

15 October 2019

Trust in water

**Consultation under section 13 of the Water Industry Act 1991 on proposed modifications to Condition B and Condition E of the licence of Portsmouth Water Limited**

**ofwat**

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## About this document

This document invites comments on the proposals of the Water Services Regulation Authority (**Ofwat**) to modify 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.

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 purpose of the proposed modification is to provide 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 proposed modification does not place limits on the charges that Portsmouth Water Limited can make to Southern Water in relation to the bulk supply arrangements associated with the Havant Thicket reservoir. It will make 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.

Under section 13 of the Water Industry Act 1991 (WIA91) we are able to modify the conditions of a company’s licence if it agrees to the change we are proposing to make.

This document is a Notice under section 13 of the WIA91.

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## Responding to this consultation

We invite stakeholders to comment on our proposed modifications no later than 12 November 2019.

Portsmouth Water should provide in writing its agreement or otherwise to the proposed modifications by this date.

You can email your responses to [PR19@Ofwat.gov.uk](mailto:PR19@Ofwat.gov.uk) or post them to:

PR19  
Ofwat  
Centre City Tower  
7 Hill Street  
Birmingham B5 4UA.

If you wish to discuss any aspect of this document, please direct your enquiry to Colin Green by email to [colin.green@ofwat.gov.uk](mailto:colin.green@ofwat.gov.uk)

We will publish responses to this document on our website at [www.ofwat.gov.uk](http://www.ofwat.gov.uk). Information provided in response to this consultation, including personal information, may be published or disclosed in accordance with access to information legislation – primarily the Freedom of Information Act 2000 (FoIA), data protection legislation and the Environmental Information Regulations 2004.

If you would like the information that you provide to be treated as confidential, please be aware that, under the FoIA, there is a statutory 'Code of Practice' which deals, among other things, with obligations of confidence. In view of this, it would be helpful if you could explain to us why you regard the information you have provided as confidential. If we receive a request for disclosure of the information, we will take full account of your explanation, but we cannot give an assurance that we can maintain confidentiality in all circumstances. An automatic confidentiality disclaimer generated by your IT system will not, of itself, be regarded as binding on Ofwat.

## 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 Winter Storage Reservoir (“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.

## Why are we proposing a licence change?

In the PR19 draft determinations we set out our proposed approach to the development of the Havant Thicket reservoir in the [Havant Thicket policy issues appendix](#). We noted that the proposed water transfers between Portsmouth Water and Southern Water are ambitious and unusual in that a large proportion of the bulk supply is contingent on construction of the Havant Thicket reservoir in Portsmouth Water's area.

As we stated in that document, we need 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. We consulted on a number of options:

- **Option 1:** delivery through Direct Procurement for Customers (DPC);
- **Option 2a:** dealing with Havant Thicket reservoir as part of the proposed wholesale controls; and
- **Option 2b:** determining a separate price control to limit what can be recovered from Portsmouth Water's own customers, although this will require a change to Portsmouth Water's licence to implement it.

We have considered all responses to the above consultation. We have also continued to engage regularly with Portsmouth Water and Southern Water during this period.

We consider that option 2b is the most appropriate, 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 would also ensure 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 would also allow for a more appropriate design option for the activities concerned. Our emerging thinking regarding implementation is set out in Annex 3.

We are also proposing to make clear, for the avoidance of doubt, that, to the extent that they would not already be covered by the existing exclusion for bulk supplies of water to another water undertaker, Condition E will not apply to the amounts paid by Southern Water. 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.

## Our proposed licence modification

We propose a licence modification to Condition B: Charges and Condition E: Undue Preference/Discrimination in Charges of the company's licence in order to allow us to introduce a separate control consistent with the proposal we set out in the [Havant Thicket policy issues appendix](#) that we published in July 2019 alongside our draft determination of price controls for Portsmouth Water. The proposed modification would 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 the 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.
- 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); and

We are currently considering representations we have received in response to our Draft Determination. These representations include the following suggestions for mid-period adjustments to the price control:

- a gated cost adjustment process linked to planning and procurement outcomes;
- a reset of the weighted average cost of capital (WACC) for 2025-2030;
- indexation of the cost of new debt; and
- revenue reconciliation adjustments.

We have not concluded our consideration of those representations, but none of the suggested adjustments would affect the proposed licence modification.

Our Final Determination will set out the scope of the adjustments we would consider under this provision and our proposed approach to determining the adjustments. Where appropriate, our approach will be subject to consultation as part of our price review methodology at the time of the mid-period determination. The mid-period determination will be subject to the consultation and appeals process applicable to the price review process at that time.

In addition, the proposed licence modification:

- sets 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 customers<sup>1</sup>;
- adds 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 Charges<sup>2</sup>;
- excludes 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

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<sup>1</sup> 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.

<sup>2</sup> 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.

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.

- allows 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.

Where the price controls that Ofwat has determined at a price review are referred to the Competition and Markets Authority (**CMA**), the CMA would also be able to consider (and, if appropriate, change) the price control for Havant Thicket Activities determined by Ofwat in the same way as for the other price controls determined by Ofwat.

We will have regard to all the relevant circumstances (including what we know about the terms and conditions of the bulk supply agreement and the associated revenues) when setting the Havant Thicket Activities price control, both now and at future price reviews.

We also propose to modify Condition E: Undue Preference/Discrimination in Charges of the company's licence to make clear that Condition E would 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. We propose modifying the licence to make clear that Condition E would also not apply to the amounts paid by Southern Water before the bulk supply of water is provided.

Annex 1 and Annex 2 show the proposed changes to the current text of Condition B and Condition E, respectively, of Portsmouth Water's licence as underlined text.

## Implementation of a separate control

We have continued to engage with Portsmouth Water and Southern Water in recent months to consider how best a separate control could be implemented. We are still developing our position. We consider it is helpful to set out our emerging thinking on this – this is included in Annex 3. We would also welcome feedback from stakeholders on this.

If Portsmouth Water consents to the licence change then we would set out our final position on how the separate control would be implemented when we publish our final PR19 determinations in December 2019.

The determination of a separate control will not in itself require Portsmouth Water to construct the Havant Thicket reservoir or to provide the related bulk supply of water to Southern Water. We expect that requirement to be included in the agreement that Portsmouth Water and Southern Water are negotiating. If there is no requirement (if Portsmouth Water and Southern Water do not reach an agreement and no separate requirement is introduced) then we would not expect the separate control to have any practical effect and we would expect it to be removed at the next price review.

## Next steps

Responses to this document, including formal agreement or otherwise to the proposed licence modifications from Portsmouth Water, should be provided to Ofwat no later than **12 November 2019**.

Subject to the responses to this consultation and the agreement of Portsmouth Water, we expect to amend the company's licence before the end of 2019.

We would also welcome feedback on our emerging thinking in Annex 3 about how we might implement the separate control. We ask that any comments on this are clearly separated in your response from those regarding the licence change proposal.

If Portsmouth Water does not agree to the licence change, we would consider alternative options to ensure customers are protected, including the possibility of delivery through a direct procurement for customers (DPC) process.

## **Annex 1: Draft Condition B showing proposed Havant Thicket changes**

[The proposed changes are shown as red underlined text.]

### **Condition B:Charges**

#### Part I. Explanatory Provisions

##### 1 Introduction

The purposes of this Condition are set out in the following sub-paragraphs.

- 1.1 To empower the Water Services Regulation Authority to make determinations setting controls in respect of the charges to be levied by and/or revenue allowed to the Appointee or to any part of the Appointee's business (having regard to its costs) for the supply of water services.
- 1.2 To provide for reviews of the Appointed Business to be carried out by the Water Services Regulation Authority, so that the Water Services Regulation Authority can determine whether one or more Price Controls should be changed. This is dealt with in Part III under the heading "Periodic Reviews".
- 1.3 To enable the Appointee:
  - (1) ...
  - (2) to refer to the Water Services Regulation Authority for determination from time to time the question of changing the Price Control or Price Controls to allow for Notified Items and Relevant Changes of Circumstance;
  - (3) to refer to the Water Services Regulation Authority for determination at any time the question of changing the Price Control or Price Controls

where circumstances have a substantial adverse effect on the Appointed Business;

- (4) where notice to terminate the Appointment has been given, to refer to the Water Services Regulation Authority for determination the question what the Price Control or Price Controls should be in the future, on the assumption that the Appointment was to continue in force, for the purpose of facilitating consideration of the terms on which a new appointee could accept transfers of property, rights and liabilities from the Appointee, as provided in section 9(4) of the Water Industry Act 1991.

These matters are dealt with in Part IV under the heading "Interim Determinations".

- 1.4 To provide for the Water Services Regulation Authority to initiate changes to the Price Control or Price Controls to allow for Notified Items and Relevant Changes of Circumstance. This is also dealt with in Part IV.
- 1.5 To enable the Appointee to require the Water Services Regulation Authority to refer to the Competition and Markets Authority matters arising out of determinations by the Water Services Regulation Authority referred to in sub-paragraphs 1.2 and 1.4 and references referred to in sub-paragraph 1.3. These matters are dealt with in Part V under the heading "References to the Competition and Markets Authority".
- 1.6 To require the Appointee to give Information to the Water Services Regulation Authority to enable it to make determinations under this Condition. This is dealt with in Part VI under the heading "Provision of Information to the Water Services Regulation Authority".
- 2 Defined terms which apply for the purposes of all Parts of this Condition

In this Condition:

references to "**the Appointed Business**" shall be construed as if the Appointed Business included the management and holding by the Appointee of any protected land;

"**End-User**" means a person who, otherwise than as a person holding an appointment or a licence under the Water Industry Act 1991 or under other legislation in respect of the supply of water or sewerage services enacted from time to time, is a customer of the Appointee or a user of the goods or services concerned;

"**Excluded Charges**" unless and until otherwise agreed between the Water Services Regulation Authority and the Appointee, are

- (1) amounts payable in respect of an unmeasured supply of water by means of stand-pipes or water tanks and in respect of the erection or maintenance of stand-pipes or water tanks;
- (2) charges for a supply of water provided by the Appointee under section 59 of the Water Industry Act 1991;
- (3) charges for unmeasured supplies of water to cattle troughs;
- (4) charges for unmeasured building water supplies;
- (5) amounts payable in respect of an unmeasured supply of water by means of bowsers or water tankers;
- (6) charges for unmeasured supplies of water to farm taps and other agricultural water points; and
- (6A) at any time before (but not including) 1 April 2015, charges in any Charging Year for supplies of water (or for the provision of sewerage services or for the reception, treatment and disposal of trade effluent) to premises where the premises were supplied in the relevant Prior

Year with not less than such quantity of water as is specified from time to time under section 7(5)(a) of the Water Industry Act 1991

AND, for the avoidance of doubt, but without prejudice to the meaning of Standard Charges in respect of water supply, shall also include:

- (7) at any time before (but not including) 1 April 2015, charges payable for any such connection as is described in section 146(2) of the Water Industry Act 1991;
- (8) charges for a supply of water in bulk to another water undertaker;
- (9) amounts payable under any such agreement as is described in section 20(1)(b) of the Water Resources Act 1991; and
- (10) charges payable under any agreement for any unmeasured supply of water which are calculated by reference to the rateable value of hereditaments, occupied by the person to whom the supply is provided, fixed in accordance with section 32, 33 or, as the case may be, 34 of the General Rate Act 1967 or, as the case may be, fixed in accordance with section 54 of the Local Government Finance Act 1988; and
- (11) to the extent that they do not fall within sub-paragraph (8) of this definition, amounts payable by Southern Water under any agreement entered into between it and the Appointee in respect of any matters which fall within the scope of the Havant Thicket Activities.

but so that where this Condition requires reference to be made to Excluded Charges in a Charging Year prior to that starting on 1 April 1990 the expression "Excluded Charges" shall be read and construed as though:

- (a) there were added to sub-paragraph (2) of this definition the words "and charges for a supply of water provided by the Appointee under section 37 of Schedule 3 to the 1945 Act"; and

- (b) there were added to sub-paragraph (9) of this definition the words "and any agreement entered into by the Appointee under section 81 of the Water Resources Act 1963 with respect to any of the matters referred to in sections 81(1)(b) and 81(1)(d) of that Act";

**"Havant Thicket Activities"** means activities carried out by the Appointee in performance of its functions as a water undertaker that are so designated from time to time (which designation, for the avoidance of doubt, shall be reversible) by the Water Services Regulation Authority which consist of or are related to:

(a) the planning, development, construction, operation and maintenance of a reservoir located at Havant Thicket and its associated infrastructure, for the purpose of facilitating a supply of water in bulk by the Appointee to Southern Water; or

(b) the supply of water in bulk by the Appointee to Southern Water which has been so facilitated;

**"Interim Determination"** means a determination by the Water Services Regulation Authority of the relevant questions pursuant to a reference by the Appointee under paragraph 13 or pursuant to paragraph 14 or, as the case may be, a determination by the Competition and Markets Authority of the relevant questions or of a disputed determination subject to a reference to it pursuant to paragraph 15 that relates to a reference by the Appointee under paragraph 13 or a determination pursuant to paragraph 14;

**"Network Plus Water Activities"** means all activities carried out by the Appointee in performance of its functions as a water undertaker other than Water Resources Activities ~~and~~, Retail Activities and Havant Thicket Activities;

**"Price Control"** means a control set by the Water Services Regulation Authority, pursuant to a Periodic Review or Interim Determination, or deemed

to be so set by virtue of sub-paragraph 15.2, in respect of the charges to be levied by and/or revenue allowed to an Appointed Business or any part thereof (having regard to its costs) and such matters ancillary to the said control, by way of a determination pursuant to this Condition. The appropriate nature and form of each control for Water Resources Activities ~~and~~, Retail Activities and Havant Thicket Activities will depend on the circumstances of each case;

**"Retail Activities"** means such activities that constitute the provision of goods or services by the Appointee directly to one or more End-Users, and such activities ancillary to such provision including ownership of meters, and that are so designated from time to time (which designation, for the avoidance of doubt, shall be reversible) by the Water Services Regulation Authority, but for the avoidance of doubt shall not include the following:

- (a) water resources, raw water distribution, water treatment or treated water distribution (as each of those is defined in the Water Services Regulation Authority's Regulatory Accounting Guideline (RAG) 4.06);  
or
- (b) in so far as the ownership of meters is so designated, the ownership of meters that were installed at, or in order to measure supplies to, End-Users' premises on or before the date of such designation;

**"Southern Water"** means Southern Water Services Limited, or any successor company appointed under section 6 of the Water Industry Act 1991 as water undertaker in respect of the area for which Southern Water Services Limited holds such an appointment;

**"Standard Charges"** means

- (1) charges fixed under any such charges scheme as is referred to in section 143 of the Water Industry Act 1991;

- (2) charges fixed by the Appointee in respect of its Water Resources Activities and Network Plus Water Activities;
- (3) charges payable under any such agreement as is referred to in section 142 of the Water Industry Act 1991 under or for which all the charges payable are in accordance with standard charges published or fixed by the Appointee;
- (4) charges determined by agreement in respect of a supply of water provided by the Appointee for non-domestic purposes where all the charges so determined in respect of that supply are in accordance with standard charges published or fixed by the Appointee;
- (5) charges fixed under any such charges scheme made by the Appointee under section 31 of the 1973 Act as, by virtue of paragraph 16(1) of Schedule 26 of the Water Act 1989, had effect on and after the transfer date as if it were a charges scheme made under section 76 of the Water Act 1989 by the Appointee;
- (6) charges in respect of any such supply which the Appointee was under a duty to make under section 27 of the 1945 Act as, by virtue of paragraph 8 of Schedule 26 of the Water Act 1989, is a supply which the Appointee is under a duty to make on and after the transfer date where all charges in respect of such supply are in accordance with standard charges published or fixed by the Appointee;
- (7) charges payable under any agreement made or entered into by the Appointee under any local statutory provision or under any other power conferred on the Appointee otherwise than by virtue of the Act, under which all the charges payable are in accordance with standard charges published or fixed by the Appointee; and

provided that no part of this definition shall apply to any charge which is for the time being an Excluded Charge by virtue of (6A) of the definition of Excluded Charges;

but so that where this Condition requires reference to be made to Standard Charges in a Charging Year prior to that starting on 1 April 1990 the expression "Standard Charges" shall be read and construed as though:

- (a) there were added to sub-paragraph (5) of this definition the words "and any charges scheme made by the Appointee under section 31 of the 1973 Act"; and
- (b) there were added to sub-paragraph (6) of this definition the words "and any such supply which the Appointee was under a duty to make under section 27 of the 1945 Act, where all the charges in respect of such supply were in accordance with standard charges published or fixed by the Appointee".

In this definition references to standard charges published or fixed by the Appointee are to such charges, where published or fixed under a charges scheme or otherwise;

**"Termination Notice"** means a notice given in accordance with Condition O;

an **"unmeasured supply"** is one where none of the charges for that supply is based on measured quantities of volume;

**"Water Resources Activities"** means -

- (a) such activities carried out by the Appointee in performance of its functions as a water undertaker in connection with abstraction licences, raw water abstraction, raw water transport and raw water storage, and such ancillary activities, as may be so designated from time to time (which designation, for the avoidance of doubt, shall be reversible) by the Water Services Regulation Authority;

- (b) EXCEPT THAT: Water Resources Activities shall not include water treatment and treated water distribution.

### 3 Interpretation

Where the context so requires, terms used in the definition in the Part of Water Resources Activities shall have the meanings assigned to them in the Water Services Regulation Authority's Regulatory Accounting Guideline (RAG) 4.06.

4 [Not used]

5 [Not used]

6 [Not used]

### Part III. Periodic Reviews

7 [Not used]

#### 8 Periodic Reviews of the Appointed Business

8.1 The Appointee shall:

- (a) levy charges in a way best calculated to comply with the Price Control or Price Controls determined by the Water Services Regulation Authority pursuant to sub-paragraph 8.3 or sub-paragraph 8.4; and

- (b) where the allowed charges and/or revenue determined in respect of any such Havant Thicket Activities Price Control is a negative amount, ensure that such amount is, in levying charges, deducted from the amounts allowed to be levied by virtue of the other Price Controls.

8.2 The Appointee shall furnish to the Water Services Regulation Authority such Information as the Water Services Regulation Authority may reasonably require

to enable it to carry out a Periodic Review pursuant to sub-paragraph 8.3 or sub-paragraph 8.4.

8.3 In respect of the Appointed Business's Retail Activities, the Water Services Regulation Authority shall determine (having regard to all the circumstances which are relevant in the light of the principles which apply by virtue of Part I of the Water Industry Act 1991 in relation to the Water Services Regulation Authority's determinations, including, without limitation, any change in circumstance which has occurred since the last Periodic Review or which is to occur):

- (1) what is the appropriate nature, form and level of one or more Price Controls in respect of the relevant part or parts of the Appointed Business;
- (2) how the Appointee shall, in respect of each such Price Control applicable to it, demonstrate the compliance referred to in sub-paragraph 8.1; and
- (3) for how long each such Price Control in respect of the Appointee shall last (being a period of consecutive Charging Years).

8.4

- (1) In respect of the Appointed Business's Water Resources Activities and Network Plus Water Activities (except for those activities for which there are Excluded Charges), and in respect of the Appointed Business's Havant Thicket Activities, the Water Services Regulation Authority shall determine separate Price Controls in accordance with this sub-paragraph (having regard to all the circumstances which are relevant in the light of the principles which apply by virtue of Part I of the Water Industry Act 1991 in relation to the Water Services Regulation Authority's determinations including, without limitation, any change in circumstance which has occurred since the last Periodic Review or which is to occur).

(2) In relation to Network Plus Water Activities, the Water Services Regulation Authority shall determine:

(c) one single Price Control in respect of the Appointed Business's Network Plus Water Activities, such Price Control consisting of, in each Charging Year:

(i) the percentage change (expressed, in the case of an increase, as a positive number, in the case of a decrease, as a negative number, and, in the case of no change, as zero) in the Relevant Index between that published for the month of November in the Prior Year and that published for the immediately preceding November; and

(ii) a number, "**K**" which may be a positive number or a negative number or zero

which shall together be expressed as a percentage, and which shall limit the change in the charges to be levied by and/or revenue allowed to the Appointed Business in each Charging Year in respect of the activities concerned; and

(d) how the Appointee shall, in respect of the Network Plus Water Activities Price Control applicable to it, demonstrate the compliance referred to in sub-paragraph 8.1.

(3) In relation to Water Resources Activities, the Water Services Regulation Authority shall determine:

(e) what is the appropriate nature, form and level of the Price Control in respect of Water Resources Activities; and

(f) how the Appointee shall demonstrate the compliance referred to in sub-paragraph 8.1 in respect of Water Resources Activities,

and in making any such determination will include an annual adjustment to reflect any percentage change in the Relevant Index between that published for the month of November in the Prior Year and that published for the immediately preceding November.

(4) In relation to the Havant Thicket Activities, the Water Services Regulation Authority shall determine:

(a) what is the appropriate nature, form and level of the Price Control in respect of Havant Thicket Activities (except that any such Price Control shall not limit the level of any Excluded Charge or the revenue from Excluded Charges);

(b) how the Appointee shall demonstrate the compliance referred to in sub-paragraph 8.1 in respect of Havant Thicket Activities; and

(c) for how long such Price Control in respect of the Appointee shall last (being a period of consecutive Charging Years),

and, in making any such determination, the Water Services Regulation Authority may, where appropriate:

(d) include an annual adjustment to reflect any percentage change in the Relevant Index between that published for the month of November in the Prior Year and that published for the immediately preceding November;

(e) determine that the charges to be levied by and/or revenue allowed to the Appointed Business in respect of the Havant Thicket Activities shall be a positive amount, zero or a negative amount.

8.5 Each Price Control determined under sub-paragraph 8.3 pursuant to a Periodic Review shall be set for a period which shall be a number of Charging Years to be determined by the Water Services Regulation Authority, in conjunction with its determination pursuant to sub-paragraph 8.3, in each case starting on 1

April, with the first such period starting on 1 April 2015, provided that no such period shall exceed five consecutive Charging Years.

8.6 Each Price Control determined under sub-paragraph 8.4(2) or 8.4(3) pursuant to a Periodic Review shall be set:

- (1) for the five consecutive Charging Years starting on 1 April 2020; and
- (2) thereafter for each period of five consecutive Charging Years starting on the fifth anniversary of the first day of the period in respect of which the immediately preceding Periodic Review was carried out.

8.6A Each Price Control determined under sub-paragraph 8.4(4) pursuant to a Periodic Review shall be set for a period which shall be a number of Charging Years to be determined by the Water Services Regulation Authority, in conjunction with its determination pursuant to that sub-paragraph, in each case starting on 1 April, and with the first such period starting on 1 April 2020, provided that:

- (1) each period shall be for either five or ten consecutive Charging Years; and
- (2) where any such period is determined to be ten consecutive Charging Years, the Water Services Regulation Authority may, notwithstanding that determination and pursuant to a Periodic Review, make a further determination under sub-paragraph 8.4(4) which has effect:
  - (i) starting on 1 April which falls after the period of five consecutive Charging Years has passed; and
  - (ii) on and from that date, in substitution for the prior determination.

8.7 If, at any time after 1 April 2020, the Water Services Regulation Authority is unable to conduct a Periodic Review by 31 December in the Charging Year before the Review Charging Year, then:

- (1) in respect of Retail Activities, the previous determination pursuant to sub-paragraph 8.3 – in so far as that determination includes the matters decided under sub-paragraphs 8.3(1) and (2) – in respect of the final Charging Year of the period that was set in that previous determination pursuant to sub-paragraph 8.3(3), shall continue to apply for consecutive Charging Years until the next relevant determination under sub-paragraph 8.3 (or equivalent determination by the Competition and Markets Authority pursuant to paragraph 15) or the next relevant Interim Determination becomes effective;
- (2) in respect of Water Resources Activities ~~or Network Plus Water Activities~~, the previous determination pursuant to sub-paragraph 8.4(3), and in respect of Network Plus Water Activities the previous determination pursuant to sub-paragraph 8.4(2), in respect of the final Charging Year of the period that was set in that previous determination shall continue to apply for consecutive Charging Years until the next relevant determination under (as the case may be) sub-paragraph 8.4(2) or (3) (or equivalent determination by the Competition and Markets Authority pursuant to paragraph 15) or the next relevant Interim Determination becomes effective;
- (3) in respect of Havant Thicket Activities, the previous determination pursuant to sub-paragraph 8.4(4) – in so far as that determination includes the matters decided under sub-paragraphs 8.4(4)(a), (b), (d) and (e) – in respect of the final Charging Year of the period that was set in that previous determination pursuant to sub-paragraph 8.4(4)(c), shall continue to apply for consecutive Charging Years until the next relevant determination under sub-paragraph 8.4(4) (or equivalent determination by the Competition and Markets Authority pursuant to paragraph 15) or the next relevant Interim Determination becomes effective;
- (4) the Water Services Regulation Authority shall conduct a Periodic Review as soon as reasonably practicable thereafter, provided that the Appointee has not given a relevant notice under paragraph 15.

- 8.8 Where there is a material change to the basis of compiling the Relevant Index, this Condition, in so far as it relates to that part of the calculation of any Price Control to which the Relevant Index is relevant, shall be modified in such a manner as the Water Services Regulation Authority, after prior consultation with the Appointee, may determine to be appropriate to take account of such change.
- 8.9 The Water Services Regulation Authority may, at its discretion, from time to time (whether pursuant to a Periodic Review in connection with a determination pursuant to sub-paragraph 8.3 or sub-paragraph 8.4, or at other times) designate any activity that is carried out as part ~~as part~~ of the Appointed Business as falling within:
- (i) Retail Activities (subject to the definition of "Retail Activities" in paragraph 2);
  - (ii) Water Resources Activities (subject to the definition of "Water Resources Activities" in paragraph 2); ~~or~~
  - (iii) Havant Thicket Activities (subject to the definition of "Havant Thicket Activities" in paragraph 2); or
  - (iv) Network Plus Water Activities (subject to the definition of "Network Plus Water Activities" in paragraph 2).
- 8.10 Where a designation is made under sub-paragraph 8.9 pursuant to a Periodic Review in conjunction with a determination pursuant to sub-paragraph 8.3 or sub-paragraph 8.4, that designation shall be treated for the purposes of sub-paragraph 15.1 as part of the determination.
- 8.11 Where a designation is made under sub-paragraph 8.9 otherwise than pursuant to a Periodic Review in conjunction with a determination pursuant to sub-paragraph 8.3 or sub-paragraph 8.4, that designation shall be treated for the purposes of sub-paragraph 15.1 as part of the next following determination in respect of the activity concerned.

9 Non Retail Charges Publication

9.1 The Appointee may from time to time be required to publish charges fixed for the purposes of demonstrating compliance with the Price Controls determined in respect of its [Havant Thicket Activities](#), Water Resources Activities and Network Plus Water Activities. Such requirement shall be made by way of a notice from the Water Services Regulation Authority to the Appointee specifying the information to be provided, the method of publication, the time by which publication is required (being a reasonable period of time) and the period for which the published charges are to be effective. The Appointee shall comply with the said requirement by notice and adhere to the charges accordingly published.

10 Periodic Reviews relating to the Appointed Business where a Termination Notice has been given

10.1 Where a Termination Notice has been given by the Secretary of State to the Appointee, the Appointee may refer to the Water Services Regulation Authority for determination by it the question whether, on the assumption that such a Termination Notice had not been given, (but subject thereto, having regard to all the circumstances which are relevant in the light of the principles which apply by virtue of Part I of the Water Industry Act 1991 in relation to the Water Services Regulation Authority's determination or determinations, including, without limitation any change in circumstance which has occurred since the most recent one or more Periodic Reviews or which is to occur), the Price Controls, and in the case of Retail Activities, [Havant Thicket Activities](#) and Water Resources Activities, the nature, form and level of one or more Price Controls should be changed (and if so what change should be made to the relevant Price Control or Price Controls and, in the case of Retail Activities, [Havant Thicket Activities](#) and Water Resources Activities, to the nature, form and level of the relevant Price Control or Price Controls) for one or more periods (as decided by the Water Services Regulation Authority) of consecutive Charging Years starting with the Charging Year starting 1 April last before the Termination Notice is to expire.

- 10.2 A reference to the Water Services Regulation Authority under this paragraph 10 shall be made by notice given to the Water Services Regulation Authority not earlier than 1 July and not later than 14 July in the Charging Year next but one before that commencing on the said 1 April.

### **Part 3A Performance Measure Adjustments**

- 11.1 This Part 3A applies where the Water Services Regulation Authority has notified the Appointee by 31 December in the Charging Year before the Review Charging Year that a Price Control determined under sub-paragraph 8.3 in respect of the Appointee's Retail Activities or sub-paragraph 8.4 in respect of the Appointee's Water Resources Activities or Network Plus Water Activities may be adjusted to reflect the Appointee's performance in relation to a specific Performance Commitment.
- 11.2 The Appointee may by notice to the Water Services Regulation Authority refer for a determination under this Part the question set out in sub-paragraph 11.5 or the Water Services Regulation Authority may make a determination under this Part of the question set out in sub-paragraph 11.5 on its own initiative.
- 11.3 Any such reference by the Appointee must be made no later than 15 August in the year before the first Charging Year for which any adjustment to a Price Control is sought.
- 11.4 Any such determination by the Water Services Regulation Authority must be made no later than 15 November in the year before the first Charging Year for which any adjustment to a Price Control would take effect.
- 11.5 Under this Part the Water Services Regulation Authority may determine the question of whether there should be a change to the revenue allowed under, or, as the case may be, the level of, any Price Control determined under sub-paragraph 8.3 in respect of the Appointee's Retail Activities or sub-paragraph 8.4 in respect of its Water Resources Activities or Network Plus Water

Activities for the following and any subsequent Charging Year and, if so, the amount of such change.

- 11.6 The Appointee shall furnish to the Water Services Regulation Authority such Information as the Water Services Regulation Authority may reasonably require for the purpose of making a determination pursuant to this Part.
- 11.7 In making a determination pursuant to this Part, the Water Services Regulation Authority shall:
- (g) consider the Appointee's performance in relation to each relevant Performance Commitment in the period for which performance is being assessed and, in deciding for which Charging Year or Charging Years an adjustment to a Price Control should be made, shall consider both that and the Appointee's expected performance in the current year or one or more future years up to, but not including, the next Review Charging Year; and
  - (h) take account of the adjustments to the relevant Price Control which the Water Services Regulation Authority notified to the Appointee under sub-paragraph 11(1) above in relation to each relevant Performance Commitment in question.
- 11.8 In this Part "**Performance Commitment**" means a target or other measure of the performance of the Appointee in relation to the carrying out of the Regulated Activities that the Water Services Regulation Authority has notified to the Appointee by 31 December in the Charging Year before the Review Charging Year or which is set by the Competition and Markets Authority following a determination under paragraph 15.
- 11.9 In this Condition references to a "**Price Control**" include a Price Control that has been changed in accordance with a determination made under this Part.
- 11.10 Where a notification of a Performance Commitment is made for the purposes of sub-paragraph 11.1, that notification shall be treated for the purposes of

sub-paragraph 15.1 (regarding references to the Competition and Markets Authority) as part of the relevant determination made under sub-paragraph 8.3 or sub-paragraph 8.4.

Part IV. Interim Determinations

12 Matters of interpretation and construction which apply for the purposes of this Part IV

12.1 In this Part of this Condition:

**"the Appropriate Discount Rate"** means such rate of return upon borrowing as, at the time at which the Appropriate Discount Rate falls to be applied from time to time under this Condition, investors and creditors would reasonably expect of a properly managed company holding the Appointment whose sole business consists of being a water undertaker and, without excluding other considerations which may also be relevant, having its equity share capital listed on The London Stock Exchange, and the same Appropriate Discount Rate shall be applied for all purposes in determining questions the subject of the same reference (including questions determined by the Water Services Regulation Authority under paragraph 14 when it determines questions referred to it by the Appointee under paragraph 13);

**"equity share capital"** has the same meaning as in the Companies Act 2006;

**"making a Relevant Determination"** means, as regards each Price Control to which an Interim Determination relates or is to relate, making one or more determinations pursuant to sub-paragraph 8.3 or sub-paragraph 8.4, pursuant to a Periodic Review, as to that Price Control, or making any subsequent Interim Determination as to whether the level of that Price Control should be changed (and, if so, what change should be made to the level of the Price Control or Price Controls), and **"Relevant Determination"** shall be construed accordingly;

**"Net Present Value"** means the net present value calculated as at 30 September in the year in which the relevant Reference Notice is given or, where in any year no Reference Notice is given under paragraph 13 but the Water Services Regulation Authority gives a notice to the Appointee under paragraph 14, as at 30 September in the year in which the Water Services Regulation Authority gives the notice, by discounting subsequent cash flows and inflating earlier cash flows at the Appropriate Discount Rate, assuming all cash flows in any Charging Year occur on 30 September in that Charging Year;

a **"Notified Item"** is any item notified by the Water Services Regulation Authority to the Appointee as not having been allowed for (either in full or at all) in making a Relevant Determination; and for the purpose of this definition:

- (a) where any such item was not allowed for in full then it shall only be a Notified Item to the extent that it was not allowed for; and
- (b) where, in determining whether the Relevant Determination should be changed (and if so what change should be made to it), the Water Services Regulation Authority, or, as the case may be, the Competition and Markets Authority, allows for any such item as was previously so notified by the Water Services Regulation Authority then references in this Condition to Notified Items and Relevant Items shall be taken, for the purposes of any subsequent Interim Determination, to exclude such item to the extent that the Water Services Regulation Authority, or, as the case may be, the Competition and Markets Authority, allowed for it as aforesaid;

a **"Relevant Change of Circumstance"** is any of the following:

- (1) (a) the application to the Appointee of any legal requirement; and

- (b) any change to any legal requirement which applies to the Appointee (including any legal requirement ceasing to apply, being withdrawn or not being renewed);
- (2) either of the following circumstances for any Charging Year in respect of which the Secretary of State, or, as the case may be, the Water Services Regulation Authority, notified the Appointee that variations in value received or expected to be received from Relevant Disposals of Land shall constitute a Relevant Change of Circumstance:
- (a) where for any Charging Year the value received or expected to be received from a Relevant Disposal of any Identified Land is, or is expected to be, different from the value which the Secretary of State, or, as the case may be, the Water Services Regulation Authority, notified the Appointee was the value attributable to a Relevant Disposal of that Identified Land for that Charging Year which had been allowed for in making a Relevant Determination;  
or
  - (b) where for any Charging Year, and to the extent not taken into account under (a) above, the aggregate value received or expected to be received from Relevant Disposals of Non-identified Land is, or is expected to be, different from the value which the Secretary of State, or, as the case may be, the Water Services Regulation Authority, notified the Appointee was the value attributable to Relevant Disposals of Non-identified Land for that Charging Year which had been allowed for in making a Relevant Determination

and so that any notification by the Water Services Regulation Authority for the purposes of this sub-paragraph (2) shall be relevant for the purposes of this sub-paragraph (2) to the exclusion of any earlier notification by the Secretary of State or the Water Services Regulation

Authority for the purposes of this sub-paragraph (2) to the extent that the first mentioned notification is made in respect of matters in respect of which that earlier notification was made.

For the purposes of this sub-paragraph (2):

- (i) "**Identified Land**" means any piece or parcel of protected land identified in any such notification referred to in (a) above as is relevant for the time being for the purposes of this sub-paragraph (2) as being included in that notification, not being, or being part of, a piece or parcel of land which has previously been the subject of a transfer under paragraph 7 of Condition K;
- (ii) "**land**" includes any interest or right in or over land;
- (iii) "**Non-identified Land**" means any piece or parcel of protected land, not being, or being part of:
  - (A) a piece or parcel of protected land identified in any such notification referred to in (a) above as is relevant for the time being for the purposes of this sub-paragraph (2); or
  - (B) a piece or parcel of protected land which has previously been the subject of a transfer under paragraph 7 of Condition K;
- (iv) "**protected land**" and "**disposal**" have the meanings respectively given to them in section 219 of the Water Industry Act 1991;
- (v) a "**Relevant Disposal**" means and includes any disposal by the Appointee;

- (vi) a "**Relevant Disposal of Land**" means and includes a Relevant Disposal of Identified Land and a Relevant Disposal of Non-identified Land;
  - (vii) "**value**" includes value of any kind including, without limitation, cash, the value of real or personal property or any interest in such property, the value of any right or benefit (actual or prospective) and the value of any release, in whole or in part, of any obligation or claim, provided that to the extent that any property, right or benefit shall consist of a right to receive cash or any other asset then no value shall be attributed to that property, right or benefit but the cash or other asset the subject thereof shall be included and treated as value received or expected to be received in the Charging Year in which it is received or expected to be received;
  - (viii) references to "**value received or expected to be received**" shall be construed so as to include receipts by, and grants to, the Appointee, any Associated Company or any other business in which either the Appointee or any Associated Company has a material direct or indirect interest;
  - (ix) in the case of a right or benefit, but subject to the proviso to (vii) above, value shall be deemed to have been received at the time the right is granted or the benefit arises;
- (3) where:
- (i) in making a Relevant Determination, an amount has been allowed for on account of steps taken or to be taken for the purpose of securing or facilitating compliance with a legal requirement (not being one to comply with which the Appointee has determined to make a change to the basis on which it charges customers for water supply services) or achieving a

service standard adopted or to be adopted by the Appointee;  
and

(ii) in any such case:

(A) the Appointee has not taken (by the date by which it was assumed for the purposes of assessing the amount allowed for as aforesaid it would take those steps) any or all of those steps which, for the purpose of assessing the amount allowed for as aforesaid, it was assumed it would take; and

(B) as a result, the amount allowed for as aforesaid is substantially greater than the sum of (a) the costs (if any) actually incurred by the Appointee for the relevant purpose specified in (i) above and (b) so much (if any) of that amount as has been otherwise offset by prudent management of the capital programme; and

(C) that purpose has not been otherwise achieved;

a "**Relevant Item**" is any of the following:

- (1) A Relevant Change of Circumstance (other than a Relevant Change of Circumstance falling within sub-paragraph (2) of the definition);
- (2) A Notified Item; and
- (3) A Relevant Disposal of Land

and references to a Relevant Item are to a Relevant Change of Circumstance (other than a Relevant Change of Circumstance falling within sub-paragraph (2) of the definition), a Notified Item or a Relevant Disposal of Land as the context may require.

12.2 In the definition of a "Relevant Change of Circumstance" and for the purpose of that definition:

- (1) a "**legal requirement**" is any of the following:
  - (a) any enactment or subordinate legislation to the extent that it applies to the Appointee in its capacity as a water undertaker (and for this purpose, but without prejudice to the generality of the foregoing, "subordinate legislation" includes any order made under section 18 of the Water Industry Act 1991 and any authorisation granted, approval given, or prohibition imposed, by the Secretary of State under The Water Supply (Water Quality) Regulations 2016);
  - (b) any regulation made by the Council or the Commission of the European Union to the extent that it applies to the Appointee in its capacity as a water undertaker, or decision taken by the said Commission which is binding on the Appointee in its capacity as a water undertaker and to the extent that it is so binding;
  - (c) any licence, consent or authorisation given or to be given by the Secretary of State, the Environment Agency or other body of competent jurisdiction to the Appointee for the purpose of carrying on any of the functions of a water undertaker;
  - (d) any undertaking given by the Appointee to, and accepted by, the Secretary of State or, as the case may be, the Water Services Regulation Authority for the purposes of section 19(1)(b) of the Water Industry Act 1991;
  - (e) other than any such undertaking as is referred to in (d), any undertaking given by the Appointee to any enforcement authority, and accepted by that enforcement authority, to take all such steps:

- (i) as are specified by that enforcement authority to be necessary or appropriate for the Appointee to take for the purpose of securing or facilitating compliance with any legal requirement in relation to which that enforcement authority is the enforcement authority; or
  - (ii) the taking of which is specified by that enforcement authority to be a condition or requirement of granting or renewing any such licence, consent or authorisation as is referred to in (c) or agreeing not to withdraw the same;
- (f) the Conditions of these Appointments; and
- (g) any interpretation of law, or finding, contained in any judgment given by a court or tribunal of competent jurisdiction in respect of which the period for making an appeal has expired which requires any legal requirement falling within (a) to (f) above to have effect in a way;
  - (i) different to that in which it previously had effect; or
  - (ii) different to that in which it was taken to have effect:
    - (A) for the purpose of making a Relevant Determination or, as the case may be,
    - (B) in determining whether a Relevant Determination should be changed

but so that nothing in sub-paragraphs (a) to (g) above shall apply so as to include:

- (i) any such legal requirement as is referred to in section 41 of the Environment Act 1995, or

(ii) that section

to the extent in either case that they require the Appointee to pay fees or charges to the relevant enforcement authority; and

(2) "**enforcement authority**" means any person or body having jurisdiction to enforce or to take action under or in respect of the relevant legal requirement.

12.3 In paragraph 13 and in the definition of a "Relevant Change of Circumstance":

(1) references to costs include references to expenditure and loss of revenue and references to costs being incurred include references to expenditure being made and loss of revenue being suffered;

(2) references to receipts include references to receipts, cash or other assets of any sort, whether of a capital or revenue nature and including receipts of grants, contributions, gifts and loans; and

(3) without prejudice to sub-paragraph (1) above, "Operating Expenditure" in sub-paragraph 13.2(6) includes third party services as defined in pro forma A7 and A8 of the Water Services Regulation Authority's Regulatory Accounting Guideline 3.07. For the avoidance of doubt, depreciation, the write-down/off of assets, the profits/loss on disposal of assets and infrastructure renewals expenditure or charges are excluded.

12.4 (1) For the purposes of sub-paragraph 13.2(1) costs, receipts and savings shall be ascertained at the general price level prevailing, or expected to prevail, on 30 September in the year in which the Appointee gives notice under sub-paragraph 13.1, or the Water Services Regulation Authority gives notice under sub-paragraph 14.1.

(2) In sub-paragraphs 13.2(8) and 13.2(9) and sub-paragraph (3) below "**at Outturn Prices**", in relation to the amount of any Base Cash Flow or

depreciation, means that amount as adjusted to take account of the actual or expected cumulative percentage change in the Relevant Index from that prevailing, or expected to prevail, on 30 September in the year in which the Appointee gives notice under sub-paragraph 13.1, or the Water Services Regulation Authority gives notice under sub-paragraph 14.1, up to and including that prevailing, or expected to prevail, on 30 September in the year in which the Base Cash Flow or depreciation occurred, or is expected to occur.

- (3) In sub-paragraph 13.2(8) "**Current Value**", in relation to any Base Cash Flow or depreciation at Outturn Prices, means that amount, as adjusted to take account of the actual or expected cumulative percentage change in the Relevant Index from 30 September in the year in which that Base Cash Flow or depreciation occurred or is expected to occur, up to and including 30 September in the relevant year.

12.5 For the purpose of section 13(5)(b) of the Water Industry Act 1991, the provisions of this Condition, to the extent that they relate to a Relevant Change of Circumstance falling within sub-paragraph (2) of that definition, are provisions of the Appointments which cannot be modified. This sub-paragraph shall cease to have effect if, but only if, this Condition ceases to contain any provision relating to changes to the Relevant Determination to allow for Notified Items and Relevant Changes of Circumstance.

13 References to the Water Services Regulation Authority relating to Notified Items and Relevant Changes of Circumstance and circumstances having a substantial effect on the Appointed Business

13.1 The Appointee may from time to time refer to the Water Services Regulation Authority for determination by it (having considered the proposals of the Appointee) the questions set out in sub-paragraph 13.2 or, as the case may be, sub-paragraph 13.3. Such reference shall be made by notice given to the Water Services Regulation Authority, which, in the case of the questions set out in

sub-paragraph 13.2, shall be given in accordance with sub-paragraph 13.4. For the purposes of sub-paragraph 13.2 a single reference may be made in respect of any number of Notified Items and Relevant Changes of Circumstance and sub-paragraph 13.2 shall be construed accordingly.

13.2 In the case of a Notified Item or where there has been or is to be a Relevant Change of Circumstance all of the following:

- (1) what are, or are likely to be, the costs, receipts and savings reasonably attributable to the Relevant Item and also, in the case of a Relevant Change of Circumstance falling within sub-paragraph (2) of the definition, the costs, receipts and savings reasonably connected with the Relevant Disposal of Land;
- (2) except in the case of a Relevant Change of Circumstance falling within sub-paragraph (2) of the definition, to what extent:
  - (a) are the costs determined under (1) reasonably recoverable through charges for services provided, functions carried out by, and other activities of, the Appointee in its capacity as a water undertaker which are not Standard Charges for water supply (not being Excluded Charges);
  - (b) in the case of receipts and savings, is the Relevant Item relevant to services provided, functions carried out by, and other activities of, the Appointee as a water undertaker which are not water supply in respect of which the Appointee makes Standard Charges (not being Excluded Charges)

and where it is determined that such costs are reasonably recoverable as aforesaid or, as the case may be, that the Relevant Item is relevant as aforesaid, either in full or to an extent, then references hereafter to costs, receipts and savings reasonably attributable to a Relevant Item are to those costs, receipts and savings except to that extent;

(3) both of the following:

- (a) what costs reasonably attributable to, or connected with, the Relevant Item as determined under (1) and what timing of incurring of such costs are appropriate and reasonable for the Appointee in all the circumstances to incur and programme, or, as the case may be, to have incurred and programmed, by reason of the Relevant Item; and
- (b) what receipts and savings reasonably attributable to, or connected with, the Relevant Item as determined under (1) and what timing of such receipts and savings is appropriate and reasonable for the Appointee in all the circumstances to achieve and programme or, as the case may be, to have achieved and programmed, by reason of the Relevant Item

and for the purpose of determining the separate amounts under (a) and (b), but without prejudice to the generality of the foregoing:

- (i) no account shall be taken of:
  - (A) any trivial amounts;
  - (B) any costs, to the extent that they would have been, or would be, avoided by prudent management action taken since the transfer date (and for this purpose what constitutes "prudent management action" shall be assessed by reference to the circumstances which were known or which ought reasonably to have been known to the Appointee at the relevant time);
  - (C) any savings achieved by management action taken since the transfer date over and above those

which would have been achieved by prudent management action (and for this purpose what constitutes "prudent management action" shall be assessed by reference to the circumstances at the relevant time);~~or~~

- (D) any amounts attributable to matters allowed for in making a Relevant Determination, except to the extent that such amounts otherwise fall to be taken into account as amounts reasonably attributable to, or connected with, the Relevant Item under this sub-paragraph (3) and sub-paragraph (1) by virtue of the definition of a Notified Item and a Relevant Change of Circumstance; ~~and~~

(E) any costs, receipts or savings that are associated with the Havant Thicket Activities; and

- (ii) in the case of a Relevant Change of Circumstance falling within sub-paragraph (1) of the definition, regard shall be had to whether either:
- (a) the Secretary of State has notified the Water Services Regulation Authority of any change of policy, concerning any environmental or water-quality standard, which has been made since the last Relevant Determination; or
- (b) the Appointee has itself given notice to the Water Services Regulation Authority of the application to it of, or any change to, any legal requirement, before referring that legal requirement to the Water Services Regulation Authority under sub-paragraph 13.1;

- (4) having determined under (3) the separate amounts of costs and of receipts and savings in respect of each Relevant Item, what are the annual cash flows thereof (costs being netted off against the amount of receipts and savings for this purpose) over each Charging Year included in the timing determined under (3) (those annual cash flows being hereinafter referred to as "**the Base Cash Flows**");
- (5) what is the annual aggregate of:
- (a) one half of the Base Cash Flows in respect of Relevant Changes of Circumstance falling within sub-paragraph (2) of that definition; and
  - (b) the Base Cash Flows in respect of all other Relevant Changes of Circumstance and Notified Items

in both cases the subject of the notice or notices under sub-paragraph 13.4 or sub-paragraph 14.1;

- (6) (a) where any part of an annual aggregate derived under sub-paragraph (5) consists of items to which (b) below does not apply, what is the Net Present Value of that part of the annual aggregate, calculated up to the start of the first of the Charging Years for which the next Periodic Review falls to be carried out;
- (b) where any part of the annual aggregate derived under sub-paragraph (5) consists of revenue and/or Operating Expenditure, what is the Net Present Value of that part of the annual aggregate, calculated over 15 years; and
- (c) what is the aggregate of the Net Present Values calculated under (a) and (b) ("**the Materiality Amount**");

- (7) is the Materiality Amount equal to or does it exceed ten per cent of the turnover attributable to the Appointed Business in the latest financial year for which accounting statements have been prepared and delivered to the Water Services Regulation Authority under Condition F, as shown by those accounting statements, and for this purpose where the Materiality Amount is a negative figure it shall be treated as though it were a positive figure;
- (8) if so, for each year, ("**the relevant year**") until the first of the Charging Years for which the next Periodic Review falls to be carried out (having regard to any Review Notice or Reference Notice which has been given at the time when the reference is made),
- (a) what are the following amounts:
- (i) all Base Cash Flows at Outturn Prices attributable to the creation or acquisition of depreciable assets ("**Allowable Capital Expenditure**");
  - (ii) all the Base Cash Flows at Outturn Prices (save in respect of Relevant Changes of Circumstance falling within sub-paragraph (2) of that definition, where one half of the Base Cash Flow at Outturn Prices shall be used) attributable to the creation, acquisition or disposal of non-depreciable assets ("**Allowable Infrastructure Asset Expenditure**");
  - (iii) all other Base Cash Flows at Outturn Prices ("**Other Allowable Expenditure**");
  - (iv) the sum of the Current Value of all Allowable Capital Expenditure occurring up to and including the relevant year, divided by the weighted average expected life of the assets attributable to that Allowable Capital Expenditure

at the time those assets were or are expected to be created or acquired ("**Allowable Depreciation**");

- (v) the sum of the Current Value of all Allowable Capital Expenditure occurring up to and including the relevant year less the sum of the Current Value of all Allowable Depreciation occurring up to and including the relevant year ("**Allowable Net Asset Value**");
- (vi) the sum of the Current Value of all Allowable Infrastructure Asset Expenditure occurring up to and including the relevant year ("**Allowable Infrastructure Asset Value**");
- (vii) the Appropriate Discount Rate, adjusted so as to exclude any allowance for changes in the Relevant Index, multiplied by the sum of:
  - (A) the Allowable Net Asset Value for the relevant year; and
  - (B) the Allowable Infrastructure Asset Value for the relevant year;

("the **Allowable Return**"); and

- (b) what is the sum of:
  - (i) Other Allowable Expenditure;
  - (ii) Allowable Depreciation; and
  - (iii) the Allowable Return;

(the "**Annual Allowable Amount**")

(9) what change to the level of Price Control or Price Controls over the period beginning from the first of the Charging Years referred to in subparagraph 13.4(1) (in any case where a Reference Notice has been given in respect of sub paragraph 13.2) or subparagraph 14.1(1) (in any other case) until the first of the Charging Years for which the next Periodic Review falls to be carried out (having regard to any Review Notice or Reference Notice which has been given at the time when the reference is made) ("**the Relevant Period**") is most likely to allow, or, as the case may be, require, the Appointee to make such charges over the Relevant Period ("**Adjusted Charges**"), in such a manner as to secure that the increase, or, as the case may be, the decrease, in revenue attributable to the making of Adjusted Charges would, in each year of the Relevant Period, be equal to:

(i) the Annual Allowable Amount for that year,

plus

(ii) where Base Cash Flows at Outturn Prices have occurred prior to the first year of the Relevant Period, the amount, which, calculated as a constant annual amount over the Relevant Period, would result in the sum of the Net Present Values of these amounts equalling the sum of the Net Present Values of the Annual Allowable Amounts for each of the years prior to the Relevant Period,

Provided that -

(a) where costs have been allowed for in determining the Annual Allowable Amount, it shall be assumed that those costs will be financed other than by the proceeds of an issue of equity share capital and

- (b) the revenue attributable to the making of Adjusted Charges over the Relevant Period shall not result in interest cover which, measured both by its level in any one year and by trends in that level over time, is less than that appropriate to the financial position and performance which investors and creditors would reasonably expect of a properly managed company holding the Appointment, whose sole business consists of being a water undertaker and having its equity share capital listed on The London Stock Exchange.

13.3 All of the following:

- (1) whether any circumstance (other than a Relevant Change of Circumstance) has occurred which has or will have:
  - (a) a substantial adverse effect on the Appointed Business or on its assets, liabilities, financial position, or profits or losses, not being one which would have been avoided by prudent management action taken since the transfer date; or
  - (b) a substantial favourable effect on the Appointed Business, or on its assets, liabilities, financial position, or profits or losses, being one which is (i) fortuitous and (ii) not attributable to prudent management action; and
- (2) if so, what change should be made to the level of Price Control or Price Controls.

For this purpose:

- (i) what constitutes "prudent management action" shall be assessed by reference to the circumstances which were known or which ought reasonably to have been known to the Appointee at the relevant time;

- (ii) an effect shall not be regarded as a substantial adverse effect or a substantial favourable effect in any case unless, if the questions set out in sub-paragraph 13.2 were to be asked in relation to the circumstance giving rise to it, the answer to that in 13.2(7) (taking the reference in it to ten per cent as a reference to twenty per cent) would be in the affirmative.

13.4 A Reference Notice given to the Water Services Regulation Authority in respect of sub-paragraph 13.2 shall contain or be accompanied by reasonable details of the Relevant Item in respect of which the Reference Notice is given and, unless the Water Services Regulation Authority otherwise consents, shall be given not later than:

- (1) the fifteenth day of September immediately preceding the first of the Charging Years in respect of which the Appointee wishes the change to the level of Price Control or Price Controls to take effect; or
- (2) if later, where the Water Services Regulation Authority has given a notice to the Appointee under sub-paragraph 14.1 in respect of the same Charging Year, within fourteen days from the receipt by the Appointee of that notice.

14 Changes to the level of a Price Control or Price Controls initiated by the Water Services Regulation Authority relating to Notified Items and Relevant Changes of Circumstance and circumstances within sub-paragraph 13.3(1)(b)

14.1 In the case of a Notified Item or where any Relevant Change of Circumstance has occurred or is to occur, the Water Services Regulation Authority may, having given notice to the Appointee specifying the Notified Item or, as the case may be, the Relevant Change of Circumstance, of its intention so to do not later than:

- (1) the fifteenth day of September immediately preceding the first of the Charging Years in respect of which it proposes the change to the level of a Price Control or Price Controls to take effect; or
- (2) if later, where the Appointee has given a Reference Notice to the Water Services Regulation Authority in respect of sub-paragraph 13.2 and falling within sub-paragraph 13.4(1) in respect of the same Charging Year, within fourteen days from the receipt by the Water Services Regulation Authority of that Reference Notice

determine the questions set out in sub-paragraph 13.2 in respect of that Notified Item or, as the case may be, that Relevant Change of Circumstance. A single notice may be given under this sub-paragraph 14.1 in respect of any number of Notified Items and Relevant Changes of Circumstance and sub-paragraph 13.2 shall be construed accordingly.

- 14.2 Where sub-paragraph 13.4(2) or 14.1(2) applies, the questions set out in (5) to (9) inclusive of sub-paragraph 13.2 shall be determined in respect of all Notified Items and Relevant Changes of Circumstance in respect of which the Appointee and the Water Services Regulation Authority have given notice, taken as a whole.
- 14.3 In the case of sub-paragraph 13.3, the Water Services Regulation Authority shall give notice to the Appointee of its intention to determine the questions set out in sub-paragraph 13.3(1)(b) and (2).

Part V. References to the Competition and Markets Authority

15 References to the Competition and Markets Authority

15.1 Where:

- (1) pursuant to paragraph 8 or following a reference under paragraph 10, the Water Services Regulation Authority has not given notice to the Appointee of its determination or determinations within one year from

the relevant Review Notice Date(s) or, in the case of a reference under paragraph 10, within one year from the date of the relevant Reference Notice;

- (2) following a reference under paragraph 13, the Water Services Regulation Authority has not given notice to the Appointee of its determinations (including any determinations under paragraph 14 which fall to be taken into account in determining the questions the subject of the reference under paragraph 13) within 3 months from the date of the relevant Reference Notice; or
- (3) the Appointee disputes any determination made by the Water Services Regulation Authority under sub-paragraph 8.3 or sub-paragraph 8.4 or any Interim Determination made by the Water Services Regulation Authority under Part IV of this Condition

the Appointee may, by notice given to the Water Services Regulation Authority within:

- (a) 13 months from the Review Notice Date or, in the case of a reference under paragraph 10, from the date of the relevant Reference Notice (in the cases referred to in sub-paragraph (1));
- (b) 4 months from the date of the relevant Reference Notice (in the case referred to in sub-paragraph (2)); or
- (c) 2 months from the date on which the Water Services Regulation Authority gives notice of its relevant determination or determinations to the Appointee (in the case referred to in sub-paragraph (3))

require the Water Services Regulation Authority to refer to the Competition and Markets Authority for determination (such determination to be effective as if made by the Water Services Regulation Authority) by it:

- (i) in any case referred to in sub-paragraph (1) or (2), the relevant question or questions (including, where relevant, the questions in respect of any Notified Item or Relevant Change of Circumstance the subject of a notice under paragraph 14); or
- (ii) in any case referred to in sub-paragraph (3), the disputed determination.

15.2 Where the Appointee requires the Water Services Regulation Authority to make a reference to the Competition and Markets Authority under sub-paragraph 15.1 in the case referred to in section (3) of that sub-paragraph, the Appointee shall levy charges in a way best calculated to comply with the Price Control or Price Controls determined by the Water Services Regulation Authority as if a reference had not been made until the Competition and Markets Authority makes its determination following such reference. The determination made by the Competition and Markets Authority shall then take effect as if it had been made by the Water Services Regulation Authority.

15.3 Where after 1 April 2019 the Appointee requests the Water Services Regulation Authority to make a reference to the Competition and Markets Authority in respect of any determination under sub-paragraph 8.3 concerning Retail Activities, or under sub-paragraph 8.4 concerning Water Resources Activities, [Havant Thicket Activities](#) or Network Plus Water Activities, such reference must comprise all such determinations made under sub-paragraphs 8.3 or 8.4 at the same time relating to the Appointee.

16 **[Not used]**

Part VI. Provision of Information to the Water Services Regulation Authority

17

17.1 The Appointee shall furnish to the Water Services Regulation Authority:

- (1) ...

- (2) not later than 30 September immediately following the date of the Reference Notice (in the case of a reference under paragraph 10);
- (3) at the time when it gives the relevant Reference Notice to the Water Services Regulation Authority (in the case of a reference under paragraph 13 falling within sub-paragraph 13.4(1));
- (4) as soon as reasonably practicable and in any event not later than the expiry of one month from the date of the Water Services Regulation Authority's notice to the Appointee under paragraph 14 (in the case of such a notice, including the case of a reference under paragraph 13 falling within sub-paragraph 13.4(2))

such Information as the Appointee reasonably believes is necessary or, as the case may be, as the Water Services Regulation Authority may reasonably require in its said notice, to enable the Water Services Regulation Authority to make its determination. The Appointee shall also furnish to the Water Services Regulation Authority as soon as reasonably practicable such further Information as the Water Services Regulation Authority may from time to time by notice to the Appointee reasonably require to make its determination.

- 17.2 The Appointee shall also furnish to the Water Services Regulation Authority from time to time when so requested by the Water Services Regulation Authority such Information as the Water Services Regulation Authority may reasonably require to decide whether or not to make determinations under paragraph 14.
- 17.3 Any Information furnished to the Water Services Regulation Authority under this paragraph 17 or under paragraph 8 shall, if the Water Services Regulation Authority so requires to make its determination, be reported on by a person appointed by the Appointee and approved by the Water Services Regulation Authority (such approval not to be unreasonably withheld) ("**the Reporter**").

17.4 The Appointee shall enter into a written contract of engagement with the Reporter which shall:

- (1) where such a report is required by the Water Services Regulation Authority under sub-paragraph 17.3, require the Reporter to prepare and furnish to the Water Services Regulation Authority, and separately to the Appointee, a written report addressed jointly to the Water Services Regulation Authority and the Appointee in form and substance such as may be specified by, or consistent with any guidelines specified by, the Water Services Regulation Authority at the time when it requires the report to be furnished, the matters so specified being reasonably appropriate to enable the Water Services Regulation Authority to make its determination (to the extent that the Information in respect of which that report is required to be prepared and furnished is relevant to that determination); and
- (2) include a term that the Reporter will provide such further explanation or clarification of his report as the Water Services Regulation Authority may reasonably require and such further Information in respect of, or verification of, the matters which are the subject of his report as the Water Services Regulation Authority may reasonably require.

The contract of engagement may also include provisions requiring the Reporter, his employees and agents to keep confidential and not to disclose, except to the Water Services Regulation Authority or as required by law, any information which the Reporter obtains in the course of preparing his report.

17.5 The Appointee shall co-operate fully with the Reporter to enable him to prepare his report, including without limitation, so far as is necessary for that purpose:

- (1) subject to reasonable prior notice to the Appointee, giving to the Reporter access at reasonable hours to any Relevant Plant and to any premises occupied by the Appointee in relation to the Appointed Business; and

- (2) subject to reasonable prior notice to the Appointee, allowing the Reporter at reasonable hours:
  - (a) to inspect and make photocopies of, and take extracts from, any books and records of the Appointee maintained in relation to the Appointed Business;
  - (b) to carry out inspections, measurements and tests on or in relation to any such premises or Relevant Plant; and
  - (c) to take on to such premises or on to or in to any Relevant Plant such other persons and such equipment as may be necessary for the purposes of preparing and completing his report.

17.6 Nothing in sub-paragraph 17.5 shall require the Appointee:

- (1) to do anything which is outside its reasonable control; or
- (2) to do, or to allow the Reporter to do, anything which would materially disrupt the Appointee's business (unless it is essential that that thing be done to enable the Reporter to prepare his report).

17.7 In sub-paragraphs 17.4 and 17.5:

- (1) references to the Reporter include references to his employees and agents; and
- (2) "**Relevant Plant**" means any plant used by the Appointee for the purpose of carrying out the Regulated Activities including, without limitation, water mains and other pipes and their accessories.

Part VII. Developing the Price Controls

18.1 The Appointee will use all reasonable endeavours to work with the Water Services Regulation Authority, subject to the Appointee's legal duties and obligations, in a constructive and cooperative manner on the development of the Price Controls so that they might be appropriately targeted or operated more effectively in respect of specific activities undertaken as part of the Appointed Business.

Part VIII. Price Controls in effect before 1 April 2020

19

19.1 The provisions of Condition B of this instrument in the form that had effect immediately prior to 15 April 2017 shall continue to have effect in respect of the Price Controls set for a period ending before 1 April 2020 and in respect of the making of any Interim Determinations to set any such Price Controls.

19.2 In the event that the Water Services Regulation Authority is, in respect of the Appointed Business, unable to determine Price Controls, for the period or periods starting on 1 April 2020, under sub-paragraph 8.3 and sub-paragraph 8.4 of this Condition B by 31 December 2019, the provisions of Condition B in the form that had effect immediately prior to 15 April 2017 shall continue to have effect in respect of the Price Controls until such time as a determination under sub-paragraph 8.3 and sub-paragraph 8.4 of the current Condition B is made and takes effect.

## **Annex 2: Draft Condition E showing proposed Havant Thicket changes**

[The proposed changes are shown as red underlined text.]

### **Condition E: Undue Preference/Discrimination in Charges**

#### **Introduction**

This condition requires that the Appointee must not set its charges in a way which results in undue preference in favour of, or undue discrimination against, any of its customers or potential customers. This condition also sets out a number of limits to this requirement.

#### **Requirement not to show undue preference or undue discrimination**

- E1 Subject to paragraphs E2 to E4, in fixing or agreeing any charges for the carrying out of the Regulated Activities (whether Class Charges or Bespoke Charges), the Appointee must not show undue preference to, or exercise undue discrimination against:
- E1.1 any class of customers or potential customers of the Appointee;
  - E1.2 any particular customer in relation to whom the Appointee has fixed or agreed a Bespoke Charge; or
  - E1.3 any potential customer in relation to whom the Appointee has offered to fix or agree a Bespoke Charge.

#### **Limits to requirement not to show undue preference or exercise undue discrimination**

- E2 Paragraph E1 shall not apply to the fixing or agreeing of:
- E2.1 any charge which is an Infrastructure Charge the amount of which is subject to a limit set out in Condition C (Infrastructure Charges);

E2.2 any charge which is determined by terms or conditions of an agreement that was:

E2.2.1 entered into by the Water Authority and transferred to the Appointee in accordance with a scheme under Schedule 2 to the Water Act 1989; or

E2.2.2 entered into by the Appointee before the transfer date but continuing in effect after that date;

E2.3 any charge which is determined by:

E2.3.1 where the Appointee is a water undertaker, terms or conditions on which any supply of water in bulk is given by the Appointee to another water undertaker; ~~or~~

E2.3.2 where the Appointee is a sewerage undertaker, terms or conditions on which any main connection by another sewerage undertaker is permitted into the Appointee's sewerage system; or

E2.3.3 to the extent that they do not fall within sub-paragraph E2.3.1, terms and conditions determined under any agreement entered into between the Appointee and another water undertaker in respect of any matters which fall within the scope of the Havant Thicket Activities (as defined in Condition B (Charges));

E2.4 any charge which is determined by terms or conditions determined by Ofwat (or by a person appointed by Ofwat) under section 56 of the Water Industry Act 1991;

E2.5 any charge which is determined by conditions imposed by Ofwat under section 122 of the Water Industry Act 1991; or

- E2.6 any charge which is determined by the provisions included in any notice served by the Environment Agency or Natural Resources Wales under section 132 of the Water Industry Act 1991 or anything required to be done by the Appointee under section 133 of the Water Industry Act 1991 so as to secure compliance with those provisions.
- E3 In fixing or agreeing any charges in compliance with paragraph E1, the Appointee is not required to consider any charges referred to in paragraph E2.
- E4 Paragraph E1 shall not require the Appointee to take any action in contravention of any local statutory provision.

## **Annex 3: Emerging thinking regarding implementation of the separate control**

The amendment of the licence of Portsmouth Water would allow us to designate the relevant "Havant Thicket Activities" that will fall within a separate "Havant Thicket" price control. The Havant Thicket reservoir is being developed for the benefit of Southern Water's customers, and it would be inappropriate for Portsmouth Water's customers to underwrite the development of the project. On that basis, our guiding principle is that Portsmouth Water's customers should not incur any costs related to the development and the construction of the reservoir. The following sets out the key design features of a Havant Thicket price control based on our emerging thinking regarding the implementation of the separate control.

### **Duration of the Havant Thicket price control**

The Havant Thicket control would have a ten-year price control period, covering 2020-2030. The Havant Thicket reservoir will take approximately 10 years to build before it can enable the related bulk supply to Southern Water under an 80-year agreement. There are significant merits from aligning the duration of the price control with the construction period, including stronger incentives to manage the delivery of the project, cost efficiency and providing regulatory certainty to Portsmouth Water and Southern Water.

### **Mid-period reconciliation in 2024**

We intend to perform a mid-period reconciliation of allowed revenue for the Havant Thicket price control at the 2024 price review (PR24). These adjustments will be applied through a mid-period determination of the separate price control.

The reconciliation mechanism will include a limited number of revenue and/or RCV adjustments to apply to the remaining five years of the Havant Thicket price control from 2025-2030. These adjustments are required to account for some key commercial details of the final bulk supply agreement with Southern Water, cost outcomes, cost of new debt indexation and tax. Some of those adjustments will have a direct effect on the allowed revenue that Portsmouth Water can recover from its customers. Other adjustments will feed into the baseline revenue requirement for the Havant Thicket reservoir over 2025-2030. We will take these adjustments into account at PR24 when undertaking an assessment of Southern Water's efficient allowance for 2025-2030.

## **Sharing of economic profit between Portsmouth Water and its customers**

We expect that Portsmouth Water would not recover any economic profit from Southern Water under the bulk supply agreement during construction prior to the water transfer becoming operational. Therefore, to the extent that there are economic profits to be shared with Portsmouth Water's customers, they would only cover the period when the water transfer is operational. According to the construction timelines proposed, this could happen as early as 2027. Any economic profit derived by Portsmouth Water under the bulk supply agreement with Southern Water prior to the water transfer becoming partially operational will be treated as a capital contribution and netted off the company's Havant Thicket Activities RCV.

Portsmouth Water will share 50% of the Net Present Value (NPV) of any economic profits<sup>3</sup> earned in the 2020-2030 period once water is available to supply under the bulk supply. This is consistent with the principles of our PR19 water trading incentives policy which allows companies to retain 50% of the NPV of the lifetime economic profit of qualifying exports. To the extent that economic profit can only be derived by Portsmouth Water once the water transfer is operational, the earliest starting point of profit sharing will be 2027. We are considering whether the mid period determination should include any sharing of the expected economic profit that Portsmouth Water might earn in the period after 2027.

## **Cost of new debt indexation and revision of the WACC**

We propose to apply our cost of new debt indexation mechanism to the Havant Thicket price control at the mid-period reconciliation in 2024. In addition, we would consider the merits of updating the weighted average cost of capital (WACC) for the remaining five years of the price control period (2025-2030) as part of the PR24 price review.

## **Tax reconciliation**

There are two distinct elements related to tax reconciliation. Firstly, we would adjust the Havant Thicket control for the forecast tax Portsmouth Water would incur on the economic profits earned as part of the bulk supply agreement with Southern Water throughout 2020-2030. Secondly, we would apply a tax reconciliation adjustment

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<sup>3</sup> Economic profit is defined as the outturn bulk supply revenues above the cost, inclusive of a return on capital.

calculated in PR24 related to changes in corporate tax rates and capital allowances, consistent with our overall approach to tax reconciliation in PR19.

### **Application of mid-period adjustments to allowed revenues in 2025-2030**

The accounting treatment of the bulk supply revenues is such that they cannot be recognised by Portsmouth Water as receipts in its accounts before the water transfer becomes partially operational. The timing of the application of the mid-period adjustments in the 2025-2030 period should be consistent with the accounting treatment of the bulk supply revenues Portsmouth Water derives from the agreement with Southern Water. We consider that the timing of such adjustments should be aligned with the time where the bulk supply revenues can be recognised. In our engagement with Portsmouth Water, we have established that the revenues can be recognised at the time where the water transfer becomes partially operational. According to the construction timelines proposed, this could happen as early as 2027. Therefore, the adjustments can be profiled appropriately during the 2025-2030 period to start once the water transfer is partially operational, which would trigger an event that would allow Portsmouth Water to recognise the bulk supply revenues in its accounts.

### **Recovering allowed revenues for the Havant Thicket price control in 2020-2030**

Throughout the 2020-2030 period, Portsmouth Water would be required to comply with its Havant Thicket price control. The allowed revenue that Portsmouth Water could recover from its own customers would be zero in the first five years (2020-25), which is a requirement that Portsmouth Water can comply with relatively easily since no charges or rebates to customers would be required. However, the remaining years could introduce a requirement for a negative price control, because the company would start sharing the economic profit derived under the bulk supply agreement with its customers. In those circumstances there would be a requirement on Portsmouth Water to ensure that it returns the correct amount of revenue to its customers through reduced charges in respect of other price controls to comply with its price control during 2025-2030. Any over/under-recovery would then be reconciled through an end-of-period revenue adjustment in the following price review.

Finally, we would expect to include an annual adjustment to the Havant Thicket price control during 2025-30 to reflect any percentage change in inflation between that published for the month of November in the Prior Year and that published for the immediately preceding November. We think that this should be consistent with our approach to inflation indexation for the other wholesale price controls.

## Reconciliation in 2029

In 2029, the same adjustments would be applied when setting a new price control for the period from 1 April 2030 as in the mid-period reconciliation in PR24, to account for outturn performance for the remaining years of the Havant Thicket price control from 2024-2030.

There are two key additional adjustments relevant to Havant Thicket Activities at this stage:

- the application as an additional end-of-period adjustment of any bespoke performance commitment ODI related to delivery of the reservoir; and
- totex sharing in line with our overall approach to totex sharing in PR19.

Cost out/under performance will be shared between Portsmouth Water and Southern Water with each party exposed to 50% cost out/underperformance risk. Portsmouth Water's customers are only affected by cost out/underperformance to the extent that it impacts the level of outturn economic profits (with lower outturn costs increasing economic profits and vice versa). This is subject to the constraint that Portsmouth Water is not allowed to recover any economic profit under the bulk supply agreement prior to the reservoir being partially operational.

We propose to introduce a gated process allowing for an update of cost allowances based on tender outcomes once these materialise around 2022. The gated process assists in mitigating the significant cost uncertainty associated with the construction of the Havant Thicket reservoir at the time of the PR19 Final Determination. In light of the introduction of the gated cost update process, our current view is that totex sharing would not be necessary at the mid-point of the control because the cost uncertainty risk would be mitigated. Therefore, totex sharing applies only at the end of the Havant Thicket control period in PR29.

The regulatory treatment of the Havant Thicket price control for the remainder of the bulk supply agreement after 2030 will be consistent with our policy position in future price reviews. However, the regulatory treatment of the economic profits related to the Havant Thicket reservoir remains consistent with the water trading incentives policy set out in the PR19 Final Methodology. Therefore, Portsmouth Water would be able to recover 50% of the outturn economic profits related to the bulk supply agreement with Southern Water in each successive price control period until the end of the bulk supply agreement.

The policy intent behind a separate Havant Thicket price control is consistent with the position we set out in the Draft Determination. Our position is that our approach will:

- maintain continuity of incentives throughout the construction period, including our approach to cost and risk sharing;
- enable strong delivery performance measures, including financial penalties for delay;
- provide greater regulatory certainty to Portsmouth Water and Southern Water; and
- ultimately offer greater customer protection.

We have sought to provide appropriate clarity related to the proposed price control in our engagement with Portsmouth Water after the Draft Determination. This licence modification would allow us to proceed with our proposed approach as the licence modification is needed before we can make a PR19 Final Determination that includes a separate Havant Thicket control.

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.

Ofwat  
Centre City Tower  
7 Hill Street  
Birmingham B5 4UA

Phone: 0121 644 7500  
Fax: 0121 644 7533  
Website: [www.ofwat.gov.uk](http://www.ofwat.gov.uk)  
Email: [mailbox@ofwat.gsi.gov.uk](mailto:mailbox@ofwat.gsi.gov.uk)

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