December 2019

PR19 final determinations

PR19 final determinations: Portsmouth Water final determination

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About this document

This document supports the 'Notification of the final determination of price controls for Portsmouth Water' and sets out further details about the final determination price control, service and incentive package for Portsmouth Water for 2020 to 2025. All figures in this document are in 2017-18 prices except where otherwise stated.

The final determination documentation sets out:

- the outcomes for Portsmouth Water to deliver;
- the allowed revenue that Portsmouth Water can recover from its customers; and
- how we have determined allowed revenues based on our calculation of efficient costs and the allowed return on capital.

This final determination is in accordance with our PR19 methodology (as updated), our statutory duties[1] and the UK Government's statement of strategic priorities and objectives for Ofwat[2]. We have also had regard to the principles of best regulatory practice, including the principles under which regulatory activities should be transparent, accountable, proportionate, consistent and targeted.

Our final determination carefully considers all of the representations we received from companies and stakeholders on our draft determination and takes account of the most up-to-date information available where appropriate. Where appropriate, we explicitly set out our response to points and issues raised by respondents. Where information was provided late and we have not been able to take full account of this in the final determination, this is explicitly stated.

There are five appendices to this document on cost efficiency, outcomes performance, past delivery, allowed revenue and, where relevant, additional information. For all documents related to the Portsmouth Water final determination, please see the final determinations webpage. Where we reference other documents related to our final determinations we do not include the 'PR19 final determinations' prefix to the document title, for documents relating to our initial assessment of plans or draft determinations the full document title is referenced.

If Portsmouth Water accepts our final determination, it will be accepting that it has adequate funding to properly carry out the regulated business, including meeting its statutory and regulatory obligations, and to deliver the outcomes within its final determination.

1 See the 'Policy summary' for more information.
2 See 'UK Government priorities and our 2019 price review final determinations' for more information.

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Amendment	Date
Page 36, Table 3.7 – Amendments made to: • Abstraction charges and business rates (£m) for Water resources from £0 million to £8.4 million and for Network plus – water from £0 million to £8.0 million. • Amendment to Net allowed totex subject to cost sharing reconciliation (£m) for Water resources from £32.3 million to £23.9 million and for Network plus – water from £144.8 million to £136.7 million.	18 May 2020

1 Summary

The water sector faces challenges of climate change, a growing population and increasing customer expectations, while improving affordability of an essential service. The 2019 price review (PR19) enables and incentivises companies to address these challenges both in 2020-25 period and longer term.

To do this the sector needs to innovate and challenge itself to deliver better performance for customers and the environment. Companies need to engage and work with customers and other companies, the supply chain and with other stakeholders.

Our PR19 methodology set out a framework for companies to address the challenges facing the sector with particular focus on improved service, affordability, increased resilience and greater innovation. We published our draft determination for Portsmouth Water on 18 July 2019, based on our detailed review of the revised plans submitted to us on 1 April 2019. The company and a number of stakeholders provided representation responses on our draft determination on 30 August 2019.

Our final determination carefully considers all of the representations we received from companies and stakeholders on our draft determination and takes account of the most up-to-date information available where appropriate. We consider the changes we have made in our final determination to be in line with our statutory duties.

1.1 What our final determination includes

This section sets out the overall shape of our final determination for Portsmouth Water, covering the customer bill profile, costs, outcomes for customers and allowed revenues. More detail is provided in the following sections of this document.

Bill profile

Our final determination for Portsmouth Water will cut average bills by 5.4% in real terms in the 2020-25 period compared to the company's proposed 4.0% reduction. Table 1.1 below sets out the difference in bill profile between the company's business plan submission in April 2019, our draft determination and the final determination. Average bills are lower than proposed by Portsmouth Water,

reflecting our view of efficient costs and a reduction in the allowed return. Further details on bills are set out in section 6.

Table 1.1: Bill profile for 2020-25 before inflation

	2019-20	2020-21	2021-22	2022-23	2023-24	2024-25
Company plan (April resubmission)	£101	£97	£97	£97	£97	£97
Draft determination	£101	£90	£90	£90	£90	£90
Final determination	£101	£96	£95	£96	£96	£96

Costs

Our final determination allows wholesale totex of £176.2 million excluding Havant Thicket related expenditure. This is:

- £3.4 million higher than in our draft determination and
- £9.1 million higher than stated in the company's representation on our draft determination.

Our final determination allows Portsmouth Water £18.8 million to invest in improvements to service, resilience and the environment. Our enhancement allowance for Portsmouth Water is unchanged from the draft determination. Key parts of our allowance are:

- £4.1 million to improve the environment by efficiently delivering its obligations as set out in the whole Water Industry National Environment Programme (WINEP) programme including expenditure on Drinking Water Protected Areas and eels regulations;
- £5.5 million to address the impact of deteriorating raw water quality;
- £1.2 million for resilience enhancement; and
- £5.2 million for new meter installations.

Further details on our cost allowances are set out in section 3.

Outcomes for customers

Our final determination package includes a full set of performance commitments, specifying the minimum level of service that Portsmouth Water must commit to

deliver for customers and the environment under this price review. These sit alongside the company's statutory and licence requirements. Each performance commitment also has a financial or reputational incentive to hold the company to account for delivery of these commitments.

Further details of key performance commitments are set out in table 1.2 below and in section 2.

Table 1.2: Key performance commitments for Portsmouth Water

Area	Measure
Key common performance commitments	• 15.2% reduction on a three year average basis in leakage. This is at least 15% reduction from PR14 performance commitment levels • 6.3% reduction in per capita consumption by 2024-25 • A level of 5 minutes for 2024-25 for water supply interruptions
Bespoke performance commitments	• 9% reduction in the number of water appearance customer contacts by 2024-25 • 74% reduction in the number of customers who receive, or are at risk of receiving, pressure below the minimum standard 2024-25
Overall incentive package	Overall, the likely range of returns from outcome delivery incentive package in our final determination equates to a return on regulatory equity range of – 1.64% (P10) to + 1.28% (P90).

Note the calculations behind these numbers are outlined in the 'Portsmouth Water - Outcomes performance commitment appendix'.

Allowed revenues

Our final determination sets allowances for total revenue or average revenue for each of the price controls. Table 1.3 shows the allowed revenues in the final determination across each price control. Further details on our calculation of allowed revenues are set out in section 4.

Table 1.3: Allowed revenue, 2020-25 (£ million)

	Water Resources	Network plus - water	Havant Thicket	Wholesale total	Residential retail	Total
Company view of allowed revenue (£m)	29.8	140.2	0.0	170.0	23.9	193.8
Final allowed revenues (£m)	28.0	142.9	0.0	170.8	22.0	192.8

Note retail revenue is the sum of the margin, retail costs, and adjustments. The residential retail control is an average revenue control. We have included forecast revenue (in real terms) for this control to illustrate the total revenue across all controls.

As set out in the 'Allowed return on capital technical appendix', we are updating our assessment of the allowed return on capital for Portsmouth Water's final determination. The sector allowed return is 2.96% (on a CPIH basis, 1.96% on a RPI basis) at the appointee level. After adjustment for the retail margin, the industry-wide allowed return on capital for the wholesale price controls at a sector level is 2.92% (on a CPIH basis, 1.92% on a RPI basis), a reduction of 0.16 percentage points from our draft determination, reflecting our assessment of market evidence. The allowed retail margin for the household retail control remains at 1.0%, consistent with the draft determination.

For Portsmouth Water we have accepted the proposal in its business plan for a company-specific adjustment to the allowed return on debt, uplifting the allowed return for the water controls equivalent to 3.11% (on a CPIH basis, 2.11% on a RPI basis). We allow the sector return for the separate Havant Thicket control. The allowed retail margin for the household retail control remains at 1.0%, consistent with the draft determination.

Portsmouth Water's Regulatory Capital Value (RCV) growth in 2020-25 is 12.1%, excluding Havant Thicket, and 63% of its RCV will be indexed to CPIH in 2025. We first consider financeability for Portsmouth Water excluding the Havant Thicket control for the purposes of assessing the requirement to advance revenue to address weak financial ratios. We bring forward £0.9 million of revenue from future periods. We subsequently consider financeability of the Appointee including the Havant Thicket control.

We consider that Portsmouth Water's final determination is financeable on the basis of the notional structure, based on a reasonable allowed return on capital and revenue advanced through pay as you go (PAYG) adjustments. The determination is

sufficient to deliver its obligations and commitments to customers. Further detail on our assessment of financeability is set out in section 5.

Havant Thicket

Our draft determination proposed a separate 10 year price control in relation to the Havant Thicket reservoir, recognising it is distinct from Portsmouth Water's existing wholesale services that are driven by the needs of its own customers.

To determine the separate control, we made changes to Portsmouth Water's conditions of appointment which came in to effect on 25 November 2019. We summarise key aspects of our decision in this document. Full detail on our regulatory approach to enable the development of the reservoir is set out in the 'Havant Thicket appendix'.

Putting the sector in balance

We have encouraged companies to take greater account of customers' interests – and to transparently demonstrate that they are doing so in the way they finance themselves, pay dividends to their shareholders, and determine performance related executive pay. Portsmouth Water commits to meeting the expectations set out in our 'Putting the sector in balance position statement'.

The company confirmed it would implement our default gearing outperformance mechanism. Under its actual financial structure, Portsmouth Water expects to maintain gearing below the level that would trigger sharing payments under the gearing outperformance sharing mechanism in 2020-25.

To meet our expectations, the company will need to demonstrate to stakeholders that dividends and performance related pay policies are substantially aligned to its performance for customers. We expect the company will need to revise its proposed base dividend yield for 2020-25 to take account of the lower allowed return in our final determination and our revised expectations for a reasonable base dividend yield that we set out in the 'Aligning risk and return technical appendix'.

In the 'Putting the sector in balance' position statement we also encouraged companies to adopt a voluntary sharing mechanism, particularly where, for example, companies outperform our cost of debt assumptions. Portsmouth Water has not proposed any voluntary sharing mechanisms. However, the company does operate a

payment matching scheme which matches payments to customers paying down debt balances, subject to certain criteria.

We provide further detail on these issues in section 7.

1.2 Representations on the draft determination

All companies and stakeholders were invited to make representations on our fast track draft determinations by 24 May 2019 and on our slow track and significant scrutiny draft determinations by 30 August 2019. More detail about the issues raised in the representations by the company and our consideration of those issues can be found elsewhere in this document, the technical appendices and other documents published alongside our final determinations. Table 1.4 highlights the key points made by Portsmouth Water in its representation and a summary of our response to each of those points.

Table 1.4: Company representation

Key point in Portsmouth Water representation	Summary of our response
Portsmouth Water states that it is unable to conclude on its 'combined' business financeability assessment, on account of regulatory uncertainty over the separate price control for the Havant Thicket reservoir and the proposed lower allowed return for the Havant Thicket reservoir.	We have carefully considered all of our duties, in particular our financing functions and consumer protection duties, and are satisfied that our final determination fulfils our duties in the round. Our assessment of notional financeability for the final determination is made in the context of changes made to the draft determination in our final determination. We consider the company's final determination is financeable on the basis of the notional structure based on the allowed revenues which include a reasonable allowed return on capital. The final determination is sufficient to ensure the company will be in a position to deliver its obligations and commitments to customers. It is the company's responsibility to maintain financial resilience under its actual financial structure and it must bear the risks associated with its choice of capital and financing structure.
Portsmouth Water raises a number of points in relation to the Havant Thicket reservoir: • The proposed allowed return is too low and should at least be equal to the wholesale price control cost of capital. It argues in favour of a full reset of the allowed return after 5 years.	We apply the allowed return for the sector to the of 2.92% (CPIH deflated) for the separate Havant Thicket price control. We will also reset the allowed return for the 2025-30 period to be consistent with the revised wholesale price controls at PR24

Key point in Portsmouth Water representation	Summary of our response
• An allowance for economic profits should be retained by the company during the construction of the Havant Thicket reservoir and shared with customers after the water supply date. • It disagrees with our proposed £13.8 million disallowance of Havant Thicket reservoir expenditure for the ten-year control, accepting an efficiency challenge of £1.6 million. • It argues for a forward looking gated adjustment mechanism to refine the cost allowance for the Havant Thicket reservoir, based on planning and procurement outcomes.	We do not expect Portsmouth Water to earn economic profits during construction of the Havant Thicket reservoir. It will be able to enhance returns to shareholders by earning economic profit from the bulk supply charges paid by Southern Water throughout the operation of the reservoir. We set a ten year Havant Thicket reservoir cost allowance of £123.6 million (£61.4 million in 2020-25), slightly higher than draft determination. See section 3 for further details. We include a gated cost adjustment mechanism based on planning and procurement outcomes by 2022 and a mid-period determination to allow adjustment for outcomes from the gated mechanism, cost of new debt indexation and tax reconciliation, as well as to take account of some key commercial details of the final bulk supply agreement with Southern Water. See the 'Havant Thicket appendix' for further details.
Portsmouth Water challenges our intervention on the performance commitment level for per capita consumption. It argues that a 6.3% reduction is unreasonable due to specific local factors, such as low bills, low metering penetration and an inability to compulsorily meter. The company also asserts that its customers do not support anything other than widespread compulsory metering. It advocates the reinstatement of its original 5% proposal.	We retain the 6.3% performance commitment level set at draft determination because we do not consider the arguments sufficient to demonstrate this level cannot be achieved. We consider from evidence provided that customers call for greater promotion of metering from Portsmouth Water to ensure those who could benefit from metering do so; see section 2.
Portsmouth Water claims it is being unfairly penalised by a £1.9 million underperformance payment relating to its water quality contacts performance commitment for 2015-20. The company had agreed to honour its PR14 target which was based on mistakenly underreported figures and it has since delivered sector-leading performance on the measure. It proposes a lower payment of £0.5 million based on performance against its original PR14 business plan performance commitment.	We reject the company's proposal and are not changing the £1.9 million underperformance payment accrued in PR14. Retaining our proposed underperformance payment in these circumstances is consistent with our policy of maintaining the integrity of the outcomes approach by not changing the incentive packages that companies accepted at final determinations. See 'PR19 final determinations: Portsmouth Water - Accounting for past delivery final decisions' for more details.
Portsmouth Water challenges our £2.7 million negative adjustment to the wholesale revenue forecasting incentive mechanism (WRFIM). It argues that it has not over-recovered revenue	We continue to reject the claim, overall we make a £4.4 million adjustment to revenue for WRFIM. To provide confidence in the accuracy and legitimacy of the regulatory process we only correct unambiguous errors. The company does

Key point in Portsmouth Water representation	Summary of our response
from customers and claims that the adjustment contravenes previous agreements with Ofwat.	not provide evidence that would allow us to confirm the alleged error or to support its claim an agreement was made for its correction. See 'Portsmouth Water – Accounting for past delivery additional information' for more details.

We also received representations on Portsmouth Water's draft determination from other stakeholders as shown in table 1.5, which shows a summary of our response to company-specific comments. Representations from some other stakeholders relate to all companies and are described in the relevant technical appendices. More detail about the issues raised in the representations by stakeholders can be found elsewhere in this document, the technical appendices and other documents published alongside our final determinations.

Table 1.5: Stakeholder representations

Stakeholder representation	Summary of our response
The **Consumer Council for Water** argues that Ofwat should consider retracting Portsmouth Water's company-specific adjustment to the allowed return if the company fails to deliver its commitments.	We hold companies to account by attaching a financial or reputational incentive to each performance commitment.
Southern Water broadly supports Ofwat's position on the Havant Thicket reservoir, but calls for further clarification or development on a several issues, including ensuring parity between Southern Water and Portsmouth Water customers, securing financeability for the project, and further developing the regulatory framework.	We drew on Southern Water's views on costs in our efficiency challenge and have involved the company in the licence modification process where appropriate. Detail of the Havant Thicket price control is included in the 'Havant Thicket appendix'.

1.3 Key changes from the draft determination

Our final determination carefully considers the representations we received from companies and stakeholders on our draft determinations on 30 August 2019. It also takes account of the most up-to-date information available where appropriate. Changes to overall revenue and costs allowances are set out in table 1.6.

Table 1.6: Difference in cost and revenue allowance final to draft determination

	Draft determination	Final determination
Allowed revenues (£m, 2017-18 CPIH deflated)	181.2	192.8
Wholesale cost allowance[1] (£m, 2017-18 CPIH deflated)	231.6	237.6
Retail cost allowance (£m, nominal)	21.9	21.3
Wholesale allowed return[2] (% - CPIH basis)	3.26%	3.11%

[1] Note that we include pension deficit recovery costs in the wholesale cost allowances we present in table 1.6 above and in table 3.1 later in this document. At the draft determination we published cost allowances excluding pension deficit recovery costs. The numbers we show here as the draft determination allowances can be calculated by adding the pension deficit recovery costs from draft determination table 3.2 to draft determination table 3.1 total allowances. Our decisions on individual elements of the totex allowance are set out in section 3.
[2] The allowed retail margin for the household retail control remains at 1.0%, consistent with the draft determination.

Significant changes from the draft determination for Portsmouth Water are:

- We cap our combined totex allowance for water resources and water network plus at 10% above that requested by Portsmouth Water.
- We revert to the company's September 2018 business plan proposal on leakage to deliver a 15.2% reduction on a three year average basis.
- We increase the water supply interruptions 2024-25 level (making it easier to achieve) to five minutes, with an amended glidepath in the first four years, and reduce the outcome delivery incentive underperformance rate to be symmetrical with its outperformance rate.
- We accept outperformance payments on the biodiversity bespoke performance commitment, but we also include underperformance payments.
- Taking account of company representations, we revise our approach to determine the mix of operating and capital expenditure to take better account of the nature of our decisions on cost allowances. We apply the updated approach in our technical intervention to PAYG rates.

Significant changes at final determination for the Havant Thicket price control are:

- We set a cost allowance of £123.6 million. We introduce a cost adjustment mechanism linked to planning and procurement gateways.
- We adopt the industry wholesale allowed return of 2.92% (CPIH deflated) for the separate price control compared to 2.72% at draft determination.
- We set a bespoke performance commitment and associated underperformance payment linked to delivery of the reservoir.

2 Outcomes

Key changes from the draft determination

The key changes made to the outcomes elements of the draft determination are:

- We revert to the company's September business plan proposal on leakage to deliver 15.2% reduction on a three year average basis since the company's proposal will achieve at least a 15% improvement on PR14 levels and can earn outperformance payments to fund further service improvements including to achieve Water Resources Management Plan levels.
- We increase the water supply interruptions 2024-25 level (making it easier to achieve) to five minutes, with an amended glidepath in the first four years taking account of wider evidence to calibrate the stretch of the performance commitment for an efficient company. We reduce the outcome delivery incentive underperformance rate to be symmetrical with its outperformance rate. Together these changes provide a more balanced spread of incentives and risks on water supply interruptions.
- We accept outperformance payments on biodiversity bespoke performance commitment as there is evidence of customer support but we also propose having underperformance payments, in line with our methodology and consistent with our proposals for other companies

Throughout PR19, we have been asking companies to:

- make stretching performance commitments to their customers;
- have stronger incentives to deliver on their commitments; and
- better reflect resilience in their commitments

The outcomes framework is a key component in driving companies to focus on delivering the objectives that matter to today's customers, future customers and the environment in the 2020-25 period and beyond. Outcomes define the service package that companies should deliver for their customers and their incentives to do this.

There are two key elements of the outcomes framework: performance commitments and outcome delivery incentives. Performance commitments specify the services that customers should receive and set out in detail the levels of performance that the companies commit to achieve within the five year period from April 2020 to

March 2025. Outcome delivery incentives are the reputational and financial incentives that companies have, to deliver on their performance commitments to customers. They specify the financial or reputational consequences for companies of outperformance or underperformance against each of these commitments (they are referred to as 'out' where there is a payment to the company for better than committed performance, 'under' where there is a payment to customers where there is worse than committed performance, or 'out-and-under' incentives, depending on their design).

Most outcome delivery incentives will be settled at the end of each year to bring incentive payments closer to the time of delivery of the service ('in-period' incentives) and some will be settled once at the end of the five year period ('end-of period' incentives). The outcomes framework gives companies the freedom to innovate and explore to find the most cost-effective way of delivering what matters to their customers.

The company is currently delivering upper quartile overall performance, it is performing at upper quartile levels on supply interruptions and water quality contacts. It is the second-best performer in the sector on service incentive mechanism (SIM) and achieved 80% of its performance commitments in 2018-19, ranking third in the industry.

In its September business plan, the company proposed upper quartile performance for supply interruptions, however, its proposals for some commitments, for example leakage reduction and per capita consumption, were not well evidenced and appeared not to be stretching. It also provided insufficient supporting evidence for the calculation of outcome delivery incentive rates and there were concerns with the customer research and triangulation[3] as well as having outcome delivery incentive rates that sufficiently protect customers in areas where the company has past performance issues such as asset health.

In its revised plan Portsmouth Water made an increased leakage reduction performance commitment from 15.2% to 20% on a three year average basis. The company did not consider that increasing per capita consumption reductions was achievable. The company amended its outcome delivery incentive rates to reflect customer preferences and priorities and provide management with an appropriate incentive to deliver the desired outcomes. This included reflecting customer expectations that underperformance rates are greater than outperformance rates. The company also amended rates on its biodiversity performance commitments. In

[3] Triangulation is the method used in averaging across multiple sources of research and data to set outcome delivery incentive rates.

its draft determination, we intervened to increase the stretch on per capita consumption and remove outperformance payments on biodiversity and we accepted its revised leakage levels.

In its representations the company focused largely on per capita consumption but also makes representations on other areas including its biodiversity performance commitment. See section 2.1 for our full assessment of biodiversity performance commitment and per capita consumption.

On leakage, we are reverting to the company's September business plan proposal of 15.2% leakage reduction on a three year average basis since we consider this is stretching and consistent with the wider sector challenge to reduce leakage with base cost allowances. The company expects to deliver at least a 15% improvement on PR14 levels. The company can earn outcome delivery incentives if it improves performance beyond these stretching levels to fund further service improvement including Water Resource Management Plan levels where these go beyond the performance commitment level. We note the company has been improving on leakage reduction throughout PR14.

The outcomes framework sits in the broader context of the company's statutory and licence requirements for service delivery. Independently of the outcomes framework, each company also has to ensure that it complies with its legal obligations, or risk enforcement action. If a company's performance falls below the level set for a performance commitment (irrespective of the existence of any deadband or collar), we will consider whether this is indicative of wider compliance issues to the detriment of consumers and whether enforcement action, with the potential for remedial and fining measures, is warranted.

Please see the 'Delivering outcomes for customers policy appendix' for further details on our policy decisions on cross-cutting issues such as common performance commitments and outcome delivery incentive rates.

2.1 Customer engagement

In our PR19 methodology we set out our expectations that companies should demonstrate ambition and innovation in their approach to engaging customers as they develop their business plans. This includes direct engagement with customers to develop a package of performance commitments and outcome delivery incentives.

We expected customer challenge groups to provide independent challenge to companies and independent assurance to us on: the quality of a company's customer engagement and the degree to which this is reflected in its business plan.

We continued our assessment of customer engagement evidence following each company's submission of its representations to our draft determination in August 2019. We find variability in both the quality of engagement undertaken by companies and the extent to which customers' views are reflected in company proposals.

In our initial assessment of plans, we assessed that Portsmouth Water's September 2018 business plan fell short of high quality with little evidence of effective engagement with customers. Specifically, we found the company's approach to using customer research to set outcome incentives rates to be insufficient and that it was unclear how the proposed incentive rates reflect customer views.

In response to our initial assessment of its plan, as part of its April 2019 revised business plan, Portsmouth Water submitted additional evidence of customer support on: incentive rates on a variety of performance commitments; extending the social tariff; extending catchment management to non-priority zones; and whether water quality contacts are appropriate as an asset health measure. We found that the customer research was indicative of customer views, although due to the sample size involved (44 customers in 6 focus groups), this research cannot be considered to be statistically significant.

Portsmouth Water submits new customer engagement research in its August 2019 representations to our draft determinations that considers customers' preferences to bill profiles during the 2020-25 period. While we find that the research is robust in terms of sample size, the bill profile proposed by the company and our bill profile are not presented to the customer in an impartial manner. However, the research is indicative of customers' views and consistent with the research findings of other companies. We are therefore using it in determining the company's bill profile. See section 6 for further details.

In its representations to our draft determination, Portsmouth Water disagrees with our intervention in setting a per capita consumption performance commitment level at 6.3% as opposed to the 5% reduction proposed by the company in its April 2019 revised business plan. It states that increasing metering to help achieve this level is not supported in its customer engagement research as customers would only support widespread metering. The company further argues that our draft determination decision on per capita consumption fails to consider its circumstances. It notes that current performance is already efficient for the region, the impact of metering will be limited due to the low level of its charges, that metering penetration

needs to be at least 50% to achieve significant reduction and its inability to compulsorily install meters limits the company's options relative to neighbours. It also argues that its starting point is likely to be higher than previously expected.

The company's customer challenge group has heavily challenged the company on this performance commitment and specifically notes that the customer engagement evidence is conflicting about customer preferences on demand management approaches. Contrary to what the company has claimed, we find that the customer research the company submits with its September 2018 business plan shows that customers call for greater promotion of metering from Portsmouth Water. The company's area does not have a water stressed status the company's Water Resource Management Plan is heavily reliant on demand management and the company has options to supply Southern Water so it has additional rationale to manage its own demand. While the company's bills are low and there is no current ability for compulsory metering, its meter penetration does not appear ambitious within the industry. Therefore, we retain the 6.3% reduction for final determination.

The company further states that the removal of outperformance payments in relation to biodiversity (reward) performance commitment is not aligned with its customers' priorities. In relation to biodiversity (reward), the company has provided us with further information and we are therefore accepting outperformance payments at the rate proposed by the company which reflects its customers' valuations. While the company representations give us confidence in the robustness of the performance commitment and that there is customer support for outperformance payments, it proposes no underperformance payments as it is going beyond statutory requirements. The performance commitment is to deliver improvements in biodiversity on company land by funding other organisations. However, we are amending the outcome delivery incentives such that the company also has underperformance payments, in line with the methodology and consistent with our proposals for other companies.

We set out in our PR19 methodology that we expect companies to reflect their customers' preferences in the levels they propose for performance commitment levels and outcome delivery incentives. We also expected companies to challenge the level of stretch in their performance commitments against a range of approaches (for example, against comparative and historical information). In our PR19 methodology we also expected companies to use customer valuations to set outcome delivery incentive rates and noted that we would compare these valuations and rates and challenge companies where appropriate. Therefore, when making our decisions, we have taken into account several factors in setting our final determination outcome delivery incentive rates including the quality of customer

evidence provided. Our suite of final determination documents explains the rationale for our decisions, including the evidence used to inform our decisions.

2.2 Performance commitments and outcome delivery incentives

Portsmouth Water's performance commitments and outcome delivery incentives for the 2020-25 period are listed in table 2.2 and table 2.3. The full details of these performance commitments and outcome delivery incentives are set out in the 'Portsmouth Water - Outcomes performance commitment appendix'.

The key changes we are making in the final determination are set out in table 2.1[4] below. 'Portsmouth Water – Delivering outcomes for customers final decisions' sets out our final decisions in terms of changes to our draft determination for the company's performance commitments and outcome delivery incentives, having considered stakeholder and company representations to our draft determination.

[4] Please note, table 2.1 focuses on policy changes and does not include changes made to correct errors in our draft determinations or changes made as a consequence of other amendments such as updating enhanced outcome delivery incentive rates for amendments to standard outcome delivery incentive rates using the same methodology and approach as at draft determinations.

Table 2.1: Summary of key changes to draft determinations on outcomes

Key changes
Increasing the water supply interruptions 2024-25 level (making it easier to achieve) to five minutes, with an amended glidepath in the first four years taking account of wider evidence to calibrate the stretch of the performance commitment for an efficient company. We reduce the underperformance rate to be symmetrical with its outperformance rate. Together these two changes provide a more balanced spread of incentives and risks on water supply interruptions.
Increasing the performance commitment levels for mains repairs by a reducing percentage, for all companies, in all years, reducing the stretch. The aim is to allow all companies the flexibility to deliver the step change in leakage reduction, allowing more flexibility in the earlier years to use proactive mains repairs to reduce leakage.
Adjusting the deadband on the compliance risk index (CRI, which measures compliance with the Drinking Water Inspectorate's (DWI's) water quality standards) to a score of 2.00 throughout the period reducing the risk of underperformance payments in the last three years of the 2020-25. This allows more flexibility in performance to take into account the uncertainty created by the ban on the use of metaldehyde being overturned by the High Court and also aligns with the median level of current company performance.
Accepting outperformance payments in relation to biodiversity reward to reflect customer priorities.
We are amending the company's leakage performance commitment level from 20% reduction by 2024-25 to 15.2% consistent with the wider sector challenge to reduce leakage with base cost allowances and since the company is proposing to achieve at least a 15% improvement on PR14 levels and so that it can earn outcome delivery incentives, if it improves performance beyond stretching levels, to fund further service improvement including Water Resource Management Plan levels where these go beyond the performance commitment level. We note the company is meeting its leakage levels in PR14.

Table 2.2: Summary of performance commitments: common performance commitments

Name of common performance commitment	Type of outcome delivery incentive			
	Financial			Reputational
	Under	Out	In-period	
Water quality compliance (CRI) [PR19PRT_PRT-Network Plus-01]	X		X	
Water supply interruptions [PR19PRT_PRT-Network Plus-02]	X	X	X	
Leakage [PR19PRT_PRT-Network Plus-07]	X	X	X	
Per capita consumption [PR19PRT_PRT-Water Resources 03]	X	X	X	
Mains repairs [PR19PRT_PRT-Network Plus-03]	X		X	
Unplanned outage [PR19PRT_PRT-Network Plus-04]	X		X	
Risk of severe restrictions in a drought [PR19PRT_PRT-Water Resources-04]				X
Priority services for customers in vulnerable circumstances [PR19PRT_PRT-Retail-05]				X
C-MeX: Customer measure of experience [PR19PRT_PRT-Retail-01]	X	X	X	
D-MeX: Developer services measure of experience [PR19PRT_PRT-Network Plus-11]	X	X	X	

Table 2.3: Summary of performance commitments: bespoke performance commitments

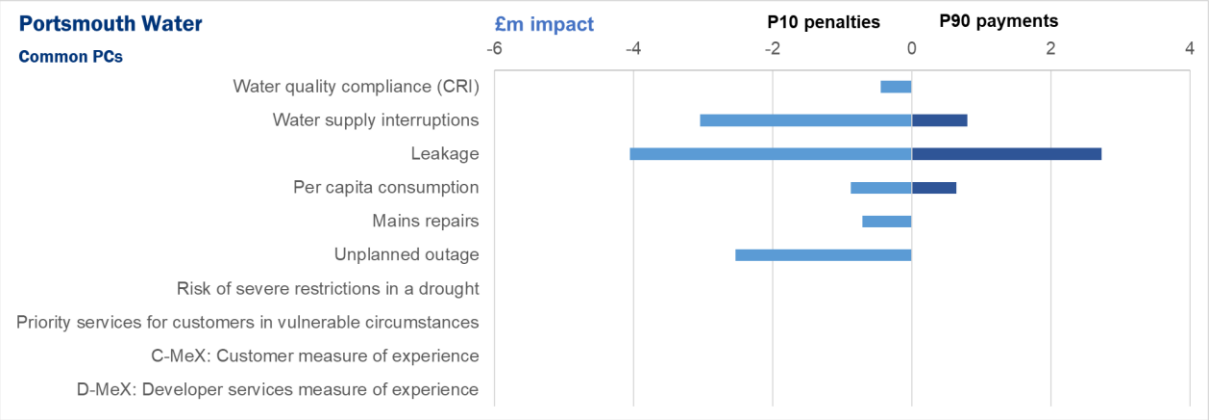
Name of bespoke performance commitment	Type of outcome delivery incentive				
	Financial				Reputational
	Under	Out	In-period	End of period	
Water quality contacts [PR19PRT_PRT-Network Plus-06]	X		X		
Low pressure [PR19PRT_PRT-Network Plus-05]	X		X		
Catchment Management [PR19PRT_PRT-Network Plus-08]	X	X	X		
Abstraction Incentive Mechanism [PR19PRT_PRT-Water Resources-02]	X	X	X		
Biodiversity (reward) [PR19PRT_PRT-Water Resources-01]	X	X		X	
Biodiversity (penalty) [PR19PRT_PRT-Water Resources-06]	X		X		
Voids [PR19PRT_PRT-Retail-02]	X	X	X		
Affordability [PR19PRT_PRT-Retail-03]	X		X		
Resilience schemes to ensure peak demands can be met [PR19PRT_PRT-Network Plus-12]					X
Avoidance of water supply restrictions [PR19PRT_PRT-Water Resources-05]					X
Carbon [PR19PRT_PRT-Network Plus-09]					X
Addressing Vulnerability [PR19PRT_PRT-Retail-04]					X
RoSPA [PR19PRT_PRT-Network Plus-10]					X
WINEP Delivery [PR19PRT_NEP01]					X
Water Industry National Environment Programme [PR19PRT_NEP02]	X		X		
Havant Thicket [PR19PRT_15]	X			X	

Figure 2.1 and figure 2.2 provide an indication of the financial value of each of Portsmouth Water's outcome delivery incentives (taking into account the impact of our final determination decisions) showing how much the company would have to return to customers if it underperformed to the P10 level and how much the company would gain if it outperformed to the P90 level. The P90 is the performance threshold at which there is only a 10% chance of outturn performance being better. The P10 is the performance threshold at which there is only a 10% chance of outturn performance being worse.

The figures cover common and bespoke commitments respectively. The estimates are based on the company's own view of the plausible bounds of performance submitted in its April 2019 submission. Where we have changed service levels for performance commitments, we have amended these estimates so that the distance between the service level and estimate remains the same.

Our analysis has built on the estimates companies have provided, but there is a range of plausible estimates of what may happen in plausible worst case (P10) and plausible best case (P90). There is inherent uncertainty in forecasting these parameters and the figures presented should be seen as indicative of the likely range of financial impacts for each performance commitment.

Figure 2.1: Projected P10 underperformance payments and P90 outperformance payments for common performance commitments over 2020-25 (£ million)



P10 underperformance payments and P90 outperformance payments for C-Mex: Customer measure of experience and D-Mex: Developer services measure of experience are not shown in this figure but are shown in table 5.1 below.

Figure 2.2: Projected P10 underperformance payments and P90 outperformance payments for bespoke performance commitments over 2020-25 (£ million)

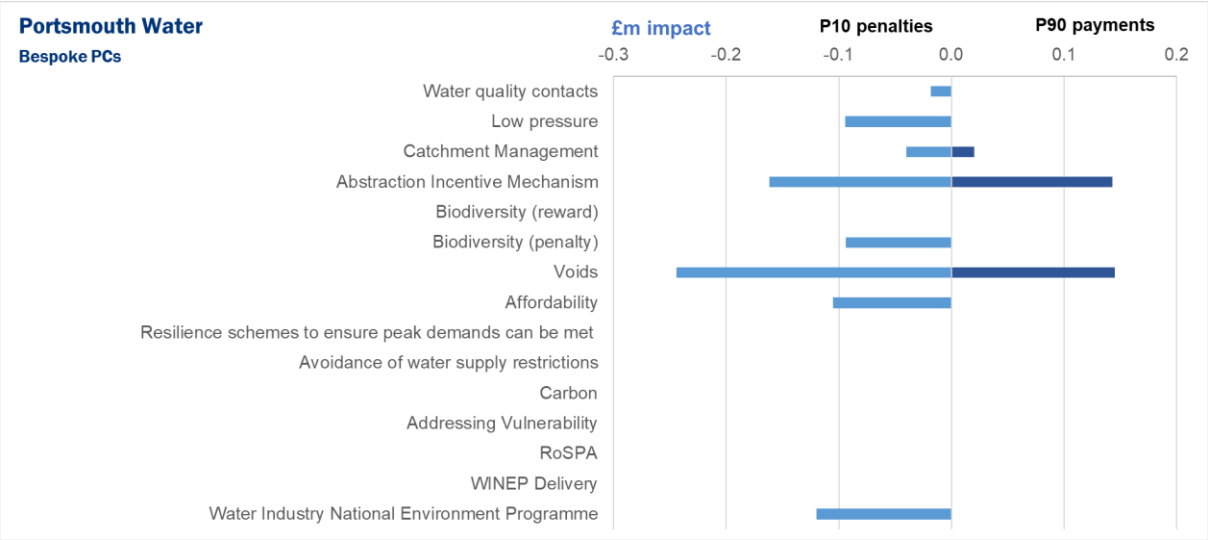


Table 2.4 provides an indication of the financial value of the overall package at the upper and lower extreme levels of performance (expressed as a percentage point impacts on RoRE (return on regulatory equity)) and the overall impact of our final determination decisions. Further information on how we have calculated these values is set out in the 'Delivering outcomes for customers policy appendix'.

Table 2.4: Impact of draft determination and final determination decisions on RoRE range

	Draft determination		Final determination	
	% of 5 year regulatory equity		% of 5 year regulatory equity	
	P10	P90	P10	P90
Portsmouth Water	-2.73	+0.92	-1.64	+1.28

The figures in the above tables are estimates. In the PR19 methodology we said that we expect companies to propose approaches to protect customers in case their outcome delivery incentive payments turn out to be much higher than expected. We asked companies, in our initial assessment of business plans 'PR19 initial assessment of plans: Delivering outcomes for customers policy appendix', to put in place additional protections for customers where we considered protections were not adequate.

We are applying caps and collars to financially material and/or highly uncertain performance commitments and allowing caps and collars on other performance commitments where company proposals are supported by high quality customer engagement. Where, through these reasons, the vast majority of companies have caps and collars on a common performance commitment, we will apply caps and collars to all companies.

We are applying a standard sharing mechanism for all companies, where 50% of outperformance payments that exceed 3% of return on regulatory equity (RoRE) in any year are shared with customers through bill reductions in the following year. We set out further detail of the mechanism in the 'Delivering outcomes for customers policy appendix'.

In our PR19 methodology, we decided to replace the existing service incentive mechanism with two new common performance commitments to incentivise companies to provide an excellent experience for residential customers (our customer measure of experience, or C-MeX) and developer services customers (our developer services measure of experience, or D-MeX). C-MeX and D-MeX will operate from April 2020 and incentivise companies to improve their performance relative to other water companies and the wider economy.

We set out further details on how C-MeX and D-MeX will operate in the 2020-25 period, including any changes from draft determinations, in the 'Customer measure of experience (C-MeX) and developer services measure of experience (D-MeX) policy appendix'.

2.3 Delivering a framework for resilience in the round

Resilience is one of our four themes for PR19. We set out our expectations for water companies' business plans in our PR19 methodology. Overall, Portsmouth Water's September 2018 business plan falls short of demonstrating that the company has applied an integrated resilience framework that will deliver resilience in the round. It does however provide sufficient evidence that the company has considered a wide range of risks, and provides clear and transparent evidence of the company's approach to risk assessment and prioritisation.

We recognise that it may take some time for companies to fully understand best practice approaches to resilience in the round and implementing a systems-based approach to resilience. In our initial assessment of business plans, we set Portsmouth Water an action (PRT.LR.A2) to develop a resilience action plan which demonstrates that it has a framework in place to deliver resilience in the round, and

to submit this to us by 22 August 2019. We expected the resilience action plan to build upon the feedback that we provided following our initial assessment of the business plan.

Portsmouth Water's resilience action falls significantly short of our expectations in many areas. In particular, we are concerned that:

- the action plan is very high level and does not provide sufficient detail to give us confidence that it provides a framework capable of delivering resilience in the round. We expect the resilience action plan to provide a detailed framework, including clear governance and accountable owners for actions, capable of delivering resilience in the round;
- a maturity assessment has not been conducted therefore it is difficult to determine the extent to which the actions identified target the right areas for improvement. We expect the company to clearly demonstrate how its action plan is influenced by an understanding of its baseline maturity; and
- the company does not address our feedback from the initial assessment of business plans but states it has plans to do so. We expect the company to clearly respond to our feedback and demonstrate how this informed the development of its action plan.

Overall, Portsmouth Water, along with the sector, has further work to do to implement a fully integrated resilience framework. The company should continue to work with the sector, with Ofwat, and across sectors to incorporate best practice and address the concerns highlighted about its resilience framework above. Ofwat plans to engage the sector through its strategy to encourage further joint development of resilience approaches to accelerate best practice through the industry. We also may consider the progress companies have made as part of assessing company business plans in the 2024 price review.

3 Cost allowances

Key changes from the draft determination

- Our final determination allowance for Portsmouth Water is £176.2 million for the wholesale services, excluding Havant Thicket. This compares with £172.8 million at draft determination. In retail, our final determination allowance is £21.3 million, compared with £21.9 million at draft determination.
- Our base allowance is affected by a number of changes we have made since draft determinations:
  - we include company outturn data from 2018-19 in our econometric models;
  - we exclude non-section 185 diversions costs (i.e., diversions other than those required by section 185 of the Water Industry Act 1991) from our econometric models and allow companies to recover related income outside the price control, from the relevant transport authority;
  - we strengthen the catch-up challenge applied to wholesale modelled base costs. We use the 4th placed company as an efficiency benchmark, rather than the 5th place (upper quartile) company at draft determinations;
  - we reduce the frontier shift challenge from 1.5% per year to 1.1% per year, but we extend it to all wholesale base costs.
- We cap our combined allowance for water resources and water network plus at 10% above that requested by the company.

Throughout price review 2019 we set out that we expect companies to demonstrate an increase in cost efficiency. In our final determinations, we set a cost-outcomes package that provides a strong incentive for companies to invest and operate efficiently and at the same time deliver a marked improvement in their level of performance, particularly on outcomes that matter to customers and the environment. Our cost-outcomes package is demanding but achievable. It will incentivise companies to innovate, which will pave the way for a more efficient, higher performing sector, with more meaningful, trusted relationship with customers.

Portsmouth Water submitted a business plan for 2020-25 that is efficient in wholesale water. Due to our incentive based approach to setting allowances, and that the company helps set an efficiency challenge for the rest of the sector, we are allowing the company 10% more than the costs it requests for wholesale water services. In residential retail, the company's requested costs are less efficient than our efficiency benchmark and we challenge Portsmouth Water's proposed costs to ensure customers pay only for efficient costs. We make an allowance of £61.4 million for the 2020-25 period within the separate price control for the delivery of

Havant Thicket reservoir and transfer infrastructure, for the transfer of water to Southern Water. We intervened to create the separate control at draft determination in consideration of Portsmouth Water's role to secure long-term resilience to drought in the western area. We provide further details in the 'Havant Thicket appendix'.

Overall, our allowance for Portsmouth Water is £6.1 million higher than at draft determination.

At draft determinations we allowed Portsmouth Water 14% above the costs that it requested for wholesale water services (i.e., water resources and water network plus). Changes to our data and modelling approach since draft determinations revised our efficiency benchmark and implied that Portsmouth Water would get 16% more than requested. At final determinations, we intervene by capping the excess cost allowance in wholesale water for Portsmouth Water at 10%5. While we set out in our PR19 methodology that we do not intend to apply a cap as we did at PR14, we said that it would be inappropriate for us to rule out the use of capping if appropriate to protect the interests of customers. Our 10% cap for Portsmouth Water leaves considerable reward for its efficient business plan. We consider this strikes a balance between protecting customer interests while also retaining the incentive for the company to submit stretching business plans in future price reviews. At PR14 we intervened to cap our excess allowances at 5% above requested costs.

Our approach to setting total expenditure (totex) allowances is detailed in our publication 'Securing cost efficiency technical appendix'. In addition to challenging companies to be more efficient we have also, where appropriate, set safeguards to protect customers if specific investments are not delivered as planned.

In the 'Portsmouth Water – Cost efficiency final determination appendix' we provide more detailed information on our cost challenge for enhancement expenditure, our allowance for cost adjustment claims and transitional expenditure and our unit cost adjustments related to uncertain schemes in WINEP.

3.1 Allowed expenditure for wholesale services

Table 3.1 shows total expenditure (totex) allowances by year and by wholesale price control for the period 2020-25. We phase our allowed totex over 2020-25 using the company business plan totex profile.

[5] This cap of excess cost allowance is applied on base and enhancement expenditure. That is, it excludes pension deficit recovery costs, third party costs, and costs for strategic regional water resources development where relevant (See Table 3.3).

Table 3.1: Totex[1] by year for wholesale controls, 2020-25 (£ million, 2017-18 CPIH deflated prices)

	2020-21	2021-22	2022-23	2023-24	2024-25	Total	Company August 2019 - total
Water Resources	7.3	5.6	5.3	6.7	6.4	31.3	29.0
Water network plus	29.0	29.3	29.7	28.5	28.5	145.0	138.1
Havant Thicket	10.1	6.1	7.1	17.6	20.4	61.4	65.3
Total	**46.4**	**41.0**	**42.1**	**52.9**	**55.3**	**237.6**	**232.4**

[1] Totex includes all costs. This includes pension deficit recovery costs, third party costs, operating lease adjustments, allowances related to the development of strategic regional water resource solutions and costs that are assumed to be recovered through grants and contributions.

Table 3.2 sets out the components of our totex allowance. The main components are base and enhancement costs. Base expenditure refers to routine, year on year costs, which companies incur in the normal running of their business to operate, maintain and incrementally improve service to customers. Enhancement expenditure refers to investment for the purpose of enhancing the capacity or quality of service beyond base level.

Our base costs for wholesale water include operating and maintenance costs, as well as costs associated with the connection of new developments (i.e., new developments and new connection costs) and costs for addressing low pressure.

We adjust allowed costs to reflect a change in the accounting treatment of leases as discussed in the 'Securing cost efficiency technical appendix'. We use the adjustment to operating costs that the company proposed in its business plan. The company proposes no adjustment in its business plan.

Our draft determination allowance included all revenues and costs in relation to diversions. This approach was criticised by companies who said that it did not take into account forecast step changes in diversions costs for some companies as a result of large infrastructure projects such as High Speed 2 (HS2). Following our draft determinations consultation, we exclude revenue relating to diversions other than those required by section 185 of the Water Industry Act 1991 ('non-section 185 diversions').

Non-section 185 diversions costs are included in table 3.2. Companies will be able to recover most of the non-section 185 diversions costs directly, usually from transport authorities, outside of the price control. This is in addition to our total revenue allowance.

Table 3.2: Totex by wholesale price control and type of cost, 2020-25 (£ million, 2017-18 CPIH deflated prices)

	Water resources	Water network plus	Havant Thicket	Total
Base expenditure	25.5	138.0		163.6
Enhancement expenditure	6.8	12.0		18.8
Operating lease adjustment	-	-		-
Gross allowed totex for calculation of cost sharing rates	32.3	150.1	61.4	243.8
Strategic regional water resources solutions and other cash items	-	-		-
Third party costs	-	1.2		1.2
Non-section 185 diversions	-	-		-
Ex-ante cost sharing adjustment	-1.1	-6.3		-7.4
Gross totex	31.3	145.0	61.4	237.6
Grants and contributions after adjustment for income offset[1]	-	5.3		5.3
Net allowed totex used in PAYG calculation	31.3	139.6		232.3
Pensions deficit recovery costs[2]	-	-		-
Total	**31.3**	**139.6**	**61.4**	**232.3**

[1] Includes price control and non-price control grants and contributions.
[2] We are displaying pension deficit recovery costs separately as they are not included in the calculation for PAYG (see section 4).

Movement in allowed wholesale expenditure between draft and final determinations

Table 3.3 compares our totex allowance at final determination to our allowance at draft determination. The table only includes base and enhancement expenditure. That is, it excludes pension deficit recovery costs, third party costs, and costs for strategic regional water resources development where relevant.

Following the change in approach to non-section 185 diversions costs discussed above, for final determinations, our allowance also excludes non-section 185 diversions costs of the amount stated in table 3.2. Our draft determinations allowance does not exclude these costs.

Table 3.3 also provides the company's requested costs in its April 2019 submission, and its revised requested costs in August 2019, in response to our draft determinations for slow-track companies. Table 3.4 provides further detail.

Table 3.3: Totex by service, 2020-25 (£ million, 2017-18 CPIH deflated prices)

Price Control	Company April 2019	Company August 2019	Draft determination allowance	Final determination allowance
Wholesale water	165.8	165.8	189.0	182.4
Havant Thicket	65.5	65.3	58.8	61.4

Table 3.4: Totex by type of cost, 2020-25 (£ million, 2017-18 CPIH deflated prices)

	Draft determination allowance	Final determination allowance
Base expenditure	170.1	163.6
Enhancement	18.8	18.8
- Environmental obligations (WINEP)	4.1	4.1
- Supply-demand balance and metering enhancement	7.9	7.9
- Resilience enhancement	1.2	1.2
- Other enhancement (e.g. investment to address raw water deterioration and to meet lead standards)	5.6	5.6
Havant Thicket	58.8	61.4

3.2 Wholesale base expenditure

Table 3.5 shows a comparison between the company's requested and our allowed base expenditure.

Table 3.5: Base expenditure, 2020-25 (£ million, 2017-18 CPIH deflated prices)

Price Control	Company August 2019	Final determination allowance
Water Resources	21.5	25.5
Water Network plus	121.3	138.0
Total	**142.8**	**163.6**

Company business plan base costs exclude enhancement opex.

Due to our incentive based approach to setting allowances and to the company helping to set an efficiency challenge for the rest of the sector, the company receives a higher base allowance than requested. This is because we assess Portsmouth Water's 2020-25 base expenditure as efficient.

For final determinations, we retain our approach of including growth related expenditure in our base econometric models. We have also made an adjustment depending on whether the company operates in an area with a relatively high or low forecast of population growth, relative to the historical average for the sector. This follows representations made at draft determinations that the models did not adequately compensate for companies with a high growth forecast. We also consider that the models overcompensate for companies that operate in an area with a low growth forecast. We consider that using the symmetrical adjustment approach set out in our PR19 methodology best accommodates for these factors.

3.3 Enhancement expenditure

For wholesale enhancement expenditure we challenge the scope of work, the evidence provided to support solution options and the efficient delivery of programmes. We cost benchmark with the rest of the industry where we can. In particular, we challenge the expenditure proposed by Portsmouth Water for its resilience programme.

Table 3.6 summarises our allowances for enhancement expenditure.

Table 3.6: Enhancement expenditure, 2020-25 (£ million, 2017-18 CPIH deflated prices)

Price Control	Company August 2019	Final determination allowance
Water Resources	7.4	6.8
Water Network plus	15.6	12.0
Total wholesale	**23.0**	**18.8**

Our final determination allows Portsmouth Water £18.8 million to invest in improvements to service, resilience and the environment. Our enhancement allowance for Portsmouth Water is unchanged from the draft determination. Key parts of our allowance are:

- £4.1 million to improve the environment by efficiently delivering its obligations as set out in the whole WINEP programme including expenditure on Drinking Water Protected Areas and eels regulations;
- £5.5 million to address the impact of deteriorating raw water quality;
- £5.2 million for new meter installations; and
- £1.2 million for resilience enhancement.

Our final determination also allows expenditure for Portsmouth Water to build Havant Thicket reservoir to displace water it can then supply to Southern Water.

Below we discuss key areas of our determination on enhancement cost proposals. Our document 'Portsmouth Water - Cost efficiency final determination appendix' sets out in more detail the cost allowances by investment area for each price control, and we give full reasoning in our published cost assessment models (enhancement feeder models and cost claims feeder models).

Metering

We use a benchmark model to make allowances for installing new meters. Portsmouth Water's costs are more efficient than our benchmarks and we allow in full the £5.2 million the company requests. The final determination allowance we make is unchanged from the draft determination allowance.

Resilience

Our draft determination for water resilience enhancement allowed Portsmouth Water to invest £1.2 million to maintain supplies to customers in the event of: pollution of its

groundwater sources; failure of a critical main between Hoads Hill and Gosport and; failure of a main from Nelson to Waterlooville and Lovedean We did not make an allowance for mitigation of failures at treatment assets within Farlington water treatment works (£1.3 million).

The company does not raise substantive issues on its draft determination allowance for the investments to mitigate pollution of groundwater sources; failure of the mains between: Hoads Hill and Gosport or; Nelson to Waterlooville and Lovedean. It provides additional information about its proposals at Farlington.

We maintain our draft determination decision to not make an allowance to mitigate failures at Farlington treatment works. The company provides insufficient evidence to demonstrate that the anticipated failures are beyond management control. Furthermore, it does not provide sufficient and convincing evidence that the majority of this investment is not for renewing a main which is base activity.

As a result of the above, our final determination allowance for water resilience enhancement remains £1.2 million.

Leakage

We expect an efficient company to achieve its stretching performance commitments from our base allowance. Only where the company's performance commitment goes beyond the industry forecast upper quartile leakage performance, do we make an enhancement allowance for leakage reduction. As this is not achieved by Portsmouth Water, our allowance is unchanged from draft determination and we do not allow any of the requested £1.5 million under enhancement. In 'Securing cost efficiency technical appendix' we set out our policy on the funding of leakage reduction costs, including how we derive the upper quartile threshold for leakage enhancement costs.

3.4 Havant Thicket separate control

We are retaining our intervention to set a new separate revenue control for the development of the Havant Thicket reservoir covering ten years. The separate price control will limit the amount that Portsmouth Water can charge its customers in respect of activities relating to the development of the Havant Thicket reservoir. Aligning with the construction period of the reservoir, our ten-year control:

- aids transparency;
- enables greater regulatory oversight;

- maintains continuity of incentives for efficiency throughout the construction period, aligned to our approach to cost and risk sharing; and
- enhances customer protection, recognising that it would be inappropriate for Portsmouth Water's customers to underwrite the development of the project.

We provide further details of the revenue control in the 'Havant Thicket appendix'.

Table 3.6a: Enhancement totex expenditure for Havant Thicket, 2020-30 (£ million, 2017-18 CPIH deflated prices)

Service	Company August 2019	Final determination allowance
Havant Thicket	130.9	123.6

Portsmouth Water disagreed with our £13.8 million disallowance of expenditure at draft determination in the proposed ten year control for delivering Havant Thicket reservoir and associated transfer infrastructure. However, it accepts an efficiency challenge of £1.6 million related to the project costs for the network reinforcement necessary to facilitate the water transfer. Southern Water's representation provides a review of Portsmouth Water's expected construction costs for the Havant Thicket reservoir. The review supports the high level cost estimation approach followed by Portsmouth Water, but highlights scope for cost efficiency on several specific components of the project. The review suggests that the reservoir element could be delivered for £13.4 million less than Portsmouth Water's April 2019 business plan estimate.

We set a ten year cost allowance of £123.6 million for final determination (£61.4 million in 2020-25), including transitional expenditure of £5.2 million in the allowance for 2020-21. We challenge the company's costs in areas such as design and project management, scheme risk uncertainty and transfer infrastructure, where we consider it provides insufficient evidence to justify the costs it presents. This results in an overall efficiency challenge of £11.7 million on the company's requested costs at draft determination. We also intervene to introduce a cost adjustment mechanism linked to planning and procurement gateways. Cost performance is shared equally between Portsmouth Water shareholders and Southern Water. Portsmouth Water's customers do not bear cost performance risk. We include further detail of our cost assessment in the cost adjustment claim feeder model Havant Thicket (PRT) separate control and more information on the cost adjustment mechanism in the 'Havant Thicket appendix'.

3.5 Cost sharing

In the water resources and water network plus controls we have a cost sharing arrangement. In these controls, when a company overruns its totex allowance, the additional cost incurred above our allowance will be shared between its investors and customers. When a company spends less than its totex allowance, it will share the benefits with customers.

For the draft determinations we calculated each company's cost sharing rates based on the ratio of the company's view of costs in its September 2018 business plan relative to our view of efficient costs. For the final determinations, we calculate the company's view of costs based on a 50% weight on the company's final cost proposals in its August 2019 representation to the draft determination and 50% weight on the September 2018 business plan. We explain our approach to calculating cost sharing rates in the 'Securing cost efficiency technical appendix'.

Table 3.7 sets out the cost sharing rates for PR19 and net totex that is subject to cost sharing at the end of the 2020-25 period. We calculate cost sharing rates based on totex gross of grants and contributions (but after making adjustments for operating leases and excluding costs of strategic regional water resources development costs, third party costs and pension deficit recovery costs). At the end of the 2020-25 period, we will apply cost sharing to totex net of grants and contributions.

For final determination we introduce an uncertainty mechanism for business rates and abstraction charges. Under the uncertainty mechanism these costs are subject to different cost sharing rates. We discuss the uncertainty mechanism in section 4.4.5. Our allowance for business rates and abstraction charges costs are excluded from table 3.7.

Table 3.7 does not apply to the Havant Thicket separate control. We explain our approach to cost sharing arrangements for the Havant Thicket separate control in 'Havant Thicket appendix'.

Table 3.7: Cost sharing rates for 2020-25 and totex for end-of-period reconciliation

	Water resources	Network plus – water
Totex for cost sharing rates – September 2018 business plan	30.3	131.6
Totex for cost sharing rates – August 2019	29.0	136.8
Weighted company view of totex for cost sharing rates	29.7	134.2
Gross allowed totex for cost sharing rates	32.3	150.1
Cost sharing ratio	0.90	
Cost sharing rate – outperformance	60%	
Cost sharing rate – underperformance	50%	
Grants and contributions before the deduction of income offset	-	5.3
Abstraction charges and business rates[6]	8.4	8.0
Net allowed totex subject to cost sharing reconciliation[7]	**23.9**	**136.7**

3.6 Allowed expenditure in residential retail

Table 3.8 sets out our total expenditure allowance for residential retail. Our allowance does not include any of our allowed pension deficit recovery costs. These costs have been wholly allocated to wholesale controls.

Portsmouth Water submits a cost adjustment claim of £1 million, related to low average bill size in its area. The company has the lowest average bill size across all companies by a relatively significant margin. It argues our econometric models, which use average bill size as a cost driver, do not adequately capture the effect of average bill size at the low end of the range, and consequently underestimate its expenditure requirements. We find a lack of strong and convincing evidence that

[6] Amendment to Abstraction charges and business rates (£m) for Water resources and for Network plus – water
[7] Amendment to Net allowed totex subject to cost sharing reconciliation (£m) for Water resources and for Network plus – water

Portsmouth Water is materially disadvantaged by the inclusion of bill size as a cost driver and therefore do not make an adjustment to the company's cost allowance.

Table 3.8: Expenditure, residential retail, 2020-25 (£ million, nominal)

	2020-21	2021-22	2022-23	2023-24	2024-25	Total
Residential retail	4.1	4.2	4.3	4.3	4.4	21.3
Company view	4.6	4.6	4.7	4.7	4.8	23.5

Note the residential retail control is an average revenue control. Allowed cost and the associated allowed revenue is based on a forecast of the number of customers. There will be an end-of-period true up based on the actual number of connected households.

3.7 Direct procurement for customers

We set out in our PR19 methodology that we expect company business plans to consider direct procurement for customers where this is likely to deliver the greatest value for customers. Direct procurement for customers promotes innovation and resilience by allowing new participants to bring fresh ideas and approaches to the delivery of key projects. Companies are to consider direct procurement for customers for discrete, large-scale enhancement projects expected to cost over £100 million, based on whole-life totex.

The company provides sufficient evidence that the Havant Thicket reservoir is technically suitable for a direct procurement for customers process within Portsmouth Water's business plan. We considered the evidence provided on the limited financial benefits of delivery through a direct procurement for customers process and weighed them against the potential risks associated with late delivery of the scheme and the impact on customers under a direct procurement for customers process. We have determined, as we explain further in 'Havant Thicket policy issues appendix', that the Havant Thicket reservoir is best delivered in a separate price control using a traditional in-house procurement to protect customer interests and provide greater transparency.

We expect any other major schemes which may arise due to significant changes to Portsmouth Water's business plan to be reviewed against the direct procurement for customers' criteria, as detailed in the PR19 methodology. If the criteria are met, we expect Portsmouth Water to undertake further work to review detailed costs and commitments to ensure delivery is via the most efficient route, and to assess delivery via direct procurement for customers, to ensure that customers receive the best value.

4 Calculation of allowed revenue

Key changes from the draft determination

The key changes we are making to the calculation of allowed revenue in the draft determination are:

- We allow £192.8 million of revenue across all price controls for Portsmouth Water in the final determination, compared to £181.2 million in the draft determination and £193.8 million in the company's April 2019 revised business plan.
- The allowed return on capital for the wholesale price controls is 2.92% for the sector (on a CPIH basis, 1.92% on a RPI basis). For Portsmouth Water we have included a company-specific adjustment to the allowed return on debt, uplifting the allowed return for the water resources and water network plus wholesale controls equivalent to 3.11% (on a CPIH basis, 2.11% on a RPI basis). The allowed retail margin for the household retail control remains at 1.0%, consistent with the draft determination.
- We apply the allowed return on capital for the sector to the Havant Thicket price control.
- Taking account of company representations, we revise our approach to determine the mix of operating and capital expenditure to take better account of the nature of our decisions on cost allowances. We apply the updated approach in our technical intervention to PAYG rates.
- We maintain an uplift to PAYG rates to address a notional financeability constraint. However we amend the adjustment to bring forward allowed revenue by £0.9 million.
- Allowed revenue includes Portsmouth Water's contribution to the innovation competition.
- We revise our approach to calculating grants and contributions.
- We reflect Portsmouth Water's latest information on its actual performance in 2018-19 and expected performance in 2019-20 from its 15 July submission.
- We continue to exclude the claim for additional revenue within the wholesale revenue forecasting incentive mechanism, to correct the error the company made in completing the PR14 business plan. We consider Portsmouth Water does not provide sufficient evidence that there was an unambiguous error in its reporting and that the adjustments to correct them are appropriate. We explain our assessment in detail in 'Portsmouth Water - Accounting for past delivery additional information.' Taking account of the company's latest information, we are reducing revenue by £1.8 million compared to the draft determination.

This section sets out the calculation of allowed revenue for each of the price controls, based on our assessment of efficient costs. We set out in section 4.1 the components of allowed revenue for each of the price controls. We then set out information relevant to the calculation of the components of that allowed revenue in sections 4.2 and 4.4.

4.1 Allowed revenue

We calculate revenue separately for each of the wholesale controls and for the residential retail control. We set out the calculation of five year revenues for each of these controls in this section.

Wholesale controls

For the wholesale controls (that is water resources, water network plus, and Havant Thicket), allowed revenue is calculated based on the following elements. Not all elements are applicable to all wholesale controls, as set out in table 4.1.

- Pay as you go (PAYG) – this reflects the allocation of our efficient totex baseline to costs that are recovered from revenue in 2020-25. The proportion of totex not recovered from PAYG is added to the regulatory capital value (RCV) which is recovered over a longer period of time.
- Allowed return on capital – this is calculated based on our assessment of the allowed return on capital multiplied by the average RCV for each year.
- RCV run-off – this reflects the amount of RCV that is amortised from the RCV in the period of the price control.
- PR14 reconciliations – this reflects the application of out/underperformance payments from PR14 through revenue adjustments in 2020-25.
- Corporation tax allowance – this is estimated from projected corporation tax rates, profit forecasts and assumed levels of tax relief contained in our financial model for the draft determination.
- Grants and contributions – this represents revenue that we expect to be received from developers in respect of work undertaken by companies to service new developments. It includes income from connection charges, infrastructure charges and s185 diversion recharges. The total grants and contributions amount deducted from totex may not agree to this amount, as we only include grants and contributions income relating to the price control (and some income is outside the price control).
- Non-price control income – income from charges excluded from the price controls. For example, this includes bulk supplies, standpipes, unmeasured cattle

troughs, and other services. In a change from our draft determination, we also now include diversions recharges which are in respect of the New Roads and Street Works act 1991 activities and other non-section 185 diversions. We deduct the forecast income from these charges from the allowed revenue, because costs relating to these charges are included in the calculation of allowed revenue.

- Innovation competition – this represents the additional revenue that the company will collect from its customers for the purpose of a collectively funded innovation competition for the period 2020-25. The amount each company's customers will contribute will be proportionate to individual company revenue at draft determinations. We expect the revenue collected from customers to be ring-fenced and administered so that it will not be used for purposes other than the innovation competition.
- Revenue re-profiling – this reflects the change in revenue in 2017-18 prices as a result of adjustments made to annual revenues to smooth the final bill profile consistent with customer preferences. The financial model calculates revenue adjustments on a net present value (NPV) neutral basis.

We set out the calculation of the allowed revenue for Portsmouth Water's wholesale controls in table 4.1. We summarise the total of the build up of allowed revenue as five year totals, however our financial model calculates the allowed revenue on an annual basis for the purposes of our draft determination. We state the allowed revenue for each price control on an annual basis in section 6.

We explain how we calculate PAYG, RCV run-off and the allowed return on capital in section 4.2, the revenue adjustments for PR14 reconciliations in section 4.3, and other elements of allowed revenue in section 4.4.

Table 4.1: Calculation of allowed revenue (£ million)

	Water resources	Water network plus	Havant Thicket	Total – Final determination	Total - Draft determination
Pay as you go	25.6	96.0	0.0	121.6	108.2
RCV run-off	1.4	33.3	1.5	36.2	37.0
Allowed return on capital	0.9	19.8	3.5	24.3	25.7
Revenue adjustments for PR14 reconciliations	0.0	-8.8	0.0	-8.8	-5.9
Fast track reward	0.0	0.0	0.0	0.0	0.0
Tax	0.0	0.0	0.0	0.0	0.1
Grants and contributions after adjustment for income offset (price control)	0.0	5.3	0.0	5.3	5.8
Deduct non-price control income	0.0	-3.5	-4.9	-8.5	-12.7
Innovation competition	0.0	0.6	0.0	0.6	0.0
Revenue re-profiling	0.0	0.1	0.0	0.1	0.4
Final allowed revenues	28.0	142.9	0.0	170.8	158.6

We set out the calculation of allowed revenue for each wholesale control on an annual basis in the 'Portsmouth Water - Allowed revenue appendix' in tables 1.1 to 1.2 and table 6.1 for the ten year Havant Thicket price control.

Allowed revenues for the Havant Thicket control are zero to reflect the income Portsmouth Water will receive from Southern Water under the bulk supply agreement to pay for the project. We have included the revenue for the first five

years of this control in table 4.1 above. Further details are set out in the 'Havant Thicket appendix'.

In our new strategy for regulating water and wastewater companies in England and Wales, we highlight that innovation is crucial for meeting the challenges the sector faces.

The adoption of innovative approaches is key to delivering long-term resilience and great customer service at an affordable price, and the sector will need to step up and increase innovation in order meet the strategic challenges it faces in a cost-effective and sustainable way. We also want to see companies work more effectively together and with their supply chain to better tackle these challenges.

Our outcomes and total expenditure approach facilitate this innovation, by giving companies the flexibility and freedom to adopt innovative means of delivering services. We are promoting innovation by setting Portsmouth Water stretching outcome performance commitments. Our outcome delivery incentives approach means that companies have to return money to customers where they fall short, but it also gives companies the opportunity to earn additional financial payments if they successfully improve performance and deliver for customers above and beyond the level expected of most companies. This encourages companies to look for innovative ways of delivering better services to customers and improving the environment.

However, as well as our existing package of measures which encourages companies to innovate individually, we have been considering how we can stimulate innovation more widely in the sector and encourage collaborative innovation initiatives.

In our new strategy consultation[8], we explored options for customer-funded interventions designed to drive innovation to benefit customers in the longer-term. Having reviewed the responses to the consultation, we are publishing our decision in 'Driving Transformational Innovation in the Water Sector' alongside the PR19 final determinations, confirming that we are making up to £200 million available for innovation activities for the period 2020-25 through the introduction of an innovation competition. We will work together with companies and other stakeholders in the sector to set up a competition which will effectively drive innovation in the sector to the benefit of customers across England and Wales.

[8] Ofwat's emerging strategy: Driving transformational innovation in the sector.

4.1.1 Residential retail control

For the residential retail control, allowed revenue is calculated as:

- Retail cost to serve – this reflects our efficient view of costs per customer for the retail business.
- Net margin on wholesale and retail activities – this is calculated based on the wholesale revenue applicable to residential retail customers, plus the retail cost to serve, with a net margin applied. Net margins are calculated excluding any adjustments to residential retail (see table 4.2 below) – the full calculation is set out in our financial models.
- Our methodology set out an early view of the retail margin that applies for the retail price controls. This was used by Portsmouth Water in its business plan and is unchanged in our final determinations.

Allowed revenue for the residential retail control is set on a nominal basis. We present the make-up of the allowed revenue in nominal prices in table 4.2.

Table 4.2: Retail margins, 2020-25 (nominal price base)

	Draft determination	Final determination
Total wholesale revenue - nominal (£m)	168.3	183.3
Proportion of wholesale revenue allocated to residential (%)	74.5%	74.5%
Residential retail costs (£m)	21.9	21.3
Total retail costs (£m)	**147.3**	**157.9**
Residential retail net margin (%)	1.0%	1.0%
Residential retail net margin (£m)	**1.5**	**1.6**
Residential retail adjustments (£m)[1]	1.4	1.4
Residential retail revenue (£m)[2]	**24.9**	**24.3**

[1] Residential retail adjustments for the PR14 residential retail service incentive mechanism and residential retail revenue reconciliations are set out in table 4.11. The figures in table 4.2 are in nominal prices, and the figures in 4.11 are in 2017-18 FYA CPIH deflated prices. The difference between the two tables is due to the difference in price bases.
[2] Residential retail revenue is the sum of the net margin, retail costs, and adjustments. Company view may not sum as this may include other adjustments.

We set out the calculation of residential retail revenue on an annual basis in the 'Portsmouth Water - Allowed revenue appendix' in table 1.3.

4.2 Cost recovery now and in the long term for the wholesale controls

Our totex cost allowances are sufficient to meet an efficient company's operating and capital expenditure. Companies recover this expenditure either in period from current customers using PAYG or add it to the RCV and recover from future generations of customers using the RCV run-off rates. Consistent with our methodology, we assess how each company's choice of PAYG and RCV run-off rates reflect the levels of proposed expenditure, bill profiles, affordability and customer views relevant to the short and the long term.

To determine the allowed revenue, the PAYG rate is applied to the totex allowance for each wholesale control for each year of the price control. The proportion of the totex allowance that is not recovered in PAYG is added to the RCV and recovered from customers in future periods. For the final determinations we revise our approach to the calculation of PAYG rates to better reflect the source of changes we make to costs claimed by companies as a result of our totex cost assessment. Our revised approach follows a process of further consultation with companies following the submission of representations on the draft determination. We explain our revised approach in 'Securing cost efficiency technical appendix.

In this section we set out our approach to calculating the PAYG rates, the RCV to which the allowed return on capital is applied and the RCV run-off rates.

4.2.1 PAYG in allowed revenue

We calculate total PAYG totex for each year of each wholesale price control based on the totex allowance for each year multiplied by the relevant PAYG rate for that year. To this we add allowed pension deficit recovery costs to derive total PAYG revenue.

We summarise in table 4.3 the average PAYG rates across 2020-25 for each wholesale control, and the calculation of total PAYG revenue. The PAYG rates shown in the table are a weighted average across the five years 2020-25, the annual PAYG revenue and PAYG rates for each wholesale control are shown in the 'Portsmouth Water - Allowed revenue appendix', tables 2.1 to 2.2 and table 6.2 for the ten year Havant Thicket price control.

To PAYG totex we add the allowed costs for pension deficit recovery set out in table 3.2 to derive the total amount to be recovered in 2020-25 for each price control.

Table 4.3: PAYG allowances for each wholesale control (5 year)

	Water resources	Water network plus	Havant Thicket	Total
Totex allowance (£m)	31.3	139.6	61.4	232.3
Final determination PAYG rate (%)	81.8%	68.8%	0.0%	52.3%
Pay as you go totex (£m)	25.6	96.0	-	121.6
Pension deficit recovery cost (£m)	-	-	-	-
Total pay as you go (£m)	**25.6**	**96.0**	**-**	**121.6**

Table 4.4: PAYG rates for each wholesale control (5 year)

	Water resources	Water network plus	Havant Thicket
Company April plan (%)	28.5%	63.5%	N/A
Draft determination (%)	67.3%	64.2%	0.0%
Final determination (%)	81.8%	68.8%	0.0%

Note the company did not propose a separate control for Havant Thicket in its business plan. The equivalent PAYG rate in our final determination for water resources and Havant Thicket together would be 27.6%.

In its revised business plan, Portsmouth Water includes the costs associated with Havant Thicket reservoir in the water resources wholesale control. Portsmouth Water allocates all of the Havant Thicket costs to RCV and none to PAYG in 2020-25. We accepted this approach in our draft determination and adjusted PAYG rates for the water resources control to reflect our proposal to include Havant Thicket as a separate wholesale price control. In its representations, Portsmouth Water confirms that all expenditure relating to Havant Thicket in 2020-25 will accrue to RCV and we have amended Portsmouth Water's licence to allow for the separate Havant Thicket price control. We maintain the approach from the draft determination and set a PAYG rate of 0% for the years 2020-25 for the separate Havant Thicket control for

the final determination. We set out the PAYG rates for the ten years to 2029-30 in the 'Portsmouth Water - Allowed revenue appendix', table 6.2.

In the draft determination, we applied Portsmouth Water's approach to PAYG rates of recovering in each year an amount equivalent to operating costs. In its business plan, Portsmouth Water proposed an increase of 4.8% to PAYG rates for the water resources control (including Havant Thicket expenditure) to improve financial ratios. On the basis of our financeability assessment, we applied an uplift of 0.7% to the water network plus control. The intervention reduced the PAYG revenue advanced to £1 million versus £4.5 million proposed in the April revised plan.

In its representations, Portsmouth Water states that if the final determination includes the return on capital allowed in the draft determination, the company requires an uplift of 3.5% to PAYG rates to improve notional financeability for the core business. Following our assessment of notional financeability for the final determination, we accept the requirement for revenue advancement; however, again we consider a lower uplift is required.

Taking account of company representations, we have revised our approach to the calculation of the mix of operating and capital expenditure following our totex interventions.

In order to calculate the mix of operating and capital expenditure we follow the approach set out in 'Securing cost efficiency technical appendix'. We set out how we apply the technical intervention in the 'Aligning risk and return technical appendix' and we have published our calculation of the PAYG rates for each company alongside our determinations.

We are maintaining the amount of revenue brought forward at £0.9 million through a PAYG adjustment of 0.50% across all controls to increase cash flows in the 2020-25 period and to improve notional financeability. We advance revenue through the use of PAYG rates to align to financial ratios targeted by the company on a notional basis. We set out our financeability assessment in section 5.2.

The movements in PAYG rates between the company plan, the draft determination and final determination reflect the differences in the mix of operating and capital expenditure in our totex allowance along with the increase to PAYG rates for notional financeability in the final determination.

4.2.2 Opening RCV adjustments

As part of its business plan Portsmouth Water proposed allocations of the RCV for water resources price controls based on Ofwat guidance. We are allocating the company's RCV between the existing wholesale control and water resources in accordance with the proportions proposed by Portsmouth Water.

We make reconciliation adjustments ('midnight adjustments') related to the company's performance against incentive mechanisms from previous price reviews and for land sales in order to determine the opening RCV for the period of the PR19 controls. We also adjust the RCV upwards to reflect a change in the accounting treatment of leases, which causes some assets formerly recognised as operating leases to be recognised on the company's Balance sheet. In doing so, we follow the approach set out in IN 18/09 Guidance for reporting operating leases in PR19 business plans. The company proposed no adjustment in its plan.

Table 4.5: Opening RCV, 1 April 2020 (£ million)

	Water resources	Water network plus
RCV – 31 March 2020	148.4	
% of RCV allocated by control	3.06%	96.94%
RCV – 31 March 2020	4.5	143.8
Midnight adjustments to RCV	-0.1	-2.6
Midnight adjustments relating to operating leases	-	-
Opening RCV – 1 April 2020	4.5	141.2

4.2.3 Allowed return on capital

Companies are allowed a return on the RCV, equal to the allowed return on capital.

Portsmouth Water's business plan incorporates the sector draft determination allowed return on capital plus its 0.30% proposed company-specific adjustment for the wholesale price controls of 3.25% - CPIH deflated (2.25% - RPI deflated).

The sector allowed return on capital for the wholesale price controls in our final determinations is 2.92% – CPIH deflated (1.92% – RPI deflated). We set out the

basis for the allowed return on capital in our ‘Allowed return on capital technical appendix’.

We have allowed an uplift to the company’s allowed return on debt of 33 basis points, equating to an allowed return for the water resources and water network plus controls of 3.11% (on a CPIH basis, 2.11% on a RPI basis). We allow the sector return for the separate Havant Thicket control. We set out the detail of our assessment supporting this decision in our ‘Havant Thicket appendix’.

Consistent with Portsmouth Water’s business plan and the draft determination, we assess notional financeability on the basis of the sector allowed return on capital. We discuss our financeability assessment in section 5.2.

The PR19 methodology confirmed we are transitioning to CPIH as our primary inflation index from 2020. At 1 April 2020, we will index 50% of RCV to RPI; the rest, including totex that is added to the RCV, will be indexed to CPIH. Table 4.6 and table 4.7 set out the opening and closing balance for each component of RCV as of 1 April 2020 and 1 April 2025 respectively.

The PR19 methodology confirms our protection of the value of the RCV as at 31 March 2020 across each of the wholesale price controls. This applies to the RCV that is defined as ‘RPI inflated RCV’ and ‘CPIH inflated RCV’ in tables 4.6 and 4.7; this RCV is run-off (or amortised) over time. Totex that is added to the RCV from 1 April 2020 is stated as ‘post 2020 investment’.

In determining the ‘Allowed return on capital’ revenue building block, we apply the relevant deflated allowed return on capital to the average RCV for the year for each component (RPI inflated, CPIH inflated and post 2020 investment). This results in an allowed return on capital for each wholesale control over the period 2020-25 as set out in table 4.8.

Table 4.6: Opening RCV by wholesale control for each component of RCV, 1 April 2020 (£ million)

	Water resources	Water network plus	Total
RPI inflated RCV	2.2	70.6	72.9
CPIH inflated RCV	2.2	70.6	72.9
Other adjustments	-	-	-
Total RCV	**4.5**	**141.2**	**145.7**

Note Havant Thicket has an opening shadow RCV of £0.0m.

Table 4.7: Closing RCV by wholesale control for each component of RCV, 31 March 2025 and the shadow RCV for Havant Thicket (£ million)

	Water resources	Water network plus	Total	Havant Thicket
RPI inflated RCV	1.7	58.7	60.4	0.0
CPIH inflated RCV	1.6	56.6	58.2	0.0
Post 2020 investment	5.6	39.2	44.7	60.0
Other adjustments	-	-	-	-
Total RCV	**8.8**	**154.5**	**163.3**	**60.0**

Note further details on Havant Thicket shadow RCV are included in 'Portsmouth Water – Allowed revenue appendix' tables 6.3 to 6.4

Table 4.8: Allowed return on capital by wholesale control for each component of RCV, 2020-25 (£ million)

	Water resources	Water network plus	Total	Havant Thicket
RPI inflated RCV	0.2	6.8	7.0	0.0
CPIH inflated RCV	0.3	9.8	10.1	0.0
Post 2020 investment	0.4	3.2	3.6	3.5
Other adjustments	-	-	-	-
Allowed return on capital[1]	0.9	19.8	20.8	3.5
Company April 2019 – return on capital[2]	5.2	23.1	28.4	-

[1] Allowed return on capital is calculated by multiplying the annual average RCV for each element of RCV (RPI inflated, CPIH inflated and post 2020 investment) by the wholesale WACC for each control. The allowed return on capital for each year of the price control for each wholesale control is shown in the 'Portsmouth Water - Allowed revenue appendix' in tables 4.1 to 4.2 and tables 6.3 to 6.5 for the ten year Havant Thicket control.
[2] Company view includes Havant Thicket in the water resources control.

4.2.4 RCV run-off

RCV run-off is the proportion of the RCV which is recovered in the 2020-25 period. Companies are able to propose different run-off rates for RPI inflated and CPIH inflated RCV and also, for the water resources controls, for post 1 April 2020 investment. Table 4.9 sets out the resultant RCV run-off revenue for each component of RCV for each wholesale control.

Table 4.9: RCV run-off on the RCV (5 year) (£ million)

	Water resources	Water network plus	Total	Havant Thicket
CPIH inflated RCV	0.6	14.0	14.6	-
RPI inflated RCV	0.7	14.9	15.5	-
Post 2020 investment	0.1	4.4	4.5	1.5
Total RCV run-off	**1.4**	**33.3**	**34.7**	**1.5**

Note total RCV run-off is calculated by multiplying the opening RCV by the relevant RCV run-off rate for each element of RCV (RPI inflated, CPIH inflated and post 2020 investment) by the RCV run-off rate for each control (50% of run-off is applied to post 2020 investment in the year of additions).

Note for Havant Thicket, this is the run-off on the shadow RCV.

For the draft determination, we applied Portsmouth Water's approach to RCV run-off rates which are based on average lives for assets plus annual maintenance costs within each wholesale control for the water network plus control. We intervened to move costs for Havant Thicket from the water resources control to the separate Havant Thicket control and to reset RCV run-off rates for the water resources and Havant Thicket control. We maintained Portsmouth Water's allocation of all expenditure to RCV and its approach to applying a run-off rate from the assumed start date for the bulk supply agreement of 1 April 2020. We maintain the approach for the final determination.

Portsmouth Water does not make any representations in relation to RCV run-off rates and we continue to apply the company's approach to RCV run-off rates for the final determination as amended in the draft determination for Havant Thicket. We make an adjustment to RCV run-off rates for water resources to separate out RCV run-off for the Havant Thicket control. For the Havant Thicket control, we assume a cost recovery period of 80 years for expenditure related to Havant Thicket. We adjust RCV run-off rates for the water resources control to provide the remaining RCV run-off revenue in the business plan for the water resources control. We have published our calculation of the RCV run-off rates for water resources and the Havant Thicket control alongside our determinations.

Table 4.10 sets out the average RCV run-off rates across 2020-25 for each wholesale control proposed in the company's business plan and for our draft and final determinations.

Table 4.10: RCV run-off rates for each wholesale control (5 year)

	Water resources	Water network plus
Company April 2019 (%)	3.45%	4.39%
Draft determination (%)	3.54%	4.39%
Final determination (%)	4.04%	4.39%

Note RCV run-off (%) reflects the average of the rates applied to the CPIH and RPI inflated RCV components across the 5 years 2020-25. Company plan is adjusted to remove Havant Thicket for comparison with the draft and final determinations.

The annual rates for each wholesale control are set out in the 'Portsmouth Water - Allowed revenue appendix' in tables 5.1 to 5.2 and table 6.6 for the ten year Havant Thicket control.

4.3 PR14 reconciliations

In PR14, we set mechanisms to incentivise companies to do the right thing for their customers. These financial incentives cover cost efficiency, outcomes performance, revenue forecasting (wholesale and retail), customer service (the service incentive mechanism), water trading and land sales. It is important to reconcile the financial impacts of these mechanisms in PR19 to ensure that customers only pay for the service the company delivers.

We are also applying adjustments to reflect performance in the final year of the 2010 to 2015 period, which could not be fully taken into account in PR14, and the inflation correction to the RCV from the capital expenditure incentive scheme (CIS). These adjustments apply to the RCV (the 'midnight adjustment') and revenue for the 2020-25 period. These adjustments are made in line with the 'PR14 reconciliation rulebook'.

We are publishing models for each of these reconciliations, and for the overall RCV and revenue adjustments on our website. 'Portsmouth Water - Accounting for past delivery final decisions' provides a detailed explanation of all policy interventions we are making in the models. Table 4.11 summarises our interventions. Table 4.12 sets out the resulting adjustments to revenue and the RCV. In its representations Portsmouth Water claims it is being unfairly penalised by a £1.9 million underperformance payment relating to its water quality contacts performance commitment for 2015-20. We retain the £1.9 million underperformance payment, but because the company addresses the issue appropriately in its 15 July 2019

submission we do not need to intervene in the final determination. Our assessment of this issue is covered in 'Portsmouth Water - Accounting for past delivery final decisions'. The 'Portsmouth Water - Accounting for past delivery appendix' sets out how these adjustments are allocated across controls and how the RCV adjustment feeds into the midnight adjustments to RCV set out in table 4.5.

The 'Accounting for past delivery technical appendix' sets our further details on our reconciliation of PR14 incentives, the residential and business retail service incentive mechanisms and our deliverability assessment.

For outcome delivery incentives, the information we use to reflect performance in 2019-20 is based on the company's latest expectations. Final figures for 2019-20 will not be able to be taken into account in PR19. We set out in the 'PR14 reconciliation rulebook' that we plan to complete the reconciliation for 2019-20 outcome delivery incentives at PR24 for 2025-30 so that we use final information.

However, most outcome delivery incentives for the 2020-25 period are in period and will have been reconciled before this date. In light of this we consider it would be more appropriate to complete this reconciliation in the autumn of 2020 and apply any change to bills for 2021-22 as part of the new in-period process. We are designating all of the financial PR14 performance commitments as being in-period for this purpose. Any adjustment between the 2019-20 forecast and actual figures should be modest and we do not expect a significant impact on bills. If, contrary to expectations the bill impact is more significant, we expect companies to take measures to smooth the impact for their customers. The new PR19 mechanism to share benefits with customers from unexpected high outcome delivery incentive payments in a year will not apply to PR14 outcome delivery incentives. Instead the PR14 protection that caps the impact across the five years 2015-20 will apply.

The above applies equally to the company's 2015-20 in period outcome delivery incentives and we use forecast information for 2019-20 to reconcile these outcome delivery incentives. For the avoidance of doubt, no application is required in 2019 for in period determinations.

Table 4.11: Reconciliation of PR14 incentives, interventions (2017-18 prices, unless otherwise stated)

Incentive	Intervention(s)
Outcome delivery incentives	We are intervening to remove the residential retail service incentive mechanism outperformance payment of £0.212 million per year (2012-13 prices) from the outcome delivery incentive model. We are reconciling the residential retail service incentive mechanism in a separate model and are

Incentive	Intervention(s)
	therefore removing this outperformance payment from this model to avoid duplication. Our intervention reduces the retail revenue adjustment at the end of the 2015-20 period from + £1.034 million to - £0.186 million.
Residential retail revenue	We are intervening to round the company's modification factor figures to 2 decimal places to ensure consistency with the 'PR14 reconciliation rulebook'. We are intervening to use the 2019-20 reforecast customer numbers provided by the company in response to a query, as the company's updated figures were not in accordance with the definition. We are also including a figure of 3.90% for the 'Materiality threshold for financing adjustment - Discount Rate' in line with the 'PR14 reconciliation rulebook'. Overall, our interventions do not result in any changes to the total residential retail revenue payment at the end of the 2015-20 period which remains at - £0.064 million.
Wholesale revenue forecasting incentive mechanism	We are excluding the claim for additional revenue to correct the error the company made in completing the PR14 business plan. We consider Portsmouth Water does not provide sufficient and convincing evidence that there was an unambiguous error in its reporting and that the adjustments to correct them are appropriate. We note that if there was an error, the impact of the error on the allowed revenue adjustment is partially offset by the higher PR14 totex allowance that would flow from such an error in reporting. We explain our assessment in detail in 'Portsmouth Water - Accounting for past delivery additional information.' Our intervention increases the total wholesale revenue forecasting incentive mechanism adjustment at the end of the 2015-20 period from - £0.489 million to - £4.442 million.
Totex	No interventions required.
Land sales	No interventions required.
Residential retail service incentive mechanism	We are intervening to set Portsmouth Water's residential retail service incentive mechanism adjustment to +6.00% of residential retail revenue to reflect its performance from 2015-16 to 2018-19. This equates to +£1.439 million in total revenue over the period. This increases revenue relative to the company's estimate of the mechanism's impact and is driven by updating our analysis to take account of companies' finalised scores for 2018-19.
Water trading	No interventions required.
PR09 blind year adjustments	No interventions required.

Table 4.12: Reconciliation of PR14 incentives, 2020-25 (£ million, 2017-18)

Incentive	RCV adjustments		Revenue adjustments	
	Company view[1]	Ofwat view[1]	Company view[1]	Ofwat view[1]
Outcome delivery incentives	0.0	0.0	-2.2	-3.4
Residential retail revenue	N/A	N/A	-0.1	-0.1
Wholesale revenue forecasting incentive mechanism	N/A	N/A	-0.5	-4.4
Totex	-0.4	-0.4	-0.7	-0.7
Land sales	0.0	0.0	N/A	N/A
Residential retail service incentive mechanism	N/A	N/A	1.2	1.4
PR09 blind year adjustments[2]	-2.3	-2.3	-0.1	-0.1
Water trading	N/A	N/A	0.2	0.2
Other adjustments	0.0	0.0	0.0	0.0
Total	**-2.7**	**-2.7**	**-2.2**	**-7.1**
Total post profiling[3]	**N/A**	**N/A**	**-3.7**	**-7.5**

[1] The company view is based on data from the 15 July 2019 company submissions. It does not reflect impacts of the subsequent representations. The Ofwat view is based on the 15 July 2019 company submissions and takes account of representations and any interventions we are making.
[2] PR09 blind year adjustments includes the CIS RCV inflation correction. We show these separately in 'Portsmouth Water - Accounting for past delivery appendix'.
[3] Total post profiling is the total revenue over the period, taking account of the time value of money and the company's choices of how it wishes to apply revenue adjustments either in the first year or spread over a number of years.

4.4 Other allowed revenue

Other components of allowed revenue are:

- The fast track reward, where applicable;
- Corporation tax allowance – this is estimated from projected corporation tax rates, profit forecasts and assumed levels of tax relief contained in our financial model for the final determination.

- Grants and contributions – this represents revenue that we expect to be received from developers in respect of work undertaken by companies to service new developments.
- Non-price control income – this forecast income is deducted from the total allowed revenues, as this revenue is not recovered from the charges covered by the price control – but is expected to cover some of the costs included in the calculation of the price control.

Table 4.13: Calculation of other allowed revenue (£ million)

	Water resources	Water network plus	Havant Thicket	Total
Fast track reward	0.0	0.0	0.0	0.0
Tax	0.0	0.0	0.0	0.0
Grants and contributions (price control)	0.0	5.3	0.0	5.3
Deduct non-price control income	0.0	-3.5	-4.9	-8.5

4.4.1 Taxation

We calculate a tax allowance reflecting the corporation tax that the company expects to pay in 2020-25. We calculate the tax allowance using our financial model based on the projected taxable profits of the appointed business and the current and enacted UK corporation tax rates and associated reliefs and allowances as at 30 September 2019. Any future changes to tax rates and allowances will be taken account of in the tax reconciliation model, further details are set out in the 'Aligning risk and return technical appendix'.

Portsmouth Water provided information in data tables relevant to the calculation of the expected tax charge. The company also provides revised tax information to reflect a separate control for Havant Thicket. We use the information provided by the company and apply this to the final determination.

Table 4.14: Tax (£ million) – Breakdown by price control

	Water resources	Water network plus	Havant Thicket	Total
Tax	0.0	0.0	0.0	0.0

4.4.2 Grants and contributions

Companies receive grants and contributions from developers towards company expenditure to:

- reinforce the network as a consequence of new properties being connected;
- connect a new property (e.g. the meter and connection pipe);
- provide new water mains or public sewers (i.e., requisitions); and
- move an existing main or sewer or other apparatus at the request of a third-party (i.e., diversions).

Grants and contributions (price control)

Grants and contributions before the deduction of income offset allowances (i.e., 'gross' grants and contributions) are used to calculate net totex for cost sharing and within the developer services reconciliation adjustment, as explained in 'Our approach to regulating developer services'.

Grants and contributions after the deduction of income offset allowances (i.e., 'net' grants and contributions) are used to calculate net totex for use in the financial modelling. This ensures that income offset allowances, that are funded by existing customers rather than developers, are captured within net totex that is used to calculate pay-as-you-go revenue and RCV additions. Developer services costs that are funded by developers are excluded from net totex, and are instead treated as grants and contributions within the financial model (as shown in tables 3.2 and 4.1).

Our approach to calculating 'gross' and 'net' grants and contributions is outlined in 'Cost efficiency technical appendix'. The main difference from draft determinations is that we no longer estimate a cost recovery rate for each company. The starting point for each calculation is 'gross' grants and contributions reported in companies' business plans. To arrive at 'net' grants and contributions we deduct company-specific income offset allowances rather than assume a common recovery rate for all companies. We also apply the modelled base cost efficiency challenge to grants and

contributions to ensure alignment between grants and contributions and cost assessment.

Table 4.15 below shows our assumed amounts of 'gross' grants and contributions (price control) that is used to calculate net totex for cost sharing.

Table 4.15: Grants and contributions before the deduction of income offset allowances (£ million)

	Water resources	Water network plus	Total
Grants & contributions (before deduction of income offset allowances)	0.0	5.3	5.3

Table 4.16 below shows our assumed amounts of 'net' grants and contributions (price control) that is captured within net totex that is used to calculate pay-as-you-go revenue and RCV additions.

Table 4.16: Grants and contributions after the deduction of income offset allowances (price control) (£ million) – breakdown by price control and category

	Water resources	Water network plus	Total
Grants & contributions (price control)	0.0	5.3	5.3

Grants and contributions (non-price control)

For final determinations, we set non-section 185 diversions income outside of the price control, as explained in 'Our approach to regulating developer services'.

Table 4.17 below shows our assumed amounts of grants and contributions (non-price control) that are made up of non-section 185 diversions income.

Table 4.17: Grants and contributions (non-price control) (£ million) – breakdown by price control and category

	Water resources	Water network plus	Total
Grants & contributions (non-price control)	0.0	0.0	0.0

4.4.3 Non-price control income

Non-price control income is income from the excluded charges defined in licence condition B. For example, it includes bulk supplies, standpipes, unmeasured cattle troughs, and other services. For the final determination we confirm that diversions which are not requested under section 185 of the Water Industry Act 1991, for example, works under the New Roads and Street Works Act 1991 or those associated with High Speed 2, are also excluded from the price control. These are capital contributions and so do not get shown in tables 4.1 and 4.18.

This is deducted from the total allowed revenues, as this revenue is not recovered from the charges covered by the price control – but is expected to cover some of the costs included in the calculation of the price control. We have reviewed the company forecast of 'non-price control income' and use this in the final determination.

Table 4.18: Non-price control income (£ million) – Breakdown by price control

	Water resources	Water network plus	Havant Thicket	Total
Non-price control income	0.0	-3.5	-4.9	-8.5

Note negative numbers represent a deduction from the allowed revenue.

4.4.4 Uncertainty mechanisms

Given the range of risk mitigation measures included in price controls, the PR19 methodology said that final determinations would only include bespoke uncertainty mechanisms where robust and compelling evidence was presented for that item. Portsmouth Water does not propose any uncertainty mechanisms.

We are including a PR24 reconciliation mechanism for business rates in our final determination for Portsmouth Water along with all other companies because:

- There is uncertainty about business rates costs because the Valuation Office Agency (VOA) will be carrying out revaluation exercises during 2020-25, and increases (or decreases) in cost levels could be material.
- Companies can only exercise limited control over cost levels by engaging with the VOA and, possibly, by considering the business rate implications of asset development choices.

We are also including a PR24 reconciliation mechanism for Environment Agency abstraction licence costs in our final determination for Portsmouth Water along with all other companies serving England[9] because:

- The Environment Agency expects to consult on changes to its basis for setting abstraction licence fees during 2020 meaning that there is material uncertainty about company cost levels in 2020-25.
- Companies can only exercise limited control over cost levels by engaging with the consultation process and providing accurate information when required for licence fee setting purposes.

In each case, the cost variance to the company's PR19 cost allowance will be subject to a 75 (customer share):25 (company share) symmetrical sharing rate in the totex reconciliation at PR24. This means that the company will still be incentivised to manage costs efficiently, whilst receiving appropriate protection against material cost increases. Conversely, customers will receive a benefit if outturn costs are lower than the allowance levels we have set.

We do not include any uncertainty mechanisms for the costs Portsmouth Water will incur associated with the development of Havant Thicket Winter Storage Reservoir because the separate price control arrangements for that reservoir now allow for a review half way through a ten year price control.

[9] The Environment Agency's responsibilities apply only to England.

5 Risk analysis and financeability

Key changes from the draft determination

The key changes made to the risk analysis and financeability elements of the draft determination are:

- For the final determination, we apply our view of a sector risk range for totex, C-Mex, D-Mex and financing costs (including embedded debt) as part of our assessment of risk ranges for our final determination. We also apply updated views on risk ranges for outcome delivery incentives, determined under our Outcomes Framework.
- We revise our notional dividend yield to 3.00% (from 3.15% in the draft determination) and apply a dividend growth of 1.18%. This takes account of the allowed cost of equity in the final determination. For Portsmouth Water we restrict the base dividend to 1.46% in our notional financeability assessment due to the high level of RCV growth in the final determination.
- We revise our approach to pension deficit recovery costs in our financial modelling of the notional company to match cash out flow for pensions deficit recovery costs to the allowed funding.
- For the final determination we advance allowed revenue by £0.9 million to ensure our determinations are financeable on the basis of the notional structure.
- Portsmouth Water is an efficient in our totex assessment. We accept it is appropriate for current customers to bear the cost of the incentive payments associated with its expected outperformance rather than pass this on to future customers through increased RCV. Therefore, we accept the company's representation and apply the additional totex allowance in PAYG.

We consider the final determination is financeable on the basis of the notional capital structure.

Portsmouth Water is responsible for ensuring it delivers its obligations and commitments in the context of its choice of capital and financing structure. Portsmouth Water may need to bring forward its plans to introduce additional equity to maintain its financial resilience. We will closely monitor changes in levels of the company's gearing, credit ratings and other key financial metrics during 2020-25.

In this section we discuss the possible range of returns for the notional financial structure. In section 5.1 we present the risk ranges of our final determinations for Portsmouth Water. We comment also on the financeability of the final determination and any adjustments that we have made to the bill profile in section 5.2. We comment on the financial resilience of the actual capital structure in section 5.3.

5.1 Risk analysis

The PR19 methodology set out that we expect companies to demonstrate a clear understanding of financial risk to the delivery of their business plans and to explain and demonstrate how they manage and mitigate that risk. It required companies to use return on regulatory equity (RoRE) analysis to assess the impact of upside and downside risk on the basis of their notional capital structures based on a prescribed suite of scenarios using the company's assessment of P10/P90 confidence limit values[10].

RoRE is calculated as the return on equity for the equity portion of the RCV based on our notional gearing assumption. A company's base RoRE is aligned with our allowed real post-tax cost of equity, but it can differ between companies because the blended real cost of equity will vary according to the proportion of the RCV (and notional regulatory equity) that is indexed to RPI or CPIH[11]. The proportion of RCV (and notional regulatory equity) that is linked to RPI or CPIH varies between companies according to factors that include the size of the investment programme, the proportion of totex that is capitalised and RCV run-off rates.

In addition, base RoRE includes the margin for the retail price control. While the retail margin is 1% on retail and wholesale costs for all companies, it varies between companies when measured against regulatory equity.

Table 5.1 and figure 5.1 sets out the annual average risk ranges for Portsmouth Water in our final determination. The risk ranges show the plausible range of company returns based on Portsmouth Water's RCV and cost data for 2020-25, the allowed equity return and a notional gearing level of 60%. The final determination ranges reflect our approaches to the assessment of risk ranges for outcome delivery incentives and our approach to apply a common approach to the assessment of risk ranges for totex and financing costs for the sector.

[10] P90 is the performance threshold at which there is only a 10% chance of outturn performance being better. P10 is the performance threshold at which there is only a 10% chance of outturn performance being worse.

[11] RPI is the retail price index; CPIH is the consumer price index including owner-occupiers' housing costs; both are published by the Office for National Statistics.

Our PR19 methodology aims to increase the strength of financial incentives to better align the incentives placed on companies with the interests of customers. Our determinations aim to be stretching to encourage companies to deliver further efficiencies and better levels of service to customers. The incentives we put in place incentivise companies to outperform the cost allowances and performance commitments set in our determinations, our incentive mechanisms also aim to protect customer interests where companies underperform.

Portsmouth Water has significant scope to earn upside from outperformance as well as the risk of lower returns from underperformance. The modest positive skew to its overall risk range is driven by its position as an efficient company in our cost assessment. Our view is that an efficient company should be able to achieve the base return on the notional structure. The onus is on companies to manage the risk and effect of any downside scenarios while maintaining financial resilience.

We asked companies to update their risk ranges in their representations. We state those risk ranges in table 5.1 against the cost allowances and base return on regulatory equity in our final determinations. These risk ranges are not fully comparable with our final determination ranges as they take account of company views of the cost efficiency and outcome delivery incentive stretch in our draft determinations which we revise for the final determinations.

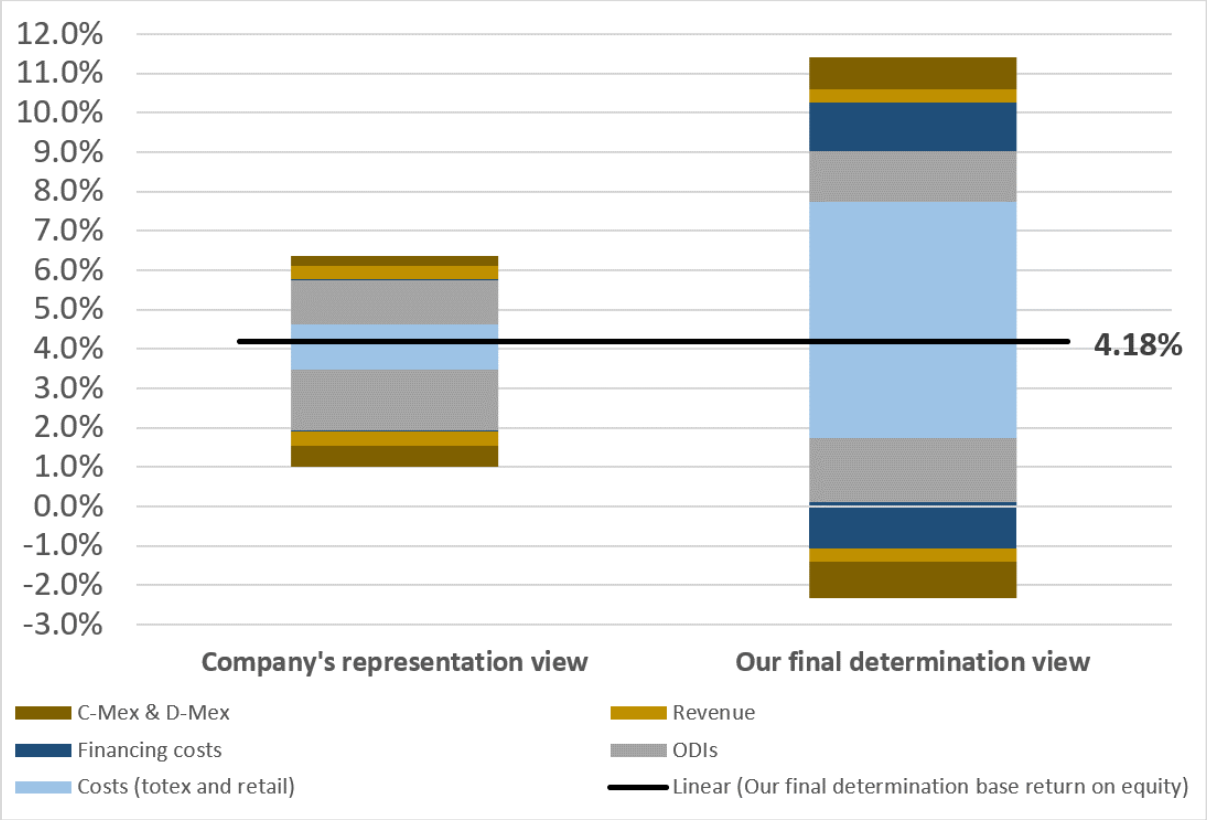
Table 5.1: Portsmouth Water final determination risk ranges[12]

	Range implied in company representation		Final determination ranges	
Base RoRE	-		4.18%	
Risk ranges	**Lower bound**	**Upper bound**	**Lower bound**	**Upper bound**
Totex	-0.68%	0.41%	-2.41%	3.52%
Outcome delivery incentives	-1.55%	1.12%	-1.64%	1.28%
Financing costs	-0.02%	0.02%	-1.16%	1.23%
Retail costs	-0.03%	0.04%	-0.03%	0.04%
C-MeX and D-MeX	-0.52%	0.26%	-0.91%	0.82%
Revenues (includes Retail)	-0.36%	0.33%	-0.36%	0.33%
Total	**-3.17%**	**2.18%**	**-6.51%**	**7.23%**

We calculate the company's range based on the resubmitted ranges the company states in its representation that are in monetary terms. As we have calculated the ranges in the financial model used for the final determination we have not stated the company's view of the base equity return.

[12] Includes Havant Thicket.

Figure 5.1: Company representation and final determination RoRE ranges for Portsmouth Water



Note representation view is based on Ofwat's calculation of the RoRE ranges for the company using the final determination financial model and is based on the company submission that accompanied its representation. To facilitate comparison with our final determination, we present the risk range around the base allowed return on equity for Portsmouth Water's final determination.

The final determination risk range reflects the following interventions that we make for all companies:

- The totex range is our assessment of the plausible range based on evidence of the historic sector performance and taking account of the company's cost sharing rates that apply in its final determination.
- The financing cost risk range is based on our assessment of the range for a notional water company including both embedded and new debt.
- The outcome delivery incentive risk range has been determined under our Outcomes Framework as set out in table 2.4.
- The C-MeX risk range is calculated as 12% upside and 12% downside of Residential Retail Revenue, reflecting the cap and collar limits for this incentive.
- The D-Mex risk range is calculated as 6% upside and 12% downside of developer services revenue, reflecting the cap and collar limits for this incentive.

We set out further details on the issues above in the 'Aligning risk and return technical appendix'.

5.2 Financeability

Companies in the water sector must make significant investment both to maintain and deliver required enhancements to the asset base. Therefore it is important that companies are able to access finance on reasonable terms if they are to meet their obligations and commitments to customers. In recent price review periods, almost all of the new investment in this sector has been funded by debt and retained earnings, however, there may be a requirement for direct equity investment where there is a very significant investment requirement, to ensure companies maintain good credit quality.

We must set our determinations in the manner which we consider best calculated to satisfy our duties. Our financeability assessment considers whether the allowed revenues, relative to efficient costs, are sufficient for an efficient company to finance its investment on reasonable terms and to deliver its activities in the long term, while protecting the interests of existing and future customers. In carrying out our financeability assessment, we assume that an efficient company is able to deliver a level of performance that is consistent with our efficient cost allowances.

Our financeability assessment assumes there is no out/underperformance with respect to the levels of service provided to customers. Our approach protects the interests of customers as it ensures companies and their investors bear the consequences of inefficiency and underperformance in delivery of their obligations and commitments to customers.

We carry out our financeability assessment on the basis of the notional capital structure that underpins our allowed return on capital as companies are entitled to determine the financial structure appropriate for their circumstances, provided they bear the associated risks. For example, if a company's choice of financing structure results in it incurring higher debt costs than reflected in our view of efficient allowed returns, the company will bear this cost. The approach is consistent with meeting all of our regulatory duties and with the approach we and other regulators have taken in previous reviews.

Our PR19 methodology requires companies to provide Board assurance that the business plan is financeable on both the notional and their actual capital structures and requires companies to provide evidence to support these statements, including

evidence supporting the target credit rating and that this is supported by the financial ratios that underpin the plan.

In its April business plan, Portsmouth Water sets out that its 'Board assures that the plan is financeable on both the notional and actual capital structures, the company remains financially resilient over the longer-term and protects customers' interests in the short and long term'. The company states that its plan targets a credit rating of Baa1 on a notional basis.

Subsequently, we asked companies to provide additional Board assurance, in their representation to our draft determination, that they will remain financeable, taking account of the reasonably foreseeable range of plausible outcomes of their final determination including evidence of further downward pressure on the allowed return. Companies also took account of these issues in the risk analysis presented in section 5.1.

In its representations and subsequent submissions, Portsmouth Water provides Board assurance that the plan is financeable at Baa1/BBB+ for the notional structure that is qualified by the application of capital injections, PAYG adjustments of 3.5% and making the corrections and revisions set out in its representation. The company sets out that any further reduction in cost of capital, including any reduction in the Havant Thicket control below the company-specific cost of capital, would result in the business plan no longer being financeable for the notional or actual structures.

In the draft determination, we allowed a company-specific adjustment to the allowed cost of debt of 30 bps, equivalent to an appointee return on capital of 3.36% (CPIH) for the water resources and water network plus wholesale controls. We applied a standalone return on capital for the Havant Thicket control of 2.72% (CPIH), including the company-specific adjustment. For the final determination we apply a return on capital for the water resources and water network plus controls including an uplift of 33bps, which, is consistent with our assessment based on market evidence. We apply the sector allowed return on capital, excluding the company-specific adjustment to the Havant Thicket control. Further information on the allowed return and the company-specific adjustment is set out in our assessment in the 'Allowed return on capital: technical appendix' and further information on the approach to Havant Thicket is in the 'Havant Thicket appendix'.

We have carefully considered the representations made by Portsmouth Water including the qualifications on the assurances provided. We have considered this in the context that the allowed return which is based on market data is lower than our draft determination and the basis on which the company provided assurance about the financeability of its plan. However we are satisfied that the market data supports

our view that allowed returns are sufficient to reward investors for the risks they face in a sector that already benefits from significant risk protections[13]. We set out the revisions we are making to our performance commitments and cost allowances elsewhere in this document. We consider the revenues allowed in our final determination, which reflect our assessment of efficient allowed costs, are sufficient for Portsmouth Water to meet its obligations and commitments to customers on the basis of the notional structure. We comment on the financial resilience of the actual structure in section 5.3

Our financeability assessment uses a suite of financial metrics based on those used in the financial markets and by the credit rating agencies. The key financial ratios are primarily cash flow measures of a company's earnings, leverage and ability to service its debt interest and principal repayments. We provide further detail of the key ratios in the 'Aligning risk and return technical appendix'.

In its business plan, Portsmouth Water provides assurance of financeability of the notional structure based on an assessment of financial ratios incorporating an allowed cost of capital excluding the company-specific adjustment to the cost of debt it proposes. We agree this approach is appropriate and protects customers from any further financeability constraints resulting from a higher cost of debt relative to the allowed equity return. Following the approach adopted by Portsmouth Water, our draft determination assessed notional financeability on the basis of the allowed return on capital for the sector excluding the allowed company-specific uplift to the cost of debt; we follow the same approach for the final determination.

Portsmouth Water is an efficient company and our cost assessment results in the company receiving a totex allowance in excess of that requested in its April revised plan. For the draft determination, we applied the difference between our allowance and the plan totex to RCV and treated this as an injection of capital. Portsmouth Water make a representation to allocate part in 2020-25 through PAYG revenue. After further consideration, we accept it is appropriate for current customers to bear the cost of the company's current efficiencies rather than pass this on to future customers through increased RCV, subject to allowed revenues not exceeding the plan. Therefore, we accept the representation and apply the additional totex allowance in PAYG. In our assessment of financeability and the ratios we present in table 5.2, we assume the company spends its totex allowance during the period.

[13] These protections include appointments that confer effective monopolies for specified geographic regions; our commitment to remunerate efficient investment in the RCV as at 31 March 2020; price limit reopeners; inflation indexation; totex cost sharing; allowances for special cost factor claims; outcome delivery incentives; and reconciliation mechanisms for wholesale revenue, the cost of new debt and tax

However, the company has the opportunity to outperform on totex which will improve its financial position.

For the draft determination, our approach was also to first assess notional financeability for Portsmouth Water excluding the Havant Thicket control as these costs are passed through to Southern Water customers. In its representations, Portsmouth Water agrees with this approach and we maintain it for the final determination.

RCV growth in Portsmouth Water's final determination excluding Havant Thicket exceeds 10%. Therefore consistent with our policy approach set out in the 'Aligning risk and return technical appendix' we consider it is appropriate for equity to contribute to the funding of this growth. In our financeability assessment we restrict the base dividend yield to maintain gearing around the notional level of 60% in 2025, consistent with the gearing level that underpins the calculation of our allowed return. The resulting dividend yield we assume is 1.46% with dividend growth of 1.18%.

Portsmouth Water sets out it is funding the development of Havant Thicket primarily through equity with £61 million of capital injections in the period to 2025 to be made to support development. For our assessment of notional financeability we consider it is appropriate to maintain the notional gearing assumption underpinning the cost of capital. Therefore, we assume equity of £21.2 million is input in to the Havant Thicket control over the period.

In table 5.2 we set out some of the financial ratios provided by the company in its business plan, and in our draft and final determinations. Our financial modelling of the notional company excluding Havant Thicket suggests that Portsmouth Water faces a financeability constraint. Therefore, consistent with the approach in the PR19 methodology, our final determination increases PAYG rates to bring forward £0.9 million of revenue to improve cash flows and financial ratios. The financial ratios stated in table 5.2 include the effect of the increase to PAYG rates and the Havant Thicket control.

Portsmouth Water sets out in its representations that certain rating agencies reverse adjustments to accelerate revenues when calculating adjusted interest cover. As set out in the PR19 methodology, revenue advancement is preferable to cost of equity adjustments as it is net present value neutral for customers over time and has the effect of crystallising some of the inflationary return related to the partial transition from RPI to CPIH as the measure of inflation.

Portsmouth Water makes a representation that target levels for the funds from operations to net debt ratio (both Ofwat and alternative versions) should increase

from the 7-10% target in its April revised business plan to 9-12% to reflect clarification it has received of the approach taken by credit rating agencies. In particular the company states that Standard and Poors apply a modifier to take account of Portsmouth Water being a small company. We do not amend our approach to assessing financeability for small companies. We discuss the relative risk of small companies in the 'Aligning risk and return technical appendix'. We note that funds from operations to net debt for Portsmouth Water is impacted by the Havant Thicket price control where RCV run-off is recovered over a 80 year life. Costs associated with Havant Thicket are reimbursed by Southern Water over the life of the reservoir in accordance with the proposed bulk supply agreement. Our financial modelling for Portsmouth Water excluding the Havant Thicket control indicated a funds from operations to net debt ratio under the Ofwat definition within the range stated by the company in its representation. We discuss both of these issues further in the 'Aligning risk and return technical appendix'.

Our in the round assessment of notional financeability is made on the basis of the financial ratios from our financial model. It takes account of the evidence that the company provides regarding the levels and thresholds of the financial ratios that underpinned its assurance statement on the notional financeability in its business plan (also stated in table 5.2). We note that the Board assurance statement that accompanied the company's representations was made in the context of the draft determination. Our assessment of notional financeability for the final determination is made in the context of changes made in our final determination. We consider that Portsmouth Water's final determination is financeable based on the allowed revenues which include a reasonable allowed return on capital. The final

determination is sufficient to ensure it will be in a position to deliver its obligations and commitments to customers.

Table 5.2: Ofwat calculation of key financial ratios – notional structure before reconciliation adjustments (5 year average)

	Business plan	Draft determinations	Final determinations
Gearing	60.04%	58.62%	59.54%
Interest cover	3.49	3.44	3.56
Adjusted cash interest cover ratio (ACICR)	1.63	1.48	1.45
Funds from operations (FFO)/Net debt	8.78%	8.33%	8.03%
Dividend cover	0.83	0.93	1.75
Retained cash flow (RCF)/Net debt	6.06%	6.54%	7.20%
Return on capital employed (RoCE)	3.86%	3.47%	3.21%

The basis of the calculation of the ratios is set out in the PR19 methodology.
Net debt represents borrowings less cash and excludes any pension deficit liabilities.
FFO is cash flow from operational activities and excludes movements in working capital.
Cash interest excludes the indexation of index-linked debt.

We set out the average PAYG and RCV run-off rates along with the RCV growth over 2020-25 for Portsmouth Water in table 5.3. RCV growth for the April revised plan includes Havant Thicket as the costs of development are included in the water resources control. For the draft determination and final determination the table excludes the separate Havant Thicker control. Including Havant Thicket, RCV grows by 53.1% for the final determination.

RCV growth for the final determination is lower than in the company's April plan and the draft determination. Overall, changes to allowed expenditure and the reduction of the uplift to PAYG rates proposed in the April plan means that there is less expenditure added to RCV. We have made a technical adjustment to RCV run-off rates to allocate RCV run-off for Havant Thicket to the separate control. We are not amending Portsmouth Water's underlying RCV run-off rates.

Table 5.3: PAYG rates, RCV run-off and growth

	PAYG	RCV run-off	RCV growth
Company April 2019	49.0%	3.90%	56.22%
Draft determinations	47.9%	3.84%	18.02%
Final determinations	52.3%	3.95%	12.09%

Note: PAYG rates and RCV run-off rates include Havant Thicket for the purposes of comparison to the Portsmouth Water business plan. Company view of RCV growth includes Havant Thicket, but the draft and final determination calculations exclude this.

The PAYG and RCV run-off rates are averages across five years and across all wholesale controls. We set out the changes we make to PAYG and RCV run-off rates along with the five year average for each control in section 4.2 and annual PAYG and RCV run-off rates in the 'Portsmouth Water - Allowed revenue appendix'. Changes to totex allowances and PAYG rates for individual controls can result in small changes to the average RCV run-off rates presented in the table above.

In assessing the financeability of the notional company, we consider the headroom available in the final determination to allow the company to continue to meet its annual interest costs. We estimate 5 year headroom of £7 million above an adjusted cash interest cover of 1.0 times, against our totex downside of £10 million and outcome delivery incentives downside of £4 million calculated as 1% return on regulatory equity. We note however that Portsmouth Water is efficient against our cost assessment and so our high level analysis suggests the downside risk is overstated for this company. We set out further detail in relation to our approach to assessing headroom within final determinations in the 'Aligning risk and return technical appendix'.

5.3 Financial resilience

It is the responsibility of each company to choose and manage its financial structure to maintain financial resilience in the long term. A company's financial resilience can be impacted by its financing choices, for example, where a company chooses a structure with a high level of gearing, this can reduce available headroom to withstand cost shocks. Interest costs, levels of dividends paid and company performance in delivering obligations and commitments to customers can also impact on financial resilience.

Portsmouth Water is responsible for the financeability of the company and the maintenance of long-term financial resilience under its actual structure. We comment further on the financial resilience of Portsmouth Water's actual structure in figure 5.2.

Figure 5.2: Financial resilience of Portsmouth Water's actual financial structure

Portsmouth Water reported gearing of 66.3% as at 31 March 2019. In its business plan it sets out that it expects its gearing to be between 55% and 60% during 2020-25, as a result of equity injections associated with capital investment, in part for funding the Havant Thicket Winter Storage Reservoir development.

At the time of our final determination it has a corporate family credit rating of Baa1 (negative) with Moody's and a credit rating of BBB+ (negative) with S&P.

Subsequent to its representation, the Board has updated its board assurance which sets out that its core business remains financeable under its actual capital structure and assuming a cost of capital in line with the draft determination, however, the company has raised concerns about further reductions to the allowed return from the draft determination.

As stated in section 5.2 we consider the company to be financeable on the notional basis and there is a need for companies to ensure that that they are also financially resilient under their actual structures.

However, we have not accepted all of the company's representations and the allowed return is lower in the final determination reflecting market expectations on the cost of finance.

It is the company's responsibility to maintain its financial resilience under its actual financial structure and as set out in section 7, the company will need to reduce its base dividend yield for 2020-25 in the context of the allowed return and our final determination.

We will closely monitor changes in the levels of the company's gearing, credit rating and other key financial metrics during 2020-25 to test that adequate steps are being taken by management and its financial resilience is being maintained.

In its future reporting, we expect the company to explain clearly in its long-term viability statement how the Board has identified and assessed the potential risks to its financial resilience and the mitigating actions it is taking to address those risks. Portsmouth Water has committed to assess its financial resilience beyond 2025 in its next long-term viability statement.

6 Affordability and bill profile

6.1 Bill profile

Portsmouth Water proposes an average bill profile with a 4.0% reduction. Our bill profile contains a greater reduction of 5.4% over 2020-25.

Portsmouth Water submits additional evidence on bill profiles and acceptability in its representation, which shows that 73% of its customers support a bill profile that is flatter in nominal terms over a bill profile that gives a bigger bill cut in 2020-21 but then leads to larger increases at the end of the period, which is supported by 7% of customers. The company states its preference is for flat real terms bills which therefore rise with but not above inflation. While we consider that customers prefer bills that are as close to flat in nominal terms as possible, our final determination provides an average bill for Portsmouth Water that falls in 2020-21 before staying broadly flat in real terms which aligns more closely with the company's April 2019 business plan. A flat nominal bill would lead to an unacceptable deterioration of financial ratios.

Table 6.1: Average bills (2017-18 CPIH deflated)

	2019-20	2020-21	2021-22	2022-23	2023-24	2024-25
Company April 2019	£101	£97	£97	£97	£97	£97
Draft determinations	£101	£90	£90	£90	£90	£90
Final determinations – before reprofiling	£101	£96	£97	£96	£95	£94
Final determinations	£101	£96	£95	£96	£96	£96

Throughout the price control we have put a strong emphasis on companies planning for the long-term, both in terms of their goals and their bills. Following actions we set out at initial assessment of business plans, nine companies (Portsmouth Water was not one of these companies) undertook additional customer testing on their long-term bill profiles with several making adjustments as a result. We expect companies to continue to pay attention to this issue, taking customer views into account and planning in a way that ensures they control costs into the future.

6.2 Help for customers who are struggling to pay

Our final determinations for Portsmouth Water will deliver a real terms reduction to the average bill between 2020 and 2025.

In addition, Portsmouth Water commits to:

- increase its social tariff cross-subsidy to pay for 8,000 social tariff recipients and then either gain customer support or self-fund the extension necessary to meet its goal of reaching 10,000 customers by 2024-25;
- continue to track and report the success rate of its payment matching scheme;
- update its billing system so it can more accurately record different customer needs and circumstances; and
- keep its average bill at below 0.5% of average household income and provide flat bills in real terms for the next 15 years.

Portsmouth Water has two bespoke performance commitments on affordability and vulnerability, which will require it to:

- reach 10,000 customers through its social tariff; and
- obtain high stakeholder satisfaction with the non-financial support it offers to customers.

Companies will be reporting their performance against the Priority Services Register (PSR) common performance commitment and their bespoke affordability and vulnerability performance commitments to us and their customers on an annual basis during the price control period. In addition, companies put forward in their business plans further measures for addressing affordability and vulnerability issues. We expect companies to report periodically to their customers on their progress in addressing affordability and vulnerability concerns. We will also be considering how we will scrutinise and report on companies' progress in this important area, including working with other stakeholders in the water sector and beyond.

6.3 Total revenue allowances and k factors

Table 6.2 summarises the allowed revenue for each control. This is expressed in a 2017-18 CPIH price base so that this can be compared with the rest of this document.

Table 6.2: Allowed revenue by year (£ million, 2017-18 prices)

	2020-21	2021-22	2022-23	2023-24	2024-25	Total
Water resources	5.5	5.5	5.6	5.7	5.7	28.0
Water network plus	28.2	28.4	28.6	28.7	29.0	142.9
Havant Thicket	0.0	0.0	0.0	0.0	0.0	0.0
Residential retail	4.4	4.4	4.4	4.4	4.4	22.0
Total	**38.2**	**38.3**	**38.5**	**38.7**	**39.1**	**192.8**

The water resources and water network plus controls are in the form of a percentage limit (inflation plus or minus a number that we determine for each year of the control (the 'K' factor)) on the change in allowed revenue (R) from the previous charging year (t-1). This is based broadly on the formula:

$$R_t = R_{t-1} \times \left[1 + \frac{CPIH_t + K_t}{100}\right]$$

Table 6.3 sets out the K factors in each year for each of these two controls. For the first year, we have set a 'base' revenue which will be used as the starting revenue for calculating 2020-21 allowed revenues.

Table 6.3: Base Revenue and K factors by charging year (2017-18 prices)

	Base (£m)	2020-21	2021-22	2022-23	2023-24	2024-25
Water resources	5.5	0.00%	0.08%	0.52%	2.04%	0.53%
Water network plus	28.2	0.00%	0.61%	0.79%	0.53%	1.09%

7 Putting the sector in balance

Key points

- Portsmouth Water is reporting gearing of 66.3% as at 31 March 201914. Portsmouth Water forecasts that its level of gearing (57.4% by 2021 and 55.3% by 2025) will remain well below the level that triggers sharing of financing gains with customers on account of high gearing as set out in the 'Aligning risk and return technical appendix'. We are updating the gearing outperformance sharing mechanism to introduce a glidepath to the gearing level that the triggers sharing payments as set out in the 'Aligning risk and return technical appendix'
- Consistent with the lower allowed return on equity in our final determination, we are revising our calculation of the dividend yield as a guide to the reasonable base dividend yield in the absence of out/underperformance in 2020-25. We set out that the acceptable level of base dividend yield can be expected to vary depending on the scale of a company's RCV growth in 2020-25 and future investment needs
- We expect the company will need to reduce its proposed base dividend yield for 2020-25 to take account of the lower allowed return in our final determination and our revised expectations for a reasonable base dividend yield that we set out in the 'Aligning risk and return technical appendix'.
- On executive pay, Portsmouth Water falls short of the 60% alignment to delivery for customers we identify as current good practice. We retain our expectation of the company that it will ensure its dividend and performance related pay policies demonstrate substantial alignment with the customer interest, underpinned by stretching performance targets throughout 2020-25.

In July 2018 we published our 'Putting the sector in balance: position statement'. The position statement sets out the steps we expect companies to take to demonstrate they strike the right balance between the interests of customers and their investors. In summary, we expect that:

- company dividend policies for actual financial structures and performance related executive pay policies show appropriate alignment between returns to owners and executives and what is delivered for customers[15];

[14] Based on net debt to regulatory capital value.
[15] We explain more fully our expectations in the 'Aligning risk and return technical appendix' that accompanies this draft determination.

- companies with high levels of gearing share financing gains from high gearing with customers; and
- companies provide assurance and supporting evidence to demonstrate their long-term financial resilience and management of financial risks for the actual financial structure, taking account of their future investment needs.

We also encourage companies to adopt voluntary sharing mechanisms, particularly where, for example, companies outperform our cost of debt assumptions.

In our final determinations, we have amended our gearing outperformance sharing mechanism to contain a glidepath. We explain this in the final determination 'Aligning risk and return technical appendix'.

Our assessment of Portsmouth Water's proposals is in table 7.1. We comment on the financial resilience of Portsmouth Water in section 5.2.

Table 7.1: Our assessment of Portsmouth Water's proposals to balance the interests of customers

Our assessment of the company's proposals to balance the interests of customers
Gearing outperformance benefit sharing mechanism The company has confirmed it would implement our default gearing outperformance mechanism within its business plan, though the company forecasts that its gearing level through 2020-25 will remain well below the threshold that triggers the mechanism.
Voluntary sharing mechanisms Portsmouth Water has not proposed any voluntary sharing mechanisms. However, the company does operate a payment matching scheme which matches payments to customers paying down debt balances, subject to certain criteria.
Dividend policy for 2020-25 Portsmouth Water confirms that it is committed to the expectations on dividend policy as set out in our 'Putting the sector in balance' position statement. In doing so it has indicated a base dividend yield of 5% for 2020-25 for financial modelling purposes. We expect the company will need to revise its proposed base dividend yield for 2020-25 to take account of the lower allowed return in our final determination and our revised expectations for a reasonable base dividend yield that we set out in the 'Aligning risk and return technical appendix'. The company's dividend policy refers to all the areas included in the 'Putting the Sector in balance' position statement (out/underperformance & benefit sharing, employee interest & pension obligations, actual capital structure, need for future investment and financial resilience). The company confirms that the base dividend will be adjusted to reflect wider performance factors such as performance in relation to service levels and outcome delivery incentive measures. It has detailed the specific obligations and commitments to customers that will be considered and confirms that the level of performance delivery considered will be determined with reference to the final determination. It confirms that dividends can be increased or lowered from the base depending on the actual performance of the company and explains how performance delivery will impact on dividends paid. The company commits to setting out clearly in each Annual Performance Report, the dividend policy, the factors that have been considered in determining the dividend and how these relate to the dividend declared.

Our assessment of the company's proposals to balance the interests of customers
Consistent with the lower allowed cost of equity in our final determination, we have revised our calculation of the dividend yield that we consider to be reasonable for assessing the base dividend for water companies in 2020-25. We consider the acceptable level of base dividend yield is up to 4% but this can be expected to vary depending on the scale of a company's RCV growth and future investment needs. We set out further details in 'Aligning risk and return technical appendix'. We expect Portsmouth Water to be transparent when explaining its dividend policy and reporting on dividends paid over 2020-25 to demonstrate how it has delivered on the commitments in relation to its dividend policy and to ensure it meets the expectations we set out in 'Putting the sector in balance' as updated in the final determination 'Aligning risk and return technical appendix'.
Performance related executive pay policy for 2020-25 In our 'Aligning risk and return technical appendix' we identify that 60% alignment to delivery for customers is current good practice among the companies that we regulate. Based on our calculations, Portsmouth Water's measures that are directly aligned to customer delivery falls short of good practice, and therefore consider that there is scope for it to improve this position. We expect Portsmouth Water's policy on performance related executive pay to demonstrate a substantial alignment to the delivery of service for customers throughout 2020-25. Portsmouth Water states that it will adopt the expectations on performance related pay for 2020-25 as set out in our 'Putting the sector in balance: position statement'. The company states that the policy is currently under review, but indicates the following: • Annual bonus based on 32% customer service or customer benefits, 30% water quality, efficiency or sustainability outcomes and 38% business investment and financial performance outcomes. • Long-term bonus based upon achieving strategic business objectives that underpin the delivery of the business plan, 40% of which linked to customer, environmental, water quality or sustainability outcomes, but the company stated that this will increase for 2020-25. • Measures will include all Ofwat defined and bespoke outcome delivery incentives as well as targets set by the remuneration committee. • Targets will be fully aligned to the final determinations, and where the company's position is not upper quartile the remuneration committee will set targets which align unless there are specific reasons to do otherwise • The remuneration committee will be responsible for the process of developing the implementing the policy, and is committed to continually setting stretching targets through a process of reviewing their appropriateness at least annually. • Commitment to clear and open reporting of the policy, through the annual report, including any changes and the underlying reasons for the change. The company has stated that the remuneration committee will finalise the precise details of the performance related pay once the final determination is made to ensure that the targets and reward are balanced and stretching. We expect the company's remuneration committee to ensure there is on-going rigorous challenge as to how the policies are applied and to ensure that only truly stretching performance is rewarded. In so doing, we expect it to be equipped with the appropriate powers to carry this out, including for example, the use of withholding periods, clawback arrangements and underpin / gateway arrangements. We expect Portsmouth Water to be transparent when explaining and reporting against its performance related executive pay policy in 2020-25, to ensure it meets the expectations we set out in 'Putting the sector in balance' as updated in the final determination 'Aligning risk and return technical appendix'.

Ofwat (The Water Services Regulation Authority) is a non-ministerial government department. We regulate the water sector in England and Wales.

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