



**Publishing  
future  
regulatory  
capital values**

**Consultation paper**

September 2001

# **PUBLISHING FUTURE REGULATORY CAPITAL VALUES**

## **A CONSULTATION PAPER**

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# 1. INTRODUCTION

## Purpose

The purpose of this consultation paper is to consider whether future regulatory capital values (RCVs) for the period to 2005 should be published and if so the manner and in what level of detail. We proposed this consultation as part of 'The Ofwat Forward Programme 2001-02'.

The key issues on which we are seeking views include:

1. Should we publish future RCVs?
2. If future RCVs are published, how should this be done and when?
3. What level of detail should we provide?
4. How extensive should the explanatory text and commentary be?
5. Should company level RCVs be disaggregated?
6. What price base should be used?

## Background and summary

In January Ofwat set out in MD 166 the regulatory framework and duties for all regulated water and sewerage undertakers. This summarised our approach to periodic reviews. We highlighted the importance of RCVs in this process but emphasised that they are only one parameter. The genuinely critical numbers for the industry and consumers are the price limits themselves – the essence of incentive regulation.

The calculation of RCVs is an essential element in Ofwat's price determination process and is used for measuring financial performance. The investment community and others also use RCVs as a proxy for market values in their valuation techniques.

Prices are set so that revenues cover the cost of the efficient provision of operations and capital investment, and allow a reasonable return on capital. The RCV represents the capital base of each appointed business that is remunerated at the cost of capital when setting price limits. The ability of the appointed business to maintain an adequate level and trend of critical financial indicators is also taken into account so that, provided the business is efficiently managed and financed, it will remain able to finance its functions (including new investment), readily and at reasonable cost. We also take account of the duty, where appropriate, of the appointed business to maintain investment grade credit ratings.

The concept of RCVs was initially only of academic interest in the early nineties. It was subsequently developed during the MMC referrals for gas and water companies between 1993 and 1995. More recently RCVs have assumed even greater significance because they have been enshrined in bond covenants.

The investment community believes that publication of future RCVs will increase the transparency of the regulatory framework. They point to the publication by Ofgem of similar material about the electricity distribution businesses<sup>1</sup>, the National Grid and Transco in the gas industry.

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<sup>1</sup> Review of the Public Electricity Suppliers 1998 to 2000. Distribution Price Control Review. Final Proposal Ofgem December 1999.

Thus RCVs have become important for analysts and investors but they are currently only published retrospectively. Future numbers are provided to the individual appointed business but are only published if the company chooses to do so. The publication of future RCVs should allow investors to understand better the long-term value of the regulated water companies.

The Inter-Regulatory Working Group paper favours publication of RCVs for all utilities because it may make comparison easier and increase transparency in the approaches taken by each regulator.

Only the retrospective RCVs are published. These are included each year in the 'Financial performance and expenditure report'. MD171 (May 2001) consulted on changes to the Regulatory Accounting Guidelines (RAGs). One issue raised in detail was the disclosure of retrospective RCVs in the regulatory accounts for water companies. Disclosure and/or integration of RCVs into the accounts would improve the links between regulatory decisions and actual performance. The accounts would be more transparent and useful to interested parties and assist in providing a more stable regulatory framework. If disclosure of RCVs were adopted in the regulatory accounts, then the basis of calculation would also be formally set out in the RAGs. We are now considering responses to this earlier consultation.

## **2. BASIS OF THE RCV METHODOLOGY**

The Director has to set price limits at periodic reviews in accordance with his duties under the Water Industry Act 1991 (WIA 1991). One of his primary duties is "to secure that companies... are able (in particular by securing reasonable returns on their capital) to finance the proper carrying out of the functions of such undertakers".

There is no definition of 'capital' in the WIA 1991. The current replacement cost (Modern Equivalent Asset or MEA) valuation of companies' assets at privatisation was around £120 billion. The proceeds from privatisation of the water and sewerage companies was of the order of £6 billion. Following the consultation paper 'Assessing capital values' in November 1992, Ofwat constructed a capital base for use in price limits. This was termed the 'Regulatory Capital Value'.

The RCV is an acquisition-based valuation derived from the flotation value (including any initial debt) of water companies at the time of privatisation (a proxy was used for those companies that were not floated). This is adjusted for net new allowable capital expenditure and depreciation charges incurred since then, including, at the 1999 review, an adjustment to reflect past capital efficiencies.

The method for calculating the RCVs for the 1999 Periodic Review was outlined in 'Setting Price Limits for Water and Sewerage Services' (February 1998). The 'Financial Model Rule Book' (October 1998) gave further details of the inputs and outputs of the financial model involved and explained the calculations performed. Further clarification was also provided in MD145 (March 1999).

The approach taken at the 1999 Periodic Review built on that adopted at the 1994 review. Any net investment over and above the levels of investment projected in 1994 for the period 1995-2000 (including agreed claims for logging up) may not be included in the regulatory capital value. Exceptions to this rule required clear and incontrovertible evidence that customers had been consulted, that the investment was a clear priority for them, and that they were prepared to pay higher bills.

Companies were allowed to retain the benefits of capital efficiencies for five years. This required a comparison of net actual expenditure and depreciation with net projected expenditure and depreciation. The expenditure comparison took account of the reasons for the variation and the impact of new obligations that had been logged up over the period. The approach worked well for expenditure but was more problematic for depreciation.

Adjusting the regulatory capital value for the depreciation element of any capital efficiency cannot be properly achieved because the difference between actual and allowed depreciation picks up many other factors such as different views on accounting policies and MEA valuations. The projected depreciation element was therefore limited to the depreciation attributable to the difference in expenditure using a standard mix of asset lives.

### **3. CURRENT PRACTICE IN DISCLOSING RCVs**

Ofwat wants to improve the transparency of the periodic review process. We published far more information at the last Periodic Review in 1999 than in 1994.

We currently publish company specific **retrospective** data for RCVs (both for the year end and as a year average) in the annual 'Financial performance and expenditure of the water companies in England and Wales' report and its supplement. The report for the period 2000-2001, the first year of the new price limits, was published in July. This contains the company specific RCVs for 2000-2001.

We did not publish company specific numbers for future RCVs in the 1999 Final Determination document, but we did set out the industry aggregate position and told each company its future numbers in confidence along with other data relating to price limits. The companies were told they were free to publish this if they wished – both Dŵr Cymru/Welsh Water and Severn Trent Water have now chosen to do so.

### **4. PROPOSED OPTIONS FOR PUBLISHING FUTURE RCVs**

There are many ways to publish the RCVs. This paper puts forward four options:

1. Retain the current position where companies can choose whether to publish the future RCVs and Ofwat will continue to publish them retrospectively.
2. We might publish future RCVs (year end and year average) for each company from 2001-2005.
3. We might publish a rolling reconciliation of the RCVs for each company from 2001-2005. This is similar to the OFGEM approach for the electricity distribution price review.
4. As for option 3 but include a more detailed component analysis of the RCVs for each company from 2001-2005.

Our provisional preference is for the complex rolling reconciliation version (option 4) because this offers the greatest transparency.

The format and proposed layout for options 2,3 and 4 are shown in Annex A.

Any proposal for publishing RCVs will need to be put in context with a full explanation of the calculations. One of the proposals in MD171 is to include a section on the methodology underlying RCVs within the accounting policies. A similar explanation would also be appropriate with any publication of future RCVs. This explanation would include:

- the role of RCVs in price setting
- the economic principles underlying the RCVs
- a brief description of the method of calculation
- a description of adjustments that might be made at periodic reviews

All of the options focus on the RCV at the company level. There are no proposals to split the RCV, for example, into separate water and sewerage components. Indicative price limits were published at the time of the last review and are used as guidelines for assessing tariff proposals. However, Ofwat would need to make certain assumptions, not least about the apportionment of the proceeds at privatisation, in order to split the company RCV. This may reduce the value and usefulness of the numbers. We welcome comments on this issue.

The advent of competition may warrant further disaggregation of the RCV. In his statement of 31 March 2001 on the future of competition the Secretary of State outlined the potential for new retail and production licences together with common carriage. This might require disaggregation of the RCV and has been foreshadowed in MD171. However, the format that this might take is better left until the shape of competition becomes clearer following formal consultation by the Secretary of State.

Price limits are set for five years – as are the underlying assumptions. Consequently, the future RCVs remain unchanged. The only exceptions to this are changes to RCVs arising from interim determinations and where licences are continued following mergers. Consideration will also need to be given to what price base should be used for reporting. It might be desirable for the figures to be republished each year to bring them to the current year price base. This means that the initial figures would be published at 2001-2002 prices and then revised by the Retail Price Index each year.

## **5. RESPONSE TO THE CONSULTATION**

We would like to hear from all those with an interest in the issues raised in this document. Send your views by 19 November 2001 to:

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Unless otherwise requested, the responses will be placed in the Ofwat library and made accessible to the public.

Attachment:  
Annex A

## PROPOSALS

### ANNEX A

#### **Format for options 2, 3 and 4 (numbers are for illustration only).**

##### **OPTION 2. Simple disclosure**

@ 2001-02 price base £m	2001-02	2002-03	2003-04	2004-05
Year end RCV	2,150	2,315	2,505	2,705
Year average RCV	2,075	2,232	2,410	2,605

##### **OPTION 3. Simple rolling reconciliation basis**

@ 2001-02 price base £m	2001-02	2002-03	2003-04	2004-05
Opening RCV	2,000	2,150	2,315	2,505
Depreciation	(200)	(225)	(225)	(250)
Net new investment	400	450	475	500
Capital efficiencies	(50)	(60)	(60)	(50)
Closing RCV	2,150	2,315	2,505	2,705
Average year RCV	2,075	2,232	2,410	2,605

##### **OPTION 4. More complex rolling reconciliation basis**

@ 2001-02 price base £m	2001-02	2002-03	2003-04	2004-05
1. Opening RCV	2,000	2,150	2,315	2,505
2. Capital expenditure	440	480	500	515
3. Infrastructure renewals expenditure	50	60	70	80
4. Grants and contributions	(20)	(20)	(25)	(25)
5. Depreciation	(200)	(225)	(225)	(250)
6. Infrastructure renewals charge	(70)	(70)	(70)	(70)
7. Capital efficiencies	(50)	(60)	(60)	(50)
Closing RCV	2,150	2,315	2,505	2,705
Average year RCV	2,075	2,232	2,410	2,605