December 2019

PR19 final determinations

Dŵr Cymru – Accounting for past delivery additional information

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Loughor Estuary project

1 Our draft determinations

In our draft determination we proposed to intervene to disallow Dŵr Cymru's request to account for the expenditure on its Loughor Estuary project incurred between 2015-16 and 2018-19 as PR19 transitional expenditure. The company's submission intended to ensure the costs would be allowed in full, as opposed to being subject to totex cost sharing as prescribed by the PR14 methodology.

We changed the Sewerage: actual totex costs (outturn prices) as follows:

- 2016-17: from £285.063 million to £289.316 million;
- 2017-18: from £297.622 million to £315.789 million;
- 2018-19: from £336.872 million to £368.550 million; and
- 2019-20: no adjustment, accepted £20.867 million as part of PR19 transitional costs.

Our intervention increased the company's actual sewerage totex costs for 2015-19 to reflect annual actual totex on its Loughor Estuary. Overall, our interventions reduced the wastewater totex menu revenue adjustment from - £8.273 million to - £5.162 million (2017-18 FYA CPIH deflated price base) and changed the wastewater totex menu RCV adjustment from - £23.180 million to £1.395 million (2017-18 FYA CPIH deflated price base).

2 Stakeholder representations

In its representation on our draft determination, Dŵr Cymru retains its position that the expenditure in relation to the Loughor Estuary warrant an exception to Ofwat's standard approach as:

- the Loughor Estuary project is required to meet a new legal requirement. Following a decision of the European Court of Justice in May 2017 that found the UK Government in breach of the Urban Waste Water Treatment Directive in respect of the Llanelli and Gowerton catchments, the company was instructed by Natural Resources Wales to meet a reduced spill frequency to ensure compliance by 31 December 2020;
- Dŵr Cymru argues this investment could not have been delayed until 2019 without significant risk of infraction fines, which would be payable by the Welsh Government, and severe consequences for its customers; and
- therefore its expenditure should be allowed in full.

The company states that this is its consistent view as explained to Ofwat over the last four years.

The company also revises the profile of expenditure for Loughor to take account of the actual expenditure reported in the '2018/19 annual performance report part 4' and the reforecast 2019-20 expenditure, in line with its 15 July 2019 submission. The outturn 2018-19 expenditure is reduced from £32 million to £19 million (outturn prices) and 2019-20 expenditure (which it proposes to treat as transitional expenditure to be recovered through PR19) increases from £20 million to £33 million.

Dŵr Cymru does not reiterate its proposal from its April 2019 revised business plan submission to consider all Loughor Estuary expenditure as transitional expenditure (which was also included in the 15 July 2019 submission). Instead, in order to ensure the financial model allows a similar result, Dŵr Cymru transforms the expenditure actually incurred between 2015-16 and 2018-19, by dividing it by the wastewater sharing rate (50.6%). This results in the RCV and revenue adjustment calculations fully funding the expenditure incurred in these years in the RCV and Revenue feeder models and associated tables.

In its April 2019 revised business plan submission Dŵr Cymru also stated:

- any other treatment which does not fully fund this expenditure would have perverse regulatory consequences, as it would penalise a company for taking an innovative and more beneficial approach, with lower costs to customers, a better environmental and societal outcomes, and which was necessitated by the unique legal and political context, and
- it had not pursued the option of seeking an interim determination of K (IDoK) during the 2015-20 period to avoid an immediate increase in bills for customers.

We received no other representations in relation to the intervention on Dŵr Cymru's totex allowance and reconciliation for costs related to the Loughor Estuary.

3 Our assessment and reasons

We have reviewed the information and actively considered all issues raised in the representation the company provides to us. We consider that the company does not provide sufficient and convincing evidence to justify an exception to the PR14 and PR19 price control rules, namely not to apply the cost sharing mechanism to the spending above allowances incurred between 2015-16 and 2018-19.

In PR14 the company proposed expenditure and we gave a specific allowance of £18 million (2012-13 prices) to meet the Urban Wastewater Treatment Directive requirements in relation to the Loughor Estuary due to a pending case in the European Commission relating to the high number of combined sewer overflow (CSO) spills[1]. At the time of the submission of the 2015-20 business plan the company was already aware of the need to comply with the Urban Wastewater Treatment Directive and that the pending European Commission complaint might lead to a ruling from the European Court of Justice accelerating the timescale for delivery.

As we stated at our PR14 final determination[2], which Dŵr Cymru accepted, our allowance provided funding for the company to meet all statutory obligations and it was the company's responsibility to manage uncertainty around these costs through the cost sharing mechanism in the totex reconciliation. Our PR14 totex allowance was an 'in the round' allowance, and we did not list out all items we considered and our allowance for each of them.

Uncertainty associated with the scope and timing of work that is required always exists when setting price controls, which is in part why we include the cost sharing mechanism. It is central to the purpose of price controls that companies cannot retrospectively reopen price limits, except in very limited circumstances as specified in licence conditions and final determination. To do otherwise would be to the detriment of customers as companies only seek to reopen price limits in their favour, and not in favour of customers.

We do not consider that it is relevant that this expenditure could not be delayed until 2019-20 due to the technical solution adopted, as the risk that some expenditure would be required before 2019-20 formed part of the overall PR14 final determination that the company accepted. Expenditure on the Loughor Estuary project incurred before 2019-20 should therefore be subject to the cost sharing mechanism in the totex reconciliation, as for any other expenditure.

We consider, however, as we did at draft determination, the 2019-20 expenditure is eligible for the transition programme, since the required completion of the scheme is in 2020-21. We fund companies' transition programme expenditure for investment incurred during 2019-20, where it is efficient to bring forward investment and to enable them to meet statutory deadlines early in the next regulatory period.

We have examined further evidence from the company on the movement of accruals for 2018-19, and the outturn figures appear reasonable. We have also assessed the 2019-20 expenditure and confirm that the full amount of the requested expenditure

[1] This investment was a continuation of an asset management period 5 (AMP5) (2010-15) investment aiming to reduce combined sewer overflow (CSO) discharges to 10 spills per year.
[2] The cost claim is covered in 'PL14S011 – Cost template', tab 'UC1-NEW' under the name 'Llanelli/ Gowerton'.

for 2019-20 can be treated as transitional. Based on our assessment we accept the revised values submitted in the company's 15 July 2019 submission.

We consider that applying our standard price control framework will have positive regulatory consequences. Applying the final determinations as agreed at PR14 reinforces regulatory certainty, which strengthens the incentives for companies to deliver for customers through the existing framework. Companies are funded to meet all statutory obligations, and to manage delivery of these through the cost sharing mechanism.

We do not consider that our approach penalises the company for using an innovative solution to fulfil its statutory obligations, as the company suggests. The company reiterated in its April 2019 revised business plan that the more expensive conventional storage solution[3] was also technically infeasible, would have been highly carbon intensive, and so would have had adverse environmental consequences. So it would not have been the most cost beneficial solution for customers. Therefore, regardless of when the company needed to start this investment relative to the conventional storage solution, the innovative approach would always have been the preferred solution. As with any uncertain expenditure, the company could then manage this through the cost sharing mechanism.

We note that the company did not apply for an interim determination of K. We do not consider the company's reasons for why it opted not do so is relevant for our decision on whether to allow the proposed treatment of the Loughor Estuary project expenditure for the PR14 totex reconciliation. As an interim determination of K was not sought, this expenditure should be considered under the standard price control framework, as set out above.

4 Our final decision

We reject the company's mechanistic approaches to fully fund Loughor Estuary project costs as set out both in its 15 July 2019 submission, and the alternative approach set out in its representation. The company accepted the risks associated with the Urban Waste Water Treatment Directive in respect of the Llanelli and Gowerton catchments in its PR14 final determination, and the cost sharing mechanism and transition mechanisms allow it to manage these risks.

We accept the company's latest outturn figures and allow the 2019-20 expenditure under the transition programme as part of its PR19 allowance.

[3] The company estimated its April 2019 revised business plan to cost £650 million compared to £114 million for the adopted solution.

Our intervention for the final determination reduces the wastewater totex menu revenue adjustment from - £8.377 million to - £5.826 million (2017-18 FYA CPIH deflated price base) and reduces the wastewater totex menu RCV adjustment from - £25.394 million to - £5.657 million (2017-18 FYA CPIH deflated price base) relative to the 15 July 2019 submission. These figures include the impact of the company's updated figures for Loughor Estuary and other changes to totex.

Overall, we are allowing £4.412 million more through the totex menu revenue adjustment and £5.659 million more through the totex menu RCV adjustment in this final determination than in the draft determination (2017-18 FYA CPIH deflated price base). These movements reflect both our interventions described above and the movements in actual totex reported by the company between draft and final determination.

We are also allowing an additional £12 million (2017-18 FYA CPIH deflated price base) relative to the draft determination in transitional expenditure for the Loughor Estuary project for expenditure in 2019-20 as explained in section 3.3 of 'Dŵr Cymru – final determination'.

Ofwat (The Water Services Regulation Authority) is a non-ministerial government department. We regulate the water sector in England and Wales.

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