BUSINESS PLAN 2025 TO 2030

PRT13 ALIGNING RISK AND RETURN

CONTENTS

1. AT A GLANCE

A. Return on Regulatory Equity (RoRE)

Our business plan reflects an appropriate balance of risk and reward. Our projected RoRE range is +3.0% / -5.4% compared with Ofwat's PR24 guidance +4.8% / -4.9%.

Figure 1: RoRE Range: Ofwat vs Company

Our performance commitment incentives have been set following Ofwat's methodology. Following evaluation with our Board we have set our performance commitments based on Ofwat's company-specific rates rather than industry averages. This is because our proportionally low RCV means we are an outlier, resulting in a magnification in incentive rates in RoRE terms. Using Ofwat averaged ODI rates our RoRE range assessment is +6.3% / -8.4% which reflects too wide a a range of risk and reward relative to current allowed return on equity.

Our assessment has considered the specific risks the company faces on the Havant Thicket control and consider the wider risk and opportunities centred around our performance commitments. We have evaluated the risk and reward at appointee level but considered the range excluding the Havant Thicket control.

B. Financeability

Our plan is financeable and has been assured by our Board. On a notional company basis our plan assumes gearing is maintained line with the notional company through provision of additional £93m of equity. Dividend yield for the notional company structure is projected to be 2.24% in line with our dividend policy and Ofwat guidance.

Gearing and interest cover credit metrics meet guidance for Moody's Baa1, but we assess our plan as Baa2, one notch above investment grade. This is consistent with our current Moody's rating where the scale of investment relative to our RCV effectively creates a rating ceiling during the construction of Havant Thicket Reservoir.

The Moody's scorecard includes an assessment for construction risk based on capex as a proportion of RCV. The scale of the investment relative to our current RCV indicates we will remain at our Baa2 rating through peak construction period over the 10-year price control period.

Figure 2: Financeability - Gearing (Notional Company)

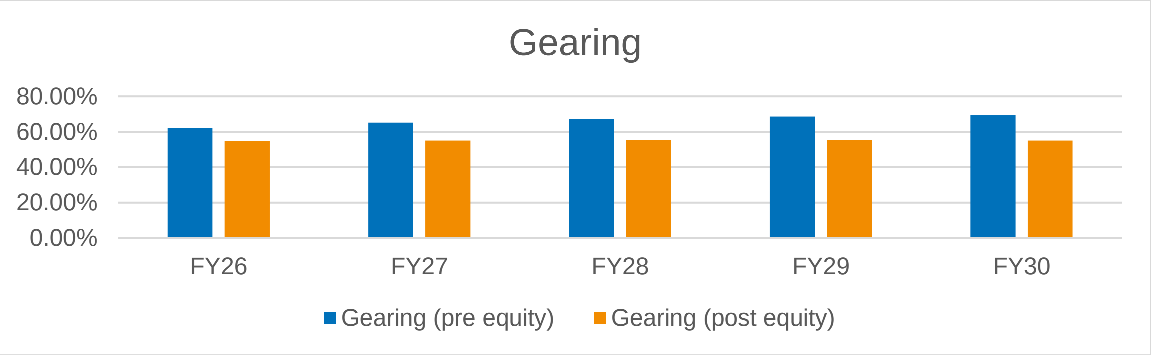


Figure 3: Financeability - New equity (Notional Company)

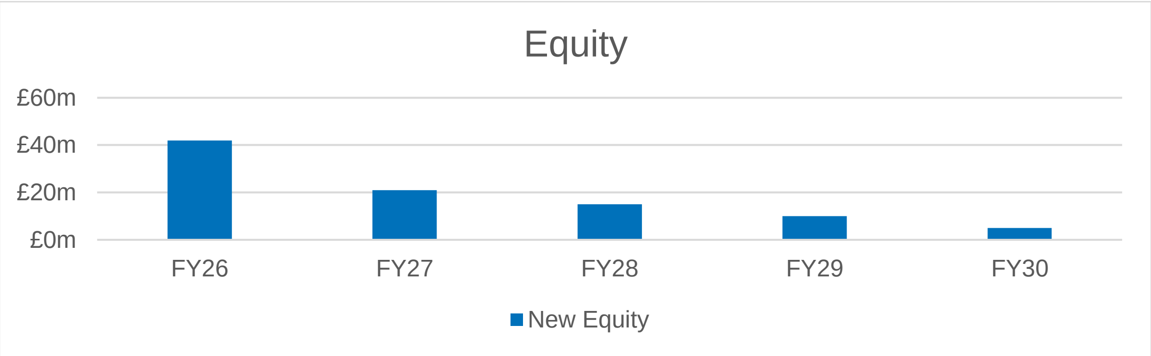


Table 1: Ofwat Financial Model Dashboard - Key Metrics

Key financial ratios	2025-26	2026-27	2027-28	2028-29	2029-30	5yr avg.
Adjusted cash interest cover ratio (Ofwat)	1.518	1.548	1.547	1.547	1.548	1.542
Adjusted cash interest cover ratio - (Alternative)	1.407	1.443	1.447	1.452	1.457	1.442
Funds from operations / net debt (Ofwat)	6.81%	7.11%	7.29%	7.52%	7.67%	7.31%
Funds from operations / net debt - (Alternative)	6.05%	6.32%	6.50%	6.71%	6.85%	6.51%
Gearing - Appointee	54.91%	55.08%	55.16%	55.01%	54.92%	55.02%
Dividends	**2025-26**	**2026-27**	**2027-28**	**2028-29**	**2029-30**	**Total**
Dividends (£m real)	2.46	7.87	7.55	7.46	7.40	32.74
Dividend yield %	0.89%	2.81%	2.58%	2.49%	2.45%	2.24%
Dividend growth %	-	-	-	-	-	-

Our plan reflects a Weighted Average Cost of Capital (WACC) of 3.37% for the retail and wholesale controls. Allowed returns to have been set in line with the PR24 final methodology 'early view' guidance for the retail and wholesale controls. We have included a small company premium in line with Ofwat's notional small company guidance. This is supported by our customers.

We have proposed a bespoke cost of capital for the Havant Thicket control. Our plan assumes a cost of capital of 4.13% for the Havant Thicket control from PR24. We believe a higher cost of debt is supportable to reflect the timing and quantum of financing required to deliver the scheme. We have included reports from Frontier Economics and NERA which provide the analytical basis for our proposed WACC.

We are proposing the same cost of equity for the wholesale and Havant Thicket control. NERA proposed a higher asset Beta recognising the degree of construction risk. We have not included this in our proposed cost of capital as we think it is appropriate that risk should be considered over the life of the asset.

We anticipate that the cost of equity will be reviewed to consider up to date market data. Our expectation is that the cost of equity adequately rewards investors for risk to ensure the sector remains attractive to investors, given the need for equity support for future investment and taking into consideration returns available on alternative investment markets. Our expectation is that any revision to the cost of equity is reflected in both the Havant Thicket and main wholesale controls.

We have reviewed the change in cost of debt benchmarks since the final methodology was published and expect the final cost of capital to be updated to reflect the latest view of market data to align with the cost of debt index methodology.

For the Havant Thicket price control, we have proposed the cost of debt index is amended to recognise the absence of embedded debt in the 10-year control, and to align weighting with the RCV profile and debt requirements. This is consistent with the methodology used to evaluate the bespoke cost of debt for Havant Thicket. We have proposed that this approach is applied consistently across the 10-year price control reconciliation of cost of debt at PR24 and PR29.

C. Financial Resilience

We have a robust capital structure and have secured the financing to support the construction of Havant Thicket Reservoir. Investors have committed £170m of new equity in AMP7. £140m is already in place as at October 2023.

We have also secured £280m of debt funding, including a £75m CPI-linked bond and £205m of flexible bank facilities. We have secured funding from the UK Infrastructure Bank, opening a path for further water sector support.

We have evaluated long term financial resilience based on our current capital structure. Our plan is financeable based on our actual company structure and equity already committed. Our plan maintains our Baa2 credit rating on all downside scenarios through the mitigations available including reducing dividends and liquidity support.

We expect to agree a change control to our Havant Thicket Reservoir programme associated with the alignment works with Southern Water's recycled water scheme. This involves increasing the capacity of the pipeline from Bedhampton to the reservoir at Havant Thicket to accommodate a second source of water from the recycling plant at Southern Water's Budds Farm wastewater treatment plant.

We are in discussions with the Ofwat Major Projects Team about a second Cost Adjustment Mechanism to align with a new planning application in March 2023. The second Cost Adjustment Mechanism process is expected to align with the PR24 timeline. Initial estimates are that the new scope could increase expenditure by £70m and delay completion of the reservoir by 1-2 years.

Our assessment is that the new scope is financeable but requires shareholder support. We will finance the additional investment through a combination of new equity and debt financing following the principles established in the first cost adjustment exercise. Our investors Ancala have confirmed continuing support for the scheme and can demonstrate their track record of support since their acquisition of the company in 2017.

We plan to raise additional financing to support the non-Havant Thicket growth and refinance £205m facilities expiring in 2029. We are due to refinance our long-term Artesian funding in 2032.The Board has considered the financing strategy as part of the PR24 assurance. The refinancing will review the equity requirements for PR29.

We propose that updated versions of the PR24 financial model and the relevant business plan tables and associated assurance are submitted as part of the cost adjustment exercise, along with the financing strategy, dividend policy and additional equity requirements.

D. Dividend Policy

Our dividend policy maintains a provision for a 4% base yield on equity during AMP8 (based on dividends declared). The assessment process for adjusting dividends to reflect performance for customers and the environment is outlined transparently in the dividend policy published annually in our Annual Performance Report.

The policy is used as a mechanistic guide to enable our Board to assure and approve dividend distributions and covers all distributions to shareholders including intercompany interest and loan repayments. The mechanistic approach also aims to provide transparency for customers on the assessment of dividends.

Our plan assumes a 4% base (declared) dividend yield, as our investors have committed significant equity up front to support the Havant Thicket project and wider investments. The dividend yield has been adjusted to reflect actual regulatory gearing, reducing notional company dividends as company gearing is above the notional gearing structure.

Further equity support for the change to the Havant Thicket scope is anticipated. Any further equity requirements will be supported through reducing dividends or securing further equity from investors in line with the provisions of our policy.

E. Executive Pay

Through AMP7 we have reviewed our policy on executive pay and performance related pay. All company employees now have a performance related pay structure aligned to delivering performance for customers and the environment.

60% of measures in the short term and long-term components of executive pay are aligned to delivery for customers and the environment. Targets have been reviewed for 2023-24 to include new measures on totex and health & wellbeing, and the weighting of financial and personal objectives has been reduced.

Stretching targets for AMP8 will be set once the PR24 outcome is known. Performance will be linked to outperformance on performance commitments or to upper quartile performance in the absence of specific performance commitments. The Remuneration Committee will take a balanced view and assess overall performance, not just specific metrics.

To strengthen controls on executive pay we are introducing specific underpinning, malus, and clawback clauses in our Executive director contracts from 2023-24 onwards.

F. Voluntary Sharing Mechanisms

Our plan proposes a customer sharing mechanism on ODI rewards where 5% net rewards are shared with customers.

Our research findings show that our customers feel we should concentrate on delivering value in areas that feel relevant to the business. Supporting customers who are struggling (both financially and due to health vulnerabilities) and protecting the environment are the main areas that feel appropriate.

The ODI reward sharing mechanism will increase funding to our Arrears Assist to target help for customers who are struggling with affording their household bills, and support local organisations supporting vulnerable customers.

We are not proposing any additional sharing mechanisms on tax and financing costs.

We do not expect to pay tax in AMP8 due to the scale of investment and there is limited scope for financing outperformance. The legacy embedded Artesian limits our ability to outperform the cost of debt until it is refinanced in 2032 and higher levels of index-linked debt limit financing gains in high inflation environments.

G. Uncertainty Mechanisms

We are not proposing any additional uncertainty mechanisms or notified items, in addition to those specified in the licence or incorporated into the PR24 methodology.

H. Board Assurance

Our Board have been fully engaged through the development of the business plan. Full details of the assurance process are outlined in the supporting document PRT15: Board Assurance.

The Board were involved in the development of the plan from 2021 through a bimonthly/monthly PR24 Steering Group. Meetings were attended by all members of the Board, members of the executive team and the PR24 programme team. Further discussions on dividend policy and executive pay have been covered at Board meetings and through other Board sub-committees.

The Board have reviewed the assurance criteria and requirements of the quality and ambition assessment of the PR24 plan.

The Board reviewed the financeability of the plan based on the notional capital structure and agreed the approach to align the plan with notional gearing through new equity. They also reviewed the proposals on cost of capital including the bespoke cost of capital for Havant Thicket.

The Board were satisfied that the plan targeted maintaining credit ratings at least two notches above the minimum of the investment grade but acknowledge the constraint on achieving a Baa1 rating.

Moody's methodology effectively creating a ceiling at Baa2 due to the scale of Havant Thicket investment relative to Portsmouth Water's RCV. Financial ratios for the downside scenarios were reviewed and the Board were satisfied that the actual capital structure was financially resilient against the prescribed downside scenarios in Ofwat's methodology.

Dividend policy and executive pay have been extensively reviewed. The Board discussed the 4% dividend yield on actual equity and concluded it was supported based on the provision of upfront equity but noted that this was subject to annual review in line with the published dividend policy. Executive pay was reviewed, and targets have been amended from 2023-24 and the Board agreed to the proposal to introduce malus and clawback policies for executive director contracts.

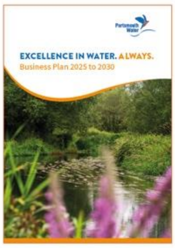
Additional scenarios were agreed around the Havant Thicket control. The Board recognised that the change of scope relating to the alignment works will require further consideration in relation to dividend policy and equity requirements.

Board discussions were supported by expert third party assurance. The following assurance activities covered requirements on risk and reward.

- Jacobs: review of Performance Commitments.
- KPMG: Models and financial assurance.
- Cost of Capital: reports from First Economics, NERA Economic Consulting.
- Financeability / Financial Resilience: support from Centrus Corporate Finance
- Executive Pay: advice and assurance from Deloitte
- Econometric and financial modelling: Frontier Economics

2. DOCUMENT MAP

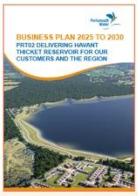
Business Plan to 2030



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

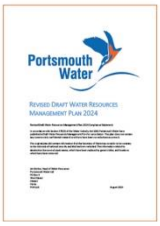
PRT13
Aligning Risk and Return

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

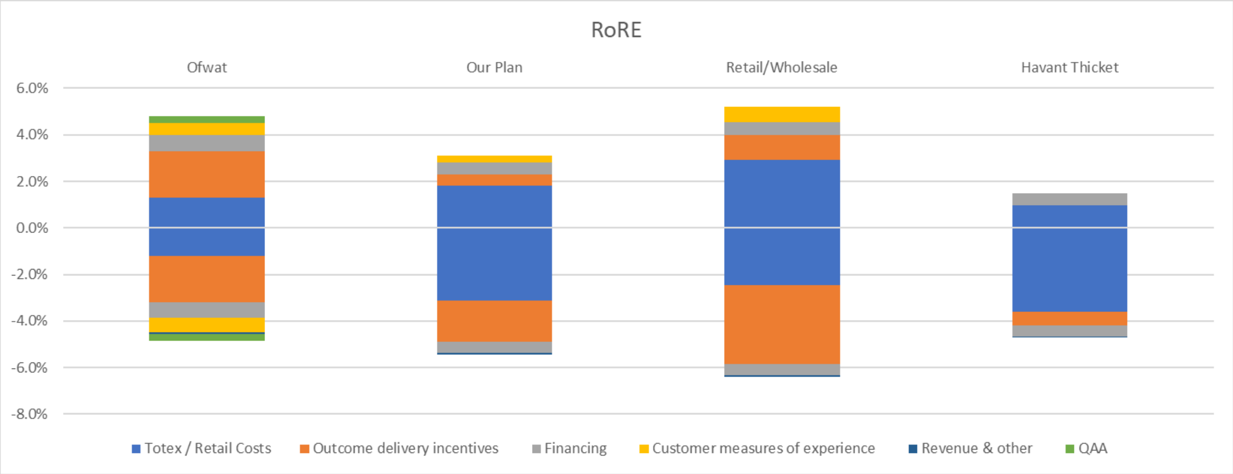
3. ALIGNING RISK AND RETURN

A. Understanding risk in our plan

RoRE analysis

Our business plan reflects an appropriate balance of risk and reward. Our projected RoRE range is +3.0% / -5.4% compared with Ofwat's PR24 guidance +4.8% / -4.9%.

Figure 4: RoRE Range - Ofwat vs Company RoRE Range



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Our assessment has considered the specific risks the company faces on the Havant Thicket control and considered the wider risks and opportunities, centred around our performance commitments. We have evaluated the risk and reward at Appointee level but considered the range excluding the Havant Thicket price control.

RoRE analysis: Retail and Wholesale Controls

Due to the atypical nature of the Havant Thicket control, we have assessed RoRE on both a combined and separate basis to evaluate the risks associated with serving Portsmouth Water customers.

To evaluate the risk range, we started by assessing the risk on performance commitments and used this to assess implications on totex. For financing and revenue, we have aligned with Ofwat PR24 methodology guidance.

ODIs: RoRE impacts were assessed against risks identified through out risk and resilience assessment. The main assumptions centred on:

- Risk of significant interruption events to coastal community.
- Weather impact on network performance.
- Discharge and pollution incidents.
- Success of our smart metering programme.

Table 2: RoRE Range: Company ODI P10 (low) and P90 (high)

Outcome Delivery Incentives (£m, 2022-23 prices)	P10	P50	P90	P10	P90
Interruptions	-4.1	0.9	0.9	1 significant customer interruption event	Continued sector leading performance
CRI	-0.7	-0.1	0.0	DWI notices not addressed	
Water Quality Contacts	0.1	0.3	0.4		
Biodiversity	0.0	0.0	0.0		
Discharge Permit Compliance	-5.9	0.0	0.0	1 unpermitted discharge per year	0 unpermitted discharge per year
Serious Pollution Incidents	-0.4	0.0	0.0	1 serious pollution event	0 serious pollution event
Leakage	-1.7	0.1	0.6	3 Harsh Winters	Gains for customer side leakage
PCC	-0.8	0.0	2.6	Negative reaction to smart metering	Positive impacts of smart metering
Business Demand	-1.2	0.0	0.3	Negative reaction to smart metering	Positive impacts of smart metering
Operational GHG	0.0	0.0	0.0		
Mains Repairs	-0.1	0.3	1.6	3 Harsh Winters	Favourable weather & effective maintenance
Unplanned Outage	-4.3	-0.2	0.0	3 Harsh Winters	Favourable weather & effective maintenance

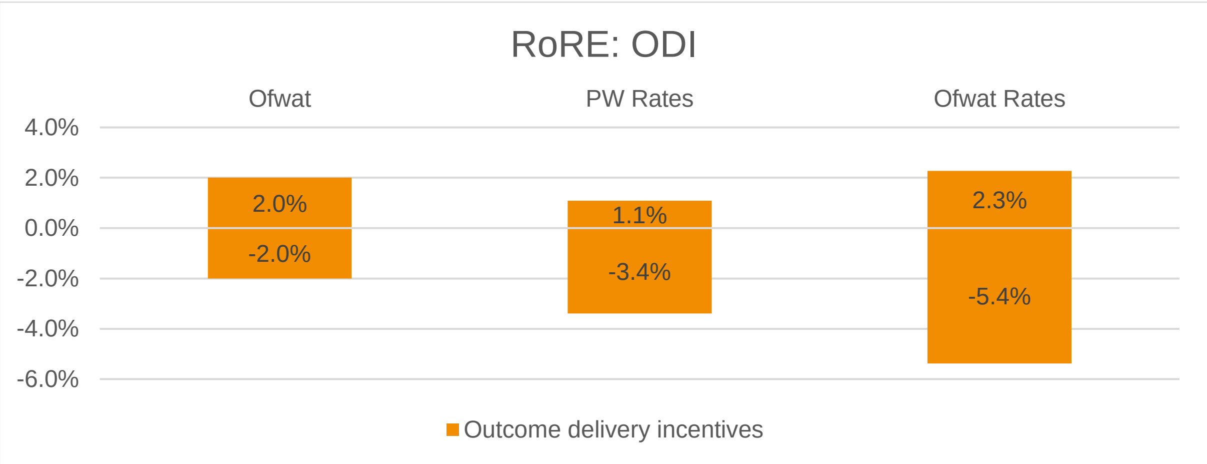
Total	-19.1	1.3	6.3
RoRE	-3.4%		1.1%

In reviewing the RoRE range we assessed the risk range using ODI rates based on the Ofwat methodology. We identified that the averaging approach used to set the industry ODI rates had a large incidence effect on Portsmouth Water, due to our being an outlier in terms of the proportional size of our RCV.

We support Ofwat's common methodology but view the impact of the methodology on RoRE in our cases as an unintended consequence. Following review with our Board we have submitted our PR24 plan based on Ofwat's company-specific rates. The RoRE range on ODIs using these company-specific rates is -3.4% to 1.1% compared with the Ofwat guidance of +/- 1-3%. Using Ofwat's rates the range would be -5.4% to 2.5%.

Further detail is included in the supplementary document PR05: Delivering Outcomes for Our Customers.

Figure 5: RoRE Range: Ofwat's company-specific vs averaged ODI rates



Other key assumptions used for assessing our RoRE range are set out below.

- **Totex**: We have aligned with Ofwat guidance of +/- 8.5% variance to final determination cost allowances. This equates to roughly a 50% efficiency challenge reflected in the plan, or c.£7m a year. This has been assessed against for:
  - Additional investment to recover leakage and main repairs: +£1-£2m per annum.
  - Recover cost after major interruptions: +£1m.
  - Pollution fines.
  - Additional production costs: +£1m.
  - Efficiency risk: +£3m.
- Financing: We have followed Ofwat's guidance, but we have recalculated the inflation element reflecting our actual levels of index-linked debt. Our higher levels of index-linked debt reduce our sensitivity to inflation.

- Customer measures of experience: Our RoRE range reflects our current upper quartile position. Our low case assumes we move to average performance driven by dissatisfaction from the smart metering programme. Our high case assumes we are the frontier company but do not achieve the maximum reward.
- **Revenue and other RoRE risks**: Aligned to Ofwat's PR24 guidance.

Our estimated RoRE range for retail and wholesale controls is -6.4% to 5.0%

Table 3: RoRE Analysis Retail and Wholesale Only (Table RR30.46-57)

Line Description	Units	DPs						Average
			2025-26	2026-27	2027-28	2028-29	2029-30	2025-30
RoRE - high case								
Totex RoRE - high case	%	2	3.01%	3.26%	2.74%	2.37%	2.16%	2.71%
Outcome delivery incentives RoRE - high case	%	2	1.51%	1.36%	1.19%	0.45%	0.96%	1.09%
Financing RoRE - high case	%	2	0.40%	0.51%	0.56%	0.58%	0.60%	0.53%
Customer measures of experience RoRE - high case	%	2	0.83%	0.74%	0.67%	0.62%	0.58%	0.69%
Revenue & other RoRE - high case	%	2	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%
RoRE - high case ~ total	%	2	5.74%	5.88%	5.15%	4.02%	4.29%	5.02%
RoRE - low case								
Totex RoRE - low case	%	2	-2.73%	-3.01%	-2.51%	-2.16%	-1.96%	-2.47%
Outcome delivery incentives RoRE - low case	%	2	-7.93%	-2.37%	-1.89%	-2.38%	-2.41%	-3.39%
Financing RoRE - low case	%	2	-0.35%	-0.46%	-0.51%	-0.53%	-0.55%	-0.48%
Customer measures of experience RoRE - low case	%	2	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%
Revenue & other RoRE - low case	%	2	-0.05%	-0.05%	-0.05%	-0.05%	-0.05%	-0.05%
RoRE - low case ~ total	%	2	-11.07%	-5.89%	-4.95%	-5.12%	-4.96%	-6.40%

RoRE Analysis: Havant Thicket Price Control

Evaluating Havant Thicket on a standalone basis we assess a RoRE range of -4.7% to +1.5%. While the range is narrower for the Havant Thicket price control compared to the retail and wholesale controls, the risk is more concentrated. The magnitude of risk is greater due to the scale of Havant Thicket relative to Portsmouth Water as a whole. The risk range is based on a standard downside scenario that has been run on the Havant Thicket scheme and consistent with financial resilience stress testing. The low case assumes a 20% programme overspend and a two-year delay to delivery while the high case assumes the scheme is delivered a year ahead of programme and with £15m cost outperformance.

The scenarios have been benchmarked against the programme Montecarlo risk assessment process and broadly align to a P10 and P90 position.

Low case:

- RoRE reflects a £75m cost overrun and assumes that 25% is borne by contractors through the commercial protections. Net downside is a c.£55m overspend to be shared by Portsmouth Water and Southern Water customers.
- Delay resulting in £4.4m penalties due to a 24-month delay to dry commissioning and a 6-month delay to wet commissioning at the end of AMP8.

High case: RoRE reflects a £15m cost efficiency, due to early completion and management of risk.

Table 4: RoRE Analysis Havant Thicket Only (Table RR30.46-57)

Line Description	Units	DPs	2025-26	2026-27	2027-28	2028-29	2029-30	Average 2025-30
RoRE - high case								
Totex RoRE - high case	%	2	0.00%	1.64%	3.18%	0.00%	0.00%	0.96%
Outcome delivery incentives RoRE - high case	%	2	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%
Financing RoRE - high case	%	2	0.40%	0.51%	0.56%	0.58%	0.60%	0.53%
Customer measures of experience RoRE - high case	%	2	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%
Revenue & other RoRE - high case	%	2	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%
RoRE - high case ~ total	%	2	0.40%	2.15%	3.74%	0.58%	0.60%	1.49%
RoRE - low case								
Totex RoRE - low case	%	2	-3.58%	-6.55%	-4.77%	-1.57%	-1.59%	-3.61%
Outcome delivery incentives RoRE - low case	%	2	0.00%	-0.18%	-0.71%	-0.53%	-1.42%	-0.57%
Financing RoRE - low case	%	2	-0.35%	-0.46%	-0.51%	-0.53%	-0.55%	-0.48%
Customer measures of experience RoRE - low case	%	2	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%
Revenue & other RoRE - low case	%	2	-0.05%	-0.05%	-0.05%	-0.05%	-0.05%	-0.05%
RoRE - low case ~ total	%	2	-3.98%	-7.25%	-6.04%	-2.68%	-3.60%	-4.71%

RoRE Analysis: Appointee Level

Combined RoRE range at appointee level is +3.1% / -5.4% vs Ofwat PR24 guidance +4.8% / -4.9%.

Table 5: RoRE Analysis Appointee (Table RR30.46-57)

Line Description	Units	DPs	2025-26	2026-27	2027-28	2028-29	2029-30	Average 2025-30
RoRE - high case								
Totex RoRE - high case	%	2	1.33%	2.42%	3.08%	1.16%	1.09%	1.82%
Outcome delivery incentives RoRE - high case	%	2	0.62%	0.57%	0.52%	0.20%	0.45%	0.47%
Financing RoRE - high case	%	2	0.40%	0.51%	0.56%	0.58%	0.60%	0.53%
Customer measures of experience RoRE - high case	%	2	0.34%	0.31%	0.29%	0.28%	0.27%	0.30%
Revenue & other RoRE - high case	%	2	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%
RoRE - high case ~ total	%	2	2.70%	3.81%	4.44%	2.22%	2.41%	3.12%
RoRE - low case								
Totex RoRE - low case	%	2	-3.23%	-5.08%	-3.79%	-1.84%	-1.76%	-3.14%
Outcome delivery incentives RoRE - low case	%	2	-3.27%	-1.09%	-1.22%	-1.37%	-1.88%	-1.77%
Financing RoRE - low case	%	2	-0.35%	-0.46%	-0.51%	-0.53%	-0.55%	-0.48%
Customer measures of experience RoRE - low case	%	2	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%
Revenue & other RoRE - low case	%	2	-0.05%	-0.05%	-0.05%	-0.05%	-0.05%	-0.05%
RoRE - low case ~ total	%	2	-6.90%	-6.68%	-5.56%	-3.79%	-4.24%	-5.43%

Further support on RoRE range estimate is included with table RR30 and commentary.

B. Financing our AMP8 plan

A sustainable and responsible capital structure

Portsmouth Water has a resilient capital structure and is well positioned for the step up in investment in AMP8. Financing is already in place to support construction of the Havant Thicket Reservoir. The financing exercise sized capital requirements to accommodation increased cost of Havant Thicket, as well as the requirements of our Water Resources Management Plan, WINEP and water quality investment.

New equity has been secured to support the construction of Havant Thicket. Over AMP7 our investors have committed £170m of new equity to support investment; £140m has already been deployed as new equity and through repayment of legacy intercompany loans. The remaining £30m is committed and assumed to be deployed in financial year 2024-25 (subject to the capital investment profile requirements of Havant Thicket).

New debt finance was secured in March 2023. This includes a £75m CPI-linked bond and £205m of sustainability-linked banking facilities. Further liquidity is available within group structure to be drawn as intercompany loans or equity.

Prudent use of derivatives has reduced our exposure to inflation and interest rates. Our legacy exposure to the Artesian RPI-linked bond has now been reduced by fixing the wedge between RPI with CPI through a basis swap. This reduces the risk on refinancing and the risk of divergence from CPI-linked RCV growth. We have reduced our exposure to floating debt by partial hedging through interest rate swaps to ensure greater cashflow certainty during the peak Havant Thicket construction period.

We currently hold a Baa2 Stable credit rating with Moody's. Our PR24 business plan targets credit metrics that are in line with a Baa1 rating, but our expectation is that our rating will remain at Baa2 due to the scale of the Havant Thicket scheme relative to Portsmouth Water's RCV. Moody's rating assessment methodology effectively creates a ceiling rating of Baa2 through the construction period due to the scale of investment relative to the Portsmouth Water RCV in the peak construction years. We expect to raise a further £100m-£170m of financing to support the AMP8 business plan. We are also due to refinance the £205m of banking facilities in 2029.

On a notional company basis, we have assumed £93m of new equity in AMP8 to keep the gearing in line with Ofwat's 55% notional company assumption throughout AMP8. Our notional company plan meets the credit metrics for a Baa1 Moody's rating. We have not assumed any other financeability adjustments to pay-as-you-go (PAYG) and run-off rates. PAYG and run-off are calculated in line with the natural business plan opex / capex ratios and asset lives to maintain a balanced position on financeability and affordability.

We have assessed our current actual company plan based on equity and debt financing secured in 2023. We anticipate entering AMP8 below the notional company gearing level of 55% due to the provision of up front equity, with gearing increasing towards the end of AMP8. The plan achieves Moody's Baa1 rating metrics, but again we anticipate this will result in a Baa2 rating due to the rating ceiling during Havant Thicket construction.

Our dividend policy assumes a base yield of 4% on actual regulatory equity, based on AMP8 declared dividends and our actual capital structure. This equates to 3.4% on the basis of dividends paid. Our policy includes provisions to reduce dividend yield to ensure dividends are earned for performance for customer and the environment, to secure long term financial resilience and in consideration of future risks. Our PR24 business plan submission reflects an average base dividend yield of 2.24% (dividends paid) on a notional basis, reflecting the lower gearing of the notional company.

Our PR24 plan has been submitted in line with the agreed funding from the January 2023 Cost Adjustment Mechanism Final Determination. We are currently in discussion with Southern Water and Ofwat about a change of scope to the Havant Thicket Reservoir scheme to increase the capacity of the pipeline to accommodate water from the SRO Water Recycling scheme. Current estimates are that this will delay investment in AMP7 but increase overall costs by c.£70m and delay the scheme by 1-2 years. The change is subject to a new planning application.

A second Cost Adjustment Mechanism would be required to accommodate the scope changes; this is expected to run in parallel to PR24 and be reflected in prices from 1 April 2025. The increased scope results in a requirement for additional equity based on the notional and actual company. We expect this will be part of the assessment criteria of the Cost Adjustment Mechanism and aligned with the PR24 timetable. Our investors Ancala have confirmed that equity is available to support further growth.

C. Allowed Return

Wholesale WACC

For AMP8 we have based the cost of capital that underpins each of the water resources and network plus wholesale price controls, and the margin that underpins our residential retail price control, on the guidance provided by Ofwat in its PR24 final methodology. Our business plan assumes the same WACC for each wholesale price control.

Table 6: Ofwat PR4 Final Methodology Allowed Return 'Early view'

	PR24 'early view' - point	PR24 'early view' - range
Cost of equity	4.14%	3.67% to 4.60%
Cost of debt	2.60%	2.60%[1]
Gearing	55%	55%
Appointee WACC	3.29%	3.08% to 3.50%
Retail margin adjustment	0.06%	0.06%
Wholesale WACC	3.23%	3.02% to 3.44%

1) Unlike the cost of equity we do not express the cost of debt as a range due to it being more observable and requiring less judgment and inference to estimate.

We expect Ofwat to review the assumptions for the cost of capital in line with the published methodology and updated for latest market data. Recent updated benchmarks from June 2023 show that there has been a one percentage point increase in the 20-year index-linked gilt yields (a benchmark for the risk-free rate) since Ofwat applied a cut-off to market data, along with a smaller but still significant rise in Ofwat's benchmarks for the cost of new debt.

Table 7: Ofwat PR24 Final Methodology: Allowed Return on Capital (Table APP11)

	20-year index-linked gilt yields	iBoxx £ non-financials A 10+ year index	iBoxx £ non-financials BBB 10+ year index
September 2022	-0.05%	5.02%	5.85%
June 2023	1.01%	5.51%	6.27%
Change	+1.06%	+0.49%	+0.52%

Source: Bank of England and S&P Markit iBoxx websites.

We considered updating our submitted cost of capital to reflect updated market data but have chosen to submit a plan in line with PR24 final methodology 'Early View'. As outlined in our representations through the Havant Thicket Cost Adjustment Mechanism we are seeking a bespoke cost of debt that reflects the economic characteristics of the scheme (see later section).

Small company premium

We have included a company specific premium to reflect the financing diseconomies of scale at the point of issuance. This is in line with the guidance provided by Ofwat in its methodology statements guidance on a small notional water only company (reproduced below).

4.6.2 Our 'early view' point estimate for company-specific adjustments

For the embedded debt uplift, considerable analysis has recently been carried out to establish the costs a small notional water company might face (Table 4.9).

Table 4.9 Recent estimates for embedded debt company-specific adjustment

	Embedded debt CSA
Ofwat PR19 Initial Assessment of Plans (IAP) (January 2019)	25-40 bps
Ofwat Final Determinations (December 2019)	35 bps
CMA PR19 Final Determination (March 2021)	30 bps

Given that the issue predominantly relates to long-dated debt issued in the early 2000s, we consider it unlikely that updating this analysis would lead to a substantively different conclusion. We therefore consider it useful to signal for our 'early view' that an uplift of **30bps** over the sector cost of embedded debt allowance would be appropriate for the notional small water only company.

We carried out customer engagement to demonstrate customer support for the higher costs associated with this uplift. Research commissioned from Blue Marble demonstrates support for a small company uplift through both quantitative and qualitative methods. Full details of the results and methodology of the research is provided in section PRT03: Engaging and Understanding our Customer and our Communities.

Figure 6: Small Company Premium Customer Research

Consumer Panel Barometer Wave 6 Report Small Company Premium and Long-Term Delivery Plan September 2023

Executive summary

- The majority of customers believe there are benefits of having a small, locally based water company reflected in better customer service and response to problems. However, customers are less likely to associate social value, innovation, or local benefits with smaller company size.
- There is widespread support for 2025-30 bills to carry a small company premium. 76% accept £1.61 with 88% accepting £1.08p. Customers see this as a small price to pay for a company offering good service – and in the context of the planned improvements costed in the PR24 business plan.
- The alternative, merging with a larger company to negate the need for a SCP, is very unpopular and customers think will result in a poorer experience.

Havant Thicket cost of capital

In line with representations made in our submission to Ofwat to support our Cost Adjustment Claim we have included a bespoke cost of debt for the Havant Thicket price control. Our proposed cost of capital reflects the economic characteristics and unusual nature of the Havant Thicket scheme reflecting the scale relative to Portsmouth Water existing RCV, the compressed construction period and the timing and liquidity requirements of the scheme.

To underpin the theoretical basis for a bespoke cost of capital and to quantify the appropriate level, we commissioned research from economic consultants First Economics and NERA. Their findings support our assertion that the economic characteristics of the Havant Thicket 10-year price control require a bespoke approach to setting the cost of debt. This is based on the following primary economic considerations:

- The scale of the Havant Thicket scheme relative to the existing RCV.
- The compressed nature of the construction programme.
- The lack of any embedded debt in the 10-year price control.
- Additional liquidity and headroom requirements.

Our approach to setting the cost of capital has been informed by evaluating our actual financing and costs but has not been based on our actual costs. The analysis by First Economics and NERA has reviewed appropriate benchmark and regulatory precedents. We have adopted the recommendations from these independent reports, and we are submitting a proposed bespoke cost of capital based on their economic guidance and aligning with the principles in the PR24 final methodology.

Havant Thicket cost of capital: Portsmouth Water Capital Structure and Financing Costs

Portsmouth Water's view on the requirements for the Havant Thicket return are informed by the experiences in securing financing for the scheme. Our financing strategy and proposed capital structure was designed on the following principles.

- Upfront equity:
  - The absence of an IDoK provision meant upfront equity was required to meet covenants until the additional investment was recognised in prices from 1 April 2025.
  - Ofwat requirement ("*any adjustment we make to totex allowances for the project is contingent on Portsmouth Water's shareholders injecting appropriate levels of additional* equity" Havant Thicket – Cost adjustment: Draft Decision)

- Securing 100% financing for Havant Thicket programme:
  - Securing the full financing requirement to deliver scheme given compressed construction programme.
  - Creating certainty of debt costs through construction.
- Ensuring flexibility and liquidity to manage programme uncertainties:
  - The scale, construction period and risk profile, coupled with the scale of the project relative to Portsmouth Water align financing to project financing principles.
  - Funding through a combination of longer-term institutional and flexible debt facilities provides flexibility and the ability to put higher levels of liquidity in place to manage risk and uncertainties.
  - Debt facilities were sized to accommodate risk of cost overruns and delay (20% cost overrun / 2-year delay).
- Securing amendments to our covenant structure:
  - As the Controlling Creditor of the current structure, Assured Guaranty consent on amendments to the current STID were critical to support financing exercise and maintain programme.
  - The critical change was consenting for the Regulated Asset Ratio covenant to change to follow a shadow RCV due the absence of the IDoK provision within the Havant Thicket price control.

The financing strategy was extensively market tested through the financing exercise. Our original strategy centred on a mix of fixed and index-linked institutional debt supported by medium-term bank revolving credit facilities. The financing exercise was initiated in September 2022. Through the period we observed a high degree of market volatility impacted by the shift in global economic policy on interest rates and fall out from the “Truss mini budget’.

Market engagement indicated that the best value markets centred on CPI-linked institutional facilities and bank facilities. The institutional fixed lending market pricing and market liquidity at the time meant that better value was found in banking markets, resulting in a decision to shift capital mix. Financing has been secured through a combination of relationship banks and institutional lenders Aberdeen Asset Management and PIC. We have also been able to secure funding from UK Investment Bank, a first for the UK water sector.

Table 8: Analysis of 2023 new financing

Financing	Amount	Tenor	Terms	Associate Fees / Costs	Issuance costs (annualised over term)
New Equity	£150m (£120m in FY25 and £30m in FY25)		Equity deployed as new equity / settlement of historic intercompany debt	£1.5m	1% upfront
Credit wrapped CPI linked bond (Aberdeen / PIC)	£75m	14 years	2.6325% coupon CPI accretion	£1.7m	0.16%
Syndicated loans: RCF	£105m	5+1 years	SONIA + 160 bps 0.56% commitment fee	£1.7m	0.33%

(NatWest / ING / Siemens)					
Syndicated loans: Term Loan (UKIB)	£50m	6 years	SONIA + 160 bps 0.56% commitment fee	£0.9m	0.29%
Bilateral RCF (Lloyds)	£50m	5+1 years	SONIA + 150 bps 0.53% commitment fee	£0.8m	0.31%
Liquidity RCF (At Holding company)	£45m	5+1 years	SONIA + 3% 1.2% commitment fee	£1m	0.45%
Assured Guarantee Consent		9.5 years	Covenant changes to enable RCV recognition	£3.0	0.25%

Despite the increased cost of the Havant Thicket scheme, the level of debt finance and construction profile meant that our financing requirements were not high enough to access bond markets.

Reviewing the incurred costs, the equity costs appear efficient compared to the 2% guidance included in Ofwat's risk and reward guidance (based on Severn Trent recent issuance costs). However, while private equity issuance has lower underwriting fees there have been additional fees associated with the change of consent on the guarantee on the structured financing arrangements.

This is reflected in the fact that our incurred debt issuance costs, including bank fees, legal and advisory costs have been materially higher than the Ofwat assumption of 0.1%. We estimate the actual issuance cost are 0.635%. This includes the consent fee for changes to the Securitised Intercreditor Deed required to ensure the additional totex allowance can be recognised by creditors. This was a requirement to ensure covenant compliance along with upfront equity to reduce leverage and financing costs until the additional cost are reflected in revenues at PR24.

Cost of carry / liquidity costs

Another key feature of the financing requirement for the Havant Thicket scheme is the higher cost of carry / liquidity costs due to the requirement to have secured the debt upfront. The cost has been minimised through the use of facilities, which are more efficient than drawing on debt ahead of requirement and depositing funds.

We estimate that the cost of carry / liquidity for the Havant Thicket price control will be a further 0.40% over AMP8. The cost is higher over the remainder of AMP7 where the facilities are expected to be undrawn. Benchmarking the cost of carry / liquidity costs from financing activities and recent deposit rates supports revolving credit facilities as the most efficient source of liquidity.

Table 9: Cost of Carry / Liquidity Costs

Liquidity	Facility cost	Offsetting deposit rate	Cost of carry
Syndicated RCF	0.56% commitment fee	-	0.56%

UKIB Term Loan / RCF drawing	1.6% + SONIA	SONIA	1.6%
CPI Linked bond	2.6325% + 0.16% + CPI	SONIA	Subject to SONIA / CPI

Moody's Rating Assessment: Baa2 Stable

Portsmouth Water hold a corporate family credit rating with Moody's. As part of the assurance on financeability of the capital structure we engaged Moody's Rating Assessment Service (RAS) to undertake a rating assessment on the proposed capital structure. The capital structure targeted gearing <70% and AICR at 1.5x aligned with the Baa1 rating held at the time.

Moody's indicated that the Baa2 outcome is likely to be a ceiling for the rating until after the critical years of construction. This is due to the size of the project relative to the RCV of Portsmouth Water.

Moody's rating announcement is included in supporting document PRT13.01.

Table 10: Havant Thicket: Moody's Rating Assessment Service Scorecard September 2022

	Pre CAM	RAS Scenarios
Factor 1 - Business Profile		
a) Stability of Regulatory Environment	Aa	Aa
b) Asset Ownership Model	Aa	Aa
c) Cost and Investment Recovery	A	A
d) Revenue Risk	Aa	Aa
e) Scale and Complexity of Capital Programme & Asset Condition Risk	**Ba**	**Caa**
Factor 2: Financial Policy		
	Ba	**Baa/Ba**
Factor 3 - Leverage and Coverage		
a) Adjusted Interest Cover Ratio (3yr avg.)	Ba	**Baa**
b) Net Debt / RAB (3yr avg.)	Baa	Baa
c) FFO / Net Debt (3yr avg.)	Ba	Ba
d) RCF / Net Debt (3yr avg.)	Ba	Ba / Baa
Rating		
Indicated Rating from Grid	Baa3	Ba1
Rating Lift on Structural Considerations and Sources of Uplift from Creditor Protection	1.5	1.5
a) Indicated Rating from Grid	Baa1	Baa3
b) Actual Rating Assigned	Baa1	Baa2

Moody's feedback has provided clarity on how their UK Water Utilities methodology will be adapted for the Havant Thicket investment. The Baa2 RAS rating represents a strong outcome given their revised methodology, particularly with the indicated headroom within the Baa2 category.

Ofwat's query that the scorecard outcome of Baa3 means that the Baa2 outcome is "risky" was addressed through written confirmation from Moody's that their award of the Baa2 outcome reflects all the risks that the company faces and that Portsmouth Water is well positioned within the category with considerable headroom.

The RAS outcome was subsequently ratified following a formal assessment upon conclusion of the financing exercise. Moody's announced the Baa2 rating in the formal announcement on 10 March 2023. The full rating assessment is included in the supporting documents.

Figure 7: Moody's Rating Outlook, 10 March 2023

Rating outlook

The rating outlook is stable, reflecting our expectation that with the aforementioned equity commitments Portsmouth Water will be geared, as measured by net debt to shadow RCV (including HTWSR's RCV), at or slightly below the regulatory assumption of 60% and maintain an adjusted interest coverage ratio (AICR) at least in line with minimum guidance for the Baa2 rating (1.3x).

Factors that could lead to an upgrade

Given our expectation of weak interest coverage metrics over the remainder of the current regulatory period. upward rating pressure is not currently anticipated. However, upward rating pressure could arise upon (1) successful completion of the three key years of the construction phase with no significant cost overruns or delays; and (2) the company exhibiting an AICR sustainably above 1.5x.

Factors that could lead to a downgrade

The rating could come under downward pressure if (1) the outstanding HTWSR actual construction works did not progress as currently envisaged, or construction delays or cost overruns increase liquidity needs, unless mitigated appropriately; or (2) Portsmouth Water was likely to exhibit gearing, measured as net debt to shadow RCV (including HTWSR's RCV), significantly above 70% during the years of peak construction spend, or an AICR persistently below 1.3x, although significant gearing headroom may allow the company to sustain an AICR slightly below this level.

Havant Thicket cost of capital: First Economics Report

John Earwaker of First Economics was commissioned by Portsmouth Water to advise on the economic principles that should be considered when calibrating the allowed return on capital for the Havant Thicket Reservoir project. The full report PRT13.02 is included to support this document.

The paper considers in turn the allowed cost of debt, the issuance and liquidity costs allowance, and the allowed cost of equity. The full report PRT13.02 is included to support this document. The main conclusions are:

- There is a clear case for putting in place a bespoke cost of debt allowance built from bespoke time-period weightings that align to the atypical profile of Portsmouth Water's borrowings.
- Similarly, the allowance for issuance and liquidity costs ought to be tailored to the costs that an efficient company would unavoidably incur when arranging the financing for the Havant Thicket project.
- The regulatory approach to the cost of equity needs to be settled with a long-term perspective that considers the compensation for bearing risk during both the construction and the operational phases of the project.

Cost of Debt

First Economics propose the SHETL case study provides a template for the way in which Ofwat and Portsmouth Water might consider handling the atypical profile of borrowing that the Havant Thicket Reservoir project generates. Ofgem has deemed it appropriate to give SHETL (the north of Scotland transmission licensee) a bespoke cost of debt index/allowance. In its RIIO-1 price control decision, Ofgem identified that the scale of SHETL's investment programme, when looked at as a percentage of SHETL's starting RAV, was likely to far exceed the investment being undertaken by other licensees.

The thinking might be that:

- Ofwat should continue to hold Portsmouth Water to a benchmark, market-based cost of debt – e.g. the iBoxx £ non-financials indices – rather than revert to a pass-through of actual interest costs; but

- the specific market benchmarks for the Havant Thicket cost of debt allowance should align with the profile of the Havant Thicket RCV growth rather than a historical weighting of interest rates that Portsmouth Water did not, and could not have, taken advantage of.

Issuance and Liquidity Costs

This body of precedent suggests that there should be a proper, clean-sheet evaluation of the appropriate allowance for issuance and liquidity costs within the Havant Thicket Reservoir price control at the PR24 review. As in the case of the cost of debt allowance, this assessment can be based on the costs that a notional company would incur in securing finance for the project – i.e. it need not amount to a pass-through of Portsmouth Water's actual costs. But to the extent that it would not be possible for a company to obtain the required financing while incurring costs of only 10 basis points per annum, there is no reason why efficient, unavoidable cost should not be passed on in full to customers.

Cost of Equity

The key task at PR24 and at future reviews will be to determine whether the Havant Thicket Reservoir's initial concentrated construction risk and subsequent low 'operational intensity' require Ofwat to depart from the standard industry beta. The review of regulatory precedents revealed that there was a distinct lack of consensus on this issue.

Ofgem in previous price controls has set higher betas for companies with higher capex-to-RAV ratios and lower betas for companies with lower capex-to-RAV ratios. Ofwat in its recent periodic reviews has rejected the argument that water-only companies' relatively high totex in comparison to RCVs necessitates a higher return on equity, this was support by CMA during PR19 appeals.

First Economics view is that *"the size of a company's expenditure relative to the size of investors' equity capital does exert an impact on betas, and we include this as a key risk factor in all our cost of capital reports. The experience of the last two years seems to be quite a good case study in this respect in that companies with relatively high expenditure-to-RCV ratios have suffered proportionately more from high commodity prices and high inflation generally at the same time as the emergence of high inflation has exerted a downward impact on share price generally – i.e., this cost shock has been pro-cyclical. Be that as it may, we do think there is a need for further debate on this point during PR24. The one thing we can say for certain is that Portsmouth Water and Ofwat will need to be consistent in their approach over time – i.e., whatever position is reached in PR24 during a period of heightened construction risk needs to be mirrored in PR29 and subsequently when Havant Thicket Reservoir moves into its less intensive operational phase."*

Havant Thicket cost of capital: NERA Report

We commissioned NERA to prepare an independent report on the estimation of the cost of capital for Havant Thicket. The report covers some of the same ground as the Frontier Economics report but NERA was tasked with developing a quantified proposal for a Havant Thicket bespoke cost of capital. The brief requested that where possible NERA consider approaches to setting the cost of capital that align with the mechanisms and methodologies within Ofwat's PR24 methodology. NERA's report is included in supporting document PRT13.03.

NERA's main conclusion is that Havant Thicket requires a bespoke cost of capital to account for its specific characteristics.

- For PR19 true-up, NERA propose adjustments to Havant Thicket's PR19 cost of debt reconciliation model recognising that Havant Thicket will be funded entirely by new debt.
- NERA propose bespoke cost of equity and cost of debt adjustments for Havant Thicket at PR24 to account for its greater risk and atypical debt profile.
- NERA estimate Havant Thicket's bespoke Cost of Capital for PR24 at 5.17% to 5.77%. This includes a bespoke cost of debt of 4.23%.

To calculate the PR19 cost of debt reconciliation NERA propose an alternative mechanism for PR19 that preserves Ofwat's overall mechanism but makes the following modifications. The principles can then be extended to set the PR24 cost of debt.

- A weight on new debt of 100 per cent (as opposed to 20 per cent) to recognise that Havant Thicket issued all its debt within the 10-year control.
- Weights for the allowed cost of new debt trailing average based on Havant Thicket's RCV growth (as opposed to equal weighting) to recognise that most of Havant Thicket's RCV growth occurs at the end of the PR19 period (consistent with Ofgem's approach for SHET, a Scottish TO, at recent reviews).
- Ofwat's outperformance wedge of 15bps is removed given that Ofwat's wedge was based on industry-wide data, whereas Havant Thicket's relatively small issuance size means that it is likely to underperform (consistent with the principles applied to the small company premium in Ofwat's PR24 methodology).

Issuance and liquidity costs have been estimated at an additional cost of borrowing for Havant Thicket of 108bps, based on the following efficient benchmarks:

- Approximately three-fold higher transaction costs (19 bps) than the notional allowance (c.7 bps) reflecting Havant Thicket's necessarily short-tenor of around eight years, to match the construction period, relative to the wider industry tenor of around 20 years.
- Requirement for liquidity facilities to provide funding ahead of investment, based on the Thames Tideway Tunnel liquidity allowance building block (88 bps).

On the cost of equity, NERA concludes:

"allowing HT the same asset beta as the industry (0.26 to 0.29 under Ofwat's PR24 final methodology) would fail to recognise that HT will face a greater risk over PR24 than the wider sector as demonstrated by PRT's far higher capex:RCV ratio. Therefore, we propose Ofwat sets an asset beta range of 0.45 to 0.55 based on Ofgem/CEPA proposed asset beta range for the construction phase of energy network assets."

The full NERA estimated cost of capital for Havant Thicket is outlined in the table below.

Table 11: NERA report Havant Thicket Cost of Capital Estimate, September 2022

Real, CPIH	Ofwat Industry	Bespoke HT (Lower Bound)	Bespoke HT (Upper Bound)
PR19 cost of new debt (embedded debt)	2.34%	3.12%	3.12%
PR24 cost of new debt	3.28%	3.42%	3.42%
Share of PR24 debt	17%	12%	12%
Issuance and liquidity costs	0.10%	1.08%	1.08%
Cost of debt	**2.60%**	**4.23%**	**4.23%**
Notional Gearing	55%	55%	55%
RfR	0.47%	0.47%	0.47%
ERP	5.99%	5.99%	5.99%
Asset beta (no debt beta)	0.28	0.45	0.55
Asset beta (debt beta)	0.33	0.51	0.61
Equity beta	0.61	1.00	1.22
Cost of equity	**4.14%**	**6.46%**	**7.79%**
Appointee WACC	3.29%	5.23%	5.83%
Retail margin deduction	0.06%	0.06%	0.06%
Wholesale WACC (real)	**3.23%**	**5.17%**	**5.77%**

Note: We assume a debt beta of 0.1 as per Ofwat's midpoint; we rely on notional gearing to convert asset beta from no debt beta to with debt beta.

Source: NERA analysis and Ofwat (Dec 22), Creating tomorrow, together: our final methodology for PR24, Appendix 11 – Allowed return on capital, pp.7-8

NERA's calculation has been based on market data and benchmarks that are consistent with Ofwat's final methodology 'early view'. The report runs a sensitivity based on updated cost of debt benchmarks to calculate the trailing average cost of PR19 debt and the PR24 cost of new debt. Updated benchmark data increases the cost of capital estimated range to 5.34 to 5.94 per cent with a cost of debt of 4.53% reflecting the increase in interest rates.

Table 12: NERA report Havant Thicket Cost of Capital Estimate, September 2023

Real, CPIH	Ofwat Industry	Bespoke HT (Lower Bound)	Bespoke HT (Upper Bound)
PR19 cost of new debt (embedded debt)	2.34%	3.41%	3.41%
PR24 cost of new debt	3.67%	3.82%	3.82%
Share of PR24 debt	17%	12%	12%
Issuance and liquidity costs	0.10%	1.08%	1.08%
Cost of debt	**2.67%**	**4.53%**	**4.53%**
Notional Gearing	55%	55%	55%
RfR	0.47%	0.47%	0.47%
ERP	5.99%	5.99%	5.99%
Asset beta (no debt beta)	0.28	0.45	0.55
Asset beta (debt beta)	0.33	0.51	0.61
Equity beta	0.61	1.00	1.22
Cost of equity	**4.14%**	**6.46%**	**7.79%**
Appointee WACC	3.33%	5.40%	6.00%
Retail margin deduction	0.06%	0.06%	0.06%
Wholesale WACC (real)	**3.27%**	**5.34%**	**5.94%**

Note: We assume a debt beta of 0.1 as per Ofwat's midpoint; we rely on notional gearing to convert asset beta from no debt beta to with debt beta.

Source: NERA analysis and Ofwat (Dec 22), Creating tomorrow, together: our final methodology for PR24, Appendix 11 – Allowed return on capital, pp.7-8.

Cost of Capital by price control

We are proposing a bespoke cost of capital for the Havant Thicket control of 4.13%. In setting the cost of capital we have taken into consideration the guidance from the First Economics' report and the NERA estimates of the cost of debt.

Our conclusions are as follows.

- We agree with the conclusions of both reports that the characteristics of the Havant Thicket control support a bespoke approach to the cost of debt.
- We support the approach proposed by First Economics approach taken with the SHETL arrangements in Ofgem's RIIO-T1 reflect a suitable model for setting the cost of debt.
- We agree with First Economics' recommendations that Ofwat should continue to utilise market-based cost of debt benchmarks, and liquidity and issuance cost should be based on efficient benchmarks rather than Portsmouth Water's own costs.
- We agree with NERA's methodology and estimate of the cost of debt for PR24. The approach aligns to the principles outlined in the First Economics report.

- We support the NERA recommendation that the PR19 rule book should reflect adjustments to Havant Thicket's PR19 cost of debt reconciliation model recognising that Havant Thicket will be 100% funded by new debt, and the weighting of debt should align with RCV growth.
- We are proposing a cost of equity in line with the Ofwat wholesale WACC. We agree with First Economics' position on the cost of equity and have chosen not to include the NERA estimate of cost of equity reflecting a higher asset beta due to scale of RCV growth. We believe the total cost of capital should be assessed in the round and recognise that the cost of capital should be assessed over the life of the asset and believe there are benefits in aligning with the wholesale cost of equity. This position is dependent on an appropriate allowance for the cost of debt reflecting the quantum and timing of debt requirements for an atypical scheme.
- We note comments from Ofwat in correspondence on the Havant Thicket CAM that the nature of the bespoke control, the provision of a bespoke cost of debt and the level of contingency, could result in a lower cost of equity. On balance we don't think this can be supported given the residual risk to shareholders through the construction period. Portsmouth Water has evidenced the risk exposure through the CAM submission and consideration needs to be given to the scale of programme relative to the current one and the lack of recent track record of similar projects. We believe this is supported by the findings of the First Economics and NERA reports and in the round reflects the right balance between affordability and financeability for Southern Water customers.
- We recognise that market volatility may require Ofwat to update the wholesale WACC. We have submitted our plan based on the PR24 Methodology 'Early View' guidance, but we expect that any changes will be applied to the Havant Thicket WACC.

Table 13: Allowed return on capital by wholesale control (Table RR26)

RR26
Portsmouth Water

Allowed return on capital by wholesale price control

Line Description	Units	DPs	Water resources	Water network+	Wastewater network+	Bioresources	Additional control 1
			Assumed notional structure (nominal)				
			2025-30				
Notional gearing	%	2	55.00%	55.00%	0.00%	0.00%	55.00%
Total Market Return (TMR)	%	2	6.46%	6.46%	0.00%	0.00%	6.46%
Risk free rate (RFR)	%	2	0.47%	0.47%	0.00%	0.00%	0.47%
Equity Risk Premium (ERP)	%	2	5.99%	5.99%	0.00%	0.00%	5.99%
Debt beta	dec	2	0.10	0.10	0.00	0.00	0.10
Raw equity beta for listed company comparator	dec	2	0.59	0.59	0.00	0.00	0.61
Actual gearing of listed company comparator	%	2	53.35%	53.35%	0.00%	0.00%	53.35%
Unlevered beta	dec	2	0.27	0.27	0.00	0.00	0.27
Asset beta	dec	2	0.32	0.32	0.00	0.00	0.32
Re-levered equity beta	dec	2	0.59	0.59	0.00	0.00	0.59
Overall cost of equity (used in WACC)	%	2	4.00%	4.00%	0.00%	0.00%	4.00%
Cost of embedded debt	%	2	2.64%	2.64%	0.00%	0.00%	3.12%
Cost of new debt	%	2	3.28%	3.28%	0.00%	0.00%	3.42%
Ratio of embedded to new debt	%	2	83.00%	83.00%	0.00%	0.00%	88.50%
Issuance and liquidity costs	%	2	0.10%	0.10%	0.00%	0.00%	1.08%
Overall cost of debt (used in WACC)	%	2	2.85%	2.85%	0.00%	0.00%	4.23%
Wholesale WACC	%	2	3.37%	3.37%	0.00%	0.00%	4.13%

D. Financeability (Notional Company)

The financeability of our PR24 business plan has been assessed through the Ofwat financial model and through separate assurance for our Board by Centrus Financial. We have assumed the following cost of debt assumptions in the Ofwat financial model, which are consistent with the cost of capital assumptions. These assumptions are outlined in Table RR4.

Table 14: Notional company cost of debt assumptions

	Wholesale Controls	HTWSR Control
Notional Gearing	55%	55%
Level of index linked debt	33%	33%
Cost of debt (Real)	2.85%	4.23%
Cost of debt (Nominal)	4.91%	6.31%
Interest rate on RPI linked debt	1.85%	3.23%
Interest rate on CPI linked debt	2.85%	4.23%
Interest rate on fixed debt	4.91%	6.31%
Interest rate on cash interest rate	4.91%	6.31%

Opening gearing in our PR24 submission was materially in line with the notional company. The PR24 submission assumes investment in line with the Havant Thicket Cost Adjustment Mechanism final determination (https://www.ofwat.gov.uk/wp-content/uploads/2022/12/Havant-Thicket-CAM-final-decision-document.pdf). Actual totex is anticipated to be delayed so the company expectation is actual AMP8 opening gearing will be below the notional structure.

Financial Levers - Equity, Pay as You Go (PAYG) and Run-Off Rates

Our PR24 business plan assumes annual equity injections for the notional company to maintain gearing in line with the notional company assumption of 55%.

Figure 8: Financeability – Gearing (Notional Company)

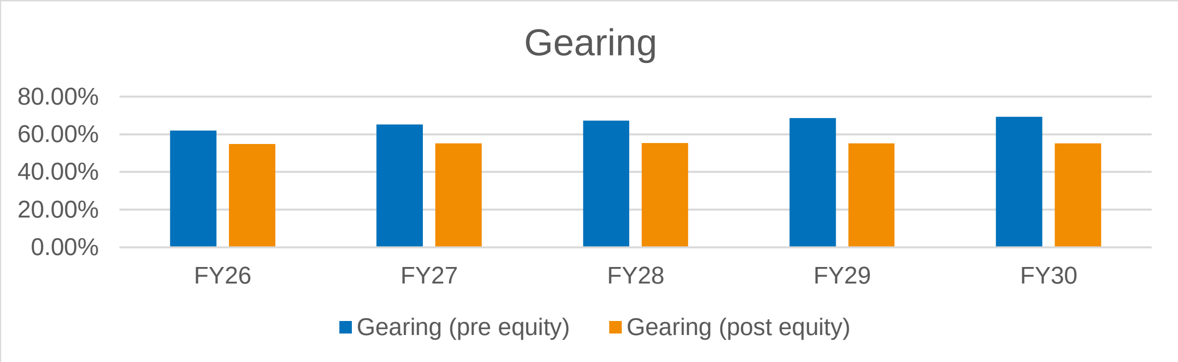
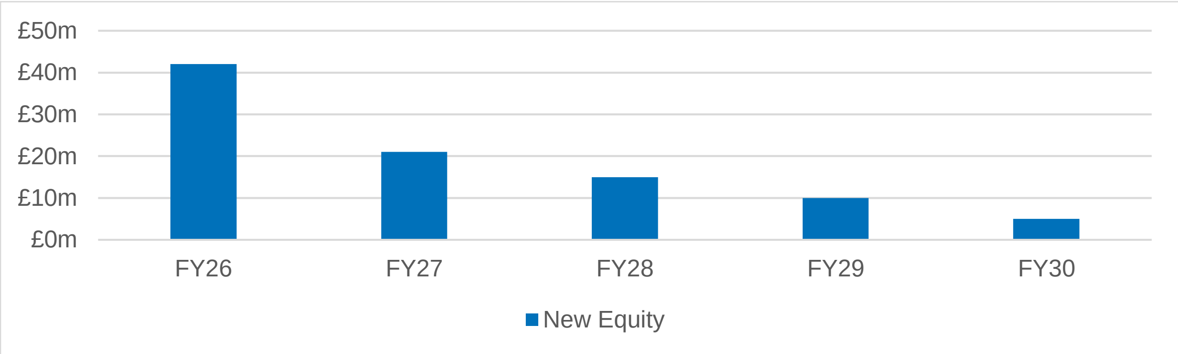


Figure 9: Financeability - New equity (Notional Company)



Dividend projections have been calculated in line with our dividend policy based on our actual company structure. The dividend yield on the notional company in our PR24 plan is 2.24% (dividends paid in AMP8). This is based on our dividend policy of a 4% base yield on actual company gearing (3.4% based on dividends paid in AMP8).

Table 15: Ofwat Financial Model Dashboard – Key Metrics

Key financial ratios		2025-26	2026-27	2027-28	2028-29	2029-30	5yr avg.
Adjusted cash interest cover ratio (Ofwat)		1.518	1.548	1.547	1.547	1.548	1.542
Adjusted cash interest cover ratio - (Alternative)		1.407	1.443	1.447	1.452	1.457	1.442
Funds from operations / net debt (Ofwat)		6.81%	7.11%	7.29%	7.52%	7.67%	7.31%
Funds from operations / net debt - (Alternative)		6.05%	6.32%	6.50%	6.71%	6.85%	6.51%
Gearing - Appointee		54.91%	55.08%	55.16%	55.01%	54.92%	55.02%
Dividends		2025-26	2026-27	2027-28	2028-29	2029-30	Total
Dividends (£m real)		2.46	7.87	7.55	7.46	7.40	32.74

Dividend yield %	0.89%	2.81%	2.58%	2.49%	2.45%	2.24%
Dividend growth %	-	-	-	-	-	-

We have not assumed any other financeability adjustments to PAYG and run-off rates. PAYG is calculated in line with the natural business plan opex and capex ratios to maintain a balanced position on financeability and affordability. Run-off rates have been aligned with the natural rate of capital maintenance and underlying asset lives. Run-off rates are within the guidelines of the PR24 final methodology. Further information is available in the commentary for Tables RR1 and RR11.

The Havant Thicket control assumes 100% non-PAYG during AMP8, as the asset is not anticipated to operate within the period due to the alignment works with the Southern Water recycling scheme delaying the programme by 12-24 months. The run-off rate is calculated based on a straight-line recovery over the 80-year bulk supply agreement, reflecting the totex limits agreed through the Cost Adjustment Mechanism.

Table 46: PAYG and Run-off Rates (Table RR11)

PAYG rates for each wholesale control (5 year)

	Item reference	Units	DP	Water resources	Water network plus	Wastewater network plus	Bioresources	Additional control 1	Additional control 2
PAYG rates for each wholesale control (5 year)		%	2	76.51%	39.46%	0.00%	0.00%	0.00%	0.00%

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

	Item reference	Units	DP	Water resources	Water network plus	Wastewater network plus	Bioresources	Additional control 1	Additional control 2	2025-30
RCV run off rates for each wholesale control (5 year)		%	2	4.21%	4.30%	0.00%	0.00%	1.38%	0.00%	2.67%

Target credit rating

We have targeted a credit rating two notches above investment grade in line with the PR24 final methodology. Portsmouth Water holds a single credit rating with Moody's. Ofwat granted consent to Portsmouth Water to maintain an Issuer Credit Rating from only one Credit Rating Agency for five years from 17 May 2023. On this basis we have assessed our target rating based on Moody's methodology.

The Moody's Baa1 rating key thresholds are maintaining an Adjusted Interest Cover Ratio of 1.5x and gearing <72%. However, within Moody's rating methodology a key consideration is the scale and complexity of the capital programme. This results in an effective ceiling on the Portsmouth Water rating during the construction period for Havant Thicket.

Table 57: Centrus Financial Board Assurance: Notional Company Assessment

Notional Company | Moody's Scorecard

The credit rating of PW is currently impacted by the construction risks of the Havant Thicket Reservoir. We anticipate this risk diminishing as construction milestones are successfully met

		Moody's Scorecard		Centrus Assessment		
		Weighting	Moody's Guidance	Sub-Factor Outcome Detail		Scorecard-Indicated Outcome
REGULATORY ENVIRONMENT AND ASSET OWNERSHIP MODEL	Stability and Predictability of Regulatory Regime	15.0%	As per the latest Moody's report on PWL dated 10th March	*Assumed that these ratings will remain unchanged through-out AMP8. However, as of Jan 2023 Moody's have a negative outlook on the UK Water Sector. Moody's have highlighted that this could revert to stable in the event of 1. Lower cost pressures and more favourable Macro environment 2. A more supportive regulatory approach for PR24*	-->	Aa
	Asset Ownership Model	5.0%			-->	Aa
	Cost and Investment Recovery (Ability and Timeliness)	15.0%			-->	A
	Revenue Risk	5.0%			-->	Aa
SCALE AND COMPLEXITY OF CAPITAL PROGRAM	Scale and Complexity of Capital Program	10.0%	Baa: total annual capex 8%-12% of RCV Ba: total annual capex 12%-20% of RCV B: total annual capex 20%-30% of RCV CAA: total annual capex >30% of RCV		-->	Caa
FINANCIAL POLICY	Financial Policy	10.0%	As per the latest Moody's report on PWL dated 10th March	*Assumed this will remain unchanged. The additional equity to ensure a low level of gearing is credit positive*	-->	Baa
LEVERAGE AND COVERAGE	Adjusted Interest Coverage Ratio (AMP8 average)	12.5%	Baa: 1.5-2.5x Ba: 1.2 -1.5x	*1.4x*	-->	Ba
	Net Debt / RCV (AMP8 average)	10.0%	A: 40-55% Baa: 55%-70%	*55%*	-->	A
	FFO / Net Debt (AMP8 average)	12.5%	Baa: 10-15% Ba: 6-10%	*6.3%*	-->	Ba
	RCF / Net Debt (AMP8 average)	5.0%	Baa: 6-10% Ba: 4-6%	*4.3%*	-->	B
	Scorecard-Indicated Outcome Before Notch Lift					Ba2
			Notch lift			1.5
			Scorecard- Indicated Outcome			Ba1
			Additional two notches adjustment (in line with actual company)			2
	Actual rating assigned					Baa2

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Assurance

The financeability of our PR24 business plan has been assessed through the Ofwat financial model and through separate assurance for the Board by Centrus Financial. The report from Centrus is included within supporting document PRT13.04.

E. Financial Resilience (Actual Company)

We have evaluated long-term financial resilience based on our current capital structure. Our plan is financeable based on our actual company structure and the shareholder equity already committed. Our plan maintains our Baa2 credit rating on all downside scenarios though mitigations available including reducing dividends and liquidity support.

We expect to agree a change control to our Havant Thicket programme associated with the alignment works with Southern Water's recycled water scheme. This involves increasing capacity of the pipeline from Bedhampton to the reservoir at Havant Thicket to accommodate a second source of water from the recycling plant at Southern Water's Budds Farm wastewater treatment plant.

We are in discussions with the Ofwat Major Projects Team about a second cost adjustment mechanism to align with a new planning application in March 2023. The second cost adjustment mechanism process is expected to align with the PR24 timeline. Initial estimates are that new scope could increase expenditure by £77m and delay completion of the reservoir by 1-2 years.

Our assessment is the new scope is financeable but requires shareholder support. We will finance the additional investment through a combination of new equity and debt financing following the principles established in the first cost adjustment exercise. Our investors Ancala have confirmed continuing support for the scheme and can demonstrate their track record of support since their acquisition of the company in 2017.

We plan to raise additional financing to support the non-Havant Thicket growth and refinance £205m facilities expiring in 2029. We are also due to refinance our long-term Artesian funding in 2032.The Board has considered the financing strategy as part of the PR24 assurance.

Assessing Financial Resilience: PR24 Plan

Our PR24 business plan has been submitted in line with the Havant Thicket totex profile included in the first Cost Adjustment Mechanism. The business plan is financeable based on our current capital structure.

The plan broadly maintains average gearing and interest cover within the general guidance for a Baa1 rating (72% gearing and AICR of 1.5x). The key covenant ratio for the Artesian funding, ICR of 1.4x, is met throughout the plan. The Artesian ICR offsets capital expenditure with drawing against equity or debt facilities. Gearing and interest cover metrics tighten over the AMP, and the Board recognise that further equity would be needed to support any additional scope on Havant Thicket.

Table 18: Financial Ratios (Actual Company) (Table RR16)

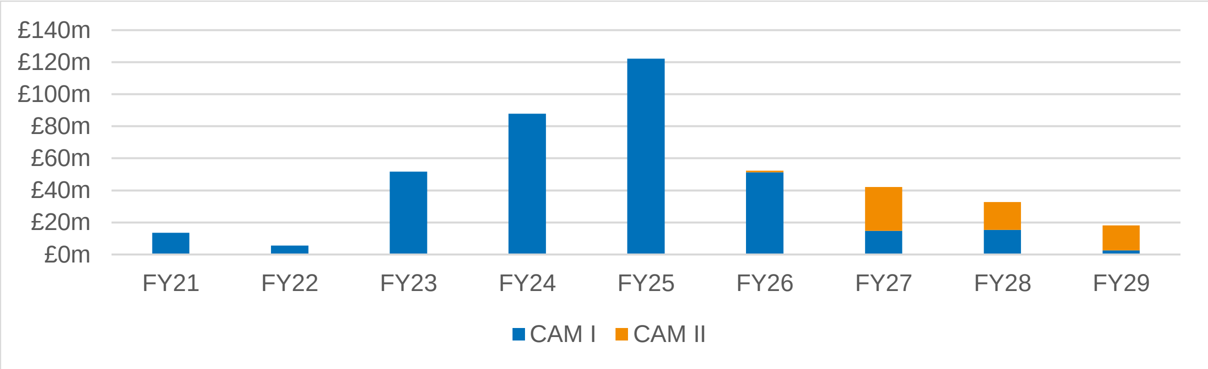
Line Description	Units	DPs	2025-26	2026-27	2027-28	2028-29	2029-30	2025-30	PR24 BP reference
Actual capital structure									
Gearing - Actual capital structure	%	2	65.00%	67.99%	69.92%	71.12%	71.76%	69.37%	RR16.24
Interest cover - Actual capital structure	ratio	2	2.92	2.58	2.40	2.41	2.39	2.51	RR16.25
Adjusted cash interest cover - Actual capital structure	ratio	2	1.78	1.55	1.42	1.41	1.38	1.48	RR16.26
Adjusted cash interest cover (alternative calcualtion) - Actual capital structure	ratio	2	1.64	1.44	1.33	1.32	1.30	1.38	RR16.27
FFO/Net Debt - Actual capital structure	%	2	6.24%	5.71%	5.39%	5.41%	5.41%	5.59%	RR16.28
FFO/Net Debt (alternative calculation) - Actual capital structure	%	2	4.73%	4.36%	4.13%	4.21%	4.22%	4.31%	RR16.29
Dividend cover - Actual capital structure	ratio	2	1.13	1.11	1.00	1.04	1.03	1.06	RR16.30
RCF/Net Debt - Actual capital structure	ratio	2	0.04	0.04	0.04	0.04	0.04	0.04	RR16.31
RCF/Capex - Actual capital structure	ratio	2	0.14	0.26	0.30	0.44	0.54	0.29	RR16.32
Return on capital employed - Actual capital structure	%	2	4.70%	4.80%	4.76%	4.79%	4.79%	4.77%	RR16.33
Dividend yield - Actual capital structure	%	2	4.09%	4.00%	3.97%	3.99%	3.97%	4.00%	RR16.34
RORE - Actual capital structure	%	2	4.61%	4.43%	3.99%	4.14%	4.10%	0.00%	RR16.35
Target Credit Rating - Actual capital structure	text	0	Baa2	Baa2	Baa2	Baa2	Baa2	Baa2	RR16.36
Moody's AICR	ratio	2	1.78	1.55	1.42	1.41	1.38	1.48	RR16.37
Artesian ICR	ratio	2	1.40	1.40	1.40	1.40	1.40	1.40	RR16.38
Other financial model values									
FFO Pre interest	£m	3	37.911	42.621	46.757	50.034	52.585	229.908	RR16.47
Adjustments for post financeability reconciliations	£m	3	-0.403	-0.424	-0.445	-0.468	-0.491	-2.231	RR16.48
RCV run-off	£m	3	14.551	16.662	18.732	20.461	21.867	92.272	RR16.49
Excess Fast Money	£m	3	1.713	1.768	1.824	1.807	1.805	8.917	RR16.50
Net debt	£m	3	330.912	363.453	393.052	410.960	426.798	1,925.175	RR16.51
RCV balance	£m	3	602.604	659.837	712.612	747.074	777.181	3,499.308	RR16.52
Indexation of index linked loans	£m	3	2.507	2.876	3.112	3.327	3.492	15.315	RR16.53

Assessing Financial Resilience: Havant Thicket CAM II

The proposed second Cost Adjustment Mechanism, to account for the change in scope for the project, is expected to align with the PR24 timeline. Initial estimates are that the new scope could increase expenditure by £77m and delay completion of the reservoir by 1-2 years.

Our assessment is that the new scope is financeable but requires shareholder support. We will finance the additional capital investment through a combination of new equity and debt finance following the principles established in the first cost adjustment exercise. Our investors, Ancala, have confirmed continuing support for the scheme and can demonstrate their track record of support since their acquisition of the company in 2017.

Figure 10: Havant Thicket Totex: Latest Forecast Including CAM II Estimates



The Board has considered the financing strategy as part of the PR24 assurance. We propose that updated versions of the PR24 financial model and relevant business plan tables and associated assurance are submitted as part of the Cost Adjustment Mechanism, along with the financing strategy, dividend policy and additional equity requirements.

Following risk and return guidance we have assumed equity requirement would be funded through.

- Reducing dividend yield to 2%.
- Provision of £45m additional shareholder equity support (aligned to available liquidity currently available).

Key financial analysis of impact are as follows.

Table 19: Havant Thicket: CAM II Impacts

CAM II vs CAM I	Units	2025-26	2026-27	2027-28	2028-29	2029-30	AMP8
Totex	2022-23 prices	+£1.1m	+£27.3m	+£17.5m	+£15.4m	+£15.4m	+£76.8m
Totex	Nominal	+£1.2m	+£30.0m	+£19.6m	+£17.6m	+£18.0m	+£86.3m
RCV	Nominal	+£1.2m	+£31.0m	+£50.6m	+£68.4m	+£86.6m	+£86.6m

BSA Revenue	Nominal	+£0.0m	+£0.9m	+£2.2m	+£3.3m	+£4.3m	+£10.6m
Dividend yield	Nominal	2%	2%	2%	2%	2%	+£0.0m
New Equity	Nominal		+£30.0m	+£15.0m			+£45.0m
CAM II Key Metrics							
Gearing	%	65.0%	63.5%	64.0%	65.3%	66.0%	64.8%
Moodys AICR	Multiple	1.8	1.6	1.5	1.5	1.5	1.6
Covenant IC	Multiple	1.4x	1.4x	1.4x	1.4x	1.4x	1.4x

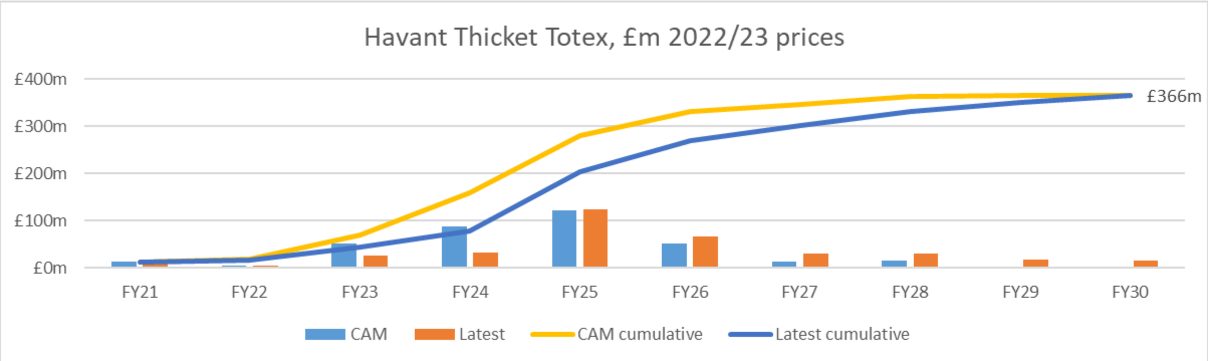
Assessing Financial Resilience: Havant Thicket Latest View

Portsmouth Water has signed a commercial agreement with Southern Water to enable the reservoir to progress works now, which will deliver significant savings to Southern Water customers and reduce the environmental impact of the works, when compared with implementing changes later. It has been agreed with Ofwat that this change in scope will be addressed through a second Cost Adjustment Mechanism to establish a new regulatory allowance for the project in 2024.

The change in scope has resulted in delays to the investment programme to incorporate changes to the design of the pipeline and reservoir infrastructure; current estimates are for a 1–2-year delay to completion of the reservoir.

Changes are subject to a successful planning application but the decision to proceed with the scope change means that the programme will be delayed by a minimum of 12 months. The resultant delay in investment will reduce gearing and improve financial headroom over AMP8.

Figure 11: Havant Thicket Totex: Cost Adjustment Mechanism vs Latest Forecast



Re-running our financial analysis for our actual company structure we see more headroom in the early years of our plan.

- Average gearing is 63.9% vs 69.3% assumed in the PR24 plan.

- Average adjusted interest cover is 1.7x vs 1.5x.
- Baa2 Moody's rating maintained.

Table 20: Havant Thicket Latest Totex Forecast Sensitivity

Financial ratios: Havant Thicket Latest Totex Profile										
Line Description	Units	DPs	2025-26	2026-27	2027-28	2028-29	2029-30	2025-30	PR24 BP reference
Actual capital structure										
Gearing - Actual capital structure	%	2	52.93%	59.48%	64.44%	68.37%	71.56%	63.94%	RR16.24
Interest cover - Actual capital structure	ratio	2	3.94	3.19	2.81	2.52	2.40	2.83	RR16.25
Adjusted cash interest cover - Actual capital structure	ratio	2	2.40	1.92	1.66	1.47	1.39	1.67	RR16.26
Adjusted cash interest cover (alternative calcualtion) - Actual capital structure	ratio	2	2.22	1.79	1.55	1.38	1.30	1.56	RR16.27
FFO/Net Debt - Actual capital structure	%	2	8.69%	7.33%	6.45%	5.81%	5.44%	6.53%	RR16.28
FFO/Net Debt (alternative calculation) - Actual capital structure	%	2	6.84%	5.78%	5.09%	4.56%	4.25%	5.13%	RR16.29
Dividend cover - Actual capital structure	ratio	2	1.45	1.42	1.27	1.09	0.98	1.24	RR16.30
RCF/Net Debt - Actual capital structure	ratio	2	0.06	0.05	0.05	0.04	0.04	0.05	RR16.31
RCF/Capex - Actual capital structure	ratio	2	0.17	0.24	0.27	0.34	0.38	0.26	RR16.32
Return on capital employed - Actual capital structure	%	2	5.34%	5.32%	5.23%	5.09%	1.10%	4.32%	RR16.33
Dividend yield - Actual capital structure	%	2	3.04%	3.16%	3.36%	3.64%	3.94%	3.40%	RR16.34
RORE - Actual capital structure	%	2	3.43%	3.50%	3.37%	3.78%	4.07%	0.00%	RR16.35
Target Credit Rating - Actual capital structure	text	0	Baa2	Baa2	Baa2	Baa2	Baa2	Baa2	RR16.36

We have used this sensitivity as the **base case for our further financial resilience assurance** as this reflects our best view of the likely totex funding profile.

Assessing Financial Resilience: Stress Testing

As part of the Board Assurance, we engaged Centrus to stress test our plan against the scenarios outlined in the PR24 final methodology and two further bespoke scenarios.

We agreed with our Board to run two additional scenarios associated with the Havant Thicket bespoke price control.

- Scope change associated with the alignment works increasing cost by £70m.
- 20% cost overrun on allowed totex.

The full list of scenarios are as follows.

1. Totex underperformance (10% of totex) over five years.
2. ODI underperformance payment (3% RoRE) in one year.
3. Inflation 2% below the base case in the business plan in each year of the price review.
4. Deflation of -1% for two years, followed by a return to the long-term inflation target.
5. 10% spike in inflation with a 2% increase in the wedge between RPI and CPIH, followed by two years at 5% and a 1% increase in the wedge.
6. Increase in the level of bad debt (20%) over current bad debt levels.
7. Debt refinanced as it matures, with new debt financed at 2% above the forward projections.
8. Financial penalty – equivalent to 6% of one year's Appointee turnover.
9. CAM2 additional Capex (assumes equity support).
10. 20% CAM overspend on Havant Thicket control.

The scenarios were assessed against covenants, key rating agency gearing and interest cover ratios based on the current capital structure, and targeted to maintain a minimum of a Baa3 rating (which would assume dividend lock up).

Centrus' analysis found that under most scenarios we could maintain a Baa2 credit rating. For two scenarios intervention was required; these are the scenarios where additional totex is required.

Scenario 1: Totex underperformance (10% of totex) over 5 years.

Scenario 10: 20% CAM overspend on Havant Thicket control.

For both scenarios additional equity would be required by reducing dividends or provision of equity. For scenario 1 this can be addressed through dividends only.

Figure 12: Centrus Financeability and Financial Resilience Assurance

Actual Company | Financial Covenant & Ratio Tests Summary

Under all scenarios, PW maintains covenant thresholds and credit metrics above Baa3* guidance

A cross indicates financial resilience concern (<Baa3 or a covenant breach

	Covenants	Gearing		AICR	
		AMP8 Avg.	3 Year Avg.	AMP8 Avg.	3 Year Avg.
Base Case	✓	✓	✓	✓	✓
Totex underperformance (10% of totex) over 5 years.	✓	✓	✓	✓	✓
ODI underperformance payment (3% RoRE) in one year (Yr2)	✓	✓	✓	✓	✓
Inflation 2% below the base case in the business plan in each year of the price review	✓	✓	✓	✓	✓
Deflation of -1% for 2 years, followed by a return to the long-term inflation target	✓	✓	✓	✓	✓
10% spike in inflation with a 2% increase in wedge between RPI and CPIH, followed by two years at 5% and a 1% increase in wedge	✓	✓	✓	✓	✓
Increase in the level of bad debt (20%) over current bad debt levels	✓	✓	✓	✓	✓
Debt refinanced as it matures, with new debt financed at 2% above the forward projections.	✓	✓	✓	✓	✓
Financial penalty – equivalent to 6% of one year of Appointee turnover	✓	✓	✓	✓	✓
Additional Capex CAM2	✓	✓	✓	✓	✓
20% Capex overspend	✓	✓	✓	✓	✓

*Under all scenarios the gearing and AICR metrics are forecast to perform above Baa2 on an AMP8 average and 3 year average basis
Detailed ratios on covenants and credit ratios are shown in Appendix

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Full details are provided in the Centrus report to the Portsmouth Water Board in supporting document PRT13.04 and table RR17 and commentary.

Assessing Financial Resilience: AMP8 Financing Strategy

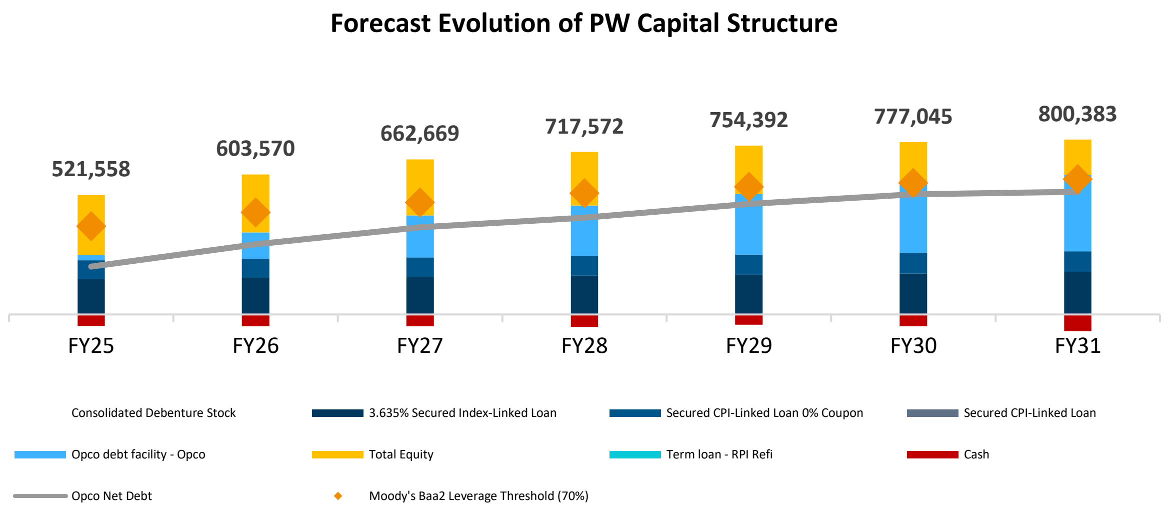
As part of our wider Board assurance Centrus were also asked to review the financing strategy for AMP8. Conclusions shared with Board are set out below.

Further equity requirements

The financing strategy has been constructed to ensure that we have committed equity and debt financing to fully fund Havant Thicket Reservoir, with some headroom to provide liquidity if needed, and that our financing costs during construction of the reservoir are materially fixed. Key refinancing events occur in 2028 and 2033, in the middle of AMP8 and AMP9 respectively. The original capital structure proposed will maintain a strong investment rating of Baa2, in line with the RAS outcome, and the intention is to revert to a Baa1 rating upon the completion of the early years of the HTWSR construction.

We do not see a requirement for additional equity in AMP8 unless an additional project is awarded - in which case additional equity may be required in 2028-29 to ensure a Moody's three year average AICR above 1.50x in line with Baa1 rating guidance. The company can maintain a Baa2 rating without an equity injection.

Figure 13: Centrus Analysis on AMP8 Financing Strategy, PR24 Steering Committee, August 2023



Key Refinancing Events

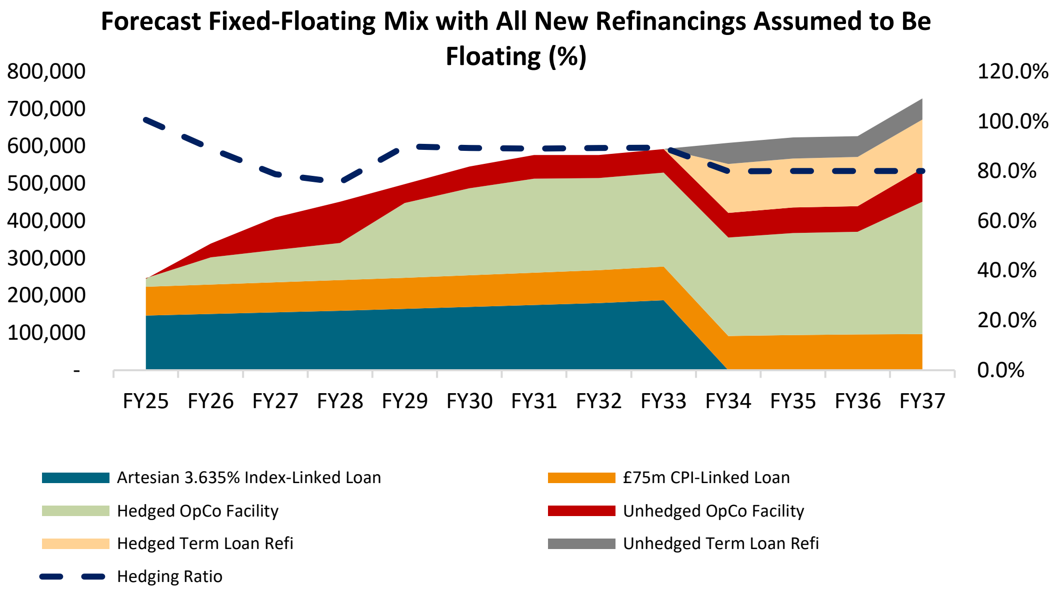
The first refinancing of the new debt occurs towards the end of AMP8; therefore, there is no refinancing risk during the early years of the Havant Thicket construction. Whilst there is substantial refinancing from 2028-31, given the Artesian maturities, this will be conducted with the company substantially de-risked due to Havant Thicket's near-complete construction.

Three major refinancing events are identified in the next 15 years – maturity concentration and liquidity covenants will influence the tenor and timing of these refinancings. Our base case plan assumes a refinancing of the Opco Revolving Credit Facilities (RCF) by 2028 with a 12+ year nominal debt instrument, while also raising additional RCFs to support AMP9 capex.

Hedging Strategy

We are proposing that a new policy is adopted to ensure that a minimum amount of debt outstanding is hedged during the next AMP at 80% and maximum of 105%.

Figure 14: Centrus Analysis on AMP8 Financing Strategy, PR24 Steering Committee, August 2023



F. Dividend Policy

Dividend Yield and Dividend Policy

Our reward package is built on principles that customers are protected from us not meeting their performance commitments. Where we perform well:

- Customers benefit from better service and lower bills through totex sharing.
- Our employees benefit from a company-wide bonus scheme aligned to our performance commitments.
- Shareholders benefit through allowed returns in line with our dividend policy.

We have maintained the dividend policy we developed in AMP7. Through Board engagement we carefully considered Ofwat's guidance on dividend yield. For the purposes of the financeability and financial resilience assessment we have evaluated a dividend yield based on declaration of a 4% base dividend on actual regulatory equity.

The 4% yield reflects the maximum base yield per our dividend policy and Ofwat guidance, and will align to the reported dividend yield in the future Annual Performance Report. Our dividend policy includes provisions to reduce dividend yield in relation to RCV growth and financial resilience.

Ofwat requested an upfront equity commitment to support construction of Havant Thicket. £170m of new equity has been provided in AMP7, reducing leverage significantly. Given equity has been provided upfront we believe maintaining a 4% yield is a reasonable base assumption. This is subject to annual assessment in line with our dividend policy and Ofwat guidance. When evaluated at a notional company level the dividend yield is diluted by the additional equity required to maintain notional gearing of 55% and target credit rating.

Portsmouth Water

2023 Annual Performance Report Dividend

Dividend policy

Dividend policy is set to align with the 5-year business plan agreed with Ofwat. A new dividend policy was adopted in April 2020 in line with the proposal in our PR19 business plan submission. The policy was set in line with regulatory guidance in Ofwat's PR19 Final Methodology and the Draft Determination. The policy was revised for the financial year 2021/22 to reflect additional guidance provided in Ofwat's PR19 Final Determination to reflect a yield of 4% on regulated equity (vs 5% in the previous published dividend policy).

In assessing our dividend policy and our proposed dividend the Board consider the following factors:

1. Delivery of performance commitments to customers and stakeholders over a rolling 3-year period, this includes:
   - Customer Service: C-MeX, D-MeX, Written complaints
   - Performance Commitments: Leakage, Interruptions to supply, Water Quality (CRI)
   - Commitments to customers: Vulnerable customers, Sustainable abstraction, Community commitments
   - Employees: Health & Safety, Pensions
2. Overall financial performance of the appointed and non-appointed business including performance against Totex allowances and other regulatory financial incentives.
3. Financeability tests on medium-term liquidity, and long-term financial viability testing to consider long-term financial resilience, including consideration of future capital requirements to support RCV growth and investment requirements.
4. Compliance with regulatory requirements, in particular Licence Condition P and Licence Condition F.

The dividend is calculated in two components:

- A return on the equity component of the Regulatory Capital Value (RCV) which is calculated as 4% of the equity component of the RCV at the end of the financial period, in line with the PR19 FD guidance.
- A "recirculating" dividend in relation to a legacy financing arrangement, which is value neutral because distributions are received back in intercompany interest receipts. The recirculating dividend has been stopped from 2023 and the associated financing structure is being unwound.

The company will adjust the dividend payable for following items:

- The dividend is reduced by the interest payable in relation to subordinated intercompany loans to ensure overall distributions to holding companies are maintained in line with PR19 dividend guidance.
- The dividend is reduced in the event of net financial penalties relating to in-period Outcome Delivery Incentives following publication of Ofwat's final determination of in-period Outcome Delivery Incentives (published in November following end of financial year).

The Board will consider any required further reduction to the dividend payable where:

- The Company performance over a rolling 3-year performance does not deliver on commitments to customers and stakeholders.
- Financial performance does not support payment of a dividend.
- Forecast 5-year Totex expenditure is higher than allowances in the PR19 final determination.
- Regulatory gearing is above the limits set in the Ofwat Gearing Outperformance Sharing Mechanism.
- Real growth of the asset base within the AMP is not adequately support by shareholder funding.
- Financeability tests on medium-term liquidity and financial viability testing give rise to concerns about long term financial resilience.
- There is non-compliance with regulatory licence conditions, including License Condition P clauses on dividend policy and credit ratings / cash lock up and licence Condition F Regulatory Accounting Statements.

The Board will consider further additions to the dividend proposal where:

- Profits are available from non-appointed activities.
- Net financial rewards are available through the in-period Outcome Delivery Incentives following consideration of projected future performance.
- There are proceeds arising from the Company share of property disposals.

The Board will consider further additions to the base dividend at the end of the 2020-2025 price control for:

- Outperformance against the wholesale five-year Totex incentive mechanism.

The company will transparently set out and explain to stakeholders the application of the dividend policy each year and how it relates to performance in each year.

G. Executive Pay

Through AMP7 we have reviewed our policy on executive pay and performance-related pay. All company employees now have a performance-related pay structure aligned to delivering performance for customers and the environment.

60% of measures in the short-term and long-term components of executive pay are aligned to delivery for customers and the environment. Targets have been reviewed for 2023-24 to include new measures on totex and health & wellbeing, and the weighting of financial and personal objectives has been reduced.

Stretching targets for AMP8 will be set once PR24 outcome is known. Performance will be linked to outperformance on performance commitments or to upper quartile performance in the absence of specific performance commitments. The Remuneration Committee will take a balanced view and assess overall performance, not just specific metrics.

To strengthen controls on executive pay we are introducing specific underpinning, malus, and clawback clauses in our Executive director contracts from 2023-24 onwards.

Alignment to performance for customers, community, and the environment

Our Remuneration Committee reviewed the bonus structure for executives for 2023-24 to reflect Ofwat policy guidance and dialogue. Deloitte were engaged to provide advice on best practice in terms of pay and rewards structures in the water sector. Deloitte led the committee through a review of the existing bonus scheme and options to better align our scheme with Ofwat guidance.

Portsmouth Water

Figure 15: Deloitte Review of Senior Executive Incentive Arrangements – Discussion Document, June 2023

Introduction – Ofwat perspective

Background

Following on from correspondence from Ofwat that performance related executive pay should demonstrate a substantial link to stretching performance delivery for customers Portsmouth Water is currently reviewing the incentive arrangements for senior executives.

This paper considers potential responses by the Company in the context of emerging Ofwat guidance and market practice from the water sector. It then considers a proposed approach following conversations and collaboration between Deloitte and Portsmouth Water.

Ofwat guidance on pay

- Focus on customers, communities & the environment – while the PR24 guidance recommends a "substantial link" to these measures, during engagement with other companies Ofwat have often referenced that a weighting of 60% representing best practice.
- Financial targets – although financial targets can be included in the bonus, Ofwat do not generally consider them to count as measurements for the "benefit of customers, communities & the environment". Ofwat do not appear to be sympathetic to the argument that customers benefit from companies that are financially resilient (i.e. Capex, reducing debts etc.). Ofwat do state that Totex and the ODI component of RORE may be considered as financial measures for the benefit of customers.
- New end of period adjustment – during 2023 Ofwat consulted on a new end of period adjustment (applicable for remainder of the current cycle and the next cycle), allowing Ofwat to adjust revenue allowance where expectations on pay are not met.
- Governance/decision making/adjustment – the best practice guidelines extends beyond the choice of metrics and also includes:
  - Stretch of targets
  - Consideration of overall performance/ broader practice (e.g. reputation) and scope for discretion
  - Deferral, malus and clawback
- Total incentive opportunity – generally Ofwat have focused on annual bonuses in isolation. This partly reflects the fact that there is a wide range of LTI practice in the sector, making comparison between companies challenging. However, in recent engagement, we are aware of Ofwat looking at the *totality* of the incentive package (i.e. bonus and LTIs).

The bonus and the LTIP1 scheme that applies to Executive Directors and Executive team members was amended for 2023-24 to improve transparency of the linkage between performance for customers and the environment. The schemes use a common set of measures; 66.6% of performance earnings are paid in the year following performance with the remainder retained and paid in the year following the end of the AMP cycle.

Measures were amended for 2023-24.

- A capex measure was replaced with a new totex measure.
- Three new measures were introduced to align with guidance on health and safety, carbon, and social value (community partnership initiative).
- The weighting of the measures was reviewed to ensure the customer, community and environment measures equate to 60% of performance-related pay.

Figure 16: Remuneration Committee Approved Bonus / LTIP 1 Structure 2023-24

Customers, communities & the environment	60%	*Change*
Service – current ODIs[1] - Compliance Risk Index - Interruptions - Leakage - PCC - Mains repairs - Unplanned Outage - C-Mex - D-Mex - Priority Services - Severe Drought	45%	*3 new measures*
New measure: - Health and Safety i.e. reportable accidents		
Carbon net zero (NEW)		
Community Partnership Initiative (NEW)		
Totex	15%	*Replacing Capex and + 2%*
Financial	**20%**	***Change***
EBITDA	15%	*+2%*
Cash	5%	*-2%*
Personal including customer supporting	**20%**	***Change***
Individual Objectives (including customer element)	20%	*-13%*

Stretching targets

For the remainder of PR24 the bonus targets will be set to align to ODI measures and customer measures of experience. Where measures do not relate to customer commitments an appropriate benchmark will be set by the Remuneration Committee aligning to upper quartile performance or a specified improvement plan.

The following approach will be maintained when setting bonus and LTIP measures for AMP8.

- Bonus measures will be set for the five-year AMP cycle, aligned to the final determination.
- Targets will be reviewed annually to ensure they remain stretching.
- Bonus/LTIP measures will align to ODI commitments, price control deliverables or upper quartile benchmarks if a performance commitment is not available.
- Bonus/LTIP measures can be pass or fail, or based on linear interpolation to a target from threshold performance level e.g. totex outperformance.
- Bonus/LTIP 1 set on a capped bonus pot, based on a percentage of salary (CEO currently 65%, CFO currently 35%, Executives 25%).

Governance / decision making / adjustments

The Remuneration Committee will assess overall performance in the round, not just focus on specific metrics. Justification for bonus payments will be supported with disclosures in the Annual Performance Report, which will set out the aspects considered.

- Current disclosures will be expanded further, with increased disclosure on how overall the incentive outcome considers and aligns with overall performance.
- A defined change process will be included in the remuneration process, so the committee actively considers overall performance before approving formulaic outcomes.
- Committee discretion on measures is limited to reducing bonus / LTIP awards for Executive Directors.
- The Remuneration Committee retains the power to withhold bonuses due to governance, behavioural or reputation concerns.

Malus / Clawback Clauses

As part of the PR24 process the Remuneration Committee has given further consideration on whether malus and clawback clauses are required for performance-related pay.

Malus and clawback provisions are intended to provide safeguards and in the wider market they are structured to apply in cases of extreme failure. They would not apply in simple cases of “poor performance” or where there are small shortfalls against plan performance.

Although related, malus and clawback differ as follows:

- Malus relates to the ability to withhold / reduce / cancel payments of variable remuneration before the sums have been paid to the participant.
- Clawback involves requiring an individual to repay amounts they have received after payment.

In the listed environment, malus and clawback became mainstream practice following changes to the Corporate Governance Code in 2014. In 2018, this position was enhanced by further guidance on the circumstances in which the provisions should become enforceable.

The following table summarises the typical circumstances (as disclosed) in which malus and clawback provisions can be applied in FTSE 250 companies. It should be noted that in certain cases provisions are summarised in public disclosures and the detailed triggers can extend further than the detail shown below.

Figure 17: Deloitte analysis: Malus and Clawback Disclosures FTSE 250

Circumstances that trigger malus and clawback provisions in incentive plans

Trigger	% of companies disclosing
Misstatement of results/error in performance calculation resulting in awards being made	99%
Reputational damage	81%
Corporate failure	59%
Misconduct	
• gross/justifying summary dismissal	59%
• serious/material	19%
• not defined	21%
Failure of risk management and control	47%
Performance not sustained	5%
Other reasons	58%

Note: common other reasons include fraud or breach of the company’s code of conduct

From 2023-24 the Remuneration Committee is strengthening malus and clawback provisions and a new clause will be included in Executive Director contracts.

- Scope of clause / trigger scenarios: Clauses will align with best practice and focus on customer, community, and environment performance in the long term.
- Participants: Contractual clawback clauses will be introduced for Executive Directors' contracts. Malus clauses around retained LTIP payments will be strengthened for Executive Committee members.
- Timeframe: Time frames for a clawback event will be set in line with the FTSE 250 median period, which for the bonus is three years and for the LTIP is two years.
- Plans: Clawback clauses will apply to annual bonus and LTIP provisions relating customer, community, and the environment.
- Disclosure: The company will consider how provisions are disclosed and the extent to which this is set out in the Remuneration Report.
- Detailed provisions and documentation: We are seeking legal advice prior to implementation. The clauses will be set out in clearly drafted legal terms, provided clarity on circumstances and timing with a clearly documented decision-making process.

H. Voluntary Sharing Mechanisms

We have reviewed the scope for voluntary sharing mechanisms, and we are not proposing any additional sharing mechanisms on tax and financing costs.

Taxation

Our PR24 plan assumes no tax is a payable due to:

- Available brought forward losses.
- The high level of investment including availability of full expensing of main pool assets in 2024-25.
- Following statutory accounting treatment of deferring revenue from the bulk supply agreement with Southern Water, resulting in no taxable profits during construction.

As no taxation is anticipated we are not proposing a sharing mechanism during PR24 but will review at PR29.

Financing

We recognise that high inflation could result in windfall gains for some companies with low cost fixed embedded debt. Portsmouth Water has limited scope to outperform on this basis due to level of index-linked debt and the current cost of embedded debt.

The legacy embedded Artesian bonds limits our ability to outperform the allowed cost of debt until it is refinanced in 2032. The coupon is 3.645% and the bond is linked to RPI. The new CPI-linked bond is more competitive, but still linked to inflation, albeit CPI. As demonstrated in our RoRE analysis our inflation linked RoRE range is narrower than Ofwat's notional company range.

Customer Sharing Mechanism

As set out above, our reward package is built on principles that customers are protected from us not meeting our performance commitments. Where companies' performance well.

- Customers benefit from better service and lower bills through totex sharing.

- Our employees benefit from a company-wide bonus scheme aligned to our performance commitments.
- Shareholder benefit through allowed returns in line with our dividend policy.

Recognising our privileged position as a regulated monopoly we are proposing an additional sharing mechanism to provided targeted to support to targeted groups. Our plan proposes a customer sharing mechanism on ODI rewards where 10% of net rewards are shared with customers.

We undertook research with our customers to understand where we can best offer greater support or social value. We considered community grant schemes amongst several initiatives.

Customer research findings were clear that our customers feel we should concentrate on delivering value in areas that feel relevant to our business. The main areas where customers valued greater support were:

- Supporting customers who are struggling (both financially and due to health vulnerabilities).
- Protecting the environment.

The ODI reward sharing mechanism will increase funding to our Arrears Assist to target help to customers who are struggling with affording their household bills, and support local organisations supporting vulnerable customers.

I. Uncertainty Mechanisms

We are not proposing any additional uncertainty mechanisms or notified items, in addition to those specified in the licence or incorporated into the PR24 methodology.

4. SUMMARY

Our 2024 Business Plan

- **RoRE**: Our business plan delivers a balanced position on risk and reward with a RoRE range of +3.1% / -5.4%. Following evaluation with our Board we have set our performance commitments based on Ofwat's company-specific rates rather than industry averages, as our proportionally low RCV means we are an outlier, resulting in a magnification in incentive rates.
- **Allowed return**: We have submitted a wholesale plan with a WACC aligned to the PR24 methodology 'early view', and reflecting the inclusion of a small company premium, which is supported by our customers. We have proposed a bespoke cost of capital for the Havant Thicket price control reflecting the quantum and timing of debt issuance. Our wholesale price control allowed return is 3.37%; for the Havant Thicket price control it is 4.13%.
- **Financeability**: Our plan is financeable on a notional company basis; it targets a rating two notches above investment grade but is projected to maintain a Baa2 rating due to scale of Havant Thicket growth relative to the current RCV. Our submitted plan aligns to the Havant Thicket Cost Adjustment Mechanism totex profile. Actual gearing is projected to be in line with the notional company at the beginning of AMP8 and assumes we maintain gearing in line with notional company through further equity injections through AMP8. PAYG and run off rates are set in line with natural rates. Dividend Yield, based on dividends paid, is 2.24% on a notional company basis.
- **Financial Resilience**: We have a robust capital structure and financing is already in place to deliver the Havant Thicket scheme. We have assessed financeability on the basis of our current actual capital structure following £150m equity commitment secured in July 2023. The capital structure is resilient to downside scenarios through withholding dividends or through utilisation of liquidity facilities in place at holding company level. While the plan is financeable on current equity, we anticipate further equity commitments in AMP8 to support the change control on the Havant Thicket Reservoir scheme to support alignment works with Southern Water's recycling scheme. Current cost estimates for the additional works are £70-£80m.
- **Dividend Policy:** Our dividend policy calculates a maximum base dividend based on 4% yield (dividends declared in AMP8). This is set on actual yield to reflect company capital structure. The dividend policy includes a mechanistic approach to adjust dividends to consider performance for customers, and to secure financial resilience including supporting RCV growth. Our plan assumes a 4% base return as equity has been committed upfront to support RCV growth on Havant Thicket.
- **Executive Pay:** We have updated our executive bonus and long-term incentives from 2023-24 to strengthen the transparency between rewards and performance for customers and the environment. We have considered Ofwat guidance and are introducing new malus and clawback clauses into our Executive Director contracts.
- **Sharing Mechanisms:** We have considered options for additional sharing mechanisms for tax and financing but are not proposing additional sharing mechanisms due to expectation that no tax will be paid in AMP8 and limitations to outperformance on financing due to high levels of index-linked debt and the cost of embedded debt. We are proposing an additional sharing mechanism where 10% of ODI outperformance payments are retained to support vulnerable customers directly.

5. GOVERNANCE AND ASSURANCE

Our Board have been fully engaged through the development of the business plan. Full details of the assurance process are outlined in PRT15: Board Assurance.

The Board were involved in the development of the plan from 2021 through a bimonthly/monthly PR24 Steering Group. Meetings were attended by all members of the Board, members of the executive team and the PR24 programme team. Further discussions on dividend policy and executive pay have been covered at Board meetings and through other Board sub-committees.

The Board have reviewed the assurance criteria and requirements of the quality and ambition assessment of the PR24 plan.

The Board reviewed the financeability of the plan based on the notional capital structure and agreed the plan alignment with notional gearing through new equity. The assurance reviewed the proposals on cost of capital including the bespoke cost of capital for Havant Thicket.

The Board were satisfied that the plan targeted maintaining credit ratings at least two notches above the minimum of the investment grade but acknowledge the constraint on achieving a Baa1 rating.

Moody's methodology affectively creates a rating ceiling at Baa2 due to the scale of Havant Thicket investment relative to Portsmouth Water's RCV. Financial ratios for the downside scenarios were reviewed and the Board were satisfied that the actual capital structure was financially resilient against the prescribed downside scenarios in Ofwat's methodology.

Dividend policy and executive pay have been extensively reviewed. The Board discussed the 4% dividend yield on actual equity and concluded it was supported based on the upfront equity but noted that this was subject to annual review in line with the published dividend policy. Executive pay was reviewed, and targets have been amended from 2023-24 and the Board agreed to the proposal to introduce malus and clawback policies for executive director contracts.

Additional scenarios were agreed around the Havant Thicket control. The Board recognised that change of scope relating to the alignment works will require further consideration around dividend policy and equity requirements.

Board discussions were supported by expert third party assurance. The following assurance activities covered requirements on risk and reward.

- Jacobs: review of Performance Commitments.
- KPMG: Models and financial assurance.
- Cost of Capital: reports from First Economics, NERA Economic Consulting.
- Financeability / Financial Resilience: support from Centrus Corporate Finance.
- Exec Pay: advice and assurance from Deloitte.
- Econometric and financial modelling: Frontier Economics.

PRT13 APPENDIX

PRT13 APPENDIX

The following are links to view supporting documentation:

PRT13.01 Credit_Opinion-Portsmouth-Water-Limited-10Mar2023 (Moodys).pdf

PRT13.02 Havant Thicket Resevoir Allowed Cost of Captial.pdf (First Economics Report)

PRT13.03 Cost of Capital for Havant Thicket.pdf (NERA Economic Consulting)

PRT13.04 Financeability and Financial Resilience Centrus Assurance.pdf

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