Portsmouth Water

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

Water 2020
OFWAT
21 Bloomsbury Street
London
WC1B 3HF

10 February 2016

Dear Sir

PRT Response to Ofwat Consultation on Water 2020

Thank you for the opportunity to comment on the Water 2020 consultation, published on 10 December 2015, describing your preferred options for the future regulatory framework for 2020 and beyond. We give our consent that our response is placed in the public domain, if appropriate.

Firstly we welcome the early publication of your consultation and the communications undertaken by Ofwat staff prior to its publication. This will help all stakeholders plan their engagement strategies and business plans efficiently.

Further, we welcome the opportunity to help shape the framework. We are aware that the companies have provided many suggestions through the WaterUK "Market Place for Ideas." We welcome this initiative, and are pleased that Ofwat are considering many of the issues presented.

We have completed our response to the consultation on the template provided. We would like to highlight two specific areas of concern we currently have on the proposals, and look forward to further discussion in due course.

Indexation of future price controls

We understand the desire to move to CPI - but have reservations on the proposed process. In particular we have strong reservations about both the timing and the process of transition. In broad terms we have concerns about the impact on financability and related costs for PRT.

Portsmouth Water has all of its debt in a single long dated (2032) index linked instrument. This means that the Company has little or no opportunity to rebalance the debt or move into CPI linked bonds. As such, the Company will need to use hedging instruments to manage risk.

Initial indications by the rating agencies are that this move will be credit negative which raises concern about the future cost of capital and our ability to maintain an investment grade credit rating.

Further, we are concerned that the proposal will be dependent upon the establishment by the Treasury of a UK CPI bond market; without this our ability to put in place affordable RPI/CPI swaps will be effected. Early discussions with financial institutions confirm that the initial cost of SWAPs will be high due to generally low liquidity in the market and the lack of an active CPI bond market. As a consequence it is difficult to see how the currently proposed methodology will not result in an increased cost to the company.

Accordingly we feel that the overall methodology used should recognise individual company circumstances. Our initial modelling indicates that the impact of the transition will lead to a worsening of PRTs overall gearing and interest cover ratio over time, which would impact both the Company's credit rating and ability to raise finance.

We are also concerned about the initial impact on customer bills. Whilst it is suggested that this can be managed through Pay As You Go (PAYG) levers, the ability to do this may be limited by operational requirements. We feel that the PAYG mechanism was not designed for this purpose and may not be a fully effective solution to this issue.

Whilst we have no disagreement with the use of CPI for indexation of prices we feel it is an unnecessary and potentially damaging step to move away from RPI for the indexing of RCV. As the RCV is essentially an artificial concept we would maintain indexation by RPI for some years until a CPI market is established and not create issues of financability and indeed legitimacy in the short term.

We look forward to further discussions on this issue in particular, starting with a teleconference call on 12 February.

Water Resources

The Company operates within the South East of England and is in the fortunate position of having sufficient water resource available for the 25 year period of its Water Resources Management Plan.

Within this plan we are also able to provide two significant bulk supplies, both to Southern Water on our eastern and western boarders. Neither of these trades require "new investment" other than the pipe network to facilitate the supply. We do not believe the incentives proposed by Ofwat would apply to such trades, given the methodology focuses very much on the development of "new" water resources. Therefore an incentive should be developed for these types of trade.

Further in this context, the discussion around water resources and trades assumes the bulk supply is a normal 24 hour / 365 day requirement. This is not always the case. Bulk supplies could be requested to help incumbents meet short duration events, such as summer peak or autumn low river flows, and may not be required each year or even in a 10 year period.

This is the case with the two trades with Southern Water. We believe the model is unlikely to provide solutions to such a request and the framework needs to have a mechanism for rewarding investment made to provide such resilience.

We would therefore welcome the opportunity to ensure Ofwat are fully aware of the issues in formulating its framework further.

Yours faithfully,

Helen Orton
Finance and Regulation Director