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31 January 2022

Dear Sir or Madam,

**PR24 and beyond: Discussion paper on risk and return**

Thank you for the opportunity to contribute to the discussion on risk and return in the water sector and the engagement with Ofwat through recent workshops.

We believe that it is critical that risk and return needs to be considered in conjunction with the ongoing discussion on financial resilience. The investment needs to address the supply demand challenges, deliver on environmental and decarbonisation challenges in the future need financing and the ability to attract efficient funding is under pinned by confidence in the sector. Investor confidence in the regulatory framework and ability of companies to deliver a stable return is still critical if we are to meet the investment needs of the future.

As a small but efficient and high performing company we think the framework around risk and return should continue to consider individual company requirements. We welcome the proposal to retain the provision for a small company premium on the cost of debt and the removal of the benefits test. We would advocate wider consideration of implications of risk and return policies for smaller companies without access to financial markets of larger companies particularly when considering cost of embedded debt.

Finally, we would recommend the risk and return framework considers the different aspect of water and sewerage services to ensure that water only companies have balanced level of incentives water and sewerage operators.

Your sincerely,

[REDACTED]

**Chief Financial Officer**

## ***Response to key discussion areas***

### *Balance of risk and RoRE risk ranges*

In general, as a smaller company we should advocate steps to reduce the number of complex reconciliations on basis of materiality and cost benefit. We are supportive of retention of a role for interim determinations as a key protection for material changes in circumstance.

As part of this RoRE assessment we would advocate that Ofwat considers the carefully the approach to assessing risk and performance between water and wastewater controls rather than WoCs and WaSCs. We believe Ofwat should take consideration of the challenge in the provision of a single service vs a dual service. While we have delivered high level of service and efficiency, we would challenge whether ODI reward and Totex allowances are balanced between water and sewerage services based on evidence of recent performance.

### *Return on equity*

We support industry representations that Ofwat thinking on equity returns should factor in the all considerations from the recent CMA appeals. We have concerns that the approach outlined in the discussion document does not reflect a balanced view of the developed thinking and that Ofwat should consider the risk of an overly aggressive methodology on setting the cost of equity.

We are supportive of the approach to accelerate the transition to CPIH following confirmation of alignment of RPI and CPI from 2030. However, we believe wider consideration should be give the challenges for companies with long dated RPI linked instruments. We would take this as an opportunity to emphasise that derivative markets will play a key role in supporting businesses to manage the transition and Ofwat and companies need to identify ways to increase transparency to address concern around 'kick the can swaps'.

### *RCV and notional capital structure*

As argued in our financial resilience response we are advocating flexibility for companies to identify the most efficient capital structure for their individual needs, this is especially important for Portsmouth Water given the period of high growth compared to other companies.

We believe there is an important role for equity to play in supporting RCV growth but it seems perverse that we would not take advantage of current low interest rates / tax advantages on behalf of our customers given the scale of investment challenges in the future. As such at this stage we would challenge whether a reduction in the notional gearing is the right approach to take. We believe that financial resilience cannot be disconnected from allowed returns and reducing returns and offsetting concern on resilience by reducing the notional gearing may not deliver best long-term value to customers.

### *Cost of debt*

We would be supportive of the approach to resist the move to a single cost of debt for embedded and new debt. We remain concerned with the challenges of competing with an industry derived efficient cost of embedded debt based on WASC and large WoCs. Our long dated Artesian structure expiring in 2032 will continue to struggle in comparison to industry benchmarks with more diverse portfolios and more recently issued debt. We also believe

that the current framework disadvantages Portsmouth by not reflecting the true cost of our embedded debt while other companies have benefited from years of significant financing outperformance due to their size. We believe the combination of price and service performance we have delivered for our customer has not been reflected in the levels of return compare to the outperformance earned by companies in part due to their scale.

We are supportive of Ofwat's retention of provision for small company premium. We advocate that cost of issuance from small size should include transaction costs, liquidity costs and cost of carry (i.e. not just the difference in coupon). We believe our arguments made at the last price review still will support our position at PR24 and we have further extended the efficiency frontier since then benefiting our customer but also customer nationally through the cost assessment and totex incentives.

### *Financability*

We acknowledge the point that financability could improve at PR24 as full transition to CPIH indexation will result in higher in period real returns but the benefit from the higher interest historical debt rates maturing will not benefit all companies in AMP8. We maintain that a requirement to reduce gearing to align more closely with the notional structure could constrain capacity for investments in a period of high investment for Portsmouth water.