

March 2021

Final guidance to facilitate the development, construction and operation of the Havant Thicket reservoir

About this document

This document provides guidance on the regulatory framework for the Havant Thicket reservoir.

This document should be read in conjunction with our [final 2019 price determination for Portsmouth Water](#) and the final determination takes precedence over this guidance, if there is a conflict between the two documents.

We strongly support the proposed development of the Havant Thicket reservoir 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.

As this approach is one of a kind, we have developed a bespoke regulatory framework in order to protect customers and provide necessary clarity to companies and investors regarding the remuneration of the project to ensure project efficiency and financeability. The guidance should therefore not be seen as setting a precedent for other projects whether or not those projects have some similar characteristics.

This guidance seeks to provide investors with greater confidence about future regulatory periods, by providing guidance as to how we might treat the project in future price controls, and in particular provides further information on the treatment of:

- recovery of efficient costs over the life of the project;
- treatment of the bulk supply agreement should either party enter into special administration; and
- regulatory treatment of the outcome delivery incentives associated with the timely delivery of the reservoir.

The Havant Thicket reservoir

As part of their business plans for the 2019 price review (PR19), Southern Water and Portsmouth Water proposed a large bulk transfer of water from Portsmouth Water to Southern Water. This transfer is predicated on the construction of a new reservoir in Portsmouth Water's operating area; the Havant Thicket reservoir.

Portsmouth Water will design, construct, operate and maintain a reservoir of approximately 8,700 mega-litre (Ml) capacity. This will enable Portsmouth Water to provide Southern Water with up to 21 Ml/day from its Gaters Mill water treatment works.¹

At PR19 Ofwat determined a separate price control under Portsmouth Water's Licence; the Havant Thicket price control. This has an initial duration of 10 years, to align the price control with the expected construction period of the reservoir and reflects the long term bulk supply arrangements between the parties.

Portsmouth Water will recover the efficient costs of constructing, operating, maintaining and financing the reservoir from the charges payable under the bulk supply agreement. It may also earn an economic profit which will be shared with its customers equally. The PR19 final determination sets out how those economic profits will be shared in relation to the separate price control.

Bulk supply framework

Southern Water will enter into a bulk supply agreement with Portsmouth Water. The bulk supply agreement is a commercial agreement entered into by the parties and has an expected duration of 80 years. Under the bulk supply agreement charges are payable by Southern Water to Portsmouth Water. These charges include a capacity charge which represents the cost of constructing, operating, maintaining and financing the reservoir, and a volumetric charge which reflects the incremental operating costs of providing water to Southern Water. The capacity charge will be payable for the duration of the agreement.

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. For price setting purposes our current regulatory practise is that costs associated with providing a bulk supply form part of the supplier's cost base, with revenues from the bulk supply being netted off when determining allowed revenues. This methodology ensures that the customers of the supplier do not pay for the costs of fulfilling the bulk supply as the benefits of the bulk supply accrue to the customers of the recipient undertaker. Portsmouth Water's customers benefit as a share of economic profits are passed to them through lower bills. Water trading

¹ Although future options may exist for Southern Water to connect the reservoir directly to its network.

incentives allow companies to share a proportion of the economic profits from new bulk supply arrangements.²

Ofwat does not limit the prices of bulk supplies through price controls. They are normally negotiated between water undertakers as part of the bulk supply agreement. Ofwat expects bulk supply prices to be consistent with the 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 Act).

Recovery of efficient costs

Southern Water's payments to Portsmouth Water will comprise part of Southern Water's costs of carrying out its regulated activities for customers.

We expect Portsmouth Water to recover the efficient costs of financing, constructing, operating and maintaining the reservoir, over the lifetime of the bulk supply agreement (which is 80 years) and for these costs to be included in Southern Water's allowed revenue in future price control determinations, in addition to allowances to perform the rest of its regulated activities. In arriving at the allowances for both Portsmouth Water and Southern Water in future determinations, we expect to make both cost and revenue allowances adjusting for any relevant changes associated with any mid-period review and cost sharing rates.

For the 10 years of the price control, we expect Southern Water to mirror the building blocks set out in the Havant Thicket price control in its business plan submission to us and we will reflect that in setting Southern Water's allowed revenue. 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, we similarly expect Southern Water's business plans to us to mirror Portsmouth Water's efficient costs for Havant Thicket and we will reflect that in setting Southern Water's allowed revenue. We expect both parties to report transparently on the costs incurred in the construction of the asset relative to the efficient cost allowance determined by Ofwat, the recovery of those costs and the recovery of economic profit, in future annual performance reports (or any successor regulatory financial statements).

As set out in Portsmouth Water's final determination ([Havant Thicket appendix](#)), we will conduct a reconciliation of costs at the 2029 Price Review, when construction of the reservoir is expected to be complete. In assessing the adjusted economic cost of the project, as set out in the final determination, there will be an assessment of any material change of circumstances. Where the costs for such material change of circumstances are deemed as

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.

being economic and efficient, they will form an adjustment to the gross cost allowance. Portsmouth Water and Southern Water may seek in principle agreement from Ofwat for material changes in order that any significant additional costs can be financed by Portsmouth Water and Southern Water in advance of the final reconciliation. We will consider any such occurrence on a case by case basis and whether a proposed material change of circumstances is likely to be deemed economic and efficient.

We understand that the bulk supply agreement also covers certain events of default and provides that even in the event of a default, Southern Water will continue to pay bulk supply charges to Portsmouth Water (less certain adjustments including any liquidated damages set out in the bulk supply agreement), and that this arrangement is considered necessary to ensure the project is financeable. Consistent with the objective that the asset is being constructed for the purpose of the provision of a bulk supply to Southern Water's licensed area, we confirm that an event of default will not be a basis for excluding the costs due to Portsmouth Water from being included in Southern Water's allowed revenue.

For this reason, we consider that any risk to Portsmouth Water arising from a default by Southern Water will only be for the duration of that price control. If Southern Water fails to pay Portsmouth Water under the bulk supply agreement, we will claw back any amounts which were due to Portsmouth Water but not paid, at the next price review reconciliation and Southern Water will be required to pay any outstanding amount to Portsmouth Water as a condition for continuing to receive the relevant allowance. This will be the case even in the unlikely event that a special administration order is issued in respect of Southern Water and the special administrator fails to comply with the bulk supply agreement. We consider that this will remove any economic incentive on Southern Water or any special administrator appointed to Southern Water, from defaulting under the bulk supply agreement.

In certain default scenarios a lump sum termination payment becomes payable by Southern Water to Portsmouth Water. Any lump sum termination payments which occur during the initial 10 year price control period will be allocated against the Havant Thicket RCV. To the extent there are sums included in termination sums which Portsmouth Water evidence as being lost economic profit and/or breakage costs, Ofwat will need to determine the treatment of those sums at the time by reference to the outstanding obligations and liabilities that Portsmouth Water customers will bear. 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.

Legal framework

Ofwat must carry out certain of its functions, including setting price controls, in line with its general duties set out in section 2 of the Act. As at the date of this note, these include:

- protecting the interests of consumers wherever appropriate by promoting effective competition;

- securing that the functions of an undertaker are properly carried out;
- securing that an efficient undertaker is able (in particular by securing reasonable returns on its capital) to finance the proper carrying out of those functions;
- performing our regulatory duties in the manner which we consider best
- calculated to promote economy and efficiency on the part of an undertaker in the carrying out of its functions;
- contributing to the achievement of sustainable development; and
- securing the long-term resilience of water supply and wastewater systems and securing that undertakers take steps to enable them, in the long term, to meet the need for water supplies and wastewater services; this includes promoting appropriate long-term planning investment and the taking of measures by undertakers to manage water resources in sustainable ways and to increase efficiency in the use of water and reduce demand for water so as to reduce pressure on water resources.

One of the ways in which Ofwat contributes to sustainable development and the securing of long-term resilience of water supplies, is by facilitating bulk supplies between undertakers. Under section 40 of the Act, Ofwat may step in if the parties to a potential bulk supply arrangement are unable to agree the terms of that supply and if one of the parties asks it to do so. Ofwat has a similar power under section 40A of the Act if the parties to an existing bulk supply agreement are unable to agree a variation to the terms of the agreement. An order under either section has effect as an agreement between the relevant parties.

Obligations under a bulk supply agreement entered into voluntarily are not enforceable under section 37 of the Act.

Transfer scheme under schedule 2 of the Act

A statutory transfer scheme is a means of transferring assets, rights and liabilities between undertakers when one undertaker or potential undertaker replaces another undertaker, or in circumstances where a special administrator is appointed by the court. Any transfer scheme must be approved by the Secretary of State or Ofwat.

If Ofwat is approving a transfer scheme impacting on all or substantially all of Portsmouth Water's business, Ofwat would ensure that the bulk supply agreement is included in such transfer scheme in that the bulk supply is necessary to enable Southern Water to carry out its functions. Any advice given by Ofwat to the Secretary of State as to any such approval will be consistent with this position.

If Ofwat is approving a transfer scheme impacting on all or substantially all of Southern Water's business, Ofwat would ensure that the bulk supply agreement is included in such transfer scheme, in that the bulk supply is necessary for Portsmouth Water to finance its functions. Any advice given by Ofwat to the Secretary of State as to any such approval will be consistent with this position.

In the event of a special administrator being appointed we would expect the special administrator to comply with the bulk supply agreement and to include the bulk supply agreement in any transfer scheme to a new appointee, given that the bulk supply is necessary for Southern Water to carry out its functions. A special administrator must carry out the activities of the undertaker until a new owner is found or the business is transferred to a new appointee, and in that time, the special administrator is subject to the same statutory, licence and contractual obligations as the undertaker. The special administrator may also seek government financial assistance under the Act in order to ensure that he or she can continue to carry out the undertaker's obligations.

Outcome delivery incentives

As part the final determinations for the 2019 price review, we set Portsmouth Water an outcome delivery incentive (ODI) linked to the successful completion of the reservoir.

Normally we give effect to ODIs as an adjustment to a company's future revenue allowance to reflect any rewards or penalties resulting from the ODI. However, the Havant Thicket price control has been set to zero as Portsmouth Water's customers will not be required to contribute towards the funding of the reservoir.

As the reservoir is being constructed for the benefit of Southern Water's customers it is appropriate that they should gain the benefit from any ODI penalties paid by Portsmouth Water, rather than Portsmouth Water's customers.

We will determine whether (and if so the extent of) any such penalties should be applied as part of the 2029 price review. The payment of any such penalties by Portsmouth Water to Southern Water can be given effect through the bulk supply agreement. Adjustments made to the Havant Thicket price control to reflect ODI performance will be offset by adjustments to the bulk supply charges to achieve a net zero control.

Enforcement

Both Southern Water and Portsmouth Water agreed a licence condition modification that they will in all material respects comply with the bulk supply agreement.

We expect the parties to the bulk supply agreement to work together to address problems, with enforcement being a last resort. In particular, we will not take enforcement action if express remedies or actions are available under the bulk supply agreement to resolve issues arising in relation to it. Where Ofwat does take action in respect of a licence breach, we will take into consideration all relevant circumstances, including whether or not the parties have taken all reasonable contractual and non-contractual steps to resolve the licence breach in deciding what, if any, further action is required.

**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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