

2014 Price Review
Business Plan Supporting Appendices
Depreciation

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Executive Summary

Depreciation is the component of the revenue requirement and therefore bills which reflects the recovery of investment in water assets over time. The level of depreciation in our plan is summarised in the table below and our approach to calculating it is described in the following sections.

Table 1 Summary of depreciation

| £m 2012-13 prices | 2015-16 | 2016-17 | 2017-18 | 2018-19 | 2019-20 | Total |
|-----------------------|---------|---------|---------|---------|---------|-------|
| Wholesale | 35.7 | 35.7 | 36.0 | 36.1 | 36.0 | 179.5 |
| Retail household (HH) | 0.1 | 0.4 | 0.6 | 0.8 | 1.0 | 3.0 |
| Retail non-household | 0.0 | 0.1 | 0.1 | 0.1 | 0.1 | 0.3 |
| Total | 35.8 | 36.2 | 36.7 | 37.0 | 37.1 | 182.8 |

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Section 1. Current Cost Depreciation on existing and new assets

RCV run-off rate

The RCV run off rate has been set to be consistent with the level of CCD in the 2012-13 Regulatory Accounts. A reducing balance approach to depreciation has been taken to maintain a smooth profile of prices to customers.

The run off rate used in the plan is 3.26% which represents a remaining asset life of just over 30 years.

Table 2 Depreciation on existing RCV assets

| £m 2012-13 prices | 2015-16 | 2016-17 | 2017-18 | 2018-19 | 2019-20 | Total |
|-------------------|---------|---------|---------|---------|---------|-------|
| Wholesale | 35.1 | 33.9 | 32.8 | 31.8 | 30.7 | 164.4 |

Depreciation (CCD) on new asset additions

Depreciation on new additions is based on a straight line depreciation calculation. Half of the annual depreciation is applied in the first year with subsequent years attracting the full charge. Ofwat has proposed that a single average asset life is specified for these new additions.

An asset life of 50 years had been selected. This life is a broad balance between the assumed asset life for infrastructure assets of 80 years and the life of non-infrastructure assets of 30 years. In addition to this selection of the asset life has been the desire to maintain a sustainable and constant level of overall depreciation which can contribute to the maintenance of flat bills for customers.

Table 3 Depreciation on new asset additions

| £m 2012-13 prices | 2015-16 | 2016-17 | 2017-18 | 2018-19 | 2019-20 | Total |
|--------------------------------------|---------|---------|---------|---------|---------|-------|
| Depreciation on new wholesale assets | 0.6 | 1.8 | 3.1 | 4.3 | 5.3 | 15.1 |

Comparison of CCD with SEW risk based asset modelling

The level of CCD derived above has been checked against the output of the our models used for risk based asset planning. These models are the internal tools we use to value the existing assets and to determine remaining useful asset lives. Although there are differences in profiles between the two approaches, the level of CCD across the period is very similar.

Table 4 Comparison of total CCD

| £m 2012-13 prices | 2015-16 | 2016-17 | 2017-18 | 2018-19 | 2019-20 | Total |
|---|---------|---------|---------|---------|---------|-------|
| Raw risk based modelling output | 33.5 | 34.2 | 35.8 | 37.8 | 39.1 | 180.4 |
| Average asset life CCD approach in plan | 35.7 | 35.7 | 36.0 | 36.1 | 36.0 | 179.5 |

The approach selected for the plan is preferred as it produces a smoother price profile for customers (which our customer research strongly supports).

Retail depreciation

For calculating depreciation on retail asset additions an asset life of 6 years is assumed. Depreciation on new additions is based on a straight line depreciation calculation with half of the annual depreciation applied in the first year and subsequent years attracting the full charge.

Table 5 Depreciation on retail asset additions

| £m 2012-13 prices | 2015-16 | 2016-17 | 2017-18 | 2018-19 | 2019-20 | Total |
|---|---------|---------|---------|---------|---------|-------|
| Depreciation on new HH retail additions | 0.6 | 1.8 | 3.1 | 4.3 | 5.3 | 15.1 |
| Depreciation on new non HH retail additions | 0.0 | 0.1 | 0.1 | 0.1 | 0.1 | 0.3 |

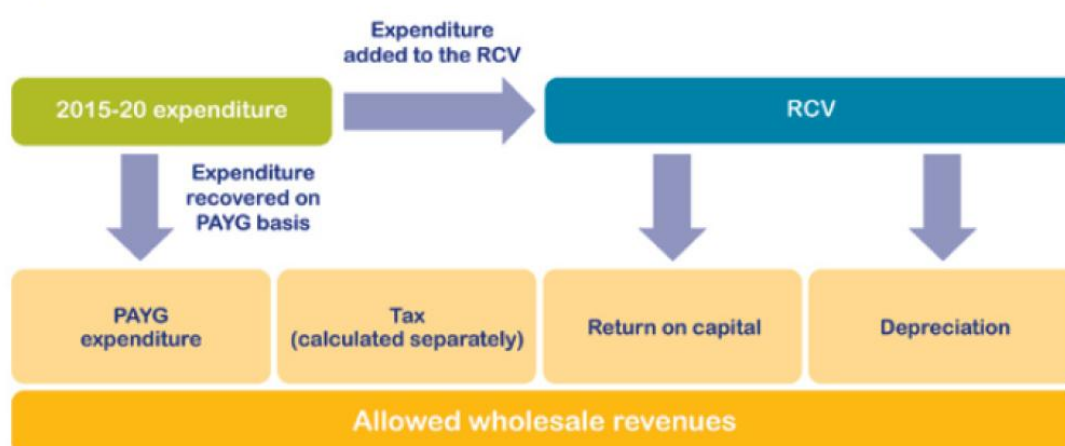
Depreciation on household and non household additions is calculated separately. Depreciation on household retail additions is included in the average cost to serve (ACTS) calculation. Depreciation on non household retail additions is included in the default tariffs.

Section 2. Pay as you go ratio

The pay as you go ratio (PAYG) is introduced as part of Ofwat’s methodology change with the move to a Totex form of cost allocation. Both Opex and Capex expenditure is classified as Totex. Totex is then split into two possible regulatory treatments – pay as you go, or ‘fast money’ – which goes directly to the revenue requirement and has a direct, pound for pound impact on bills and ‘slow money’ which is added to the RCV and depreciated over a longer time frame resulting in a more dampened impact on bills in the shorter term.

Figure 1

Building blocks for allowed wholesale return



Source: [Ofwat](#)

In our plan we have included operating cost and our below ground capital expenditure (IRE) as “Pay as You Go” (PAYG) “fast” money, and the balance of capital expenditure as “slow” money. The year by year PAYG ratio on this basis is shown in the table below.

Table 6 PAYG ratios from wholesale Opex + IRE

| | 2015-16 | 2016-17 | 2017-18 | 2018-19 | 2019-20 | Average |
|--------------------|---------|---------|---------|---------|---------|---------|
| (Opex + IRE)/Totex | 62.0% | 58.3% | 56.9% | 60.3% | 64.6% | 60.4% |

The objective of our plan is to produce bills that are as low as possible and present an acceptable bill profile for customers whilst balancing financeability constraints, particularly towards the end of the period. We reviewed the opportunities to amend the PAYG ratio to reduce and smooth prices for customers but concluded that this would cause an undue strain on a number of our key financeability ratios.

In our financial modelling we have used this year by year PAYG ratio. We have presented an additional line on Table W10 with these separate PAYG ratios.

The Ofwat tables only collect a single average PAYG ratio in their tables which implies that this is the approach that Ofwat will take in setting prices. However, predominantly as a result of our uneven supply demand expenditure, a constant PAYG ratio results in an uneven and inappropriate revenue requirement which does not meet our objectives.

If Ofwat wished to use a single PAYG ratio for us they should use 60.4%. However, Ofwat would then come up against the same problem that we experienced of uneven bills. Ofwat would then need to deal with this by reprofiling the resulting bills to present a smoothed profile.

An additional reason that we have used specific year by year PAYG ratios is that to do otherwise, with a single ratio, creates financeability issues for us towards the end of the period. Again if Ofwat were to use a single ratio for the whole period they would come up against this constraint and need to address this issue.

Section 3. Historic cost depreciation and the introduction of IFRS accounting.

Historic cost depreciation on assets existing at 31 March 2015

Opening adjustments for IFRS accounting

Upon adoption of IFRS, fixed assets will be re-valued to fair value and this will be the deemed cost of the assets at 1 April 2014. Accumulated depreciation on fixed assets will start again from nil. As a result, the calculation of future depreciation values will include an element relating to this increase in the value of fixed assets. It should be noted that the increase to fair value of fixed assets will create a revaluation reserve in the shareholders' funds side of the balance sheet. This reserve will be amortised over the life of the underlying assets, effectively releasing an amount into the revenue reserves equal to the depreciation on the uplift value which will offset this additional depreciation charge.

Forecast for existing assets

The financial system has been able to generate the future depreciation value on those non-infrastructure assets on the fixed asset register at 31 March 2013. The additional depreciation relating to expenditure in 2013-14 and 2014-15 and any items in work in progress at 31 March 2013 has been added to these system generated figures.

Historic cost depreciation on new asset additions from 1 April 2015

Under IFRS infrastructure renewals accounting will no longer apply. Our analysis has concluded that for the statutory accounts approximately 50% of traditional IRE expenditure will be allocated to Opex with the remaining 50% being treated as Capex and depreciated as long life assets.

Table 7 Estimated proportion of IRE considered as Opex for IFRS statutory reporting

| | 2015-16 | 2016-17 | 2017-18 | 2018-19 | 2019-20 |
|--------------------|---------|---------|---------|---------|---------|
| Opex IRE/Total IRE | 50% | 50% | 50% | 49% | 48% |

The asset life assumed for new asset additions is 50 years.

The treatment of existing IRC/IRE accrual balances

It is forecast that at the time of adoption of IFRS there is likely to be an over accrual of IRC of £1.078m. This will mean that an over deduction under UKGAAP will have been made in the tax computation for IRE not yet incurred. It is anticipated that this over deduction will be spread over the life of the infrastructure assets and therefore will have no material effect.

Section 4. Table W10 – Cost recovery for water service**2015 RCV****Line 1-2**

A reducing balance approach has been used. We foresee no differences for the period 2020-25 and have continued with the same assumption.

Post 2015 totex RCV additions**Line 3**

A straight line approach to depreciation is used for additions. We foresee no differences for the period 2020-25 and have continued with the same assumption.

Totex PAYG% split**Line 4- 4a**

This single PAYG% is calculated as the total Opex plus infrastructure renewals expenditure additions divided by Totex. We do not believe that a single PAYG% is appropriate for our plan. We have provided annual figures in this table to allow a smoother profile of prices to customers. It is based on each years Opex plus infrastructure renewals expenditure additions divided by annual Totex.