Cost Adjustment Claim CAC2: replacement of head office building

Overview
This cost adjustment claim relates to the replacement of our head office building. This large and atypical expenditure of replacing an asset that was constructed 60 years ago is not covered by the modelled allowance for base expenditure.

Need for adjustment
Expenditure on a new head office building is an atypical and material investment for a water company, and especially material for a company as small as Portsmouth Water. Our head office was built around 60 years ago, in 1967. Given the long asset lives of office buildings, replacing a head office is an infrequent occurrence for the water industry in England and Wales. As far as we are aware, in the last 12 years, the period covered by Ofwat's modelling dataset, only two companies incurred major costs related to head office, Severn Trent Water and Bristol Water.

We have reached a point where it is now necessary to invest in a new building. A number of years ago our Board instigated a study into the condition of our current head office at Havant. It was found the building would be in need of significant repairs over the coming years and it was not economic to invest in the current building. A number of options were identified and evaluated (see below). After considering all the options it was decided that the most economic option would be for the business to relocate to a new building on an alternative area on the current head office site and sell the land occupied by the current building for development, to offset the costs of the new build.

The cost of the new building is estimated to be £9.3m. However, this will be offset by the proceeds from the sale and re-development of the existing office building site. The estimated proceeds are £4-4.5m reducing the cost from £9.3m to £4.8-5.3m[1].

We consider that Ofwat's modelled base cost allowance would not allow us to fund this expenditure. This is for two reasons:

- First, there are not enough data points related to head office expenditures that are included in the data sample for base costs. Ofwat's base cost models are estimated using the last 12 years of data. At PR24, Ofwat has decided to include some atypical expenditure in the definition of base costs. We understand that this has included some of the expenditures incurred by Severn Trent Water and Bristol Water. However, this is not a sufficient number of observations for the models to capture a relationship between head office costs and the cost drivers.
- Second, Ofwat's models do not contain specific cost drivers for head office that would enable the models to pick up the costs incurred by those two companies and estimate an allowance for each company.

In terms of the classification of the claim, this relates to an 'atypically large investment'.

The claim is not symmetrical. In our view the modelled allowance for base costs does not capture expenditure on head office replacement and therefore there is no case to adjust allowances for other companies as a result of this claim.

We consider the claim against Ofwat's guidance and criteria in more detail below.

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[1] We assume that there will be no clawback of the sale value under Condition K of our licence, on the basis that net proceeds after deducting the cost of the new building will be negative.

Unique circumstances
The replacement of a head office building is not a unique circumstance that only affects Portsmouth Water. However, given the long life of an office building and the fact that each company has a single asset means that the need to replace a head office building in any particular AMP is highly unusual and atypical.

In addition, the scale of the expenditure relative to overall totex is more significant for a smaller company. For example, we estimate that the head office investment by Severn Trent Water amounted to 0.1% of net totex compared to our estimate of at least 1.5%.

Management control
The decision to invest in a new head office building in the next AMP is a decision within management control, but the factors that have led to this decision are outside of management control.

In 2019 the Board instigated a study into the condition of the current head office at Havant. The study found that the building was in need of significant repairs. The areas that required investment included a replacement flat roof, replacement double glazed windows and doors, outside cladding, LED lighting, internal fire doors, and asbestos removal. The cost of these one-off works was estimated at around £4m, to extend the life of the building. A full refurbishment of the current building, including long-term repairs, would cost an estimated £9m, with no offsetting land sale income.

Given the scale of these costs the Board considered a number of options:
(i) Alternative locations to lease an office building.
(ii) Remaining on the current site and refurbishing / rebuilding the existing building.
(iii) Finding a partner for a sale and leaseback arrangement.
(iv) The current proposal to build a new head office on an alternative area within the current overall site.
(v) Delaying the investment for another AMP.

We have evaluated all of these options, taking account of build and fit-out costs, carbon impacts, impact on employee retention, and operational performance and risks. The appraisal also took account of the proceeds of any land redevelopment which would be enabled by the move. In the case of the sale and leaseback option we had evidence from earlier market testing that ruled out this option. The process of options appraisal shows that we have taken reasonable steps to control costs and identify areas for cost savings. The proposed option to build a new head office was the best overall option in terms of costs and performance.

Materiality
We estimate that the net cost of the scheme, after deducting the proceeds from the sale of land for development, to be about £4.8-5.3m or between 1.5% and 1.7% of net totex for the network-plus price control, exceeding Ofwat's criteria of 1% of expected totex. The investment has been allocated to the network-plus price control as this is by far the largest of our price controls, accounts for the majority of our staff and activities. This is consistent with allocation based on the 'principal use' as set out in RAG 2.08.

Value of claim	£4.8m - £5.3m
Current estimate of AMP8 net totex	c.£320m
Materiality (% of net totex)	1.5%-1.7%

Implicit allowance
At this stage we have assessed the implicit allowance as either very small or zero. Our assessment of the implicit allowance has taken account of the following issues.

First, we have considered whether the one-off capital costs of a head office building are fully captured within the base cost models. As outlined above there are compelling reasons to argue that there is no allowance for the one-off capital costs of a new head office within the modelled costs:

- There are not enough data points related to head office expenditures that are included in the data sample for base costs. Ofwat's base cost models are estimated using the last 12 years of data. At PR24, Ofwat has decided to include some atypical expenditure in the definition of base costs. We understand that this has included the expenditures incurred by Severn Trent Water and Bristol Water. However, this is not a sufficient number of observations for the models to capture a relationship between head office costs and the cost drivers.
- Ofwat's models do not contain specific cost drivers for head office that would have, in principle, enabled the models to pick up the costs incurred by those two companies and estimate an allowance for each company which, over time, could be sufficient to cover the costs of building a new head office.

Second, we have considered whether the base cost allowance would include ongoing maintenance and refurbishment costs which would be reduced or avoided and therefore provide an implicit allowance. This would be the case, for example, if older buildings have materially higher operating and maintenance costs than newer buildings.

At this stage we do not consider that an implicit allowance is appropriate for this factor. This is based on the following:

- In our experience, the rationale for replacing the existing building is not that the operating and maintenance costs have been significantly higher to date but that a significant refurbishment programme would be required in the near future. Given the age of the existing building (around 60 years) and the fact that costs have not been materially higher to date indicates that models are unlikely to capture a higher level of operating and maintenance costs.
- However, even if this were not the case, any benefit for Portsmouth Water would be temporary as the models would capture an average amount of operating and maintenance expenditure associated with a head office. Any period of below average expenditure (as a result of the new office) would be offset over the long term as the building aged.

Finally, we have considered whether the new head office buildings would facilitate other cost efficiencies or performance improvements that should be adjusted for. While the head office will be designed to optimise performance and to reflect best practice in office design, our assessment is that this will enable us to continue to meet expectations for service that is delivered from base expenditure. A core part of our decision to invest in the new head office is that maintaining with the existing building would pose a risk to maintaining operational performance.

Therefore, at this stage we have assessed the implicit allowance as either very small or zero. We will continue to review this and, if appropriate, update this assumption in our October business plan submission.

Cost efficiency

Our commitment to delivering cost efficiency for this investment is highlighted by the following:

- A robust appraisal of different options for meeting the needs of the business and our customers. As outlined above this included a 'deferral' option, rebuilding on the existing site, sale and leaseback, leasing space in existing development and the preferred option of a new building on an alternative area of the current site.
- Expert input on costs from our cost and fit out consultants (Ridge & Partners LLP).
- Maximising the potential for proceeds from land re-development to minimise the cost to customers of the project.

Given the stage of development of the proposal we highlight that further benchmarking of the build costs may be appropriate and will be undertaken prior to the final submission of claim. This will further test the cost efficiency of the scheme. The current cost estimate is summarised in the table below.

Item	**Estimate (2022/23 prices)**	**Source / Notes**
New build office to Cat-A GIFA 20,000sq ft	£5.017m	
Cat B fit-out	£2.096m	
External works (car parking/roads)	£0.737m	
Contractors costs, overheads & fees	£1.478m	
Total New build cost	**£9.328m**	Ridge & Partners
Proceeds from land re-development	£4.0m–£4.5m	Property consultants
Net costs	**£4.828m - £5.328m**	

Need for investment

As outlined above, the need for the investment is demonstrated by the following:

- A detailed analysis of the cost implications of the existing building. The areas that required investment included a replacement flat roof, replacement double glazed windows and doors, outside cladding, LED lighting, internal fire doors, and asbestos removal. The cost of these works was estimated at around £4m. A full refurbishment of the current building, including long-term repairs, would cost an estimated £9m, with no offsetting land sale income.
- Robust options appraisal. A range of options were evaluated: alternative locations to lease an office building; remaining on the current site and refurbish / rebuild the existing building; finding a partner for a sale and leaseback arrangement; the current proposal to build a new head office on an alternative area within the current overall site; and delaying the investment for another AMP. The proposal presented here is the best in terms of value for money for customers.
- As considered above in the section on implicit allowance, the investment has not previously been funded by customers. It is a large, atypical investment that is not represented in the modelling dataset.

Best option for customers

The table below assesses the claim against Ofwat's criteria for showing that the claim is the best option for customers.

Ofwat guidance to demonstrate proposed claim is best option for customers

Ofwat guidance	**Claim for head office**
Did the company consider an appropriate range of options to meet the need?	We considered five different options, including the option to delay investment. The proposed option provides the best value to customers.
Has a cost–benefit analysis been undertaken to select proposed option? There should be compelling evidence that the proposed solution represents best value for customers, communities and the environment in the long term? Is third-party technical assurance of the analysis provided?	The option evaluation took account of costs and benefits (in terms of service performance and risks).
Has the impact of the investment on performance commitments been quantified?	The replacement of the head office forms part of base service delivery and will support the company in achieving proposed performance commitment levels. The alternative options would pose greater risk of underperformance on PCLs.
Have the uncertainties relating to costs and benefit delivery been explored and mitigated? Have flexible, lower risk and modular solutions been assessed – including where utilisation will be low?	The proposed option is lower risk than the alternatives as it minimises disruption during the transition from the current to the new building.
Has the company secured appropriate third-party funding (proportionate to the third-party benefits) to deliver the project?	Proceeds from the sale and re-development of the portion of land occupied by the existing building will mitigate a substantial proportion of the costs of the new building.
Has the company appropriately presented the scheme to be delivered as Direct Procurement for Customers (DPC) where applicable?	Not applicable for DPC.
Where appropriate, have customer views informed the selection of the proposed solution, and have customers been provided sufficient information (including alternatives and its contribution to addressing the need) to have informed views?	Customer research supports the overall package of cost and service improvement in the business plan. The new head office will be a key component in the delivery of this plan.

Customer protection
We would propose to include a price control deliverable (PCD) to protect customers if the investment is cancelled, delayed or amended. We will develop proposals for the calibration of the PCD to provide appropriate protection for customers and incentives for Portsmouth Water.

Table commentary
In the Ofwat data table we have included historic expenditure on our head office building up to 2021-22.
We have assumed receipts from the sale of land for development of £4m, and that these will not be shared with customers under Condition K.

We have not completed any values in respect of 2022-23, 2023-24 and 2024-25 as all expenditure included within the CAC is incurred in AMP8.

The profile of the AMP8 expenditure has not yet been finalised. We have therefore spread the costs evenly between the five years of AMP8. We have included all expenditure to the Network+ price control, within the water distribution business unit on the ‘principal use’ basis.