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PR19 draft methodology

Water 2020
Ofwat
Centre City Tower
7 Hill Street
Birmingham
B5 4UA

30 August 2017

Dear Sir/Madam,

PR19 draft methodology

We are pleased to respond to Ofwat's consultation on its draft methodology for PR19. Our response follows Board discussion of and input on Ofwat's proposals and their potential impact.

While Tideway is not subject to the price review, we will be affected by its outcome. We have reviewed the draft methodology through three lenses: the impact it will have on Thames Water supporting the delivery of the project over the period 2020-25, changes in regulatory focus and expectations which may affect us prior to 2030 and the potential implications for Tideway from 2030 when we are expected to come under the industry price review cycle.

PR19 themes

We are supportive of Ofwat's four PR19 themes and have recently met with Cathryn Ross, Keith Mason and David Black to discuss how great customer service, innovation, resilience and affordability apply to Tideway and our approach in these areas. We believe there is a common understanding between us on the relevance of these areas and how we are taking them forward. We have discussed with Ofwat Tideway's approach to innovation, including specific initiatives such as our award winning Health and Safety training which we open up to other organisations, inclusivity in the workplace, engineering solutions, support for direct procurement and our plans for new and enhanced public spaces. To support our aims we have with others established a formal innovation programme which has engaged 23 other client and supply chain organisations. Innovation is central to Tideway as we take the project forward and seek to deliver the best outcomes for all stakeholders. We have offered to support Ofwat as it continues to refine its approach to innovation and will continue to push for a sustainable and collaborative approach to innovation across the water, infrastructure and construction sectors.

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Methodology

We note Ofwat's approach to risk and return and the recognition that companies need to be remunerated for the risk associated with their investment. We acknowledge the proposed approach to financeability, which needs to ensure that revenues, relative to allowed costs, are sufficient for a company to finance its investment on reasonable terms. This is important to maintain investor confidence in light of the continued need to attract substantial capital to the sector. It was this confidence in the regime that was a major factor in the successful procurement of Tideway itself (as the Infrastructure Provider for the Thames Tideway Tunnel) leading to a cost of capital of c. 2.5% and corresponding positive impact on customer bills. It will be important for Ofwat to maintain a balanced approach to risk and return for PR19 and future price controls to support investor confidence, the financing of the sector and ultimately as a key driver of customer affordability.

In the short term, Tideway is most affected by PR19 through its impact on Thames Water, and in particular the arrangements for Thames Water's TTT price control. It is important that Thames Water's works are adequately funded and that the company is incentivised to support the successful completion of our project. We support the maintenance of a separate TTT price control to allow a focused approach to be taken to funding and performance commitments for Thames Water's TTT works. In particular, Ofwat's standard approach to cost assessment may not adequately recognise the specific activities required of Thames Water to support the project. We would welcome further clarity from Ofwat on its proposed approach in this case. To ensure that we are able to support the proposals that Thames Water puts forward in its business plan we have already begun to engage with the company on its plans.

Ofwat's proposals may have other impacts on Tideway during AMP7 such as through the design of the wholesale charging arrangements and the possible unintended impact on the collection of Tideway's Allowed Revenue. It will be important to ensure that any impact on the mechanics of this collection process is well understood as details are finalised and that arrangements are consistent with the provisions relating to Tideway's revenue set out in the licences of both Thames Water and Tideway.

Longer term implications

Looking further ahead, there are other aspects of PR19 that may affect Tideway if they remain as part of Ofwat's approach beyond 2030. This includes the shift to CPIH, which we comment on in our response. As Ofwat indicated in its May 2016 Water 2020 decision document, Tideway will not transition to CPIH before 2030. However, as set out in Ofwat's economic guidance, in broad terms post 2030 Tideway will be regulated in accordance with the prevailing regulatory regime for wholesale activities. Ofwat indicated in May 2016 that this may include a transition to CPIH. If Tideway is to transition to CPIH at that time it will be important that market conditions for CPIH financing exist and that the arrangements are designed so as to be in the long term best interests of customers. We would be pleased to discuss how this and other aspects of Ofwat's approach to PR19 might affect Tideway in the future.

Beyond the implications set out above, we see some aspects of PR19 which have wider applicability than the price review itself, and may ultimately be reflected in industry reporting and governance requirements that affect Tideway. For example, this may include requirements in relation to corporate and financial resilience. Tideway is keen to perform well in these areas and monitors its own performance alongside Ofwat guidelines and other requirements.

Engagement

To support a successful PR19 for customers, we will continue to engage with Thames Water on its plans to support delivery of the project and will, as appropriate, liaise with Ofwat. We are keen to support Ofwat as it continues to develop its thinking in relation to both direct procurement and innovation. We will also be meeting with Keith Mason to discuss how Ofwat's current proposals for undertakers might apply to Tideway and its business model from 2030.

Please do not hesitate to contact me if you would like to discuss this response further.

Yours sincerely



Matt Parr

Head of Strategy and Regulation

PR19 methodology – Tideway response

1 Questions

1.1 Outcomes

- **Q1. Do you agree with our proposals for common and bespoke performance commitments?**

1.1.2 While Tideway is not directly subject to this framework, we are affected by changes to Thames Water's commitments and incentives that relate to the Thames Tideway Tunnel (TTT) project. Our responses to the questions on outcomes therefore focus on how Ofwat's proposals apply to Thames Water. The industry-wide outcomes framework in place from 2030 (when Tideway will fall into the industry-wide price review cycle) will need to be carefully tailored to Tideway's circumstances.

1.1.3 In the 2015-20 period Thames Water has four commitments that are relevant to Tideway: one relating to schedule, two to engagement and one that is relevant to Counters Creek. Tideway and Thames Water have started to discuss potential arrangements for the 2020-25 period that can ultimately support good outcomes for stakeholders. It is important to Tideway that an appropriate set of performance commitments and incentives is put in place so support the successful delivery of the project.

1.1.4 Tideway notes Ofwat's preference for outcome-focused commitments and will support Thames Water in investigating whether such outcome-focused measures can be introduced in relation to the TTT project. Given the likelihood that the benefits of the project will not be fully realised during the period 2020-25, we believe there may be a case for considering output and behaviour-related commitments.

1.1.5 To ensure that they remain powerful and stretching in line with Ofwat's ambitions, Thames Water's PR19 package of commitments and incentives will need to evolve from the PR14 version. Providing that it allows for such developments, we support Ofwat's proposal that companies should retain their PR14 performance commitments in their PR19 set unless change is supported by strong evidence and reasoning.

1.2 Resilience

- **Q1. Do you agree with our resilience planning principles?**

1.2.2 We are supportive of Ofwat's resilience planning principles, although several aspects do not apply directly to Tideway due to the nature of our business. Tideway exists to construct and maintain a single asset (the Thames Tideway Tunnel) and make it available for use by Thames Water, and we are currently in the construction phase of the project.

1.2.3 Nevertheless, we recognise that certain aspects of resilience, and in particular corporate and financial resilience, are relevant to Tideway, and we are keen to follow the principles as far as they apply to our business. We monitor our own performance in corporate and financial resilience and aim to reflect industry best practice. For example, we recently published updated holding company principles for Board leadership, transparency and governance, and our long-term viability statement covers the period to 2024 (in line with the planned handover of the tunnel to Thames Water).

1.2.4 We are also working with Thames Water to consider how the tunnel will be integrated into its operations. Tideway and Thames Water have clear obligations to one another identified in the Interface and Operations and Maintenance (O&M) Agreements and we are currently developing an integrated operating strategy to outline how the system will be operated in line with the Operating Techniques Thames Water has agreed with the EA. However, this is reliant on the availability and resilience of a number of key Thames Water assets for which it may need to make submissions as part of its PR19 business plan. We would therefore encourage Ofwat to consider the integration of the Tideway and Thames Water assets in relation to operational resilience.

1.3 Wholesale controls

- **Q1. Do you agree with our proposals for the form of control for network plus water and network plus wastewater set out in the 'Wholesale controls' chapter and [appendix 7](#), 'Wholesale revenue incentives'?**

1.3.2 Tideway is not directly affected by these proposals. However, it will be important for the detailed wholesale revenue and charging arrangements developed to be clear on how Tideway's Allowed Revenue will be recovered, and to be consistent with the treatment specified in Tideway's and Thames Water's licences. In particular, when developing detailed arrangements, it will be important to consider how Tideway's Allowed Revenue will feed through into wastewater charges to ensure there are no unintended consequences.

1.3.3 We support Ofwat's proposals to maintain a separate TTT price control to allow a focused approach to be taken to funding and performance commitments for Thames Water's TTT works.

1.4 Direct procurement

- **Q1. Do you agree with our draft guidance that appointees should focus on projects likely to deliver the greatest customer value for DPC at PR19? (We ask that appointees provide a list and description of which projects, based on our guidance, they consider would be in scope at PR19.)**

1.4.2 Tideway has a keen interest in Ofwat's direct procurement proposals due to the similarities with the Tideway model (although we note there are some key differences, in particular the use of a contract-based rather than licence-based approach).

- 1.4.3 We are supportive of Ofwat's guidance that companies should focus on projects with the greatest potential benefit to customers. It is essential that projects only go ahead under DPC where there is value to customers. To allow companies to assess the value of DPC for different projects, it would be helpful for Ofwat to set out cost-benefit guidelines, including clear guidance on how to assess the relevant counterfactual. We would consider the relevant counterfactual to be delivery by the company.
- 1.4.4 To support the successful introduction of DPC it will be important to gauge market interest. In the early stages of the process, it is likely to be necessary to carry out market testing to establish appetite for DPC projects. The level of interest will affect the degree of competition and the likely costs of DPC, which will be a key input for the cost-benefit analysis.
- 1.4.5 We believe there is some uncertainty about whether the benefits that can be achieved with a contract-based approach are as great as under a licence-based approach. In particular, the lack of a licence may make it difficult to achieve efficient financing costs. As a result, focusing on the most beneficial projects is most likely to ensure that DPC is used only where there is value to customers. Tideway is in discussion with Ofwat around the viability of using the New Appointments and Variations (NAV) regime to license successful bidders under DPC.
- 1.4.6 We support Ofwat's request for a list and description of projects that would be in scope for direct procurement at PR19. It would be helpful if Ofwat publishes this list shortly after the consultation closes, to inform the market of the likely pipeline of direct procurement opportunities and to help in the continued development of the approach.
- **Q2. What are your views on the type of tender model (ie an early or late tender model) appointees should use? Do you have any views on whether or not we need to specify a tender model companies should use?**
- 1.4.7 As Ofwat suggests, the tender model should be appropriate to the specific project. This will ensure that the activities involved and the associated risk are allocated in the way that generates best value for customers. Risk should be allocated to the party that can bear it most efficiently, which may affect whether an early or late tender model is more appropriate, in particular for projects with complex planning requirements. Notwithstanding the potential for innovation with early tender models, late tender models may be more promising in the early days of DPC to allow the model to become established and well-understood by investors.
- 1.4.8 Given that the projects subject to DPC are likely to be significantly smaller than Tideway's project, it will be important to keep development and procurement costs to a minimum to maximise the probability of achieving better value for money for customers than provision by the incumbent water company. With this in mind, while it may be important for Ofwat to allow a degree of flexibility to companies, it is also important for the model to be standardised as far as practicable to minimise procurement costs and help generate market interest in the pipeline of DPC projects.

- **Q3. What are your views on the overall commercial and regulatory model, including our draft procurement and contract principles set out in [appendix 10](#), 'Direct procurement for customers'?**

- 1.4.9 We support Ofwat's plans to make necessary changes to appointees' licence changes, which will help create confidence in the commercial and regulatory model.
- 1.4.10 Ofwat's role in DPC will need careful consideration to ensure the framework delivers maximum value for customers. It is important for the regulatory arrangements to be clear and well-understood by all parties. In particular, it would be beneficial for Ofwat to qualify its statement that it would need to be satisfied with the outcome of the tender in order to allow companies to recover the CAP's revenue stream from their customers. It would be helpful for Ofwat to be clear and transparent about the scope of this review of the tender process to avoid the perception of regulatory risk, which could reduce competition and/or drive up financing costs to the detriment of customers. Ultimately a bidder could find they win the procurement only to find that the regulator does not believe the value for money achieved is acceptable. One possible approach would be for Ofwat to limit its review to checking that the companies have followed a pre-agreed tender process.
- 1.4.11 Another aspect of the arrangements that will need to be carefully considered is the tax and accounting arrangements. In Tideway's case, these arrangements were subject to significant scrutiny during the procurement process to ensure they supported financeability for both the bidder and the incumbent company.
- 1.4.12 The draft procurement and contract principles are an important step forward in providing clarity to companies and investors on how DPC will work. Consultation and further development will be required prior to December to ensure that the principles protect customers and provide sufficient certainty to companies and investors. Where practical, standardisation of the model is likely to reduce transaction costs and maximise investor interest, improving value for customers. For example, it may be valuable for the industry to work together to translate the principles into a set of standard contract terms to be used as a basis for direct procurements.
- 1.4.13 There are some areas where additional clarity on Ofwat's principles is likely to be required to ensure they have the intended benefit. One key set of principles are those related to recovery of revenue by the CAP, as these will play a key role in determining financing costs. Lack of certainty over revenue will drive up financing costs and reduce value for money for customers. For example, the requirement to ensure that CAP base revenue is "reasonable" may be open to interpretation. This is an area where tighter principles are likely to be to the benefit of both customers and investors.
- 1.4.14 To protect customers, companies and investors, it will also be important to be clear on the requirements for the contract if things go wrong, for example failed procurement or insolvency of the CAP. It will be important for these arrangements to protect customers and consider the impact on bidders, given

the CAP will sit outside the scope of the Water Industry Act special administration regime.

- 1.4.15 The proposed licence changes for appointees play an important role in the potential for DPC to generate benefits for customers. It will be important to give comfort to investors that the arrangements will be preserved in the event of special administration. This could perhaps be included in any issued Ofwat guidance, licence change documentation or its final methodology.
- 1.4.16 The methodology suggests that the requirement for the appointee to adhere to various aspects of the contract could cover opex changes and refinancing gain-sharing, to ensure the appointee shares any such changes to customers. It is unclear whether the requirement is symmetrical and would also protect CAP investors in the event of such changes, and an asymmetric mechanism is likely to be reflected in financing costs. Tideway has a symmetrical cost of debt tracker that was seen by investors as an attractive feature of the model. A similar mechanism in the DPC model might support the competitive process. Further clarity in this area would be beneficial to ensure financing costs are kept to a minimum.

1.5 Cost assessment

- **Q1. Do you agree with our overall approach to cost assessment?**

- 1.5.2 As Tideway will not be subject to cost assessment at PR19, Tideway's interest in Ofwat's approach relates to its application to Thames Water's TTT works.
- 1.5.3 Ofwat's proposal to use benchmarking as the main tool for cost assessment may not be appropriate for Thames Water's TTT works, which are unlikely to be well-described by econometric models given the unique of the project and the potential for significant land sales in the period. We would be concerned if Thames Water was not appropriately funded for its TTT works as this may ultimately lead to delays and higher costs to the customer. A cost adjustment claim may therefore be the best way to ensure an efficient baseline is set for the Thames Water TTT price control.

1.6 Risk and return

- **Q3. Do you agree with our proposal to index price controls to CPIH (subject to its redesignation as a national statistic before we publish our final methodology)?**

- 1.6.2 As set out in our covering letter, it is important that Ofwat maintains a balanced approach to risk and return for PR19 and future price controls to support investor confidence, efficient financing of the sector and ultimately affordability for customers. Given the implications of indexation for companies' financing, it will be important for the proposed transition to CPIH to reflect the principle of a balanced approach to risk and return.
- 1.6.3 As Ofwat indicated in its May 2016 Water 2020 decision document, Tideway will not transition to CPIH before 2030. However, as set out in Ofwat's economic guidance, in broad terms post-2030 Tideway will be regulated in accordance with

the prevailing regulatory regime for wholesale activities. Ofwat indicated in May 2016 that this may include a transition to CPIH. As for the rest of the industry, it will be important to ensure that market conditions for CPIH financing exist (as explored in the paragraphs below), and that the arrangements are designed so as to be in the long term best interests of customers and that the proposed detailed methodology is sufficiently clear and transparent at an early stage of the process. Any transition for Tideway should be transparent in its calculation of the real WACC and should be NPV neutral. Given the long-term nature of financing decisions, Ofwat's proposals in this area have an impact on Tideway in the short-term as well as beyond 2030.

- 1.6.4 The market for CPI-linked debt is currently in its infancy. Although it is likely to develop further it does face significant regulatory and liquidity hurdles and it is hampered by the lack of government issuance in CPI as a reference point for pricing.
- 1.6.5 Despite the high level of historical correlation between CPI and CPIH, given the absence of a CPIH market it is likely that an issuer will have to fund in CPI (or even RPI) and take "wedge" risk. This is exacerbated at present by the lack of track record for the housing element (and the lack of reliability in data collection that led to only now CPIH being readmitted as a national statistic). The new methodology for collection of data on rental costs still needs to go through a few business cycles before its stability can be validated and to ensure that the CPI/CPIH correlation still holds. Also, to the extent that the BoE keeps tracking a CPI target (as opposed to a CPIH target) the long term forecast of CPIH may be exposed to more volatility than that of CPI.

1.7 The initial assessment of business plans: securing high quality, ambition and innovation

Q2. Do you agree with our proposed approach to assessing a company's ability to deliver results for customers and the environment from innovation?

- 1.7.1 While Tideway is not subject to PR19, we are keen to engage in industry developments in relation to innovation, particularly in relation to civil engineering and infrastructure. We welcome the increased prominence of innovation in PR19 through its inclusion as one of the PR19 themes, and as one of the characteristics of business plans that will be assessed. Innovation complements the other three PR19 themes and will feed into the achievement of Ofwat's objectives across many areas of the price review, to the benefit of customers.
- 1.7.2 Assessing companies' capacity and readiness to innovate in a systematic way is likely to be challenging given the differences between company structures, systems and processes. In particular, companies may carry out different types of innovation, and face different customer willingness for innovation and any associated risks. It will be helpful for Ofwat to provide more clarity on the framework it plans to use to make this assessment and we would be open to discussing innovation further with Ofwat.
- 1.7.3 Tideway has a formal innovation programme, and is working with its Alliance and the wider industry to deliver a sustainable legacy of innovation by capturing and

sharing our solutions via 'The Great Think', hosted on i3P (Infrastructure Industry Innovation Platform). This is a cross-sector client-led initiative intended to support the UK Construction 2025 vision of an industry that is efficient and technologically advanced. Current client members include Tideway, Crossrail, Network Rail, the Environment Agency, Anglian Water, Heathrow, Highways England and Hinkley Point C.

- 1.7.4 Tideway was a co-creator of i3P (the other being Crossrail), and was instrumental in its development and launch. Tideway has continued to lead the strategic development of i3P through the commitment of a senior industry player to work with influential industry bodies in driving the collaborative innovation agenda. Our ambition is for this platform to become the go-to place for collaborative innovation, allowing benefits to be shared for the benefit of customers/end users.
- 1.7.5 There are a number of specific initiatives which reflect successful innovation on the project to date. These include our award winning Health and Safety training which we open up to other organisations, inclusivity in the workplace, engineering solutions and our plans for new and enhanced public spaces.
- 1.7.6 Tideway is keen to share the lessons from its innovation programme for the benefit of customers in the water sector and beyond. This may be through i3P or other forums for collaboration within the sector.