Portsmouth Water: Direct procurement for customers detailed actions

In Portsmouth Water's business plan "Business Plan 2020-2025" Portsmouth Water identified the Havant Thicket Winter Storage Reservoir (HTWSR) scheme as meeting the threshold set for the evaluation of schemes for Direct Procurement for Customers (DPC). We have reviewed Portsmouth Water's assessments of this scheme and during our review we did not find the reasons why the HTWSR scheme was rejected by Portsmouth Water for DPC convincing.

We require Portsmouth Water to supply us with the following information on this scheme as follows:

Scheme	Action	Date
HTWSR	• A revised economic analysis of the scheme including a new Net Present Value analysis using the standardised assumptions provided in Table A • Supporting evidence for the use of 82% leverage in the Standard approach in the NPV analysis provided supporting the DPC recommendation. • A summary of the results of the network modelling and option development that was due for delivery in December with regard to the dilution of the operational flexibility and a risk assessment to the operation with regard to a third party operating HTWSR. • Evidence for the 18-24 month time frame for the delay incurred for the Procurement of the CAP. • A summary of the commercial arrangement and mechanisms to be entered into with Southern Water to ensure Portsmouth Water's customers are not at risk from the HTWSR scheme.	1 April 2019

Table A – Standard assumptions for the NPV analysis of Direct Procurement for Customer schemes

The business case submissions from the water companies as part of the Price Review 2019 had thirteen economic assessments of schemes that were considered technically suitable for Direct Procurement for Customers (DPC). There were significant differences in the assumptions used to identify the NPV differential for the DPC case (factual) and in-house (counterfactual). The table below sets out a set of assumptions and range of sensitivities that should be used in the event that companies do not have any specific market information for the relevant scheme.

Area	Item	DPC (Factual) Assumptions	In-house (Counterfactual) Assumptions
Customer Payments	Value	Determined by CAP contract payments and Appointee costs	Determined by Allowed Revenues from PR framework
	Timing	From first payment by customers which would usually be expected after asset completion. If improved contractual terms are identified with earlier payments then these should be considered.	From first payment by customers which would usually be when the appointee starts collecting from customers as per its business plan ‘allowed revenue’ profile.
Contract period	Length	Mid-case 25 years, Lower-case 20 years, Upper-case 50 years	Not needed

Area	**Item**	**DPC (Factual) Assumptions**	**In-house (Counterfactual) Assumptions**
PV Calculation	Period	From the start of the customer payments until the end of the asset life (or until there is no difference in asset value, maintenance and finance costs).	
	Discount rate	Discount rate of 3.5% real decreasing overtime (Based on HM Treasury Green Book Supplementary Guidance: discounting (3.5% 0-30 years, 3.0% 31-75 years, 2.5% 76-125 years)	
Indexation		CPIH	CPIH
Asset Depreciation	Method	Straight line or as per companies policy for asset type, the treatment should be consistent between DPC and in-house deliver.	
	Depreciation Rate	Mid-case - As per company policy for this asset type Lowercase +25% faster company policy rate	As per company policy for this asset type
Financing Costs	Cost of debt	Construction: forward Libor 6m swap + 220bsp –240bsp Operation: forward Gilt / Libor 6m swap + 120bsp –140bsp RCV bullet repayment: forward Gilt / Libor 6m swap + 120bsp –140bsp	As per company business plan
	Cost of equity	Equity IRR (Real) 8% (Upper case 7%, lower case 10%)	As per company business plan

Area	**Item**	**DPC (Factual) Assumptions**	**In-house (Counterfactual) Assumptions**
	Gearing	Mid case 85% (Upper case 90%, lower case 80%) after asset completion.	As per company business plan or Ofwat notional of 60%.
	Assumptions	Given the ranges available above, please provide explanation justifying your selections made	N/A
Cost differentials	Capex efficiency saving	Mid case 10% (Uppercase +15%, lowercase 5%)	In-house is base case
	Opex efficiency saving	Mid case 10% (Uppercase +15%, lowercase 5%)	In-house is base case
	Additional Bidder Costs	Additional bidder costs of 2% of capital spend, (Upper case 1%, lowercase 3%)	In-house is base case
	Procurement	Procurement costs of 1% of capital spend, (Uppercase 0.5%, Lowercase 2%)	In-house is base case
	Management	Contract management costs £150k per annum. (Lowercase £300k per annum for high operational interaction schemes)	In-house is base case

Area	Item	DPC (Factual) Assumptions	In-house (Counterfactual) Assumptions
Terminal Value	Assumptions	Please disclose clearly any assumptions about terminal value	N/A