December 2019

PR19 final determinations

Thames Water – Thames Tideway Tunnel performance commitments additional information appendix

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1 Background to the Thames Tideway Tunnel

The Thames Tideway Tunnel (TTT) is of unprecedented scale, size and complexity in the water sector in England and Wales. It is the first project to be delivered by a separately licenced infrastructure provider.[1]

Thames Water is required to carry out enabling and interface works in respect of the project and procure an infrastructure provider to deliver the project. In 2014 the company's licence was amended to enable us to determine a separate Thames Tideway Tunnel price control for costs incurred in connection with the project. Initially in place for a five-year period, in 2018 the separate control was extended to 2025.

Following a competitive procurement process, Bazalgette Tunnel Limited (trading as Tideway) was appointed as the infrastructure provider for the project and granted a project licence in 2015. Under its licence, Tideway must design, construct, finance, test, commission and maintain the tunnel so that it is available for use in conjunction with Thames Water's sewerage network.

The TTT is unique in the sector in that there are two distinct regulated entities responsible for different elements necessary to deliver and operate the same asset. Once complete, the tunnel will form an integral part of Thames Water's sewerage system although it will continue to be owned and maintained by Tideway.

The success of the project requires co-operation from Thames Water and Tideway and a failure by Thames Water to deliver its obligations in a timely manner will have cost implications for Tideway and ultimately customers who bear a share of cost overruns. For this reason the company had a number of TTT-specific performance commitments and outcome delivery incentives at PR14 and has again at PR19.

1.1 Our final determinations

For our final determinations we set out the definitions for the performance commitments relating to the TTT in 'PR19 final determinations: Thames Water – Outcomes performance commitment appendix'.

[1] Regulated by Ofwat under the Water Industry (Specified Infrastructure Projects) (English Undertakers) Regulations 2013 (SIP Regulations).

Reference	Performance commitment
ET01	Readiness to receive tunnel flow at Beckton STW
ET02	Effective stakeholder engagement
ET04	Critical asset readiness for the London Tideway Tunnels
ET05	Establish an effective system operator for the London Tideway Tunnels
ET06	Maximising the value of Tideway project land sales
ET07	Managing early handback of Tideway project land

In this document we discuss the representations we receive from stakeholders relating to our draft determinations, our assessment and our final decisions for Thames Water's PR19 final determination.

2 Readiness to receive tunnel flow at Beckton STW (ET01)

2.1 Our draft determinations

We removed outperformance payments and redefined the performance commitment so that the company incurs underperformance payments for each month of delay after the System Commissioning Commencement Date (SCCD).

2.2 Stakeholders' representations

The company agrees with our interventions but proposes that if the SCCD changes, underperformance should be calculated in line with the revised SCCD. Tideway supports the proposed revisions and confirms that the company cannot unilaterally change the target date.

2.3 Our assessment and reasons

Change required for the final determination.

We agree with the revised drafting. We are reassured that the company cannot unilaterally change the target date.

2.4 Our final decision

We revise the definition of the performance commitment in line with the company's proposals.

3 Effective stakeholder engagement (ET02)

3.1 Our draft determinations

We increased the performance commitment levels to 5.0 for every year of the 2020-25 period.

3.2 Stakeholders' representations

The company proposes reducing the performance commitment levels from 5.0 to 4.5 (out of 6.0) due to the limitations of the survey because there are only four respondents and seven questions.

Tideway supports our proposed levels, noting they appear stretching but achievable based on the company's recent performance (4.8 in 2018-19). Tideway considers the company's concern of a single low score is misplaced because respondents are encouraged to review the company's performance in the round. To address this, Tideway proposes a requirement to report individual questions scoring below 4.0 to the Liaison Committee for discussion.

3.3 Our assessment and reasons

Change required for the final determination.

We consider it is important to set stretching performance commitment levels, and based on historical performance these performance commitment levels are stretching and achievable. For this reason we do not change the performance commitment levels.

Instead we incorporate Tideway's proposal in the performance commitment definition.

3.4 Our final decision

We revise the definition on reporting questions that score below 4.0.

4 Critical asset readiness for the London Tideway Tunnels (LTT) (ET04)

4.1 Our draft determinations

We redefined the scope and design of this performance commitment to focus on the readiness of the company's critical assets for the Thames Tideway Tunnel and its wider wastewater network.

We increased the underperformance rate to £1.43m per month in line with [redacted]

We also removed outperformance payments and underperformance collars for this performance commitment.

4.2 Stakeholders' representations

Performance commitment definition

The company agrees with our interventions to the performance commitment's definition.

The company proposes that if the System Commissioning Commencement Date (SCCD) changes, the target date for the performance commitment should also change.

The company also proposes clarifying that works in scope of ET01 are excluded from this performance commitment and other minor drafting changes.

Tideway agrees with these drafting proposals.

Tideway also proposes annual reporting to the Liaison Committee should be part of this performance commitment to reinforce the approach set out in the Joint Approach.

Outcome delivery incentive payments

The company says the underperformance rates overstate the impact on customers. It says its proposed rate of £1.25m per month in its April 2019 revised business plan fairly compensates customers for the cost of delay. The company notes the Alliance Agreement includes a cost recovery mechanism which will penalise it for delays.

The company also proposes the underperformance rate should be proportional to the number of sites delivered (i.e. out of 10) with the financial impact per undelivered asset determined by an independent expert under the Joint Approach governance process.

Tideway proposes an increase in the underperformance rate to reflect the impact of delays to system commissioning on customers. Tideway proposes [redacted] per month which is in line with run rate costs to Tideway in the six months before the forecast SCCD adjusted for regulatory sharing incentives. This is an increase relative to our draft determinations (£1.4m per month) because Tideway has confirmed that its estimated reduction prior to the draft determinations was about managing the company's financial exposure rather than an evaluation of potential cost reductions.

In response, the company says Tideway's proposal would equate to a [redacted] return on regulatory equity (RoRE) impact on the TTT price control and [redacted] of the company's overall RoRE. The company argues this overstates the impact on customers, is well outside our proposed RoRE range and will dominate its outcomes package.

4.3 Our assessment and reasons

Performance commitment definition

Change required for the final determination.

As with performance commitment ET01, we recognise the need for drafting changes relating to the SCCD. We also want to avoid double counting of scope with ET01. For these reasons we accept the company’s proposals.

We have changed the reporting requirements to provide that readiness will be reported in line with the Joint Approach to Handover and Acceptance agreed between the company and Tideway and in line with the Interface Agreement. This will be supported by external audit.

Outcome delivery incentive payments

Change required for the final determination.

We consider an adjustment for the number of critical assets delivered is overly complex particularly given the approximate approach for the overall penalty rate. It also would not reflect that Handover is not de-risked by partial delivery and even with partial delivery, the impact on customers remains. The company should be appropriately incentivised to deliver all critical assets.

We note the risk of double penalties for delays but have clarified that the arrangements in the Alliance Agreement are designed to pay rewards for meeting milestones, rather than penalise for delays.

We recognise the need to ensure appropriate financial exposure and balance in the company's overall incentive package. However the company has overstated its RoRE exposure – it refers to maximum annual impacts (i.e. 12 months of delays) whereas in its August 2019 representations it estimates no delays at a p10 level and we understand from engagement with the company and Tideway, that delays are most likely to be under 3 months. Tideway's proposed rate equates to [redacted] financial impact for three months of delay (around [redacted] of appointee RoRE).

We also note under our other changes in the final determination, the target date (SCCD) is able to move for significant delays that are outside of company control, reducing financial risk to the company. With this change, we note the remaining financial exposure risk so we decide to limit the maximum underperformance payments to 12 months of delays. This will move as the target date moves.

With this addition and based on our assessment of financial risk we therefore consider the potential financial impact is within our appointee-level indicative range, does not unbalance the package and is proportionate to the impact on customers.

For these reasons we increase the underperformance rate based on Tideway’s revised estimate of run rate costs for delay, adjusted by regulatory sharing incentives to reflect the potential impact on customers (where customers bear 60% of cost overruns). [redacted]

4.4 Our final decision

We revise the definition of the performance commitment in line with the company's proposals.

We revise the underperformance rate for this performance commitment to be £6.259m per month.

We set out that underperformance payments will apply up to a maximum of 12 months of delays from the target date.

5 Establish an effective system operator (ET05)

5.1 Our draft determinations

We intervened to separate out the reputational elements of the company's proposals for ET04 into this new performance commitment.

5.2 Stakeholders' representations

Performance commitment definition

The company agrees with our interventions to the performance commitment definition. The company proposes minor drafting changes relating to the System Commissioning Commencement Date, to reflect similar proposals for ET01 and ET05, and other minor corrections.

Tideway agrees with these proposals.

Outcome delivery incentive payments

The company supports this performance commitment being a reputational incentive.

Tideway proposes this performance commitment is changed so that it includes both a reputational and a financial incentive, by including underperformance payments. The stakeholder says this will ensure the company allocates appropriate resources to this work.

Tideway also proposes annual reporting to the Liaison Committee is included in this performance commitment. Tideway also says that if we do not change the outcome delivery incentive (ODI) type for this performance commitment, we should require a public statement from the company on the status of its readiness for operations, to strengthen reputational incentives.

5.3 Our assessment and reasons

We consider the company's proposed changes to the performance commitment definition are appropriate.

We do not consider financial incentives are necessary for this performance commitment. This is because we consider as defined this performance commitment lacks sufficiently objective milestones which would form the basis of an effective financial ODI.

We agree that the company should also be required to report its progress annually to the Liaison Committee on whether it is on track to meet this performance commitment. This is in addition to the requirement that it must report its progress in its annual performance report.

5.4 Our final decision

We revise the definition of the performance commitment in line with the company's proposals.

We revise the definition of the performance commitment to clarify that the company will report on its progress as to whether it is on track to meet this performance commitment in its annual performance report and to the Liaison Committee.

6 Maximising the value of Tideway project land sales (ET06)

6.1 Our draft determinations

We intervened to set a new performance commitment based on the net profits made on the actual sales of the 12 sites related to the Thames Tideway Tunnel project scheduled to be sold in the 2020-25 period. By allowing the company to retain 20%

of profits and losses, this aimed to incentivise the company to minimise losses and maximise profits. The outcome delivery incentives would be applied at the end of the period through an RCV adjustment.

We also asked the company to confirm whether a licence change was required because unlike other land sales, project land acquired for the Thames Tideway Tunnel is subject to a 100-0 customer sharing rate in the company's licence; in other words customers bear all of the losses and all of the gains from sales.

6.2 Stakeholders' representations

The company welcomes and supports the overall design of the new performance commitment. The company recognises the performance commitment is more customer focused, transparent and will incentivise it to maximise returns for customers.

The company proposes some adjustments to the calculation of the incentive:

- partial sales adjustment – to reflect that some of the project land will not be available for resale due to retention for operational use or the presence of underground infrastructure;
- valuation adjustment – to reflect where the company may have overpaid or underpaid for some sites relative to independent valuations at the time; and
- temporary works adjustment – the company says that where the costs of removing temporary works on a site exceed overall customer value, an adjustment should be made to reflect the diminution in value from leaving the temporary works in place.

The company also proposes the performance commitment runs into the 2025-30 period if market factors suggest a delay in land sales will increase value.

The company also advises that it considers a modification to its licence would be required to enable this performance commitment to come into effect.

Tideway expresses concern with two key issues with the performance commitment:

- it does not relate to land not intended for sale, which may not sufficiently incentivise the company to facilitate handback for that land; and
- it may conflict with the Joint Approach leading to the company insisting that Tideway remove temporary works even when the costs of doing so far outweigh the resulting increase in land value.

Tideway proposes a replacement performance commitment relating to land handback aligned to the timescales in the Joint Approach, or an alternative approach where ET06 is modified to require some temporary works be left in place and additional penalties are incurred for delayed handback for all relevant sites.

6.3 Our assessment and reasons

Change required for the final determination.

We recognise that some sites that are not intended for resale, including Thames Water's existing operational sites and sites that have been rented from third parties, will not be covered by this performance commitment. As a result we discuss a new performance commitment relating to the timely handback of all sites (see our interventions for ET07). For this performance commitment (ET06) we consider the scope should still be the 12 sites intended for sale.

We consulted on modifying the company's licence to alter the customer sharing rate of 100-0 to 80-20. The company did not consent to this change. As a result, we consider it necessary to change the type of this outcome delivery incentive from financial to reputational. For this reason we do not need to incorporate adjustments relating to contemporary valuations or the removal of temporary works.

We incorporate an adjustment to reflect partial sales. We recognise that some portions of sites will not be sold either because of the underground infrastructure or because Thames Water intends to retain for operational use. We therefore include a simple percentage adjustment. We set out in the performance commitment the assurance the company will need to provide. It should reflect the percentage of land sold is a fair reflection of the split between the land sold and the land retained relative to the acquisition price paid by the company – it should not necessarily be a proportion of land area unless that fairly reflects the relative value of land that is sold or retained.

6.4 Our final decision

We change the performance commitment to have a reputational outcome delivery incentive.

We change the definition to incorporate an adjustment to the baseline value for each site to be a fair reflection of the proportion that is sold.

We also change the name of this performance commitment to ‘Maximising the value of Tideway project land sales’ to clarify that its scope relates to the disposal of land for the Thames Tideway Tunnel project.

7 Managing early handback of Tideway project land (ET07)

7.1 Our draft determinations

We did not include a performance commitment relating to the timely handback of Tideway project land. We considered our approach relating to the performance commitment ET06 provided sufficient incentive for the company to receive land from Tideway in a timely manner.

7.2 Stakeholders’ representations

In its August 2019 representation, Tideway says the company may not be adequately incentivised to facilitate handback of land outside the scope of the performance commitment ET06, which could lead to overall delays to project Handover and associated costs.

Following engagement with us in September 2019, both the company and Tideway provide revised submissions relating to timely handback by Tideway of project land in the 2020-25 period.

The company’s preferred approach is no performance commitment and to utilise the Joint Approach to Handover and System Acceptance as agreed between the company and Tideway in April 2019. However, it says if we do proceed with a performance commitment, that performance commitment should recognise the Joint Approach, cover all relevant sites, include both outperformance and underperformance payments, and have a deadband for each site for a short period following the target date.

Tideway puts forward similar proposals but says the target date for each site should be three months after the land is certified as ready for handback, providing up to three months of potential outperformance payments. Tideway proposes no deadband and that underperformance payments should come into effect from the target date. In line with the Integrated Mitigated Project Master Programme, the target dates for each site are reforecast and revised each quarter. Tideway proposes

ODI rates based on its estimated run rate at Handover. Tideway also proposes all outperformance payments should be lost if the company delays Handover due to property-related issues.

7.3 Our assessment and reasons

Change required for the final determination.

Based on these submissions we consider a new performance commitment is required. Under the Interface Agreement, the handback of land from Tideway to Thames Water is required to take place by 31 March 2024. This creates the risk that if all handback areas (aggregated into 21 sites) are handed back at the same time rather than to an agreed early schedule, there could be delays to Handover which will impact customers. Customers can also share in reduced or avoided costs by Tideway.

As both stakeholders note, an approach that accelerates land handback reduces overall and individual project risk. Early handback also benefits customers because it enables Tideway to vacate the land early and enables Thames Water to dispose of purchased or rented land and utilise any operational sites. Both stakeholders agree that land handback should take place as soon as possible after construction, completion and certification.

For these reasons we set a performance commitment that has both outperformance and underperformance payments to provide sufficient incentives on Thames Water to support and accept land in line with the Joint Approach. We recognise the Joint Approach agreed by both stakeholders and this performance commitment is intended to support the overall objective of reducing project risk which is in the interests of customers.

The design and scope of the new performance commitment is set out below. This detail is included in Thames Water's performance commitment appendix.

- Scope: all relevant handback areas set out in the Joint Approach. These cover all project land – operational sites owned by Thames Water, rented sites and those intended for disposal. This ensures incentives apply to all project land. Each handback area will have its own target date for the purposes of this performance commitment, which will be three months after the certification date for each area. There will be a further one month period after this target date before underperformance payments apply. In line with the Integrated Mitigated Project Master Programme, the target date for each handback area can change quarterly

following reforecasting or revisions by the Project Manager – this ensures a sensible and flexible approach should acceptable programme delays arise.
- Units: outperformance under this performance commitment will be measured by the net total number of months before the target date for each handback area that the company accepts the land. Underperformance under this performance commitment will be measured by the net total number of months taken from four months after certification that the company fails to take back the land. The company will report the total number of months before the target date for each handback area that the company receives the land, less the total number of months after one month after the target date for each handback area that the company fails to take back the land.
- ODI payments: for each handback area, outperformance payments will apply for the number of full months before the target date that the company receives the project land. This represents outperformance relative to the target date. After one month after the target date, underperformance payments will apply for each month after the target date that the company does not accept the land.
- ODI rates: [redacted] This leads Tideway to propose an ODI rate of around £0.03m per handback area per month. We broadly agree with this methodology to estimating the financial impact on customers, but adjust to £0.02m per handback area per month to manage the company's financial exposure and recognise forecasting errors and limitations of this approach. We will apply this rate symmetrically for both outperformance and underperformance rates. While we apply this evenly for all handback areas for simplicity, we note that the three areas relating to Chambers Wharf are disproportionately large and pose a greater risk to project delivery. As a result, for the purposes of this performance commitment they will count as three handback areas each.
- ODI form, timing and reporting: this will be a revenue adjustment applied at the end of the period. While the performance commitment and ODI payments are calculated on an aggregate basis, the company will report on a per handback area basis in its annual performance report to demonstrate to its stakeholders how it is performing and how expected ODI payments have been calculated.

Given how we design this performance commitment, we do not consider Tideway's proposal to claw back outperformance payments is necessary; we consider the balance is appropriate and complementary incentives also apply for the company to avoid significant delays to Handover.

7.4 Our final decision

We introduce a new performance commitment (ET07) in our final determination to incentivise the company to accept handback from Tideway of project land in a timely manner.

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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