7 November 2013

Registered Office:
Portsmouth Water Ltd
PO Box 8
Havant
Hampshire PO9 1LG

Tel: 023 9249 9888
Fax: 023 9245 3632
Web: www.portsmouthwater.co.uk

Andrew Chesworth
Email: Andrew.chesworth@ofwat.gsi.gov.uk

Please ask for	Nick Sheeran
Our Ref	NJS/KL
Your Ref	

OFWAT CONSULTATION ON "POSSIBLE NOTICE TO DETERMINE THAMES WATER'S PRICE LIMITS FOR 2014-15"

PORTSMOUTH WATER'S RESPONSE

Portsmouth Water is pleased to respond to the Ofwat informal consultation on "Possible notice to determine Thames Water's price limits for 2014-15".

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:

Cont'd/ . . .

General points:

This consultation raises a number of important points of principle which are potentially of general relevance, as the consultation recognises by emphasising the need to have regard to the principles of best regulatory practice, including that actions are targeted and proportionate. The comments below are made in this context.

Q1 Do you agree that the basis of RPI in the current control period may have resulted in significant revenue gains not anticipated when price limits were set?

- The consultation considers the impact of a change made by the Office of National Statistics in June 2010 to the calculation of the RPI index, arguing that this change resulted in an unearned benefit by increasing calculated RPI but not changing costs.

- At the same time, the consultation reaffirms Ofwat's commitment to using RPI to index wholesale allow revenues and RCV, to help secure the continuation of low-cost finance for investment in the water sector.

- As investors place considerable importance on the stability and transparency provided by the automatic application of RPI to price limits (and hence revenues) and to the RCV, this reaffirmation is welcome.

- However investors may find this reaffirmation difficult to square with the suggestion that, rather than being automatic, the application of RPI in practice may be subject to a review of the impact of the frequent statistical changes to the composition or calculation of RPI.

- RPI by its nature is a general measure of inflation in the overall economy, and so does not – and is not intended to within the water sector's regulatory framework – perfectly represent the actual cost pressures faced by a water company.

- Its primary role in this well-established regulatory framework is to enable a real terms headline price control to be set, within which companies would manage in normal circumstances.

- Companies' licences give Ofwat the ability to use a different measure of indexation should there be a material change in the calculation of RPI; as the consultation acknowledges, the change in question is not material in this context.

- In view of the above, seeking to amend Thames Water's price limits to take account of these changes in the RPI formula would not be targeted, proportionate or represent best regulatory practice.

Q2 Do you agree that the impact of sustained monetary interventions on the market costs of finance may have had significant favourable effects on the market costs of finance for an efficiently financed company, relevant to a review of Thames Water's price limits in 2014-15?

- A well established principle of the regulatory framework is that the cost of capital is set for a fixed period at price reviews, and companies are expected to live within this.

- Ofwat has previously considered other approaches, such as debt indexation, and rejected these as not being in the interests of consumers.

- The weighted average cost of capital (WACC) set at price reviews is an overall assessment, and is part of a package that companies either accept or reject taking into account risks and uncertainties at the time.

Cont'd/ . . .

- Seeking to reopen the WACC calculation within a price control period would be widely seen as a significant departure from the established stable and predictable regulatory framework that investors value, risking undermining investor confidence and increasing the future cost of finance.

- In addition to these matters of principle, while it is clear that monetary interventions have depressed UK interest rates, the extent to which a company could reasonably be expected to have taken advantage of this low-interest rate environment is less clear.

- It would not be economic for companies to pre-finance investment in future price control periods due to negative real interest rates on deposits creating a very high cost to carry – so the potential benefit is limited to new financing or refinancing required in this price control period, and to the impact on the level of existing non-fixed rate debt.

- The impact of monetary interventions on the cost of equity is far from clear. It is hard to argue that the required equity returns have been reduced by the world becoming less risky in recent years, given the ongoing volatility and uncertainty in the UK and global economy. A more reasonable view would be that there has been a flight to safety which will reverse once sustained economic growth returns.

- In view of the above, seeking to amend Thames Water's price limits by opening up the WACC calculation mid-period would not be targeted, proportionate or represent best regulatory practice.

Q3 Are there other relevant changes and effects we should consider?

- As noted above investors place considerable importance on the stability and transparency provided by the automatic application of RPI to the RCV.

- Ofwat's reaffirmation of the commitment to using RPI to index the RCV, and recognition that it would not be appropriate to adjust the RCV for changes to the calculation of RPI is therefore welcome.

- Regarding the net effects of recession on operating costs, an established component of the regulatory framework is for companies to manage their costs within a period relative to RPI. In addition, the net impact of changes to a company's costs would be difficult to assess, so the consultation's conclusion to exclude this factor from consideration is appropriate.

- Revenue shortfalls should also be excluded from consideration given the clear commitment to the application of the revenue correction mechanism at PR14.

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:

Nick Sheeran
Finance and Regulation Director,
Telephone number: 023 9224 9210
Email address: n.sheeran@portsmouthwater.co.uk