

Gate two query process

Strategic solution(s)	SESRO
Query number	SER003
Date sent to company	08/12/2022
Response due by	12/12/2022

In the gate two guidance, we asked companies to assess value for money of delivery via DPC using Ofwat's prescribed standard assumptions (for reference we were expecting SRO to use the assumptions provided to companies at PR19: [Thames-Water-Direct-procurement-for-customers-detailed-actions.pdf](https://www.ofwat.gov.uk/wp-content/uploads/2019/07/Thames-Water-Direct-procurement-for-customers-detailed-actions.pdf) ([ofwat.gov.uk](https://www.ofwat.gov.uk)))

Please explain how you have used the prescribed assumptions in the assessments, and where you have deviated from the assumptions provide rationale for the different approach and any underpinning analysis to support that approach, for example, current market rates etc.

Solution owner response

Context and Overall Approach:

Our Gate 2 modelling was initially developed to support an indicative comparison of the SIPR (RAB) and DPC models compared to 'in house' procurement, focused on SESRO, our largest scheme. As there are no standard assumptions to apply for SIPR, we used a top-down approach to derive the WACC.

As a result, our Gate 2 model does not allow for the inclusion of all of the parameters as set out in Ofwat's prescribed assumptions, we have not modelled the full range of sensitivities set out in that guidance, and there are differences of approach, including on how the WACC is derived. Notwithstanding, we have sought to align with Ofwat assumptions where possible – please see the detailed comparison in Table 1 below.

We note that an ‘Early Assessment of Value for Money’ in Ofwat’s draft guidance¹ requires a high level assessment of VfM (a full financial model is not required), and that the draft PR24 methodology² establishes that competitive tendering (DPC or, where applicable, SIPR) will be used by default for projects that meet size and discreteness criteria. We are committed to competitive tendering for such SROs, and our initial VfM modelling supports this.

A full financial model for SESRO will be developed with our new consultants as a priority from January, alongside a market engagement exercise and further risk analysis to inform more representative modelling assumptions. We are happy to work closely with Ofwat on this, including on developing appropriate modelling assumptions and approach for SIPR (as indicated in your September guidance), which could potentially be submitted as part of a ‘Control Point B’ submission in spring 2023.

Gate 2 Modelling approach: IRR and cost of debt assumptions used to estimate the WACC

As set out in the Gate 2 submission, our DPC model assumes that equity investors will achieve an Internal Rate of Return (IRR) equal to the cost of equity in the WACC composition (set out in the tables below), therefore project equity IRR being equal to cost of equity.

The WACC in our model is based on a top-down approach using industry WACC comparators, rather than built bottom-up. For DPC modelling, we used a CPIH-deflated vanilla WACC range of 2.50% to 3.83%:

- The low end of the range uses the Thames Tideway Tunnel (TTT) WACC, considered to be a relevant water industry comparator.
- The upper end of the range uses the 17/18 WACC from the OFTO regime.

Breakdowns of these comparator WACC figures are shown below.

Table 1 - OFTOs 17/18 WACC composition:

Equity contribution	58.80%
Debt contribution (gearing)	41.20%

¹ Section 5.3, Draft Guidance for Appointees delivering DPC projects, Ofwat, September 2022

² Creating tomorrow, together: consulting on our methodology for PR24, Ofwat, July 2022

Cost of equity (<i>also used for DPC equity IRR calculation</i>)	5.21%
Cost of debt	1.86%
WACC (real)	3.83%

Source: Based on CEPA's Evaluation of OFTO Tender Round 2 and 3 benefits. Source: Table 4.1 of 'Review of cost of capital ranges for new assets for Ofgem's Networks Division', Ofgem, 2018 ([cepareport_newassets_23jan2018.pdf \(ofgem.gov.uk\)](#)) (values adjusted for inflation (CPI-H) and to exclude tax).

Table 2 - TTT WACC composition:

Equity Contribution	37.50%
Debt contribution (gearing)	62.50%
Cost of equity (<i>also used for DPC equity IRR calculation</i>)	4.00%
Cost of debt	1.60%
WACC (real)	2.50%

Source: Approximated based on reported WACC and other known parameters, for example as discussed here: [Thames-Tideway-Tunnel_1-1.pdf-1.pdf \(oxera.com\)](#) (TTT WACC breakdown is not in the public domain)

Net Present Value:

We did not present Net Present Value as an output from our modelling. Instead, we presented average annualised cost to customers (AAC) to compare delivery models, with ranges representing key sensitivities. In response to this query we have provided NPV values using Ofwat's standard discounting assumptions, in Table 4 below. This shows a slight difference in the rankings of different scenarios between AAC and NPV calculations due to the differences in mechanics and timings of payments between different models - however, these changes do not impact the overall conclusions in our report.

Alignment with Ofwat PR19 DPC modelling assumptions:

Table 1 overleaf outlines Ofwat's PR19 assumptions, and the assumptions used in our Gate 2 model.

Table 3 – comparison between our Gate 2 modelling and Ofwat’s prescribed PR19 assumptions

Area	Item	DPC (Factual) Assumptions	In-house (Counterfactual) Assumptions	Assumptions used in our Gate 2 model
Customer Payments	Value	Determined by CAP contract payments and Appointee costs	Determined by Allowed Revenues from PR framework	Our model aligns with these assumptions
	Timing	From first payment by customers which would usually be expected after asset completion. If improved contractual terms are identified with earlier payments then these should be considered.	From first payment by customers which would usually be when the appointee starts collecting from customers as per its business plan ‘allowed revenue’ profile.	Our model aligns with these assumptions. Payment is assumed to start in year one of construction for the in-house model.
Contract period	Length	Mid-case 25 years, Lower-case 20 years, Upper-case 50 years	Not needed	Our model uses a 20-year DPC contract duration post-construction (c.30 year total duration for SESRO, T2ST and T2AT). After which assets are assumed to transfer onto Thames Water’s RCV, and the in-house model is assumed for the remainder of the modelled period.
PV Calculation	Period	From the start of the customer payments until the end of the asset life (or until there is no difference in asset value, maintenance and finance costs).		Present Value not presented as an output from our modelling. Instead, we presented average annualised cost (averaged over the entire appraisal period/useful economic life of the asset) to compare DPC to in-house and SIPR models. This will be addressed in a full financial model.
	Discount rate	Discount rate of 3.5% real decreasing overtime (Based on HM Treasury Green Book Supplementary Guidance: discounting (3.5% 0-30 years, 3.0% 31-75 years, 2.5% 76-125 years)		
Indexation		CPIH	CPIH	Not applicable – we undertook modelling in real terms, as 5.3 of the September guidance indicates is appropriate.
Asset Depreciation	Method	Straight line or as per companies policy for asset type, the treatment should be consistent between DPC and in-house deliver.		Our model aligns with these assumptions – we applied straight-line depreciation.
	Depreciation	Mid-case - As per company policy for this	As per company policy for	We did not model different depreciation

Area	Item	DPC (Factual) Assumptions	In-house (Counterfactual) Assumptions	Assumptions used in our Gate 2 model
	Rate	asset type Lowercase +25% faster company policy rate	this asset type	scenarios for DPC. This will be addressed in a full financial model.
Financing Costs	Cost of debt	Construction: Forward Libor 6m swap + 220bsp –240bsp Operation: forward Gilt / Libor 6m swap + 120bsp –140bsp RCV bullet repayment: forward Gilt / Libor 6m swap + 120bsp –140bsp	As per company policy for this asset type	For in-house, our model complies with Ofwat assumptions – we used notional gearing of 60%. For DPC, as set out in the text above, our model used top-down cost of capital assumptions based on industry comparators. Please see Table 1 and Table 2 above for details of these assumptions.
	Cost of equity	Equity IRR (Real) 8% (Upper case 7%, lower case 10%)	As per company business plan	
	Gearing	Mid case 85% (Upper case 90%, lower case 80%) after asset completion.	As per company business plan or Ofwat notional of 60%.	
	Assumptions	Given the ranges available above, please provide explanation justifying your selections made	N/A	
Cost differentials	Capex efficiency saving	Mid case 10% (Uppercase +15%, lowercase 5%)	In-house is base case	Our modelling assumes a range of 10-15% efficiency for DPC – aligning to the mid- and upper-case assumptions.
	Opex efficiency saving	Mid case 10% (Uppercase +15%, lowercase 5%)	In-house is base case	
	Additional Bidder Costs	Additional bidder costs of 2% of capital spend, (Upper case 1%, lowercase 3%)	In-house is base case	Our modelling assumes transaction costs from 2-5% of capex, which broadly aligns with these assumptions.
	Procurement	Procurement costs of 1% of capital spend, (Uppercase 0.5%, Lowercase 2%)	In-house is base case	

Area	Item	DPC (Factual) Assumptions	In-house (Counterfactual) Assumptions	Assumptions used in our Gate 2 model
	Management	Contract management costs £150k per annum. (Lowercase £300k per annum for high operational interaction schemes)	In-house is base case	Additional management costs not included and are assumed to be within margin of error of estimated operating costs.
Terminal Value	Assumptions	Please disclose clearly any assumptions about terminal value	N/A	Our model assumes assets fully depreciate over the appraisal period/useful economic life (80 years post-construction for SESRO scheme) Assets are assumed to be transferred to water company RCV at the end of the DPC contract duration, at which point the transfer value is determined by straight line depreciation.

Table 4 Net Present Values

Note that the values in the table below are highly dependent on the modelling assumptions made, and should be considered indicative, for comparison only.

SESRO	Average annualised values (AAV), £m	NPV, £m	AAV (as % of 'in house – high' case)	NPV, as % of 'in house – high' case	Ranking - order of AAV (1 Low)	Ranking - order of NPV (1 Low)
In house - High	69.5	1901	100	100	6	6
In house - Low	63.1	1699	91	89	3	4
DPC - High	65.7	1682	95	88	5	3
DPC - Low	53.1	1242	76	65	1	1
SIPR - High	64.8	1774	93	93	4	5
SIPR - Low	54.6	1471	79	77	2	2

Date of response to RAPID	12/12/2022
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