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**By Email**

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Dear Rhiannon

**SETTING PRICE LIMITS FOR 2010-2015: FRAMEWORK AND APPROACH  
- A CONSULTATION PAPER**

This letter is the Portsmouth Water response to the Ofwat papers outlining the approach to be taken at the forthcoming price review.

The paper will make a number of general comments before dealing with each section of the consultation paper as they affect Portsmouth Water. Representatives of the Company have contributed to the Water UK response and support its content.

The regulatory framework that has evolved for the water industry has delivered real benefits for the customer and for the environment and the investment community understand and have confidence in the price setting framework used at PR04. We therefore believe that any change in the price setting process should be evolutionary and that increased complexity based on academic work should be avoided.

In our Strategic Direction Statement we highlighted the key challenges facing the Company and the Water Industry over the next twenty five years. The main challenge is how to maintain services to customers including security of supply at a reasonable price, whilst meeting the often conflicting goals set for the environment and dealing with Climate Change.

In general, the tone and content of the consultation document and supporting papers was disappointing and the major changes (Revenue Cap, Menu Regulation, Indexation of Debt Costs) appeared to be addressing the perceived outcome of the last review rather than providing a framework for the challenges ahead. It also appears to set the scene for a regime of targets, penalties and increased data intensity, whilst providing little opportunity for outperformance or incentive to deliver sustainable solutions.

When reviewed in isolation, the Revenue Cap and Menu Regulation may be sound ideas, but when viewed together with the Indexation of Debt costs, the removal of notified items and the clawback of the tax benefit from gearing up appear to indicate that Ofwat are looking to take away opportunities for outperformance. In terms of the Revenue Cap and Menu Regulation Ofwat clearly believe that the risk of outperformance is in favour of the Company because of information asymmetry, and the indexing of debt costs is being suggested in order to avoid companies benefiting in the future from changing interest rates as happened after PR04. In the future the danger is that Ofwat cut off all the upside potential, but don't allow for any of the downside risk, such as energy costs or the potential shortage of contract labour.

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We understood that Ofwat is looking to simplify regulation and the Baker review questioned whether the price review could be completed with less data. This seems to have been ignored. The proposals in the consultation document introduce more complex items such as Menu Regulation and the Indexation of Debt Costs, and require more data through the need to produce cost benefit analysis for all projects. Furthermore we suspect that some of these measures are not generally understood except by the regulation specialists in the companies and academics.

The new measures if introduced (Revenue Cap, Menu Regulation, Indexation of debt and clawback of tax benefits resulting from gearing up) will add significant complexity both to the price setting process, but also in the reporting of company results. Each of these items will require a correction at the following review, but under current accounting standards companies will not be allowed to reflect the under or over performance in the balance sheet in the years between reviews. This will leave companies having to explain in their Report and Accounts potentially material future changes to its revenue. We are not sure that investors will appreciate such complexities. Whilst individually the changes may be sound, together they add complexity and the question to be asked is - are the changes worth it?

For a small company such as Portsmouth Water with a low charge for water (average £85), it is questionable whether the customer would benefit from this increased complexity. We suspect the resource required to handle these changes, plus the other new reporting requirements such as CBA, is disproportionate to the benefit.

Despite identifying incentives as a key issue in the Executive Summary, there is little in the document to incentivise innovation or customer service. The incentives for operating costs are broadly as identified at the last review, Menu Regulation as set out does not provide increased incentives, its purpose is to encourage companies to submit more "realistic assumptions" in the Business Plans. This is not the same as providing an incentive to push forward the efficiency frontier or achieve catch-up. Also it is not clear that there is a problem with the assumptions made by companies and whether this needs to be addressed at all.

Competition is also identified as a key issue in the Executive Summary, although it will have little bearing on the prices set at PR09. We wonder whether Ofwat has awarded Competition too much priority which should actually be reserved for PR09 and meeting the key Industry challenges. On page 4 of the Executive Summary, Ofwat state "At a time when the sector is facing a range of challenges including climate change, weather volatility, demographic changes and environmental concerns, we consider that competition is fundamental as a driver of efficiency, choice and value". Leaving aside the notion that choice is a goal in itself, when in reality it is a means of achieving value and better service, it is not clear why competition is fundamental as it is unlikely to be of benefit in addressing the key challenges, indeed the amount of effort required to introduce competition could deflect attention and focus from the real challenges.

The Company therefore considers that the key issues for PR09 are not those listed in the Executive Summary of the document, but should have been.

- A framework for dealing with the key issues identified at the beginning of the letter including incentives for innovative solutions to meet the challenge of sustainability
- Incentives for outperformance and to improve customer service that will ultimately benefit customers
- To ensure that the Industry can be financed efficiently

The second section of this letter will deal with the detailed proposals in the consultation document.

#### **Draft Business Plans**

The consultation document includes a statement that each company must provide a draft plan which "has no need for any specific financeability adjustments". It is not clear what Ofwat expects companies to do, if an appropriate WACC does not generate sufficient financial ratios. If it means that companies should adopt a certain level or equity on index linked debt then it should say so. Financeability is covered later in this letter.

#### **Notified Items**

The impression given by the consultation document is that Ofwat will be reluctant to allow any notified items. It should be recognised that this will be perceived as an increase in risk by investors.

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For the current notified items our view would be:

- Changes in the number of meter optants - as the publicity on meters increases it is likely that more people will come forward to opt for a meter. There is evidence of this occurring. Therefore on balance, we would retain this item
- Increases in bad debt and the cost of managing debt - Investors see debt as a risk and take comfort from this notified item. Therefore we favour keeping this notified item which if removed will constitute an increase in risk
- Increases in charges for abstraction - if the issue of compensation is resolved before the final determination, this item is not required
- Charges for lane rental/traffic management - if the full impacts are known before the final determination this item is not required, but if not known it should be retained
- Increases in the taxation of infrastructure expenditure arising from the introduction of IFRS - the background to this item has not changed. Companies may have to adopt IFRS after the determination which will impact cashflow. Therefore this should be retained

#### **Justifying proposals for service and investment**

During the consultation process we have expressed our concern that the requirement for cost benefit analysis for all projects is an inappropriate use of this tool and particularly onerous for small companies. There have also been mixed messages, in Ofwat documents CBA is to be undertaken for all projects whereas verbally individuals from within Ofwat have suggested it need not be applied for investment to maintain current service levels but should be used for enhancements. The requirement that methodologies should have "appropriate academic or technical peer review" will require the use of consultant to design and review the methodology, costs which are out of proportion to most of the types of projects to be undertaken by Portsmouth Water. The requirement to undertake CBA for statutory drivers would appear to be a waste of time and money and a clear example of complicating regulation for no benefit. This analysis should have been done when the driver was established.

#### **Menu Regulation**

Menu Regulation is being presented as an improvement in the way Company's are incentivised and a means of reducing risk in the Industry. Given our current understanding of this approach, we are not convinced it does either. Menu regulation is really being proposed so as to give companies less of an incentive to inflate business plans, but we are not convinced this is a problem that needs to be addressed. Furthermore, based on the initial document PR09/07 and the workshops, there would appear to be little incentive for companies to move away from the 'baseline'. The details of how the methodology will work still need to be established and the setting of the 'baseline' is critical to the approach. We would also like to see worked examples of how efficiency gains or losses will feed through to price limits. The Company has not yet received enough detail to be able to decide if it supports Menu Regulation, and would hope that Ofwat would consult further on the final detail before arriving at a decision, whether to proceed.

#### **Pensions**

The statement on Pensions was very ambiguous. It is important that Ofwat establish what they will allow in companies business plans in terms of the contributions to Pension Schemes, and whether they should be based on FRS17, SSAP24 or cash contributions. Although deficits have reduced since PR04, there have been changes to Pension legislation which has altered the relationship between Trustees and companies and furthermore increasing longevity will place further burdens on pension schemes and is likely to lead to higher funding requirements. It is important that Ofwat issue full guidance on how it proposes to deal with Pension costs reflecting the fact that deficits will fluctuate and will need to be funded.

### **THE OVERALL APPROACH TO SETTING THE COST OF CAPITAL**

#### **Indexing the cost of capital to a market benchmark**

Portsmouth Water considers this proposal to be totally inappropriate and does not believe that customers should bear the risk of interest rate movements. Early indications from the Investor Survey being produced for Water UK indicates that there is little support for this proposal. First Economics have provided a paper to Ofwat through Water UK, which presents the arguments against this proposal and we strongly support that paper.

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The argument for indexation is that by setting a 'long term' cost of debt, customers are paying more than they need to. This approach would appear to avoid the benefit some companies gained after the PR04 review when interest rates fell to the lowest levels in decades and they were able to obtain funding at levels below that in the Final Determination. This approach is rejected by First Economics who believe this approach is based on a flawed assessment. The Competition Commission also failed to support indexation of debt in the review of airports. We also believe that it will be difficult to define a benchmark and index and will add increasing complexity for little benefit in most circumstances.

### **Taxation**

Ofwat have made two proposals relating to tax; the tax shield on interest and the clawback of tax benefits arising from refinancing. Both of these proposals would appear to be seeking to influence companies capital structures, a position which Ofwat have always sought to avoid, correctly in our view. Reduced taxation is one of the benefits from increased gearing but there are other risks which companies consider before doing this and Ofwat risks upsetting this balance which will influence companies in their decisions. Again these proposals add complexity at the following price review and we would urge Ofwat not to adopt these proposals.

### **Small Company Premium**

We are disappointed that Ofwat has taken the view that this premium is no longer valid without any consultation with Industry. The factors which justified the need at 2004 are still relevant and nothing in our view has changed to justify the new Ofwat position. In addition we are not sure that there will still be as much appetite for the Artesian financing which made relatively low cost debt available to small companies between 2001 and 2007. It is also likely that a number of small companies will have financeability issues without the small company premium, and this would include Portsmouth Water. It is not sufficient to argue as Ofwat have done that most small companies have large amounts of index linked debt which would improve the outcome of the financeability tests. At least one rating agency does not recognise index linked debt and Ofwat should determine prices and financeability on a notional balance sheets and industry wide assumptions, not on individual company debt structures.

The water only companies have commissioned a study on the need for a small company premium and this has been presented to Ofwat for further discussion.

### **Financeability**

We note Ofwat's proposed approach for dealing with financeability at PR09, but believe it is crucial that Ofwat make clear that it will carry out financeability tests at PR09 and is not ruling out uplifts. This is very important for Portsmouth Water, where as a result of its RCV being understated, it is likely that such adjustments may be required.

We are not convinced that equity issuance is a practical or efficient solution, particularly for small companies. There is not much evidence of this being successfully undertaken in the sector but the Water UK Investor Survey may provide a view as to whether there is appetite for investors for this and at what cost. There is also evidence that the availability of Index Linked finance has reduced, which may limit options for this approach to reducing the need for financeability uplifts. Therefore in arriving at the determination of prices Ofwat should recognise these limitations and not rule out adjustments at this stage, although we acknowledge they could be NPV neutral.

Ofwat also indicated a 'more flexible approach to financial ratios'. It is not clear what this means but Ofwat cannot ignore and therefore should adopt the ratios, and levels for those ratios, against which companies ability to raise finance are judged by the Markets.

### **PR09/06 Logging down and shortfalling**

We are disappointed at the lack of consultation before PR09/06 was published, particularly as there does appear to be an unreasonable amount of asymmetric risk for companies. The assessments of whether the outputs are being met are applied subjectively and the penalties are disproportionate and were not in evidence in the methodology at the last review. The penalties for failing to meet targets are very severe, but there is no incentive for pushing forward the boundaries in customer service.

PR09/06 makes no reference to logging up which we presume will still continue, but Ofwat need to make this clear and confirm the process.

**Uncertainty and Risk**

As noted earlier many of the major changes to the methodology have been aimed at reducing companies potential for achieving an upside, whilst not addressing the potential downside risks. Two examples of significant risks are Energy costs, and the potential difficulties in recruiting contractors. The workload in Thames and the Olympics are already sucking in labour to the capital, which is increasing labour rates in the South East and creating difficulties in obtaining sufficient contract workers to complete programmes. This situation will get significantly worse for the PR09 period.

**Revenue Cap**

The Company broadly supports this proposal providing it is symmetrical, ie there is a correction for shortfalls as well as higher revenue, and that the billing adjustment can be introduced without adding to the regulatory burden. We do not believe however that this mechanism will have much impact on water efficiency as we do not, at present, encourage water usage to generate revenue.

Yours sincerely

A handwritten signature in black ink, appearing to read 'Neville Smith', followed by a period.

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