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PR19 final determinations

Havant Thicket appendix

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PR19 final determinations: Havant Thicket appendix

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1 Summary

In this document we set out our regulatory approach to enable the development of the Havant Thicket reservoir. It is tailored to recognise the specific circumstances of the project, promote efficient outcomes and to ensure customers are adequately protected[1].

We consider that a separate 10 year price control better aligns the cost and risk sharing arrangements between customers and shareholders of both Portsmouth Water and Southern Water given the long term nature of the project.

This technical appendix sets out the details of our final determination. Since the separate Havant Thicket control is a wholesale control, we adopt the same well understood principles for the design and implementation of the control as for other wholesale controls with small adjustments where necessary to tailor for the specific circumstances of Havant Thicket.

Our decisions take into account the representations made on all our draft determinations, responses from companies to our queries and additional information provided following further engagement with companies and other stakeholders as part of the final determination process. In the interest of brevity, where no representations have been made on our draft determination proposals, we do not repeat our reasoning in all cases. Please see the PR19 draft determinations for further details.

We made changes to Portsmouth Water's conditions of appointment which came in to effect on 25 November 2019. These modifications allow us to determine a separate 10 year price control for the Havant Thicket reservoir.

[1] Our approach has been tailored to the specific circumstances of the Havant Thicket reservoir. Our framework for long term water resources will develop with the support of the Regulators' Alliance for the Promotion of Infrastructure Development (RAPID) and our approach to Havant Thicket should not be considered a precedent for other projects in the future.

2 What we said in our draft determinations

2.1 Background

We have challenged water companies to assess a wide range of options for securing water supply resilience including investment in new infrastructure and water transfers. 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 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 generate an additional 21Ml/d of available water to be traded with Southern Water. Overall, Portsmouth Water intends to increase its water transfers to 60Ml/d which will make a significant contribution to Southern Water meeting the water needs of its customers.

2.2 Regulatory approach to water transfers

The provision of bulk supplies of water to neighbouring water companies typically uses the existing assets of the appointed company and is part of its regulated business. The costs of providing bulk supplies to another water undertaker fall within the scope of the wholesale price controls. Investment associated with bulk supplies is included within totex allowances and added to the regulatory capital value (RCV).

While the costs of providing bulk supplies fall within the scope of the price controls, bulk supply charges are not regulated in the same way as other charges. Revenues from bulk supply charges are outside the wholesale price controls. Instead, we net-off the expected revenues from bulk supply charges when determining the level of the price controls. This means that revenues from the provision of bulk supplies offset the costs of the regulated business. Customers benefit as economic profits are passed to them through lower bills. Our water trading incentives allow companies to share a proportion of the economic profits from new bulk supply arrangements[2].

[2] Subject to the company having an approved water trading and procurement code and the bulk supply terms meeting the requirements for a qualifying trade.

We do not limit the prices of bulk supplies through price controls. They are normally negotiated between water undertakers as part of the bulk supply agreement. We expect bulk supply prices to be consistent with our bulk supply pricing policy principles. If companies do not agree the prices and conditions of new bulk supply agreements, then they can, in some circumstances, be referred to Ofwat for a determination under section 40 of the Water Industry Act 1991.

The proposed water transfers between Portsmouth Water and Southern Water are ambitious and unusual in that a large proportion of the overall bulk supply of water to Southern Water depends on the construction of the Havant Thicket reservoir in Portsmouth Water's area.

Portsmouth Water and Southern Water are negotiating commercial arrangements to deal with the complex allocation of costs and risks associated with the construction of the reservoir as well as the core aspects of bulk supplies. The allocation of costs and risks between Portsmouth Water and Southern Water needs to ensure that customers are adequately protected, avoiding inappropriate transfers of risks to customers that should be borne by the companies and their investors.

The regulatory framework must protect the customers of Portsmouth Water and Southern Water and encourage efficient behaviour. Our regulatory framework sets price limits and provides a package of cost and performance incentives to ensure companies deliver wholesale water services to their customers. We need to make sure that the protections and incentives in the price control framework appropriately reflect the complex allocation of costs and risks for the development of the Havant Thicket reservoir.

2.3 Proposed policy approach

We strongly support the proposed development of 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. 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.

Our draft determination proposed a separate 10 year price control in relation to the Havant Thicket reservoir, recognising it is distinct from Portsmouth Water's existing wholesale services that are driven by the needs of its own customers. In contrast, the water resource capacity delivered by the Havant Thicket Reservoir will be used to free up water resources elsewhere in Portsmouth Water's area and make them available to supply to Southern Water. The proposed 10 year duration closely aligns to the construction period for the reservoir, providing greater continuity of the regulatory framework throughout construction. Our draft determination aimed to:

- provide appropriate incentives to deliver efficient outcomes for customers and the environment from the development and construction of the Havant Thicket reservoir. This includes protecting customers of Portsmouth Water from funding the reservoir development through their bills;
- ensure that there are appropriate cost- and risk-sharing arrangements between companies to:
  - protect Portsmouth Water's customers from exposure to cost overruns and stranding risk which should be shared between Portsmouth Water's shareholders and Southern Water's shareholders and customers;
  - allow customers and shareholders of Portsmouth Water and Southern Water to share the benefits of any efficiency gains and profits from water trading; and
  - provide strong protections for Southern Water's customers. This includes incentives to encourage Portsmouth Water to deliver the reservoir in a timely manner and support Southern Water to meet its legal requirements to reduce abstractions.
- ensure that there are no wider service risks to customers of Portsmouth Water and Southern Water; and
- ensure that the proposed arrangements do not have a negative impact on the financial resilience of Portsmouth Water or Southern Water.

2.4 Our proposals

Key aspects of our approach for the draft determination were that:

- the proposed price control included a limit on what Portsmouth Water can charge its customers in relation to the Havant Thicket reservoir. We were not proposing limits on what Portsmouth Water can charge Southern Water under the bulk supply arrangements;
- we determined the economic cost of developing the reservoir under a building blocks approach before netting off the revenues that Portsmouth Water are expected to receive under the bulk supply arrangement to determine the limit on revenues that can be recovered from Portsmouth Water's customers. The bulk supply charges paid by Southern Water should be sufficient to fund the economic cost of developing the Havant Thicket reservoir, resulting in a zero or negative price limit[3]. The risk that the bulk supply revenues are not sufficient sits with Portsmouth Water's shareholders;

[3] A negative price control will only occur where non-price control income, such as bulk supply revenues, generate an economic profit. Since revenues are greater than the revenue requirement to fund efficient costs of construction, operation, maintenance and financing of the reservoir, sharing the excess income with Portsmouth Water's customers will result in a negative price control. This is consistent with the current approach to bulk supply revenues although the negative revenue effect on customer bills is less transparent in the context of broader wholesale water price controls.

- we proposed a bespoke weighted average cost of capital (WACC) of 2.72% (CPIH deflated) to recognise that we anticipated that the project would be funded by new debt. In addition, Portsmouth Water would be able to earn economic profits from the bulk supply charges paid by Southern Water that would separately enhance returns to shareholders;
- we proposed a cost allowance of £121.5m, after applying an efficiency challenge of £13.8m. Our efficiency challenge was based upon cost comparison with similar projects, review of project risk allowance and challenge in areas where insufficient evidence for scope and costs were provided. We additionally excluded the requested expenditure relating to additional reservoir assets such as car parks and a visitor centre;
- we recognised that Portsmouth Water may earn economic profits under the bulk supply agreement. We proposed to maintain the policy principles of water trading incentives to enable profits to be shared equally between shareholders and customers over the lifetime of the bulk supply agreement. However, we set out that we would give effect to these in a different manner, recognising the following:
    - Initially, the uncertainty around construction costs and bulk supply revenues makes it difficult to robustly assess the expected economic profit. We proposed to reconcile economic profits at the end of the period to ensure that customers and shareholders benefit from equal sharing on an NPV-neutral basis;
    - The existing water trading incentives typically allow companies to recover their share of the expected economic profits up front, providing greater certainty to investors and strengthening the incentives to trade water. Advancing expected economic profits creates an intergenerational transfer of value and increases risks to future customers, especially under an 80 year bulk supply agreement. We proposed that water trading incentives should be profiled over the lifetime of the agreement to address this issue.
- we proposed that Portsmouth Water should be exposed to a bespoke performance commitment and associated underperformance payment linked to delivery of the Havant Thicket reservoir;
- we proposed that we would not have reopeners for the separate revenue control at the 2024 price review (PR24). We set out that a 10 year control will provide greater certainty to Portsmouth Water and its customers about the recovery of costs over the period and provide clarity to its customers that they will not be responsible for any of the costs of the Havant Thicket reservoir during the construction period, consistent with the principles that both companies set out in their business plans.

Further information on our draft determination is in the July 2019 Havant Thicket policy issues appendix.

3 Stakeholders' representations, our assessment and reasons

3.1 Introduction

We received representations to our proposed approach for the Havant Thicket reservoir from three stakeholders (Portsmouth Water, Southern Water and CCWater). We have had ongoing engagement with both Portsmouth Water and Southern Water to clarify our proposed approach set out in our draft determination.

There is support for a separate price control, recognising the benefits of cost transparency around the development of the Havant Thicket reservoir that is to be funded by Southern Water's customers rather than Portsmouth Water's customers.

Portsmouth Water set out that its support for a separate price control is conditional on us addressing its material concerns in relation to:

- the allowed rate of return and financeability;
- the cost allowances;
- providing clarity on the application of the PR19 water trading incentives policy in relation to sharing economic profits with customers; and
- providing clarity on future regulatory treatment of the Havant Thicket reservoir after the initial 10 year period.

Southern Water broadly supports our draft determination approach with regards to Havant Thicket, but provides representations on the following specific aspects of the draft determination:

- the need for further detail on the regulatory framework and how it will apply to the Havant Thicket reservoir;
- the allowed rate of return and financeability;
- the treatment of efficient costs, material cost changes and cost sharing;
- the treatment of the outcome delivery incentive (ODI) related to delivery and the link to the bulk supply arrangements;
- the recognition of Havant Thicket bulk supply revenues in Southern Water's revenue allowances; and
- the application of the section 37 duty to supply to ensure parity for customers of Southern Water.

The following sections provide further detail of the representations made, our consideration of the representations and our final decisions.

3.2 Allowed return and financeability

3.2.1 What we said in our draft determinations

Our draft determination proposed a bespoke weighted average cost of capital (WACC) of 2.72% (CPIH deflated) for the Havant Thicket price control. This reflected our sector wholesale cost of equity (4.21% in CPIH terms), but a different cost of debt – 1.72% instead of the sector assumption of 2.33%.

Our decision to set a different cost of debt reflected two factors:

- a no embedded debt assumption, as this would be inappropriate for a project whose debt financing will be new debt only (which would apply, for example, if the project was delivered by direct procurement for customers); and
- a 30 basis point uplift to the sector cost of new debt assumption – reflecting our decision at Initial Assessment of Business Plans to allow Portsmouth Water a company-specific adjustment to its cost of debt at PR19.

We also consulted on whether to apply our cost of new debt indexation mechanism when considering efficient costs as part of PR24 and the 2029 price review (PR29) and how this mechanism might apply in the context of a 10 year control. In addition, we recognised that Portsmouth Water would be able to earn economic profits from the bulk supply charges paid by Southern Water that would separately enhance returns to shareholders.

3.2.2 Stakeholders' representations

Portsmouth Water set out in its representation that it considers that our approach on the allowed return on capital was not consistent with a 10 year cost of financing and the bespoke allowed return on capital did not reflect the inherent equity risks of construction. It argues for a higher and more certain return to investors that should be set, as a minimum, at the level of the allowed return on capital that we determine for Portsmouth Water's water resources and water network plus price controls. In contrast, Southern Water and CCWater support our approach to the allowed return on capital, although Southern Water emphasises the need to ensure that the returns are sufficient to ensure that Portsmouth Water remains financeable.

Portsmouth Water considers that the recognition of scope to earn economic profits under the bulk supply agreement and the export incentive is positive. However, the uncertainty around the likely quantum of returns, relative to the allowed return on capital, makes a robust assessment of financeability difficult and as a result raises issues for rating agencies and investors. Portsmouth Water also raises concerns in relation to the scale of exposure to cost and financing risk over a 10 year price control and argues for a full reset of the allowed return on capital after 5 years.

Portsmouth Water also raises financeability concerns related to the timing of when bulk supply revenues could be recognised under statutory accounting rules[4]. There is a potential to misalign the timing at which statutory accounts and the price controls would recognise payments from Southern Water as income in a way that adversely affects financial ratios.

3.2.3 Our final determination decision

We have considered the representations received from stakeholders and the further engagement with Portsmouth Water and Southern Water on these matters. We have decided to adopt the industry wholesale WACC of 2.92% (CPIH deflated) for the purposes of determining the allowed return for the separate Havant Thicket price control.[5] We will reset the allowed return for the 2025-30 period to be consistent with the revised wholesale price controls at PR24. We will also apply the cost of new debt indexation adjustment mechanism and apply any equivalent mechanism for 2025-30 to the extent it is adopted for other wholesale controls at PR24.

We acknowledge that there may be inherent factors that increase the risks to Portsmouth Water's shareholders during the construction phase of the Havant Thicket reservoir. However, the impact of inherent equity risks are likely to be offset by lower actual debt costs, due to being financed entirely with new debt. We also consider that some construction risks will be shared with Southern Water's customers and investors through the bulk supply arrangement. Therefore, we accept that there is a case for increasing the allowed return under the separate price control from the level proposed in our draft determination, but that there is not a sufficient justification for determining an allowed return above the industry wholesale allowed return on capital.

Portsmouth Water will be able to enhance returns to shareholders by earning economic profits from the bulk supply charges paid by Southern Water throughout the operation of the reservoir. However, we do not expect Portsmouth Water to earn economic profit during construction. This is consistent with the accounting treatment of revenues, which would not be recognised before Portsmouth Water begins to provide the associated bulk supply to Southern Water. Our approach aligns the price control treatment of economic profit with the accounting approach of revenue recognitions.

[4] Revenue cannot be recognised ahead of delivery of a bulk supply.
[5] This wholesale WACC excludes the Company-Specific Adjustment of 0.33% on the allowed cost of debt which applies to Portsmouth Water's other wholesale controls.

If bulk supply charges paid by Southern Water exceed the level needed to fund the expected efficient level of expenditure during construction then we will adjust the Havant Thicket RCV at PR29 to be consistent with the principle that economic profits are not earned before a bulk supply is provided. We intend to net off the excess income earned during construction by lowering the Havant Thicket RCV. Our approach will result in an outcome equivalent to Portsmouth Water not earning any economic profit during construction since it will effectively transfer the profit earned by Portsmouth Water to Southern Water's customers after 2030 through lower future notional bulk supply charges. This will be applied as a one-off adjustment when determining price limits for the period from 1 April 2030 at PR29.

We consider that by aligning our approach to the existing framework for regulating wholesale controls, we bring more certainty/familiarity for equity and debt investors. This approach need not result in higher bulk supply prices, although this would be for Southern Water and Portsmouth Water to negotiate.

3.3 Cost allowances

3.3.1 What we said in our draft determinations

We proposed a cost allowance of £121.5 million, after applying an efficiency challenge of £13.8 million. Our efficiency challenge was based upon cost comparison with similar projects, a review of project risk allowance and challenge in areas where insufficient evidence for scope and costs were provided. We additionally excluded the requested expenditure relating to additional reservoir assets such as car parks and a visitor centre which appear outside the scope of the water services that Southern Water's customers should fund.

3.3.2 Stakeholders' representations

Portsmouth Water strongly disagrees with our proposed £13.8 million disallowance of expenditure. It considers that the bottom up estimation of the project costs is more robust than our benchmarking approach. It accepts an efficiency challenge of £1.6 million related to the project costs for the network reinforcement to facilitate the water transfer.

Portsmouth Water argues that the proposed disallowance is inappropriate because:

- the car parking and the visitor centre is a requirement for obtaining planning permission and that expenditure should be allowed;

- the approach to cost contingency is in line with best practice and appropriate given the extent of cost uncertainty; and
- the scale of disallowance will have a negative impact on financeability.

Portsmouth Water also notes that the cost estimates for the project were very uncertain at this stage in the project development. It proposes a forward looking reassessment of allowed expenditure when costs are more certain following the planning and procurement process.

Southern Water provides an independent review of Portsmouth Water's expected construction costs for the Havant Thicket Reservoir. Although this review supports the high level cost estimation approach followed by Portsmouth Water, it highlights scope for cost efficiency challenges on several specific components of the project costs, suggesting that the reservoir element could be delivered for £13.4 million less than Portsmouth Water's April 2019 estimate.

3.3.3 Our final determination decision

We are setting a cost allowance of £123.6 million, after applying an overall efficiency challenge of £10.1 million. This includes transitional expenditure of £5.4 million that has been included in the cost allowance for 2020-21. Our cost efficiency challenge now includes:

- a £1.8 million adjustment to reduce design and PMO costs in line with the evidence provided by Southern Water;
- a £2.0 million adjustment for scheme risk allowance and estimating uncertainty, in line with Southern Water's evidence and our consideration that the cost adjustment mechanism removes potential risks and uncertainties from the programme;
- an efficiency challenge of £1.1 million on expenditure required for the visitor centre and public art, and the removal of a further £1.0 million for income opportunities relating to the reservoir and its facilities. We have included £4.6 million of expenditure for the visitor centre and car parking acknowledging their part in the planning permission;
- an efficiency challenge of 20% to the network reinforcement expenditure (£6.4 million) as Portsmouth Water has not been able to provide sufficient evidence of the scope and optioneering of the network enhancement required or the associated costs. The company has accepted an efficiency challenge of £1.6 million in relation to these costs; and
- we allow operational costs of £0.6 million assuming that the transfer of water will start within the 10 year control period and potentially before the reservoir is full.

We are also introducing a cost adjustment mechanism linked to planning and procurement gateways. This approach recognises the significant cost uncertainty at this early stage of project development. In determining cost allowances once there is greater certainty, we ensure that Portsmouth Water faces appropriate incentives to deliver the reservoir efficiently without large contingencies to mitigate the cost uncertainty. This should deliver more appropriate outcomes for customers.

We will track the early development of the project to construction readiness to allow for the scope of the project and our view of the efficient cost allowance to be updated once the outcomes of the planning and procurement processes are known. This may include adjustments to cost allowances where we are applying an efficiency challenge due to insufficient evidence or justification of scope or costs at this stage of the project. Not all costs will fall within the scope of the cost adjustment mechanism. Only those that are directly influenced by the requirements of planning consents or the outcome of the procurement process may be adjusted, for example environmental mitigation requirements, contract costs and contingencies.

Planning and procurement is expected to be completed in 2022. At this point we will undertake a further assessment of the scope of the project and the cost allowance for the Havant Thicket price control. If appropriate, we will set out our view of the efficient cost allowance that would then be implemented through a mid-period determination in 2024. Portsmouth Water will then manage the delivery of the Havant Thicket reservoir against the revised cost allowance.

3.4 Regulatory treatment and price control reconciliation

3.4.1 What we said in our draft determinations

Bulk supply prices are negotiated between companies and are not normally subject to regulatory intervention unless we are asked to determine disputes in relation to the terms and conditions. The bulk supply revenues are expected to fund the efficient cost of developing the reservoir, ensuring that Portsmouth Water's customers are protected. Portsmouth Water may earn economic profits from the bulk supply prices that it negotiates with Southern Water. These revenues would be expected to more than offset the costs of the reservoir and we would determine a negative price limit to pass on the benefits to Portsmouth Water's customers. The risk that the bulk supply revenues are not sufficient to cover the costs of the reservoir sits with Portsmouth Water's shareholders.

Portsmouth Water and Southern Water can share the benefits of new water trading through our water trading incentives allowed under our PR19 policy framework. The export incentives allow Portsmouth Water to claim a 50% share of the expected economic profits of the trade over the lifetime of the bulk supply agreement. The import incentives allow Southern Water to share in the cost saving generated by the water trade up to specified limits. Where water trading incentives claims meet the relevant criteria we include incentive payments in future price limits.

We set out that we will not determine water trading incentives claims until the reservoir is completed and therefore enabling the bulk supplies. In general, we would not expect Portsmouth Water's investors to earn an economic profit in advance of the water being available to be supplied to Southern Water. This ensures that customers are protected in light of the uncertainty of the costs of the project, the date when bulk supplies can be taken and the bulk supply prices agreed between the companies. As a result, we proposed a zero price limit for the separate price control for the 2020-30 period.

We proposed to make adjustments for the difference when determining price limits for the period from 1 April 2030 to share economic profits during operation of the reservoir in the 2020-30 period. We proposed that our end-of-period reconciliation model would:

- calculate cost under- or outperformance over the 2020-30 period;
- determine adjustments for water trading incentives;
- apply adjustments for the indexation of the cost of new debt; and
- apply any underperformance payments arising from the outcome delivery incentives related to delivery of the reservoir.

We set out that we would consider intervening to cap the value of water trading incentive payments within each price control period to minimise the intergenerational transfer of value given the proposed long term contract duration.

3.4.2 Stakeholders' representations

Portsmouth Water welcomes the engagement following the publication of the draft determination. It set out that greater clarity on the operation of the regulatory regime is needed in order to get a better understanding of the financial impact of the proposed package. In its representations, Portsmouth Water set out that:

- the sharing of economic profit should be done in a manner that supports the financeability of the Havant Thicket reservoir. Portsmouth Water is concerned that the mechanics of sharing profits with customers could undermine financial ratios in the short term;
- economic profits should be allowable from day 1 and that Portsmouth Water should retain economic profits and share economic profits with its customers equally on an NPV-neutral basis over the operational life of the reservoir;

- the end-of-period reconciliation mechanism should exclude the impact of the outcome delivery incentive and any financing under- or outperformance;
- greater clarity is needed on the definition and calculation of economic profit, including clarity around ensuring that the application of any adjustments to cost allowances is appropriately addressed in the reconciliation mechanism; and
- it needs clarity on future regulatory treatment of the Havant Thicket price control, including assurances that we will set out in all future price control determinations the efficient level of costs and revenues required to fund the reservoir before bulk supply revenues are netted off.

Southern Water requests more detail on the application of the regulatory framework and the future regulatory treatment of the Havant Thicket reservoir.

3.4.3 Our final determination decision

For the Havant Thicket control, we calculate the efficient economic costs of the Havant Thicket reservoir using the same building blocks approach to calculating revenue allowances we use to determine the allowed revenues for wholesale water price controls. We then calculate a notional bulk supply revenue that is sufficient to meet the efficient economic cost over the 2020-30 period. Taken together, this results in a zero price limit for the separate Havant Thicket price control. We use the notional bulk supply revenue to determine the associated totex allowance for Southern Water's wholesale price controls for the 2020-25 period.

We do not expect Portsmouth Water to earn economic profits during construction of the Havant Thicket reservoir. It will be able to earn economic profit on the bulk supply of water to Southern Water once the Havant Thicket reservoir is operational. We confirm that for a qualifying trade, Portsmouth Water's shareholders can claim 50% of the economic profits on an NPV-neutral basis over the operational life of the reservoir. The remaining profits would be shared with Portsmouth Water's customers. We are supportive of Portsmouth Water's proposal to profile export trading incentives throughout the expected life of the bulk supply agreement to address our concerns in relation to the intergenerational transfer of value.

We expect that a bulk supply agreement between Portsmouth Water and Southern Water related to the development of the Havant Thicket reservoir would represent a qualifying trade and that the PR19 water trading incentives policy would apply. Portsmouth Water and Southern Water are expected to finalise the bulk supply agreement in due course. Once water starts to be supplied under the agreement, we expect both Portsmouth Water and Southern Water to demonstrate that the agreement meets the requirements of their approved trading and procurement codes[6] when making claims for water trading incentives.

We have published a draft of the 'Havant Thicket reconciliation model' alongside our final determination for clarity around how we would determine the economic profit to be shared with customers. Annex 2 sets out the policy approach to reconciliation in more detail.

We define economic profit as the difference between the revenues earned within a charging year from excluded charges and the efficient economic costs incurred by Portsmouth Water. For the reconciliation of the separate Havant Thicket price control, we will adjust future price limits at PR29 to share 50% of economic profits earned by Portsmouth Water in the 2020-30 period with its customers.

In PR29, we will calculate economic profits as outturn revenues earned relative to the adjusted economic cost[7] rather than outturn costs. This ensures that Portsmouth Water's customers are insulated from cost under- or outperformance. This approach is aligned with the concept of customers sharing expected economic profits under our normal regulatory approach in PR19.

Totex sharing is calculated independently and is based on outturn cost performance relative to the adjusted baseline cost allowance[8]. Cost performance will be shared equally between Portsmouth Water's shareholders and Southern Water. Portsmouth Water's customers will not bear cost performance risk.

For the separate Havant Thicket price control, totex sharing will be applied in PR29 when setting future price controls from 2030. We consider that this is appropriate as we will review the baseline cost allowances under the gated cost adjustment mechanism and, where appropriate, implement changes through our mid-period determination in 2024. It also preserves continuity of incentives during construction while at the same time allowing flexibility to profile the timing of expenditure based on project needs.

The mid-period determination will be calculated through our PR24 financial model. This will take into account the outputs of the gated cost process, the cost of new debt indexation reconciliation and tax reconciliation adjustments to determine the building blocks of the calculation for the Havant Thicket control. The Havant Thicket

[6] Southern Water does not currently have an approved trading and procurement code. We expect it to have this in place within a year of entering into the agreement if it plans to claim PR19 import incentives in the future. Portsmouth Water has an approved trading and procurement code in place.
[7] The adjusted economic cost is the gross cost allowance for the Havant Thicket price control set through this final determination, adjusted by our mid-period determination, outturn volume of water supplied and cost adjustments agreed by both Portsmouth Water and Southern Water with respect to material changes in circumstances.
[8] We adjust for the outcomes of the gated cost adjustment mechanism, agreed cost adjustments for material change in circumstance, and operating costs from the bulk supply of water.

reconciliation model will only calculate the sharing of economic profit between Portsmouth Water's shareholders and customers and the totex sharing, which will be inputs into the financial model at PR29. Cost of new debt indexation for the 2025-30 period and tax reconciliation for the 2025-30 period will also be applied as reconciliation adjustments in PR29 to the extent that these mechanisms are adopted for other wholesale controls at PR29. Finally, the outcome delivery incentive will also be applied as a reconciliation adjustment in PR29.

3.5 Project delivery and other framework issues

3.5.1 What we said in our draft determinations

We proposed that Portsmouth Water should have a bespoke performance commitment and associated underperformance payment linked to delivery of the Havant Thicket reservoir.

Southern Water needs confidence that the Havant Thicket reservoir is delivered by 2029 to ensure it has an adequate bulk supply to meet its legal obligations. Project delays will increase the risk of water restrictions for customers of Southern Water and potentially have a detrimental environmental impact where Southern Water uses drought orders and permits to maintain water supplies. Southern Water can mitigate these risks contractually through the bulk supply arrangement by agreeing financial compensation arrangements with Portsmouth Water for non-delivery of water.

We agree that such an approach may provide strong financial incentives to meet the bulk supply obligations. However, there is a strong public interest to ensure that the reservoir is completed. We also need to ensure that Portsmouth Water's customers do not face increased risk to supply due to the strong incentives to meet the bulk supply obligations to Southern Water. We set out that this may be best addressed by Portsmouth Water developing a bespoke performance commitment to apply based on the length of any delay. We expected Portsmouth Water to propose a bespoke performance commitment in response to our draft determination as well as to provide clarity on how delays are addressed within bulk supply arrangements.

Our draft determination proposed that the wholesale revenue forecasting incentive (RFI) would not apply to the separate Havant Thicket price control. We set out that we need to clarify the operation of the RFI for the water resources and water network plus price controls of Portsmouth Water to ensure that revenues are not reallocated between the separate Havant Thicket price control and the other wholesale water price controls.

3.5.2 Stakeholders' representations

Portsmouth Water also provides details of its proposed outcome delivery incentive linked to project completion of the Havant Thicket reservoir. This includes outperformance payments for early delivery of the scheme. In its representation, Southern Water also set out a proposed framework for outcome delivery incentives linked to key project milestones including planning, procurement and construction deliverables.

Portsmouth Water also provides further proposals in relation to its proposed outcome delivery incentive. It proposes:

- an outcome delivery incentive that is linked to a failure to complete dry commissioning of the Havant Thicket reservoir;
- that the performance commitment is defined in a way that recognises factors that may be outside the reasonable management control of Portsmouth Water and therefore the outcome delivery incentive mechanism should not apply, including:
  - delays to signature of the bulk supply agreement between Portsmouth Water and Southern Water;
  - unanticipated planning conditions that impose a delay on construction; and
  - adverse site conditions, archeologic discovery or difficulty in acquiring the necessary land.
- that underperformance payments should not apply where there is sufficient headroom available to be able to supply Southern Water without impact to its customers. This is likely to be during periods of normal or mild drought conditions only;
- that where any damages apply as part of the bulk supply agreement with Southern Water, they need to be netted off the outcome delivery incentive; and
- that there is an outperformance payment for completing the project earlier than planned.

Portsmouth Water also proposes that the dry commissioning date is revised alongside the gated cost adjustment mechanism and that outcome delivery incentive payments are calibrated at that time to reflect the adjusted economic cost of the project.

In its representations, Southern Water sets out that:

- it agrees that where project deliverables are affected by factors outside of Portsmouth Water's control, it may be reasonable for underperformance payments not to apply under the outcome delivery incentive. It considers that it would be for Portsmouth Water to demonstrate that prudent management action could not have mitigated or remedied the impact;

- it disagrees with rewards for early delivery of the reservoir without clear evidence of customers' willingness to pay that demonstrates the economic value to customers of delivering water early; and
- underperformance payments should be calibrated to be no more than the equivalent of -3.00% of Return on Regulated Equity (RoRE).

3.5.3 Our final determination decision

As set out in our draft determination, we consider that Portsmouth Water should be exposed to a bespoke performance commitment and associated underperformance payment linked to delivery of the Havant Thicket reservoir. Southern Water needs confidence that the Havant Thicket reservoir is going to be delivered in 2029 to ensure it has an adequate bulk supply that meets its legal obligations.

We are therefore setting an outcome delivery incentive that is linked to:

- successfully achieving dry commissioning of the Havant Thicket reservoir by 30 September 2026 (Milestone 1); and
- achieving full wet commissioning and operation of the Havant Thicket reservoir by 30 June 2029 (Milestone 2).

We consider that both milestones are important to protect customers and provide the necessary confidence that the reservoir will be delivered in a timely manner and that water will be available.

Underperformance payments for late delivery will be calculated for each month that Portsmouth Water is late in delivering the relevant milestone, although this will be subject to a deadband of up to 3 months from the proposed delivery dates. The calculation of the monthly incentive rate is set out in Table 3.1 below. The overall underperformance payment will be applied as a reconciliation adjustment at PR29. The monthly underperformance payments will accrue from the relevant milestone dates until the end of the price control period i.e. 31 March 2030.

It is important that Portsmouth Water faces an appropriate balance of incentives to deliver both dry commissioning and full operation of the Havant Ticket reservoir. It is therefore important that a delay in achieving dry commissioning does not remove incentives to achieve full operation in a timely manner. For this reason, we will only apply 20% of the monthly incentive rate to the delivery of milestone 1.

Table 3.1: Calculation of the monthly incentive rate (£ million)

	Monthly incentive rate
Expected annual return on capital in 2029-30	£3.39m
Expected Havant Thicket RCV run-off in 2029-30	£1.35m
Overall monthly incentive rate – annual return on capital and RCV run-off, expressed monthly	£0.39m
Monthly incentive rate for milestone 1 (20% of overall monthly incentive rate)	£0.08m
Monthly incentive rate for milestone 2 (80% of overall monthly incentive rate)	£0.32m

The accrual of underperformance payments under the outcome delivery incentive and the payment of damages under the bulk supply agreement could result in double jeopardy if Portsmouth Water is penalised twice for the same delay in delivering the reservoir. To avoid such an outcome, we expect the companies, when agreeing the terms of the bulk supply agreement in relation to the payment of damages, to take account of potential underperformance payments under the outcome delivery incentive we have set out.

In addition, we are introducing an additional reconciliation mechanism to claw back unspent totex at the end of the 2020-2030 period. Our PR19 policy in relation to funding major construction schemes is to set an outcome delivery incentive to claw back the unspent totex where we return unspent funds to customers that haven't already been returned through totex sharing. Under this approach, we multiply the percentage of the construction programme the company hasn't delivered, the allowed totex in our final determination and the totex sharing rate to calculate the amount that needs to be returned to customers. We consider that the same approach is required for the Havant Thicket reservoir.

Since we already have a bespoke mechanism for reconciling the Havant Thicket control, we will apply this adjustment in the reconciliation model. We expect the final construction profile of Havant Thicket to be set out as part of the gated cost adjustment mechanism. The timely delivery of the infrastructure programme can then be monitored against the agreed construction profile. More information about our approach is in Annex 2 and the 'Havant Thicket reconciliation model' we are publishing alongside the final determination.

We accept that the delivery of the Havant Thicket reservoir may be influenced by factors outside of the management control of Portsmouth Water. These could include:

- planning conditions or refusal of consent;
- delays in parties entering into the bulk supply agreement, meaning that they do not do so until after 1 April 2020;
- environmental protection requirements; and
- restricted access to land.

In most cases, external events will impact delivery milestones for major work packages but are unlikely to trigger overall cancellation of the project. Moreover, we consider that most of the risks are around the early phases of the project development and it is therefore inappropriate to remove the outcome delivery incentive in those circumstances. We will review the target dates in the performance commitment definition when making our decisions in relation to the cost adjustment mechanism.

Where there is sufficient evidence that the timing of project deliverables has changed due to factors outside Portsmouth Water's reasonable control, we would align the target dates for the purpose of the outcome delivery incentive. Similarly, when calculating underperformance payments at PR29, we will consider evidence provided by Portsmouth Water in relation to factors that may have influenced delivery that were outside its control or influence and, if appropriate, reduce underperformance payments. However, we will expect compelling evidence that events were beyond Portsmouth Water's reasonable control and that management took reasonable actions to mitigate the effects to delivery of the Havant Thicket reservoir. We expect an appropriate independent third-party assurance to confirm this evidence. We will also take into account Southern Water's view of the extent to which events were beyond the reasonable control of Portsmouth Water's management.

As the other party to the proposed bulk supply agreement, Southern Water will have an important role in holding Portsmouth Water to account for the timely delivery of the Havant Thicket reservoir and the associated bulk supply. We will also be monitoring progress and will, if necessary, take appropriate action in the event of undue delays to protect customers' interests and ensure that both Portsmouth Water and Southern Water properly carry out their functions as water undertakers.

Finally, we confirm that we have designated as Havant Thicket Activities the activities set out in Annex 5 of the 'Notification of the final determination of price controls for Portsmouth Water'. It is these activities that are within the scope of the separate Havant Thicket price control and we are satisfied, having considered representations we received from Portsmouth Water and Southern Water, that they cover the works that the parties currently agree will be needed under the proposed bulk supply agreement. We note, for the avoidance of any possible doubt, that the inclusion of any activity within the designation of Havant Thicket Activities does not:

- impose any obligation on Portsmouth Water to carry out that activity;

- impose any obligation on Southern Water to pay for that activity; or
- require that activity to be carried out (if it is undertaken) with anything other than that degree of skill, diligence, industry knowledge and judgement and foresight which would reasonably and ordinarily be expected from a skilled and experienced efficient operator acting in the same type of undertaking or in similar circumstances and complying with the relevant legal obligations.

3.6 Other issues raised by representations

3.6.1 Stakeholders' representations

Southern Water has raised a point regarding Portsmouth Water's obligation to comply with section 37 of the Water Industry Act (the general duty of water undertakers to maintain the water supply system etc.). It suggests that Portsmouth Water interprets the duty as requiring it to prioritise its own customers, and that in the event of a drought it would need to use the extra capacity released by the construction of the Havant Thicket reservoir for its own customers even though the reservoir would have been built at the expense of Southern Water's customers. This could potentially give rise to an undue preference or cross-subsidy in terms of Portsmouth Water's customers benefitting from enhanced resilience to drought events.

Southern Water considers that there is an opportunity for Ofwat, through the licence modification process, to clarify Portsmouth Water's obligations.

3.6.2 Our final determination decision

We recognise that greater clarity around the interaction between water undertakers' obligations to supply their own customers and their obligations to provide bulk supplies of water to other water undertakers under bulk supply agreements may be beneficial. This is an area that has been raised in relation to potential strategic transfers and we recognise that the sector considers it to be an important issue. We will consider this issue further in 2020 and engage and consult with stakeholders across the industry.

4 Calculation of costs and allowed revenues

This section sets out our assessment of efficient costs for the activities relating to the development of the Havant Thicket reservoir. We also set out our proposed limit on the revenue that Portsmouth Water could recover from its own customers for the activities related to the development of the Havant Thicket reservoir.

4.1 Havant Thicket costs

For the Havant Thicket control, the efficient economic costs of the Havant Thicket reservoir are calculated using the same building blocks approach used to determine the wholesale water price controls. Not all elements are applicable to the Havant Thicket revenue control as set out in Table 4.1.

- Pay as you go (PAYG) – this reflects the allocation of our efficient totex allowance to costs that are recovered from revenue in the 2020-30 period. The proportion of totex not recovered from PAYG is added to the Havant Thicket regulatory capital value (Havant Thicket RCV) which is recovered over a longer period of time.
- Allowed return on capital – this is calculated based on our assessment of the cost of capital multiplied by the average Havant Thicket RCV for each year.
- Havant Thicket RCV run-off – this reflects the amount of Havant Thicket RCV that is amortised in the period of the price control.
- Non-price control income – this is the anticipated bulk supply revenues earned through charges paid by Southern Water. It can also include income from other services, such as revenues from visitors. We deduct the expected non-price control income to determine the final price control allowance.

We set out the calculation of the costs for Portsmouth Water's Havant Thicket control in Table 4.1. We summarise the total of the build-up of costs as the total over ten years. However our financial model calculates it on an annual basis for the purposes of our final determination.

We explain how we calculate PAYG, Havant Thicket RCV run off and the allowed return on capital and other elements of allowed revenue in the following sections.

Table 4.1: Calculation of allowed revenue 2020-30 (£ million)

	Havant Thicket separate price control
Pay as you go	0.6
Havant Thicket RCV run-off	7.6
Return on capital	18.7
Tax	0.0
Deduct other income (non-price control)	-26.9
Final allowed revenues	**0.0**

For the separate Havant Thicket price control, we are setting the allowed revenues to zero. This recognises that Portsmouth Water's customers are not funding the development of the reservoir through their bills. Customers and shareholders of Portsmouth Water should only receive economic profits associated with the Havant Thicket reservoir once the bulk supplies to Southern Water are provided.

Bulk supply prices are unknown at this time as they still form part of the ongoing negotiations between Portsmouth Water and Southern Water. We have assumed bulk supply prices are set on accounting costs (i.e. there is no economic profit), which ensures that Portsmouth Water's customers do not pay for the costs relating to Havant Thicket.

4.2 Cost recovery of Havant Thicket

We adopt an RCV approach for the Havant Thicket revenue control. However, we recognise that while we are using a building blocks approach, many of the protections of stranding risk are captured under the proposed bulk supply agreement between Portsmouth Water and Southern Water. We assume that the opening balance of the Havant Thicket RCV is zero and that for the duration of construction, almost all of the total expenditure will be added to the RCV. We anticipate a small amount of operating expenditure in 2028-2029 and 2029-30 and have determined a pay-as-you-go (PAYG) rate of 37.2% in 2028-29 and 100% in 2029-30.

RCV run-off in this instance is the proportion of the Havant Thicket RCV which is recovered in the 2020-30 period. We depreciate the RCV on a straight-line basis to an end date 80 years after the assumed start date of the bulk supply agreement of 1 April 2020.

4.3 Allowed return on capital

Companies receive an allowed return on their RCV, which we set as a weighted average cost of capital (WACC). The specific characteristics and regulatory framework of Havant Thicket have required us to determine the appropriate level of the cost of capital for its separate price control.

The PR19 methodology confirms we are transitioning to CPIH as our primary inflation index from 2020. At 1 April 2020, all new totex added to the RCV will be indexed to CPIH. The Havant Thicket control will start on 1 April 2020 with an RCV of zero, which will therefore be entirely linked to CPIH. This means that the relevant return which will apply will also be CPIH-linked. The allowed return on capital for the Havant Thicket price control is the same as for other wholesale controls in our final determinations: 2.92% – CPIH deflated. We set out the basis for the sector wholesale allowed return on capital in our 'Allowed return on capital technical appendix'.

4.4 Other allowed revenue

Non-price control income is the expected income that is deducted from the efficient costs. This revenue is not recovered from charges covered by the price control, but is expected to cover costs included in the calculation of the price control. This mainly covers revenues from bulk supply charges and advance payments made against these, but it can include other income.

For the purposes of the separate price control for Havant Thicket, we assume that the non-price control income fully covers the expected costs that will be incurred in the 10 year period. This ensures that customers do not fund the development of the reservoir through customer bills. We do not expect any economic profits during construction. Our reconciliation adjustments at the 2029 price review will ensure that excess revenues during construction are treated as capital contributions and netted off the Havant Thicket Activities RCV. We will also share economic profits between Portsmouth Water's shareholders and customers during the operational phase of the reservoir.

From 2030 onwards, we would not expect to reconcile economic profits but will instead base future determinations on expected bulk supply revenues in line with the regulatory treatment of bulk supplies at that time.

4.5 Taxation

We calculate a tax allowance reflecting the corporation tax that the company expects to pay in 2020-25. For PR19 we calculate the tax allowance using our financial model based on the projected taxable profits of the appointed business and the current UK corporation tax rates and associated reliefs and allowances.

Our decision to propose a separate control in Portsmouth Water's draft determination requires a separate allowance for taxation relating to Havant Thicket.

In its representation, Portsmouth Water provides updated tax details separating out the inputs over the water resources and Havant Thicket controls. The company has reconsidered the tax deductions available for Havant Thicket and is now assuming that the majority of the expenditure will qualify for capital allowances. We use the information provided by the company and apply this to the final determination. We note the uncertainty surrounding the level of tax deductions available for Havant Thicket and should the actual position be materially different to the company's forecasts, we may decide to include this within the reconciliation.

Portsmouth Water currently has taxable trading losses and wants to retain them for the benefit of its customers in 2025-30, instead of them being applied to the Havant Thicket control. We note Portsmouth Water's preference but the approach set out in our PR19 methodology is to cap tax allowances at the level of the combined wholesale control and this results in any tax losses available being spread over all wholesale controls, regardless of which control generates the losses.

As part of our approach to calculating separate controls, we first model Portsmouth Water without Havant Thicket, and we note this indicates that all tax losses will be used within the 2020-25 period by the existing business and none will be available after 2025, such that trading losses would not need to be retained for 2025-30. If the company subsequently expects that the existing business will not utilise all the available tax losses and considers it to be an issue, the company should raise it during consultations on future price review methodology and within the planned Havant Thicket reconciliation, to allow us to consider the issue further for 2025-30.

Annex 1: Calculation of Havant Thicket allowed revenues

Table A1: Calculation of allowed revenue (£ million)

	2020-21	2021-22	2022-23	2023-24	2024-25	2025-26	2026-27	2027-28	2028-29	2029-30	Total
Pay as you go	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.3	0.3	0.6
Havant Thicket RCV run-off	0.1	0.2	0.2	0.4	0.6	0.9	1.2	1.3	1.4	1.3	7.6
Allowed return on capital	0.1	0.4	0.6	0.9	1.5	2.2	2.9	3.3	3.4	3.4	18.7
Tax	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Deduct bulk supply income	-0.2	-0.5	-0.8	-1.3	-2.1	-3.1	-4.1	-4.7	-5.1	-5.0	-26.9
Final allowed revenues	**0.0**	**0.0**	**0.0**	**0.0**	**0.0**	**0.0**	**0.0**	**0.0**	**0.0**	**0.0**	**0.0**

Table A2: Post 2020 investment Havant Thicket RCV (£ million)

	2020-21	2021-22	2022-23	2023-24	2024-25	2025-26	2026-27	2027-28	2028-29	2029-30
Opening Havant Thicket RCV	-	10.07	16.02	22.90	40.16	59.98	89.52	110.49	117.39	116.79
Additions	10.13	6.12	7.12	17.64	20.42	30.44	22.16	8.25	0.77	-
Less : Havant Thicket RCV run-off	0.06	0.16	0.24	0.38	0.60	0.90	1.19	1.34	1.37	1.35
Closing Havant Thicket RCV	10.07	16.02	22.90	40.16	59.98	89.52	110.49	117.39	116.79	115.44

Annex 2: Havant Thicket reconciliation model

We intend to perform a mid-period reconciliation of allowed revenue for the Havant Thicket price control at the time of the 2024 price review (PR24). These adjustments will be applied through a mid-period determination of the separate, Havant Thicket price control. We have published an illustrative version of the 'Havant Thicket reconciliation model' alongside our final determination for clarity around how we may determine the economic profit to be shared with customers.

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 over the 2025 to 2030 period. These potential 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 in relation to the Havant Thicket price control. Other adjustments will feed into the baseline revenue requirement for the Havant Thicket reservoir over the 2025 to 2030 period. We will take these adjustments into account at PR24 when undertaking an assessment of Portsmouth Water and Southern Water's efficient allowances for the 2025 to 2030 period.

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 the construction phase and 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. The water transfer is considered to be operational after achieving milestone 2 of the outcome delivery incentive of full wet commissioning. According to the construction timelines proposed, this should happen in 2029. Any economic profit derived by Portsmouth Water under the bulk supply agreement with Southern Water prior to the water transfer becoming operational will be treated as a capital contribution and netted off the company's Havant Thicket Activities RCV.

Portsmouth Water will share with its customers 50% of the Net Present Value (NPV) of any economic profits[9] 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

[9] Economic profit is defined as the outturn bulk supply revenues above the forecast cost, inclusive of a return on capital.

only be derived by Portsmouth Water once the water transfer is operational, the earliest starting point of profit sharing will be 2029. In addition, the economic profit will be determined based on expected economic profits - economic profits are equal to outturn revenues earned under the bulk supply agreement net of the final determination baseline cost allowance rather than outturn costs. This is consistent with our PR19 water trading incentives policy where customers share in expected economic profits rather than outturn economic profits.

We are not allowing for any sharing of the expected economic profit that Portsmouth Water might earn in the period after 2029 in the mid-period review in 2024. Therefore, expected economic profits will be shared with Portsmouth Water's customers in PR29.

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 (that is, the 2025 to 2030 period) 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 the 2020 to 2030 period. Secondly, we would apply a tax reconciliation adjustment calculated in PR24 related to changes in corporate tax rates and capital allowances, consistent with our overall approach to tax reconciliation in PR19. We note the uncertainty surrounding the level of tax deductions available for Havant Thicket and should the actual position be materially different to the company's forecasts, we may decide to include this within the Havant Thicket reconciliation model.

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

The limited set of adjustments we are proposing in the mid-period determination are not all directly relevant to the allowed revenue that Portsmouth Water can recover from its own customers as Portsmouth Water's customers will not bear any costs related to the reservoir. Therefore, the mid-period determination will apply as a run of the financial model at PR24 rather than a reconciliation within the Havant Thicket reconciliation model. In other words, the outputs of the gated cost process, cost of new debt indexation reconciliation and tax reconciliation adjustments will be financial modelling inputs to determine the level of the revenue allowance building blocks for the Havant Thicket control during the 2025 to 2030 period. This is a modelling process beyond the scope of the Havant Thicket reconciliation model.

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

Throughout the 2020 to 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 (that is, the 2020 to 25 period), 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 non-zero price control due to the gated cost adjustment mechanism changing the allocation between companies based on the improved cost information available at the time. In those circumstances there would be a requirement on Portsmouth Water to ensure that it collects the correct amount of revenue from its customers in order to comply with its Havant Thicket price control during the 2025 to 2030 period. Any over- or 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 2020-30 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 several key additional adjustments relevant to Havant Thicket Activities at this stage:

- the application of an additional end-of-period adjustment for the bespoke performance commitment ODI related to delivery of the reservoir;
- totex sharing consistent with the principles of our overall approach to totex sharing in PR19;
- a volumetric cost adjustment to the cost allowances to reflect outturn volume of water traded; and

- an adjustment to claw back any unspent totex for the construction of the reservoir.

Cost under- and outperformance will be shared between Portsmouth Water and Southern Water with each party exposed to 50% cost under- and outperformance risk. Portsmouth Water's customers are not affected by cost under- and outperformance as they do not share in the risk of totex sharing with the companies bearing all the cost efficiency risk. In addition, Portsmouth Water's customers are insulated from cost performance through their share of economic profits since economic profits are set on an expected basis, that is, costs are not adjusted for actuals.

We are introducing a gated process to allow for an update to 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 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.

We include a volumetric cost adjustment to the cost allowance to address the uncertainty related to the volume of water that will be traded once the bulk supply transfer is operational towards the end of the 2020 to 2030 period and the associated operating expenditure. The adjustment is designed to ensure that the baseline cost allowance is reconciled to reflect outturn volume of water traded under the bulk supply agreement. We achieve this through a unit rate of volumetric costs expressed in £/m3 which we set out in the final determination. When reconciling revenues in PR29, the Havant Thicket reconciliation model will compare forecast volume of water traded and actual volume of water traded and will apply a revenue adjustment based on the difference between the two, multiplied by the forecast unit rate as set out in the final determination and potentially adjusted through the gated cost adjustment mechanism in 2022. Our approach ensures that the cost allowance reflects the outturn size of the bulk supply transfer while also ensuring the appropriate calculation of totex sharing and economic profit adjustments.

Finally, we are introducing an additional reconciliation mechanism to claw back unspent totex at the end of the 2020-2030 period. This is essential in order for us to be able to apply totex sharing appropriately and to protect customers. Partial delivery of the infrastructure programme related to the Havant Thicket reservoir by the end of March 2030 might allow Portsmouth Water to realise savings compared to the adjusted baseline cost allowance. These potential savings are not associated with cost efficiency but with the inability of the Portsmouth Water to complete the Havant

Thicket reservoir by the end of the price control period. Our PR19 policy in relation to funding major construction schemes is to set an outcome delivery incentive to claw back the unspent totex where we return unspent funds to customers that haven't already been returned through totex sharing. Under this approach, we multiply the percentage of the construction programme the company hasn't delivered, the allowed totex in our final determination and the totex sharing rate to calculate the amount that needs to be returned to customers. Since we already have a bespoke mechanism for reconciling the Havant Thicket control, we will use the reconciliation model to implement the same approach. We expect the final construction profile of Havant Thicket to be set out as part of the gated cost adjustment mechanism. The timely delivery of the infrastructure programme can then be monitored against the agreed construction profile.

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 expected 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 underperformance payments for delay;
- provide greater regulatory certainty to Portsmouth Water and Southern Water; and
- ultimately offer greater customer protection.

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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