

22 November 2012



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Please ask for Mr N Smith
Our Ref NS/ja
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Dear Regina

Section 13 Proposal to Modify Licences

The Board has given serious consideration to the modification to Licence Conditions B and C as set out in your Consultation document of 26 October 2012 and the clarifications of the 20 November 2012. We welcome the changes that have been made from the original consultation and there are positive changes in the proposals which we can support:

- Separate price limits for retail and wholesale which is clearly in line with Government policy
- All reference to the principle statement, what is supportive of the risk based approach being taken by Ofwat
- Maintaining the principle of RPI in wholesale price controls

We are not convinced however, that changes to the Licence to allow modifications to give Ofwat the flexibility to move activities from the wholesale price control is appropriate at this time. We agree that regulation in the section needs to evolve, but believe the flexibility required by Ofwat is beyond evolutionary and have several concerns.

- The Draft Water Bill is not yet on the statute book and it is therefore premature to make licence changes to facilitate competition when we are not sure what the requirement will be.
- We do not agree that the flexibility thresholds will have a similar effect on WOC's and WASC's. The thresholds will be on an industry wide basis and as the WOC's have no sewerage business this calculation will distort the flexibility limits as they apply to WOC's. For example if activities were removed from the water service up to a total of 20% of overall industry revenues, this would have an effect of over 40% on a WOC. It would make sense to have a lower flexibility threshold on each service element.
- The intention for RCV incurred up to 2015 is very vague and I suspect very confusing for Investors. Despite the Note of clarification it is still not clear when Ofwat states that "efficiently incurred expenditure (at 2015) will be protected", whether this includes RCV for activities that are subsequently removed from Wholesale. Whether or not the capital expenditure has been efficiently incurred is surely a "red herring". Ofwat could remove a good deal of concern if it simply stated that the RCV at 2015 will remain within the Wholesale business and be protected and any activities which are removed from Wholesale will pay a rent for the use of assets. Ofwat could retain the right to review whether the capital was incurred efficiently.

Furthermore we are concerned that the uncertainty caused by these changes and investor reaction is inconsistent with the Government's aims as stated in Defra's Strategic Policy statement to Ofwat, which states:

"i. A Transparent and Predictable Regulatory Regime [p.9]

This section sets out the Government's priorities for Ofwat in relation to:

- Ensuring that the water sector remains an attractive investment prospect.
- Taking appropriate account of investor views on the impact of the existing regulatory framework and any proposals for reform.
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- Recognising that regulatory approaches will need to continue to evolve if they are to remain relevant to the changing needs of the sector."

The Board is however keen to resolve these issues and would support the suggestions recently made by the Chairman of Ofwat at a recent dinner with the Company Chairman. As it was understood the proposal was that companies accept the modifications proposed by Ofwat in the Section 13 consultation but indicated that they would prefer to have a modification which limited licence changes to what would be needed to move retail, sludge and water resources outside the wholesale control. He hoped that companies might be prepared to accept this limited degree of flexibility.

Therefore the Board of Portsmouth Water would accept the Licence Modifications if activities to be moved out of wholesale price control were limited to retail, sludge and water resources, and therefore the flexibility element was removed. Under this arrangement we would expect any further changes to the wholesale price control would be subject to a new consultation after the forthcoming price review. It would also help if Ofwat could commit clearly to the principle that the RCV at 2015 for the activities subsequently removed from wholesale would continue to be remunerated by the current method. We suggest the approach outlined above will achieve this.

If Ofwat insists on retaining flexibility we would at the very least ask Ofwat to reconsider the differential impact on WOC's and WASC's.

The Board understands that the timescales for the Licence Modifications is very tight, but would ask you to consider our proposals before taking a final decision. I am of course happy to discuss any aspect of this letter.

Yours sincerely



Neville Smith
Managing Director