

Southern Water: Direct procurement for customers detailed actions

In Southern Water’s business plan “Water for Life” Southern Water identified 26 potential schemes that met the cost threshold for Direct Procurement for Customers (DPC). We have reviewed Southern Water’s technical (“discreteness”) assessments and during our review we identified a number of schemes which were rejected by Southern Water that could be suitable for DPC. Due to a lack of information in Southern Water’s business plan submission, we were unable to review the detail for each of these schemes and their suitability for DPC. The schemes that we identified were:

- Peacehaven Indirect Potable Water Reuse
- Slowhill Copse Industrial Reuse
- Inter-zone transfers (Hampshire grid)

We require Southern Water to supply us with the following information on these schemes as follows:

Scheme	Action	Action Reference
Peacehaven Indirect Potable Water Reuse	<ul style="list-style-type: none"> • A summary of the key elements of the Peacehaven Indirect Potable Water Reuse scheme. This should include all of the relevant scheme information including but not limited to the key deliverables. • A summary of the projected scheme costs clearly identifying the costs for each phase of the scheme by year. These should clearly identify the incremental costs to Southern Water. • An economic analysis of the scheme including a Net Present Value analysis using the standardised assumptions provided in Table A. This analysis should clearly identify any additional benefit to customers of progressing this scheme outside of DPC. 	SRN.CMI.A5
Slowhill Copse Industrial reuse	<ul style="list-style-type: none"> • A summary of the key elements of the Slowhill Copse Industrial Reuse scheme. This should include all of the relevant scheme information including but not limited to the key deliverables. 	SRN.CMI.A6

Scheme	Action	Action Reference
	<ul style="list-style-type: none"> • A summary of the projected scheme costs clearly identifying the costs for each phase of the scheme by year. These should clearly identify the incremental costs to Southern Water. • An economic analysis of the scheme including a Net Present Value analysis using the standardised assumptions provided in Table A. This analysis should clearly identify the any additional benefit to customers of progressing this scheme outside of DPC. 	
Inter-zone transfers (Hampshire)	<ul style="list-style-type: none"> • A summary of the key elements of the Inter-zone transfers (Hampshire) scheme proposed for AMP7 and AMP8. This should include all of the relevant scheme information including but not limited to the key deliverables. • A summary of the projected scheme costs clearly identifying the costs for each phase of the scheme by year. These should clearly identify the incremental costs to Southern Water. • An economic analysis of the scheme including a Net Present Value analysis using the standardised assumptions provided in Table A. This analysis should clearly identify any additional benefit to customers of progressing this scheme outside of DPC. 	SRN.CMI.A7

In addition, Southern Water proposed the Fawley Desalination plant as a potential DPC scheme but were not in a position to provide a value for money assessment. We require Southern Water to supply us the following for the scheme:

Scheme	Action	Date
Fawley Desalination plant	<ul style="list-style-type: none"> • A summary of the key elements of the Fawley Desalination plant proposed for AMP7 and AMP8. This should include all of the relevant scheme information including but not limited to the key deliverables. • A summary of the projected scheme costs clearly identifying the costs for each phase of the scheme by year. These should clearly identify the incremental costs to Southern Water. 	SRN.CMI.A8

	<ul style="list-style-type: none">• An economic analysis of the scheme including a Net Present Value analysis using the standardised assumptions provided in Table A. This analysis should clearly identify any additional benefit to customers of progressing this scheme outside of DPC.	
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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
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).	

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Area	Item	DPC (Factual) Assumptions	In-house (Counterfactual) Assumptions
	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	
	Cost of equity	Equity IRR (Real) 8% (Upper case 7%, lower case 10%)	
	Gearing	Mid case 85% (Upper case 90%, lower case 80%) after asset completion. As per company business plan or Ofwat notional odf 60%.	

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