

Joint statement on strategic regional solution development

Affinity Water, Anglian Water, Severn Trent Water, Southern Water, Thames Water, United Utilities and Water Resources South East

25 March 2019

During February and March Affinity Water, Anglian Water, Severn Trent Water, Southern Water, Thames Water and United Utilities have worked together to develop a set of proposals that seek to address the potential challenges associated with the promotion of strategic regional solutions as set out in Ofwat's initial assessment of plans.

The group of companies have collaborated to develop a set of principles, working documents and discussion papers which demonstrate how the gated process would work for the promotion of a regional scheme.

Further work has been identified which the companies will continue to work together to address.

1 Executive summary

This document sets out the work that has been jointly undertaken by the six water companies. These companies are Affinity Water, Anglian Water, Severn Trent Water, Southern Water, Thames Water, and United Utilities, with the support of Water Resources South East (WRSE). We have jointly assessed, reviewed and provided constructive comments back on the proposal for developing regional strategic solutions as set out by Ofwat in its initial assessment of companies' business plans ("IAP").

The companies have worked together over the last two months, observed and supported by Ofwat and the Environment Agency, to develop the following aspects:

- **In conjunction with the other companies involved, jointly propose methods for collaborative working including setting up the joint working group for individual schemes, and how consistent assumptions and decisions will be made within these groups and between them.**
 - A terms of reference for working collaboratively across all of the companies;
 - The principle of the scheme working groups, the requirement for specific Terms of Reference;

- **Provide more detail on the gated process, the deliverables, timings and expenditure allocations at each gate.**
 - A proposal to modify the timing of the gateways based on whether the schemes are required to obtain a development consent order (DCO);
 - Increased detail of the work between the proposed gates to allow an improved understanding of the funding required per stage to be undertaken, and to confirm the overall sum to complete all gates;
 - The requirement and principles of a change protocol to manage specific changes to schemes in the proposal and to change the current list of schemes when required;
 - Gateway acceptance criteria to be confirmed using the improved detail per gate;
- **Propose ODI-type mechanisms to allow allocated funding to be recovered by customers in the event of the scheme not progressing through each gate and for the non-delivery or late delivery of outputs**
 - Development of the principles of an ODI type mechanism;

The group have also agreed a forward-looking plan for further work.

This document covers the joint understanding between the 6 water companies of the above subjects. Each company may also submit further information building on this work in response to their individual IAP feedback from Ofwat.

Whilst the companies have worked through a lot of detail in a relatively short period of time, a forward-looking plan has also been incorporated into the document which sets out the additional information that will be worked on by the companies, for submission to Ofwat by the middle of May 2019 to allow it to take account of these proposals in its draft determination process.

We hope that Ofwat, and other regulators, will collaborate with the water companies and contribute to the ongoing development of the strategic water resource programme.

Contents

1	Executive summary	1
2	Ofwat’s key questions	5
3	Introduction.....	6
4	Document structure	6
5	Background: Initial assessment of business plans	7
5.1	Strategic schemes that have been referred to in the IAP	7
6	Proposed enhancements to the Ofwat gated process.....	8
6.1	Working groups.....	9
6.2	Timelines, Gateways and governance	10
6.3	Potential enhancement to the timing of the gates and the number of gates:	11
6.3.1	Gate 1:.....	12
6.3.2	Gate 2:.....	12
6.3.3	Gate 3:.....	13
6.3.4	Gate 4 (DCO only):	13
6.4	Change control process	14
6.5	Development of an ODI type mechanism for customer protection	14
6.5.1	Introduction.....	14
6.5.2	Questions to consider:.....	15
6.6	Key Principles for the ODI type mechanism	14
7	Proposed work plan.....	20
8	Summary	21
9	Appendix A: Ofwat’s initial assessment of the costs per gateway per scheme from the IAP. 23	
9.1	Strategic schemes that have been referred to in the IAP	23
10	Appendix B: Draft terms of reference for the All Company Working Group	28
10.1	Terms of Reference	28
11	Appendix C: Discussion document setting out some draft options for working groups30	
11.1	DRAFT OPTIONS FOR JOINT WORKING	30
11.1.1	Introduction.....	30

11.2	Options for joint working.....	31
11.2.1	Memorandum of Understanding (“MoU”)	31
11.2.2	“WRSE model”	31
11.2.3	Joint Venture (“JV”).....	31
11.2.4	Single legal entity (“SLE”) / incorporated company	32
11.2.5	Comparison of options	32
11.3	Conclusions and next steps.....	34
12	Appendix D: An example of some generic programme of activities potentially required to get to gate 4.....	35
12.1	Text to be added	35
13	Appendix E: A discussion document setting out an example of an ODI type mechanism	36
13.1	Measure definition.....	36
13.2	Mitigation/exceptions.....	37
13.3	Incentive type.....	37
13.4	Outperformance/underperformance incentive rate.....	38
13.5	Worked examples.....	38
13.5.1	Example 1: project stops after gateway 1 in March 2022	38
13.5.2	Example 2: company does not deliver output needed for gateway 1 in March 2022	39
13.5.3	Example 3: Acceleration of scope	40
13.6	Risks and issues	41

2 Ofwat's key questions

In their initial assessment of business plans Ofwat set out some very specific questions regarding the strategic regional solution development. These were set out as below, including preamble. Key references have been put in to indicate where answers to these questions can be found:

Strategic regional solution development - We have identified from the plans that at least one strategic supply solution is required over the next 5-15 years to secure drought resilience in the south-east. The strategic regional solution development allocation is to allow the delivery of consistent and transparent investigations, planning and development of strategic options with the overall aim of optimum solutions being construction ready by 2025.

The company's allocation is made on the basis of having clear deliverables and customer protection for the gated delivery of the development of an eastern regional solution/transfer. The following actions are required to ensure the efficient delivery of this development programme.

- **In conjunction with the other companies involved, jointly propose methods for collaborative working including setting up the joint working group for individual schemes, and how consistent assumptions and decisions will be made within these groups and between them.**
 - A terms of reference for working collaboratively both across all of the companies and also on specific schemes;
 - The principle of the scheme working groups, the requirement for specific ToR's, with the need for NDAs to be established as appropriate to each scheme;

Refer to section 6.1; Section 10 (appendix B) and Section 11 (appendix C)

- **Provide more detail on the gated process, the deliverables, timings and expenditure allocations at each gate.**
 - A proposal to modify the timing of the gateways based on whether the schemes are required to obtain a development consent order (DCO);
 - Increased detail of the work between the proposed gates to allow an improved understanding of the funding required per stage to be undertaken, and to confirm the overall sum to complete all gates;
 - The requirement and principles of a change protocol to manage specific changes to schemes in the proposal and to change the current list of schemes when required;
 - Gateway acceptance criteria to be confirmed using the improved detail per gate

Please refer to section 6.2, 6.3 and Section 12 (Appendix D)

- **Propose ODI-type mechanisms to allow allocated funding to be recovered by customers in the event of the scheme not progressing through each gate and for the non-delivery or late delivery of outputs.**
 - Development of the principles of an ODI type mechanism;

Please refer to sections 6.5, 6.6 and Section 13 (Appendix E)

3 Introduction

As part of the initial assessment of companies business plans (IAP) Ofwat introduced proposals to support the delivery of strategic regional solutions to support drought resilience in the south east over the next 5 to 15 years. The proposals allocate funding and describe an associated gated process for the co-ordination and development of a consistent set of strategic water resource schemes. This proposal affects six companies, these being: Affinity Water, Anglian Water, Severn Trent Water, Southern Water, Thames Water and United Utilities. This group of companies form the **All Company Working Group (ACWG)**.

Each of these companies received an action that they are required to respond to questions set out in the IAP by 1 April as part of the PR19 process. This document sets out the joint response of the six companies to this specific IAP actions and should be read alongside any individual company submissions which may provide further information building on this work.

Following the publication of the IAP, the ACWG have met several times in order to establish a common approach to implementing the proposals set out by Ofwat. WRSE has provided assistance in this process, including drawing this document together, which seeks to summarise the work undertaken to date by the six companies in agreeing a set of processes and enhancements to the proposed gated process.

The document also highlights potential enhancements to the process at a generic level. In some circumstances companies will also submit their own individual response to Ofwat's proposals to make specific representations around the scheme list, allocations or the requirements of the gated process to meet their own specific requirements.

One of the key principles the ACWG have adopted is to ensure this process aligns with the process to develop statutory Water Resources Management Plans (WRMP). This will ensure that any potential unintended consequences are avoided.

4 Document structure

This document is structured in a way that sets out the work that the companies have completed to date, which includes:

- Agreed terms of reference;
- The proposed overall joint working group and the specific scheme working groups;
- Revised timelines for the gated processes depending on whether the scheme will require a Development Consent Order (DCO);
- In principle the need for a change control process to change aspects of the current schemes but also to allow current schemes to be changed or new schemes introduced;
- The principles of an ODI with some worked examples.

The document sections are:

- 1) Background setting out a summary of Ofwat's proposals;
- 2) Proposed enhancements to the Ofwat gated process for the development of the strategic regional solutions;
- 3) Proposed work plan; and a
- 4) Summary.

5 Background: Initial assessment of business plans

Water companies have proposed various assessment programmes to meet their supply demand balance challenges in the future to ensure resilient supplies, during severe and extreme droughts. These challenges will only increase due to climate change, population growth, environmental requirements and societal expectations.

Ofwat have reviewed the various proposed investment plans to meet these challenges as part of the initial assessment of business plans (IAP). In response to their assessment they have proposed a new process which will allocate up to £358m to consistently investigate, plan and develop several strategic regional solutions (reservoir, effluent reuse, transfers, desalination) in order to identify the regional optimum solutions and ensure they are construction ready by 2025. The term 'construction ready' has still to be defined, but the group have set out criteria in section 6.3 as part of the proposals. Customers will be protected as investment will be returned if an activity is not required or deliverables are not met.

5.1 Strategic schemes that have been referred to in the IAP

Whilst there have been many national water resource investigations across England and Wales, the schemes that have been included in the Ofwat IAP are those found in company business plan submissions that were considered to be of a suitable scale to be strategically important.

Since the publication of the IAP, it has been recognised by Ofwat that the proposed list of schemes is not necessarily complete and therefore this represents an initial list. This

initial list of schemes and the water companies associated with investigating them are set out in Figure 1, below:

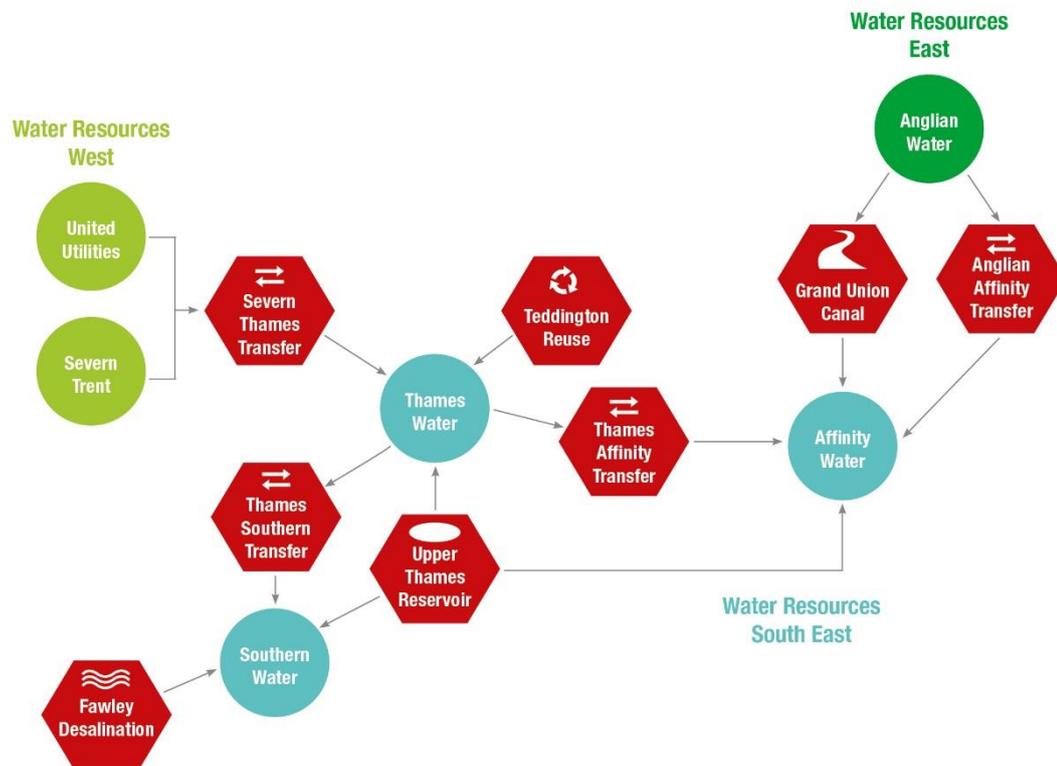


Figure 1: Regional strategic schemes as outlined in the IAP

Details of Ofwat’s proposed funding of the schemes to take them through the gated process and the allocation of money between the water companies is set out in Appendix A.

The purpose of the gated process is to advance and achieve a given level of consistency between the regional schemes to allow informed decisions to be taken.

6 Proposed enhancements to the Ofwat gated process

During February and March the six water companies have been working together to go through Ofwat’s proposals and the potential changes that could be introduced to enhance the Ofwat process.

The following subsections set the companies proposals for:

- Working groups: covering all company working group and project steering groups;

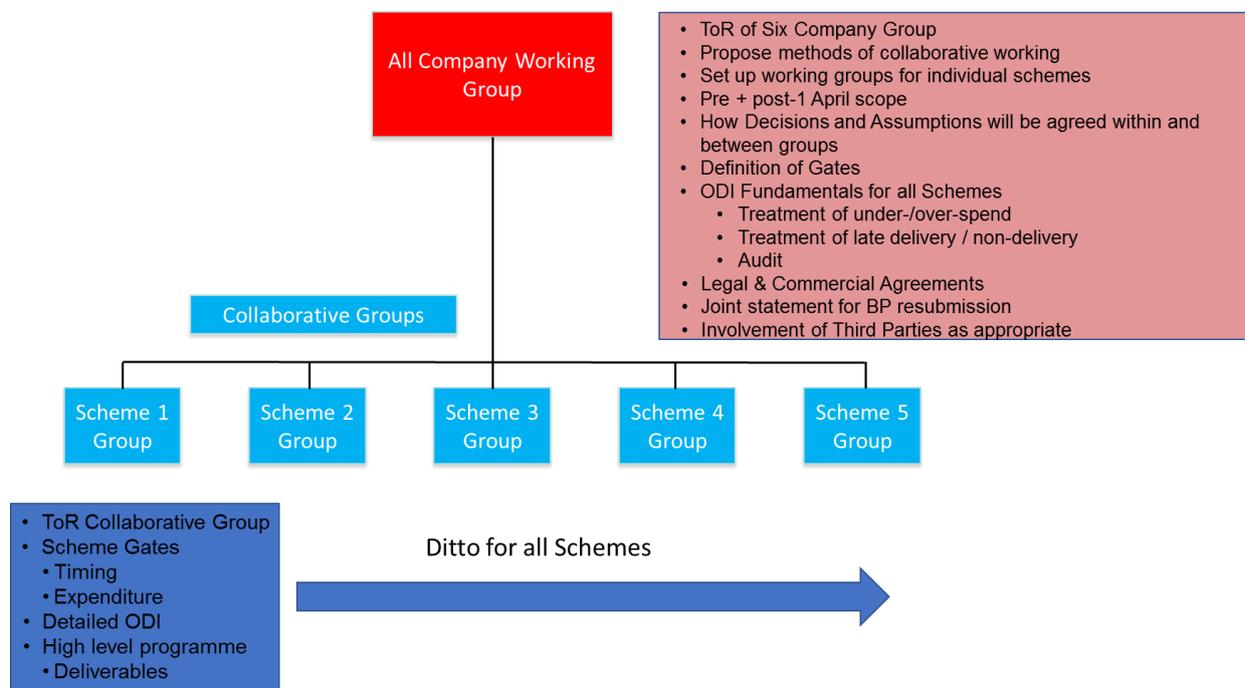
- Timing, gateways and governance; surrounding the progression of each of the schemes whilst still aligning it with the WRMP process;
- The principles of an ODI mechanism with an example.

It is hoped that this additional level of detail could be used to strengthen Ofwats proposals.

6.1 Working groups

It is proposed to develop two working group arrangements for the progression of the regional strategic schemes. This is set out in the diagram below:

Figure 2: Proposed structure of the ACWG and the scheme working groups



The ACWG (made up of the six companies and chaired by WRSE) is proposed to ensure that there is a consistent and collaborative approach adopted by each of the companies. It will also facilitate knowledge sharing about options for collaborative working for individual schemes. The high level working group will include those involved in the options, including the water companies, the regional groups and also with EA, Ofwat and Defra invited to attend. This membership may change due to changes in the options being considered. The key driver of this group is to manage consistency of approach across the options, including in costing and environmental benefits, proposing standard methodologies for the gated process and options for development of each option (e.g. the need for a Joint Venture).

Below this group will be a series of Scheme Working Groups. In some cases there is one company involved (e.g. Teddington Re-Use) and in others there will be at least three

developing multiple options (e.g. Affinity Water, Southern Water and Thames Water developing the SESRO, the transfer to Affinity Water and the transfer to Southern Water).

The Scheme Working Groups will utilise the standards and methodologies to help inform the best approach for each option. The decision and progression of each group through the gated process will be a matter for each of the working groups. Any challenges or opportunities to improve will be fed back through the ACWG to allow review, learning and agreement on any proposed changes to approaches. The scheme specific working groups will set up their own legal and commercial agreements.

These groups will be set up and utilised up to Final Determination (FD) in December 2019. It is expected the shape of these groups will be reviewed again at this stage to confirm if they are still required.

Once the proposed Regulatory Alliance has been formed and its role defined the role of the ACWG will also be reviewed and re-aligned, if it is still required. For example the ACWG might become a review body that supports consistency of approaches across the scheme working groups.

A terms of reference for the current working group has been developed and is included in appendix B. The review of the process has highlighted some areas which could be enhanced if the amendments set out below could be made.

Appendix C sets out draft options for joint working at a scheme level which will continued to be developed by the companies as they set up the appropriate working level groups.

6.2 Timelines, Gateways and governance

The gateway process that Ofwat have put forward provides a good way forward to develop strategic solutions, which can also inform the National Framework study. Some alterations to proposed process are set out below, but it is hoped that in completing this work it will help ensure that this process aligns with the development of the regional plans and company WRMPs; provides flexibility on the development of schemes in order to meet regulatory deadlines and ensures a consistency of approach.

- **Flexibility in the timing of the gateways:** By aligning the dates of the gateways with specific milestones for the development of the next company-specific or Regional WRMPs it will allow a better integration of the two processes, with clear outputs aligned.
- **Break gateway three into two gateways (DCO pathway only):** Gateway three is scheme specific as different schemes will require different levels of consents to build and operate them. Likewise, each scheme will have its own level of environmental and water quality considerations to investigate first in order to determine the final design. It is thought that instead of having one final gateway that this is broken down into two

elements for schemes progressing down a DCO route and remain with three gates for a non-DCO scheme, these are highlighted in the proposal below.

6.3 Potential enhancement to the timing of the gates and the number of gates

A generic revised gated process and timings is shown in Figure 3 below (this example is for a large scheme following the DCO route). A more detailed activity breakdown of the activities to gate 4 is included in appendix D for reference:

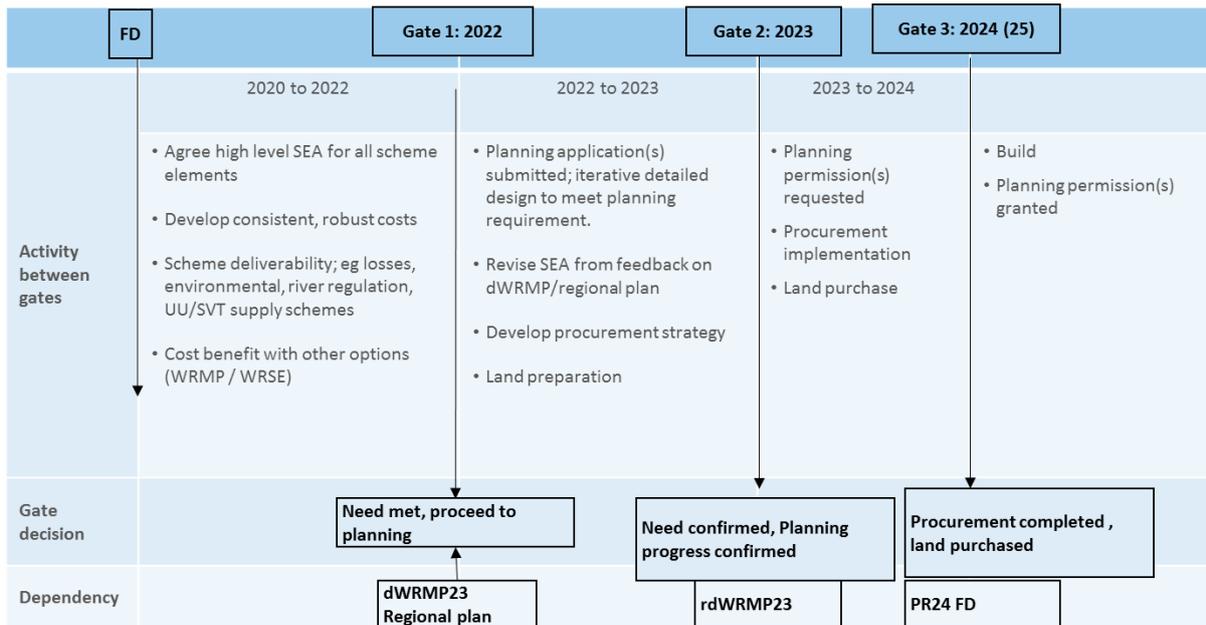
Figure 3: Example of gated process for a scheme requiring a DCO, using STT as an example

	FD	Gate 1: 2022	Gate 2: 2023	Gate 3: 2024 (25)	Gate 4 – 2026/7	
		2020 to 2022	2022 to 2023	2023 to 2024		
Activity between gates		<ul style="list-style-type: none"> • Agree high level SEA for all scheme elements • Develop consistent, robust costs • Scheme deliverability; eg losses, environmental, river regulation, UU/SVT supply schemes • Cost benefit with other options (WRMP / WRSE) 	<ul style="list-style-type: none"> • Start DCO pre-application; detailed design iterations, scoping phase of EIA • Revise SEA from feedback on dWRMP/regional plan • Develop procurement strategy • Land preparation 	<ul style="list-style-type: none"> • Continue DCO pre-application investigations • Continue DPC 5 business case development 	<ul style="list-style-type: none"> • Start DCO Application • Procurement implementation • Land purchase 	<ul style="list-style-type: none"> • Build
Gate decision		Need met, proceed to DCO pre-app	Need confirmed, continue DCO pre-app	Proceed to DCO App Start Procurement		
Dependency		dWRMP23 Regional plan	rdWRMP23	PR24 FD		

¹ A Development Consent Order (DCO) is the means of obtaining permission for developments categorised as Nationally Significant Infrastructure Projects (NSIP)

An equivalent timeline for a scheme that was not progressing through a DCO route is shown below.

Figure 4: Example of gated process for a scheme not requiring a DCO, using STT as an example



Whilst the Ofwat proposed timelines for the gateways is welcomed the following adjustments to each of the gates are set out below:

6.3.1 Gate 1:

This has been moved back one year to allow robust development of options aimed at the same need during Stage 1, for example, completing the EA work programme for the Severn Thames Transfer (STT) to compare to the South East Strategic Resilience Option (SESRO). Work will also be completed on commercial and legal alignment between companies for joint working beyond Gate1, and any initial work for planning stages.

This timing of Gate 1 aligns with the publishing of the draft WRMP23, which will confirm any draft change in the need for water in the South East, and whether one or more of these options is required to continue.

Sign off at Gate 1 will be for robust options against a known need for continuation into Stage 2. [NB: A scheme can only request a Development Consent Order (DCO) if the Secretary of State has signed off the revised draft WRMP].

6.3.2 Gate 2:

During Stage 2 we propose the initiation of planning, either local planning or pre-application of the DCO, depending on the size of the option. As this stage requires access to land the company may require assistance from the Secretary of State to obtain permissions to enter land if land owners refuse access.

Also, initiation of the procurement strategy to align with the Direct Procurement for Customers (DPC), and any land preparation work.

This Gate allows review against the published revised draft WRMP24, the regional WRSE, Water Resources West (WRW) and Water Resources East (WRE) plans.

Sign off at Gate 2 will be for options completing required DCO and DPC activities, and also proving the need from WRMP and regional plans.

6.3.3 Gate 3:

During Stage 3 we propose to complete either planning phase for non DCO, or pre-application phase for a DCO option. Also, the DPC procurement strategy will be completed, ready for implementation. Any further land preparation activity or early purchase can be considered.

Sign off at Gate 3 is achieved for DCO with a completed planning, pre-application, and DPC plan. A non-DCO option will be ready for the build stage.

6.3.4 Gate 4 (DCO only):

During Stage 4 the option will request permission from the Secretary of State to move to the Application phase of the DCO. The procurement strategy for DPC will be implemented, and land will be purchased, using compulsory powers if needed.

Sign off at Gate 4 will include a consent order from the DCO examination, completed procurement of investment provider(s) and the land purchased.

For each Gate the actual sign off mechanism and body is still in discussion. It is expected that the existing statutory powers for regulators and government will apply. Therefore, the EA /NRW will review the option in line with the statutory WRMP process and associated guidelines, including environmental protection and proving the need for further water. If the option is successful, then Ofwat will sign off the economic best value of the option against other robust options. The Secretary of State will also be required to sign off at some points to align with the WRMP sign off process, and also the Water National Policy Statement and associated DCO process. Other bodies, such as Natural England and DWI, may also be required to sign off. We are expecting the development of the Regulatory Alliance will be aligned with the National Framework.

Ofwat has provided funding using an averaged 6.4% of the overall investment within various published documents or tables, and splitting the funding 15%, 25% and 65% over 3 Gates. Companies may need further time to carry out an initial bottom-up exercise per scheme to determine the activities per stage, risks and opportunities, and therefore required funding. This may change the funding need per stage.

6.4 Change control process

The document has highlighted some proposed changes to the gated process above. During the discussions between the companies it has also been recognised that during the course of the next 5 years some of these schemes might change, be modified or substituted. It is recognised that there are other regional schemes that might be investigated by companies and or regions in the future. Therefore companies will include any new schemes in their specific company submissions by the middle of May (see forward plan) and then use the change control process to add or change schemes to the list from April 2020.

The three principles of this process should include:

- Specifying what the proposed changes to the scheme is / are. E.g. whether the scheme is stopping; being modified (scope or cost); or substituted.
- How will this will impact on any of the gateways and / or other regional schemes;
- Ensure that the proposed changes align with relevant statutory processes and the regulatory alliance governance process

We recognise that further work is required on this particular aspect but it will need to align with the proposed governance processes of the proposed Regulatory Alliance. Therefore the change control process is an interim mechanism until the proposed Regulatory Alliance has been formed and its role defined. If a change control mechanisms is still required then its purpose and role will align with the other processes set out by the Regulatory Alliance.

6.5 Development of an ODI type mechanism for customer protection

6.5.1 Introduction

In this section we set out key issues in the development of an ODI mechanism to allow allocated funding to be recovered by customers in the event of the scheme not progressing through each gate and for the non-delivery or late delivery of outputs.

This joint paper by six companies and WRSE does not propose a single specific ODI mechanism, but explores the issues and sets out some examples. This is intended to inform the development of specific ODIs by the companies and to provide a contribution to support development of Ofwat's thinking on the matter.

In developing an ODI mechanism we are making the following assumptions:

- We are currently pre-Gate 0, and Gate 0 starts at FD (December 2019).
- All options are assumed to be valid at the beginning of the process. Also, a programme of work will be defined to enable option validity to be developed / understood and decided at subsequent gates.
- Government and regulators have different roles:
 - Governments (the Secretary of State in England and Welsh Minister for the Environment, Energy and Rural Affairs in Wales) have a statutory role in approving WRMPs which select schemes to meet supply demand needs;
 - Environmental regulators have a role in providing advice to governments on WRMPs;
 - Environmental regulators have statutory role in approving consents for schemes that require impoundment or abstraction of water;
 - The economic regulator has statutory role in setting price limits which include an allocation for efficient expenditure for schemes;
 - The proposed Regulatory Alliance may have a role in coordinating input from regulators but at this stage is not thought to have a statutory authority and hence it cannot displace individual roles or responsibilities.
- Each gate is a checkpoint in the overall process where the need to continue scheme development can be assessed and a decision can be taken to continue with the recognition of development expenditure in price limits. Each gate occurs at the end of a stage of activity.
- Decisions should be taken in recognition that the gate process does not replace existing statutory processes, such as the Water Resources Management Plan. Decisions made at the gate review will affect the inclusion of development expenditure in price limits but will not be binding on other regulatory mechanisms or statutory processes.
- Stages (and their associated gates) will need to be defined carefully, in terms of either
 - a specific period of time in which to complete as much activity as possible, or
 - by a list of project outputs necessary to decide whether a project should continue, to be completed in whatever time is necessary.

6.5.2 Questions to consider:

There are a number of high level structural questions to consider about the ODI mechanism. These are set out below with some initial thoughts, which are then translated in to some principles in the following section.

6.5.2.1 What is the purpose of the ODI mechanism?

There is a recognised supply-demand need in the south east that needs to be met via one or more strategic options, but there is uncertainty about what the right option or options is / are for meeting that need. This uncertainty means we need a mechanism that enables the following approaches:

- To protect customers from incurring unnecessary expenditure by appointees when developing options to meet a defined supply-demand need.
- We may define “unnecessary” as expenditure that is not needed in the future because an option has been shown / agreed to be no longer valid, or was undertaken inefficiently in the past. Expenditure that was efficiently undertaken in good faith on an option that is subsequently dropped is not “unnecessary”.
- To allow appointees to recover expenditure efficiently incurred in developing strategic options for consideration, including additional expenditure due to scope or risk change.
- To provide an incentive on companies to avoid delays in delivering outputs, by the application of a financial penalty if outputs are delayed or not delivered. This will require careful definition of the triggers for penalties to be applied, including whether there are mitigating circumstances that would avoid a penalty being applied (including a triviality threshold or force majeure-type circumstances).

6.5.2.2 What is the structure of the ODI mechanism?

There are a number of potential formulations of the ODI mechanism, but it should be based on the following considerations:

- Expenditure allocated to appointees but subsequently deemed “unnecessary” (see above) shall be returned to customers in the form of an end-of-AMP “true down” mechanism.
- The possible application of the totex sharing mechanism, where a portion of efficient underspend is retained by the company, or a portion of overspend is incurred by the company. (See question 8 below)
- There is potential for work outputs and associated expenditure allocated to each gate to move between gates as scope and desired outputs crystallise over time.
- The performance commitment metric can measure a number of different things:
 - i. Allowed expenditure each year
 - ii. Actual expenditure each year
 - iii. Project milestones achieved each year
 - iv. A percentage of total allowed expenditure/actual expenditure/milestones in each year
 - v. Any of these could be measured annually or cumulatively over the period
- Penalty rates can be calculated in different ways:
 - vi. A simple proportion of scheme stage expenditure allowance
 - vii. A simple proportion of scheme total expenditure allowance

- viii. Proportion of annualised benefit lost due to the delayed output
- ix. Other?
- Are deadbands, caps and collars necessary to protect customers?
- The ODI structure should be relatively simple to aid the understanding of the measure by customers and stakeholders

6.5.2.3 What decision is made at each gate?

Ultimately, each gate should ensure that a decision can be taken to continue with the recognition of development expenditure in price limits. It therefore needs to consider:

- Whether work agreed at start of stage has been completed...
- ...and whether expenditure on work carried out and completed was spent efficiently (with or without sharing of any savings).
- Whether there is a need for the scheme to proceed to next stage of development or is closed down (with or without amendment of scope of future work).
- Whether we need to change dates for future gates, and confirm scope and expected cost of future stage activities with element of risk / uncertainty, based on experience to date.

Note this requires the careful definition of the scope of activity within each stage, along with any dependencies (E.g. whether modelling work by appointees relies on activity by the EA in data gathering). Completing all work in a stage is likely to be necessary but not sufficient for a scheme to be approved to continue to the next stage (with the exception of work originally agreed as necessary but subsequently agreed in-stage not to be necessary to reach the gate decision).

It may be prudent to plan stage expenditure to include element of uncertainty / contingency; later stages have higher levels of contingency which reduces as gate approaches.

6.5.2.4 Who makes decisions at each gate?

Achieving clear, well evidenced and timely decisions at each gate will be critical for the successful functioning of the ODI mechanism. The decision making therefore needs to include the following factors:

- Each of the following regulators needs to be involved in the gateway decision: Ofwat, Environment Agency, Drinking Water Inspectorate, Natural England, Natural Resources Wales (for schemes which have components in Wales), Defra, Welsh government (for schemes which have components in Wales).
- All parties listed above can input to discussion / debate on whether the scheme need to goes ahead or is closed to further development.
- Given schemes are undertaken in order to meet supply-demand need as approved in WRMP, EA/NRW (and potentially DWI or Natural England) have a final say on whether scheme goes ahead by providing advice to government on WRMPs.

- Decisions on whether development expenditure should continue to be reflected in customers' bills will fall to Ofwat.
- Given there are environmental and economic decisions to be taken, it seems prudent to recognise all the varied aspects in the decision-making.

6.5.2.5 What criteria are decisions based on?

Decision making at gates should be based on a set of defined criteria to ensure an objective approach to decision making. Important considerations are:

- Appointees should put forward an assessment of the criteria and a proposal as to whether the scheme needs to progress through the gate and development continue to be funded by customers. This should be supported by evidence provided by the appointees and derived from the work programme to date with forecasts of likely future needs if relevant.
- Criteria for decisions at each i.e. gate should be agreed no later than the start of the relevant stage.
- Decision making could be based on a set of strict criteria assigned to individual regulators (E.g. the Environment Agency in relation to scheme selection based on their likely advice to the Secretary of State). Alternatively, a collective decision could be taken in the round based on an assessment of all the criteria, acknowledging that some risks and uncertainties will remain at various gates. Given that there will be risks and uncertainties, a decision in the round would appear most appropriate, provided this is evidence based and taken in customers' best interests.
- If a decision is to be taken in the round, ideally this would be by a collective decision by all the participants in the gateway. However, consideration should be given as to what happens if a collective decision can't be reached. Ofwat could chair the gateway review and make the final decision based on input and advice from the other organisations. This may be appropriate because the decision at a gateway will affect the prices paid by customers, but will not be binding on other statutory processes including the WRMP.

6.5.2.6 Is there an appeal process for the appointees?

Decisions taken need to be consistent and compatible with existing statutory processes. The ODI mechanism and the development of strategic options must be in parallel to and consistent with the statutory WRMP process. No additional appeal mechanism is or should be available that would be incompatible with existing statutory provisions.

6.5.2.7 Duration of gates

Clarity is needed on the timing and duration of gates. Important considerations are:

- When do gates start and finish? Do they overlap with stages of work or are they in between? Any work undertaken while a gate process is undertaken could be at risk if the gate decision is to stop work. However, it would not be efficient to pause work on a scheme while a gate decision is reached as this could lead to delays or increased costs.
- How long will be allowed for decisions to be taken? A relatively short gate process which allows for timely decisions would mitigate the concerns above.
- The need for a prolonged assessment period at each gate will be mitigated by the companies working closely with the regulators, facilitated by the proposed Regulatory Alliance (also known as the Shared Infrastructure Development Unit). Outputs of work, e.g. environmental investigations, will be shared as the work progresses and therefore it is unlikely that any new information will be revealed at a formal gate.
- A formal gateway review meeting may not be required for every scheme at every gate. Ofwat could decide in consultation with the regulators (or the proposed Regulatory Alliance could agree) if a review meeting is required. With the mitigation noted above, it seems possible for a review meeting, if required, to be held within one month of the date of submission, and if it is deemed not to be required a decision provided within one month of the date of submission. Similarly, a decision could be provided to the companies within two weeks of the date of the review meeting.

6.5.2.8 Interaction with efficiency incentives

It is still to be determined whether an efficiency incentive should be applied to companies' expenditure. On the one hand, companies should be incentivised to spend efficiently. On the other hand, companies should be incentivised not to over-populate scope or cost of activity so as to make a return. Factors to consider are:

- One approach would be to retain the normal cost efficiency incentives as per the PR19 methodology (i.e. the totex incentive), which incentivises accurate forecasting as well as efficient delivery. An ex-ante approach to setting or adjusting expenditure allowances through the ODI at each gateway would naturally preserve the totex incentive. It would also give the companies sufficient confidence to incur the necessary development expenditure.
- A second approach would be to regard expenditure incurred in developing strategic resources as outside the totex sharing mechanism, in the form of a cost pass-through mechanism with an economic purchasing obligation. Any underspend could be fully returned to customers, and any efficient overspend could be fully recovered from customers, not including penalties incurred. This would involve the companies reporting actual expenditure on the scheme during the period, with Ofwat confirming at regular points that there is nothing to indicate to them that expenditure to date has not been efficiently incurred. Then, at the end of the

regulatory period, Ofwat could apply a revenue adjustment to offset the impact of the totex incentive on any over/under-spend against the ex-ante allowance. Such an approach would be appropriate when the expenditure requirements are particularly uncertain at the time of setting price limits. The risk with this approach is that it could result in decisions being made with the benefit of hindsight and therefore not allow companies to recover costs which were incurred in good faith. Such potential might act as a disincentive for companies to participate in scheme development.

- If totex incentives are retained, what rate should apply? Companies will ordinarily have different rates for the incentive. Should a common rate apply? One consideration is to whether the incentives relating to all the participants in a joint scheme are aligned. Using the same totex sharing rate for expenditure by all partners in a joint scheme would help to align incentives. This would require such expenditure to be reported separately and subject to a different totex rate than the rest of the company's expenditure.

6.6 Key Principles for the ODI type mechanism

Based on the above questions, and in the light of there being two possible approaches to efficiency, we consider the following principles should be adopted to ensure the ODI is designed to protect customers:

- Customers should not pay for expenditure to develop options beyond the point at which it is decided that options are not required;
- Companies should have confidence that efficient expenditure needed to develop options can be recovered from customers, otherwise there is a risk that options will not be developed by the time they are needed to supply customers;
- Companies should be incentivised to accurately forecast expenditure and to spend money efficiently;
- Companies should be incentivised to deliver outputs to sufficient time and quality to allow timely decisions to be made on the options;
- Where there are multiple beneficiaries of a shared option the risks should be shared proportionally between them, because to otherwise could place different incentives on the participants to the detriment of the option development;
- In any large infrastructure project there are risks and uncertainties which change over time. Sufficient flexibility should be retained to always allow decisions at each stage of development to be taken in the customers best interest, taking into account such risks and uncertainties understood at the time of the decision;
- A relatively simple formulation of the ODI should be adopted to aid transparency for customers and stakeholders, with a degree of consistency across schemes and companies;

- All relevant regulators should be involved in a timely decision making process aimed at taking an evidence based decision in customers’ best interests;
- Each gate represents a decision point about whether development expenditure is to be reflected in prices paid by customers. It is important to recognise that this is separate from the statutory WRMP process which determines the content of WRMPs. Of course decisions on expenditure and prices should be made in the context of the developing WRMPs, but gate decisions should not be considered in any way binding on the WRMP.

These principles have been adopted in an example ODI which we set out in appendix E. This example demonstrates how an ODI might function, but does not constitute a single recommended approach by the six companies. Rather, it is intended to inform the development of specific ODIs by the companies and to provide a contribution to support development of Ofwat’s thinking on the matter.

7 Proposed work plan

The working group has met and agreed a lot of information to develop this common approach to the proposed gated process. Whilst this has answered many questions there are still some outstanding issues that will be required to be resolved, these are listed in the table below The following programme below is set out in order to meet the regulatory timescales and the future gated process:

Ref no	Action	By When
1	Set out a formal change control mechanism, which can also be used to record the decisions for stopping schemes and potentially substituting new schemes if required or is appropriate. This mechanism will come into force from the 1 st April 2020.	16 th May 19
2	Set out the dates for each of the gates on a scheme by scheme basis, accepting that gate 1&2 (with the possible exception of SWS) should align with the proposed WRMP process for the next plan.	16 th May 19
3	An ODI for each scheme at working group level will be agreed and submitted to Ofwat	16 th May 19
4	Expenditure for each scheme gate will be agreed between the relevant parties and submitted to Ofwat.	16 th May 19

8 Summary

The proposed gateway process proposed by Ofwat is a positive step forward and provides a good mechanism to allow the selection and scheduling of the next key strategic options for the regions.

Whilst this process has been proposed by Ofwat the companies have worked together to propose some enhancements that would help with the identification of nationally significant schemes for water resources. The proposed plan of provides a series of deadlines to agree key activities which should help to inform the draft determination.

Good progress has been made to date including agreement on:

- A terms of reference for working collaboratively both across all of the companies and also on specific schemes;
- The principle of the scheme working groups, the requirement for specific ToR's, with the need for NDAs to be established as appropriate to each scheme;
- A proposal to modify the timing of the gateways based on whether the schemes are required to obtain a development consent order (DCO);
- Increased detail of the work between the proposed gates to allow an improved understanding of the funding required per stage to be undertaken, and to confirm the overall sum to complete all gates;
- The requirement and principles of a change protocol to manage specific changes to schemes in the proposal and to change the current list of schemes when required;
- Gateway acceptance criteria to be confirmed using the improved detail per gate
- Development of the principles of an ODI type mechanism;
- A forward-looking plan for further work for these actions is also included.

Appendix A: Ofwat’s initial assessment of the costs per gateway per scheme from the IAP.

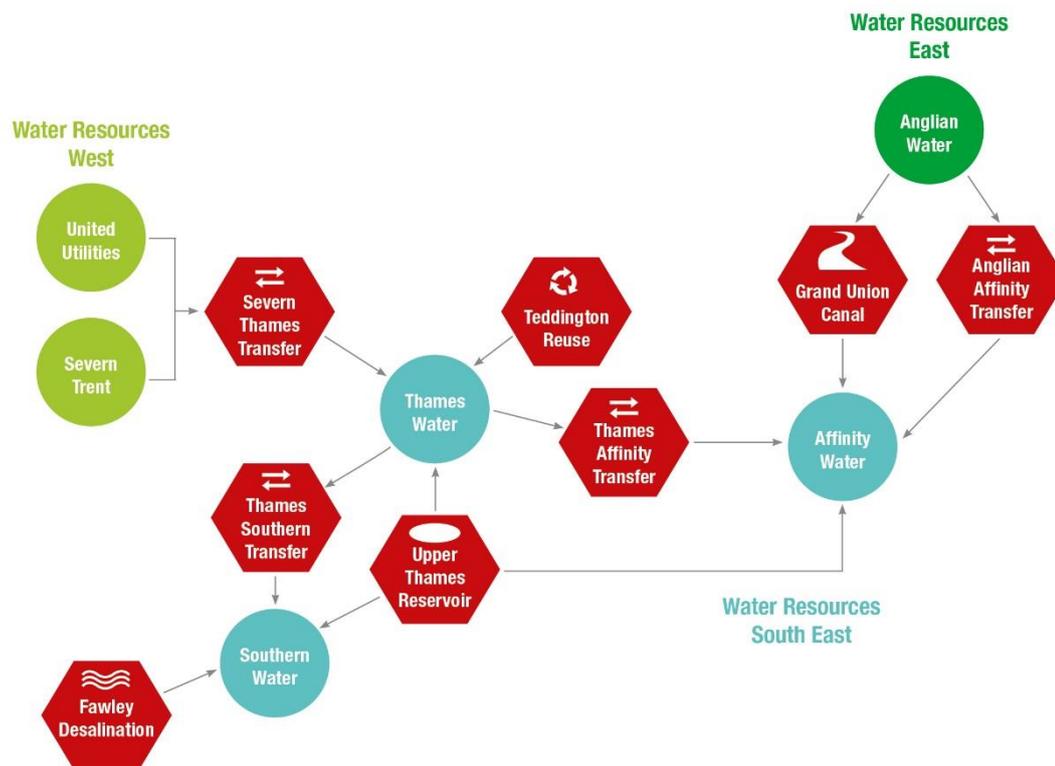
Water companies have proposed various assessment programmes to meet their supply demand balance challenges in the future to ensure resilient supplies, during severe and extreme droughts. These challenges will only increase due to climate change, population growth, environmental requirements and societal expectations.

Ofwat have reviewed the various proposed investment plans to meet these challenges as part of the initial assessment of business plans (IAP). In response to their assessment they have proposed a new process which will allocate up to £358m to consistently investigate, plan and develop several strategic regional solutions (reservoir, effluent reuse, transfers, desalination) in order to identify the regional optimum solutions and ensure they are construction ready by 2025. The term ‘construction ready’ has still to be defined, but the group have set out criteria in section 6.3 as part of the proposals. Customers will be protected as investment will be returned if an activity is not required or deliverables are not met.

A.1 Strategic schemes that have been referred to in the IAP

Whilst there have been many national water resource investigations across England and Wales, the schemes that have been included in the Ofwat IAP are those found in company business plan submissions that were considered to be of a suitable scale to be strategically important. Since the publication of the IAP Ofwat has recognised that this list of schemes is an initial list and that there are potentially other schemes that could be proposed. As such it will be for the water companies to make put forward other schemes.

The initial list of schemes and the water companies associated with investigating each of the schemes is set out in the figure below. The schematic layout of the IAP Water Resources schemes is subject to revision and is based on the initial view set out by Ofwat.



Details of Ofwats proposed funding of the schemes to take them through the gated process and the allocation of money between the water companies is set out in table 1 below.

Table 1: Water resource schemes outlined in the IAP.

Proposed regional options	Maximum development allocation (£m)
Anglian to Affinity Transfer	10.16
Fawley desalination	14.69
Grand Union Canal	10.52
Regional transfer from Thames to Affinity	40.88
Regional transfer from Thames to Southern	31.45
River Severn-River Thames transfer (pipeline and canal)	77.11
Teddington effluent reuse	64.17
Upper Thames Regional Reservoir (Abingdon - 2 sizes)	109.44
Total	358.41

The maximum development fund is based on 6.4% of the total scheme cost of the overall scheme (after making some efficiency adjustments). The 6.4% should equate to the development of the scheme option and its successful promotion to obtain the consents required to build and operate it. Therefore, the remaining 93.4% of the costs would be required to construct and commission the scheme. The data Ofwat analysed to derive the 6.4% was based on a range of different types of schemes that were included in the

business plan, each of which have a different estimate of the cost required to develop the option and obtain the necessary consents required to build and operate it. It might therefore be more reasonable to use an agreed percentage allocation for the scheme type according to how difficult it will be to cost and gain consents for schemes.

Whilst the table refers to a maximum development allocation fund, companies will have to complete work to go through a gated process in order to retain funds. Any funds which have not been achieved by completing one of the gates would have to be returned to customer. The breakdown of costs per gateway is set out in table 2 below:

Table 2: percentage allocation of costs per gateway in the IAP

Percentage of the development activity			
Base	Gateway 1	Gateway 2	Gateway 3
0.00%	15.00%	20.00%	65.00%

By combining tables one and two you can appreciate the level of funding that would be achieved, and the risks associated if they were not achieved. This breakdown is highlighted in the table below which also shows that the funding of these schemes is spread between all parties in a scheme, whether donors or recipient of water, in an equal measure. This statement does not comment on the cost estimates or allocation of costs, at this stage cost is a matter for those companies or groups promoting the individual schemes.

Companies	Proposed regional options	Maximum development allocation (£m)	Base (£m)	Gateway 1 (£m)	Gateway 2 (£m)	Gateway 3 (£m)
Affinity Water	Upper Thames Regional Reservoir (Abingdon - 2 sizes)	36.48	0.00	5.47	7.30	23.71
	Regional transfer from Thames to Southern	10.48	0.00	1.57	2.10	6.81
	Regional transfer from Thames to Affinity	13.63	0.00	2.04	2.73	8.86
	Anglian to Affinity Transfer	5.08	0.00	0.76	1.02	3.30
	Grand Union Canal	5.26	0.00	0.79	1.05	3.42

Thames Water	Upper Thames Regional Reservoir (Abingdon - 2 sizes)	36.48	0.00	5.47	7.30	23.71
	River Severn-River Thames transfer (pipeline and canal)	25.70	0.00	3.86	5.14	16.71
	Teddington effluent reuse	64.17	0.00	9.62	12.83	41.71
	Regional transfer from Thames to Southern	10.48	0.00	1.57	2.10	6.81
	Regional transfer from Thames to Affinity	13.63	0.00	2.04	2.73	8.86
Southern Water	Upper Thames Regional Reservoir (Abingdon - 2 sizes)	36.48	0.00	5.47	7.30	23.71
	Regional transfer from Thames to Southern	10.48	0.00	1.57	2.10	6.81
	Regional transfer from Thames to Affinity	13.63	0.00	2.04	2.73	8.86
	Fawley desalination	14.69	0.00	2.20	2.94	9.55
Anglian Water	Anglian to Affinity Transfer	5.08	0.00	0.76	1.02	3.30
	Grand Union Canal	5.26	0.00	0.79	1.05	3.42
Severn Trent Water	River Severn-River Thames transfer (pipeline and canal)	25.70	0.00	3.86	5.14	16.71
United Utilities Water	River Severn-River	25.70	0.00	3.86	5.14	16.71

	Thames transfer (pipeline and canal)					
	Total	358.41	0.00	53.76	71.68	232.97

The purpose of each of the gateways is to advance and achieve a given level of consistency of between the schemes to allow an informed decision to be taken to select which of the schemes to take forward. Table 3 below summarises to various gateways and when Ofwat have set out when they might be achieved.

Table 3: Ofwat’s initial definition of the gateways in the IAP

<p>Gateway 1 by 2021: Investigations and preliminary work to determine consistent inputs to decision making and designs, including: baseline and drought condition availability of water; environmental constraints; environmental, social and economic benefits; cost models and assumptions</p> <ul style="list-style-type: none"> •Initial design work of schemes to specification required for initial decision making stage •Initial design work completed (using agreed consistent assumptions) and decision-making outputs presented and selected schemes carried forward
<p>Gateway 2 by 2022: Detailed design work completed with outputs of decision-making presented and selected schemes carried forward</p>
<p>Gateway 3 by 2024: Planning permission granted for schemes and ‘construction-ready’</p>

The gateway process set out above defines a process which one gate must be reached before the next gateway can proceed. Overall the approach set out by Ofwat provides a mechanism through which strategic schemes can be developed on a consistent basis and allow a sub set of these schemes to be selected and taken forward to obtain the necessary permissions to build and operate the schemes.

Appendix B: Draft terms of reference for the All Company Working Group

Terms of Reference

- Group Tenure
 - To Final Determination (Dec 2019)
 - Post December 2019 the Group shall continue to meet in a facilitatory capacity to support and enable progress. The meetings will be quarterly.
- Membership
 - Affinity, Severn Trent, United Utilities, Thames, Southern, Anglian
 - Invites extended to Ofwat, EA, Defra, Third Parties (as appropriate)
- Secretariat
 - Chaired and facilitated by WRSE, with WRSE acting as the regional link to other regional groups as required
- Meeting Frequency
 - Every 2-3 weeks - for a period to end May 2019, then monthly to Final Determination
- Objectives of the group
 - To coordinate the delivery of the IAP actions relating to the development of the regional strategic options - as set out in the IAP by Ofwat (January 2019)
 - Agree methods of collaborative working within and between groups, facilitate and oversee joint proposals for schemes
 - Set out the review of the IAP scheme allocation and establishment of Schemes
 - ·Agree the principles of the Outcome Delivery Incentive
 - ·Publish minutes of meetings on web sites

Note: Whilst the Group will facilitate and expedite timely progress of the work by setting out the initial framework, it does not carry the work out nor collectively organise the working groups (which will be performed at working group level), nor does this group carry a decision-making authority to decide on which schemes to be progressed or developed

- To coordinate and align the changes required to the IAP gated process to fit with the wider planning process and deliver workable outcomes
- Agree the modelling and technical linkages between the strategic schemes working groups and regional groups in relation to drought and costs assumptions

Note: There is an important link with the regional planning level, where the list of schemes may be changed in time, as an output from the regional options assessments. That work will be performed in a consistent manner using methodologies that will meet regulator expectations. It is important that this group is cognisant of that work and should a change mechanism be required will have developed that mechanism in timely fashion with Ofwat

- Outputs
 - In time for companies re-submission by 1st April
 - A milestone timeline for the outputs of the Group to 1st April, Draft Determination (DD) and Final Determination (FD)
 - An agreed definition of Gates that can be used for Schemes at Gate 0 (FD)
 - Agreed assumptions on drought scenarios and cost modelling
 - The principles of the associated ODI that the individual Scheme Groups will use.
 - A Joint Statement from the Six Companies providing commitment to the working of the Strategic Solution Development
 - In time for Draft Determination (e.g. middle/end May)
 - Suggested Schemes for Gate 0 with expenditure at each gate and associated ODI
 - The interaction of the Gates with a Regulatory timeline
 - For Final Determination (Dec)
 - Final set of Schemes, with Gates and Expenditure, and associated ODI

Appendix C: Discussion document setting out some draft options for working groups

C.1 DRAFT OPTIONS FOR JOINT WORKING

C1.1 Introduction

In its IAP feedback, Ofwat identified that appointees will need to work together on developing strategic resources. Ofwat wants companies to:

“jointly propose methods for collaborative working including setting up the joint working group for individual schemes, and how consistent assumptions and decisions will be made within these groups and between them.”

This appendix is a discussion paper setting out high-level options for the joint working arrangements for individual schemes. Specifically, it looks at options for governance arrangements and allocation of funding between the appointees, and compares each option with the others.

The proposals set out below are based on the following assumptions:

- Several of the appointees operate within a whole business securitisation framework (“WBS”). The WBS prescribes the financing and operating activities of the regulated companies, and restricts the types of transactions they can undertake. In return, the appointees can maintain a higher level of gearing than they could if they were not operating under a WBS;
- Different approaches to joint working may be adopted, either across AMP7 or by different companies working on different schemes;
- For companies involved in more than one scheme, it may make sense for them to adopt the same approach to each scheme they are involved in;
- This note does not consider any relevant accounting (regulatory or otherwise), competition law or tax considerations or implications;
- We need to be aware of competition law requirements - the approach to joint working will need to be reviewed regularly; and
- Other joint working arrangements may exist which are not yet captured in this draft note.

C.2 Options for joint working

The options we are currently considering are summarised as follows (in increasing order of formality):

C.2.1 Simple Memorandum of Understanding Model (“MoU 1”)

Appointees could use a simple MoU to agree the approach to joint working, including an agreed scope of work projects they would each have to do, who would carry out the work and how totex would be expended, including any potential redistribution of the existing equal-shares allocation. Each appointee would use its existing employees and internal governance arrangements, including Executive and Board, but would need to agree monitoring and governance arrangements for shared reporting of progress and delivery of shared objective.

C.2.2 More Detailed Memorandum of Understanding Model (“MoU 2”) - similarities to current WRSE model

The Water Resources in the South East (“WRSE”) Group is a voluntary alliance of 6 appointees and 5 other stakeholders (including the Environment Agency). It works to develop long term plans for securing water supplies for south east England. It is funded by individual contributions from each appointee (and from the Environment Agency), pro-rated according to the relative size of each appointee’s customer base. Individual appointees carry out work for the good of all WRSE members according to a scope of work agreed by all. Technical work is carried out by external contractors, procured through competitive tender by a single appointee acting on behalf of all members. Quality of work is reviewed by WRSE groups. Levels of governance include a CEO-level group, a Senior Leadership Team and a Project Management Board, comprising staff from appointees. The WRSE model could be replicated (broadly) for these schemes.

C.2.3 Contractual Joint Venture/Contractual Consortium/Contractual Collaboration Model (“Contractual JV”)

A non-incorporated, contractual only joint venture between the parties could be considered which would effectively be a commercial arrangement between two or more or more of the companies as economically independent entities. Resourcing and governance of the JV would need to be agreed between the parties as part of the contractual arrangement but would likely be similar to the MoU 2 Model.

C.2.4 Incorporated Joint Venture Company (“JVCo”)

Appointees could create a JVCo, funded by each with their share (all or a proportion) of the totex allowance. The JVCo would have its own staff (seconded from the appointees or employed separately) and governance arrangement, including Executive and Board and agreed reporting and accounting procedures. The investor-appointees would agree the role, purpose and business plan of the JVCo, including scoping the work projects it would have to do and how much autonomy it held to change its agreed scope.

C.2.5 Comparison of options

Table 1 below sets out a non-exhaustive list of potential benefits and disbenefits of each option.

Table 1 - potential benefits and disbenefits of potential options for joint working

Option	Pros	Cons
MoU 1	<ul style="list-style-type: none"> • Easy to establish • Minimal set-up and on-going cost • Companies already regulated by EA and Ofwat, clear collective responsibility and direct control over appointees • Maximises flexible working and cost efficiency through use of in-house resources or consultants 	<ul style="list-style-type: none"> • Separate companies retain own incentives / objectives, reduced integration and cooperation compared with Contractual JV or JVCo • Potential for less transparency than other options • Lacks clarity of accountability - priorities within companies can change and distract from single purpose, relies on cooperation between companies • Harder to track totex - managed by each company across internal and external resources (on individual and joint activities)
MoU 2	<ul style="list-style-type: none"> • Existing precedent, easy to establish • Creates more structure than MoU 1 but without need for separate legal entity - members agree on budget and program of work in advance • Maintains flexibility to change scope of works if agreed by members • Allows totex to be pooled and paid in stages • Use of consultants helps protect each company’s commercially sensitive data • A competitive tender process helps to provide transparency 	<ul style="list-style-type: none"> • No current basis for regulation or control by Ofwat / EA, less accountability than for MoU, but can establish decision membership levels for these organisations • Lacks a separate legal identity - can suffer from a lack of clear structure and identity, which may affect both internal operation and dealings with third parties • Likely use of consultants to complete work with supervision from companies may increase costs • Absence of commercial contract to do procuring may create problems in event of dispute about outputs
Contractual JV	<ul style="list-style-type: none"> • Clear scope of the venture • The obligations and commitments (including liability) 	<ul style="list-style-type: none"> • Significant set-up and ongoing costs, especially for securitised companies

	<p>of individual companies contractual in nature and clearly understood</p> <ul style="list-style-type: none"> • Use of consultants helps protect each company's commercially sensitive data • Competitive tender process helps to provide transparency • Provisions covering the financing of the venture considered at the outset 	<ul style="list-style-type: none"> • Tax and competition law considerations would need to be considered and may defeat the plan • Securitised companies may have issues under their financing documents in relation to entering into 'joint ventures' • Strict governance required to ensure success • Likely use of consultants to complete work with supervision from companies may increase costs
JVCo	<ul style="list-style-type: none"> • Clear and compartmentalised scope , boundaries and responsibilities • Maximises transparency through separate, audited accounts • JVCo can be sold/transferred to CAP following DPC • Clear risk sharing • Allows totex shares to be pooled - upfront or each year • Use of consultants helps protects each company's commercially sensitive data • Competitive tender process helps to provide transparency 	<ul style="list-style-type: none"> • Significant set-up and ongoing costs, especially for securitised companies • Tax and competition law considerations would need to be considered but likely a lesser challenge than the Contractual JV • No current basis for regulation or control by Ofwat / EA, less accountability than for MoU • Strict governance required to ensure success • Securitised companies may have issues under their financing documents in relation to entering into 'JVs' • Likely use of consultants to complete work with supervision from companies may increase costs

To consider which option might be better than the others requires a set of criteria against which to judge them. Companies are still in the early days of discussing an agreeing their proposed approach to joint working and therefore these criteria are yet to be finalised. However, it seems reasonable that the criteria might include:

- The ease by which the joint arrangement is set up and maintained, including governance arrangements and ways of working;
- How much it would cost to set up and maintain the joint approach, including staff and overheads;
- The degree to which the joint approach provides clarity of purpose and delivers outputs accordingly;
- How much transparency and accountability each model allows; and
- The level of commercial protection afforded to each member in the event of disputes about delivery of outputs.

Notwithstanding the above analysis, it is likely that the companies will consider utilising more than one model as the requirements of the scheme change and its definition evolves. It might be, for example that one of the less formal structures is utilised initially, with a view to considering whether a more formalised structure could be utilised further into the project.

C.3 Conclusions and next steps

Each of these options appears to have benefits and disbenefits, of varying scale, and hence further work will be needed to develop and assess each option and to compare them with each other. There may also be other options not yet captured in this model.

The 6-company working group has been discussing the approach to the programme of developing the schemes in recent weeks. It is clear from these discussions and from Ofwat's IAP feedback that the scope of activities and detail of totex allocations across each stage has yet to be defined precisely but there is a consensus that expenditure up to Gate 1 is likely to be small relative to expenditure across subsequent stages of the programme.

If this assumption continues to hold, it would seem to be a prudent and pragmatic option to agree a flexible way of working that is easy to set up, with minimal cost and with little in the way of risk or legal formality. Companies can continue to develop other options for joint working and can decide later - when expenditure is likely to be much bigger than for stage 1 - whether such an arrangement needs to be replaced, and if so, with what other option.

Appendix D: An example of some generic programme of activities potentially required to get to gate 4

To align with the gateway timeline and high level stage activities in Section 6.3, a more detailed programme of activities has been provided. This is planned to be used to provide an initial bottom up view of funding to ensure that each scheme has an improved view of funding per stage and as an overall sum. The diagram below provides a view of part of the output in Stage 2, post Gate 1, for a DCO option

Generic activities for strategic scheme delivery to Gate 4, assuming DCO and DPC - **DRAFT FOR DISCUSSION**

Task Name	Activity 0	Gate 0 (July 2019)	Activity 1	Gate 1 (SOBC) - Mid 2022	Activity 2	Gate 2 (OBC / Final WRMP24) - Q4 2023	Activity 3	Gate 3 (Ready to submit DCO/FBC) - Q1 2025	Activity 4	Gate 4 (contract Award) - Q4 2027
Pre-Application										
DCO Application										
Review baseline data					Y					
Non statutory public consultations					Y		Y			
Consultation Strategy					Y					
Prepare notification to Secretary of State					Y					
Notify Secretary of State of the application					Y					
Statement of Community Consultation					Y					
Prepare supporting documents					Y		Y			
BAT Study										
Statutory consultation							Y			
Consultation Report							Y			
Notification of intent to submit DCO (Section 48 Notice)							Y			
Final refinement and preparation of the application							Y			
EIA										
EIA scoping					Y					
EIA					Y		Y			
Prepare Preliminary Environmental Information					Y		Y			
Environmental Statement					Y		Y			
Land										
Land referencing					Y					
Land purchase (voluntary)					Y		Y			
Notices / access to land					Y					
Surveys										
Topo / bathymetric survey					Y					
Ground investigations					Y		Y			
Location of existing services					Y		Y			
Land drainage info			Y		Y		Y		Y	
Water quality sampling					Y		Y			
Archaeological and ecological investigations										
Archaeological investigation					Y					
Ecological investigation					Y					
Engagement with regulators and statutory authorities										

Appendix E: A discussion document setting out an example of an ODI type mechanism

In the ODI section above we listed some principles for the design of an ODI to protect customers. These principles have been adopted in an example ODI which we set out below. This example demonstrates how an ODI might function, but does not constitute a single recommended approach by the six companies. Rather, it is intended to inform the development of specific ODIs by the companies and to provide a contribution to support development of Ofwat's thinking on the matter.

E.1 Measure definition

This measure is aligned to the proportion of the development costs for a strategic water resources scheme expected to be incurred between gate reviews. There are four gateways proposed between 2020 and 2025. At each of these gateways there will be a formal review of the progress made in developing the scheme and the evidence available at the time, assessed against a pre-determined set of criteria. All relevant regulators will be involved in the gateway: Ofwat, Environment Agency, Drinking Water Inspectorate, Natural England, Defra (and if the scheme has components in Wales, Natural Resources Wales and Welsh government).

Evidence will be presented by the companies and considered in the round to reach a collective decision as to whether the project passes a gateway. This will determine the ODI reporting and therefore, if necessary trigger an adjustment to the prices paid by customers to reflect changes in the expenditure needed for the scheme development.

The ODI for each company will be measured as the percentage of the company's option development costs allowed in that company's price limits for each year.

The company will report performance annually, with 2020/21 being the first year of performance reporting. Performance reporting will be based on decisions taken at the gateways. The percentage performance reported in each year will be designed to ensure the correct payments will apply to recompense customers for the development costs recognised in price limits.

If a collective decision is made that the scheme should not progress beyond a gateway then the company will report zero percent after that date. Alternatively, if a collective decision is made the scheme should progress to the next gateway then the company will report the ex-ante determined percentage up until the next gateway. In either case the company will report each year the percentage as agreed by the regulators at the preceding gateway.

This ex ante approach to agree the ODI reporting preserves the normal cost efficiency incentives as per the PR19 methodology (i.e. the totex incentive) in this example. However it also means that an additional element is needed to protect customers in the

exceptional event that a company fails to deliver; this is set out in the mitigation/exceptions section below.

E.2 Mitigation/exceptions

Evidence will be presented by the companies and considered in the round to reach a collective decision as to whether the project passes a gateway. The overriding factor in the gateway decision will be whether the customers' best interests are served. In exceptional circumstances the gateway decision could commit the company to report a percentage other than zero or the ex-ante allocation.

For example, in the event that the company fails to deliver a necessary output for a particular gateway, a lower percentage would be agreed to ensure that customers do not pay for that output. To ensure the correct percentage is reported, the company will seek assurance on the costs associated with that output and the reasons for non-delivery. Companies should not be penalised for circumstances outside their control.

An alternative example may be that the gateway decision is to accelerate various aspects of the work programme. In this example it could be agreed that a higher percentage than the ex-ante assumption could be reported from that point on. This would also work symmetrically so that it could be agreed at a gateway that the work programme should proceed on a delayed schedule, for example to allow for further consultation or additional analysis.

In any of these exceptional cases the company would provide assurance on the costs and evidence that it is in the customers' interest and the gateway review would determine the percentage to be reported.

E.3 Incentive type

This is a financial incentive with "underperformance" and "outperformance" elements.

It provides a mechanism for the company to recover different levels of expenditure from customers following decisions by regulators at the gate reviews. The financial adjustments should therefore be regarded as a "reckoning up" of necessary costs and not reflecting actual company performance.

The inclusion of an "outperformance" element will allow gate review decisions to accommodate acceleration or increase in scope if new evidence justifies the need for this. It is not intended to be a reward mechanism for companies.

There are no deadbands, caps or collars associated with this measure because the decision making by regulators in the gate decisions provides the necessary protection for customers.

E.4 Outperformance/underperformance incentive rate

As set out above the performance commitment is set for each company based on their contribution to the scheme during AMP7. Therefore there are separate incentive rates for each company. The rate will apply symmetrically for outperformance and underperformance.

In this example we calculate the rate based on the costs assumed for one company's contribution to the option ("company X"). The approach is:

- Take the total option costs allocated to company X, which is assumed to be £25.7m in this example
- Company X has a 50:50 totex incentive rate so the £25.7m cost is multiplied by 50% to allow for the totex sharing mechanism.
- Divide by 100 to give the value for 1% delay.

In this example the incentive rate for the company is therefore £128,500 for each per cent of the project.

E.5 Worked examples

Below we set out three examples to demonstrate how the ODI mechanism will work to protect customers. These examples use the example incentive rate from above, and the example performance commitment targets in the table below. Note that for simplicity of presentation these examples assume that gateways fall at the end of a financial reporting year, however alternative gateway dates can easily be accommodated in this mechanism.

	Unit	AMP6	AMP7				
			2020/21	2021/22	2022/23	2023/24	2024/25
Performance commitment (example)	%	N/A	10%	15%	25%	25%	25%

E.5.1 Example 1: project stops after gateway 1 in March 2022

Based on the draft/final determinations and gateway 1 decisions the scheme development progresses as planned until gateway 1 in March 2022. Evidence is reviewed against the criteria at gateway 1 and the regulators decide that there is no need to progress the scheme beyond that point. The company therefore reports zero for each subsequent year.

	Unit	AMP6	AMP7				
			2020/21	2021/22	2022/23	2023/24	2024/25
Performance commitment	%	N/A	10%	15%	0%	0%	0%

This will therefore trigger underperformance payments of:

- Year 2022/23: $(25\% - 0\%) \times \text{£}128,500 = \text{£}3,212,500$
- Year 2023/24: $(25\% - 0\%) \times \text{£}128,500 = \text{£}3,212,500$
- Year 2024/25: $(25\% - 0\%) \times \text{£}128,500 = \text{£}3,212,500$
- Total = $\text{£}9,637,500$

It can be seen that price limits had assumed that 75% of the £25.7m would be spent in these years, i.e. £19,275,000. Through the totex sharing mechanism half of this, i.e. £9,637,500, will be returned to customers. The other half is returned to customers through the ODI as above. This ensures that customers do not pay for this expenditure which is not needed.

E.5.2 Example 2: company does not deliver output needed for gateway 1 in March 2022

In this example the company does not produce a necessary environmental assessment that is required for gateway 1. The company prepares audited evidence that the cost associated with the environmental assessment is £500,000 and notes that the reason for the absence of the assessment is not for reasons outside its control. This evidence is reviewed and at the gateway review it is decided to accept this evidence. It is also decided that, based on the range of other evidence that the scheme should progress with the environment assessment being delivered by the next gateway.

It is therefore agreed that the company will report a lower percentage in 2021/22 to ensure that customers don't pay in full for the £500,000 environmental assessment. This percentage is calculated as follows:

- Ex ante allowance for the year = 15%
- Environmental assessment as a proportion of ex ante scheme development cost = $\text{£}500,000 / \text{£}25.7\text{m} = 1.95\%$
- Reported performance in 2020/21 = $15\% - 1.95\% = 13.05\%$
- Underperformance payment for 2021/22 = $(15\% - 13.05\%) \times \text{£}128,500 = \text{£}250,000$

The company subsequently delivers the environment assessment and the scheme progresses through subsequent gateways.

	Unit	AMP6	AMP7				
			2020/21	2021/22	2022/23	2023/24	2024/25
Performance commitment	%	N/A	10%	13.05%	25%	25%	25%

Overall, because the company incurs the cost of carrying out the environment assessment and returns money to customers through the ODI there is a net penalty. The potential for

such penalties incentivises the company to deliver its contribution to the scheme in a timely and robust way.

If the company needs to incur additional expenditure to complete the same environmental assessment then this would not be reflected in the ODI reporting and would be subject to the normal totex incentive. In this example with 50:50 totex sharing, if the company had to incur an additional £500,000 the total expenditure incurred by the company would be £1m and the total recoverable from customers would be the £500,000 cost of delivering the assessment once. The company is penalised by £500,000 because it has incurred this additional expenditure which it cannot recover from customers.

E.5.3 Example 3: Acceleration of scope

In this example the scheme progresses as planned up to gate 2 in March 2022. In the run-up to gate 2 it emerges through finalisation of WRMPs and engagement with the regulatory alliance that the need for the scheme is earlier than previously anticipated. The companies involved in the scheme consider whether the scheme can be delivered earlier and share evidence with the regulators. The companies submit a proposal into the gate review evidencing the accelerated plan and expenditure requirements.

A decision is then taken at gate 2 that the scheme should be accelerated because the need arises earlier than anticipated and work up to that point has shown that the subsequent stages can be delivered earlier than previously thought. It is therefore agreed that the company requires an additional expenditure allowance of £2m for 2023/24 and (following gate 3) an additional £5m for 2024/25. The additional £5m is subsequently confirmed at gate 3 and across AMP7 the company therefore reports as follows.

For 2023/24:

- Additional expenditure required £2,000,000
- Multiply by 50% to account for the totex incentive rate
- Divide by incentive rate of £128,500 to give 7.8%
- Add this to the original target of 25% to give 32.8%

Applying the same mechanism for 2024/25 gives a figure to report of 44.5%.

	Unit	AMP6	AMP7				
			2020/21	2021/22	2022/23	2023/24	2024/25
Performance commitment	%	N/A	10%	15%	25%	32.8%	44.5%

This triggers an “outperformance” payments as follows:

- Year 2023/24: $(32.8\% - 25\%) \times £128,500 = £1,000,000$
- Year 2024/25: $(44.5\% - 25\%) \times £128,500 = £2,500,000$

It can be seen that this allows companies to recover 50% of the costs associated with the increased scope through the ODI. The other 50% is recovered through the totex incentive.

It can also be seen that normal totex incentives apply after the gate, so that if the company actually spends more than the £2m assessment of the efficient expenditure needed for 2023/24 it cannot recover all of that additional expenditure. Equally the company can retain a proportion of any underspend against this ex ante assessment. This ensures that the company is always incentivised to deliver the work in an efficient way.

The mechanism set out in example 3 would work symmetrically so that it could be agreed at a gateway that the work programme should proceed on a delayed schedule, for example to allow for further consultation or additional analysis.

E.6 Risks and issues

Principal risks relating to the performance commitment are external factors, for example weather conditions can limit the ability to undertake certain environmental surveys. There are also risks associated with the number of parties involved in the scheme but this will be mitigated by clear terms of reference and joint venture agreement.

It should also be noted that there is no pre-determined expectation that this scheme will pass through all the gateways. The mechanism is designed to allow work to progress to create option value and to protect customers should it be subsequently determined that the work does not need to progress further. There are a number of other strategic options being considered for the water resources needs of South East England and not all of them are expected to progress through all gateways. If this option does not progress on the basis of the evidence considered at a gateway this should not be seen as a performance failure by the company.