



Official

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PR24 draft methodology consultation response

Ofwat
Centre City Tower
7 Hill Street
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7 September 2022

Dear Ofwat colleagues,

PR24 DRAFT METHODOLOGY CONSULTATION – TIDEWAY’S RESPONSE

Please find below Tideway’s response to this consultation.

Our response focuses on how Ofwat’s PR24 methodology can support best value delivery of major projects, in particular:

- How Ofwat’s approach to competition in major projects can encourage a broad range of market participants and investors, and maximise value for customers, the environment and wider society; and
- How incentivisation and funding of incumbents at PR24 can best support timely and efficient delivery of major projects.

We are happy to discuss any of our responses if Ofwat would find this helpful.

Yours sincerely



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Q3.6. Do you have any views on any other aspect of our proposals in relation to: a) The design of price controls; b) Water resources; c) Developer services; d) Retail activities; e) Bioresources; f) Other controls; g) The revenue forecasting incentive mechanism; or h) Direct procurement for customers?

Tideway welcomes Ofwat's continuing commitment to competitive procurement for major projects. We are pleased that Ofwat's recently published competition stocktake advocates changes to the legislative framework which would, amongst other things, enable more of the larger projects in the sector to be considered as candidates for delivery via a licensed (SIPR) rather than a contractual (DPC) model.

We believe there are a number of success factors for major projects that would encourage a broad range of market participants and investors, and maximise value for customers, the environment and wider society. We encourage Ofwat to consider including these within the final PR24 methodology and its own forward planning:

- **Ofwat should maintain a live list of likely projects and their current status**, providing a pipeline for the sector and encouraging participation by a broad range of new entrants and investors.
- **Ofwat should publish a common model for direct procurement in the sector.** A common core contractual approach, with modifications only where needed, would enable timely procurements, support investor appetite by reducing the cost of bidding, and lead to more efficient project development for all parties.
- **Ofwat should set out its thinking** within or alongside the PR24 methodology on **how future SIPR projects could be delivered**, and criteria for determining whether DPC or SIPR is more appropriate for larger projects.
- **Ofwat should set out how its approach to competition for the market will deliver social and environmental value.** Tideway has sought since the early stages of the Thames Tideway Tunnel (TTT) project to deliver value in its broadest sense and to put measures in place to ensure that we leave a positive legacy. We encourage Ofwat to consider how PR24 could facilitate the adoption of similar approaches by competitively appointed providers and ensure that the value created is maintained under the stewardship of incumbents once the construction phase is complete.
- **Ofwat should work with water companies, other regulators and stakeholders on a catchment approach** avoiding a narrow definition of the project that would miss the opportunity to address other issues in the catchment and to share costs that could otherwise fall solely on water customers.
- **Ofwat should ensure that incumbents are appropriately incentivised and funded to support delivery of competitively tendered projects.** We welcome Ofwat's commitment on these points in the draft PR24 methodology. We comment further under questions 5.2 and 6.7.

Q4.1. Do you agree with our approach to making sure that companies' price review submissions and our determinations reflect an understanding of customers', communities' and environmental concerns?

Tideway notes Ofwat's intention to simplify the PR24 process relative to PR19, including removal of the initial assessment of business plans stage. While Tideway does not oppose this move, we note that it focuses attention on the draft determinations; this will be the only formal point in the process at which stakeholders have the opportunity to understand Ofwat's assessment of companies' business plans and to highlight areas where a different approach could deliver greater benefits for customers.

We encourage Ofwat to consider how stakeholders could best be engaged before and after draft determinations on issues that are particularly complex, or for which significant uncertainty regarding the best approach remains at the time of draft determinations. For such issues, an approach that facilitates transparency and dialogue is likely to enable a higher degree and quality of stakeholder challenge than a 'one shot' consultation. We believe that this should include trilateral meetings between Ofwat, Tideway and TWUL on issues relevant to TWUL's price control, and bilateral meetings as needed.

We feel there would also be value in Tideway attending Ofwat PR24 workshops with companies where the issues covered are relevant to the TTT project (such as incentives) or to major projects in general.

Q5.2. Do you agree with our proposed guidance for bespoke performance commitments?

We support Ofwat's proposal to continue to allow bespoke performance commitments, supported by financial incentives, on issues of specific local importance. In Tideway's view there remains a strong case for bespoke incentives in areas such as IPs and DPCs, in order to avoid a situation in which companies' incentives are not aligned with those of their customers in large areas of spending. In particular, the unique nature of the interface between TWUL and Tideway means that it may be appropriate to consider a higher number of bespoke commitments than for other companies. While we understand the case for reducing the overall number of commitments relative to PR19, we would urge Ofwat to consider the customer benefits of any proposed bespoke commitments on a case by case basis rather than applying a numerical cap.

In some cases, there may be PR19 incentives that are working well to achieve the original aims and for which there is a clear rationale to roll them over to the next price control period. For example, TWUL PR19 performance commitment ET07 (Managing early handback of land) is proving effective in incentivising TWUL to accept land no longer needed for the TTT project in a timely manner. This benefits customers by enabling earlier sale or return of land, minimising compensation, reducing TWUL's RCV, and reducing the risk of schedule delays to the project (the costs of which would fall mostly on customers). Ofwat has previously indicated that if this performance commitment is still relevant after April 2025, it could be rolled over. If Ofwat does apply a cap on the number of bespoke incentives, we consider that it should exclude any such rolled-over commitments, to avoid limiting Ofwat's flexibility to allow such approaches where there is a demonstrable customer benefit.

We would appreciate a meeting with Ofwat to discuss the effectiveness of existing incentives.

Q6.7. Do you agree with our proposed approach to incentivising and funding efficient investment in reducing greenhouse gas emissions and reducing the use of storm overflows?

The TTT will have a transformational impact on storm overflows in the tidal River Thames once construction is complete and it enters its operational phase. Formal construction completion ('Handover') is currently forecast to take place in March 2025, just before the start of the next price control period. 'System Acceptance', where all testing in different conditions of the TTT is expected to be complete, is forecast for September 2026.

TWUL's PR24 determination will be important in promoting the effective testing, operation and maintenance of the TTT in a way that delivers value for money for customers, particularly during the period between Handover and System Acceptance. For example:

- Certain activities, notably managing the maintenance of the TTT, could in principle be carried out either by Tideway or TWUL. We expect to work collaboratively with TWUL to determine the best value approach and encourage Ofwat to allow sufficient flexibility in TWUL's PR24 determination to enable such an approach to be implemented.
- TWUL's TTT price control should fund all efficient costs of the company's scope of work on the TTT. If any essential work is not funded via PR24, there is a risk that the resulting uncertainty over the source of funding leads to delays and inefficiency. Most of the costs of any work that is eventually funded by Tideway will ultimately fall on customers.
- One or more bespoke performance commitments may be helpful in incentivising TWUL to achieve outcomes in the overall interests of the project and customers, both before and after System Acceptance.
- The funding mechanism (or combination of funding and incentives) should ensure TWUL is fully incentivised to support the earliest System Acceptance.

We look forward to further discussions with Ofwat in due course on the deliverables, funding and incentives that will best support TWUL's role in realising the full benefits of the TTT as efficiently as possible.

Q7.5. Do you agree with our proposed approach to setting the allowed return on debt?

In setting an allowance for embedded debt Ofwat proposes to focus on companies' balance sheet debt and the exclusion of the impact of interest rate swaps. We would welcome a discussion of how this approach would be implemented and how it may impact the analysis as it does not appear to take into consideration the characteristics of the sector and the idiosyncrasies of the sterling debt market.

While PR24 does not directly impact Tideway, we note as an example that Tideway's financing plan calls for substantial amounts of index-linked debt, consistent with many UK regulated infrastructure companies with inflation linked revenues. The market for index-linked debt is relatively small and illiquid at times. The use of inflation linked hedging is therefore a core component of companies' financing plans to provide an alternative in case the inflation bond market is either unavailable or uncompetitive, and its use should be recognised in Ofwat's analysis.

Q9.1. Do you agree with the proposed standard set of scenarios for testing financial resilience?

In their annual published Long Term Viability Statements, water companies must select and justify the scenarios that they have used to stress test their financial resilience. We believe that this approach provides a transparent picture of companies' financial resilience that recognises the different risks they face. We are concerned that the prescriptive approach set out in the draft methodology, which does not reflect companies' individual circumstances, may provide an unduly optimistic or pessimistic view of their financial resilience. This may lead to decisions by companies in their business planning and/or by Ofwat in its determinations that either do not go far enough to

support resilience, or that place inappropriate constraints on companies that have adopted a prudent approach and that have carried out robust stress testing based on their individual circumstances.

When read alongside the proposals in Ofwat's financial ring-fencing consultation, we note that the proposed methodology relies heavily on rating agencies' views. While impact on ratings is one factor that Ofwat will naturally want to take into account, we consider that Ofwat should not put too much reliance on assessing stress testing results against the impact on ratings as it is not prudent or reasonable to rely excessively on rating agency methodologies.