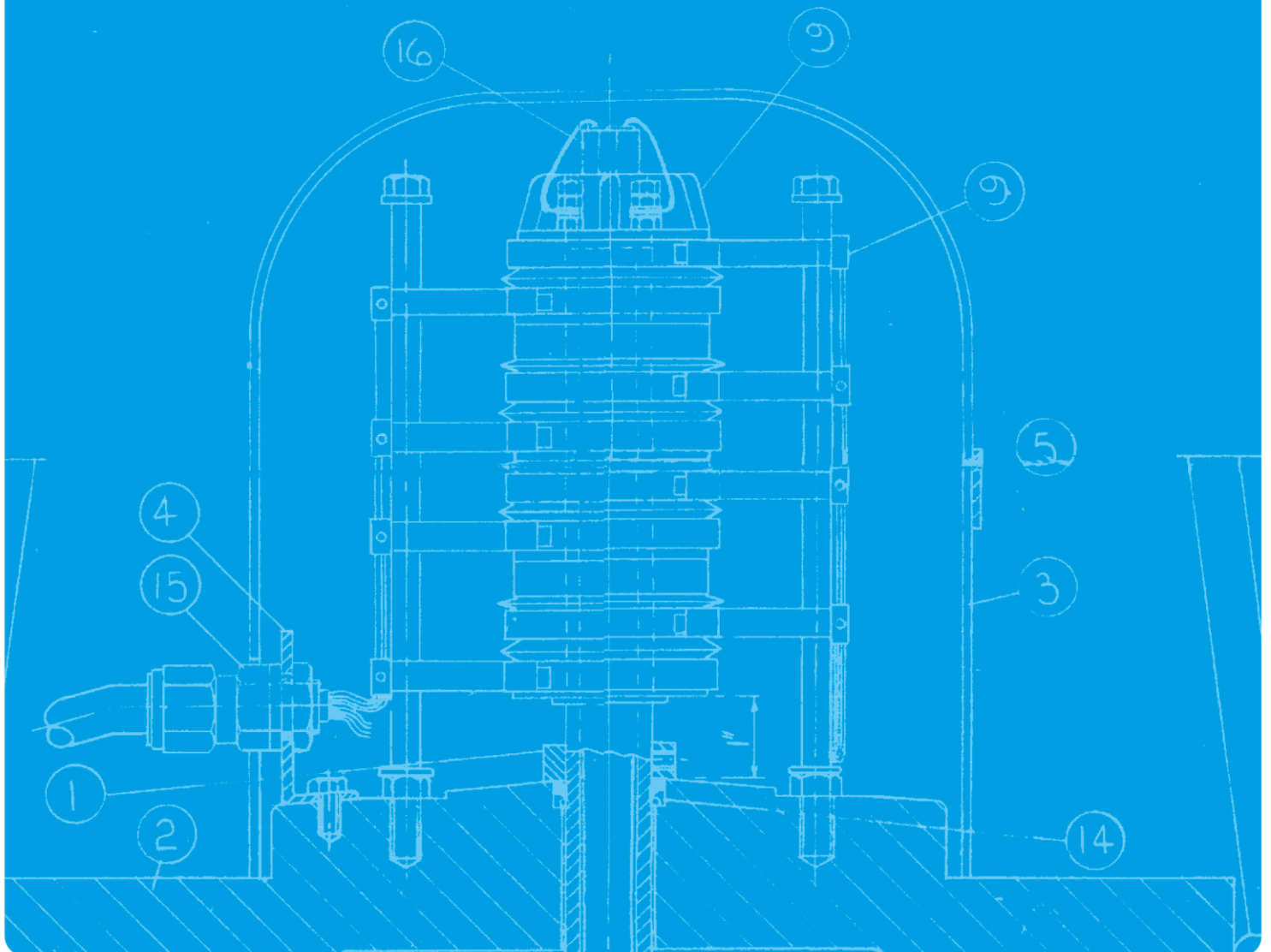


Bioresources RCV

Key facts

29 September 2017



Context

Ofwat, our economic regulator, is working to introduce a market for bioresources (sludge) from April 2020. Ofwat uses markets in this way to enable and incentivise companies to do more for less, make the best use of resources and encourage innovation.

To enable a market to open, at its 2019 price review of water and wastewater companies, Ofwat will introduce a separate binding price control for bioresources. This will be based on an explicitly allocated Regulatory Capital Value (RCV).

In advance of companies' full business plan submissions in 2018, Ofwat has asked that water and wastewater companies set out their proposed bioresource RCV allocations in September 2017. We expect Ofwat to feedback on these proposals in January 2018, and we will consider any revisions required as a consequence in time for our final business plan submission.

This document summarises for stakeholders the key facts from our submission.

Our approach to RCV allocation

We are supportive of the introduction of competition to bioresources and Ofwat's rationale for doing so. We have therefore sought to provide a transparent and balanced RCV allocation. Our approach is underpinned by three principles.

- Our RCV valuation should reflect our best assessment of what a hypothetical new entrant would do.
- We should prioritise simplicity wherever it is reasonable to do so.
- Stakeholders should have confidence in our proposed allocation – our approach to assurance reflects this and for transparency we have set out overleaf the main assumptions underpinning our proposed allocation.

A summary of our proposals is set out overleaf.

Summary

<p>Our overall gross valuation of assets</p>	<p>We considered the portfolio of assets we would expect a hypothetical entrant – seeking to maximise economic value – would build. This portfolio would constitute a combination of Thermal Hydrolysis Process (THP) plants, Acid Phase Digestion (APD) plants and Mesophilic Anaerobic Digestion (MAD) plants. In addition, investment in thickening plants to support processes would be required.</p> <p>The total cost is estimated at £596m.</p>
<p>Net economic value of assets</p>	<p>We made further adjustments to this portfolio to reflect the economic value of assets that we will own in 2020, and the costs associated with those assets. These adjustments included:</p> <ul style="list-style-type: none"> • the actual economic life of current assets; • maintenance costs; • land valuations; and • income. <p>These adjustments totalled -£140m. We did not make an adjustment for operating costs which we are not forecasting changing as a consequence of the further ageing of our assets by 2020.</p>
<p>Proposed RCV allocation</p>	<p>We have considered sensitivities to a number of key assumptions and believe values between £381m and £529m could all be justified within the methodology. We have chosen the valuation we believe most appropriate based on three principles:</p> <ul style="list-style-type: none"> • our RCV valuation should reflect a best estimate of what a hypothetical entrant would do; • it should be simple, using detail and complexity where proportionate to do so; and • stakeholders should have confidence in our proposed allocation. <p>Our proposed RCV allocation for bioresources is £456m.</p>
<p>Main assumptions we have made</p>	<p>Our proposed allocation is based on the following main, but not exhaustive, assumptions.</p> <ul style="list-style-type: none"> • No rationalisation of the asset portfolio beyond what is already planned. • Assets are scaled based on current sludge volumes and include a margin to provide a new entrant seeking to expand additional capacity (and resilience should the new entrant be unable to go to the market for that capacity). • Useful economic lives of assets are based on accounting book (the number of years of current depreciation to take the net book value to nil). • Adjustments for differentials between hypothetical assets and actual assets have been made, but we have not made an adjustment for differential operating expenditure rates based on asset ages (as explained above). • Land valuations have been determined by external valuers on a by-site basis.