Targeted Controls, Markets and Innovation

Draft Determination Representations

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Representations within this document

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Funding of schemes subject to DPC market testing

1. Issue

This response relates to actions SRN.CMI.A5-A8. In its draft determination, Ofwat has provided an efficient level of funding for development of strategic regional water resource options, including desalination and alternatives, a transfer from Thames and transfers from Wessex and South West Water. We welcome this aspect of the draft determination.

Ofwat has recognised our need for early decision gates, due to our Section 20 agreement with the Environment Agency that requires us to deliver long-term solutions to the supply-demand deficit in Hampshire by 2027.

Ofwat has also proposed an uncertainty mechanism that would apply in the event that a value for money assessment supported a decision to move from a DPC approach to a traditional in-house delivery process. Any such decision would require Ofwat's approval. The draft determination states:

> *"Where we expect companies to develop projects through a direct procurement for customers process at the final determination stage, we propose to include an uncertainty mechanism in final determinations which, unless a scheme is deferred to a future price control, facilitates the transfer of a scheme back into the traditional in-house model to ensure timely delivery.*
>
> *Our preferred uncertainty mechanism in those circumstances would be a notified item detailed in a company's final determination and which could, subject to relevant thresholds, trigger an interim determination."*

Ofwat is therefore proposing the adoption of a formal interim determination under condition B of the relevant company's licence as the applicable DPC uncertainty mechanism.

We have significant concerns with this proposal. For Southern Water, it would mean that the company would bear, in full, the additional costs that would fall on it during AMP7 in the event that a value for money assessment concludes that it would no longer be cost effective to proceed by way of a DPC. We consider that it is not reasonable for Southern Water to bear this risk in circumstances where the decision to move from a DPC approach to a traditional in-house delivery process would by definition be both beyond its control and subject to Ofwat approval. This is because a formal interim determination:

a. Is subject to a high materiality threshold (c.£75m in the case of Southern Water), which we would be unable to meet unless scheme construction costs are materially higher than we currently expect.

b. Requires consideration of a range of additional costs and cost savings attributable to the company in the remaining AMP that would go well beyond consideration of the additional costs associated with the abandoned DPC. The process is not to be undertaken lightly and would impose a significant administrative burden on Ofwat and Southern Water alike, most likely in the run up to PR24, or even during it. There are many hurdles in the way of a successful interim determination as is illustrated by the fact that there are no recent examples of a successful application. An interim determination is a disproportionate measure to address a very specific cost uncertainty; especially one that arises from a decision that would have been subject to detailed scrutiny and approval by Ofwat.

A successful interim determination late in AMP 7 with only a few years left in the price control could also produce a large unanticipated bill increase for water customers.

We agree with the need for an uncertainty mechanism but we propose an alternative remedy based on the WINEP uncertainty mechanism, using unit costs to adjust revenue in the event that Southern Water constructs the solution.

2. Our Proposed Remedy

Southern Water proposes that Ofwat should adopt an uncertainty mechanism for DPC that is derived from the WINEP uncertainty mechanism. This mechanism would be based on unit costs for particular solutions, where a cost driver is known in advance but the need for the scheme and its scale maybe uncertain.[1]

Southern Water and Ofwat agree that the desalination plant or alternatives[2] are suitable for DPC, and in the event that route is used, Southern Water would need to pay the Competitively Appointed Provider (CAP), most likely beginning when water was available, i.e. in AMP8. This route would allow for PR24 to determine an efficient funding allowance for Southern Water to pay the CAP.

If on the other hand a DPC value for money assessment concludes (with Ofwat's approval) that the project should be constructed by Southern Water on a traditional in-house delivery basis, we propose:

- An uncertainty mechanism based on agreed unit costs.
- Unit costs for each Ml of additional capacity will be developed and approved by the gate process being developed for strategic water resource solutions.
- We will set out these amounts for the desalination plant and the [redacted] re-use schemes, which is the current alternative to desalination.
- At gate 4 (April 2023 in Southern Water's case), by which point we will have developed a DPC business case, we would present final versions of the unit costs for the preferred scheme to be used in PR24 for a revenue adjustment, as we will need to have reliable benchmarked costs to assess the DPC tenders against.
- That in the event Southern Water needed to carry out construction, it would proceed at its own cost initially but the uncertainty mechanism would provide sufficient assurance that revenue could be adjusted at the start of AMP8 (2025) on a clear and agreed basis.
- PR24 would enable Ofwat to assess the efficient level of costs incurred to date relative to the unit costs set out at gate 4.

This method is comparable to Ofwat's option b) described in the draft determination appendix *Delivering customer value in large projects*.

[1] See example in our draft determination 'Southern Water – Cost efficiency draft determination appendix', July 2019.
[2] The current alternative to the desalination plant is the River [redacted] re-use scheme. This scheme has not yet been assessed for suitability for DPC, but for the purposes of this response it is assumed that if it were chosen it would also be assessed for DPC and would be subject to a similar uncertainty mechanism.

3. Supporting evidence

3.1 The interim determination process

The process for a company to apply for and Ofwat to make an interim determination is set out in Condition B of our Licence. There is a generic summary of the process on Ofwat's website:

> *"All companies can ask us to reset their price limits between five-yearly price reviews. They can ask for this if specific changes lead to a significant reduction in their revenue or increase in their costs. This is known as an interim determination.*
>
> *When we receive an application from a company we look at this against the list of criteria set out in its licence.*
>
> - *Materiality – we test the application against a set level. If the changes in costs, receipts or revenues are at least equal to 10% of the company's turnover we say the application is material. A company can add together a number of specific changes.*
>
> - *Triviality – if the value of a change relating to one issue is less than 2% of the company's turnover then we would not include this in the materiality test.*
>
> *If the company has an application that passes the test of materiality, we will examine the application and may adjust its price limits.*
>
> *The specific changes that can lead to an interim determination are called relevant changes of circumstance and notified items. Relevant changes of circumstances are described in companies' Licence Condition B. Notified items are set by us at a price review.*
>
> *Interim determination applications must be submitted at least 6 months in advance of the charging year. Interim determinations normally cover the remaining time until the next price review and the new price limits set apply from the start of the next charging year in April."*

We would need to put in a claim for additional costs arising under the DPC notified item. But according to the process set out we would also need to factor in additional costs and offsetting savings arising under other relevant changes of circumstance. Those items are (i) a change of law; (ii) a change in the value at land disposals from that anticipated at the periodic review; and (iii) a failure to achieve an output for which funding was provided at the periodic review. The interim determination process as set out in the Licence is therefore not limited to a single issue.

3.2 Materiality threshold will not be met

The aggregate value of the claim, in present value terms, must exceed the materiality threshold of 10% of Southern Water's turnover. When assessing an interim determination involving capital expenditure, Ofwat is required to consider only the capex that falls within the remainder of the AMP in which prices are to be re-determined.[3]

We consider below whether the desalination scheme is sufficient on its own to successfully trigger an interim determination. We have chosen the desalination plant for the purpose of this illustration because it is, at this time, the preferred option, subject to the gated process for strategic water resource solutions, and construction needs to start in AMP7. While two or more DPC schemes might combine to satisfy the interim determination materiality threshold, it cannot be right that the decision to fund additional costs of construction for one scheme is dependent on the withdrawal of multiple DPC schemes.

Table 1 below uses the development costs and construction costs that were in our September 2018 plan, before the costs were removed and replaced via the strategic regional water resource solutions process introduced by Ofwat via the IAP. It also uses the profiling of these costs from the September Business Plan. The calculation is a very simplified version of the materiality test that Ofwat would carry out, as set out in the Licence. The calculation is illustrative only. We set out:

- The present value of the capex expected to be incurred in AMP7
- The relevant appointee turnover as that shown in the draft determination for 2022/23
- The PV of capex as a percent of turnover.

Table 1. Summary of illustrative materiality calculation

	Costs in AMP7	Total costs including after AMP7
PV of construction costs as originally proposes	£41m	£154m
Turnover in 2022/23	£745m	£745m
10% of turnover	£75m	£75m
PV of costs as % of turnover	5.5%	20.7%
Materiality met?	No	Yes

Unless the final scheme selected costs are materially more than currently expected, the construction costs due in AMP7 only will not meet the materiality threshold. Alternatively, total capital costs (including those incurred beyond AMP7, as shown in the right hand column of Table 1) could be included. However, to do so would not agree with the provisions for interim determinations set out in Condition B.

[3] Condition B section 14.2 of Southern Water's Licence.

The costs above have been subject to an efficiency reduction of 7%.[4] The full calculation is shown in the 'TA_TC_ Materiality threshold supporting calculation' file.[5]

Note that the scheme is allocated to the water controls. We have a much greater number of waste than water customers, so to meet the materiality threshold on 10% of total turnover (c.£75m) we would need the capex of the scheme to exceed c.38% of our water turnover.[6]

3.3 Obstacles to a successful interim determination

Aside from the 10% materiality threshold, there are multiple obstacles in the way of a successful interim determination which make it inappropriate as the DPC uncertainty mechanism.

The main obstacle is that an interim determination requires consideration of all "notified items and relevant changes of circumstances". That requires the company and Ofwat to consider, among other things, whether there have been any non-trivial costs or cost savings arising from changes of law, changes in land disposals from that anticipated at the periodic review and any failure to achieve an output for which funding was provided at the periodic review. An interim determination therefore could involve revisiting a large number of cost items and represent a significant administrative burden for both Ofwat and the company.

The challenges associated with making an interim determination are illustrated by the fact that there has not been a successful interim determination since Bristol Water in 2007, as far as we can identify.

We consider that in this case there should be a straightforward uncertainty mechanism that is limited to a focus on additional costs that have fallen to the company because a value for money assessment has concluded that the DPC approach is no longer cost effective for a particular scheme. The circumstances where this was needed would already have been subject to scrutiny by Ofwat as the DPC uncertainty mechanism would only be called upon in circumstances where there has been a decision not to proceed with a DPC and Ofwat has approved this.

3.4 Applying late in AMP7 could produce a large bill increase

Applications must be made at least six months in advance of the charging year where revenue would be adjusted via the interim determination.

The most likely time we would be applying would be at Gate 4, i.e. April 2023 in our case. This would mean that the interim determination would take place during 2023/24 and the only charging year to be affected would be 2024/25, i.e. the final year of AMP7. While an adjustment of the appropriate magnitude could be made in one year, this could produce a significant bill increase in a single year. The example given above

[4] We have challenged the application of efficiency challenges such as this elsewhere in our response.
[5] See 'TA_TC_Materiality threshold supporting calculation.xlsx'
[6] £75 million / £197 million. See the full 'TA_TC_Materiality threshold supporting calculation.xlsx'

requires additional totex of c.£75m to be successful. There is a significant risk this might all be needed via an increase in totex allowance and hence revenue and customer bills in 2024/25.

For illustration, we use a totex increase of £75m and the average PAYG rate of 45.2 % for our wholesale water network plus control used by Ofwat in the draft determination. This would imply an increase in the PAYG totex of £34m. For comparison the draft determination indicates wholesale water revenue of c.£200m in that year.[7] The result would be a bill increase of around 17% in a single year, assuming no other impact from revenue building blocks such as RCV run off or return.

3.5 Our proposed remedy

In this section, we compare and contrast the two alternative options for a DPC uncertainty mechanism, namely:

- Ofwat's proposal for a "Notified Item" leading to a possible interim determination
- Our proposal for a unit cost method, comparable to Option B in Ofwat's *"Delivering customer value in large projects".*

The context for this comparison is that we are under a legal obligation to use all best endeavours to implement the long-term solutions in our WRMP and hence eliminate the supply-demand deficit in South Hampshire by 2027. This will require multiple large capital schemes. The extent to which other schemes in the programme can be delivered at planned or increased capacity will determine the capacity needed to be met by de-salination or alternatives.

Until that time, the agreement with the Environment Agency anticipates the regular application for drought permits or drought orders. In the absence of these orders we will not meet our planned levels of customer service for likelihood of usage restrictions until the long-term solutions are implemented. For the purposes of this response we therefore assume that it is in our customers' interests that a solution of some form that can deliver the capacity proposed for the desalination plant is implemented within the relevant timescales. As a result, the pros and cons are written from the perspective of practicality of implementation, rather than, for example, delivery of benefits to customers, as displayed in Table 2.

Table 2. Pros and Cons of alternative options

Option	How it would work	Pros	Cons
Notified item	Interim determination according to Licence 1 or 2 years of AMP7 affected Rest of costs set in PR24	Clear process Certainty if successful Same treatment for all projects	Materiality threshold likely to fail High AMP7 bill impacts Licence procedure sets high bar

[7] The bill impact could be mitigated by the application of the PAYG ratio, which would require only a portion to be funded directly by bills in a single year. A significant bill impact would still result.

Unit Cost method	Review in PR24 using unit cost rates agreed in gated process Southern Water bears costs in AMP7 Revenue and totex adjusted in AMP8 using unit costs AMP 8 capex assessed as part of PR24	Southern Water bears costs in AMP7 – no unexpected price increases Gate process ensures unit costs are robust Price impacts can be smoothed via PR24 Unit cost method ca address capacity requirements whether higher or lower Ofwat can use unit costs to benchmark expenditure actually incurred	Lack of statutory basis Relies on gated process- still in development Parallel development of unit costs for desalination, alternatives to it and other schemes potentially subject to DPC

We consider that the unit cost method with Southern Water bearing costs in AMP7 and allowances made in AMP8 via PR24 is the most practical option.

4. Other potential DPC schemes

We accept Ofwat's designation of other schemes as potentially appropriate for DPC:

- [redacted] industrial re-use
- [redacted] indirect potable re-use
- Inter-zonal transfers in Hampshire.

We note that uncertainty mechanisms should also apply to these schemes in the event that DPC does not go ahead.

5. Data tables impacted by this representation

Table Reference	Table Title
Table WS10	Transitional spending in the wholesale water service
Table WS1	WS1 - Wholesale water operating and capital expenditure by business unit
Table WS2	WS2 - Wholesale water capital and operating enhancement expenditure by purpose