30 August 2017

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

Please ask for Neville Smith
Our Ref NS/KL
Your Ref

Cathryn Ross
Chief Executive
Ofwat
Centre City Tower
7 Hill Street
Birmingham
B5 4UA

Email to: Cathryn.Ross@ofwat.gsi.gov.uk

Dear Cathryn

PR19 Consultation

Thank you for the opportunity to comment on the PR19 consultation document. The Board have welcomed the early insight from Ofwat into a number of key areas for the next price review and the consultation document continues this theme. We discussed the document at both our July and August meetings and, whilst we have responded to the detailed questions raised in the pro-forma provided, wanted to highlight further those areas where we have the greatest concerns.

Overall approach

We welcomed the PR14 approach to a more mature form of "risk based and proportionate" guidance to the price review process. We feel that, whilst guidance is detailed and generally clear, it has pulled away from these principles and has a much more prescriptive approach; which feels retrograde.

Rewards & Penalties

We understand the desire for stakeholders to be able to compare Company performance and, therefore, the driver for common Performance Commitments (PCs). However, we have significant concerns about the basis for setting targets and the apparent removal of the proposal to use "glide paths" to achieve significant step changes.

In particular we would caution the proposals in relation to leakage and PCC which may both have been historically influenced by company specific water resource circumstances. For example for companies without water resource issues, the current approach to using SELL has meant relatively higher levels of leakage. To expect this gap to be bridged in one year, without regard to cost, is both unrealistic and not necessarily in the benefit of customers. In respect of PCC this is significantly influenced by the level of meter penetration. For companies, without significant water resource issues (where compulsory metering programmes are not allowed) there will be significant cost and challenge involved in making a shift of this nature. We therefore strongly believe that the concept of a "reasonable" glide path should be reintroduced.

Further, we have a specific concern on the proposal to use unplanned outage as a measure of asset health. The South East of England has large areas of chalk which have very specific hydrogeological characteristics, namely short duration (1-2 days) of elevated levels of turbidity which cannot always be predicted. Our WRMP, resource headroom and design and operation of the Water Treatment Works has been developed such that the works automatically shut down when these unplanned events occur. We have over many years developed resilience into our assets such that these shut downs do not affect service to customers.

Our approach makes our water production processes highly cost effective with a high degree of resilience for our customers. The current inclusion of turbidity in the performance commitment would penalise us for economic and resilient operation of our supply function and is not an acceptable outcome of the proposals as set out.

More generally, we continue to have concerns, as previously expressed, regarding whether customers truly understand and support the principles of rewards for out-performance.

Finally we note that the methodology and level of support proposed for the setting of rewards and penalty levels appears, against a low bill level of under £100, entirely disproportionate. As an illustration, based on the RoRE range this would impact the bill by only ±£3-5 per annum.

<u>Cost of Capital</u>

You are aware of the particular company issue in relation to our embedded debt. When we have spoken previously you have indicated that any financeability testing in relation to the “efficiency” of debt raised, could not reasonably be undertaken “with the benefit of hindsight”. Ofwat have a duty to ensure that an efficient company is able to finance its function. However, the statement in chapter16 that "companies should not expect customers to bear the cost of resolving financing constraints arising from a company's choice of finance structure or inefficient financing strategy" appears to effectively be doing just that and judging with hindsight.

Small companies such as Portsmouth had to raise debt in a small number of tranches to achieve, what was at the time, a low cost of finance. We feel strongly that Ofwat should reflect this in its financeability duty.

We are of the view that the Cost of Equity should be based on an assessment of historical returns. The estimate of expected returns is difficult and includes a level of subjectivity that can only lead to uncertainty and risk to companies. We consider that the PwC report has been selective in its choice of the data and the range of equity returns could be understated as a result. We are aware that others have commissioned specific work in relation to this and therefore have not commented further in detail.

We do not agree that there should be no company specific equity premium. The CMA have made strong and consistent arguments in both 2010 and 2015 and the Ofwat assessment that this argument does not hold and does not appear to be robust. We have provided a separate report in support of a company specific premium on the cost of debt, by NERA (August 2017) which provides their position on this issue.

<u>Opportunities for water trading – Havant Thicket Winter Storage Reservoir</u>

Portsmouth Water is in a favourable water resources position and is well positioned to support the overall demand that has been forecast through the Water Resources in the South East project. This would be achieved through increasing levels of bulk supply to Southern Water which, in part, would be enabled by the build of a winter storage reservoir at Havant Thicket. This would support the “1 in 200 years” resilience requirements of Southern Water.

Whilst we agree in principle with the proposal to develop a risk sharing agreement to recognise that customers should not bear all of the risk for resource development if, ex post, it was not required, we are concerned that the proposals could generate perverse incentives not to enhance resilience. Given the demand assumption is for a dry year, which is expected say 1 year in 10, the probability that any investment is needed to meet this LoS is unlikely to be used 9 years in 10. This does not mean that that capacity put in place to meet this LoS is not required and should not be funded by customers.

Furthermore and most importantly, we challenge how these mechanisms are consistent with the expectation that water supplies become more resilient. If in the limit, we are expected to invest to meet a 1 in 200 year event, utilisation of the capacity will be expected very rarely. Why should incumbents pay for this resilience if they are to be penalised. It is difficult to reconcile your proposals with the driver for resilient supplies, and if you are to go ahead, the ex post assessment of utilisation will need to be undertaken carefully.

Havant Thicket would, most likely, be a project with just over £100m TOTEX or through life cost due to the long-life nature of the asset. On the face of it, this would likely fall within the requirements of Direct Procurement for Customers (DPC). We have a number of concerns about the proposed approach to DPC particularly the fact that there is no provision to "separate" the build from the operate activity for procurement.

An appointee will often have the depth of skills and flexibility to operate and maintain the asset in a highly efficient manner, yet are excluded from bidding for this activity. In addition for an asset of this nature, required to support resilience, with a long life and uncertain usage levels it would generate uncertain revenue streams from year to year. This level of uncertainly may make the project unattractive to potential tenderers or will result in pricing in of a significant "risk premium" resulting in a higher cost to customers.

<u>Vulnerability & Debt</u>

Having standards of service that treat customers with sensitivity at times of vulnerability is an important outcome for us. However, we believe that this is best achieved by staff being empowered to "do the right thing", rather than prescriptive policies. We see a danger within the consultation of creating an arbitrary two tier service whereby those that qualify for the label 'vulnerable' are treated differently than those customers that do not meet a company definition, but could still be in need of a tailored service. Other than for tariffing, we aspire to have services that are flexible enough to accommodate vulnerability, rather than seek to define it.

You are right to challenge the industry to maximise recovery of outstanding customer debt, where affordable. However, whilst we are not advocating a return to disconnection, it should be acknowledged that collecting water bills brings additional challenges, when compared to other debts. With a duty to supply and an inability to switch customers to pre-payment meters, recovery rates cannot be compared directly with other sectors.

Yours sincerely

Neville Smith
Managing Director