

January 2019

Trust in water

PR19 initial assessment of plans: Portsmouth Water company categorisation

About this document

In '[Delivering Water 2020: Our final methodology for the 2019 price review](#)' (the methodology) we said that we wanted companies to produce high-quality, ambitious and innovative business plans, pushing forward the performance and efficiency of the sector for customers. To encourage this we developed the initial assessment of business plans (IAP) process. The IAP was designed to incentivise all companies to produce well-evidenced plans that reflect their customers' preferences and priorities and are efficient.

We explained that the IAP would:

- assess company business plans against nine key test areas that reflect our PR19 themes and the strategic policy statements of the UK and Welsh Governments and help make sure companies deliver for customers, the environment and wider society;
- assess company business plans against three key characteristics (quality, ambition, and innovation); and
- categorise company business plans into four categories (significant scrutiny, slow-track, fast-track, or exceptional).

Following the submission of companies' business plans on 3 September 2018, we have carried out an extensive and detailed review of these plans. This review has been carried out in accordance with our methodology. More details on our overall approach to the initial assessment of business plans and our key findings by test area are set out in the 'PR19 initial assessment of plans: Summary of test area assessment'. The results of the review of all 17 business plans are summarised in the 'PR19 initial assessment of plans: Overview of company categorisation'. Our assessment is based on the information the company submitted to us as part of its business plans for the period 2020-25. The documents we have published are available on our [website](#).

This document sets out our assessment of Portsmouth Water's business plan submission under the IAP. It explains our assessment of the company plan in the round at an aggregate level and sets out a summary of our assessment across each of the nine test areas as set out in our methodology.

This document and the actions in the 'Portsmouth Water: Actions summary table' should be read in addition to the 'PR19 initial assessment of plans: Overview of company categorisation' document

1. Overview of Portsmouth Water categorisation

Our assessment of the plan

We set high expectations for water companies at PR19. We pushed them to go further than ever before, improving efficiency, customer service and resilience. We asked them to share financing gains with customers and to ensure that dividend and executive pay policy is aligned to delivering for customers. We asked them to look well beyond the five-year price review period to meet the needs of future customers and protect and improve the natural environment. We indicated in our PR19 methodology that the bar is high, and our Initial Assessment of Plans is the categorisation of company plans against those high expectations at this stage of the price review process. Where our expectations have not been fully met, we will continue to work closely with companies towards the draft and final determination stages.

We have placed Portsmouth Water in the slow track category. This categorisation is made after an in the round consideration of our assessment of Portsmouth Water's business plan across the nine test areas and the overall level of intervention in the plan required to protect the interests of customers. Our grades for each of the test areas are set out in Table 1 below.

Portsmouth Water performs well on cost efficiency, with company level costs 2% below our view of efficient costs and provides sufficient evidence to justify its company specific adjustment to the cost of capital.

It falls short of high quality in other areas, including:

- **engaging customers** - It uses a limited range and scale of engagement with customers;
- **delivering outcomes** - It proposes performance commitments that are not stretching in important areas and it is unclear whether its proposed financial incentives reflect customer preferences;
- **affordability and vulnerability** – It demonstrates a lack of ambition in the proposed coverage of assistance on affordability and vulnerability;
- **long term resilience** – It provides a lack of evidence to support its long term resilience, including a lack of a systems-based approach and assessment of the risks associated with the Havant Thicket scheme;

- **controls, markets and innovation:** - We have concerns about how robust the company's assessment is of whether it should use direct procurement for customers (DPC) to take forward its Havant Thicket reservoir proposals;
- **aligning risk and return:** - We have concerns about the level of certain financial metrics underpinning the financeability assessment. The plan provides insufficient evidence for target credit ratings.

Given the scale and scope of these concerns, the plan requires a level of material intervention to protect customer interests. We therefore give the plan slow track status.

An overview of our assessment of the business plan in relation to the nine test areas and our grades for each test area are set out below. Our detailed assessment of the test areas is provided in 'Portsmouth Water: Test area assessment' and 'Portsmouth Water: Test question assessment'.

Table 1: Overall test area assessments

Test Area	Our assessment
Engaging customers	C
Addressing affordability and vulnerability	C
Delivering outcomes for customers	C
Securing long-term resilience	C
Targeted controls, markets and innovation	C
Securing cost efficiency	B
Aligning risk and return	C
Accounting for past delivery	C
Securing confidence and assurance	C

A = High quality, ambitious and innovative plan with evidence that overall is sufficient and convincing

B = High quality plan, not sufficiently ambitious and innovative to be exceptional with evidence that overall is sufficient and convincing

C = Concerns with the plan: Plan falls short of high quality and/or evidence is insufficient and/or unconvincing in some areas

D = Substantial concerns with the plan: Plan falls significantly short of required quality and/or little or no evidence, or no convincing evidence

Engaging customers

It is clear that the company engaged with customers to inform its business plan, but there is insufficient evidence to demonstrate the depth and detail of the engagement and how the company used customer views to inform its business plan. For example, the customer engagement base was small; there was no direct

engagement with vulnerable customers and there was a lack of variety in engagement methods. The plan was not clear about what the company understands from the engagement about the risks customers are prepared to take, or about how customer behaviour should influence the company's approach to resilience.

Addressing affordability and vulnerability

The company demonstrates that its customers accept and find affordable the 4% bill decrease it has proposed for the period 2020-25. However, we are concerned that the company is not doing enough to make its social tariff available to more customers. The company projects a relatively low reach in its social tariff and Priority Services Register membership.

The company is using financial levers (decisions about moving bill increases forwards or backwards in time) to move money between periods, but is has not provided an explanation about why, or how, it is doing this.

Delivering outcomes for customers

The company proposes upper quartile performance for supply interruptions. However, we have concerns about the company's overall package of proposed performance commitments and outcome delivery incentives. The company provides insufficient evidence that its service levels for leakage, per capita consumption, catchment management, compliance risk index and water quality contacts are appropriate.

There is insufficient evidence in the plan to support the company's proposed outcome delivery incentive rates. For example, it is not clear in the plan how the company has used customer research, and we are concerned that the proposed rates may not provide sufficient incentives to improve performance. We are not convinced that outcome delivery incentives proposed for asset health will protect customers from poor service.

Securing long-term resilience

The plan demonstrates that a wide range of risks have been considered. There is a suitable risk register and the company has explained how it might reasonably avoid, mitigate and recover from financial shocks.

However, the company has provided insufficient evidence about a number of aspects of resilience, for example:

- There is no explanation to explain its lack of an integrated and systems-based approach to resilience.
- There is not enough detail about why, when assessing individual issues, resilience has been assessed as insufficient or sufficient.
- There is little detail about how the company has used environmental valuation techniques to ensure the objective assessment of nature-based solutions against more traditional options.
- There is insufficient evidence that financial resilience risks have been fully considered. For example, the company's financial resilience relies heavily on an equity injection associated with the development of the Havant Thicket reservoir project, but there is insufficient evidence that the risks associated with the project have been considered, or that the company has considered what impact there would be on its financial resilience if the project did not proceed.

Targeted controls, markets and innovation

The plan demonstrates aspects of high quality in some areas, for example, management of gaps and voids and the use of third party partnerships to support water resources. But it falls short of high quality in a number of areas including:

- Issues around metering, per capita consumption ambition and Board assurance are only partly addressed.
- There is no strategy for bilateral markets and one of the data tables submitted by the company (table WR6 – Water Resources) contained incorrect data.
- The bid assessment framework is not transparent. For example, there is insufficient evidence on how the company will handle appeals or satisfy audit and compliance best practice recommendations.
- There is insufficient evidence to demonstrate that there has been a thorough technical assessment of the Havant Thicket scheme. The evidence provided to demonstrate that it would be detrimental to the company's operations, if delivered by direct procurement for customers, is unconvincing. There is

insufficient evidence to justify the assumptions on gearing and cost of debt, which appear to underpin the Value for Money (VfM) and 'Five Case' business model that favours in house delivery over direct procurement for customers.

- There is insufficient evidence that the proposed commercial arrangements between Portsmouth Water and Southern Water for the development of the Havant Thicket reservoir will adequately protect the customers of Portsmouth Water. We are concerned that the company's customers will be exposed to costs and risks of the development, which is for the benefit of the customers of Southern Water.

Securing cost efficiency

Portsmouth Water performs well on cost efficiency. Company level costs are 2% below our view of efficient costs. Its base costs are the most efficient in the industry.

The proposed reservoir development should bring benefits to the company's ability to take part in water trading with other companies and benefits to the company's own resilience. However, the plan does not provide enough evidence to explain which of those two things, i.e. water trading and resilience, will benefit the most or how the company sees the benefits being allocated between them.

Aligning risk and return

The plan does contain aspects of high quality, including the proposed uplift to the allowed cost of debt which satisfies the three-stage approach set out in our methodology; and there is convincing explanation to support some financial decisions.

However, there are three areas where the plan falls short of high quality as it provides insufficient evidence:

- To support the choice of target credit rating for the notional structure.
- To support the choice of target credit rating for the actual structure, in the context of the investment programme and debt raising needs, and that financial ratios are consistent with the target credit rating for its actual structure.
- In respect of risk and mitigation measures in the return on regulatory equity (RoRE) assessment for the notional company.

Accounting for past delivery

Overall, Portsmouth Water's business plan falls short of high quality in accounting for past delivery, in particular in relation to outcomes and major incidents.

The plan provides sufficient evidence of deliverability in relation to costs and customer complaints handling. The company has good actual and forecast performance in costs; it is forecast to underspend against its cost allowance for 2015-20. The company is already meeting CCWater's 2020 household customer complaints target of resolving 95% of customer complaints at stage one and has the lowest number of household customer complaints per 10,000 connections in the sector.

The plan falls short of high quality as it provides insufficient evidence of deliverability in relation to outcomes and major incidents. Portsmouth Water is forecast to deliver 71% of performance commitments with financial outcome delivery incentives in 2015-20. The company provides insufficient evidence that it understands the drivers of its outcomes performance or that the plan includes appropriate measures to deliver proposed stretching levels of performance, in particular on per capita consumption and addressing vulnerability. The company had one major pollution incident in 2015-18. It provides insufficient evidence that the plan includes appropriate measures to improve performance.

Securing confidence and assurance

Overall, Portsmouth Water's plan falls short of providing sufficient evidence to demonstrate high quality in the securing confidence and assurance test area.

The company's Board provides assurance statements in the majority of areas requested. However a number of statements are not provided in full and one is omitted. Although the company includes our default gearing benefits sharing mechanism it provides insufficient evidence that it meets our expectations on executive pay and dividend policy.

On executive pay there is a lack of evidence of the performance metrics the company will use to link pay to delivery for customers; the relative weighting of metrics; how it will ensure targets are stretching, how the policy will be monitored, reported and rigorously applied and; how changes and their justification will be signalled to stakeholders. On dividend policy there is insufficient evidence that the

proposed policy accounts for delivery of obligations and commitments to customers and commits to signal changes to stakeholders.

2. Next steps and overall timeline

Actions for the company are set out in 'Portsmouth Water: Actions summary table'. The next part of the process will be the draft determination, followed by the final determination, as set out in the table below.

Date	Milestone
1 April 2019	Revised business plans submitted
18 July 2019	Draft determinations published
30 August 2019	Representations on draft determinations due
11 December 2019	Final determinations published
1 April 2020	Price controls for 2020 – 2025 come into effect

Appendices

The appendices below can be found on our [website](#).

- Portsmouth Water: Test area assessment
- Portsmouth Water: Test question assessment
- Portsmouth Water: Actions summary table
 - Portsmouth Water: Delivering outcomes for customers detailed actions
 - Portsmouth Water: Accounting for past delivery detailed actions
 - Portsmouth Water: Securing confidence and assurance detailed actions

Ofwat (The Water Services Regulation Authority) is a non-ministerial government department. We regulate the water sector in England and Wales. Our vision is to be a trusted and respected regulator, working at the leading edge, challenging ourselves and others to build trust and confidence in water.

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