

November 2019

Trust in water

Notice of reasons for Havant Thicket licence modification

About this document

This notice explains the background and reasons for the modifications that the Water Services Regulation Authority (**Ofwat**) has made to Condition B (Charges) and Condition E (Undue Preference/Discrimination in Charges) of the conditions of the appointment (**licence**) of Portsmouth Water Limited (**Portsmouth Water**) as a water undertaker with effect from 25 November 2019. This modification has been made under section 13 of the Water Industry Act 1991 (**WIA91**) with the agreement of the company concerned.

The construction and operation of the Havant Thicket Winter Storage Reservoir (**Havant Thicket reservoir**) and the provision of the bulk supply of water to Southern Water Services Limited (**Southern Water**) that the reservoir will facilitate are regulated activities of Portsmouth Water. The modification provides for a separate price control to limit the revenue that Portsmouth Water can recover from its customers in relation to the construction and operation of the reservoir and to set out the treatment of associated revenues from the bulk supply charges levied on Southern Water that will fund this.

The modification does not place limits on the charges that Portsmouth Water can make to Southern Water in relation to the bulk supply arrangements associated with the Havant Thicket reservoir. It makes clear that the revenue from Southern Water (or any relevant successor(s) of Southern Water as a water undertaker) in relation to the construction of the Havant Thicket reservoir, and the related bulk supply of water, would not be included within any wholesale price control.

We published [a notice setting out our proposal to make the modifications](#) on 15 October 2019.

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Introduction and background

Southern Water faces significant water resources deficits in the west of its region after tight limits were imposed by the Environment Agency on the amount of water it can take from environmentally sensitive rivers within its appointed area in Hampshire. Southern Water must take steps to improve water efficiency, reduce leakage and invest in new water sources to maintain secure water supplies for its customers.

Portsmouth Water benefits from having a modest water resource surplus and has been working collaboratively with Southern Water to increase water transfers.

Portsmouth Water has ambitious proposals to adopt supply-side and demand-side solutions to increase the amount of surplus water that it can provide to Southern Water, including proposals to build the Havant Thicket reservoir to maximise the amount of water that could be traded with Southern Water.

We strongly support the proposed development of the Havant Thicket reservoir by Portsmouth Water to support water transfers to Southern Water. The ambitious approach embraces our challenge to the sector for greater regional collaboration in delivering secure water resources.

The construction and operation of the Havant Thicket reservoir and the provision of the bulk supply of water to Southern Water Services that the reservoir will facilitate are regulated activities of Portsmouth Water. We need to set out how the efficient costs of these activities would be funded, including how revenues from bulk supply charges are treated in this context.

That said, it is important that current and future customers of Portsmouth Water and Southern Water are appropriately protected and that risks are allocated to those best able to manage them.

The licence modifications that have been made

We have amended Condition B of Portsmouth Water's licence to allow Ofwat to:

- designate as “Havant Thicket Activities” activities which consist of or are related to (a) the planning, development, construction, operation and maintenance of the Havant Thicket reservoir and associated infrastructure or (b) the bulk supply to Southern Water that it facilitates. The scope of Havant Thicket Activities will be set out in detail when we publish our price review final determination;
- determine the appropriate nature, form and level of the price control for Havant Thicket Activities (which could be zero or a negative amount instead of a positive amount and/or linked to changes in the all items Consumer Prices Index including owner occupiers' housing costs (CPIH)) and set it for a period of either 5 or 10 charging years. We intend to determine the separate control for Havant Thicket Activities for a ten year duration. However, subsequent price controls may follow a five year regulatory cycle. The policy in relation to subsequent price controls for Havant Thicket Activities, including future form and duration, will be consulted upon as part of the price review process at the time; and
- determine a revised price control mid-period to apply from year 6 onwards if, as proposed, we determine a price control for 10 years. This enables a series of revenue or cost reconciliation adjustments to be applied in parallel to the 2024 price review (**PR24**).

In addition, the licence modification has amended Condition B to:

- set out that Portsmouth Water is required to, where we determine the Havant Thicket price control as a negative limit, deduct any negative revenue allowance determined from the charges it levies on customers¹;

¹ The provision of bulk supplies of water to neighbouring water companies is normally a regulated service. The cost of providing bulk supplies of water are funded by the charges levied under a bulk supply agreement. The terms of the bulk supply are negotiated between companies. In some cases, the revenues from water exceed the efficient costs of providing the supply and the resultant economic profit is shared with customers. This helps to reduce bills by reducing the revenues required to fund the efficient costs of the business.

- add a new Excluded Charge to cover the amounts paid by Southern Water (to the extent that they would not already be covered by Excluded Charges) to make clear that the charges associated with the bulk supply agreement are outside the scope of all the wholesale price controls and to make clear that the separate control for Havant Thicket Activities cannot limit the level of, or the revenue from, Excluded Charges²;
- exclude costs, receipts and savings associated with the Havant Thicket Activities from the scope of the interim determination provisions in paragraph 13 of Condition B. We expect that any bulk supply agreement between Portsmouth Water and Southern Water will have provisions for adjusting the bulk supply charges that will be paid by Southern Water for material changes in circumstances. If appropriate, we will consider reporting the revised revenue building blocks calculation for Havant Thicket Activities to facilitate an adjustment, which we are expecting to set out when we make the mid-period determination in 2024 and as part of the revenue reconciliation process in 2029. Portsmouth Water's customers should not bear any differences in charges related to the updated revenue building blocks calculation; and
- allow Ofwat to, if appropriate, require Portsmouth Water to publish charges fixed for the purpose of demonstrating compliance with the separate control for Havant Thicket Activities.

We have also modified Condition E: Undue Preference/Discrimination in Charges of Portsmouth Water's licence to make clear that Condition E does not apply to, or use as a comparator, the amounts paid by Southern Water under the bulk supply agreement in relation to the designated Havant Thicket Activities. Condition E currently does not apply to any charge determined by terms and conditions on which any supply of water in bulk is given by Portsmouth Water to another water undertaker. The modification makes clear that Condition E also does not apply to any amounts paid by Southern Water before the bulk supply of water is provided.

The wording of the modifications is the same as that set out in the notice of the proposal³.

² Charges for a supply of water in bulk to another water undertaker are Excluded Charges and are not included within price control limits. Southern Water will make payments under the bulk supply agreement to Portsmouth Water during construction of the reservoir and before water is provided. We are clarifying that these payments will also be excluded.

³ Please note that, although the wording of the modifications is the same, the wording of Condition B of Portsmouth Water's licence is not the same as that set out in Annex 1 of the consultation notice because separate amendments have been made to the condition in the intervening period to reflect changes that were proposed for all 17 water companies for whom Ofwat currently sets price controls.

Why the licence modifications have been made

After considering the responses we received to our proposal, we decided to proceed with the proposed licence modifications. We have amended Condition B because we consider that a separate price control in relation to the Havant Thicket reservoir is the most appropriate option to ensure that the regulatory framework protects the customers of Portsmouth Water and Southern Water, encourages efficient behaviour and appropriately reflects the complex allocation of costs and risks for the development of the Havant Thicket reservoir. It is the most appropriate option because it:

- aids transparency;
- enables greater regulatory oversight;
- maintains continuity of incentives for efficiency throughout the construction period, aligned to our approach to cost and risk sharing; and
- enhances customer protection, recognising that it would be inappropriate for Portsmouth Water's customers to underwrite the development of the project.

A separate price control also ensures that the bespoke cost and risk sharing arrangements between Portsmouth Water and Southern Water can be accommodated in the price control design without requiring complex adjustments at the end of the period to reconcile differences. The construction and operation of the Havant Thicket reservoir and the provision of the related bulk supply of water to Southern Water would remain part of Portsmouth Water's regulated business as a water undertaker.

A separate control also allows for a more appropriate design option for the activities concerned.

We have amended Condition E because we do not consider that it is appropriate for the provisions prohibiting undue preference or undue discrimination in the setting of charges to apply to, or have regard to, such arrangements between water companies as opposed to the charges that Portsmouth Water makes to its own customers.

We received three responses to our proposal to make the Havant Thicket licence modifications (from Portsmouth Water, Southern Water and the Consumer Council for Water (**CCWater**)). All three stakeholders supported the proposed licence modifications and Portsmouth Water provided its consent to them. Both Portsmouth Water and Southern Water raised a number of points in response to Annex 3 of the consultation notice, which set out our emerging thinking about the separate Havant Thicket control, rather than the proposed licence modifications themselves. As these

comments essentially relate to the methodology for, and implementation of, a separate price control, we are therefore considering them separately from the licence modification as we finalise our final determinations of price controls.

Ofwat (The Water Services Regulation Authority) is a non-ministerial government department. We regulate the water sector in England and Wales. Our vision is to be a trusted and respected regulator, working at the leading edge, challenging ourselves and others to build trust and confidence in water.

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