

SRN58 Uncertainty Mechanisms Technical Annex

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from
**Southern
Water** 

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1. Executive summary

There are a number of areas where there is material uncertainty in the parts of the business plan. Many of these uncertainties relate to legal / policy decisions that are yet to be made at the point of business plan submission.

If we were to include costs to deliver against the more costly implications of these decisions within our plan, our plan would be significantly more costly. Also, in most cases, it is not clear whether these additional costs are required. Therefore, we have excluded these costs from our cost proposals, and set out below the uncertainty mechanisms required to provide the needed funding should these uncertainties materialise.

Some of the uncertainty areas are highly material. As such, if they were to materialise, Southern Water would require an adjustment to revenue allowances within the control period. It would not be feasible to leave any true-up to an end of period adjustment, as the business would be unable to shoulder additional costs of this scale without an associated revenue allowance. For those areas, we are seeking notified items. For other areas of uncertainty, it may be more appropriate to have an end of period true-up approach.

Therefore, we are proposing a bespoke mid-period revenue adjustment mechanism for each of the following uncertainty areas:

- 1. Water Industry National Environment Programme (WINEP) profiling:** Our WINEP programmes have been phased over 8 years to balance affordability and deliverability. We are fully committed to statutory compliance and in discussion with our regulators. The final WINEP phasing will be concluded through the regulatory process to maintain full statutory compliance. Rephasing from 8 years to 5 years would add £725 million (2022/23 prices) of further investment into the Plan and add approximately £100 to average annual bills per household over the PR24 period. We note that the uncertainty mechanism would allow for additional funding, but does not resolve the core issues of affordability and deliverability of an unphased WINEP investment.
- 2. Water Resource Management Plan (WRMP) finalisation:** Our WRMP has not yet received final sign-off from the Secretary of State. Until it does, it is possible that the final set of schemes may need to change (or their delivery dates). In addition, given the high-profile nature of our WRMP, it is possible that our plan will be subject to a public enquiry. If these events were to happen, there could be further changes to our plan beyond 2024.
- 3. Enhanced Network and Information Systems (NIS) requirements:** In June 2023, an enhanced NIS CAF (eCAF) was published for the water industry, setting out the need to accelerate 6 areas and to achieve full compliance by 31st March 2028. This requires a significant amount of additional planning and investment options to be worked through, and given the timing of this submission in October 2023, we have concluded that we will need additional time to give a considered view of the investment changes required. Initial estimates have placed these costs in the region of £100 million. However, further work is required before we could be comfortable to propose a figure for which customers would provide funding.
- 4. Bioresources farming rules for water:** There is significant uncertainty surrounding the application of Rule 1 of the Farming Rules for water, including its timing and impact. Based on the national landbank modelling assessment, it is possible that two thirds of our sludge would need to find alternative routes (rather than recycling to agriculture). The short-term solution would be to send our biosolids to landfill while we start developing our plans for thermal destruction type of technologies

(e.g., incineration) in AMP8 (design, planning), with the view to start construction in AMP9. The estimated AMP8 costs would be c.£83 million.

5. **Bioresources Industrial Emissions Directive (IED):** Within our IED proposals for AMP8, there are a number of material uncertainties, including: if the EA does not accept our alternative impermeable surface option, we would incur c.£24 million additional costs; if Ofwat does not approve our Kent consolidation cost adjustment claim proposals or the EA does not agree with our proposed timescales, it could mean an extra c.£54 million costs for IED compliance; and there could be further cost implications from the emerging EA requirements on dewatering of the order of £169 million. In total, this could be a further £247 million of additional costs.
6. **Alternative delivery models:** We have identified several projects to progress under alternative delivery routes. At present, the majority of the projects identified are at a nascent stage, with most pre-tender development activities yet to commence. As projects are developed and pre-tender activities are completed, new information can give rise to increases in estimated costs which cannot be reasonably foreseen at the time of business plan submission, nor would it be appropriate to price for such risks at an early stage in the process.
7. **Capital maintenance:** There is a lot of work ongoing across the water sector regarding asset health, capital maintenance and renewals levels. We are aware that multiple water companies are submitting cost adjustment claims (for example Thames Water and Wessex Water). We are also doing further work to understand our asset base and this may result in changes to the current proposed capital maintenance position. We will be undertaking further work in the Autumn/Winter 2023 and will be in a position to share further details with Ofwat by early 2024.

We have sought to only propose uncertainty mechanisms where there are material uncertainties, for areas that either relate to meeting statutory / legal requirements, or areas of high customer priority in the case of lead.

It is possible that clarity on some of the above areas will be reached ahead of the final determinations (in particular, this may be the case for the WINEP, WRMP, NIS requirements, and capital maintenance). Where this is the case, Southern Water proposes to provide an updated set of data tables and enhancement cases to Ofwat to reflect in the final determination, and to withdraw the request for uncertainty mechanisms in these areas.

Further details on each of the proposed uncertainty mechanism are set out below.

2. Overview of Uncertainty Areas

WINEP profiling

In July 2023, the Environment Agency (EA) wrote to all water companies expressing concerns regarding the deliverability and customer affordability of PR24. The scale of our AMP8 WINEP is close to requiring the five-year total AMP7 level of investment every year of the AMP8 period. The EA asked for companies to consider the profiling of investment to meet WINEP requirements to ensure deliverability and affordability of the AMP8 plan. As a result, we have examined options for alternative phasing of planned environmental improvements. These proposals will improve the phasing and deliverability of WINEP programmes, taking account of customer priorities and benefits for the environment.

We have identified areas of investment in our plan that we propose to phase beyond AMP8. However, even by delaying some of these WINEP actions, our assessment is that the scale of the remaining altered WINEP plan is still neither affordable nor deliverable. Thus, we have provided supplementary proposals to the EA to ensure we have a deliverable and affordable WINEP plan. This proposal involves rephasing £725 million of investment scope (see Table 1 below) to beyond AMP8.

Table 1 - Summary of AMP8 WINEP Uncertainty (unconfirmed phasing proposals)

Additional Area	Number of WINEP actions to rephase beyond AMP8	Proposed totex phased beyond AMP8 (£m, 2022/23 prices)
Remaining Environment Act 2038 phosphorus target	15	141
Low benefit -cost Water Framework Directive improvements	17	124
Nutrient Neutrality at low or no growth sites	13	128
Storm Overflows (with Portsmouth and Langstone)	206	332
TOTAL		725

Source: Southern Water.

We are fully committed to statutory compliance and in discussion with our regulators. The final WINEP phasing will be concluded through the regulatory process to maintain full statutory compliance. Rephasing from 8 years to 5 years would add £725 million (2022/23 prices) of further investment into the Plan and add approximately £100 to bills per household over the PR24 period. We note that the uncertainty mechanism would allow for additional funding, but does not resolve the core issues of affordability and deliverability of an unphased WINEP investment.

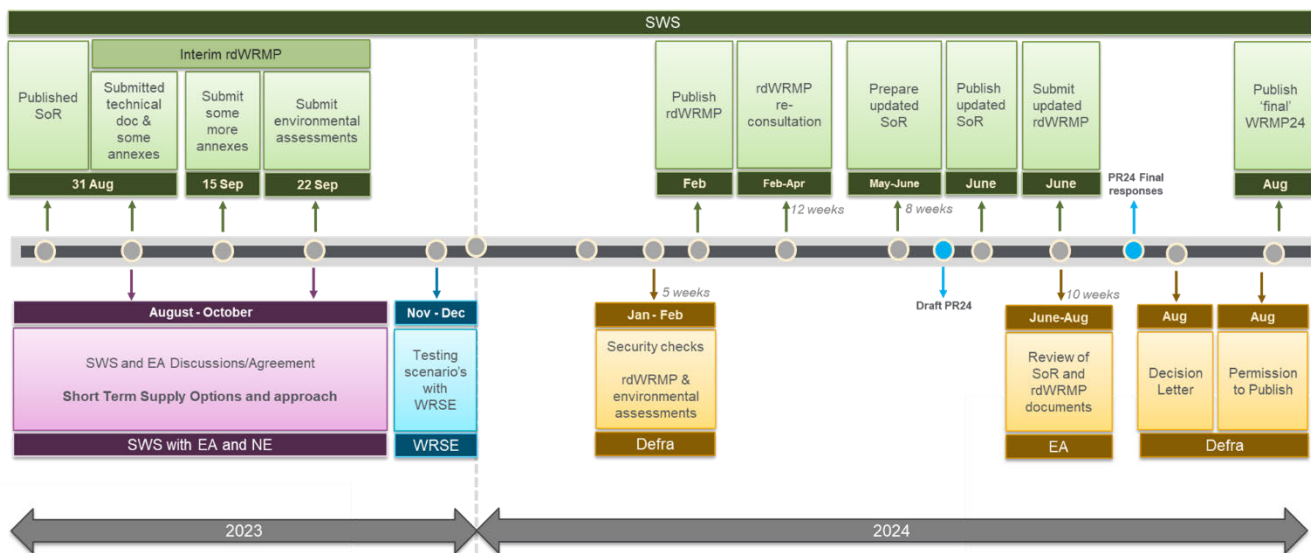
Please refer to our response to the EA letter ref: EA/16/20231, dated 19 July 2023 where we have detailed our reasons for phasing WINEP investment and outlined the phasing opportunities identified for the areas shown in the table above.

¹ Costs in our response letter to the EA are in 2020/21 prices as required by the EA, however we have re-based this to 2022/23 prices in this table for the purposes of aligning to price base of our submission.

WRMP finalisation

Our WRMP has not yet received final sign-off from the Secretary of State. The expected WRMP timeline is set out below.

Figure 1 - Updated WRMP Timeline



Source: Southern Water.

As seen in the figure above, we will discuss short term supply options and include these alongside our submission of a revised draft WRMP, targeting for November 2023. This is because we need to re-consult on specific areas of our plans where there is a change in planned delivery dates of major schemes within our WRMP. Re-consultation will take place between January and March 2024 (assuming permission is received from the EA), and we are targeting to publish our final WRMP in October 2024 (assuming approval is received from Defra).

The key areas of our plan where we need to re-consult are as follows:

Hampshire Water Transfer and Water Recycling project (Hampshire SRO)

- This scheme has evolved since WRMP19. The original proposal was for a desalination scheme at Fawley, but the plan now includes recycling from Budds Farm into Havant Thicket reservoir. This change was agreed with regulators in May 2022;
- The Budds farm recycling scheme delivery date has been delayed by 5 years (from 2031 to 2036); and
- The Havant Thicket reservoir is being jointly delivered with Portsmouth Water. This scheme has been delayed by 2 years. There is a new planning application for the pipeline to be submitted to local planning authorities and determination is expected to be complete in early 2024.

Littlehampton (Ford) Water Recycling Scheme

- This requires an understanding of the 'normal' levels of chemicals in the water courses at the proposed discharge locations of the site, and where water will enter from the treatment works;
- The sampling programme was significantly delayed during COVID periods. c. 51,000 laboratory tests have been done; but more are required to establish the baseline river water quality for potential discharge locations from the Ford Water Recycling Plant;
- The delay in securing the required laboratory services, enhanced sample analysis and number of sampling events, has extended our programme by at least 12 months;
- Due to the environmentally sensitive nature of the land between Ford and Pulborough (South Downs National Park), plotting out the potential route of the pipeline (c.18km) is complex and lengthy;

- We require environmental surveys to meet the objectives of the Environment Impact Assessment/Habitats Regulation Assessment; and
- As a result of these issues, this scheme has been delayed by 3 years (from 2028 to 2031).

Others

- We have had to incorporate the inability of Bournemouth Water Knapp Mill transfer (20MI/d scheme) and Portsmouth Water (9MI/d scheme) to deliver their planned WRMP19 schemes due to environmental impacts. This has also caused new options to be considered, developed along with further modelling and associated delays.

With the changes in delivery dates, we are now reviewing our water resourcing plans for Hampshire more widely and are exploring various practical solutions for our water resourcing in the short to medium term. The changes and delays in these schemes mean that we will have to rely on the extraction of water from River Itchen and Test to maintain supply-demand balance. This will require an extension of our licences. In order to plug the gap and reduce our reliance on these licences, we are exploring short term supply options, which involves a deep dive to exhaust all of the possible alternative options available to plug the deficit caused by the delay in our schemes.

We will submit the output of our review to the EA in the form of a short term supply options plan which will detail actions to:

- Accelerate other schemes' delivery dates; and
- Address potential adverse impacts including supply-demand deficit and the frequency of needing to implement drought interventions including drought permits and orders for local rivers.

Estimating the potential scale of changes to the WRMP is highly uncertain. But by way of illustration, the current estimate of the Hampshire Strategic Resource Option is £402 million – i.e., should a supply option be added or removed, there would be a highly material change to our plan. Also, if the WRMP changes, it could impact leakage, metering, PCC, phasing etc. This means it could have material impacts throughout not just totex but also ODIs.

This uncertainty relating to our WRMP may also affect our position on our Lead Replacement programme, as the amount of lead pipes we uncover is linked to our WRMP mains replacement activity.

Enhanced NIS requirements

In June 2023, an enhanced NIS CAF (eCAF) was published for the water industry, setting out the need to accelerate 6 areas and to achieve full compliance by 31st March 2028. This requires a significant amount of additional planning and investment options to be worked through, and given the timing of this submission in October 2023, we have concluded that we will need additional time to give a considered view of the investment changes required.

It is our aim that the eCAF submission work will be completed by end of March 2024. In the meantime for high-level budgeting purposes, a broad figure of £100 million has been estimated following an initial assessment. This process involved considering the significant increased funding that would be required to remediate the enhanced CAF objectives. We then considered the maximum amount we can spend without having too much change occurring at any one time (which would create a high risk of an operational incident). There are currently too many unknowns to produce a detailed cost estimate, e.g., the number of sites, types of solution, uplift and resilience in high-speed connectivity, local site network redesign and allocation of enterprise IP addressing. There is a large amount of discovery work and approach approval required before robust costing can take place.

We have not included this enhancement spend within our business plan given the timing of the requirement, although we expect to receive funding for this when we fully understand the level of investment required.

Therefore, we are proposing an uncertainty mechanism to ensure that once fully understood and scoped out, we will receive the full level of funding required.

Bioresources farming rules for water

There is significant uncertainty surrounding the application of Rule 1 of the Farming Rules for Water (FRfW). Currently our business-as-usual process for sludge is to treat it before it goes to agriculture, i.e., currently our only outlet for sludge is agriculture. There is uncertainty regarding the EA's and DEFRA's interpretation of Rule 1, which imposes restrictions on the timing of organic manure applications and would affect the spreading windows and application rates of biosolids to land by effectively banning most biosolids applications in late summer/autumn. While this legislation has applied since April 2018, due to a statutory guidance note issued by Defra in June 2022, the EA is not currently enforcing Rule 1 of the FRfW. However, this may change as a review is planned for 2025. This would result in further restrictions to agricultural recycling from AMP8 onwards.

The industry has collectively assessed the impact of Farming Rules for Water at national level through a National Landbank Assessment. This looked at sludge production levels and land availability. We then modelled the restrictions regarding sludge that may be enforced as a result of Rule 1 of the Farming Rules for Water. Based on this assessment, we determined that up to two thirds of our sludge would need to find alternative routes (rather than recycling to agriculture). This is covered extensively in Bioresources Strategy technical annex.

We have identified the solution of sending our biosolids to landfill, however this is a short-term solution as we recognise the capacity constraints of landfill. Our assumption is that there will be enough landfill to cover our biosolids for AMP8. In the meantime, we will start developing our plans for thermal destruction type of technologies (e.g., incineration) in AMP8 (design, planning), with the view to start construction in AMP9.

Therefore, if DEFRA decides to enforce the restrictions regarding sludge in Rule 1 of the Farming Rules for water, the estimated value of the uncertainty has been calculated as follows:

- The cost to landfill two thirds of our sludge has been modelled to increase our yearly opex by about £12.5 million p.a. Over the 5-year AMP8 period, the cost is estimated to be £62.5 million. The new annual opex cost has been modelled by multiplying our expected digested sludge volume by our expected average cost of disposal. The average cost of disposal is calculated as follows:
 - For the amount that will go to landfill (i.e., 66% per the Grieve Strategic National Landbank assessment), we have assumed a cost per ton of disposal; and
 - For the remaining proportion of sludge still going to agriculture, the current disposal cost from our operations team is used.
- If two thirds of our sludge would need to be eventually incinerated, the high-level capex for such plant has been estimated to about £200 million, using incineration cost curves from [REDACTED]. Our Engineering and Technical Solutions (ETS) team's experience dictates that c.10% of this cost would be required in AMP8 to start the design and planning process, thus the estimated cost in AMP8 would be £20 million.

So the total cost of our high-level estimate is c.£82.5 million.

Bioresources IED

Within our IED proposals for AMP8 we have identified three areas of material uncertainty:

- **Kent Consolidation Cost Adjustment Claim Proposals:** We are proposing to consolidate our seven sites in operation in Kent into two large sites. This rationalisation is fully detailed in our Cost Adjustment Claim for Advanced Anaerobic Digestion (AAD) in Kent, as well as our Bioresources Strategy technical annex. This means there is a potential benefit to realise whereby we are proposing that the five sites that will be rationalised are not enhanced in AMP8 to comply with IED. This is an area of uncertainty as we have not yet received approval from the EA to forgo IED

compliance on the sites we are planning to rationalise in AMP8. Further, we need Ofwat to approve our Kent consolidation cost adjustment claim proposals.

One of our discounted options included costing the sludge treatment centres in Kent that have been identified for rationalisation. Therefore, we have costed the impact of ensuring these sites are IED compliant in the event that our plans are rejected by the regulator (EA/Ofwat), or if the regulator does not agree with our proposed timescales. Our Cost Intelligence Team (CIT) has used cost curves for specific items extracted from the high-level design carried out by our design team, please refer to Section 4 of our IED Enhancement Business Case. The estimated value of the uncertainty has been calculated as £50.4 million.

- **Impermeable surface option:** Our traditional solution for impermeable surfaces is to use concrete as a containment solution. We are looking at an alternative solution using canvas concrete to ensure cost-effectiveness whilst maintaining IED compliance. This solution has been reviewed by the EA on other permitted areas (not related to IED). This is an area of uncertainty as the EA has not yet accepted our proposal to use this alternative solution.

If the EA does not accept our alternative impermeable solution, we will incur c.£23.7 million of additional costs. This has been costed as the difference between our BAU cost of continuing to use concrete as a containment solution compared to the estimated cost of using canvas concrete as a solution, calculated using the different unit rates for the different methods.

- **Emerging EA requirements on dewatering:** We currently have 15 sites where we do dewatering that are not covered by the Appropriate Measures guidance as they fall under exemption T21. This exemption allows us to recover wastes such as sewage grits, screenings and sewage sludge at our wastewater treatment sites. This means that no work is currently planned on these sites. However, the T21 exemption is going to be reviewed, and the potential impact and timing of any impact is uncertain. If the exemption is changed in such a way that our 15 sites fall under the Appropriate Measures guidance (and thus IED) in the future, we will require additional funding.

Given that the Appropriate Measures guidance is not currently in scope for these sites, costing of the potential impact of complying with this guidance has been performed at a high level through desktop study of the sites and unit rates derived by our costing team. Our cost estimate of the implications of ensuring IED and Appropriate Measures compliance for these sites is c.£169.2 million.

Alternative Delivery Routes

We have identified several projects to progress via alternative delivery routes. These projects are all large and complex in nature, each requiring a set of pre-tender activities including (inter alia) design works, planning and consenting, surveys and studies. At present, the majority of the projects identified are at a nascent stage, with most pre-tender development activities yet to commence.

As projects are developed and pre-tender activities are completed, new information can give rise to increases in estimated costs which cannot be reasonably foreseen at the time of business plan submission, nor would it be appropriate to price for such risks at an early stage in the process.

Common sources of cost changes include:

- Greater detail and understanding of the required technical specification for the assets resulting in design changes which increase cost;
- Issues identified during the planning and surveying processes which result in a change in an asset's design (or route, in the case of a transfer); and
- Changes in the market and competition between projects, both of which can result in an increase in the cost of resources such as labour, materials and plant.

The table below summarises current areas of uncertainty within projects we are progressing through alternative delivery routes.

Table 2 - Drivers of uncertainty in projects progressing under alternative delivery routes

Project	Current status and potential drivers of changes in costs
Sandown re-use	<p>SWS is in the process of engaging a delivery partner to develop the detailed design of the project. This may give rise to material changes in cost prior to the commencement of construction.</p> <p>It will also be necessary to acquire land and/or consents for the asset which may impact costs depending upon availability.</p> <p>Sites under consideration include ex-landfill sites and those which are on a floodplain, both of which may influence the design and cost of the project.</p>
Aylesford re-use Ford re-use Sittingbourne industrial re-use	<p>These projects are at an early stage of development, prior to the completion of design, surveys, and planning activities. Each of these activities may reveal factors which change the projects' estimated costs.</p> <p>It will also be necessary to acquire land and/or consents for the asset which may impact costs depending upon availability.</p> <p>Specifically for Sittingbourne, the project will be heavily dependent upon a single industrial user, with whom commercial agreement will need to be reached. This negotiation process has not yet commenced and may heavily influence the costs or viability of the project.</p>
LA highways SuDS	<p>This project is at a particularly early stage of development. SuDS solutions are new to the sector, and early estimations of costs are likely to be based on high-level assumptions of (for example) costs to reduce CSO spills on an area basis, rather than the specific costings for a variety of small interventions. The detailed programme will need to be developed in due course and is likely to result in changes in expected cost.</p> <p>More widely, given the novelty of SuDS and other green solutions, industry estimating costs bases are also less well developed, meaning initial estimations are likely less reliable than for other projects where greater precedent exists.</p> <p>The scale of the SuDS programme may also impact costs. To date, only small 'pilot' schemes have been implemented across the sector. For AMP8, the scale of ambition is much greater, and it is not yet clear how this will translate into economies or diseconomies of scale in delivery.</p>
Wetlands	<p>This project is at an early stage in development. Wetlands solutions are relatively new and programmes have not historically been delivered at scale.</p> <p>The acquisition of land and/or consents across a range of sites is a key enabler for this project and could become a driver of additional costs where issues arise, for example in commercial negotiations with landowners.</p>
Ham Hill & Ashford AAD bio plants	<p>These projects are at an early stage of development, prior to the completion of design, surveys and planning activities. Each of these activities may reveal factors which change the projects' estimated costs.</p> <p>We currently anticipate that the assets could be constructed on land we already own, however this remains subject to confirmation and could impact costs if this assumption is changed.</p> <p>Also, market appetite is uncertain for long term Design, Build, Finance, Operate and Maintain contracts. Initial engagement looks positive but it is uncertain as to what terms we will be able to secure.</p> <p>Further, a range of technologies are under consideration to meet our needs, each of which have different related costs.</p>
Whitfield WwTW	<p>This project is at an early stage of development, prior to the completion of design, surveys and planning activities. Each of these activities may reveal factors which change the projects' estimated costs.</p> <p>It will also be necessary to acquire land and/or consents for the asset which may impact costs depending upon availability.</p>
Smart metering	<p>This project is at a relatively early stage in development, although some development activities have commenced, e.g. market engagement and commercial model design.</p> <p>Unlike large, single assets, smart meters may not require the same programme of pre-tender activities (design, surveys, planning), however the project is exposed to market pricing and supply chain risks across the purchase, supply and installation of meters given the expected increase in smart metering across the sector.</p> <p>Initial market engagement looks positive, but the terms we will be able to secure is still uncertain.</p>

While the table above details several potential drivers of cost changes, the actual issues which affect costs are inherently unforeseeable at the time of writing, or else they would have otherwise been reflected in the cost of the project submitted with business plans. Therefore, it is justifiable to assume that projects can and will change as they are developed.

The total estimated value of the above schemes is £1.3 billion. Given the early stage of development, it is perfectly possible that outturn costs could credibly deviate by 50% from this initial estimate – i.e., a risk of

£600 million. There are recent examples in the water sector of large complex projects increasing by a greater proportion. For example:

- At PR19, the estimated cost of the Haweswater Aqueduct Resilience Programme (HARP) was £766 million. It has since escalated to £1.75 billion at tender launch; and
- At PR19, the estimated cost of Havant Thicket reservoir was £124 million, and has since escalated to at least £330 million.

Both of these projects had uncertainty mechanism approaches to allow costs to be revisited mid-control period. Further detail is provided in the Alternative Delivery technical annex.

Capital Maintenance

The water industry is facing a number of challenges, including ageing infrastructure, increasing demand for water, climate change and rising customer expectation. As a result, water companies are looking at ways to improve asset management practices in order to reduce costs and ensure the long-term sustainability of their networks. We are aware that multiple water companies are submitting cost adjustment claims to their base costs (for example Thames Water and Wessex Water). This stems from the fact that industry-wide studies are showing that current capital maintenance activities are not sufficient to meet the increased pressures and risks posed in the future. These new challenges we are facing as an industry means that we need to put more effort than ever before into understanding our assets and the investment activity required to ensure we maintain our performance commitments to customers.

We are also doing further work to understand our asset base and this may result in changes to the current proposed capital maintenance position.

This work is still ongoing at the time of our business plan submission; thus, we would like to notify Ofwat that as a result of this work we are doing to further understand the health of our asset base, there may be changes to our proposed capital maintenance position post submission. We will be undertaking further work in the Autumn and will be in a position to share further details with Ofwat in early 2024.

By way of illustration of the potential impact, we note that Thames Water is seeking a cost adjustment of £584 million, and Wessex Water is seeking an adjustment of between £86 to £214 million. Normalising by length of main, this would imply additional costs for a company the size of Southern in the range of £99 to £670 million – with a midpoint of £384 million.

3. Mechanism Proposals

We consider that it will likely take 8 weeks from a clear change request to the WINEP / WRMP for an updated set of enhancement cases and data tables to be produced. If such a change request occurs before the draft determinations are published, then we would expect the updated position to be reflected in the final determination allowance, and therefore there would be no need to an AMP8 uncertainty mechanism.

For the NIS update, unless there are further changes made to the cyber assessment framework, we propose to submit an updated enhancement case for NIS and associated data tables in January 2024 (if there are material WRMP and / or WINEP changes expected to be provided to Ofwat in February, we will discuss with Ofwat whether it would make more sense to have a single data table submission in February). This should provide sufficient time for the updated NIS position to be reflected in the final determinations.

For WINEP profiling, WRMP finalisation, and enhanced NIS requirements, we propose to make use of notified items – i.e., triviality and materiality thresholds will apply, with Ofwat assessing the evidence provided and determining whether a within-period adjustment to revenues would be required.

For the remaining areas of uncertainty, if not addressed prior to final determinations, we propose an end of period true-up approach. This would involve us submitting additional information to Ofwat as part of PR29 to explain and justify whether there were any unfunded and efficiently incurred costs in these areas.

We would only seek to use the mechanism if there were material changes arising from change in regulatory requirements relative to our business plan's assumptions. To define material, we propose to use the materiality thresholds that Ofwat set for cost adjustment claims (i.e., 1% of totex for network plus, and 6% of five-year totex for resource controls).

The mechanisms will be two-way – i.e., should costs materially reduce due in the key uncertainty areas identified above, we would expect to have our cost allowance reduced.

4. Justification of the Mechanisms

This section justifies the mechanisms in line with the three criteria that Ofwat set out in its final methodology.

Materiality

Indicative estimates of the potential size of the uncertainty for each area are set out below, and also presented in terms of impact on return on regulated equity (RoRE).

Table 3 – Materiality of each of the mechanisms

Uncertainty area	£m (2022/23)	RoRe impact
1) WINEP re-profiling	725	3.9%
2) WRMP finalisation	402	2.2%
3) Enhanced NIS requirements	100	0.5%
4) Bioresources farming rules for water	83	0.4%
5) Bioresources IED	247	1.3%
6) Alternative delivery routes	600	3.2%
7) Capital maintenance	384	2.1%
Total	2,541	13.7%

The above estimates (with the exception of WINEP) are highly illustrative. There needs to be significant further work to develop robust estimates based on regulatory / legal changes, externally-driven factors.

The total size of the indicative impact shown above is highly material, and could be even higher.

Efficiency of risk allocation and customer protection

The vast majority of the costs are outside of what could be considered prudent management control. The first five uncertainty areas shown above relate to statutory programmes and legal / regulatory requirements. If requirements in these areas were to materialise, SWS would have no choice but to incur highly material costs.

For the schemes being delivered through alternative delivery mechanisms, we have a large number of schemes that are at an early stage of development. Our initial cost estimates could either increase or decrease significantly. Therefore, it is appropriate to have a mechanism that adjusts for this material uncertainty, and is in line with the approach to having cost review points for other major projects at an early stage of development.

So that customers receive sufficient protection, we will propose a set of price control deliverables (PCDs) as part of the updated business plan submission. These will be structured to reflect the nature of any programme of works re-profiled for delivery in AMP8. We will set out the units of measurement, defined milestones (likely to be end of AMP8), and how progress will be measured, tracked, and reported.

Cost-benefit

We are proposing mechanisms with materiality thresholds (standard notified item thresholds for the notified items, and the cost adjustment claim thresholds for the other areas). Should changes to the uncertain areas described in section 3 not exceed this threshold, we would not seek to request additional funding. Absent the proposed mechanism, Southern Water would only receive partial funding at the end of the control period through the cost sharing rates.

The scale of the costs mean that it would not be feasible to leave any true-up to an end of period adjustment, as the business would be unable to shoulder additional costs of this scale without an associated revenue allowance. In addition, it would not be appropriate to only fund (at most) 50% of the required costs through cost sharing rates for a programme that is a statutory requirement.

Our proposals for the end of period true-up also provide clear benefit to customers by being two-way – i.e., should costs materially reduce due in the key uncertainty areas identified above, we would expect to have our cost allowance reduced.

Appendix 1 – Environment Agency Information Letter and SW Response



Information Letter
EA_16_2023 WINEP.r

Information Letter: EA/16/2023



SWS Report on
reprofiling 190723.p

SWS Response Letter, July 2023

These documents are available on request.