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Dear Stephen

## **OFWAT CONSULTATION ON “SETTING PRICE CONTROLS FOR 2015-20 – BUSINESS PLANNING EXPECTATIONS”**

### **PORTSMOUTH WATER’S RESPONSE**

Portsmouth Water is pleased to respond to the Ofwat consultation on “Setting Price Controls for 2015-20 – Business Planning Expectations”.

#### **Background to Portsmouth Water:**

“We aim to supply drinking water of the highest quality, providing high levels of customer service and excellent value for money.”

Portsmouth Water has been an independent water company proudly supplying water to Portsmouth for over 150 years.

The Company:

- serves large towns and cities such as Portsmouth, Gosport, Fareham, Havant, Chichester and Bognor Regis, as well as rural areas of South East Hampshire and West Sussex.
- has the lowest bills in England & Wales and is considered to be one of the most efficient companies in the water sector.
- has 21 water sources comprising 1 group of springs, 1 river and 19 borehole sites. However, despite being located in the south of England and, therefore, in an area of high water stress, the company has only had one hosepipe ban in 35 years.
- can provide a bulk supply to Southern Water of up to 15 Ml/d, currently running at 1 Ml/day (sweetening flow).
- plays an active role in Water Resources in the South East Group (WRSE).

Therefore, we believe that Portsmouth Water is well placed to comment on this consultation. We will deal with each of the questions raised in the consultation below:

#### **General points:**

Since Portsmouth Water is one of the smaller water companies in the industry the Board has always been very close to the running of the business and has taken an active part in steering the Company forward and ensuring compliance and assurance across every aspect of the business. Therefore the Board welcomes the progress made in this area and fully supports the principles involved. They know the business well and are best placed to undertake the role which Ofwat is now asking them to fulfil. We welcome the opportunity for the Company to put forward a Business Plan which we feel is right for our customers. We believe that it is only right that companies should be taking ownership of their Business Plans.

## Timetable

The Company remains concerned about the timetable, as we have outlined in our response to the previous consultation. Reducing the timetable by one month to early December for the submission of the Business Plan will, in our view, make it less likely that companies will be able to submit a high quality plan and achieve the desired “Enhanced” status. This will inevitably create more workload for both the companies and Ofwat as more companies fall into the “Standard” or “Resubmit” categories.

There was discussion (at the workshop for this latest consultation) about delaying the Final Determination for a couple of months to allow more time for iterations of the Plan and interaction with Ofwat. It would certainly be very useful to have more time allowed for these activities. However it will mean that the time allowed for company Boards to approve new wholesale and retail prices, default tariffs etc and for companies to process their annual billing cycles could be squeezed. We are concerned about the time allowed for the actual implementation of the Plan. This has not been considered in the consultation and there appears to be very little time allowed for implementation in the timetable. We believe that there needs to be more focus on this now, especially if the time allowed for this is to be reduced.

Another concern is that we still do not have specific dates for any of the key milestones in the process. We need to have clear, unambiguous milestone dates for each stage of the Plan rather than date which merely refer to seasons. We have to plan our work to fit in with the dates of our Board meetings and therefore specific dates would help immensely with our planning.

## An incentives-based price review process

### Portsmouth Water Responses to the specific questions:

- 1) ***Do you agree with our definition of a high-quality business plan? Is anything missing? Is there anything you think we should change?***

We agree with the definition of a high quality business plan as it is set out. However we do believe that the definition needs to go a bit further. The definition needs to recognise that this is a long term plan and, although the planning period is for the first five years, a high quality business plan will need to consider not just current customers but also future customers. Therefore there should be recognition in the definition of whether the plan is a good plan for the long term, say 25 years and whether it avoids inter-generational effects.

- 2) ***Do you agree that our preferred package of reputational, procedural and financial incentives will incentivise high-quality business plans? If not, what do you think we should add to the package, or change?***

We are somewhat confused by the definition of the “business plan elements” or “elements”. These are defined as “the parts of a company’s business plan which align to the separate price controls”. Does this mean that an “element” would be defined as the Plan for a whole of a price control or, alternatively, for any aspect within that price control? It is unclear what level is being referred to. For example is it possible for a particular price control plan to be assessed as “enhanced” even if one small part of that plan is actually “standard”? Or does the fact that this one small part is “standard” mean that the whole plan for that price control is assessed as Standard?

The consultation proposes that company plans will be assessed and then categorised as either “Enhanced”, “Standard” or “Resubmit”. The proposal to assigning companies to the lowest category (e.g. two elements in enhanced and one in resubmit, results in the Company being in resubmit) is an asymmetrical incentive. This will focus companies on avoiding resubmit rather than going for enhanced. This is especially true when taking into account the level of resource and cost potentially involved in achieving “enhanced”.

It should also be recognised that the consultation does not detail what the assessment criteria are for each category. This makes it very difficult for companies to assess what level they are prepared to aim for (or are even capable of achieving). Again we believe that this will make the companies generally risk averse and therefore more likely to try avoiding Resubmit rather than striving to achieve Enhanced.

Similarly the rewards for achieving an Enhanced plan are not disclosed. It is therefore difficult for companies to assess whether the additional reward is worth aiming for when taking into account the additional cost and resource necessary to make it happen. This is especially true for the smaller companies who will not have the resources to dedicate to achieving this.

Plus, if a company believes it is unlikely to achieve enhanced for one element, there is no incentive to strive for enhanced in the other elements, e.g. not incentivised overall.

It is difficult to comment on the financial incentives. The problem with being in "Resubmit" is that the incentive rate set may not be consistent with the efficiency of the company and therefore may unfairly impact on financeability in a way which is out of proportion to the reason for being assessed as resubmit.

We understand Ofwat's motives in setting the proposal in this way. It is for companies to put forward the best plan they possibly can and, by doing so, propose a Plan which is superior to other companies in the sector and, by so doing, achieve an "Enhanced" Plan. However the difficulties which this may lead to could have the opposite effect.

However it is Portsmouth Water's intention to propose the best possible Plan we can. One that takes account of our customers views and delivers good outcomes for them and for the environment; a Plan which is well evidenced and contains accurate projections and estimates and a Plan which contains fair proposals to share the pain and gain with customers.

To mitigate some of the potential issues identified above we would propose that Ofwat treats individual elements of the plan separately, allowing a Company to receive for example Enhanced for one or two elements and Standard for another. We would also suggest that Ofwat have two pre-submission meetings with each Company to discuss particular issues in pulling the Plan together. We believe that it is in the interest of all parties to have some sort of agreement on what the expectations are before Plans are submitted. The non confidential elements of these discussions could be published on Ofwat's website during the process so as not to unfairly disadvantage any Companies as a result of the meetings.

**3) Which of the options (elements earn procedural and financial rewards; two-category approach; two-process approach for retail; later decisions on resubmissions) do you think we should use, if any? Why?**

In our view it is worth considering a two category approach to address the asymmetry outlined in question 2 above, though the suggested approach outlined in Q2 response above should be considered here.

We believe that it will be very important to share resubmission requests with companies as early as possible in the process. This is because resubmitting a Plan will involve a huge amount of our resource and we will need to plan for this. Therefore we do not support later notifications of resubmission status.

We do not believe that there is any value in announcing new incentives in August. By that time the majority of the work will be done on companies' plans and therefore it will be too late to respond to these incentives.

**4) Q4 Do you think that our proposals will be effective in meeting our objective of handing back ownership of the business plans to company Boards?**

As discussed above we, and our Board, believe that this proposal will be effective and therefore we welcome it.

**The risk-based review in detail**

**5) Do you agree with the four high-level groups of tests (outcomes, costs, risk and reward, affordability and financeability) are the right ones? If not, what do you think we should add or remove?**

We support the high level group of tests. However it needs to be recognised that there are significant inter-dependencies between the categories and Ofwat will need to ensure that they are not treated in isolation.

6) **Do you think we have set out the right tests in each group? If not, what do you think we should add or remove?**

All the tests need to take a longer term perspective to reflect outcomes not based on a single price control. The tests should take account of each particular company's regulatory requirements and Statement Of Obligation (SOO) and be able to distinguish new obligations and changes in a Company's operating conditions which are outside of the Company's control. There needs to be a robust mechanism for dealing with such expenditure (e.g. crypto mitigation schemes, eel screening schemes) when applying the tests to ensure that it is treated correctly.

On risk and reward it needs to be recognised that there will be additional risks to the businesses as a result of greater competition and recognition of the fact that many incumbent water companies will in fact be the supplier of last resort.

In assessing retail costs and margin, the relevant difference should be taken account of on ACTS, e.g. a company below the ACTS will be taking more risk than a company above the ACTS if both have the same margin.

We believe that Ofwat need to recognise the importance of having dialogue with companies when they are undertaking the tests. Because the tests are not specified in advance it may be that a company has in fact provided the correct answer to a particular issue but that it may not be in a form which is recognised by the tests, in the way that they are set out. We hope that Ofwat will engage with us fully on any areas where such uncertainty may arise before making a final decision.

7) **Do you think our proposals for business plan assurance will be effective in meeting our objective of handing back ownership of business plans to company Boards?**

Our response to this question is the same as in question 4) above. We believe that the proposals will be effective in achieving this.

**Delivering focused information requirements**

8) ***Our objective in specifying the data tables (and the August submission) is to ask for all of the information we need, but no more than we need. Do you think that we have achieved this? Is there any information that you think we might not need? Is there any information that you think we will need but we have not included in the data tables?***

The final methodology has not yet been published and therefore Ofwat will have a much better appreciation than the companies of the data which you will require. We are relying on the fact that this is the case.

This data is to probably going to be used to update the Ofwat econometric models, which we have no detailed knowledge of.

There is a request for some historic capital expenditure data going back to 2008/09 and this may be difficult to obtain, for example 'meeting lead standards'.

9) ***We aim to collect data on a consistent basis from all companies. Are the data tables clear and well specified? Are there any areas where we need to look again at the way we have asked for the data to remove any ambiguities in the request?***

The way in which Outcomes have been captured in the tables presents the following problems:

- a. As Outcomes are what customers value they will inevitably span business units. The consultation asks for outcomes to be associated with the single business plan "element" and a contractual relationship between price controls be used to manage these interdependencies. This will inevitably result in complicated regulatory mechanisms.
- b. The tables require costs to be attributed to outcomes. In practice, costs result from activities and activities deliver outcomes. But there are many activities that contribute to the delivery of multiple outcomes. Therefore it is not straightforward to allocate costs to outcomes.
- c. It is unclear how you would allocate the outcomes from the cost incentive.

- d. W7 – AIM – The interaction between groundwater and surface water bodies is far more complex than the simplistic model proposed in W7. The Company believes that there is a risk that AIM will result in perverse incentives and will not work, certainly not in time for 2017. Would it not be better for the issue to be resolved through changing company’s abstraction licences themselves? Is this not a problem for Ofwat but rather the Environment Agency?

It is therefore important that specific consideration is given to this issue on a company by company basis.

- e. W12 – The tables are correcting for different costs as a result of varying demand. But this is not the key issue. The revenue correction also needs to consider the over / under recovery of revenue in a given year. Costs are largely fixed but a significant reduction in demand will lead to a significant reduction in revenue – this is potentially a more important consideration as the impact on the company is very likely to outweigh any variance in operating costs.
- f. Data definitions – these have not yet been published and, as yet, we have no date given as to when they will be released.
- g. The section A20 on scenarios is very complicated and extensive. There is a concern that the financial models being developed for some of the smaller companies will not be able to automate such complicated scenarios, and so simpler, more company specific scenarios would be more meaningful.

### **Application to small companies**

#### Q10 – 14 – see below

- 10) Do you agree with our proposal to continue to set price limits for new appointees using a relative price control? If not, what alternative do you prefer?
- 11) Do you agree that we should set Cholderton & District Water its own simplified price control?
- 12) Do you think that we should develop a new small company service incentive? If so, what form do you think this incentive should take?
- 13) Do you agree with our proposal that small water companies should not be subject to separate wholesale and retail price limits?
- 14) New appointees are growing in size. In the future do you think that we might need to adopt a different approach to regulating their prices and service? If so, what circumstances should prompt a change of approach?

With regard to small companies our view is that no matter what the size the company is, the regulator must ensure that all customers across the country receive the same level of protection and guarantees. It is the duty of the Regulator to work with those companies to ensure this and we do not feel well placed to advise on this. We also believe that it is the duty of the Regulator, when determining how to regulate these businesses, that it does so in such a way as to ensure a “level playing field” across all companies in the sector.

We would be happy to have future discussions with you on any of our responses to the above questions, if this is required. Our contact in the first instance is:

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