

## **Appendix 5.3**

# **REVIEW OF WATER RESOURCES RCV ALLOCATION**

**May 2018**

At PR19, Ofwat will set a separate price control for water resources, using a standard ‘building block’ approach. To enable this, a water resources Regulatory Capital Value (RCV) will be ‘allocated’ from the existing wholesale water RCV. Ofwat has provided guidance to companies as to the methodology that it expects them to implement in doing this. Ofwat suggested that an ‘unfocused’ approach, based on estimates of the wholesale Modern Equivalent Asset Valuation (MEAV) may be appropriate, but left much of the substance to companies and suggested a range of alternative approaches that they could also consider. To ensure the consistency of its water resources RCV allocation with Ofwat’s methodology, Northumbrian Water commissioned Economic Insight to quality assure its approach. This short report presents our findings and recommendations. Overall, we find that Northumbrian’s approach is broadly consistent with Ofwat’s methodology, but there are some areas in which Northumbrian has scope for improvement. These relate primarily to: i) the justification for Northumbrian’s use of a net MEAV approach; ii) greater use of alternative methodologies as cross-checks to Northumbrian’s favoured approach; and iii) more extensive analysis of the potential bill impacts of RCV allocation.

### 1. Introduction

TO SUPPORT THE INTRODUCTION OF A SEPARATE WATER RESOURCES PRICE CONTROL, A PROPORTION OF THE EXISTING WHOLESAL WATER RCV WILL NEED TO BE ALLOCATED TO THE NEW CONTROL.

Ofwat will introduce separate binding price controls for business areas that constituted the wholesale water price control at PR14, namely water resources and water network plus. Within their plan submissions, companies must include populated data tables relating to this, including **WS12 RCV allocation in the wholesale water service**. This table requires companies to set out detailed information on their final RCV allocation to water resources and to water network plus.

More generally, Ofwat states in its Initial Assessment of Plans that, for a plan to be considered high quality, companies should include ‘transparent, well evidenced and acceptable proposals on pre-2020 RCV allocation’.<sup>1</sup> Across all areas of company plans Ofwat has emphasised the need for strong assurance, particularly Board Assurance. This requires companies to have high quality evidence for all aspects of their plans.

In this context, Northumbrian Water (Northumbrian) commissioned Economic Insight to undertake a review of, and provide assurance around, its water resources RCV allocation at PR19. The scope of our work covered a review of Northumbrian’s initial

<sup>1</sup> [‘Delivering Water 2020: Our methodology for the 2019 price review. Appendix 13: Initial assessment of business plans.’ Ofwat, December 2017.](#)

allocation proposals, as set out in *Northumbrian Water: Allocation of the Water Resources RCV*.

This report sets out the findings of our review. It is structured as follows:

- We first summarise Ofwat’s published guidance on water resources RCV allocation.
- We then set out our review of Northumbrian’s proposed allocation.
- Lastly, we present our overall findings and recommendations.

## 2. Ofwat’s guidance on water resources RCV allocation

Ofwat has provided various pieces of advice to companies on its preferred methodology for water resources RCV allocation. As part of our assurance of Northumbrian’s approach, we have therefore reviewed relevant Ofwat guidance, which we now summarise. We first set out the high-level approach to RCV allocation described in *Delivering Water 2020*, before going on to discuss Ofwat’s technical guidance, and feedback to companies, in more detail.

### 2.1 Delivering Water 2020

In *Water 2020: our regulatory approach for water and wastewater services in England and Wales*, Ofwat confirmed its intention to introduce a separate water resources price control using a building block approach, and that this would require RCV allocation.<sup>2</sup> Ofwat also confirmed that it considered an **unfocused approach** to RCV allocation to be most appropriate. This involves allocating value based on the proportion of assets employed in a particular business area, relative to the total assets in the business. This contrasts with a **focused approach**, in which RCV allocation is based on the economic value of the assets employed. Ofwat said that it considers an unfocused approach to be most appropriate for water resources. This reflects Ofwat’s views that fully-developed water resources markets are unlikely to emerge in the immediate future; and because a focused approach could lead to the entire legacy RCV being allocated to water resources for some companies.<sup>3</sup>

Beyond the use of an unfocused approach, Ofwat decided against imposing a common allocation methodology, instead expecting companies to take the lead in how their own pre-2020 legacy RCVs are allocated. Ofwat said that this reflected its view that part of companies’ existing return on capital is already implicitly attributable to water resources, so that in setting wholesale tariffs, companies should understand how much allowed return is attributable to water resources, relative to other business areas.

### 2.2 Ofwat’s technical guidance on water resources pre-2020 legacy RCV allocation (January 2017)

In *Water resources pre-2020 legacy RCV allocation at PR19 – technical guidance*, Ofwat set out guidelines as to the approach it expects companies to follow in allocating the wholesale water RCV to water resources.<sup>4</sup> This covered: i) potential approaches to the allocation of the water resources RCV; ii) key issues for companies to consider in

<sup>2</sup> *Water 2020: our regulatory approach for water and wastewater services in England and Wales.* Ofwat, May 2017, p128.

<sup>3</sup> *Water 2020: our regulatory approach for water and wastewater services in England and Wales.* Ofwat, May 2017, p164.

<sup>4</sup> *Water resources pre-2020 legacy RCV allocation at PR19.* Ofwat, January 2017.

OFWAT INDICATED THAT AN UNFOCUSED APPROACH IS MOST APPROPRIATE FOR WATER RESOURCES.

choosing their RCV allocation; and iii) Ofwat’s expectations of the minimum it expects companies to provide in their proposed RCV allocations.

### 2.2.1 Potential approaches

Ofwat set out a range of potential approaches to allocating the water resources RCV. We describe these in the table below, alongside the issues that Ofwat wanted companies to consider.<sup>5</sup>

Table 1: Potential approaches to allocating water resources RCV

Potential approach	Description	Considerations
<b>Net MEAVs</b>	Proportion of net MEAV for water resources assets as proportion of net MEAV for all water wholesale assets.	Companies can roll forward the 2014-15 water resources net MEAV.
<b>Gross MEAVs</b>	Proportion of gross MEAV for water resources assets as proportion of gross MEAV for all water wholesale assets.	Potentially lead to lower allocation as pre-privatisation assets would have higher relative gross MEAV.
<b>Pre/post-privatisation split</b>	Split pre-privatisation assets at discount to RCV and post-privatisation assets at full value.	Potential cross-check: changes to asset records and accounting classification since privatisation may make difficult to calculate.
<b>Historic expenditure</b>	Proportion of past expenditure on, or operating costs and accounting charges for capital expenditure, incurred on water resources.	May be a good cross-check/alternative approach. Appropriate time period may in part be driven by basis for accounting charges.
<b>Projected expenditure</b>	Proportion of future expenditure expected to be expended on water resources.	In view of long life of water resource assets, may need to consider longer period than 25-year Water Resources Management Plans (WRMPs).
<b>Economic value</b>	Forward-looking revenue stream, net of operating costs, from prices for water resources/other water supply aspects, set on consistent long-run basis.	Companies with supply-demand surpluses will need to consider value of water for trading. Historic and future expenditure associated with access price for third party water resources in bilateral market could be considered, building on Average Incremental Cost data in WRMPs.
<b>Average or hybrid approach</b>	Average between different approaches.	If doing this, companies should consider impacts on wholesale charge structures.

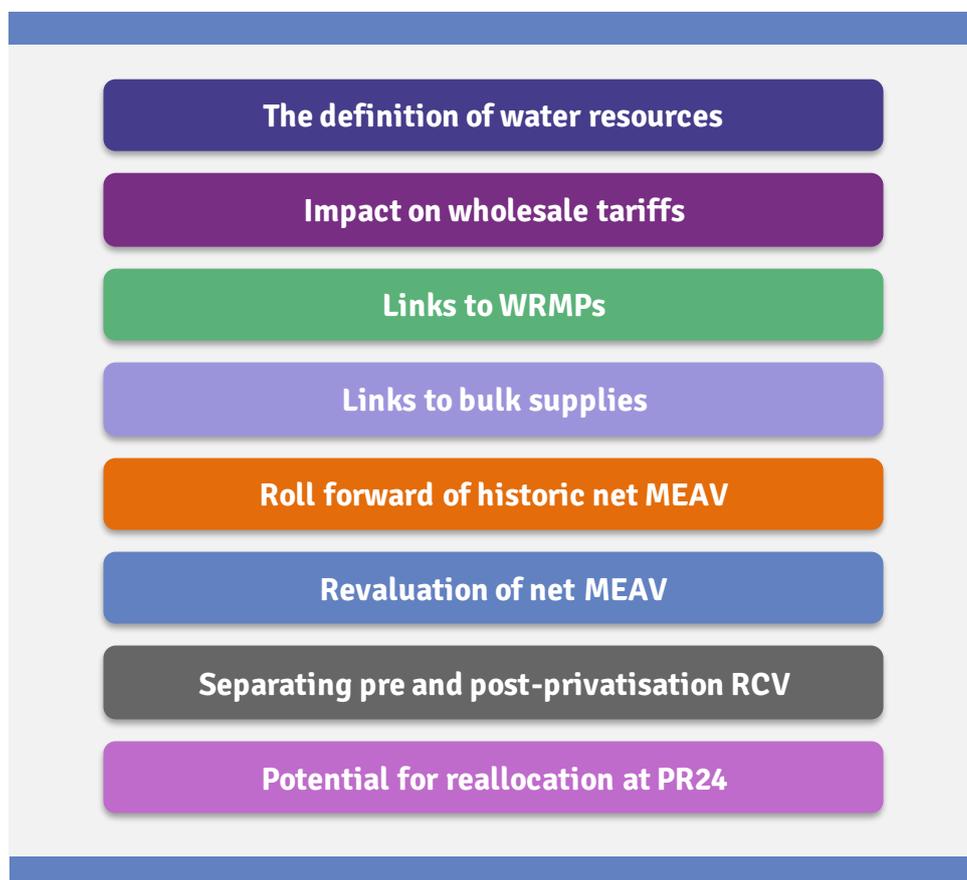
Source: Adapted from Ofwat, 'Water resources pre-2020 legacy RCV allocation', Table 1

<sup>5</sup> *'Water resources pre-2020 legacy RCV allocation at PR19.'* Ofwat, January 2017, p5.

### 2.2.2 Key issues for companies to consider

Ofwat set out the issues that companies should consider when allocating their water resources RCV. We summarise these issues in the figure below, and subsequently provide a discussion in greater detail.

Figure 1: Issues for companies to consider



Source: Ofwat

We describe Ofwat's guidance on these issues in turn.

- The definition of water resources: Ofwat said that companies should base their RCV allocation on RAG 4.06, and that companies would need to provide assurance that data had been allocated correctly, including setting out the basis for adjustments to historical information.<sup>6</sup>
- Impact on wholesale tariffs: Ofwat said that companies should analyse how their proposals could affect the calculation of wholesale charges for different services and customer groups – and that this should split out wholesale tariffs into water resource and network plus charges. This analysis should be informed by sensitivity analysis under different RCV allocation and competition scenarios.

<sup>6</sup> *'Water resources pre-2020 legacy RCV allocation at PR19.'* Ofwat, January 2017, p7.

- Links to WRMPs: Ofwat said that companies should consider their approach to RCV allocation alongside their WRMPs, particularly the interaction of RCV allocation on their water resource costs.
- Links to bulk supplies: Ofwat noted that, where bulk supply prices are related to average costs of wholesale water services, RCV allocation could affect costs associated with providing bulk supplies. Ofwat said that companies need to maintain consistency between charges and cost recovery, and pointed to companies' responsibilities to comply with competition law.
- Roll forward of historic net MEAV: Ofwat said that, as a starting point, companies should begin with a roll forward of the 2014-15 net MEAV, consistent with the approach to current cost accounts set out in the RAGs.
- Revaluation of net MEAV: Ofwat did not require companies to undertake a revaluation of net RCV in order to allocate the legacy RCV. Where companies choose to do so, however, Ofwat said that companies should do this for their entire wholesale water asset base, as this is necessary for an unfocused allocation.
- Separating pre- and post-privatisation RCV: Ofwat raised the possibility of separating historic data on capital expenditure and depreciation since privatisation by business unit, and calculating separate RCVs pre- and post-privatisation. Ofwat said that whether this was appropriate would depend on the scale of enhancement investment since privatisation.
- Potential for reallocation at PR24: Ofwat said that it recognised the advantages of allowing companies to revisit the allocation of the RCV to water resources where there are compelling reasons to do so.

### 2.2.3 Minimum expectations for proposed RCV allocations

Finally, Ofwat set out the 'minimum' it expected companies to set out in their RCV allocations. These were as follows:

- Proposed unfocused RCV allocation to water resources – both as percentage and forecast £m of the total water service RCV for 1 April 2020.
- A comparison of the previously reported 2014-15 water resources net MEAV, and an explanation of why the proposed allocation differs from this.
- Supporting calculations on how the proposed allocation has been derived.
- Details of alternative methodologies considered, with a narrative justifying the choice.
- Explanation of how the issues set out in the technical guidance have been considered.
- Sensitivity testing on wholesale tariffs and bulk supplies.
- Details of the consistency of the allocation analysis with information in the company WRMP.

- A statement from the company Board setting out factors and assurance information considered in support of the proposed allocation.

### 2.3 Ofwat’s feedback to companies on initial proposals on water resources RCV allocations

In its document, *Initial proposals on water resource RCV allocations – feedback to companies*, Ofwat set out the initial water resources RCV allocation proposals that it had received from companies, and provided feedback on companies’ approaches. Overall Ofwat said that it was satisfied that the proposed RCV allocations would not have material bill impacts.

We first describe the approaches taken by companies, before setting out Ofwat’s detailed feedback across the key issues it identified.

#### 2.3.1 Approaches taken by companies

- Consistent with Ofwat’s guidance, 11 out of 17 companies allocated their water resources using an unfocused net MEAV approach. These companies were: Anglian, Northumbrian, Severn Trent, Southern, South West, Thames, Wessex, Affinity, Portsmouth, Sutton and East Surrey, and South Staffordshire/Cambridge.
- Three companies, Bristol, South East, and Dee Valley, used hybrid approaches, incorporating net MEAV. Bristol used an average of net MEAV and historic expenditure; South east used a combination of net and gross MEAV. Dee Valley used a combination of net MEAV and economic value.
- Two companies, Yorkshire and Welsh, used a gross MEAV approach.
- United Utilities used an ‘economic value’ approach, leading to an allocation significantly below the level that would have pertained under a gross or net MEAV approach. United Utilities’ approach is, prima facie, somewhat different to Ofwat’s description of an economic value method, which is based on the forward-looking stream of net revenues. Its allocation of RCV is that which would lead to average prices for water equalling incremental cost (of an assumed volume).

IN PRACTICE, MOST COMPANIES USED AN UNFOCUSED NET MEAV APPROACH, THOUGH THERE WERE SOME EXCEPTIONS.

Table 2: Company approaches to water resources RCV allocation

Method	Companies	Notes
Net MEAV	Anglian, <b>Northumbrian</b> , Severn Trent, Southern, South West, Thames, Wessex, Affinity, Portsmouth, Sutton and East Surrey, South Staffordshire Cambridge.	Reasons cited for use: <ul style="list-style-type: none"> <li>– ‘tried and tested’ method;</li> <li>– limited bill impact;</li> <li>– complies with Ofwat guidance;</li> <li>– shortcomings in other potential approaches.</li> </ul>
Gross MEAV	Welsh, Yorkshire	Reasons cited for use: <ul style="list-style-type: none"> <li>– used in previous regulatory determinations;</li> <li>– more equal treatment for above and below ground assets;</li> <li>– limited bill impact.</li> </ul>
Economic value	United Utilities	United Utilities says ‘economic value’ in the sense that it creates access prices that encourage efficient entry and limit bill impact on non-potable customers. Net and gross MEAV would have led to higher allocation. UU says given surplus of water available, pricing would be out of line.
Hybrid: MEAV & historical expenditure	Bristol	Bristol says pure MEAV approach leads to too high an allocation to water resources, whereas historic expenditure provides transparent and straightforward calculation.
Hybrid: MEAV & economic value	Dee Valley	Transfer of two reservoirs have significant impact on Dee Valley net MEAV and income. Proposed allocation is higher than MEAV level. Dee Valley says this gives sufficient RCV for the area of the business and results in no bill impact.
Hybrid: Net and gross MEAV	South East	None.

Source: Ofwat, p13

### 2.3.2 Ofwat's detailed feedback to companies

Ofwat provided more detailed feedback across several key aspects of companies' approaches, which we summarise below.

#### ***Roll forward of historical net MEAV (and definition of water resources)***

Overall, Ofwat said that companies had generally rolled forward 2015 net MEAV in line with its guidance. Where adjustments were necessary to account for RAG 4.06 reclassifications, Ofwat checked the explanations provided. In this context, Ofwat said that it did not consider Northumbrian's adjustment, to recognise additional depreciation prior to 2015 relating to the statutory implementation of the International Financial Reporting Standards (IFRS) treatment, to be consistent with its guidance. This was because Ofwat expected companies only to apply new accounting standards. Specifically, companies should only seek to apply accounting standards to the net MEAV after 31<sup>st</sup> March 2015.<sup>7</sup>

#### ***Proposed allocation methods***

Overall, Ofwat said that it was satisfied that companies had applied their chosen methodologies in line with guidance. The exceptions were Wessex's application of the net MEAV methodology and United Utilities' application of the economic value methodology. Ofwat said that Wessex's net MEAV allocation was based on an allocation of its water resources assets only, rather than the entire wholesale water asset base. It said that UU had provided insufficient evidence to support its proposal of a 12% allocation to water resources, and that its methodology was sensitive to assumptions.<sup>8</sup>

#### ***Cross-checks against alternative approaches***

Ofwat said that the only companies that did not appear to have considered alternative approaches, or provided evidence of cross-checks, were Northumbrian and Affinity. It expected the companies to provide evidence that they had considered other potential allocation approaches and cross-checked them against their chosen approach, alongside providing a clear justification for the chosen approach in their business plan. Ofwat also said that they expect all companies to provide results of alternative methods where available, even if they doubt the appropriateness of these methods.<sup>9</sup>

#### ***Impact on wholesale tariffs***

Ofwat said that all companies have considered the impact of their proposed RCV allocation on wholesale tariffs, though to varying extents. They also said that most companies, including Northumbrian, have used the same method for allocating their RCV as for setting charges. This minimises the bill impact on different groups of customers. Ofwat noted that Northumbrian, alongside Anglian, United Utilities and Welsh, have standard charges for supplying non-potable water to customers with minimal network plus services. Ofwat said that it had asked these companies to confirm that they expect minimal bill impacts for all customers, including non-potable

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<sup>7</sup> ['Initial proposals on water resources RCV allocations – feedback to companies.'](#) Ofwat, April 2018. p17-19.

<sup>8</sup> ['Initial proposals on water resources RCV allocations – feedback to companies.'](#) Ofwat, April 2018. p19-21.

<sup>9</sup> ['Initial proposals on water resources RCV allocations – feedback to companies.'](#) Ofwat, April 2018. p21-24.

customers. Overall, Ofwat said that it expects companies to continue to consider potential bill impacts, especially to customers that make minimal use of network plus assets – and that companies should consider the impact of any other change in the balance of costs between water resources and network plus on its charging structure.<sup>10</sup>

### ***Projected bill information***

Ofwat said that it will remove the requirement for companies to provide revenue and volume information on tables WS12b and WWS12b. However, it expects companies to explain how they have identified if the bills of any customer are at potential risk of significant impact from both RCV allocation and wider changes in the balance of costs between water resources. It also says it expects companies to set out how they will manage bill impacts for customers identified as being potentially at risk.<sup>11</sup>

### ***Links to WRMPs***

Ofwat noted that the level of evidence that companies had provided varied significantly. Whereas some companies provided only limited evidence and did not reference any external assurance, others provided significant evidence, including extracts from the WRMPs. Ofwat said that it expects companies' business plans to: consider the level of detail required to support the consistency of their proposed allocation and their WRMP; and re-examine their calculation of water resources yield, to ensure it only includes water resources assets.<sup>12</sup>

### ***Links to bulk supplies***

Ofwat said that it is satisfied that companies were aware of its guidance and had provided reasonable justifications for their allocations having no impact or minimal impact on bulk supply costs.<sup>13</sup>

### ***Potential for reallocation at PR24***

Ofwat said companies have stated in their submissions that they are aware of its guidance that reallocation at PR24 would only occur in the presence of compelling reasons to do so.<sup>14</sup>

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<sup>10</sup> *'Initial proposals on water resources RCV allocations – feedback to companies.'* Ofwat, April 2018, p24-28.

<sup>11</sup> *'Initial proposals on water resources RCV allocations – feedback to companies.'* Ofwat, April 2018, p28-29.

<sup>12</sup> *'Initial proposals on water resources RCV allocations – feedback to companies.'* Ofwat, April 2018, p30-31.

<sup>13</sup> *'Initial proposals on water resources RCV allocations – feedback to companies.'* Ofwat, April 2018, p31-32.

<sup>14</sup> *'Initial proposals on water resources RCV allocations – feedback to companies.'* Ofwat, April 2018, p32.

NORTHUMBRIAN'S APPROACH IS BROADLY CONSISTENT WITH OFWAT'S METHODOLOGY, BUT THERE ARE ASPECTS THAT COULD BE IMPROVED.

### 3. Our review of Northumbrian's water resources RCV allocation

This section sets out our review of Northumbrian's water resources RCV allocation, in the light of Ofwat's approach and feedback. Based on our review of Northumbrian's methodology, there is, in general, consistency with respect to Ofwat's published method. There are, however, several respects in which Northumbrian could improve its approach to RCV allocation, most notably with respect to the consideration of alternative approaches to net MEAV.

- Northumbrian proposed a water resources RCV allocation of £334.578 million (March 2017 prices), equivalent to 17.2% of the total water service RCV. Northumbrian's approach was to roll forward past Modern Equivalent Asset Values to 2020, and then use the proportions at that date to allocate the 31<sup>st</sup> March 2020 Water RCV (pre-midnight adjustments). **The use of a net MEAV approach is consistent with Ofwat's guidance.**
- In general, **Northumbrian addressed the key 'issues to consider' as set out by Ofwat.** We show this in the table below, which sets out the extent to which Northumbrian's submission covers the key issues raised by Ofwat. In some cases, Northumbrian's submission could benefit from expanding the discussion of these issues.

Table 3: Extent to which Northumbrian's submission covers Ofwat's key issues for companies to consider

Issue	Extent to which covered by Northumbrian's submission
The definition of water resources	Northumbrian's allocation includes a statement that its allocation was done bearing this definition in mind.
Impact on wholesale tariffs	Northumbrian's allocation sets out the impact on wholesale tariffs, though in view of the emphasis that Ofwat places on bill impacts, it may be appropriate to expand on this.
Links to WRMPs	Northumbrian's submission includes a reference to its WRMP, but this is brief and refers only to 2020-25. It may be appropriate to expand on this discussion, for example including quotes from the WRMP and considering a longer timeframe.
Links to bulk supplies	This issue is covered in Northumbrian's allocation.
Roll forward of historic net MEAV	This issue is covered in Northumbrian's allocation.
Revaluation of historic net MEAV	This issue is covered in Northumbrian's allocation.
Separating pre- and post-privatisation RCV	This issue is not covered in Northumbrian's allocation, though it appears to be less important to Ofwat.
Potential for reallocation at PR24	Northumbrian did not explicitly address this issue, although we consider this to be a minor issue, as Ofwat expects reallocation to occur only in exceptional cases.

Source: Economic Insight

- Northumbrian included accounting adjustments for the transition from UK GAAP to IFRS. Northumbrian says that this reduces water network plus values by more than water resources – as the IFRS impact is primarily on infrastructure assets, which are disproportionately used in water distribution. **This accounting adjustment is not consistent with Ofwat’s guidance.**
- Northumbrian appears to have given limited consideration to other potential allocations – either as alternatives to the net MEAV approach or as cross-checks to this method. **This is not consistent with Ofwat’s guidance**, which says that it expects companies to consider other potential approaches and include proper justification for their chosen approach within their business plan.
- Ofwat expressed concern at the significant variation between companies in the level of independent assurance provided in RCV allocations. Ofwat said that it expects companies to provide evidence of independent assurance where the allocation method: is not based on data for which independent assurance has been provided to Ofwat as part of this or previous regulatory returns; and/or includes significant new assumptions. **Northumbrian’s approach was, however, consistent with Ofwat’s guidance in this respect.**
- Ofwat said that, where companies supply customers that make minimal use of network plus assets, Ofwat expects companies to consider potential bill impacts and ways of managing them. Ofwat noted that Northumbrian customers with minimal use of network plus assets could be unduly impacted by the RCV allocation. This is because changes in the water resources contribution to their bill will not be offset by changes in the network plus contribution. **While Northumbrian has given some consideration to this issue, its approach would benefit from a more systematic assessment of potential bill impacts for such customers.**
- **Northumbrian provided the information that Ofwat requested on bill impacts.** However, in its feedback, Ofwat said that the information that it originally requested on bill impacts is insufficiently granular to enable the identification of customer groups that are at risk of significant bill changes. Northumbrian will therefore also need to address this issue.

We summarise our overall assessment of Northumbrian’s submission, against Ofwat’s ‘minimum expectations’, in the table overleaf.

Table 4: Assessment of Northumbrian’s submission against Ofwat’s minimum expectations

Criteria	Assessment
Proposed unfocused RCV allocation to water resources as percentage and forecast £m of 1 April 2020 total water RCV	Northumbrian’s report includes both percentage and forecast water resources RCV figures.
Comparison to previously reported 2014-15 water resources net MEAV as proportion of total water wholesale net MEAV	Northumbrian’s report includes a comparison to published 2014-15 figures.
Explanation of why proposed unfocused RCV allocation varies from previously reported 2014-15 water resources net MEAV	Northumbrian’s report includes such an explanation. However, Ofwat has indicated that it does not consider the adjustment (relating to the transition from UK GAAP to IFRS) to be appropriate.
Supporting calculations of how RCV allocation proposal has been calculated	Northumbrian’s report provides supporting calculations. Additional calculations may, however, be required to address Ofwat’s other criticisms.
Details of alternative allocation methodologies considered	Northumbrian’s report does not include consideration of alternative methodologies.
Narrative discussion justifying choice of allocation methodology	Northumbrian’s report does not include consideration of alternative methodologies.
Explanation of how issues set out in technical guidance have been considered	While Northumbrian’s report addresses some of the issues in the technical guidance, others could benefit from additional discussion.
Consistency of analysis with information in company WRMP	Northumbrian’s report states that it has reviewed its draft WRMP and that it is not relevant to RCV allocation, because Northumbrian has no resource schemes scheduled for 2020-25 and no increase in resource yield. This could benefit from a more expansive analysis.
Statement from Board setting out factors and assurance information considered in support of proposed RCV allocation	Northumbrian’s report includes a short statement from the board, detailing that assurance for the valuation was carried out by Deloitte and assurance for the impact assessment data was carried out internally. Supporting reports were also submitted.

Source: Economic Insight

#### 4. Conclusions and recommendations

Overall, we find that Northumbrian's approach to RCV allocation is broadly consistent with Ofwat's guidance, but that there is room for improvement in several key respects. This final section sets out our advice as to how Northumbrian can proceed to further ensure the robustness of its RCV allocation. To facilitate this, we have developed a series of recommendations as to how Northumbrian can ensure robustness and consistency with Ofwat's guidelines. We first summarise each recommendation, before providing further discussion below.

- Recommendation 1: Northumbrian should remove the adjustment to historical net MEAV, based on IFRS treatment.
- Recommendation 2: Northumbrian should develop additional analysis that: i) sets out why it considers the net MEAV approach to be the most appropriate for allocating its RCV; ii) makes use of potential alternative measures as a cross-check.
- Recommendation 3: Reflecting Ofwat's revisions to its guidance, Northumbrian should develop more detailed analysis of potential bill impacts – and this should apply to all areas that relate to the creation of a separate price control for water resources. It should cover: i) identification of potential bill impacts from RCV allocation and other aspects relating to water resources/wholesale water separation; ii) Northumbrian's approach to mitigation for any adversely affected customers.
- Recommendation 4: Northumbrian should provide some additional analysis to underpin the consistency of analysis with the company's WRMP. This should include extracts from the company's WRMP, and discussion of Northumbrian's water resources situation beyond 2025.

##### 4.1 Removing the adjustment to historical net MEAV

Ofwat has explicitly said that companies should only seek to apply accounting standards to the net MEAV after 31<sup>st</sup> March 2015. We understand that Northumbrian intends to make this adjustment to its proposed RCV allocation, reflecting Ofwat's review.

##### 4.2 Additional allocation methodologies and narrative

The lack of consideration of alternative methodologies was the most significant criticism that Ofwat made of Northumbrian's proposed allocation. We consider that there are good reasons as to why alternative allocation methodologies are unlikely to be appropriate for Northumbrian, and so it is likely that net MEAV will remain Northumbrian's preferred methodology. We do not, therefore, think it likely that Northumbrian will have to materially change its proposed allocation. It will, however, be important for Northumbrian to include two key pieces of additional analysis for its plan:

- **A robust justification for the choice of net MEAV as the preferred methodology.** This can be based on a simple comparison of the advantages and disadvantages of each approach, in Northumbrian's particular context. Ofwat's summary of companies' RCV allocation approaches sets out some relevant

advantages and disadvantages. Further issues will arise when considering Northumbrian's circumstances. For instance, Northumbrian's lack of scheduled resources schemes for 2020-25 could suggest that an RCV allocation based on projected expenditure could be understated.

- **Calculation of implied RCV allocations based on other methodologies, for use as a *cross-check* to the net MEAV methodology.** Even where the implied RCV allocation is implausible, this would provide a solid justification for Northumbrian's choice of a net MEAV methodology.

As to the choice of alternative methodologies used as cross-checks, we recommend that Northumbrian prioritises the inclusion of the following.

- **Gross MEAV:** this has a strong theoretical rationale, and should be relatively easy for Northumbrian to calculate, having already developed a net MEAV estimate. Among other companies, it is the second most widely used methodology, after net MEAVs, and so should be acceptable to Ofwat.
- **Proportion of projected future expenditure on water resources:** this is a transparent metric and should be relatively easy to calculate, based on Northumbrian's knowledge of its future water resource requirements. The use of this metric as a cross-check could therefore be integrated with our Recommendation 4, the provision of additional analysis to underpin consistency with the WRMP. As Northumbrian does not have resource schemes scheduled for 2020-25, this metric has the potential to understate the water resources RCV – though as Ofwat has set out, the long lives of water resource assets mean that a long time frame may be appropriate.
- **Historical expenditure:** this is, again, a transparent metric and should be relatively easy to calculate. Northumbrian could also consider combining historical and projected expenditure, in order to generate a time period long enough to overcome the difficulty that Ofwat set out, relating to the long life of water resource assets.

#### 4.3 Detailed analysis of potential bill impacts

While Northumbrian's submission complied with Ofwat's requirements as set out in its technical guidance, Ofwat's feedback on RCV allocations, and its continued emphasis on vulnerable customers indicate that Northumbrian's plan would benefit from further analysis with respect to impacts on customer bills. This applies to all aspects of Northumbrian's approach to division of costs between price control areas, and not just to RCV allocation. There are two aspects to the additional analysis that Northumbrian should include:

- The development and application of a methodology for identifying potentially adversely affected customers. This should reflect Ofwat's observation that the information it requested for WS12b was insufficiently granular to identify at risk customers.
- A process for mitigating bill impacts on customers that are potentially at risk of adverse bill impacts.

#### 4.4 Additional analysis around Northumbrian's WRMP

Ofwat noted that there was significant variation across companies in the amount of detail that they provided on the relationship with their proposals for RCV allocation and their WRMP. As Northumbrian provided relatively little discussion of this matter, it would be helpful to expand this. This need not be as material as the detailed analysis of potential bill, impacts, but should include greater detail, including quotes from Northumbrian's WRMP. We note that Northumbrian's water resources allocation submission only set out Northumbrian's enhancement requirements for 2020-25. As the legacy water resources RCV will be expected to last beyond 2025, Northumbrian should extend the discussion to include its longer-term water resource plans.

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