Portsmouth Water

BUSINESS PLAN 2025 TO 2030
PRT09 SECURING VALUE FOR MONEY

CONTENTS

1. AT A GLANCE

Portsmouth Water has consistently been assessed by Ofwat as one of the most efficient companies in the sector. At PR19 our business plan costs were 16% below Ofwat's upper quartile-based benchmark, which resulted in our AMP7 cost allowances being capped.

This document describes how we have developed our costs for PR24, the key changes between AMP7 and AMP8 and how we have shown ambition in challenging ourselves to deliver more for less.

During AMP7 we have delivered totex that is broadly in line with what we said we would deliver in our PR19 business plan – thus outperforming against Ofwat's cost allowances which were higher than our plan costs. Our AMP8 wholesale totex is £129m higher than in AMP7, with increases in both base and enhancement costs.

The increase in base costs (from £156m in AMP7 (Asset Management Periods) to £185m in AMP8) reflects the fact that we are moving from a low point in our capital maintenance cycle to a higher period, along with a number of additional areas such as data and asset management where we need to invest more to meet the challenges of the future. We have challenged ourselves to deliver these additional activities within our base cost allowances, while at the same time delivering continued improvements in service levels for customers.

The increase in our enhancement costs (from £26m in AMP7 to £129m in AMP8) is driven principally by the requirements of our regionally developed WRMP (Water Resource Management Plan), which includes a programme to reduce demand through the introduction of smart metering. Our enhancement programme is derived from the core pathway in our LTDS which, in line with customer preferences for a smooth pattern of investment over AMPs (Asset Management Periods), includes only statutory investment in AMP8, plus a small (c.£2m) allowance for reactive lead replacement associated with our metering programme, focused on the highest risk customers.

Our plans have been robustly costed using current frameworks and supplier quotes, but we have challenged ourselves to deliver more for less. We initially applied a 15% programme level efficiency to most of our capital expenditure. This is ambitious but we believe it is achievable with a much larger investment programme. Following concerns about bill increases from our Affordability and Acceptability testing we increased this efficiency stretch to 20% for our largest programmes.

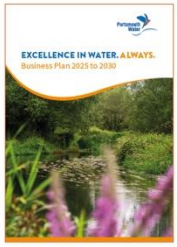
Based on an independent assessment of the wholesale botex and retail cost allowances by Frontier Economics, our costs remain consistent with upper quartile efficiency for both wholesale and retail.

We have also demonstrated ambition in applying an additional frontier shift assumption of 1.0% per annum, consistent with the view taken by the CMA (Competition and Markets Authority) for PR19.

We have not included any RPEs (Real Price Effects) in our plan, as we believe it is most appropriate for companies to manage these risks, rather than pass them on to customers. We do however propose that an ex-post true up of energy costs is appropriate, given the materiality of energy costs and the fact that the current level of volatility in energy markets make forecasting extremely challenging.

2. DOCUMENT MAP

Business Plan to 2030



PRT01
EXCELLENCE IN WATER. ALWAYS.
Business Plan 2025 to 2030

For the full navigation plan and documents visit **portsmouthwater.co.uk /business-plan-2025-2030**

Supporting Documents

PRT02
Delivering Havant Thicket Reservoir for Our Customers and the Region

PRT03
Engaging and Understanding Our Customers and Communities

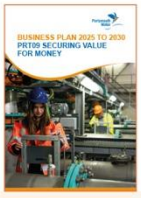
PRT04
Delivering for Our Customers and Communities

PRT05
Delivering Outcomes for Our Customers

PRT06
Managing Our Resilience in the Long Term

PRT07
Our Investment Plan

PRT08
Delivering Our Investment Plan



PRT09
Securing Value for Money

PRT10
Innovation to Enhance Our Service Delivery

PRT11
Addressing Affordability and Vulnerability

PRT12
Accounting for Past Performance

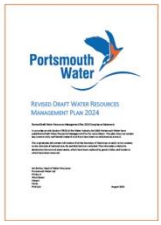
PRT13
Aligning Risk and Return

PRT14
Our People

PRT15
Board Assurance

Vision and Our Long-Term Plans

PRT16
Our 25-Year Vision (consultation version)



PRT17
Water Resource Management Plan (revised)

PRT18
Long-Term Delivery Strategy 2025-2050

3. SECURING VALUE FOR MONEY

A. Our Track Record

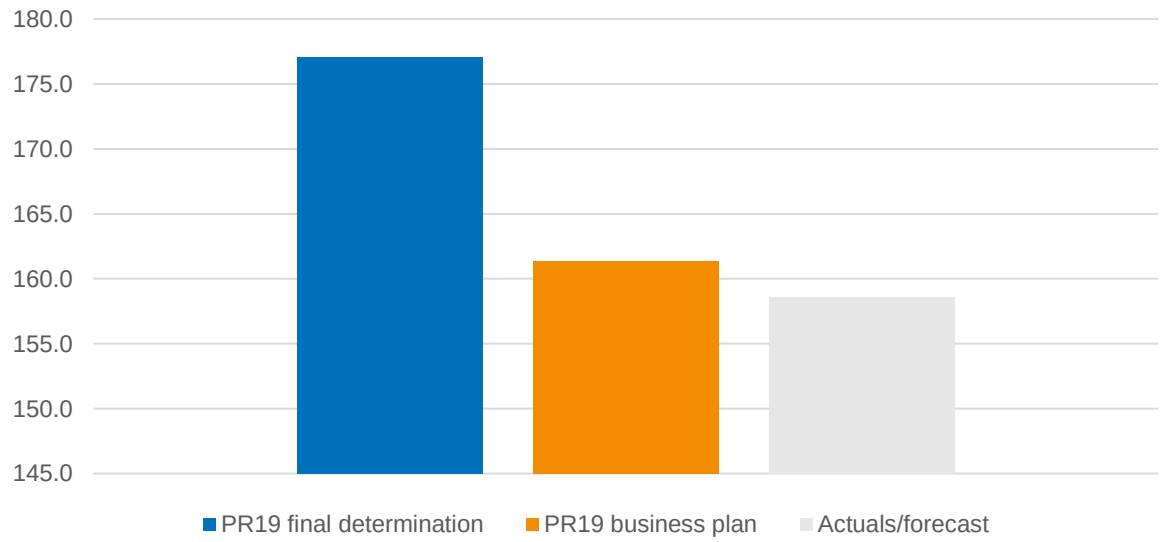
Portsmouth Water have an exceptional track record as an efficient water company. We have consistently been assessed by Ofwat as one of the most efficient companies in the sector, at multiple price reviews.

This position reflects both the skilled management of cost and risk over time, as well as the benefits of being a smaller company, with a single site, short decision-making chains, significant agility in its operations and a detailed understanding of its asset base and the communities it serves. While we do not have the benefit of the scale economies enjoyed by many of our peers, we believe our community-focused operating model has demonstrated its value to customers and stakeholders over time.

Our detailed understanding of our asset base means that we invest at the right time to ensure that we deliver the excellent service our customers expect and have enjoyed for many years. This does mean that our optimum asset maintenance spend can vary considerably between AMPs, but we believe the strategy of investing at the right time and not smoothing expenditure by replacing assets ahead of time is the right one for our customers. AMP7 represented a low point in our asset maintenance cycle, without the need for significant investment at our key assets.

The combination of our lean operating model and the low point in our asset replacement cycle was reflected in the fact that at PR19 our business plan costs were 16% below the efficient threshold identified by Ofwat. As a result, in the final determination Ofwat capped our cost allowances at 10% above our business plan costs[1]. As we move from a low to a high point in our maintenance cycle (as well as absorbing new activities within base costs) the level of required maintenance spend in AMP8 will increase materially.

Figure 1: AMP7 totex compared with the final determination and PR19 business plan (2017-18 prices)



Source: Cost reconciliation model

[1] Page 27, PR19 final determinations: Portsmouth Water final determination

As shown in Figure 1 above, during AMP7 we have delivered totex that is broadly in line with our business plan proposals, with outturn totex for the AMP forecast to be £159m compared with our business plan proposals of £161m (2017-18 prices), a difference of 1.7%. At the same time, we have delivered service to customers that is upper quartile across a range of measures, including industry-leading performance on supply interruptions, mains repairs and water quality contacts and upper quartile performance on C-Mex and D-Mex. Most of the variance between our PR19 business plan totex and the outturn position relates to higher Grants and Contributions than forecast at PR19. This delivery against our plans provides clear evidence of the credibility of our plans and our ability to accurately forecast the right level of expenditure and underlines the efficiency of our operating model.

Table 1: AMP8 totex compared to AMP7 (2017-18 prices)

Cost category	PR19 final determination	Actuals / forecast
Opex	£125m	£105m
Capex	£58m	£60m
Grants & Contributions	£(5)m	£(7)m
TOTAL	£177m	£159m

Source: PR19 final determination; APR and Table CW1

Compared to the final determination, we have lower opex and higher capex as shown in Table 1 above. Our opex for the AMP is £105m compared to a final determination assumption of £125m (2017-18 prices). In contrast our capex is £2m higher than assumed in the final determination, reflecting the need to re-prioritise investment in essential asset management activity, in particular to address emerging water quality risks, during the AMP. Grants & Contributions are higher than forecast, partly offsetting the higher capex.

The additional opex savings that we have delivered during AMP7 are derived from continued close control of our day-to-day expenditure, along with key initiatives such as the introduction of a virtual operational control centre (using a third party to handle infrequent out-of-hours customer contacts), and the negotiation of a business rates refund from the VOA (which particularly benefits customers through the bespoke 75:25 cost sharing arrangements).

As we enter AMP8, we are moving into a period of higher essential asset maintenance expenditure, as a number of our key assets reach the end of their operating life and require major refurbishment. This is coupled with the need to deliver a step change in our internal capabilities in several critical areas such as cyber resilience, asset management, data management and governance.

Our efficient operating model and headroom against Ofwat's efficient cost allowance means we can absorb these additional activities with botex, without the need for additional enhancement funding.

Overall, during AMP7 we have outperformed the final determination upper quartile benchmark, while at the same time delivering excellent performance for our customers, including upper quartile performance on C-Mex and D-Mex and sector-leading performance on water supply interruptions, mains repairs and water quality contacts. This clearly demonstrates the effectiveness of our operating model in securing value for our customers.

B. AMP8 Wholesale totex

Our AMP8 business plan includes totex of £318m (2022-23 prices, post-RPE and frontier shift), including £11m of expenditure agreed under the accelerated investment delivery process. This is split between base costs and enhancement totex as shown in the table below.

Our AMP8 totex represents an increase of £129m over our actual/forecast costs in AMP7, with increases in both the level of base expenditure and enhancements.

Table 2: AMP8 totex by price control (2022-23 prices)

Cost category	Water resources	Water Network+	AMP8 totex
Base costs	£37m	£148m	£185m
Enhancement totex	£8m	£110m	£118m
Accelerated investment	-	£11m	£11m
Developer services, 3rd party and Grants & Contributions	-	£4m	£4m
TOTAL WHOLESALE EXPENDITURE	£45m	£273m	£318m

Source: Table CW1 plus accelerated investment (post-RPE and frontier shift)

We explain the key drivers of the increase in expenditure below, along with how we have satisfied ourselves that, despite the increase compared with PR19, our AMP8 costs are efficient. We understand that an increase in costs of this magnitude is challenging, and we have responded by taking an ambitious approach to challenging the level of costs in our plan, including applying material programme level efficiencies and an assumption of frontier shift that is significantly above the level assumed at previous price reviews.

Table 3: AMP8 totex compared to AMP7 (2022-23 prices)

Cost category	AMP7	AMP8
Base costs	£156m	£185m
Enhancement totex	£26m	£129m
Developer services, 3rd party and Grants & Contributions	£7m	£4m
TOTAL WHOLESALE EXPENDITURE	£189m	£318m

Source: APR and Table CW1, plus accelerated investment (post-RPE and frontier shift)

C. AMP8 Wholesale Base expenditure (Botex)

Overview of our AMP8 botex

Base expenditure, or 'botex' covers the day-to-day running costs of the business and the maintenance and renewal of our existing assets. Our plan includes botex of £185m for the period 2025-2030, which represents an increase of 18% compared to the current regulatory period. The key components of our botex are shown below, compared with the forecast actual expenditure in the current period.

As the table shows, opex is broadly consistent with our AMP7 actuals, while capital maintenance is increasing by £27m (71%). This reflects the step change in capital maintenance requirements as we move from a low to a high point in our unavoidably lumpy maintenance cycle, as well as the absorption of new activities within base costs.

Table 4: AMP8 botex by cost category

Cost category	Botex 2020-25	Botex 2025-2030
Opex	£118m	£120m
Capital maintenance	£38m	£64m
Botex	£156m	£185m

Source: Table CW1 plus accelerated investment (post-RPE and frontier shift) and APR (Annual Performance Report)

Developing our AMP8 proposals

We have developed detailed forecasts of our AMP8 botex at a granular level, which give us confidence that we have the right level of expenditure in our plan. The principal drivers of the increase in botex are significant areas of new expenditure that are essential to ensure that we can continue to deliver excellence to our customers. These include:

- Enhancement of our asset management capabilities to ensure we can optimise our increased capital maintenance expenditure and enhance our long-term planning tools.
- Investment in cyber security to protect our critical information systems and ensure continuity of supply for customers.
- Critical maintenance activity, which for a company with a small asset base, is more variable between periods and is essential to maintain water quality and security of supply.
- Delivery of continued improvements in service to customers, including leakage reductions and further reductions in the level of interruptions.

For opex we have taken our demonstrably efficient AMP7 cost base as our start point. We have identified any likely changes in demand, including costs to deliver service improvements and any additional activities, such as increase software licencing costs as we move increasingly to a software-as-a-service model. We have also considered any potential for reducing the scope of activities in future.

The principal areas of base opex that are increasing between AMP7 and AMP8 are:

- Higher IT (Information Technology) costs as we enhance key systems and move from a capital expenditure to software as a service model.

- An increase in energy costs as hedging arrangements expire.
- Higher employee costs, in particular in relation to enhanced water quality risk management processes being introduced in the current AMP.

We have been able to absorb these cost pressures through additional efficiencies, meaning that opex overall is consistent with AMP7. We have also modernised our pension arrangements, closing our final salary scheme, reducing the level of risk to customers.

For the capital maintenance element of botex, our programme has been developed on a bottom-up basis, assessing needs on the basis of risk and ensuring that we continue to meet our statutory obligations. We also absorbed significant new areas of expenditure within our base capital maintenance.

The key areas of significant increase in capital maintenance requirements between AMP7 and AMP8 are in relation to non-infrastructure maintenance costs with infrastructure expenditure is broadly consistent with AMP7. The largest elements of our base capex programme are:

- Replacement of membrane plants at two of our water treatment works.
- Ongoing investment to enhance our asset management capabilities, building on the investment in Copperleaf in AMP7.
- Expenditure to maintain and reduce leakage including some strategic investments in our network to enhance resilience.
- Essential routine maintenance of our treatment works.
- Fleet maintenance and net zero.

Allocation between Base and Enhancement

We have carefully considered the allocation of costs between base and enhancement expenditure, taking account of both Ofwat's regulatory accounting guidelines as well as the clear steer from Ofwat that companies should deliver more for less from their base cost allowances in AMP8.

In a number of instances, we have chosen to absorb new areas of expenditure within base cost allowances, rather than seek enhancement funding for these new activities. This includes significant expenditure in relation to cyber threats, which could be considered enhancement as it addresses enhanced threat levels.

We have also included significant improvements in performance commitments in our plan, including stretching our already industry-leading performance in areas including supply interruptions, mains repairs and water quality contacts, within our base costs. Further details of 'what base buys' in respect of each of our performance commitments is provided in supporting document PRT05: Delivering Outcomes for our Customers.

Challenging our own costs

To ensure that the bottom-up botex costs in our plan were appropriate, we went through a structured internal challenge process. As noted above, as part of this process, we considered whether costs should be allocated to enhancement (and thus whether we should seek additional funding from customers) or whether they could be absorbed within base costs, and therefore not have an impact on customer bills. This resulted in a number of projects, such as leakage reduction, being reallocated from enhancement expenditure to botex.

As noted above, our base capex plan has been built at a granular level, so we have a clear view of the delivery profile for AMP8. Schemes have been costed using current frameworks, which means we also have confidence in our expenditure proposals.

However, having particular regard to customer affordability, we also believed it was appropriate to stretch ourselves by applying ambitious, but achievable efficiency challenges to our bottom-up plan.

Following consideration of deliverability, we therefore applied a 15% programme-level efficiency to all our capital maintenance costs. While this is undoubtedly stretching, we believe it is achievable as a result of the larger scale of our AMP8 programme, which unlocks opportunities for more efficient procurement through the bundling of work, and becoming more innovative in the way that we deliver services. See supporting document PRT08: Delivering our Investment Plan for details of how we are evolving our capital delivery model to deliver a significantly larger AMP8 plan.

Efficiency of our AMP8 botex

At PR19 our business plan costs were 16% below the efficient benchmark as determined by Ofwat's cost modelling. Despite the increase compared to AMP7, based on external advice received, we are confident that our botex remains efficient compared with our peers in the sector.

To satisfy ourselves that our costs remain efficient, we commissioned an independent view from Frontier Economics of the likely AMP8 cost allowances, based on Ofwat's draft suite of models, published as part of the PR24 process.

As shown below, after the application of frontier shift and Real Price Effects (see sections F and G below), our costs lie within the range of efficient upper quartile botex, as modelled by Frontier Economics. On this basis, our Board is satisfied that our base expenditure plans are efficient, while delivering the right outcomes for our customers. A copy of Frontier Economics report is included with our plan.

Table 5: Benchmarking our botex

	Efficient benchmark	Business plan costs
Botex	£182m - £212m	£185m

Source: High-level forecast of Portsmouth Water PR24 allowances, Frontier Economics

D. AMP8 Wholesale enhancement expenditure

Overview of our AMP8 enhancement expenditure

Enhancement expenditure represents the costs of meeting new service standards or complying with new statutory obligations. Our AMP8 plan includes £133m of enhancement expenditure (2022-23 prices, pre-RPE and frontier shift), which is a significant step up from our forecast enhancement expenditure for the period 2020-25 of £26m. The components of our enhancement expenditure and associated drivers are set out in the table below.

Table 6: AMP8 enhancement expenditure

Scheme	AMP8 totex	Statutory / Discretionary	Driver	Investment case
Reducing customer demand (smart metering)*	£77m	Statutory	WRMP	PRT07.06
eCAF and SEMD (Security and Emergency Measures Directive)	£16m	Statutory	eCAF / SEMD	PRT07.01
Raw Water Deterioration Protection - Cryptosporidium Treatment	£15m	Statutory	DWI (Drinking Water Inspectorate)	PRT07.02
Raw Water Deterioration - Nitrate Treatment	£15m	Statutory	DWI	PRT07.03
WINEP (Water Industry National Environment Programme)	£5m	Statutory	WINEP	PRT07.05
Isolation and Recovery of Service Reservoirs	£4m	Statutory	DWI	PRT07.04
External lead supply pipes replaced or relined	£2m	Discretionary	DWI	PRT07.07
Total enhancement expenditure	£133m			

Source: Table CW3 (pre-RPE and Frontier shift). * Includes Accelerated Investment

The increase compared with AMP7 is driven principally by the significant step up in expenditure relating to the Water Resources Management Plan, which is built around reducing demand through the installation of smart meters and associated supporting systems and behavioural change initiatives. See investment case PRT07.06 Reducing Customer Side Demand (Universal Smart Metering)

As the table shows we have restricted our AMP8 enhancement programme to delivery of our statutory obligations (including our WRMP), with just one exception, the retention of a small allowance of £2m in relation to replacement of lead supply pipes that we expect to identify as we roll out our metering programme.

We initially included a larger programme of c.£6m of expenditure in relation to the first phase of our lead reduction strategy. However, given the already significant increase in enhancement expenditure to meet statutory requirements, and the pressures on affordability we have chosen to defer most of the expenditure in this programme to AMP9. This is consistent with both customer preferences (customers were not supportive of significant expenditure in this area) and guidance from Government that the focus for AMP8 should be on delivery of statutory programmes.

In AMP8 we will continue to replace customer lead pipes on a prioritised, reactive basis, as we identify them as part of universal metering programme. This work will focus on the highest risk cases, as schools and nurseries and will have a negligible impact on customer bills.

While our proposed AMP8 enhancement expenditure of £133m represents a very material increase compared to AMP7, it is driven almost exclusively by our statutory requirements. It delivers value for customers through helping balance future supply and demand at least cost, as well as maintaining water quality and enhancing the resilience of our assets and services to customers.

Approach to developing our AMP8 proposals

Our enhancement expenditure proposals have been driven by consideration of the long term needs of our region through our Long-Term Delivery Strategy (LTDS). The LTDS framework has allowed us to test with customers the optimal programming of our enhancement expenditure across AMPs. In testing, customers showed a clear preference for a smooth profile of investment over AMPs rather than deferring expenditure to be met by future generations or front-loading investment in the next two AMPs.

Our LTDS core pathway reflects this preference and the enhancement expenditure in our plan is derived from and consistent with our LTDS core pathway. In practice, the extent of the statutory obligations that we must deliver in AMP8 (in particular the WRMP investment) mean that the scope for discretionary investment, while maintaining smooth long-term path of enhancement investment, was highly constrained. As a result, our AMP8 core pathway includes only statutory investment and the small allowance for lead supply pipe replacement, which is associated with our universal metering programme and focuses on the highest risk customers.

All statutory obligations that are required to be delivered in AMP8 have been included in our plan, in line with the requirements of the Environment Agency (via WINEP and the WRMP) and the DWI.

Costing our enhancement schemes

Because enhancement schemes are by their nature made up of activities that have not been undertaken historically, they are inherently more challenging to cost accurately than botex activities. As a small water only company that has historically had a comparatively small enhancement programme, we do not have detailed cost models, based on incurred costs, of the type that many larger companies will maintain.

Our approach to costing has therefore been a pragmatic one, using a mix of current framework contract rates for activities that are currently undertaken in some form (for example our current metering contract rates have been used for our metering programme) and obtaining competitive quotes for activities that are entirely novel (for example we sought three quotes from suppliers for our programme of WINEP investigations). Our costings include prudent allowances for risk and contingency - typically c.20% to include Portsmouth Water management costs.

Overall, we are confident that this costing approach provides us with robust set of costs for our plan.

Challenging our own costs

While we are confident that our costing approach provides a robust basis for developing our plan, we also recognise that there is an expectation from both Ofwat and our customers that we should show ambition and should challenge ourselves to deliver more for less. In line with the approach that we have taken for botex, we applied an initial 15% programme-level efficiency to all our enhancement expenditure.

This recognises the fact that with the larger enhancement programme we are delivering in AMP8 there are more opportunities to achieve scale efficiencies though bundling of work packages and through spreading risk and programme overheads across a wider programme of works. We will actively apply new technologies and innovative solutions and construction techniques to reduce cost.

Our metering programme provides a good instance of where we can be confident that we will be able to deliver further efficiencies compared to our current costs, which are based on a relatively small programme with consequently higher unit costs. Through the larger scale of our AMP8 programme and the street-by-street installation approach which we will undertake, we will reduce overheads, improve programming and reduce installation times.

Following feedback from our Affordability and Acceptability testing, and from our expert 'Red Team,' on the affordability of our plan, we decided to impose a further challenge on the largest schemes within our enhancement programme. For the universal smart metering, nitrates, cryptosporidium and eCAF schemes we have applied a total efficiency stretch of 20% to the bottom-up cost estimates.

Delivery of these programme efficiencies will be monitored during AMP8 as part of our new delivery approach and the cost data and learnings taken forward to inform future costing exercises.

Efficiency of our AMP8 enhancement costs

To satisfy ourselves that the enhancement costs included in our plan are efficient, we relied on three strands.

First, we have worked closely with Arcadis in the development of our long-term enhancement programme, which is derived from our LTDS. They have provided an external challenge in areas such as optioneering of solutions, enabling us to be more confident that we have selected the right solutions and that the costings are not out of line with their expectations.

Second, our costing approach has also been reviewed by Jacobs as part of their assurance work on our plan. They considered whether the costs were supported by clear evidence (e.g. supplier quotes or framework rates) and whether these had been used in an appropriate way.

Finally, we considered whether any of the PR19 Ofwat enhancement models provided relevant benchmarks. We found that for most elements of our enhancement programme there were not any relevant Ofwat benchmarks, either because the activities were not part of AMP7, or they were subject to assessment through shallow/deep dives rather than cost models. The two areas where models did exist are in relation to metering and lead replacement.

For metering, our PR19 metering enhancement costs were allowed in full, as they were 20% below Ofwat's benchmark rates. Our AMP8 programme has been costed using the same metering framework costs, which gives us confidence that the costs are efficient.

In respect of lead supply pipe replacement our costs at PR19 were significantly higher than the Ofwat benchmark level. This largely reflected the fact that our AMP7 lead replacement programme was very small, involving only 50 properties, meaning the unit cost was relatively high. Our AMP8 programme will be larger, with up to 200 properties. However, because we are targeting schools and nurseries on a prioritised basis, and we are proposing to replace both the customer supply pipe as well as the company-owned communication pipe, the unit cost is expected to remain higher than the median benchmark of c.£1,600 per property, which derives principally from domestic communication pipe replacements. We do not therefore think the PR19 benchmark is a useful indicator of the efficiency of our programme and would suggest that a deep dive approach is taken.

The combination of these three strands, combined with the application of a significant programme level efficiency to our costs gives us confidence that they are appropriately stretching and efficient.

E. How We Will Deliver Further Efficiencies

We are committing to significant efficiencies in this plan, relative to our current cost base and framework contracts, that have in most cases been used to cost the capital schemes in our plan. These efficiencies will be challenging to deliver and have not at this stage been fully solutionised.

However, there are a number of changes that we are making to our business in AMP8 that give us confidence that we will be able to deliver significant cost savings. These include:

- Taking advantage of scale efficiencies and the scope to more optimally package work. For example, our existing infrastructure contract, which includes meter installation as well as other network activity, has an end date that means we must retender and award in a similar timeframe to our new meter installation contract. The infrastructure contract requires similar skills set to deliver the scope and we envisage that it will be of similar size from a resourcing perspective. Award to a single delivery partner will at the very least create opportunity for contractor and client management efficiencies and more optimal resource allocation.
- Better commercial and contract management. The bigger scale of our AMP8 programme means we will need new commercial and contract management skills in the organisation to ensure we both structure our tender processes to derive best value and manage our contracts effectively in delivery. In AMP8 we intend to focus our procurement team on materials, goods and services. We will recruit a Senior Commercial Manager to focus on our main investment contracts and suppliers, and a specialist IT Commercial Manager to bring expertise to our IT upgrade programme and smart metering contracts.
- Enhanced capabilities in asset management and value engineering. A core team dedicated to asset management maturity has been established in a standalone department and are extending and embedding ISO55000 processes into business-as-usual activity. We have invested in the Copperleaf® Decision Analytics Solution tool which provides a platform to capture all the potential investment needs (or asset and operational risks), and option scope, cost, and value details. Using Copperleaf, we can optimise our wider asset management framework, to consider investments in the round and deliver greater value for money for our investments.
- Harnessing innovation. Working with expert external advisors we have developed a new innovation framework that we are currently implementing. The framework will encourage participation and encourage innovation ideas to be put forward. It includes an evaluation and decision process ‘The Execs Den’ made up of innovation sponsors, Executive members, a Non-Executive Board member and Future Innovators Team representation. The approach is linked to our approval processes (through inclusion of the Executive Team) and improvements will be funded on a ‘spend to save’ basis within the existing totex envelope.

Further details of our approach to delivery of our AMP8 programme are set out in PRT08: Delivering our Investment Programme. A fuller description of our approach to innovation, including the development of our new innovation framework are provided in PRT10: Innovation to Enhance Service Delivery.

F. Direct Procurement for Customers (DPC)

At PR19 Ofwat introduced Direct Procurement for Customers (DPC), which is designed to deliver greater value for customers through third party delivery and financing of major projects. For PR19 Ofwat required all projects above £100m to be assessed for their suitability for DPC.

For PR24 Ofwat has retained the use of DPC but made it the default delivery route for any projects with a whole life totex in excess of £200m. Schemes below this are not required to be assessed for suitability for DPC, but companies have the option of doing so where they believe that it provides greater value for money.

Our PR24 business plan does not include any projects that exceed the £200m whole life totex threshold, to which DPC by default would apply.

The only project in our plan that exceeds £100m of whole life totex (over two AMPs) is our smart metering programme, which has a totex of c.£138m over the delivery phase in the next two AMPs (including accelerated funding expenditure in AMP7). Since publication of the methodology for PR24 Ofwat has issued further guidance and correspondence on DPC, in which it made clear that it did not consider that smart metering programmes were appropriate candidates for DPC. No other discrete project or group of projects in our plan exceeds the threshold.

We therefore have not included any DPC schemes in our business plan.

G. Frontier Shift

Ofwat's cost assessment is based on comparisons to a modelled benchmark and an assumed rate of 'catch-up' to the efficiency frontier. In addition, it considers that even the most efficient companies, those at the efficiency frontier, have scope to become more efficient over time. This element is known as 'frontier shift'.

At PR19 Ofwat assumed a frontier shift of 1.1% per annum, applied to most of the costs included in the final determination. This decision was consistent with regulatory precedent that a reasonable rate of frontier shift to assume is around 1% per annum. The CMA, in its PR19 determinations applied a 1% frontier shift to most costs.

As noted above, we have already applied significant efficiencies to our bottom-up capex estimates and maintained opex broadly in line with AMP7. However, given the significant pressure on customer bills at this price review, in order to deliver our statutory requirements, we think it is right that we show ambition in this area and challenge ourselves to go beyond this typical rate of productivity improvement.

In addition to the programme-level efficiencies we have applied a further 1% per annum frontier shift, in line with established regulatory precedent and the CMA's PR19 determination. This means that we will need to reduce costs by just under 5%, by 2029-30, in addition to our programme level efficiencies.

We believe this is ambitious, but deliverable through optimisation of existing activities, utilising our enhanced asset management capabilities and technology, as well as through our commitment to innovation in AMP8 – as demonstrated through our innovative partnership with Octopus Energy/Kraken technology. Furthermore, a larger programme of capital works compared with the current period should provide the opportunity to leverage greater savings from the supply chain, including through potential bundling of contracts with neighbouring companies.

We have applied this 1.0% assumption consistently to all wholesale costs in our plan. This reduces our overall totex by £9.2m.

Table 7: Application of frontier shift

Cost category	2025-26	2026-27	2027-28	2028-29	2029-30	TOTAL
Wholesale water						
Pre-frontier shift	£56.5m	£71.5m	£66.4m	£61.9m	£59.8m	£316.1m
Post-frontier shift	£56.0m	£70.1m	£64.5m	£59.5m	£56.9m	£307.0m
Cost reduction	£0.6m	£1.4m	£1.9m	£2.4m	£2.9m	£9.2m

Source: Table CW1 and CW1a (excluding third-party costs and Grants & Contributions)

H. Real Price Effects

Totex is indexed by a general measure of inflation, CPIH, each year. To the extent that costs increase in line with general inflation this protects companies against input cost increases. Real Price Effects (RPE) are a measure of the extent to which the rate of price increases of particular inputs is either higher or lower than the headline rate of CPIH.

Where forecasts suggest that there may be material RPEs an adjustment can be made to price control cost allowances to reflect the forecast RPEs. It is effectively a transfer of risk from companies to customers. At PR19 Ofwat allowed an RPE for labour costs, which were expected to increase materially more than CPIH, with an end of period true-up for actual costs.

During AMP7 we have seen significant, above-CPIH increases in a number of cost categories, such as energy, chemicals and material costs. These have resulted in companies facing greater pressure on their cost base to meet the cost allowances set by Ofwat in the PR19 final determinations.

Against that backdrop of price volatility in AMP7, we have considered whether it is appropriate to provide for any RPEs within our business plan. We have concluded that it is appropriate for us to manage the risks associated with these price movements, rather than seek to pass the risk to customers again delivering further value for money for our customers.

We have therefore not sought to include any increases in totex for RPEs in our plan.

The one exception is in energy costs, where we believe an ex-post true up mechanism, based on an index of market prices may be appropriate to reflect the materiality of energy costs for water companies and the current volatility in energy markets that makes forecasting energy costs especially challenging. We note that Ofwat is collecting additional data on energy costs from companies. At this stage we have not designed a detailed adjustment mechanism, but we think it could be modelled on the wages RPE true up mechanism applied at PR19. We think this would be a straightforward solution which would only require agreement on: (i) the appropriate index of energy costs to be used; and (ii) a consistent assumption on the proportion of energy costs within each of the price controls.

I. Wholesale Cost Adjustment Claims

Cost adjustments claims (CACs) can be made where Ofwat's models do not sufficiently take account of either unique operating circumstances or atypical expenditure. We initially identified two cases where we felt an adjustment was necessary to appropriately reflect our specific circumstances in AMP8. Both cases related to atypical expenditure. They were:

- Replacement of our head office accommodation, which has reached the end of its life and now requires replacement.
- The lumpy prolife of maintenance expenditure that we experience as a small company with very few assets. This claim is quantified on the basis of the cost capping that Ofwat applied at PR19, which was a low point in our capital maintenance cycle.

Both claims were submitted to Ofwat as part of the early submission of CACs in June 2023.

Since then, we have reflected further, including giving consideration to the comparison of our potential modelled cost allowances with our bottom-up botex plans (see section C(v) above).

Based on that comparison, and considering the affordability pressures our customers face in AMP8, we have decided to withdraw these CACs, and absorb the costs within our base cost allowance. That is subject to the modelled allowances being consistent with our current expectations. If the modelled botex allowances are lower than we anticipate, then we may wish to reintroduce the CACs in response to the draft determination.

J. Retail Costs

Overview of our AMP8 Retail cost to serve

Cost allowances for the retail price control are based on a total cost-to-serve assessment, comprising operating expenditure, depreciation of retail assets and recharges from wholesale. Our total retail cost to serve is £29m, broken down as below.

Table 8: AMP8 household retail costs

Cost category	AMP8 totex
Customer services	£19.8m
Doubtful debt provision	£2.6m
Recharges	£5.3m
Depreciation, rates and other costs	£1.2m
TOTAL RETAIL EXPENDITURE	**£28.9m**

Source: Analysis of Portsmouth Water Retail cost data. Total cost to serve is consistent with Table RET1.

Key movements in our retail cost base

As a single service retailer with a relatively small customer base we have limited opportunities to realised scale of scope efficiencies in our Retail business. We address this through simple, customer-focused processes, but ultimately delivering in line with Ofwat retail cost allowances is a challenge for our business. During a time of historically high inflation, and wage rises, during AMP7 the lack of any price adjustment for inflation in Retail has added significantly to the challenge.

The challenge for AMP8 is managing additional level of customer demand that we expect as we switch our customers from a fixed to a metered charging basis. To help address this challenge, during AMP8, as part of our smart metering programme we will deliver a new Customer Relationship Management (CRM) system. We have partnered with Kraken, part of the Octopus energy Group, to deliver their first CRM system in the water sector.

The Kraken technology uses the latest advances in data and machine learning and has already streamlined customer service in the energy retail sector. Through its customer segmentation capabilities, it will allow us to deliver more tailored services to customers, while keeping the cost to serve low through automation and self-serve e.g. moving house details or swapping tariff (potentially reducing cost to serve by 40 per cent). Increasing automation and the use of AI (Artificial Intelligence) to eliminate repetitive, mundane tasks, will allow our teams to focus on important tasks which are crucial to delivering outcomes.

We are confident that the partnership with Kraken will help us deliver more efficient customer service while maintaining excellence in the standards of service to our customers (as reflected in our upper quartile C-Mex performance).

Set against this opportunity, we understand that the switch from a largely unengaged, unmetered customer base, to one that is fully metered will increase the level of demand on our customer service functions.

Below we show the breakdown of our forecast Retail operating expenditure compared with our total costs for the current regulatory period. Overall costs are £4.1m higher than in the current period.

The increase compared to AMP8 principally reflects the increase in recharge from Wholesale in respect of the new smart meter-enabling IT systems, and an increase in the doubtful debt provision relative to AMP7, but which is in line with the previous AMP. Our customer service costs in AMP8 are forecast to be broadly consistent with AMP7 as increases in demand are offset by future efficiencies enabled by the introduction of the Kraken system and increased levels of self-serve.

As we optimise the use of the Kraken CRM system in the water context, we expect significant opportunities to further reduce our cost to serve in future.

Table 9: Key changes in our household retail costs

Cost category	2020-25 total	2025-2030 total
Customer services	£21.4m	£19.8m
Doubtful debt provision	£1.9m	£2.6m
Recharges	£0.6m	£5.3m
Depreciation, rates and other costs	£0.9m	£1.2m
TOTAL RETAIL EXPENDITURE	**£24.8m**	**£28.9m**

Source: Analysis of Portsmouth Water Retail cost data. Total cost to serve is consistent with Table RET1.

Efficiency of our AMP8 retail costs

As we did for wholesale botex, we commissioned an independent view from Frontier Economics of the likely cost allowances, based on Ofwat's published retail cost models. As shown below, our costs lie just below the range of efficient upper quartile botex, as modelled by Frontier Economics.

Table 10: Benchmarking our household retail costs

Cost category	Efficient benchmark	Business plan costs
Retail cost to serve	£30-32m	£28.9m

Source: High-level forecast of Portsmouth Water PR24 allowances, Frontier Economics

We have not applied a frontier shift assumption to our retail costs. This is because the structure of the price control already requires companies to absorb all inflationary pressures as the cost allowances are not increased each year by CPIH as they are for wholesale activities. Given the considerable proportion of Retail costs that are employee related, absorbing all cost pressures requires significant ongoing efficiency savings to be made.

We have not included allowance for any Relative Price Effects for Retail.

4. SUMMARY

In this document we have described our totex proposals for AMP8, which build on our historical record as an efficient company that delivers high standards of service to our customers.

Our AMP8 wholesale totex will be £318m, representing an increase of £129m compared to AMP7.

Increases in botex are required to ensure that we maintain the resilience of our services to customers as we move from a low point into a higher point in our unavoidably lumpy investment cycle. Despite the increase in botex, based on independent advice, we are confident that our costs remain consistent with upper quartile performance. As a result, we have chosen to withdraw the draft Cost Adjustment Claims that we submitted in June 2023 and absorb these costs within our base cost allowances.

Our botex plans will deliver significant improvements in performance commitments at no extra cost to customers. Details of our performance commitments are set out in supporting document PRT05: Delivering Outcomes for our Customers.

The increase in our enhancement costs, from £26m in AMP7 to £129m in AMP8 is required to deliver our statutory obligations, including our WRMP and WINEP programmes.

We are acutely aware of the affordability pressures our customers are facing now, and we have responded to customer feedback and challenge from our expert 'Red Team' by removing discretionary enhancement investment, except for a small allowance to replace lead pipes for vulnerable customers on a prioritised basis.

We have also imposed a significant efficiency challenge on our enhancement costs of between 15% and 20%. Delivery of such efficiencies is ambitious, but deliverable. Further details of our approach to delivery in AMP8 can be found in PRT08: Delivering our Investment Plan.

We have also demonstrated ambition in applying an additional frontier shift assumption of 1.0% per annum, consistent with the view taken by the CMA for PR19.

We have not included any RPEs in our plan, as we believe it is most appropriate for companies to manage these risks, rather than pass them on to customers. We do however propose that an ex-post true up of energy costs is appropriate, given the materiality of energy costs and the fact that the current level of volatility in energy markets make forecasting extremely challenging.

5. GOVERNANCE AND ASSURANCE

Our costs have been subject to ongoing internal review and challenge at Executive level, overseen by the Board, as the PR24 business plan has developed. This challenge process has led to reductions in costs, reallocation of expenditure to base costs and the application of programme-level efficiencies. Our expert 'Red Team' have provided independent external challenge and advice on the overall business plan, a process which led to the removal of our draft Cost Adjustment Claims and the decision to defer discretionary expenditure on our lead strategy.

Formal assurance of our business plan costs has been carried out by Jacobs, as part of their overall assurance work on our plan.

Additional informal assurance is provided using Arcadis in developing our Long-Term Delivery Strategy, which includes our enhancement expenditure and through the expert input on cost modelling provided by Frontier Economics.

PRT09 APPENDIX

APPENDIX

Click to view:

PRT09.01 Frontier Economics - High-level forecasts of Portsmouth PR24 allowances

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