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PR24 draft methodology consultation response
Ofwat Centre City Tower
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By email to; PR24@Ofwat.gov.uk
6 September 2022

Dear Ofwat,

PR24 draft methodology consultation response

Many thanks for the opportunity to comment on the draft methodology for PR24. We have set out below our observations in relation to certain questions that we consider we are best placed to respond to.

By way of background Agilia Infrastructure Partners were formed from the client team that lead the development, on behalf of Thames Water, of the Thames Tideway Tunnel. We are currently engaged by Portsmouth Water in relation to the development and delivery of the Havant Thicket Reservoir project and also by Thames Water in relation to the development of the proposed reservoir at Abingdon. We are also working with Sizewell C in developing the RAB model for new nuclear. In addition senior Agilia team members were at the core of the UK PFI/PPP programme (through Partnerships UK which subsequently formed Infrastructure UK). As such we have market leading experience of delivering programmes of infrastructure as well as projects within the UK and beyond.

Q3.1. Do you agree that in our final methodology we should commit to introducing either an adapted water trading incentive or a new water trading incentive at PR29? If you have a preferred approach, please provide reasons, including any thoughts on how the options we set out in Appendix 2 could be improved.

We comment on this question solely in relation to the implication for RAPID Strategic Resource Option (SRO) schemes.

As Ofwat recognises in Appendix 2, “*Some future trades, such as those that might arise from the development of strategic water resource solutions, may take a very different form from the types of trades that could be supported by the current incentive. Such trades may underpin (in whole or part) the investment case for major capital expenditure, supported by long-term contracts that may cover several decades*”. Whilst we concur with Ofwat’s view that such trades are unlikely to occur in the 2025-2030 period, the approach to water trading is likely to need to be reflected in the commercial terms developed for these SRO schemes during the 2025-2030 period. As Ofwat recognises, it may also be an important element of investment decisions. Therefore, we feel strongly that it is important to address any water trading reforms as part of the PR24 process.

In relation to the possible approaches to water trading and related incentives, we make the following observations:

- **Duration of water trading arrangements:** We recognise the need for revision to the current rules, which do not support the type of trades likely to take place in relation to the RAPID SRO schemes. In

particular, the duration of water trading arrangements could be significantly extended and therefore any retained water trading benefit should be spread over the duration of the trade.

- **The point of approval of a water trade:** As noted above water trading benefits may form an important part of investment decisions and commercial arrangements for SRO schemes. It would therefore be important that trades are agreed, in principle, significantly in advance of the availability of water. For schemes with long construction periods, it could be a decade before water is available to trade. We therefore feel that an Ofwat “pre-approval” process will be needed for the 2025-2030 period to provide certainty with regards to this important element of the SRO commercial arrangements.
- **Applicability of water trading incentives:** As a licenced undertaker we would welcome clarity as to the applicability of water trading incentives to a SIPR entity. This may have a beneficial impact on investment appraisal.
- **Water Trade terminology:** We consider that the configuring of schemes that will involve water trading will also as a necessity involve collaboration; as such there may be benefit both from a policy perspective and wider public acceptability perspective to reward effective collaboration or to use ‘collaboration’ in the current water trading terminology.

In addition to the above:

- We are broadly supportive of the need to reform the current water trading incentives. We would support the proposals to calculate and claim incentives annually and to increase the import cap to sharpen market incentives.
- We would welcome further industry debate as to the proposed modification whereby Ofwat would undertake a one-off assessment to set the charge for a trade. In particular, given the possible duration of trades under the SRO schemes and planned changes in the water resource landscape that are envisaged, it seems that a more flexible approach may be required.

Q3.5. Do you agree with our proposals:

- a) To raise the size threshold above which companies should deliver schemes through DPC to around £200m lifetime totex?
- b) For companies to deliver schemes through DPC by default above this threshold?

- a) We support the proposal to increase the size threshold to require DPC.
- b) We do however believe that Ofwat should consider factors other than pure Totex when establishing the preferred ‘default’ delivery route for schemes. As Ofwat will appreciate schemes have different degrees of complexity and the DPC approach with the involvement of financiers (whose risk appetite will be limited) will lend itself better to certain schemes when compared to schemes with an actual or higher level of technical risk. For example, recycling schemes involving reverse osmosis, or thermal hydrolysis schemes are of a higher risk profile than other schemes (for example, pipelines). We would suggest therefore that an element of technical consideration should also be factored in when making any default judgement relating to preferred procurement approach.

Additionally, we were pleased to see the Ofwat Competition Stocktake Report recognises the potential benefits that a SIPR commercial delivery model can provide – particularly in driving value for money for customers.

Accordingly, whilst Ofwat may consider that DPC would take the form of the default option, it will be critical to retain the flexibility that, where SIPR can offer clear value for money benefits over DPC, a SIPR route can be taken. This would include clarity on the assessment process and key decision and approval points by Ofwat. This may also need to include a bifurcation on the RAPID gate assessment process to the extent that SIPR and DPC commercial models may need to run to different timescales.

Q3.6. Do you have any views on any other aspect of our proposals in relation to:

a) The design of price controls;

Q6.2. What are your views on how we can best align the treatment of third-party costs and revenues?

Q7.2. Do you agree with our proposals on the regulatory regime for managing companies' exposure to uncertainty over 2025-30?

We comment on the questions above in generality and only to the extent of the potential implication for the RAPID Strategic Resource Option (SRO) schemes, which will primarily be delivered through third parties under DPC (Competitively Appointed Provider (CAP)) or SIPR (Infrastructure Provider (IP)) arrangements

Many of these schemes will have the involvement of more than one water company and will also have a long duration (in both construction and operation phases) which spans multiple regulatory review cycles. Due to the scale and complexity of many of the SRO schemes, they may also face risks which are very different in terms of the potential impact, duration and the risk allocation between different parties (e.g., water company, CAP/IP, contractors) from those that water companies are typically exposed to under “business as usual” projects.

It is therefore essential that, for schemes delivered through DPC or SIPR, price controls, the treatment of third-party costs and the approach to uncertainty support the following principles.

- **Certainty and duration of cost allowances:** To meet the financeability requirements of the third-party delivery entity, there will need to be sufficient certainty that the water company or companies will be fully funded, through cost allowances, for the duration of the contract. Although we recognise that the water company’s funding may be subject to certain incentive adjustments (rewards & penalties).
- **Transparency and symmetry of funding requirements:** Also supporting financeability, it will also be critical that cost allowances are sufficiently transparent that the water company/companies involved in a scheme can demonstrate the clear flow-through of funding from regulatory allowances into the related funding stream for the CAP/IP. This would also include clarity over the treatment of funding streams in certain high impact/low probability circumstances, most notably financial distress of the water company.
- **Allocation and totality of funding:** Where more than one water company is benefiting from and will fund a new SRO asset, there must be regulatory clarity relating to how costs are allocated between parties. It is likely that any such funding allocation approach will also need to be mirrored in the commercial agreements between the water companies and the CAP/IP.



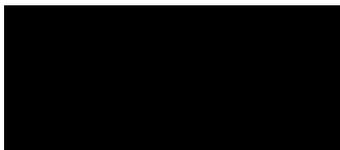
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- **Transparency of uncertainty mechanisms** such that both the funding water company and the CAP/IP have a clear understanding how such mechanisms will be applied.
- **Funding of residual risks** further consideration may be needed as to how any residual risks (typically reflecting high impact - low probability events) which may need to be retained by the water companies will be funded through cost allowances or uncertainty mechanisms.

The development of DPC has parallels with the UK PFI programme and the way that PFI projects developed and matured over time, Valuable lessons were learnt from the development of initial schemes. As mentioned above Agilia were at the heart of the PFI programme, based within the implementation team at HM Treasury. We would be happy to provide further insight from our experience to Ofwat and to discuss lessons learned.

We would of course be happy to discuss further any aspect of this submission and should you wish to do so please contact either myself or my colleague Helen Orton helen.orton@agilia.co.uk.

Yours faithfully



Agilia Infrastructure Partners

