individual impact of the various proposed changes could be limited, but their combined effect would be a credit negative rise in cash flow volatility over the medium to long term."*[2] *– Moody's Investor Services, January 2016*
>
> *"The steady, strong regulatory advantage enjoyed by U.K. water utilities could diminish… following regulator Ofwat's publication of its proposed framework for the next regulatory period (2020-2025) on Dec. 10, 2015. We consider that the most significant proposals will weigh on the sector's creditworthiness."*[3] *– Standard and Poor's Rating Services, December 2015*

The industry will continue to need to refinance historic investment, and make substantial future investment in the 'network+' elements of the value chain. By introducing a strong commitment to the historic RCV we believe Ofwat

[2] "'Water 2020' Proposals Are Credit Negative", Moody's Investor Services, 13 January 2016
[3] "Inside Credit: Proposed U.K. Water Regulatory Changes Could Dilute Utilities' Credit Quality" Standard & Poor's Rating Services, 17 December 2015

will reassure investors that historic investment will be remunerated based on the risk profile as they understood it at the time investment was made and not based on a retrospective assessment.

In addition, as set out in PwC's recent report on industry risk to Ofwat[4], there could be a substantial impact on the necessary cost of capital for RCV allocated to future sludge price controls if RCV investment were not protected. PwC identified a 3% premium to sludge services, which would increase industry required returns by more than £550m[5] over the 2020-25 period. Providing protection for pre 2020 RCV means Ofwat can protect customers from the worst effects of this additional cost.

The protection of RCV is therefore a valuable and vital commitment that can provide a strong foundation for further progressive reform of the industry. As such we strongly support this proposal.

Clarifying the protection of RCV

There are three ways in which we believe the protection of RCV can be developed to help meet its objective of mitigating investors' perception of regulator risk on past investments, whilst protecting customers' future interests:-

1. Protection of RCV should be extended such that pre 2020 RCV in sludge and water resources businesses will have returns calculated using a cost of capital at least as large as that used for the associated 'network+' businesses.
   In order to provide protection, it is important to ensure that the value of the RCV is preserved on a present value basis. Ofwat's proposals for separated price control for 'network+', water resources and sludge will likely result in some separation of cost of capital assessments for different elements of the value chain. In addition, as some elements of the value chain are opened to competition, the need for a regulatory cost of capital assessment on future investments may not be needed for some separated price controls.

   As a result it is plausible that in future periods Ofwat will need to provide a cost of capital which is applied only to the pre 2020 RCV associated with the sludge and/or water resources[6] price controls. It is important that investors can be reassured that the present value of RCV associated with these separated elements of the value chain is maintained. Such reassurance can be achieved by committing that returns will be calculated using a cost of capital at least as large as that used for associated 'network+' businesses.

   Whilst this extension of the proposed protection may not be vital between 2020 and 2025, it will provide investors with long term confidence in the RCV. This will be particularly relevant when/if stronger market reforms erode the need for an Ofwat specified RCV and rate of return for some elements of the value chain post 2025.

2. There should be annual reporting on pre and post 2020 RCVs by price control.
   Providing a clear annual statement on the pre 2020 RCV which is protected will provide investors with a clear understanding of the element of the RCV which is protected, and also which elements of the RCV are associated with new investment. This clarity, on an annual basis, will also reassure investors that past commitments will continue to be honoured in the long term, helping to reduce perceptions of regulatory risk levels as the industry moves through the price setting cycle in future.

3. We suggest Ofwat provide clarity to investors as to when the risk profile of future 'network+' investment and RCV will be provided. This could be achieved by providing guidance at the next price control determination as to how additions to the RCV will be assessed and remunerated.
   The proposed protection of RCV is designed to reassure investors that past investment in the industry will continue to be remunerated. It is natural that, as a result of making this commitment about historic

[4] "Balance of risk: Risk and reward across the water and sewerage value chain" PwC, December 2015
[5] Based on an industry sludge MEAV of £3.8bn, as stated in "Water 2020- Appendix 6: draft impact assessment"
[6] Ours views on the introduction of competition for water resources are discussed in "The Framework for Upstream Pricing"

investment and therefore implicitly drawing a distinction with future investment, questions are raised as to how future investment will be remunerated in the longer term.

Ofwat's Water 2020 regulatory framework consultation begins to provide clarity as to how investment in water resources and sludge elements of the value chain will be remunerated, with further clarification likely to emerge as the PR19 programme progresses. However currently there is little indication at this stage that Ofwat will clarify how investment in the remaining 'network+' element of the value chain will be remunerated. In the Water 2020 regulatory framework consultation Ofwat makes it clear that investors cannot assume that RCV protections will be extended to future investment. However, there is no indication as to what Ofwat's view of the risk profile on future 'network+' investment is likely to be. This ambiguity seems likely to lead to uncertainty, and consequently impacts on investor sentiments towards the industry. As 2020 approaches, this uncertainty will increase; it is therefore important that there is more clarity before then.

We recognise that the exact nature and form of the regulatory framework post 2020 remains somewhat uncertain. Ofwat could, however, provide early guidance as to what risk profile they believe should apply to future 'network+' investment, and commit at the PR19 determination to provide extended RCV protection to cover AMP7 'network+' investment. As an initial suggestion, we propose that extension of the RCV protection could form part of a future price control reconciliation methodology.

Exploring the protection of the pre-2020 RCV in the context of a separated sludge price control

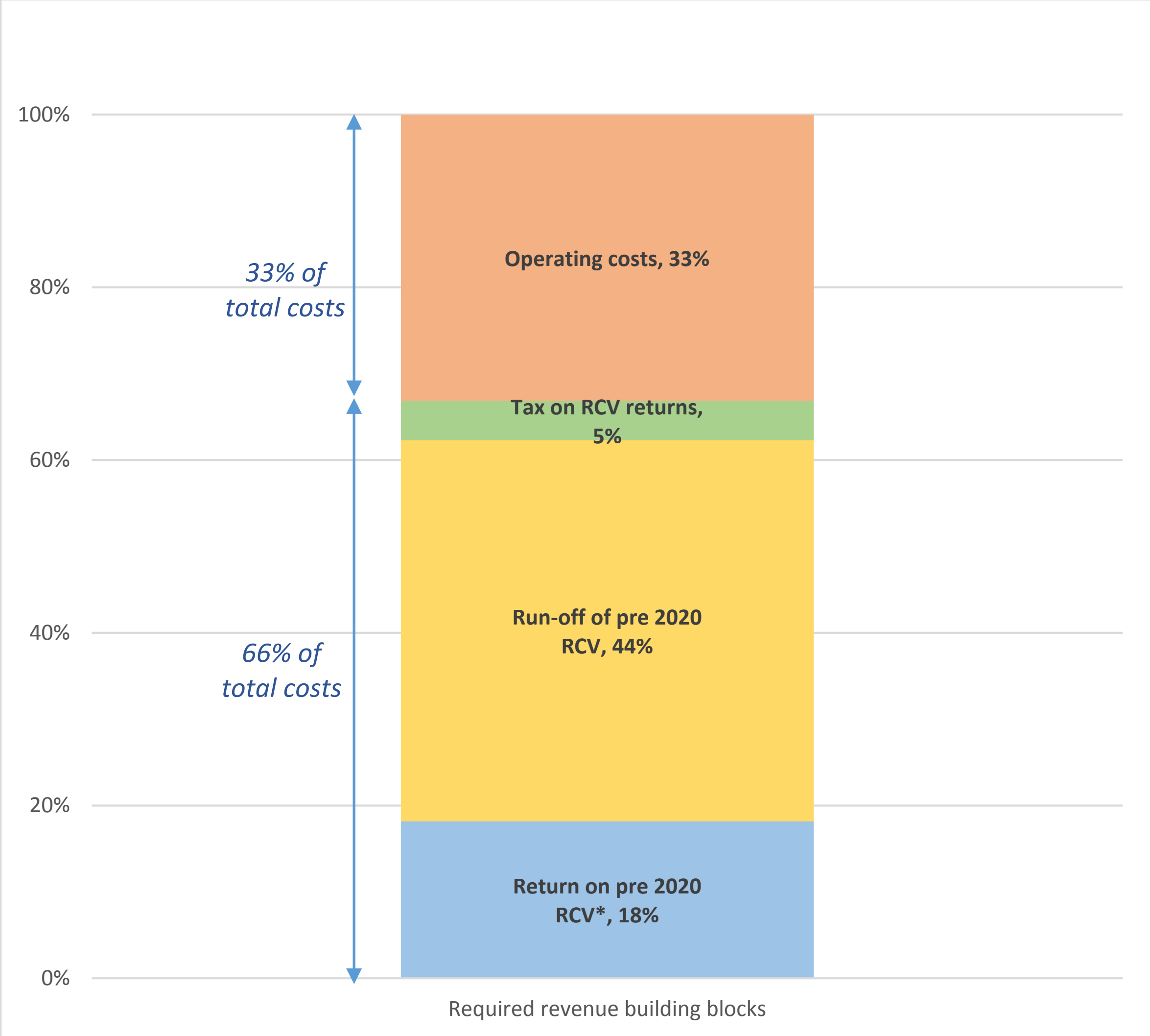
As noted in our primary response to the Water 2020 regulatory framework consultation (particularly our response to question 16) the key remaining uncertainty around Ofwat's commitment to the pre 2020 RCV is how the RCV allocated to sludge will be remunerated, given Ofwat's proposed volume adjustment to sludge revenues.

We do not believe the risk of stranding sludge assets is as small as is presumed in Ofwat's December consultation. Whilst each individual sludge asset's risk of stranding is possibly small, there are a large number of diverse assets across England. As such we think it likely that some assets will be stranded if or when sludge markets become more open, especially if incumbents start competing to deliver sludge services to each other. The approach to gate pricing is key to this.

The commitment to the RCV will only deliver the benefits highlighted by Ofwat if investors have confidence that it will be honoured in practice. The introduction of competition for sludge will likely be the first test of this. Whilst the element of the industry RCV associated with sludge is small, the nature and strength of the operation of the RCV commitment in the case of sludge will be seen as a test as to the credibility of Ofwat's protection of the rest of the RCV.

Operation of RCV protection in the context of volume risks

Revenue building blocks for a sludge price control (using UU 2014/15 costs)



**RCV allocation using a focused net MEAV basis*

As the above example shows, around 66% of a future UUW sludge control revenue could be associated with pre 2020 RCV recovery and associated tax effects in year 1 of a new price control. This leaves up to 33% of future costs exposed to volume risk, depending on the approach chosen to gate pricing and fixed operating costs. The way in which gate pricing for sludge services, and the way in which these charges interact with the protected RCV will be important to understanding the incentives businesses will be exposed to.

Ofwat's consultation suggests, in relation to the framework for sludge competition, that:-

> "*we do not consider there is any prospect of stranded assets in the 2020-25 period, as allowed revenues are still determined through a regulated allowance for efficient costs. Companies enter into trades only where it is efficient for them to do so, but need not engage in trading, should they choose to do so*".

Ofwat is also proposing that information be provided for individual STWs and STCs on costs, on an average cost basis. Ofwat suggests that:-

> "*The combination of the above two types of information will allow market participants to infer the implied 'gate price' for sludge at STWs. That is, they can estimate the price that would be paid by the*

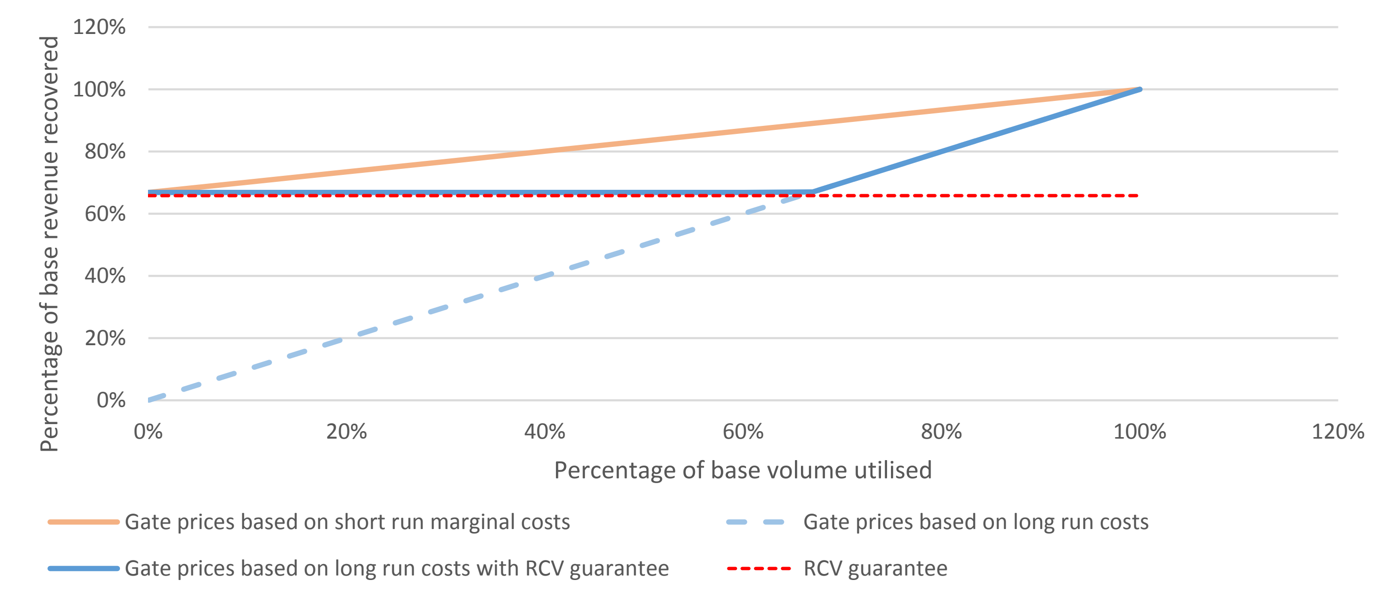
> *incumbent operator of a STW to another firm, to take sludge away for subsequent treatment and disposal at STCs*".

We support:-

- The average cost basis for pricing, together with publication of appropriate information.
- The proposition that companies should not have to enter into trades unless it is efficient for them to do so, in terms of reducing costs. Otherwise, ultimately customers will face higher bills.

It will, however, not be efficient for an incumbent to pay another company to take sludge from a STW just because the other company's average cost is lower. Unless the incumbent is short of capacity at a site, it will only reduce total costs if another company can beat its short-run marginal costs, which will almost certainly be significantly lower than average costs. This significantly limits the scope for effective competition.

Example of relationship between revenues recovered and sludge treatment volumes



As shown in the graph above there is a significant interaction between RCV protection and the gate pricing methodology.

If gate pricing is set on a short run marginal cost basis then companies' exposure to volume risk will be limited to the proportion of costs associated with variable operating costs. This, in effect, embeds the RCV protection upfront into the gate pricing regime, limiting the need for ex-post adjustments. However, this approach may also limit companies' ability to offer competitive gate prices for the use of their sludge management services.

Alternatively, if gate pricing is based on long run costs, then an additional adjustment may be needed to ensure RCV recovery in the event that volumes (and therefore revenues) drop below a base level. Under this approach, companies which find themselves recovering revenues below the level of protected RCV may feel incentivised to avoid treating additional volumes, as they will acquire additional treatment costs but no additional revenues.

At this stage there is limited information on the likely scale and variability of gate pricing for sludge, so it is difficult to determine which approach to setting gate prices is in the long term interest of customers. We recommend that Ofwat engage further with the industry in determining the best approach to gate pricing, in particular considering the interactions and impacts between gate pricing methodology and the protected RCV.

Recipient price control and timing of shortfall recovery

In the event that a sludge business does under recover against the protected RCV it is important to understand which price control will be adjusted to recover lost revenue. The revenue could accrue to the separated sludge price control or, alternatively, the original ‘network+’ business could receive a price adjustment to make up for the shortfall.

Ofwat, in its December consultation, proposes that the ‘network+’ control recovers any shortfalls. Whilst this seems a fairly straightforward approach when considering price controls for the period 2020 to 2025, it does raise questions as to what happens if at some future date sludge businesses more formally separate from ‘network+’ regulated entities.

This in part can be understood as an issue of uncertainty as to who ‘owns’ the pre 2020 RCV which Ofwat is protecting. Where there is a single, unseparated appointed business with a single overarching licence, the question of ownership is arguably not critical. Should there be a move to enable separated businesses and licences, the matter becomes more complex. This is particularly true if legal separation of sludge services becomes possible in future.

Clarity around ownership of the pre 2020 RCV would appear to be an important question to resolve if industry structures are to evolve. Inevitably investors will seek to gain a greater understanding of regulatory reforms, particularly as and when the industry starts to seek funding for investment post 2020. The current proposals of allocating RCV to separated sludge price controls, (through allowing revenue recovered against this RCV to accrue to the ‘network+’ controls) would appear to introduce possibly unnecessary complexity, and therefore confusion.

We therefore recommend that Ofwat consider carefully where ‘ownership’ of the pre 2020 RCV lies, and the longer term implications of proposals to allow for sludge revenues to be recovered through the ‘network+’ price control.

