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Dear Cathryn

Portsmouth Water Response to the PR14 Rule Book

Thank you for the opportunity to comment on the PR14 Reconciliation Rule book published in March 2015. This is a helpful exercise and should provide clarity to all stakeholders.

Our response looks at each topic in turn, recognising the overall objective that decisions should be in the customer interest. In this context, we note and concur with the assessment criteria presented on page 10 of the consultation.

2. Outcome Delivery Incentives

PRT has 13 ODIs, 9 of which are numeric performance commitments, 4 are delivery commitments.

2.2 Indexation – In preparing our Business Plan we assumed that all rewards and penalties were in 2012/13 prices and that indexation for RPI would apply. We support Option one, the use of November RPI for indexation, as it is an “actual” index and provides consistency with wholesale controls.

2.3 Time value of money – In preparing our Business Plan we assumed that all rewards and penalties would impact customer bills on 1 April 2020, but did not include a “time value of money dimension”. We believe our Totex plan underpins our performance commitments and that the achievement of rewards and or penalties should reflect management decisions rather than changes to expenditure. We therefore support option one, not to adjust ODIs for the time value of money.

2.4 Treatment of taxation – we did not consider the impact of a tax allowance for ODIs when preparing our Business Plan and in particular our RORE assessment. We believe the proposal to provide a tax allowance for both RCV adjustments and Revenue adjustments to apply at PR19 is sensible albeit not an issue that was considered within the willingness to pay surveys or calculation of the reward and penalty. We therefore support option two.

2.5 Aggregate ODI Cap and Collar – The proposed approach to the operation of the aggregate cap and collar on financial ODIs is a departure from the position set out in Final

Determinations and is not consistent with the package that companies made their decisions upon. However from a customer point of view explaining changes in bills as a consequence of rewards and penalties is difficult and a pragmatic cap of 2% appears sensible.

2.6 Scheme ODIs – PRT only have 2 scheme ODIs, and we are planning to complete both within the AMP period. We agree that Ofwat should only identify the principles that they will apply in assessing the ODI. It is the responsibility of the Company to agree milestones with relevant stakeholders, informing its CCG as appropriate. Where delay or change of scope result, the Company would inform Ofwat in a timely manner.

2.7 Asset health – whilst PRT does not have aggregate serviceability ODI, it has bursts and Mean Zonal Compliance , there is clearly value in agreement in the measures and weights the assessment will apply subsequently.

2.8.1 Other ODIs - SIM – We note the proposed changes to the SIM methodology and specifically that it will adjust household retail revenues only in future.

2.8.2 Finally we support the principle that companies publish additional information on the operation of ODIs to promote wider stakeholder understanding of how the mechanisms will operate and how a company's performance is assessed. We have already started this process with the successor to our PR14 Customer Challenge Group

3. Wholesale Water and Wastewater costs and revenues

3.2.1 We agree that adjustments to reported Totex will need to be made to make it comparable to the menu baseline included in Final Determinations, and note the proposed adjustments, which appear reasonable. PRT has an implied Totex menu choice of 96.5%. Only one adjustment was applied to the assessment of the baseline Totex, which was for third party costs.

3.2.2 Indexation – we note and agree with the proposal to deflate actual Totex by year average RPI to compare with that assumed in the FD which is in 2012/13 prices.

3.2.3 Allocation of out / under performance of Totex – we agree it is important to allocate any variance to the FD appropriately between fast and slow money. Whilst PAYG rates do vary within the AMP6 period and thus any cost efficiency could be allocated more accurately, the proposal to use an average AMP6 PAYG rate appears pragmatic, with the scope for companies to propose a different ratio, if in the customers' interest.

3.2.4 Time value of money – this appears appropriate for Totex assessment as it will reflect the timing of the expenditure.

3.2.5 Treatment of taxation – we note and support the preference is for Option 3 which would apply a tax adjustment for the customer share on the RCV of any out / underperformance.

3.3 Wholesale Revenue Forecasting Incentive Mechanism

PRT support the principle underpinning the development of WRFIM and note any adjustment will not apply before 2020.

3.3.1 In period ODIs – whilst PRT does not have in period adjustments to wholesale revenue for ODIs, it appears sensible that the allowed wholesale revenues are adjusted to reflect any in period ODI adjustments.

3.3.2 Taxation – we agree that a tax adjustment is not appropriate as this would in effect result a double tax allowance.

3.3.3 Blind year – we agree with setting revenues at PR19 based on a forecast of 2019/20 as applied historically in previous price reviews, with the benefit of reducing the scale of adjustment at PR24 as the variance for 2019/20 between FD14 and PR19 is likely to be reduced.

3.4 Water trading incentives

PRT support the development of water trading incentives and as a Company with a positive supply / demand balance it is possible that we will enter into new bulk supplies before 2020.

3.4.1 We note the proposal the financial incentives on both exporter and importer, and that the supply needs to comply with the Ofwat approved "Trading and Procurement Code"

We support Option 2b as these proposals progress from the current approach at price setting which does not provide a financial incentive to either party to enter into a bulk supply.

3.4.2 Given our comment above we welcome the development of the import incentive as well.

3.4.3 Further we agree with the proposal that indexation, time value of money and taxation all three apply for both exports and imports.

4. PR09 reconciliation

4.2 We do not agree that the approach to CIS indexation applied at PR14 Final Determinations should be revised as part of the PR19 Review. In particular, in choosing to forgo legacy of a material amount (4% of revenue) from AMP5, it is likely that the Board would have chosen a different sum had it been aware of this adjustment.

Further, the impact on customer bills can be addressed through the bill profiling and affordability mechanisms (PAYG and RCV run-off rates) introduced at PR14.

4.3 We consider that adjustments for the difference between 2014-15 actuals and the forecasts assumed in PR14 Final Determinations should be calculated and applied at PR19 in the same way that the adjustments were calculated and applied in PR14 Final Determinations (which had no materiality thresholds). We agree that the initial calculations should be undertaken by companies and submitted to Ofwat during 2015.

4.4 Finally we agree that the COPI update for the CIS model should be based on the updated index, when this becomes available. As the adjustment does not need to be applied until PR19 Determinations, the risk of the update not being available by 2016 (as anticipated in Final Determinations) does not appear to be a significant issue.

5. Household Retail

5.2 PRT had assumed that there would not be a reconciliation of household retail at the end of the period. We do not really understand the need for this proposal and this was an issue the Board was willing to accept in its assessment of the Final Determination. We therefore chose Option 4.

Actual revenues will be based on the number (and mix) of households actually billed each year. Our understanding was that the key issue was to be able to demonstrate that household retail charges properly reflect the allowed revenue per customer, not the assumed revenue in the period.

Our calculations suggest the maximum variance of Household Retail revenue over the five years is less than 0.4% which should be considered if introducing the reconciliation.

6. Other issues

We note the proposals re land sales which was introduced at PR94, and gain sharing mechanisms which we do not have in our suite of ODIs.

To conclude therefore we understand we welcome the issues described in the Rule Book and offer to work with you and others in the industry to ensure we arrive at an agreed methodology to provide clarity to all relevant stakeholders.

Kind regards,

Neville Smith

Managing Director