



TMS-DD-044: Thames
Water PR24 DD Response
- Price Control Deliverables

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1. Introduction

We support the principle of Price Control Deliverables (PCDs). We should return funding to customers when we do not deliver. However, there are several aspects of how Ofwat have applied PCDs in principle which result in a regime which is asymmetric, punitive, duplicative, and in some cases contradictory with our other obligations.

We understand that many other companies have similar concerns with the PCD regime. We welcome further opportunity to work with Ofwat on finalising a set out PCDs which protect customers whilst being proportionate and not exposing companies to unnecessary risk.

We discuss our detailed points on specific PCDs in TMS-DD-038 Thames Water PR24 DD response - Enhancement Cases. We discuss detailed points relating to assurance and reporting in TMS-DD-046 Thames Water PR24 DD Response - Reporting and additional requirements. We summarise the points relating to PCDs in this PCD Chapter for convenience. We also set out here our position and supporting rationale in response to Ofwat's wider approach to PCDs in the Draft Determination.

2. Delay penalties

Ofwat has proposed delivery profiles and annual rewards/penalties for delivery speed. We comment in this section on the application of delay penalties. We comment on the delivery profiles themselves in Section 2.

The use of delivery profiles with delay penalties reduces flexibility and dampens innovation

AMP8 requires a greater scale of delivery than we have ever previously attempted. Whilst we have developed delivery plans, it is important to recognise that 2029-30 is 6 years away. In that time, we may develop new approaches to delivering, or innovate in ways of working which mean that the order in which we deliver specific activities within a PCD could be re-optimised to achieve better outcomes for customers. Restrictive delivery profiles, with no mechanism for flexibility, are an unnecessary level of micro-regulation which provide very little benefit for customers and could in fact reduce our efficiency and quality.

Delay penalties – outperformance

We support the introduction of outperformance payments for early delivery. However, in practice the regime is highly asymmetrical. Early delivery payments are 25% of the size of late delivery penalties. This means we need to deliver 4 projects early to offset a single project being late. We have already set stretching delivery profiles at a greater scale than we have ever previously delivered – many of these are driven by compliance obligations. The nature of large portfolios of capital delivery, which often have delivery aspects beyond our control, means some projects will inevitably be late, even with excellent project delivery. We would need to deliver the vast majority of our enhancement programmes early to offset this, just to break even. This is clearly infeasible.

Delay penalties – potential increase in size

Ofwat raise the possibility of calculating the delay penalty using the sum of the Weighted Average Cost of Capital (WACC) and the run-off rate. This would approximately double the penalty compared to just using the WACC. Whilst using the WACC has a plausible theoretical foundation – i.e. the time value of money – there is no clear justification for using the run-off rate.

We are very strongly incentivised to deliver on time. Many of the PCDs proposed in the Draft Determination are also linked to a compliance obligation. Others are needed for us to even come close to achieving our ODIs – for example metering is necessary to support Per Capita Consumption and Leakage. From a delivery perspective, we need to deliver annual volumes on time in order to have sufficient capacity to then deliver the subsequent years and avoid a 'ripple effect' of missed targets. We do not need a further, additional incentive of punitive delay penalties. These would make an already highly asymmetric risk profile even more egregious.

Delay penalties for enhancement areas with other statutory obligations

It is not reasonable for there to be delay penalties where we have other statutory obligations. This is double jeopardy and does not change our practical incentives to deliver.

Delay penalties for events beyond our control

As currently framed, we are held financially responsible for all delays and incur penalties, even when the delay is entirely due to a third party or event beyond our control. This is unreasonable,

particularly with much smaller outperformance rates and tight targets – it makes us asymmetrically exposed to external shocks.

We propose that we do not incur penalties for events beyond our control. This could be implemented through the annual reporting on PCDs. In the event this proves too complex to design (or too burdensome for Ofwat and companies to administer), a 20% output band could be a plausible alternative.

20% output bands

We support Ofwat's idea of a 20% band for which outperformance and underperformance would not apply. This would apply a degree of protection for companies and for customers for early and late delivery driven by luck, e.g. favourable or unfavourable external factors. It also recognises that the PCD regime is new and so highly accurate calibration of targets is more difficult than in a more established regime. In earlier price controls the ODI regime used to include more protections (deadbands, caps and collars) as it matured. The PCD regime should be allowed to do the same, particularly recognising the scale of delivery in AMP8 is far larger than in previous AMPs.

3. Delivery profiles

Ofwat proposes specific delivery profiles. In some cases, these profiles differ to the statutory profiles we are obliged to adhere to meeting. For example, for Phosphorous removal, the Ofwat delivery profile is more stretching than set out in the relevant guidance. There is no need to introduce this inconsistency in regulatory obligations.

PCDs need to be designed to reflect how we will deliver programmes, for example the proposed PCD for Industrial Emissions Directive would not incentivise us to deliver efficiently.

Ofwat has also chosen to split out some PCDs into sub-components. Notably, it has split metering into multiple delivery profiles and unit costs for individual types of meter. PCDs should be designed to allow sufficient flexibility to deliver the best outcome for customers.

WINEP Storm Overflows

Ofwat's proposed delivery profile does not align to the regulatory completion dates. This means that delivering on time for our statutory obligations would incur underperformance penalties. This is a clear regulatory misalignment and is not appropriate. We are already well incentivised to deliver in a timely fashion through the Storm Overflows Performance Commitment. We propose aligning delivery dates to match our regulatory delivery dates.

Phosphorous removal

Ofwat's proposed delivery profile does not align to the regulatory completion dates. This means that delivering on time for our statutory obligations would incur underperformance penalties. This is a clear regulatory misalignment and is not appropriate.

4. Scope of PCDs

Ofwat has proposed PCDs for areas of spend which are already highly regulated through our statutory obligations. We are already obliged to deliver these schemes, already have a set timetable by which we must complete this work and are incentivised to be cost-efficient through the totex regime. In the event of non-delivery, we are held to account through the statutory framework, for example EA fines, and must still deliver the work. Being forced to return the funding, and then have it granted again to complete the work in AMP8, would be an unnecessary administrative burden on both Thames Water and Ofwat for no discernible benefit.

We request that PCDs are removed for all areas where we have statutory obligations, including storm overflows and phosphorous removal. If they are retained, they should be amended to remove the delay penalties (Section 1), amend the delivery profiles (Section 2), and other important clarifications (Section 3).

Storm Overflows

We also expect this PCD will only apply to schemes funded through the Final Determination, not those covered in a Delivery Mechanism.

Phosphorous removal

We also expect this PCD will only apply to schemes funded through the Final Determination, not those covered in a Delivery Mechanism.

5. Definitions for specific PCDs

Ofwat proposes amendments to how certain PCDs are structured and measured. We provide comments on these here, and in more detail in Thames Water PR24 DD response - Enhancement Cases.

Industrial Emissions Directive

The Draft Determination PCD would drive perverse incentives. To meet the permit requirements we need to cover 25 tanks. Doing these all at once would be operationally impractical and inefficient. We have carefully developed a detailed outage plan to carry out the necessary works in a way that ensures the continuity of our treatment capabilities. We have also discussed our programme with the Environment Agency to ensure our approach maximises environmental benefit. A single PCD incentivises us to take a less efficient approach. Our proposed suite of three PCDs reflects these considerations.

Supply-side schemes

The proposed PCD does not work for schemes yet to be designed in detail, particularly where the actual results of individual schemes may differ to those estimated at conceptual design stage. We propose either waiting to set the individual outputs for such schemes when more information is available, or a deadband is included to account for uncertainty. We also request Ofwat clarifies the penalty rate in the Final Determination, where a different rate may be adopted to incentivise companies to deliver WAFU benefits within AMP8 without disincentivising them from developing schemes if there are changes to the programme timeframe.

WINEP Storm Overflows

Ofwat's approach to the PCD is linked to activities, not outputs. This may be appropriate for cost modelling, but does not reflect how multiple activities combine to meet a target spill frequency. Setting specific targets for sub-components limits our flexibility to meet the output that actually matters – spill frequency. We propose that Ofwat revises the PCD structure and rate to be per outcome (i.e., per site, and per number of storm overflows discharges reduction), not split by activity.

Climate uplift

In response to Ofwat's request for a PCD relating to the climate resilience uplift, we suggest a "project complete" metric to best protect customers. This can be site specific, rather than unit cost.

6. Other comments on specific PCDs

We provide detailed comments on individual PCDs in the relevant sections of Thames Water PR24 DD response - Enhancement Cases. We summarise the key points here for Ofwat's convenience.

Metering

On metering, we disagree with the 95% connectivity each day requirement. This level of connectivity is not required to achieve the primary objective of AMI smart metering investment, which is to deliver greater volumes of demand reduction. The energy industry, which has more common standards and is more mature in smart meter rollout, does not achieve 95%. The water industry to date has achieved network performance around 89.8% and average read performance results of around 84.7%. These statistics are for relatively favourable areas, whereas in AMP8 we will increasingly be tackling more challenging properties. A 95% requirement would also substantially change our approach to procuring from our supply chain and would increase costs, as suppliers pass the additional risks of meeting this standard on to us through increased prices.

Whilst our metering programme is based on extensive surveying and previous delivery experience, it would sometimes be necessary to amend our plans considering new information received from the teams on the ground, once they begin the work. This is to be expected in any operational environment. Therefore, we believe that Ofwat should complement the PCD regime with an appropriate uncertainty mechanism (e.g., caps and collars on the volume of meters delivered) to allow us the flexibility to make the best operational decisions in the interest of consumers.

WINEP7 carryover

We are unclear how the PCD rates have been calculated. There are also differences in the number of solutions – some schemes appear to be missing from the cost assessment. Our costs are based on the latest cost forecasts, and we propose the business plan submission values should be used as a basis for the PCD unit rates.

Didcot licence transfer scheme

RWE have the contractual right to terminate our abstraction licence agreement within the AMP. The agreement is due to expire in 2030 and we have no control over RWE's decision. We propose that the PCD for this temporary scheme is set on the annual basis, £m / per MI/d / per year (as opposed to £m per/ MI/d as is the case for long-term supply schemes).

7. Reporting requirements

Ofwat proposed detailed annual reporting requirements for PCDs. In our Reporting and Assurance response document we set out our detailed concerns with these requirements, covering:

- The additional reporting burden for PCDs, which cover 17 PCDs, many with multiple lines. This will roughly double our reporting requirements compared to PR19.
- Considering the ambiguity in some of the requirements, we request clarity and proportionality in how misinterpretation of requirements early in the AMP will be treated, EG. whether a penalty will be activated.
- In some limited cases we may not have the infrastructure in place to be fully compliant with PCD reporting requirements at the start of the AMP. We request that we are not unduly penalised for this, and that we have the opportunity to clearly articulate the reasons for non-compliance and to explain our plans to become compliant.
- Some PDCs should not be classified as enhancements. For clarity we request they are explicitly removed from any enhancement spend analysis we are asked for complete.

WINEP River Water quality

The PCD requires us to make data publicly available within one hour in a common format. We note this guidance is the same as used for our Storm Overflow map, which required significant investment from our Data Science Team to develop, launch and maintain. This new requirement will require a similar level of investment, which is not funded and will take time to develop.