

Strategic Solution Interim Update Efficiency of Expenditure

27 September 2021



from
**Southern
Water** 

Contents

Contents	2
1 Efficiency of expenditure	3
1.1. Introduction	3
1.2. Costs incurred	3
1.3. Benchmarking	5
1.4. Gate 2 submission	6

Please refer to Interim Update Submission Summary Appendix 1 - Submission Navigation and Glossary for the glossary of terms, definitions and abbreviations for this document.

1 Efficiency of expenditure

1.1. Introduction

This section provides an update on the following:

- our expenditure to date;
- our progress with cost benchmarking; and
- detail on what we will submit as part of our Gate 2 submission.

1.2. Costs incurred

Explanation of costs

For Gate 1, Southern Water (SW) incurred costs materially (c.20%) below the Ofwat allowance. For Gate 2, to date, we have spent much closer to the regulatory ex ante allowance. Our current view of our Gate 2 expenditure is that we have overspent the allowance by c.2%. The key reason is that the Strategic Resource Options (SROs) we are developing are technically complex, and as we move through the accelerated gated process at pace to enable construction to start at the earliest possible date, the amount of technical and legal guidance and risk analysis significantly increases. We are moving at much greater pace than the SROs progressing through the standard gated process, and in effect, are acting as pathfinders in the process. In addition, we are delivering against the backdrop of an All Best Endeavours (ABE) obligation, which the Ofwat allowance has, in part, been based on. This requires us to undertake initial consenting and delivery activities in parallel to the early gates in preparation for the Development Consent Order (DCO) process (the preferred consenting route), which is 'front-loaded' in terms of assessment, appraisal and stakeholder engagement in order to create a solid foundation for consenting and delivery.

The work we have undertaken to date has enabled us to better understand the likely significant consenting risks to the desalination solution, which has enabled us to deselect it as an option at a relatively early stage in the Gated Process. This would not have been possible without a rigorous and robust Options Appraisal Process (OAP) that drew on the technical assessment and appraisal work developed to inform this process. Not proceeding further with this option will result in significant savings (the Gate 3 and 4 expenditure allowance was £28.1m in 2017/18 prices – a significant amount of this cost will now be avoided).

Our costs incurred so far on Gate 2 activities are detailed in Table 1. The costs are composed of actual (up until the end of August) and accrued value of work done assessments (VOWD) to the 27 September 2021.

Table 1 – Gate 2 costs (17/18 price base, £m)

	Forecast costs provided in RAP publication July 2021	Final determination cost allowance	Actual, accrued and forecast costs to 27 Sept 2021	Variance
Total costs	12.0	12.1	12.3	0.2 (2%)

It should be noted that the cost allowances capped development costs at 6% of total solutions costs. This was based on a limited number of comparisons, with at least one benchmark (the Thames Tideway Tunnel) having a much higher proportion of development costs (c10%). In its determinations, Ofwat stated that the 6% also assumes that costs for some components of complex solutions requiring DCO are more likely to

happen beyond 2025¹. This is less likely to be the case for SW than for other companies, due to the accelerated timetable that we are working towards. This requires us to work towards making our application for development consent before 2025 which, as noted above, is a 'front loaded' process in terms of assessment, appraisal and stakeholder engagement work.

For these reasons, we see the development cost allowance to be a challenging target and well below the only near comparable benchmark of Thames Tideway Tunnel (a wastewater DCO project). We consider that our outturn expenditure should therefore be allowed in full.

As part of our Gate 2 submission in December, we will provide a full cost breakdown of our Gate 2 activities, up to the 27 September. This will be in line with the activities discussed and agreed on 7 May 2021 with the Regulators Alliance for Progressing Infrastructure Development (RAPID) team. Should any new cost categories need to be introduced, we will discuss these in advance with RAPID. For example, additional costs incurred in providing further analysis on moving to the 1-in-500-year drought standard and taking the proposals forward between this Interim submission and Gate 2.

The pilot on the water recycling trial was delayed during Gate 1 due to Covid-19, work was restarted once that was possible but has resulted in us incurring some additional costs in this period that would have been expected to be incurred at Gate 1. We will provide details of this at Gate 2. It should be noted Covid-19 may have had a disruptive impact on work undertaken in both Gate 1 and Gate 2.

Cost allocation

Up to this point, we have used common resources to deliver certain activities across the different SROs e.g. we developed a common Options Appraisal Process (OAP), which was then applied to each of the SROs. This means that while it is easy to assess our overall programme costs, a series of judgements need to be made to allocate costs to each solution type. We will set out our approach to cost allocation in more detail in the December Gate 2 submission.

As per the Remediation Action Plan (RAP) actions, a series of Gate 3 activities are being carried out within the Gate 2 window in order to support the earliest possible delivery of the Emerging Preferred Option (EPO). Our costs on the SROs have been incurred in order to progress the development of multiple options as quickly as possible, in order to have a solution ready at the earliest possible date to meet our urgent need for water resources and Section 20 obligations – this is essential to meet the requirements for our customers, the environment, and key stakeholders.

These costs should be netted off our future Gate 3 allowance. It is proposed that these costs will need to be included in the RAPID decision process for Gate 2 (this was discussed with RAPID and Ofwat in the checkpoint meeting on the 26 August 2021). We will provide a more detailed breakdown of these costs as part of our Gate 2 submission in December 2021.

Some of the Gate 3 activities have been captured in our cost systems under the same reporting codes as some of the Gate 2 activities. As such, we have had to apply a cost allocation approach to separate these Gate 2 and Gate 3 cost items. We have primarily based this on the accelerated Gate 3 design plan submission. This is a bottom-up plan from our engineering function on the key activities that need to be undertaken to meet the business need. We will further scrutinise these plans and our allocation approach ahead of the Gate 2 submission.

¹ Ofwat (2019) 'PR19 draft determinations: Strategic regional water resource solutions', page 13

Treatment of inflation

Our cost allowance was set in 2017/18 prices, Consumer Prices Index Including Owner Occupiers' Housing Costs (UK) (CPIH). In order to compare our outturn costs against the allowance, we have had to deflate our outturn costs by CPIH. However, full CPIH data up to the point of submission is not yet available. Due to this, we have taken two approaches to estimating the relevant CPIH deflator, as detailed below:

- 1) We have rolled forward CPIH trend over the last year for the remaining three months of the year. We have then taken an average of the CPIH indices September 2020 to September 2021. This gives a deflation factor of 5.82% to convert prices to the 2017/18 base; and
- 2) We have taken a midpoint of the period where costs have been incurred for this Gate (March 2021). This gives a deflation factor of 5.26% to convert prices to the 2017/18 base.

Both approaches have their strengths and weaknesses. As such, we have taken a midpoint of 5.5% in order to deflate our costs. We present our costs both in outturn and in real prices in Table 2 below. If Ofwat or RAPID wish to make a different inflation assumption, it should be straightforward to adjust the assumption used if required. This is something we will keep under review and update further at Gate 2.

Table 2 - Gate 2 costs (£m)

Description	Gate 2
Total, nominal prices	13.0
Total, 2017/18 prices	12.3

1.3. Benchmarking

Following our Gate 1 submission, Ofwat challenged aspects of our costs, including the lack of benchmarking that had been included in our submission.

There is extremely limited opportunities to benchmark steps in the project development process for highly idiosyncratic water infrastructure projects, as a result there is not a wealth of relevant benchmark data available. Even if it was available, it would provide limited insight into the efficiency of our costs as there are many factors that drive legitimate differences between project requirements, including as set out above, the pathfinder nature of the accelerated gated process within the specific regulatory requirements of the water sector.

We made contact with [REDACTED], [REDACTED], and [REDACTED] to request whether they have any relevant benchmarking data that could be used. We did not receive any useable comparators in response to this request. We also commissioned [REDACTED] to assess the scope for benchmarking at Gates 1 and 2. [REDACTED] found no representative benchmarking data for water projects at this early and specific project stage. We have also not found any suitable comparator data in the public domain for projects that are in the sector, or in the same jurisdiction with the same consenting and regulatory requirements. This involved looking to other regulated sectors such as energy development and airport DCO projects with complexity and scale.

Following these attempts to source relevant benchmarking, we have reviewed the recent standard Gate 1 publications and draft determinations and can see that these difficulties have also been experienced by the other organisations in those processes.

We will continue to seek to identify relevant benchmarks ahead of our Gate 2 submission (and beyond). We would welcome a discussion with RAPID on what benchmarking may be possible at this stage of project development where both regulatory and funding requirements are being progressed in parallel with consenting and delivery activities, and whether any useful benchmarks could be gained from companies

through RAPID / Ofwat requesting data to be shared within the sector to better inform efficiency of expenditure.

1.4. Gate 2 submission

As part of our Gate 2 submission, we will:

- Provide a breakdown of the costs incurred. This will include both Gate 2 expenditure, and early start Gate 3 expenditure.
- Clearly explain any key assumptions we have made in allocating costs between the different SROs and the different gates
- Detail and explain the approaches we have used to ensure our costs have been efficiently incurred. This will include further information on our procurement approaches, and our overall approach to programme management.
- Provide an update on progress with benchmarking.