



Portsmouth Water Limited

PR19 Draft Determination Representation

Board Assurance Statement



Delivering excellence
for our customers,
our people and our
environment



Introduction

The Board of Portsmouth Water is responsible for the strategic development and oversight of the Appointed Business and takes its responsibilities seriously at all times. Led by an Independent Chairman, with two further Independent Non-executive Directors, an Investor Director and two Executives the Board seeks to foster a culture that places customers at the heart of the business, encouraging innovation, constructive challenge and debate at all levels of the organisation. This culture ensured that the full Board led a consistent and robust approach throughout the process of developing the Business Plan for PR19, from its inception through to the final submission, with customer priorities being the “golden thread” at its heart. In addition this same process has continued through to the Initial Assessment of Plan (IAP) submission on 1st April 2019 and for representations on the Draft Determination submitted on 30th August 2019. In particular this new version of the Board Assurance Statement has been modified to reflect changes made as part of the Draft Determination. The most significant of these is the creation of a separate price control for the Havant Thicket Winter Storage Reservoir programme. We appreciate that the PR19 regulatory approach requires the Board to clearly demonstrate how Board assurance has been achieved and what assurances the Board has relied upon. The most important element of this approach is the development of a Plan that is focused on the delivery of customer priorities.

Our smaller scale and flat management structure provides close links between the Board, senior management, colleagues throughout the Company and the communities and customers that we serve. In developing a Business Plan that is focused on delivering our customers’ priorities, both now and in the long-term, the Board set out a clear framework at the start of the process to ensure that:

- all the elements add up to a plan that is of high quality and ambitious, but deliverable through adopting innovative solutions;
- the overall strategy for data assurance and governance processes delivers high-quality data;
- the Business Plan will enable the company to meet its statutory and licence obligations, now and in the future;
- the Business Plan will deliver operational, financial and corporate resilience over the next control period and the long term;
- it will enable its customers to continue to have high levels of trust and confidence in the Company, through transparency and engagement with customers on issues such as its corporate and financial structures; and
- the Board has taken ownership of the overall strategy and direction of the plan in the long term.

Throughout the process, the full Board has provided strategic leadership and has been deeply involved in the preparation of the Plan, including robust challenge of key Plan assumptions, without use of sub-committees. This has continued throughout the IAP response process and the Draft Determination representation process.

Strategy

In 2016, the Board reviewed its approach to its long-term strategy through a process facilitated by Professor Dave Cooper (Head of University of Chichester Business School). It agreed its goals for the future that would drive the PR19 Business Plan. As a long term infra fund investor,

these goals were further endorsed by the new shareholder, Ancala, post the change of ownership of the business in March 2018. The goals are:

1. To put customers at the heart of everything we do.
2. To be in the top 25 companies in the Institute of Customer Service survey.
3. To be a resilient business for both our own customers and to support the wider South East.
4. To promote a culture that is innovative, vibrant, open to change and rewards those behaviours.
5. To recruit and retain the right people and support them to deliver to the best of their ability
6. To be recognised for meeting our social and environmental responsibilities.
7. To ensure that health and safety of our workforce and members of the public remains our number one priority.

Throughout the PR19 process the Board has provided strategic leadership and taken an active involvement in the preparation of the Plan. In this way, the Board has taken overall ownership of the strategy and direction of the PR19 Business Plan and will continue to do so in the long-term. The Board has established a culture of “doing the right thing” and putting customers at the heart of the business. This has resulted in high trust scores in surveys conducted by the Institute of Customer Service and the Consumer Council for Water. It has had a responsible dividend policy and this will continue into the next period.

Resilience of water supplies has been central to the Company for decades. Examples of this are the purchase of the land where the Havant Thicket Winter Storage Reservoir will be located, in the 1960's and the building of the River Itchen Treatment Works in the 1970's. At that time it was seen that in the longer-term resources in the region would need to be increased and the current Board continue to see this as a priority. A key part of the Board's strategy is to use the resilience in water resources to support the wider South East Region, which is seriously water stressed. The questions raised by Ofwat around the development of Havant Thicket Winter Storage Reservoir development formed one of the key elements of the IAP response and a larger component of the Draft Determination representation

The Company is an upper quartile performer in several of the common performance measures to be used at PR19 and the Board established its policy to remain in that position.

These strategic policies have set the tone and direction of the business plan and the planning and assurance process.

In the following section, we specifically address how the Board is able to give assurance on the Business Plan as amended and supplemented by the IAP and Draft Determination representation..

Business Planning

How has the Board challenged and satisfied itself that all the elements add up to a Business Plan that is high quality and deliverable.

PR19 has been a standard item on the Board agenda since July 2017 in order to address assurance and governance through the following processes:

- In December 2017, the Board agreed a clear plan for assurance of all elements of the plan, including where third-party assurance was required. This was reviewed, and changes made as the Plan developed. This assurance plan and the subsequent actual dates when items were considered is presented in Appendix 1 to this document.

- A RAG report showing an updated status of progress on the Business Plan was included in Board Papers every month.
- The Board received evidence from Executives and third- party assurers to ensure the quality of data and the robustness of assumptions. Third parties producing reports were invited to speak to the Board. Chapter 13 of the Business Plan contains a full list of independent third party reports to the Board.
- The Board ensured that an independent Board member attended every CCG meeting and invited the chair of the CCG to three Board meetings during the process.
- It reviewed and assessed compliance with its statutory duties and licence obligations and Government policy statement early in the process to ensure the overall strategy meets these requirements.
- A Board report summarising customer engagement was included as the plan was developed every month.
- The whole Board has been involved throughout the PR19 process, with no separate board committees being established.
- Independent Board members have, where deemed appropriate, conducted deep dives into aspects of the plan to gain assurance that a proper process has been followed and to provide further assurance to the whole Board.
- The Board has rigorously challenged each ODI, the targets set, and how they will be achieved. As part of this process it considered the key risks to the delivery of the Plan and the mitigations required. These risks are included in the RoRE analysis. The above measures have continued as the IAP response and Draft Determination representation documents were developed. In addition to the monthly Board meetings, there have been several supplementary sessions between the Board and senior management to discuss and agree the key aspects of each area of the submission. In addition the Customer Challenge Group, CCG have been fully engaged and there has been close co-ordination with Southern Water in respect of the Havant Thicket project. The Board has had direct access to external advisors as necessary. Please see the last section of the appendix for details of the Board and CCG engagement.

How has the Board challenged and satisfied itself that the overall strategy to data assurance and governance processes delivers high-quality data?

The Board has in place a tried and tested process for providing assurance on the quality of data submitted for the Annual Performance Review. We consider feedback from Ofwat on the quality of data submissions to improve our Company Monitoring Framework and our processes. Our data submissions are subject to independent audit and the auditor is invited to the Board meeting to discuss their reports.

For PR19, the Board has approved internal control procedures to ensure that the data submitted has been peer reviewed and the Chairman of The Audit Committee confirmed that there was good evidence that this had been followed. It has received third party assurance (as set out also below) covering financial and non-financial data from KPMG and Atkins respectively.

In addition, individual NED's have taken responsibility for reviewing certain aspects of the Plan, including data, and then reporting to the Board. All of the above mechanisms have remained in place for the IAP response and the Draft Determination representation process.

How has the Board challenged and satisfied itself that the business plan will enable the company to meet its statutory and licence obligations, now and in the future and take account of the UK Government's strategic policy statements?

The induction process for new Directors covers such matters to ensure they understand their duties and all changes to the obligations are brought to and discussed at the Board.

The Board has put in place a rigorous Risk Management process which addresses the risk of non-compliance with its duties.

In relation to the Business Plan submission, the Board assessed its statutory and Licence obligations, and evidence of compliance at its February 2018 and May 2019 Board meetings. The Board also undertakes a regular update of Government's priorities. The Board has recognised the Government's Strategic Policy Statement to Ofwat and the Government's 25 Year Environmental Plan. Resilience is a key pillar of the Government's policy statements and the Company's plan not only addresses resilience for the Company, but also the wider South East Region, by providing substantial additional bulk supplies to Southern Water, through the development of HTWSR. This will help Southern to meet the environmental challenges at two of their current river abstractions and ensure that the region is more resilient to droughts. The Board has also ensured the plan is consistent with the Environment Agency and Natural England's WISER document.

As a result of Board challenge, the Company has sought to enhance resilience by more aggressive leakage and PCC targets in the long-term which have been reflected in revisions to the Water Resource Management Plan. Also as a result of Board challenge, the initial proposal for mains renewals was increased from 70km to 90km over AMP7.

How has the Board challenged and satisfied itself that its plan will deliver operational, financial and corporate resilience over the next control period and long term through its governance and assurance processes, taking account of its track record of performance?

The Board has conducted a review of risks faced by the Company in terms of potential impact on the customer and the level of mitigation and resilience against those risks. It has looked at historical performance, including the Company Monitoring framework of the current AMP, on a range of measures to identify where interventions may be required. As part of its AMP 6 Programme, the Board commissioned a study to establish the level of resilience to catchment and non-infrastructure asset failures, which has driven key elements of the plan. A NED has undertaken a deep dive into the level of operational resilience within the organisation. The Board has reviewed several financial viability and financeability scenarios (see below).

In addition, the Board has reviewed the plans to ensure that the Company remains able to attract, retain and provide continual training of its staff to deliver the services required by our customers.

The Board has made a final review of the Company's assessment of resilience in the round and its conclusions were included in Chapter 6 of the Plan. This includes how the Plan has been informed by a range of options to manage resilience in customers' long-term interests. Within the IAP response the studies on resilience have been reviewed in the context of a 'systems based' approach and we are confident that we illustrate in our IAP Response submission the strong links between this study and the performance measures and ODI outcomes that have been chosen for the wider business. Our Draft Determination representation further responds to Ofwat actions in relation to resilience.

How has The Board challenged and satisfied itself that it will enable its customers' trust and confidence through appropriate measures to provide a fair balance between customers and investors (which include outperformance sharing, dividend policies and any performance related element of executive pay) and high levels of transparency and engagement with customers on issues such as its corporate and financial structures?

The Board have continually ensured there is a fair balance between customers and investors. At PR14, the Board voluntarily agreed to waive over £5m of legacy adjustments to keep bills lower than they would otherwise have been.

The Board has overseen a large and varied interaction with customers which has continued through the IAP response process. Entirely separate to the PR19 process, the Board took a decision to join the Institute of Customer Service, so that it could build on its strong historic performance on SIM scores and measure its performance against a broad spread of companies, not just other water companies and other utilities. The customer satisfaction score for 2018 was the second highest of any water company and the Company was the fourth placed utility. Through this process, we also receive a trust score in the Institute's surveys that demonstrates our customers have a high level of trust in our business. Retaining and improving this score is of fundamental importance to the full Board. An Independent NED has been present at every CCG, since the PR19 process started. The CCG has been fully involved in the IAP and Draft Determination response process as shown in detail at the end of appendix 1..

The Board has reviewed specific customer research on financial matters, including the support for a specific company adjustment and how much they are prepared to adjust bills to finance our capital programme. This is evidenced in the minutes and papers presented to the Board. The Dividend policy set by the Board during AMP6 has been responsible and well within the level modelled by Ofwat at PR14; its policy for AMP7 onwards is clearly set out in the Business Plan with a base level of 5% of Regulatory Equity which will be subject to satisfactory delivery against our performance commitments. Portsmouth Water has a transparent approach to executive pay, with the performance related elements based primarily on satisfactory delivery against a wide range of customer performance metrics and this process will continue in AMP7. Additional information regarding dividend policy and executive remuneration has been included as part of the Draft Determination representation.

Although gearing levels set out in the plan are well below 70%, an out-performance sharing mechanism has been included. Portsmouth Water has a simple corporate structure that is explained clearly to our customers and has never used complex offshore structures in its financing. Our new shareholders, Ancala, are investing for the long-term on behalf of large UK based pension funds. In order to ensure the long-term financial resilience of the Company, the shareholders are making significant, efficiently structured capital injections during AMP7 to ensure the Company will remain resilient in the long-term.

How has the Board provided ownership of the overall strategy and direction of the plan in the long term?

The Board's strategy is set out above and was established early in the process and was designed to maintain excellent customer service at an affordable price whilst at the same time meeting the challenges set by Government in terms of resilience for its own customers and the South East generally. As the Board progressed the Plan, it ensured that the performance commitments and the ODIs were consistent with this strategy.

The Board confirms that it has taken collective ownership of the overall strategy and direction of the plan, in the long-term, at all times and not just as part of the Business Plan process. An example of this is the decision taken in January 2016 to exit the non-household retail market, so that we could concentrate on further improving our services as a wholesaler and provider of household retail services

Board Challenges

The Board has continued to challenge the Executive and their interpretation of the research to ensure that the plan delivers the key strategic priorities for Government and Ofwat's key themes for PR19. It has used the independent expert reviews of aspects of the plan, to challenge the evidence of what was proposed, in some cases asking for further research and as a result, in some cases, made changes to the plan. It has challenged in many areas and we show below examples that have had a significant impact on the plan: Although research showed that customers were

happy with current performance in a number of the common performance commitments (PC's), particularly where we were already in the top quartile, the Board asked that further testing be done, and as a result of this work and partly in response to expert opinion, a number of PC's were stretched. These included Interruptions to supply and vulnerability. As a result of the IAP feedback, further limited customer research has been undertaken; PC's have been further reviewed and in most cases further changes made.

- There was little support in our research (both that undertaken for the Business Plan submission and the more recent research for the IAP) for the Company to be rewarded for out-performance and the quantum of the result was not consistent with the range of 1 to 3% of RoRE. Having considered the research the Board took the view that a key objective of PR19 was to move the frontier of performance for the industry and decided to include extended rewards if the Company achieved very stretching or industry leading targets on certain performance commitments. These were in the outcomes that customers felt were a priority. Penalties and rewards have been extended further as a result of Ofwat's IAP feedback despite this not being supported by the customer research.
- An independent review of the evidence for the proposed mains renewals strategy suggested that one assumption could have been treated in an alternative manner and possibly changed the overall resulting level of renewals. The Board asked for the analysis to be recalculated with this change in assumption. This resulted in an increase in renewals activity to maintain stable burst rates and the Board decided to accept this change in the interests of resilience.
- Our customer research has generally supported the view that those who can benefit from a switch to a measured charge should be able to do so, but did not support compulsory metering through change of occupier. It was clear to the Board that reducing Per-Capita Consumption is a key component of the Government's strategy and this was repeated in the Minister of State's letter in response to the Company's Water Resource Management Plan (WRMP). In recognition of this, some further research was undertaken, and the Board decided to include some change of occupier metering within the plan for AMP7 and commit to further promoting the benefits such that it can get customer support for full change of occupier metering in AMP8. Please note the Board's preferred approach is for the Government to enact legislation to allow us to compulsory meter where it is possible. Defra were approached in 2017 and 2018 for this change to be used in the WRMP 19, but we were advised that this was not possible in this timeframe.
- The Board encouraged the Executive Management to look for innovative solutions to issues faced by the company and this has been reflected in the approach to reducing leakage and metering as key examples. In the case of leakage, the Company included a more stretching target following the IAP feedback and further internal review.

Customer Engagement

At each meeting the Board received a paper summarising all the research activity undertaken and to be undertaken and have received papers explaining the outcome and conclusions from all of the Customer Research undertaken. They have also received, at several meetings, for discussion a paper summarising the thread of how the Outcomes, Performance commitments, and ODI's have been evidenced and derived from the research, including triangulation. This has been updated for each piece of new research.

As noted above, the Board have fully recognised the feedback from the CCG, with an Independent Director attending every CCG and full access to the Board for the CCG chair

made available. The CCG chair has met the whole Board on three occasions in the 2018/19 year.. During the process the Board have reflected on the issues raised by the CCG, particularly metering, leakage and stretch targets and have made changes to the Plan.

The Board also meets regularly with the regional Chair of CCW to discuss company specific and industry issues.

Feedback from customers is a key feature of every meeting and the Board receive a summary of every complaint and letter of thanks.

The Board believes that the Business plan has been fully informed by the customer engagement undertaken and reflects feedback from the CCG. In addition further customer research has been undertaken as part of the IAP response to Outcome Delivery Incentives and as part of the Draft Determination representation process in relation to bill levels and profiles.

Affordability

The Board have considered the proposed average bill and social tariff against national average household income and the Government threshold for a low-income household. It has undertaken this comparison on Portsmouth Water charges alone and with Southern Water charges for wastewater. The combined average bill and combined social tariff are well below the threshold for water poverty and the Portsmouth Water bill is only approximately one third of the combined water bill. In addition, at the June meeting the Independent NED's asked to see comparisons of recent bill changes against energy and Council Tax bills. These compared very favourably.

The Board has also considered the long-term affordability and stability of bills. The Company has proposed a stable bill, in real terms through AMP7 and into the following two AMPs.

The Board therefore considers that its bill levels arising from its Business plan are the most affordable in the industry and with access to the social tariff, is affordable for all customers. The Board recognises that the key task is to make sure everyone is made aware of the social tariff and the payment options available and following the IAP response we made a stronger commitment to expand our social tariff to a larger number of customers than was the case in the original plan submission. Together, with a proposal for stable (real) bills over the longer term, the Board has also concluded that this provides long-term affordability.

Outcomes

The Board has considered a paper summarising the PR19 key delivery risks and mitigation plans, including the potential range of customer and financial impacts. Monitoring of the outcomes and PC's established at PR19 and the key delivery risks will be standard items on the Board agenda. They will also form part of the weekly review of operations by senior managers in the company. These items will continue to form a large element of Executive Director bonuses.

After reviewing and challenging the key risks and mitigation and challenging Executives, the Board is confident that by driving efficiency and embracing innovation, it will deliver its Outcomes and Performance Commitments contained in the plan.

As noted above, the Board has reviewed the customer research, taken account of CCG views and challenged using expert opinion whether the ODI's are stretching. In some cases, the Board have set higher performance commitments than is indicated by the customer research which have been made more stretching following the IAP feedback. It therefore considers that the proposed outcomes, PC's and ODI's reflect customer preferences and are stretching.

Throughout the current AMP, performance against key ODI's is reviewed at every Board meeting and, where necessary, appropriate corrective actions discussed and agreed. The Board have reviewed and accepted a proposal for reporting on its performance commitments and ODI's for the next AMP. This CCG will continue to play a part in this process. The Board endorsed the proposed approach, which will be a continuation of the current process, with a review of performance against key ODIs at every Board meeting.

Resilience

The Company has built a resilient supply and water resource network over many years and the resilience study undertaken in AMP6 has confirmed this. In addition, the Board has embedded risk management into its day-to-day activities and reviews its risks on a quarterly basis. It has procedures in place to identify trends in performance and to react to events and incidents.

For the Business Plan the Board conducted a thorough review of this risk analysis based on the Cabinet Office core principles in relation to fulfilling its statutory duties and responsibilities and meeting customer expectations; the review looked at how resilient the business was against them, including its response and recovery. In AMP6 (included in the PR19 Plan) the Board approved a study to consider its key risks and potential single and multiple points of failure in the supply network and the outcomes of this work are a key part of the plan. The Water Resource Management Plan is a key element in ensuring that we have resilient water resources in the long-term and the key components have been independently produced by third parties. We also have a robust and well tested Emergency Plan for when incidents do occur, most recently used in the "Beast from the East" event, when, despite a very rapid thaw, only a very small number of customers were affected for a short duration. This event in itself serves as a strong indication of the underlying resilience of the Company's infrastructure along with the long hot summer that followed where again no significant supply issues were encountered.

Through its governance processes, the Board is confident it has the people, processes & systems, assets, plans and financing to enable the delivery of the Plan and longer-term business objectives under a wide variety of adverse scenarios. This includes the changes to the Plan made through the IAP review process.

The Board have approved a Water Resource Management Plan that will ensure resilient water supplies in a 1 in 200-year drought until at least 2045. This Plan allows for the provision of bulk supplies to Southern Water Services and includes the construction of a winter storage reservoir.

The Havant Thicket Winter Storage Reservoir scheme represents a major investment for the Company and a significant management challenge. To address this the Board has approved the appointment of a specialist consulting and cost engineering company with specific experience in this type of project to ensure that it can assure the delivery of all aspects of this project in a timely and cost-effective manner and ensure that the project does not distract senior management from delivering the PR19 business plan commitments.

A standing item on the Board agenda is a review of the Company's ability to withstand and recover from cyber-attacks and to ensure that its protection is up-to-date. Two papers have been presented on this in the January and February 2019 Board meetings.

The Board has conducted a robust assessment of its financial resilience and longer-term financial viability, to ensure it can withstand a range of events. A suite of down-side financial shocks have been modelled. These include both the financial viability scenarios set out by Ofwat and a range of "severe but plausible" company specific scenarios (which were underpinned by our Company risk assessment). The Board has also provided an updated company Viability Statement to support its conclusions.

An Independent Non-Executive Director has undertaken a deep dive assessment of our resilience, both currently and for the future.

The Board considers, therefore, that its Business Plan is informed by a robust and systematic assessment of the company's systems and services.

Whilst starting from a high base level, we are proposing to make several interventions on resilience in PR19 to improve raw water quality issues and to enable delivery of further bulk supplies of water. An assessment of these intervention options was made to determine the best way to manage long term resilience in customer's best interests and approved by the Board. The Board also considered feedback from the DWI on water quality schemes. It was satisfied that the options chosen were in the customers' best interests.

From customer research on priorities the Board were clear that "a safe and secure water supply" was the highest priority for customers and it was therefore believed that its proposals in this area were supported. However, research was undertaken to test our specific proposals for resilience and a paper summarising this was presented to the Board. This paper was discussed and as a result the Board are confident that the Business Plan has been informed by customer views on resilience.

Cost Assessments

The Board reviewed the overall capital expenditure programme, considering a report from Atkins on the approach taken by the Company to achieve a cost effective programme including the benchmarking of costs. It also discussed this report with its author. The Board specifically challenged the levels of contingency in the costs and was reassured that these were acceptable.

For Non-Infrastructure capital expenditure unit costs, an independent quantity surveyor and independent auditor were used to determine and review the costs. For Infrastructure, the actual Unit Rates used by the incumbent contractor were used. These were competitively tendered in 2015 and were regarded as efficient.

The Board considers therefore that its expenditure forecasts are robust and efficient.

Ofwat has now published its assessment of Totex efficiency and the Board notes that in addition to its industry leading efficiency position PW is the only company where planned spend is lower than that proposed by Ofwat.

The Company has one large investment proposal, a new reservoir which is supported by option appraisal carried out on behalf of the Company by Water Resources in the South East (WRSE) and an analysis by PA Consulting. Atkins has appraised the deliverability of the project and believe the costs are at P50 level. PA consulting also conducted a review of whether the project should be considered as a DPC contract. The conclusion was that this was not the best way forward for customers. The reservoir will be used to enable an additional bulk supply to Southern Water services and we are working in collaboration with them. They also conclude that this is the best approach to deliver for their customers. The Board evaluated these reports and analysis to ensure deliverability and cost efficiency, determining that the proposals were both deliverable and the most cost efficient option. In doing so, the Board concluded that the proposal put forward in the Business Plan is in the best interests of the customers of both companies. Collaborative work with Southern Water on the Havant Thicket project commenced in 2018 and there is a full governance process in place led by a Steering Group which includes non-executive directors. Our recent risk analysis of the project programme has led us to conclude that the current 2029 target for water into supply is tight and there are risks that environmental factors such as weather conditions, soil conditions and drought could easily have a major negative impact.

Throughout the business plan process, third party assurance has been received in relation to the data tables and supporting information (KPMG – Financial, Atkins – Non-Financial) and the Board have discussed findings with the relevant organisation.

Risk and Return

As identified under item under “Outcomes”, above, the Board has considered the key delivery risks and identified a range for the potential costs of failure including mitigation costs. These costs together with potential rewards and penalties for performance on ODI’s have been included in the RoRE analysis. The Board has reviewed this work and can provide assurance that it has identified the risks associated with delivery of the plan and the risk mitigation plans in place are appropriate.

Financeability

The Board’s financeability assessment

In accordance with the Business plan guidance, we have assessed financeability in both a notional and an actual capital structure and have assessed long-term financial resilience in an actual capital structure.

The Board have undertaken a series of steps to assess financeability. Further information on this Board assessment process to date was included in our submissions on 3 September 2018 and 1 April 2019. We have built upon this approach and modified it to reflect the relevant factors set out in the Draft Determination (DD).

Modification of the Board’s financeability assessment approach

Following the publication of the DD, which includes a separate Dummy price control for the delivery of Havant Thicket Winter Storage Reservoir (HTWSR) (the “HTWSR price control”) we have modified our previous approach to assessment of financeability. The original Business Plan was prepared on the basis of a single price control for the whole business, including HTWSR. This was because **the reservoir will be integral to the operation of the Portsmouth Water’s network**. Unlike many other large reservoir schemes it is not a separate standalone asset to be used directly to make bulk supplies to Southern Water Services – it is fully integrated within the PW supply system and makes significant use of headroom within existing infrastructure to make water available to Southern at PW’s western boundary.

In the DD, Ofwat’s assessment of financeability first considers the financeability of the “Core” notional business (“Core” being defined as the business excluding the HTWSR development) – reviewing key financial ratios and making any relevant financeability adjustments.

We concur with this approach (provided the relevant regulatory elements of the separate price control are set appropriately) as it is fair to PW customers because it ensures that there are no cross subsidies between the financeability of the Core business and the HTWSR price control. However we do note that it is a somewhat artificial distinction between different assets, because as noted above the HTWSR is not providing water directly to Southern Water customers. Having concluded on financeability of the Core notional business Ofwat then considers the financeability of the “Combined” notional business (“Combined” being defined as the Core business plus the HTWSR price control).

Accordingly, the Board has modified their approach to the assessment of financeability in order to take a similar approach to Ofwat. As such, the Board has considered financeability both of the Core business and the Combined business (i.e. Core plus the HTWSR price control).

The Board’s financeability assessment process

We have summarised the updated process below for reference purposes. This process is set out in further detail, together with presentation of key financial ratios, in Chapter 2 of the Company representation on the DD (the Representation):

- **Review Ofwat PR19 methodology** in relation to financeability and financial resilience including the “putting the sector in balance” consultation.
- **Assess the wider basket of factors affecting financeability** of the business and their impact. Investigate the ability of the business to manage or influence financeability and any actions taken or needed to be made to address financeability in the round. Consider the balance between qualitative and quantitative factors in assessing financeability.
- **Set out and approve the financial metrics & targets**, which will be used as part of the quantitative assessment (this is included in the Company response to the IAP at PRT.RR.A3 and updated in Chapter 2 section 2.3.1b of the Company Representation).
- **Consider the appropriate credit rating to be targeted** (see further information in the Company response to the IAP at PRT.RR.A1 & A2)
- **Assess the Core Business Plan in the Notional structure** against the key financial ratios. Consider the extent to which Equity and PAYG adjustments are required.
- **Assess the Combined Business Plan in the Notional structure** against the key financial ratios. Consider the extent to which further adjustments are required to finance the HTWSR price control including increase in cost of capital and equity injections.
- Taking all financeability adjustments into the actual capital structure - **assess the Combined Business Plan in the Actual structure against the key financial ratios.**
- **Consider the significant levels of uncertainty** relating to the regulatory approach and mechanisms to be applied in the HTWSR price control.
- **Assess the Core Business Plan in the Actual structure** against the key financial ratios.
- **Perform sensitivity analysis** to understand the Company’s financeability and ability to respond to financial shocks. Cover both AMP7 and longer term viability. Understand the results of this modelling & any appropriate mitigating actions and activities.
- **Consider the overall results of this process** in the round including qualitative and quantitative factors, balance between financeability and customer bills, available headroom and ability to raise debt and approach that may be taken by ratings agencies in the event of deterioration of key ratios.
- **Draw conclusions on overall financeability** of the Core business and of the Combined business.
- **Consider the overall results of the assessment of viability** down side scenarios. Conclude on overall long-term financial resilience.

Having been through the process above, the Board then considered the qualitative aspects of financeability and long-term resilience. This included a range of relevant factors as set out in the Company’s IAP at Chapter 2. These are summarised as follows;

- **The Company’s long track record** demonstrating high levels of operational performance, strong TOTEX efficiency, high levels of operational resilience and stable financial policies - all of which have led to a long term financially stable business.
- **Consideration of the target credit ratings**, appropriate financial ratios and results against those financial ratios.
- **A strong balance sheet** and targeted <60% gearing and a current pension surplus.
- **Results from a range of viability scenarios** & RoRE analysis.

- **Ability to maintain resilience in the long term** including, risk management processes and ability to both mitigate and respond to down-side scenarios.
- **Long-term investor commitment** to actively support the business and continue to deliver leading levels of service for customers.
- **Market evidence of continued ability to raise debt** to finance the Company's investment programme.
- **Challenges & response to current, efficiently raised, debt structure.**
- **Regulatory remedies** which may be available to help address financeability issues.
- **Future strategies to improve the financeability of the business** including reducing average cost of debt over time due to the funding requirements of the investment programme.

In addition, the Board also considered the implications of additional factors in relation to the Draft Determination:

Current significant regulatory uncertainty regarding the approach to the HTWSR price control. The Board carefully considered the wider implications of this regulatory intervention including the extent to which the related regulatory approach and mechanisms are a) bespoke and b) as yet to be finalised through further discussion with Ofwat.

Consideration of any possible change in position or approach by the Rating Agencies. The Board recognised the continued downward pressure on returns across the industry and the extent to which this may result in any change in approach or position by the Rating Agencies. It also considered the factors in the DD which could adversely impact the Rating Agencies' view of risks – such as a separate HTWSR price control and related bespoke mechanisms.

Interventions made in the DD and Representations by the Company. In the DD Ofwat has raised interventions and actions in relation to financeability and the Company has made Representations and revisions to the Business Plan submission. These have been set out in full detail in our Representation document and are summarised below.

Changes and key assumptions impacting the Board's financeability assessment

In developing the Company's Core and Combined business plan a number of revisions have been made to the Draft Determination assessment of financeability provided by Ofwat. These are summarised in Chapter 2 of the Representation.

Set out below are those revisions, which have impacted financeability, and have accordingly been taken into consideration as part of the Board's assessment of financeability – **that is the Board has assumed that these changes are fully included in the Final Determination.** Amendment to some or all of these changes at the Final Determination would have an adverse impact on the financeability of the Business Plan, the ability of the Company to maintain an investment grade credit rating and upon long-term financial viability. We have highlighted below the impact upon financeability if the changes made in this Representation were not to be included in the Final Determination. We have also highlighted those matters which have the most significant impact on financeability, and those corrections which have been agreed by Ofwat;

Area		Change	Nature	Impact on financeability if change is not included in the FD
Items judged by the Board to have a <i>material adverse impact</i> on financeability if reversed by Ofwat				
Reversal of WRFIM adjustment	Core	A correction was made to reflect the agreed approach to the	Correction	Material Adverse Material reduction in revenue & profit.

		treatment of Connection Charges at PR14.		
PAYG adjustment	Core	PAYG adjustment of 3.5%.	Representation	Material Adverse Reduces revenue, cash flow and profit.
Equity injections	Core & HTWSR	Additional equity injections to improve financeability in the actual capital structure.	Change	Material Adverse Increases gearing and cost of debt. Reduces profitability.
HTWSR price control WACC	HTWSR	The Company makes a representation in relation WACC in the price control.	Representation	Material Adverse Reduces overall returns and increases risk of adverse outturn on cost of debt.
Items judged by the Board to have an <i>adverse impact</i> on financeability if reversed by Ofwat				
Reallocation of allowed TOTEX from Capex to Opex	Core	The additional Ofwat TOTEX allowance was allocated entirely to Capex. A modest £3m reallocation (before cost sharing) to Opex was made to reflect a balanced Opex position.	Reclassification	Adverse We assess that this Opex will be required to deliver the Business Plan. Reversal would reduce profit and cash flow.
HTWSR price control Capex	HTWSR	The Company makes a representation in relation to Capex in the HTWSR price control. Increasing Capex by £12.1m over the 10 years control.	Representation	Adverse If costs are disallowed, this increases construction risk and risk of down side cost sharing.
Items judged by the Board to have a <i>less significant impact</i> on financeability, or judged unlikely to be reversed by Ofwat				
Reinstatement of £1.3m resilience capex	Core	The Company makes a representation relating to resilience Capex of £1.3m.	Representation	Marginally Adverse
Reallocation of enhancement capex between WR and N+	Core	Certain schemes appear to have been misallocated by Ofwat to the wrong price controls.	Correction	Neutral
Cost sharing ratio	Core	Ofwat acknowledges an error relating to the calculation of the cost sharing ratio.	Correction	Adverse Material reduction in revenue, RCV, profit and financeability. However this treatment has been agreed by Ofwat therefore risk of reversal is judged to be low.
Correction to non-price control income	Core & HTWSR	Ofwat acknowledges an error relating to the double counting of Non-price control income of £5.9m.	Correction	Adverse Material reduction in revenue & profit. However this treatment has been agreed by Ofwat therefore risk of reversal is judged to be low.

Key assumptions underpinning the Board's assessment of financeability

The following key assumptions underpin the Board assessment of financeability;

Core Business

- No further reduction in WACC
- Company specific premium is retained
- 3.5% PAYG adjustment
- No further reduction in revenue as a result of PR14 legacy items (in particular the treatment of PR14 Connection Charges)
- Planned equity investments approved by investors at the time required.

- The approach taken by rating agencies in the assessment of credit ratings is modified to take account of factors such as lower gearing, outperformance and PAYG adjustments.

Appointed (Combined) business

In addition, to the key assumptions set out above under the Core business;

- WACC assumption for the HTWSR price control of a minimum of the Company's wholesale WACC of 3.26%.
- Disallowed Costs restricted to a £1.7m efficiency challenge.
- Cost re-set mechanism for capex after ground condition surveys, planning determination and post tender evaluation.
- Re-set mechanism for WACC in line with normal PR24 process
- Cost setting mechanism for HTWSR operating costs in line with normal PR24 process.

Financeability assessment

The Board recognises the implications that continued downward pressure on regulatory return has for financeability of the business in both the notional and actual capital structure. The Company has articulated in detail the actions taken to address overall financeability and financial resilience and this is set out in the Business Plan Submission Chapter 11, IAP response Chapter 2 and Chapter 2 of the DD Representation. This includes the injection of significant additional equity proposed in the Business Plan financial model.

The Board recognises that the level of headroom in relation to the target quantitative ratios is extremely tight. In the Board's assessment qualitative factors have also been taken into account including consideration of the likelihood that rating agency methodology will be modified to reflect the benefit of factors such as lower gearing, out-performance and recognition of PAYG adjustments. The Board assessment also considered quantitative analysis of down-side and up-side scenarios.

In relation to down-side scenarios the Board recognises that the following areas have the most material impact upon financeability in the Actual capital structure;

- A reduction in WACC
- Reversal of the 3.5% PAYG adjustment (upon which a representation has been made)
- Application of a WRFIM adjustment of £2.9m in relation to the PR19 treatment of Connection Charges (upon which a representation has been made)

Although significant equity injections are included in the business plan, further equity injections are not effective in improving financeability. As the Company has previously explained the existing Artesian bond structure (RPI, 3.635%) has extremely restrictive terms in relation to early repayment or redemption and effectively, cannot be efficiently paid down early. Accordingly equity injections do not readily improve pressure on the FFO/net debt and AICR ratios.

This is because cash from equity injections cannot reduce the embedded debt and related interest charges. Hence whilst equity injections can be effective in managing cash flow requirements or reducing the need for new debt, they cannot reduce the interest load of embedded debt. Therefore they are only effective to a point. The Company and the Board continue to keep under review any viable options to restructure the embedded Artesian debt efficiently in the future.

Conclusion - Financeability assessment of Core business activities

After considering the financial projections for the Core business using the Ofwat model, the Board concluded:

- **Notional structure.** After applying efficiently structured capital injections, PAYG adjustments of 3.5% and making the corrections and revisions set out in the Representation, with a Baa1/BBB+ target credit rating the Business Plan is financeable.
- **Actual structure.** Following the further reduction in allowed cost of capital, the Board recognises the diminished headroom on key financial ratios. After applying efficiently structured capital injections, PAYG adjustments of 3.5% and making the corrections and revisions set out in the Representation, and considering a wider range of qualitative factors, with a Baa2/BBB target credit rating, the Business Plan is financeable.
- **PAYG.** After considering the customer research, that the use of PAYG levers is supported by customers and in their best interests for the short and long term.
- **Bill level and profile.** After considering the customer research that the bill level and bill profile is supported by customers.
- **Viability.** After undertaking financial viability scenarios and considering available mitigating actions, that the Business Plan is financially resilient.
- **FD Changes.** In addition the Board also highlights that any changes, in the Final Determination, to the key assumptions highlighted, and in particular any further reduction in cost of capital, reduction in the 3.5% PAYG adjustment or reversal of the representation made regarding the treatment of PR14 Connection Charges under the WRFIM mechanism, would result in the Business Plan in Notional and Actual structures no longer being financeable.

As a consequence of the Board's review of financeability and financial resilience, the Board concluded that the Company's Plan for the Core business;

- Is financeable in the notional and actual capital structures
- Remains financially resilient over the longer-term
- Protects customer interest in the short and long-term

Conclusion - financeability assessment of Combined business activities (Core plus HTWSR price control)

We discuss in more detail in Chapter 1 of our Representation, covering HTWSR, the range of factors that relate to the assessment of and implications to financeability in the Combined business as a consequence of the approach taken to the HTWSR price control.

As set out above under the approach to assessing financeability, the Board recognise that it cannot be the case that the Core business cross subsidises or supports the HTWSR programme in any way. However, given the water is not delivered directly to Southern Water from the reservoir itself, and that existing PW assets form part of the delivery mechanism, it is also important to recognise that it would be inequitable if water supplied to Southern Water customers was done at a lower return than we supply water to our own customers. In this respect the Board has carefully considered the impact that the HTWSR price control has on the Combined business – in particular headroom in relation to financeability and uncertainty relating to the regulatory mechanism and approach.

The Board recognises that here is a careful balance to be made between different customer groups. This is explained further in the HTWSR Chapter 1. The Board notes that, when setting the Cost of Capital and determining other regulatory mechanisms for the HTWSR price control, risk and value can be moved between both sets of customers and investors (of Portsmouth Water and Southern Water). It is therefore essential that the right balance is achieved for all

parties and that this is done in light of overall financeability considerations for the Appointed business as a whole.

The Board acknowledges and has appreciated the level of engagement and support that the Company has received from Ofwat, relating to the HTWSR programme, following the publication of the Draft Determination. However, **there are a number of bespoke regulatory approaches and mechanisms which have not yet been fully defined**. In Chapter 1 of the Representation, the Company has set out proposed principles around how revised regulatory processes could be operated and how further engagement with Ofwat could be taken forward in order to agree such regulatory mechanisms (or alternative approaches).

However, the Board recognises that, given that there remains significant uncertainty as to key aspects of the HTWSR price control, the Board is unable to conclude on the overall financeability of the Combined Business Plan at this time. These uncertainties include the following factors;

- Level of WACC for the HTWSR price control – we have made representations in relation to a higher WACC (of a minimum of the Company’s Wholesale WACC of 3.26%) and Company specific wholesale WACC in each subsequent review period.
- Uncertainty about how the price control will be dealt with in future regulatory periods.
- The impact that any apparent divergence from “business as usual” water regulation, within the price control, may have on the approach by Rating agencies and debt investors.
- Uncertainty about the final approach to regulatory mechanisms as listed below and covered in detail elsewhere in the DD Representation:
 - We have made representation on the duration of the price control
 - Cost sharing mechanisms have not been finalised
 - We have proposed a re-set mechanism for WACC
 - We have proposed a cost re-set mechanism (capex and opex)
 - We have made proposals relating to the treatment of Economic profit and water trading incentives
 - End of AMP reconciliation models have not been finalised by Ofwat
 - We disagree with the disallowed costs identified by Ofwat.
 - We have made proposals relating to a process to re-set the construction cost in line with the project maturity – cost certainty at this stage of the programme is lower than it will be when certain critical programme development milestones have been reached.
 - Uncertainty in relation to any regulatory performance commitment and any performance commitments under the BSA.

Whilst the factors above, once concluded upon, would impact on financeability in either a positive or negative way, the degree of current material uncertainty means that the Board is unable to conclude on financeability of the Combined business at this time.

Accordingly, due to the level of uncertainty explained above in relation to the HTWSR price control, **the Board are unable to reach a final conclusion relating to the financeability of the Combined Business Plan.**

The Board has proposed that, following a period of further intensive engagement and clarification in relation to key regulatory mechanisms and processes, an updated Board financeability assessment of the Combined business will be provided in advance of the Final Determination. The Company has provided further detail relating to how this engagement and clarification can be achieved, in Chapter 1 of the Representation. The Board and the Company’s senior management team remain highly committed to this process.

Assurance Summary

As a result of the actions and evidence considered by the Board, it believes that its Business Plan:

- Is endorsed by 80% of our customers.
- Will maintain customer trust and confidence and has a fair balance between customers and investors and has high levels of transparency and engagement on issues that matter to customers.
- Is of high quality and ambitious, but deliverable using innovative solutions.
- It will deliver long-term operational, financial and corporate resilience on behalf of our customers.
- Reflects our customer preferences obtained through a comprehensive process of engagement and ensures that we are transparent with our customers on all key aspects of the plan and its delivery, including corporate and financial structures.
- Meets its statutory obligations, licence conditions and the Government's priorities throughout the plan.
- Is based on robust data and efficient costs.
- Is affordable for all of our customers, even those with vulnerabilities and on the lowest incomes, including in the long term.
- Will continue to deliver excellent customer service.
- For the Core business is financeable in both the notional and actual capital structure. The Board was unable to conclude on the financeability of the Combined business (including HTWSR price control).
- Protects customer interests in both the short and long term.
- Has responded comprehensively to the questions raised by Ofwat through the IAP feedback and has modified and improved the Plan as appropriate.

Signed by the Board:



M P Kirk



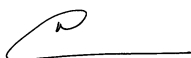
C R Taylor



M Johnson



D Owens



M Coffin



H M G Orton

PR19 and IAP Response plan for Board Governance papers and actual Dates of Presentation

	Paper	Responsibility	Plan Date	Actual Date
Business Planning	1 Summary of data key controls and governance	SM/ HMGO	22 Feb	22 Feb
	2 Assessment of statutory obligations and business plan approach	RCP/NS	22 Feb	22 Feb
	3 Disclosure and transparency of corporate structure	HMGO	22 March	22 March
	4 Board to prepare summary of the ongoing oversight and input into the long terms strategy and Business Plan process. Interim and Final papers.	Chairman	26 Apr (I) 26 July (F)	24 May, 28 June, 26 July
	4a Overarching Strategy	NS	28 June	28 June
5 Business Plan Summary Position	NS	24 May	24 May	
Customer engagement	5 Customer engagement activity. See also 8 (outcomes), 12 (resilience)	PAB	Monthly	25 Jan, 22 Feb, 22 Mar, 24 May, 28 Jun, 26 Jul, 30 Aug
	5a CCG Action List			
	5b Acceptability Testing			28 June, 26 July 30 Aug
Affordability	6 Work supporting bill levels, profile and social tariff.	HMGO/ PAB	24 May	28 July, 9 Aug 30 Aug
Outcomes	7 Outcome and ODI proposals including rewards & penalties	SM	26 April	26 April, 28 June, 26 July
	8 Customer engagement activity against Outcomes and Performance Commitments.	SM	22 Feb	22 Feb
	9 Company's planned approach to reporting on PCs & ODIs.	SM	26 April	26 April
	10 Supporting PC levels (stretch targets).	SM	26 April	26 April
	10a Paper covering results of research on Rewards and Penalties		26 April	26 April, 28 June, 26 July 26 April, 24 May, 26 July
Resilience	11a Papers covering; operational resilience,	RCP/NS	22 Feb	22 Feb, 26 April, 28 June
	11b financial resilience (scenario modelling),	HMGO	22 March 26 April	30 Aug 22 March, 24 May
	11c and overall "resilience in the round" – reports from individual Non Exec	MJ	26 April	24 May, 28 June
	12 Review of customer engagement activity in relation to resilience.	SM	24 May	24 May
Cost assessments	13 Company challenges in relation to cost and efficiency including overall TOTEX benchmarking.	NS RCP/	April/May	25 Jan, 28 June, 26 July

and Capital Programme	<p>14 Specific papers covering large investment proposals;</p> <ul style="list-style-type: none"> • Overall CAPEX plan • Havant Thicket • Catchment management • Infrastructure renewals • Water quality investments • Resilience schemes <p>14a Enhancements costs adjusted claims</p> <p>14b Atkins report on capital programme</p>	MM	<p>25 Jan</p> <p>22 March</p> <p>22 March</p> <p>22 March</p> <p>22 March</p> <p>22 March</p> <p>28 June</p>	<p>25 Jan</p> <p>22 March, 26 April, 28 June</p> <p>22 March, 22 June, 9 Aug 28 June</p> <p>22 March, 28 June</p> <p>22 March, 28 June</p> <p>26 April, 26 July</p> <p>26 July</p>
Risk & Return	15 Board review of Company paper summarising PR19 delivery risk and mitigation plans (including impact on ODI outturn and RORE assessment).	RCP/NS	24 May	28 June, 26 July, 9 Aug, 30 Aug
Financeability	<p>16 Approach to assessment of financeability (Principles & Results).</p> <p>17 Review of the Company's modelling and sensitivity analysis of financial outturn including key ratios (in line with Business Plan guidance and Ofwat Scenarios).</p> <p>18 Customer engagement covering Bill Profiles, PAYG adjustment and Small Company Premium</p>	<p>HMGO</p> <p>HMGO</p> <p>HMGO</p>	<p>25 Jan (P)</p> <p>28 Jun (R)</p> <p>28 June</p> <p>24 May & 28 June</p>	<p>25 Jan, 9 Aug</p> <p>26 July, 30 Aug</p> <p>17 Aug, 30 Aug</p> <p>24 May, 28 June</p> <p>26 July</p> <p>30 Aug</p>
Board sign off	<p>19 Develop and review wording of assurance & Governance statement.</p> <p>20 Approval of business plan for submission.</p>	<p>HMGO</p> <p>Board</p>	<p>28 June</p> <p>28 June</p>	<p>24 May, 28 June, 26 July</p> <p>9 Aug</p> <p>30 Aug</p>
Other Governance	21. Risk register and RAG report	HMGO	Monthly	25 Jan, 22 Feb, 22 Mar, 26 Apr, 24 May, 28 Jun, 26 Jul,
Water Resources	<p>22 Metering Strategy</p> <p>23 Letter from Therese Coffey Leakage Strategy</p> <p>24 Board discussion of WRMP</p> <p>25 Board discussion of Havant Thicket</p> <p>26 Board approval of Draft WRMP</p> <p>26 Board approval of Draft Final WRMP</p>			<p>Nov 17, 26 April</p> <p>26 April</p> <p>28 June</p> <p>July, Sept, Nov, Dec 2017, 9 Aug</p> <p>Oct 2017</p> <p>23 Nov 2017</p> <p>30 Aug</p>

Table and Final Data Average	27 Report from KPMG – Financial 28 Report from Atkins – Non-financial		30 Aug 30 Aug	30 Aug 9 Aug 30 Aug
Final Report from CCG	Final Report – Reviewed		30 Aug	30 Aug

IAP Response	<p>The Board has led the IAP response through calls and full meetings on the following occasions:</p> <ul style="list-style-type: none"> • 6 February 2019 – Board conference call to discuss IAP contents and initial thoughts • 28 February 2019 - full Board meeting • 6 March 2019 - Board members attend customer research • 19 March 2019 - Board conference call to discuss IAP response progress • 26 March 2019 – full Board meeting (final approval) <p>The CCG have input to the IAP response as follows:</p> <ul style="list-style-type: none"> • 4 February 2019 - Company shared its initial view of IAP with CCG • 7 February 2019 - Phone call hosted by Company discussing IAP and proposed plan of action • 4 March 2019 - Phone call hosted by Company discussing planned customer research • 6 and 7 March 2019 - CCG members attend customer research focus groups • 12 March 2019 - Phone call hosted by Company providing members with feedback from the customer research • 14 March 2019 - Company shares its revised ODI package with CCG; tracker shared with CCG Chair only. • 20 March 2019 - Phone call hosted by Company receiving CCG feedback to revised ODI package. • 28 March 2019 - CCG submits its report to the Company to accompany its response to the IAP
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DD Representation	<p>The Board has led the DD Representation through calls and full meetings on the following occasions:</p> <ul style="list-style-type: none"> • 25 July 2019 – full Board meeting - initial assessment of DD response and review of action plans • 13 August – Board call - review of financeability approach within DD representation • 22 August – full Board meeting – review of draft DD representation • Various – calls of Havant Thicket Commercial Group and Steering Group with Board members participating. <p>The CCG have input to the DD Representation as follows:</p> <ul style="list-style-type: none"> • 14 August - Company shared its view of DD with CCG including customer research
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