Additional

Draft Determination Representations

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Representations within this document

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Bewl and Darwell

Response to query raised 28 May 2019 to Simon Oates

1. Issue

We understand that there is a requirement under the Invasive non-native species (INNS) programme of WINEP that Southern Water (SRN) and South East Water (SEW) jointly develop a solution relating to the transfer of raw water between the Bewl and Darwell reservoirs.

At present, it is not clear to us what the extent of collaboration between SRN and SEW has been and, as a result, that taken together the solutions being proposed are in the best interests of customers both now and in the long term. From business plan submissions we understand that the preferred approach of each company is to commission a separate scheme at different times. However, neither company has presented evidence of collaborative working to clearly demonstrate that a joint solution would not be more cost beneficial than the separate schemes together. We want to better understand the extent to which the two parties have worked collaboratively on this issue to the benefit of all customers.

With this in mind, please could you demonstrate that:

1. You have worked collaboratively on this issue and believe that the current (SEW) and related future (SRN) business plan submissions for resolving this INNS risk represent best value;

2. Further collaboration between you will not deliver a better overall solution; and

3. Your preferred solutions together are the optimal whole life cost option, including when compared to potential joint solutions and the forecast costs of both companies across multiple 5 –year planning periods.

Given the nature of this request it may be most appropriate to consider this issue for final determination, so at the very latest any further information should be submitted as part of your representations on draft determinations that will reflect our above understanding in the absence of additional information.

2. Our proposed remedy and response

Southern Water and South East Water are reviewing the Bewl to Darwell INNS NEP scheme in light of latest information to ensure the optimal solution is implemented during AMP7. We are working together to ensure the environmental driver for the scheme is met whilst providing best value for customers by confirming the best value solution. This will largely take the form of a review of the previous options considered.

We have already held two meetings with a workshop planned in September 2019 between key staff in each company. We will, if necessary, liaise with the Environment Agency to ensure the environmental driver is met. We intend to provide a joint report by end of November 2019 confirming the preferred solution (with respective company elements) in time for the final determination.

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Havant Thicket Reservoir

1. Issue

We are pleased to see an explicit statement of (strong) support from Ofwat for the proposed development of the Havant Thicket Reservoir ("HT"). The project's innovative approach to major infrastructure asset development will set a useful precedent for the water industry and will contribute to fulfilling the recommendations of the National Infrastructure Commission's (NIC's) 'Preparing for a drier future' report[1] as well as being in line with the Government's 25-year environment plan.

We are generally supportive of the position that Ofwat took in the draft determinations with regards to HT. Ofwat's draft determinations provide useful clarity in a number of areas and further details are provided in section 3, Supporting evidence). However, there are a few components of the draft determinations that, in our view, require some amendments and/or would benefit from Ofwat providing further detail on and making additions to the regulatory approach in the final determinations.

In summary, these are:

1. **Guidance on the application of section 37** — the draft determinations do not address how Portsmouth Water (PW) will be able to treat Southern Water's ("SW's") customers on parity with its own whilst complying with its statutory duties. Without assurance that PW can give that parity for the life of HT, SW could not have confidence in receiving a water supply from the reservoir in dry years which could render the HT project futile from SW's perspective.
2. **The regulatory framework** — the draft determinations lack some detail around a number of important elements of the overall regulatory framework for HT overall. Additional detail in terms of, for example, the regulatory treatment of the reservoir once operational would help to finalise contractual arrangements for delivery, financing and funding of the project, which have to be considered and secured on a project lifetime basis.
3. **The allowed cost of capital** — PW have raised a concern with us that Ofwat's draft decision on the cost of capital may create financeability issues for them. This would be a serious concern, as it would likely impact the deliverability of the project. SW have considered alternatives, for example SW financing the HT project itself.
4. **Revenue in SW's determination** — there is no explicit recognition of the project in SW's draft determinations. Having an explicit recognition in our final determinations would help improve transparency around what our customers are paying for.
5. **Asymmetric customer benefits** — Ofwat's approach to cost outperformance sharing places asymmetric cost risk on PW's investors. We are concerned that this might result in PW seeking a higher

[1] The NIC recommended a mix of water transport and storage solutions as part of it infrastructure recommendations, *Preparing for a drier future – England's water infrastructure needs*, NIC, April 2018, p27.

level of economic profit through the bulk supply agreement ("BSA") negotiations to remunerate risks. This would result in an unjustified net transfer of wealth from our customers to PW and its customers.

6. **The treatment of costs** — given the form of control, it is not clear how Ofwat's efficiency challenge will be given effect. Furthermore, the project is in an early stage of cost estimation, which may result in material changes in costs in the future.
7. **Alignment of the delivery incentive to the incentive structure in the BSA** — the draft determinations draw no explicit link between these two overlapping areas. It is also not clear which party would receive the delivery incentive payment should PW fail to deliver the project.

A number of the above features materially affect the commercial terms of the BSA. Gaining further clarity on these will help us progress those aspects of the BSA negotiations. Until we have received further clarity, we will seek to focus our engagement with PW on the technical aspects of the BSA in order to ensure that the project is not delayed. The sooner clarity on the regulatory arrangements is provided, the sooner BSA negotiations can progress with regards to all aspects of the agreement.

2. Our Proposed Remedy

As a consequence of the above stated issues, we are proposing Ofwat make the following remedies in its final determinations:

1. **Guidance on the application of section 37** — Ofwat could use the opportunity, whilst amending PW's licence for the separate price control, to make an amendment to deal with PW and SW's concerns (discussed in more detail below) regarding the interpretation of section 37 in the context of cross-border trading. However, we do not believe that this alone would provide sufficient comfort for either party, and so we would like to invite Ofwat to issue guidance on the interpretation and application of the statutory duty. This would potentially enable PW to guarantee the provision of water to SW, meaning that our customers will be able to rely on the resource that they will pay for.

2. **The regulatory framework** — we propose that Ofwat should provide further detail and clarity in the final determinations on the regulatory framework on a range of areas including the post-2030 treatment, in particular on the shadow RCV and the export trading incentive. This will benefit customers through reducing regulatory uncertainty, thus helping ensure investment in the reservoir. We would be keen to discuss this with you in more detail quickly as, given the innovative nature of the HT structure and funding, we think it could benefit Ofwat and both parties' customers to have more detail on the framework. The regulatory framework could also go some way to answering the query posed in the point above.

3. **The allowed cost of capital** — we propose that Ofwat should consider whether PW is financeable for the allowed cost of capital proposed. While we do not have the information required to test PW's ability to finance this project, this would benefit from independent scrutiny given potential financing risks. If financeability cannot be assured, then it may be necessary to explore alternative financing and delivery options, for example SW financing HT itself. This approach will benefit customers because it will reduce the risk of project non-delivery.

4. **Revenue in SW's determination** — to provide further transparency, we would propose that Ofwat sets an explicit cost allowance line in our final determination for HT, setting the BSA costs for SW. This will help to ensure regulatory consistency and that the two companies' draft determinations are suitably aligned.

5. **Asymmetric customer benefits** — Ofwat should amend its regulatory approach so that PW is not exposed to asymmetric risk (i.e. for PW's investors to be exposed to 50% of any cost over- or under-performance). This approach will benefit our customers because without this amendment, we suspect Ofwat's approach will result in PW seeking a higher level of economic profit through the BSA negotiations to remunerate them for this risk. This would result in a transfer of wealth from our customers to PW and its customers.

6. **The treatment of costs** — we suggest that Ofwat considers setting an adjustment mechanism to update its view on cost allowances as cost estimations develop with greater certainty and become more robust. This approach will benefit our customers because it reduces the risk of them bearing costs based on early forecasts that may be materially greater than future forecasts once more information becomes available.

7. **Alignment of the delivery incentive to the incentive structure in the BSA** — it is vitally important that PW is subject to an appropriate set of incentives to deliver HT. Therefore, the incentive structure in the BSA and any ODIs need to be considered holistically.

3. Supporting evidence

3.1 Guidance on section 37

During our discussion on the bulk supply agreement ("BSA") with PW, PW raised the point that it must comply with its section 37 duty (the general duty to maintain water supply system etc.[2]). PW's interpretation of this provision is that it must prioritise its own customers, and in the event of a drought it would need to utilise the extra capacity from HT for its own customers despite it having been built at our customers' expense to supply to our customers. A right to do this was explicitly proposed by PW in the first draft of the BSA:

> *"PW has an obligation and imperative to provide water to its own customers as a priority. As such the Water Supply under the BSA will be an "interruptible supply" and not an absolute guarantee of Water Supply to SW."*[3]
>
> *"…PW may reduce, restrict, interrupt or suspend the Water Supply (or refuse to make the Water Supply available) at any time during the Water Supply Service Term and for any reason."*[4]

Given that our core driver to invest in the reservoir is to secure a supply of water to our customers in dry years, this position and interpretation of the legislation could potentially severely undermine the will to enter into the BSA.

The parties have had a series of positive discussions since this issue arose, and PW have indicated that it would be willing to treat our customers (supplied via the BSA associated with HT) on parity with its own customers, if it could gain certainty that they would not be penalised by Ofwat for doing so, and that a parity approach is consistent with the whole legislative and regulatory framework.

One such tool to achieve that certainty which we discussed with PW would be to amend PW's licence. Given that Ofwat is proposing to amend PW's licence to reflect the separate price control it would be a good opportunity to make a further amendment. We propose an amendment along the following lines:

> "*As per the terms of its bulk supply agreement with Southern Water Services Limited for the water associated with the Havant Thicket Reservoir, the Appointee shall, not show undue preference towards itself or any of its customers or potential customers, or undue discrimination against Southern Water Services Limited in the management of and supply of water from its network as it relates to the provision of water to Southern Water Services Limited.*
>
> *For these purposes, preferential or discriminatory conduct will be "undue" in all circumstances other than where the Appointee's general duty to maintain an efficient and economical system of water*

[2] Water Industry Act, Section 37.

[3] 'PRT.CMI.A1 Appendix 1_BSA Heads of Terms_14 March 2019', shared by PW 07/05/19.

[4] 'DRAFT BSA v310519 for Circulation to PW v.3', shared by PW 05/06/19.

> *supply, pursuant to section 37 of the Water Industry Act 1991, will be severely compromised by virtue of exceptional circumstances."*

However, we do not think this amendment alone (or indeed any amendment to PW's licence) would be sufficient to prevent PW from prioritising its own customers in order to comply with its section 37 obligations.

Without intervention from Ofwat, the section 37 obligation could hamper efforts to encourage cross-border trading of water, not just between us and PW but more widely across the industry, potentially limiting trading to circumstances where a water company is just selling existing excess capacity rather than building new infrastructure to create extra capacity. To this end, SW would like to invite Ofwat to provide assistance in overcoming this issue. SW requires comfort that it will receive water from HT in the event of a drought and PW requires comfort that it will not be penalised for providing the supply at the expense of its own customers.

Whilst we recognise that a change in the primary legislation is unlikely to be forthcoming, there are steps that Ofwat could take beyond the proposed licence change to give both parties the additional certainty about how Ofwat would interpret and enforce section 37 in these circumstances. Our initial suggestion would be that Ofwat could issue guidance on how section 37 would be interpreted where water companies have taken advantage of cross-border trading. The guidance could be issued to the industry generally, as part of PW's final determination or, if preferable, in a private letter to us and PW. Such guidance would enable both parties to understand how Ofwat would apply section 37 if PW's supply was not sufficient to meet both our and its own customers' demands. However, we would also welcome any alternative suggestions that Ofwat may have which could give both parties the comfort they require to proceed with the BSA.

3.2 Regulatory framework

We have some concerns that the novelty and the lack of supporting detail regarding the regulatory treatment of HT may reduce investors' propensity to invest in the project and PW more broadly.

In the draft determinations Ofwat proposed a new regulatory framework, affecting a major part of PW's business, in roughly 20 pages. While there were a series of useful details and principles provided, we consider that it would be helpful for further detail and clarity to be provided in the final determinations.

We note that a company-specific separate control for certain activities is not unprecedented. For example, Thames Water has a separate price control for its interfacing activities for the Thames Tideway Tunnel project ("TTT"). However, we note with the TTT example, the separate price control was proposed by the company in question, discussed with the company ahead of the PR14 draft determinations (rather than being introduced by them), and represented a much smaller proportion of its overall business.

We consider that there would be no or minimal cost to Ofwat caused by providing further clarity on the regulatory framework and doing so could help allay the concerns that PW has regarding investor uncertainty. In particular, we consider that further clarity could be provided on:

The regulatory treatment post-2030

There is little detail in the draft determinations on the regulatory treatment of the HT project beyond 2030. The extent of the detail provided in the draft determinations is a statement that Ofwat considers there is merit in aligning future price limits to the regulatory cycle for other wholesale price controls, for example determining five-year price limits.

We recognise that it is standard practice for regulators not to make extensive policy statements about future price reviews, and to maintain a fair degree of future discretion. However, given the relatively large amount of investment that will be required from PW, and the life of the project and corresponding contractual arrangements, it is of particular importance for Ofwat to set out at the very least the key principles about the longer term regulatory treatment of HT in the final determination, for example, the approach to the allowed cost of capital.

Shadow RCV

In the draft determinations, Ofwat uses the term ‘shadow RCV’. Ofwat states that it uses this approach to recognise that while it is using a building blocks approach, many of the protections of stranding risk are captured under the proposed BSA between PW and SW.

We are not clear on the distinction between shadow RCV and regular RCV. Further clarity would be welcomed. Unless there are good reasons not to, we recommend the term ‘RCV’ is used, not ‘shadow’.

Export trading incentive

In the Havant Thicket Policy Issues Appendix, Ofwat makes a series of statements about economic profit and the treatment of the export trading incentive.

Table 1: Ofwat statement in the Havant Thicket Policy Issues Appendix

#	Ofwat statement in the Havant Thicket Policy Issues Appendix	Reference
1	“Towards the end of the ten-year period we will consider any necessary revenue adjustments in relation to the period from 1 April 2030. This will include any necessary adjustment to ensure that customers share the benefits of any economic profits.”	p12
2	“In general, we would not expect Portsmouth Water’s investors to earn an economic profit in advance of the water being available to supply.”	p13
3	“To the extent that the complex allocation of costs, benefits and risks during construction also makes an allowance for economic profits during construction difficult to estimate, we propose to make adjustments in determining price limits from 1 April 2030 for the difference between the actual and assumed bulk supply revenues for the 2020-30 period. These adjustments will ensure that customers and shareholders receive their appropriate share of benefits from trading consistent with the proposed cost and risk sharing arrangements proposed.”	p13

Source: Ofwat

From the statements provided in the draft determinations, the proposed treatment of economic profit is not clear. We note that Ofwat proposes to set out its reconciliation model for calculating these revenue adjustments for future price limits with the final determinations. This may provide sufficient clarity. However, if Ofwat were able to provide any further clarity on the treatment of economic profit and the export trading incentive in advance, that could help SW and PW progress with the BSA negotiations ahead of the final determination. We assume that Ofwat’s standard position of economic profit being split 50:50 between the exporting company and its customers will apply.

3.3 The allowed cost of capital

We note that Ofwat has set an allowed WACC (CPIH, real) of 2.72% (which may be subject to change for the final determinations), representing the industry WACC, with no allowance for embedded debt, plus PW’s small company premium.

We note that when Ofwat estimates the industry WACC, it uses a notional financial structure, which assumes the same level of gearing, embedded and new debt costs across the sector. Ofwat’s approach for HT deviates from this approach by setting a project-specific WACC.

Moving away from the well-established approach of setting the same cost of capital for all investments in the sector would require extensive consultation and consideration as to the incentive effects on companies.

PW have raised a concern with us that this comparatively low WACC may create significant issues for PW to secure financing for the project and hence for financeability of PW overall.

PW are better placed than us to assess whether their business including HT is financeable. However, if HT were to cause PW to be non-financeable, this could undermine project viability and delivery for customers based on the current approach of PW's on balance sheet delivery.

While there may be means to compel PW to progress with the project (such as a strong outcome delivery incentive, a section 40 determination[5], or a licence change), we consider all of these to be sub-optimal compared to PW voluntarily progressing the project.

If including HT and Ofwat's regulatory treatment were to make PW non-financeable, there are a number of alternative options that could be considered:

1. **Use a Direct Procurement Customers (DPC) approach** – This approach has significant drawbacks and Ofwat has already ruled out DPC for HT.
2. **SW finances the project** – SW has a larger balance sheet, and so (depending on the final determinations) may be able to finance HT where PW cannot. Initial analysis has shown that SW's credit rating would not deteriorate materially, therefore we may be able to accommodate HT without credit risk or a risk to our customers.
3. **Creation of a stand-alone vehicle** – Depending on how the vehicle is structured, this could help improve the financeability of the project.

We have not explored these options in detail, but we note that alternative arrangements might be possible. However, we are concerned that any such alternative approach could have negative implications for timing and delivery of the scheme.

Should Ofwat consider that alternative delivery mechanisms may be required, Ofwat may wish to consider stating a mechanism in the final determinations that would enable alternative treatment, for example, the ability to transfer RCV allowances between the two companies, should SW be required to deliver the project itself.

3.4 Revenue in SW's determination

Although the draft determinations provide a large degree of transparency as to the treatment of costs and revenues for PW, there is no explicit recognition of the project in SW's draft determinations.

[5] Section 40 of the Water Industry ACT 1991 provides for Ofwat to intervene on the terms of bulks supplies.

To provide further transparency, we suggest that Ofwat shows an explicit line in our final determination, showing the BSA costs to SW. This should help ensure that the two companies' draft determinations are suitably aligned.

3.5 Asymmetric customer benefits

In Ofwat's draft determinations, Ofwat propose that any cost overruns of the project should be shared between PW and SW (50:50) without any adverse consequences for PW's customers. Ofwat also proposes that PW customers should share in any cost outperformance, receiving a 50% share of the cost outperformance retained by PW. This results in a pure subsidy/gain for PW's customers on an expected basis without any corresponding risk. This is not justified from an economic or financial perspective, and requires an amendment in the final determination.

This approach would expose PW as a company to asymmetric risk – i.e. 50% of cost overruns, but only 25% of cost outperformance. We suspect that this will result in PW seeking a higher level of economic profit through the BSA negotiations to remunerate them for this risk. This would result in a transfer of wealth from our customers to PW and its customers.

Given that the HT regulatory approach is to entirely insulate PW's customers from any cost overrun risk, we do not see why they should receive any benefits from cost outperformance.

Though not sharing any cost outperformance, PW's customers would benefit from the proportion of economic profit that will be passed on to them through the export trading incentive mechanism, and the option of PW using the surplus capacity from the reservoir itself or selling to a third party, (in the event that SW does not exercise its overriding right to do so.

3.6 The treatment of costs

Allowed costs

In the draft determinations, Ofwat states that it has applied an efficiency challenge (as detailed below). However, from the form of control, it is not clear how such a challenge will be given effect.

The form of control that Ofwat is proposing to put in place is a total revenue control, which is net zero with respect to revenue – i.e. zero impact on PW customers. It is unclear whether if PW incurred much higher costs, and had an agreement in place with SW to pay these costs, whether this would comply with Ofwat's control, or whether Ofwat would expect PW's investors to bear 50% of any cost overruns relative to Ofwat's efficient view of costs. Given that PW and SW have yet to agree a BSA, gaining clarity on this point now, is highly important.

If Ofwat is expecting to make its view of costs a 'hard requirement' in the final determinations (for example, by reflecting the cost assumptions in PW's licence), then it will need to be recognised that PW's cost estimates are still in a relatively early stage of development.

One approach could be to have an assumed position on costs for the final determinations, but for an updated view to inform any 'hard requirement' to be provided in two years' time once further work on cost estimation has been undertaken.

Cost estimation

We note that in the draft determinations Ofwat applied the following challenges to PW's cost estimates for HT:

Table 2: Ofwat challenges to PW's cost estimates for HT

	Requested (£m)	Allowed (£m)
Whole programme P50 Cost	105.600	92.922
Resilience work in PW network to support transfers	31.800	28.620
Less environmental mitigation (post 2029) included in P50 costs	-2.100	Incorporated
TOTAL programme TOTEX (to 2029)	135.300	121.542

Source: Ofwat (2019) 'Havant Thicket Separate Feeder Model'

At a high level, this equates to a 10.2% challenge on costs. [redacted]

While at a high level, our own cost expectations for HT are broadly similar to Ofwat's, it should be noted that the reservoir is still in an early stage of development, and we have seen material changes in cost estimates from PW as they further refine the scope.

By way of background, SW engaged with PW through the development of the draft WRMP during 2017. Originally the costs for construction of HT were based on a forecast of £65m, which PW advised to us. In 2018, following further discussions, we were advised that the cost of HT should be increased to £95 million (a total cost of approximately £125m, which included £30m for PW's infrastructure improvements). In 2019, PW's estimates for the Project have further increased to £135m.

This is not a criticism of PW's approach to cost estimation, simply a statement of fact that the cost estimates are still in a relatively early stage.

Reinforcement of PW's network

As stated above, we understand that the draft determinations include the assumption of £28.6m for reinforcement to PW's network. This is a material component of the total project costs (c.25%). However, we have not yet seen clear evidence from PW that:

- this reinforcement work is definitely required;
- there are no concomitant benefits from this reinforcement investment to PW's customer base more broadly.

Clearly if the reinforcement work is not required, then the overall cost estimate for the project would materially change. The reason we raise the second point, is that if PW customers were to be significantly benefiting from this investment, it may be appropriate for part of the costs to be borne by PW customers (i.e. through PW's main price control), rather than by our customers. Furthermore, we are in discussions with PW about different options for delivery through their network, which could potentially reduce the cost.

This material uncertainty in the cost of the project further supports the idea of providing a mechanism to update cost estimates once further cost estimation has taken place.

3.7 Alignment of the delivery incentive to the incentive structure in the BSA

We note that Ofwat is proposing that PW should be exposed to a bespoke performance commitment and associated financial penalty linked to delivery of the HT reservoir.

We are currently negotiating with PW what the appropriate incentive structure could be within the BSA negotiations (e.g. liquidated damages). One of the issues we have come across is that the cost to our customers of PW not providing the water (in certain circumstances) is much greater than the revenues that PW could provide without becoming non-financeable. We are currently seeking to negotiate a set of terms that both parties could accept.

Given this issue, it would make sense to consider the total amount that PW is exposed to under Ofwat's delivery incentive and the BSA's liquidated damages together.

We also suggest that Ofwat considers structuring the ODI to align to different milestones of the project, rather than leave the entire payment depending on completion in 10 years' time. For the latest view of relevant milestones, we suggest Ofwat speaks to PW. However, based on our previous discussions with PW, we provide an indicative set of milestones as illustration below:

- End of April 2020 – ITT ready to issue.
- End of March 2023 – Detailed design and environmental mitigation works complete.
- End of September 2026 – Embankment construction complete.
- End of March 2029 – Reservoir fully commissioned and water available for use.

We consider that having a series of milestones could help provide greater certainty that the project was on track to be delivered on time. These milestones could be structured in a similar way to the gated process that Ofwat has set out in 'PR19 draft determinations: Strategic regional water resource solutions'.

Although the draft determinations did not explicitly state so, we assume that should PW fail its performance commitment, the delivery incentive payment would be paid to SW and its customers, as we are the customers of the project, and any failure of PW to deliver the project on time and to specification would result in a negative impact to SW and our customers. We would appreciate clarity on this point in the final determinations.

3.8 Other observations on Ofwat's draft determinations

Separate price control

We support the use of a separate price control for HT. We consider that this will help improve transparency of cost and revenue allocation. This is particularly important given PW's commitment that its customer base will not be negatively affected by the construction of HT, and the assurances we require from the project that our customers will not be unduly cross-subsidising PW's customers.

For the avoidance of doubt, we are not supporting the concept of a separate price control being applied across the water sector for every large project – we would consider that to be disproportionate. However, in the specific context of HT, where the investment is leading to a near doubling of PW's RCV, and where there are additional clear drivers for increased transparency due to the interactions of our respective customer bases, we consider a separate price control is a sensible approach.

Stranding risk

In the draft determinations, Ofwat states that stranding risk should be shared between PW's shareholders and SW's shareholders and customers. We agree with this principle, and will use it as the basis for further discussions on termination payments with PW in our ongoing BSA negotiations.

4. Data tables affected by this response

We have aligned the costs in WS2 for Havant Thicket with those in the draft determination for Portsmouth Water. There is a follow on impact on WS1.

Table Reference	Table Title
WS1	WS1 - Wholesale water operating and capital expenditure by business unit
WS2	WS2 - Wholesale water capital and operating enhancement

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