



Delayed Allowance Mechanism

DRAFT proposal to Ofwat – FOR DISCUSSION



Introduction

Southern Water has considered, following discussion with Ofwat, the development of a mechanism in which the approval for allowances for certain AMP8 projects would be delayed from the PR24 decision to a relevant time during AMP8, to aid deliverability of the core plan and to potentially moderate the average household bill increase over AMP8 (**Delayed Approval Mechanism**).

We welcome and support this opportunity to submit our proposal as it would align with and start to mitigate two of our concerns - deliverability and affordability – that we identified in our PR24 plan submissions. We had already proposed to either rephase projects and/or deliver some projects through Alternative Delivery options and we welcome further opportunities to start to alleviate these concerns¹.

This paper provides Southern Water's initial thoughts about such a mechanism. Owing to the short timescales required by Ofwat, this mechanism does not have Southern Water Board approval, but is provided to aid discussion.

The Delayed Approval Mechanism would allow non-core projects (or parts of projects) that: i) would benefit from further refinement, and ii) have a regulatory needs case – to be ring-fenced, assessed, and approved during AMP8, instead of approved in the PR24 final determination at the start of AMP8. This would have the effect of allowing the company and the regulator to fully reassess whether the project cost is efficient later, when project maturity will have increased. The bill would be uplifted to reflect the project allowances only at the point of approval and not from the start of AMP8. An approval in-period would follow the same process and have the same effect as an approval within the PR24 review.

The mechanism sits alongside the significant size of projects that we had already identifying as benefiting from Alternative Delivery/DPC. Such delivery routes benefit both the deliverability and affordability of the plan in total – if we had to self-deliver these projects then these would add to the deliverability and affordability burden on the company in AMP8. We encourage Ofwat to allow the candidate list of Alternative Delivery projects to progress on that basis, in its DD.

We set out below:

- Features of the mechanism;
- Proposed non-core projects in the mechanism (subject to final confirmation);
- Reminder of the projects designated for Alternative Delivery;
- Impact on the average household bill; and
- Limitations.

Features of the mechanism

We are proposing the following mechanism features:

1. Non-core projects in the mechanism would be identified and ring-fenced from core projects, which will be assessed during the PR24 review. Southern Water would seek approval for ring-fenced non-core projects during the AMP;
2. Ofwat would designate 'Approval Points' during the AMP, at which time Southern Water would submit a new project business case and Ofwat would assess the scope and cost efficiency of the case;
3. Ofwat would then consult its interim determination on each project considered and if approved, Ofwat would modify Southern Water's licence to allow in-period PAYG and RCV run-off adjustments to bills. The updated RCV projection for the remainder of the AMP would also be updated to reflect the approved funding, to allow for debt

¹ For the avoidance of doubt, a Delayed Allowance Mechanism, as contemplated, would not on its own address the RORE risk issue already identified in the current plan. This would require a final determination package with the right balance for incentives and penalties.

4. Project approval within the AMP through the mechanism would have the same features and effect as approval in the PR24 review;
5. Specific proposed timing:
 - a. Southern Water would provide a business case (including proposed PCD) for non-core projects seeking approval by December 31st each year, starting in 2025;
 - b. Ofwat would complete the project assessment by March 31st, ahead of consultation and a final licence condition interim determination by July 31st, which could be referenced to the CMA; and
 - c. Bills can be adjusted for the start of the following financial year – according to the approval given in Ofwat’s interim determination.
6. Other specific regulatory treatments:
 - i. Core project funding approval for spend in 2025 and 2026 will be required in 2024 as part of the PR24 determination. This means that some projects may need to be split between early and later approvals;
 - ii. Non-core projects in the mechanism would be subject to the same materiality threshold as in the PR24 review;
 - iii. Owing to the reduction in both Ofwat risk and Southern Water opportunity for a delayed approval (see explanation below), the cost sharing rates for these projects would be 50:50;
 - iv. Any change in real price effects within the non-core projects should be reflected in the interim determination during the AMP; and
 - v. PCDs would be similar in nature to those we proposed in the PR24 review but would be finalised and applied at the point the allowance is approved.

Proposed non-core projects in the mechanism (subject to final confirmation)

This paper provides an initial assessment of the non-core parts of projects which could benefit from the further refinement, which the mechanism could grant. These projects need to be fully assessed for their suitability and we can give final Board-approved confirmation in response to Ofwat’s PR24 draft determination.

The table below identifies the sub-set of projects which could benefit from the mechanism, separating between the core part of the project needing approval in the PR24 review in 2024 and the non-core part of the project which would be approved during the AMP, through the mechanism. We have initially identified c.£700m of non-core projects in addition to those projects already identified as candidates for alternative delivery (further information below).

Project		Total Value (£2022 prices)	Core (£2022 prices)	Non-core (£2022 prices)
Non-core projects for mechanism	CSO's (CWW3.13 to CWW3.48)	£431m	£377m	£54m
	River Monitoring (CWW3.9)	£43m ¹	£8m	£35m
	NIS/SEMD (CW3.124 and CW3.121)	£133m	£66m	£67m ²
	Nutrients (see below)	£857m	£611m	£246m
	Supply resilience - 4 sites (CW3.118)	£304m	£258m	£46m
	WRMP Demand Mains replacement (CW3.134)	£198m	£132m	£66m
	WRMP Mitigation (CW3.136)	£91m	£21m	£70m
	Alt Delivery Enabling (e.g. SWS' development costs) (CWW3.182, CW3.131, CW3.53) ³	£282m	£232m	£50m ⁴
	TOTAL	£2,339m	£1,705m	£634m

NB: Numbers are consistent with our February 2024 data table submission.

1. Post Feb submission value based on query 251.
2. 50% of the total value, based on Yr4 and Yr5 increases and significantly increased scale of the programme.
3. This includes our AMP8 costs for development of the schemes in SUP12 and the costs for SESRO and T2ST SROs in CW8 and included in CW3.53.
4. Value of Development costs from the SESRO and Thames to Southern Transfer uncertainty.

Reminder of the projects designated for Alternative Delivery

As a reminder, the table below shows the value of the projects which would benefit from Alternative Delivery and were included in our business plan. Clearly, if any project had to be delivered in-house, this would add to the deliverability and affordability burden on the company.

Project		Total Scheme Costs (£2022 prices)	Alt Delivery Enabling (SWS development costs); (£2022 prices)
DPC / Alternate Delivery	Recycling schemes (excl SRO)	£404m	£35m
	SRO	£351m	£68m
	SESRO / T2S	£132m	£132m
	Bioresources AAD (Kent)	£185m	£10.8m
	Whitfield	£55.4m	£5.4m
	Smart Metering	£180m	£15m
	CSO's	£197m	£15.8m
	TOTAL	£1,504.4m	£282m

NB: Numbers are consistent with our February 2024 data table submission.

We note that our business plan included c.£120m of payments to Alternative Delivery CAP partners for projects that would become operational in AMP8. Since such Alternative Delivery projects have yet to be approved. Following the precedent of the Delayed Approval Mechanism, Ofwat could account for these costs in the bill calculation only once such projects are approved, during the AMP. We also note that recent correspondence from RAPID regarding the revised criteria for inclusion of schemes into the RAPID gated process further supports our initial plan for alternative delivery.

Impact on the average household bill

One effect of the proposed mechanism would be to remove investment from the February data tables and hence change the calculation of the average household bills that would be subject to the PR24 determination. If Ofwat chose to account for bills without the non-core project spend, then the mechanism will reduce the increase in average household bills from the end of AMP7 to the end of AMP8. We will assess the effect of this removal from the water and waste bills, as set out in the February data tables, and this information will follow.

In our response to OFW-OBQ-SRN-270 we detailed the approach we took in our original plan submission to smooth bills specifically to address concern around the bill increases and the large step up from 2024-25 to 2025-26 but also to ensure we were financeable from the start of AMP8. The approach we took to smooth the bill was to first, smooth £403 million of PR19 reconciliation (in relation to Water and Waste Water Networks expenditure) from 2025-26 across the full 5 years period to 2029-20, and then, secondly, to reduce 2025-26 revenues by a further £105 million but to only spread over years 2026-27, 2027-28, and 2028-29, in order to minimise the impact of smoothing on the final 2029-30 bill.

Limitations

While we see merit in this mechanism, we recognise the following limitations and points to note:

- **Delayed bill increase:** While delaying approval removes the non-core projects from the PR24 determination and hence the projection of bills concluded in 2024, the effect of later approval is likely to re-instate the current bill increase. We suggest that Ofwat should be clear with our customers in the PR24 determination about the eventual possible impact on bills; and
- **Reduced risk to Ofwat, reduced opportunities to Southern Water:** The mechanism would allow Ofwat to assess more refined project business cases, drafted at that time. This would have the effect of reducing both the risk to Ofwat from approving less developed project plans, but also reducing the opportunity for Southern Water to outperform those budgets.

However, broadly we see benefits in pursuing a mechanism with these features and we would welcome further discussion with Ofwat so that this proposal can be considered in the forthcoming draft determination consultation.