

July 2019

Trust in water

PR19 draft determinations

Portsmouth Water – Cost efficiency draft determination appendix

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1. Wholesale water activities

1.1 Enhancement

The tables below summarise the adjustments we make to set the efficient level of enhancement totex for the water resources and network plus water price controls. Where appropriate, we reallocate enhancement expenditure between enhancement activities. In the tables, we present the company requested cost for each activity where we made a material challenge, after any reallocation that we may have done. Our disallowances to company enhancement proposals include a challenge on the need to invest, on the efficiency of the proposals or on the classification of the expenditure as enhancement (in which case we consider that the expenditure is covered by our base allowance). For draft determinations we make an adjustment to the enhancement allowances to account for an implicit allowance for enhancement opex included within our base models. We set out our method of estimating the opex implicit allowance in 'Securing cost efficiency technical appendix'. Costs for new developments, new connections and addressing low pressure are now considered within wholesale water base ("botex plus") econometric models. We show details of specific areas of material disallowance or efficiency challenge in the table below and we provide details in our published feeder models.

Table 1: Material disallowances of and efficiency challenges to enhancement costs for the water resources price control 2020-25 (£ million of 2017-18)

Area of enhancement	Company requested totex	Ofwat view of requested totex after reallocations	Our allowance
All Enhancement totex	14.0	14.0	11.5
Material areas of disallowance and efficiency challenge in enhancement totex (£ million)	Ofwat view of requested totex after reallocations	Our allowance	
Supply and demand enhancements: Total ¹	4.1	2.6	
WINEP / NEP ~ Eels Regulations	2.3	1.7	

Note 1: The disallowed expenditure is associated with leakage reduction but the current price control allocation relates to the expenditure the company requests in this line which is dominated by Havant Thicket reservoir development prior to us moving it to a new price control. We will review this allocation for final determination.

Note 2: Our enhancement totex allowance is net of an implicit allowance for enhancement opex. We have not netted off an implicit allowance for enhancement opex from our allowances for the individual enhancement lines.

Table 2: Material disallowances of and efficiency challenges to enhancement costs for the water network plus price control 2020-25 (£ million of 2017-18).

Area of enhancement	Company requested totex	Owat view of requested totex after reallocations	Our allowance
All Enhancement totex	9.0	9.0	5.8
Material areas of disallowance and efficiency challenge in enhancement totex (£ million)	Owat view of requested totex after reallocations	Our allowance	
Resilience	2.8	1.2	
Investment to address raw water deterioration	5.8	5.5	

Note 1: Our enhancement totex allowance is net of an implicit allowance for enhancement opex. We have not netted off an implicit allowance for enhancement opex from our allowances for the individual enhancement lines. This explains why the sum of our allowance for the individual lines is higher than our total enhancement allowance.

Table 3: Material disallowances of and efficiency challenges to enhancement costs for the Havant Thicket price control 2020-25 (£ million of 2017-18).

Area of enhancement	Company requested totex	Ofwat view of requested totex after reallocations¹	Our allowance¹
All Enhancement totex	65.5	65.5	58.8
Material areas of disallowance and efficiency challenge in enhancement totex (£ million)	Ofwat view of requested totex after reallocations	Our allowance	
Havant Thicket reservoir development	50.1	45.0	
Resilience work in Portsmouth water network to support transfers	15.4	13.9	

Note 1: The company provides a breakdown of expenditure across the whole project timescale 2019-2029. We assess the project as a whole and then pro-rata the request and allowance to determine values for the 2020-25 period.

1.2 Transition expenditure

Table 4 sets out our allowances in wholesale water controls under the transition programme for both base and enhancement expenditure. The programme allows companies to bring forward planned investment from 2020-25 to 2019-20, where it is efficient to do so and/or to enable the company to meet statutory deadlines early in the next regulatory period. Although the expenditure is incurred in 2019-20, for the purpose of cost performance incentives we consider it as expenditure incurred in the following regulatory period (2020-25).

Table 4: Allowed transition capital expenditure in wholesale water price controls 2019-20 (£ million, 2017-18 CPIH deflated prices)

Description of expenditure	Company requested expenditure		Our allowed expenditure		Rationale
	Water Resources	Water Network Plus	Water Resources	Water Network Plus	
Havant Thicket	5.2	0.0	5.2	0.0	<p>The investment relates to work on Havant Thicket Reservoir in order to provide water supply to Southern Water in 2029. The investment is well justified and meets the expectations of our methodology, and we therefore allow it.</p> <p>The company provides extensive evidence to explain that the investment was not part of the long-term planning from PR14 due to additional information arising in 2017/18 on the need of additional water and further specifications of the project, which were agreed with Southern Water. Furthermore, the company justifies that it is efficient to bring this investment forward. Delays to the scheme would impact on the ability for the company to transfer water to Southern Water, hence we accept the need for transition funding.</p>

2. Cost adjustment claims

Table 5 summarises our consideration and allowances for the cost adjustment claims submitted by the company. We give further details in our published cost adjustment claim feeder model for Portsmouth Water. In its April 2019 plan, Portsmouth Water submitted a new cost claim on average bill size for the residential retail control which we rejected.

Table 5: Cost adjustment claims and our allowed totex adjustments, 2020-25 (£ million, nominal)

Description of Claim	Value of company claim	Our allowed adjustment	Rationale for decision
Bill size (residential retail)	1.0	0.0	<p>This cost claim is a new claim submitted in the April 2019 plan which the company did not include in the September 2018 plan. The company claims to be penalised by our retail econometric models for having the lowest bill in the industry. While not disputing the use of average bill size as a variable in our retail models, the company argues that bill size in our bad debt models has an adverse impact on their revenue allowance.</p> <p>We reject the cost claim because (i) the data does not provide clear intuition as to why a quadratic term would be appropriate to relax the assumption of linearity between bad debt costs and bill size; (ii) it is not clear how the value of the claim was calculated; (iii) we tested the bad debt and total cost models excluding Portsmouth Water from the historical data used to generate the model coefficients. We found that the models give a greater allowance to Portsmouth Water when the company is included in the historical data set compared to the allowance the models give when the company is excluded from the data.</p>

3. WINEP uncertainty mechanism

Our totex allowance for companies includes an allowance for environmental obligations set out in the Water Industry National Environment Programme (WINEP). Some of the requirements in WINEP are not expected to be confirmed until December 2021 at the earliest, which is after we make our final determinations in December 2019. Unconfirmed requirements in WINEP are known as 'amber' schemes.

Where we make an allowance for amber schemes, we use a mechanism to adjust our totex for schemes which are later confirmed as not required. As Portsmouth Water's WINEP does not list any schemes with 'amber' status there is no need for such a mechanism and we are not specifying one.

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