

PR24 DRAFT DETERMINATION RESPONSE EXECUTIVE SUMMARY



EXECUTIVE SUMMARY

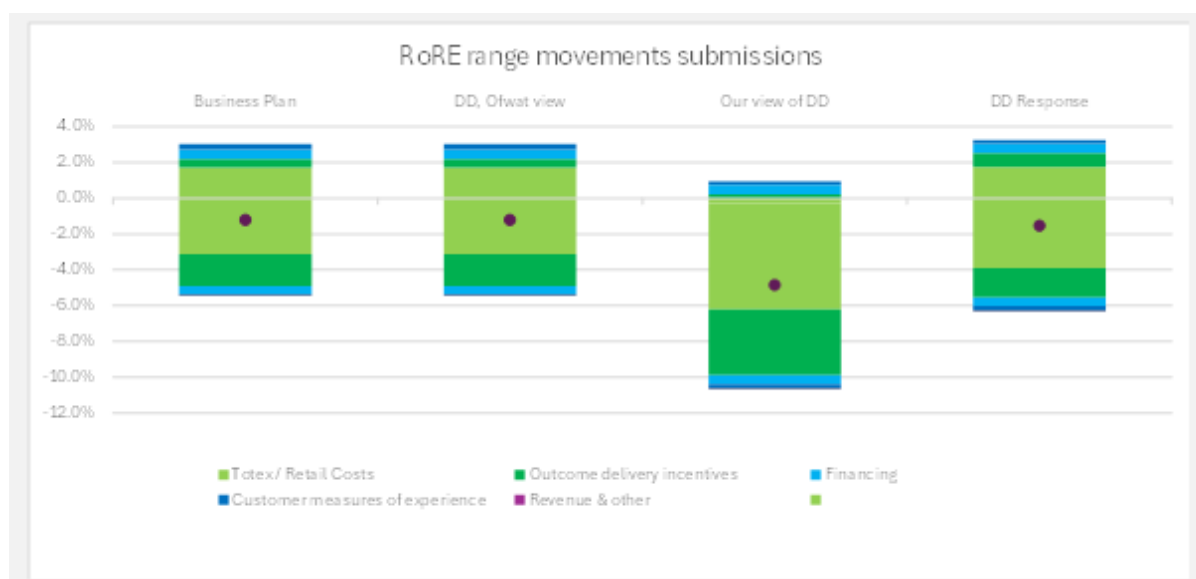
A. Executive Summary

We are pleased to provide our response to Ofwat’s PR24 Draft Determination.

We welcome and support many of the updated policy positions Ofwat has taken in the Draft Determination, for example recognition that leakage costs should be treated as enhancement costs, specific funding for climate change resilience and net zero and funding for an increase in mains replacement. The Ofwat team has also responded pragmatically to specific issues such as concerns over the Discharge Permit Compliance and Biodiversity performance commitments, where there were clear errors in the Draft Determination.

Despite these positives, overall, the Draft Determination package is not one that we could accept. As we show in our response, the overall balance of risk within the Draft Determination is strongly negatively skewed, despite Ofwat’s recognition of the importance of achieving a better balance than at PR19. The overall skew in risk is illustrated below, along with the range that reflects our Draft Determination response.

Figure 1: RORE range from business plan to Draft Determination response



The allowed cost of capital in the Draft Determination is not commensurate with the balance of risk represented by the Draft Determination. The allowed cost of equity, at 4.80% represents only a small increment (c.80bps) on current investment grade bond yields. It will not be sufficient to attract the new equity that the sector requires to fund the necessary step change in investment in AMP8. We provide further details in the document *PR24 Draft Determination response: Risk and Return*.

As well as revisiting the overall risk and return balance for the Final Determination, including ensuring that the cost of equity is sufficient, there are a number of key changes that are required to Portsmouth Water's Final Determination to make it one that we could accept. These include:

- A bespoke **cost of debt for Havant Thicket Reservoir** that is sufficient to make the additional scope of the project investable, including securing the additional financing that is required. We calculate that this is 60bps higher than the Draft Determination proposal – which would add less than £1 to Southern Water's water bills in AMP8 and ensure that the benefits of this regional resource are maximised. In addition, it is vital that the Final Determination provides clarity on the regulatory treatment, including a route to recovering our efficient costs in AMP8. Without this recovery, taken together with a potential sector downgrade from Moody's, there is a material risk of a reduction in our Moody's credit rating which could make the project unfinanceable. We provide further evidence to support our proposals on the cost of debt in *PR24 Draft Determination Response: Havant Thicket*.
- **Enhancement cost allowances** in the Draft Determination are £47m lower than in our plan and would mean that we could not deliver investment to meet our WRMP and DWI statutory obligations. We have provided more evidence on our key investments, including addressing Ofwat's deep dive challenges, with help from external advisers. We maintain the costs from our October plan, which we believe are efficient and have already been subject to significant internal efficiency challenges of between 15-20%. See *PR24 Draft Determination Response - Expenditure allowances*.
- **Smart meter cost allowances** are inadequate to enable us to deliver our plan and are based on simplistic and immature modelling. We have updated our costs by allocating some elements of our enhancement case to base costs, reducing the enhancement costs of our programme from £72 to £58m. We also propose that the atypical costs associated with our CRM/meter data management system are reviewed separately. We have worked with Frontier Economics to review the modelling and propose some essential corrections, which have the effect of narrowing the gap between our revised plan costs and the modelled costs, but we believe a more balanced assessment in the round is required. We believe this should result in our costs being allowed in full. Further evidence is provided in *PR24 Draft Determination Response - Expenditure allowances*.
- Closely aligned to the smart meter allowances, is the proposed **PCD for smart metering**. This sets an operability target that is misaligned to what the market can deliver at reasonable cost. As configured it would result in the handing back of significant proportions of smart meter funding allowances and jeopardise the sector's smart meter roll out. We recognise Ofwat's concern that smart meters need to be both efficiently installed and operating effectively to yield the full benefits; we believe a more effective solution to this is a bespoke performance commitment, based on average operability, and set at a challenging but achievable level. See *PR24 Draft Determination response - Outcomes* for more details.
- Also associated with allowing adequate funding for our smart metering programme, which is an essential tool to help us manage consumption, is the **PCC performance commitment**. This is undeliverable and effectively penalises us twice for our AMP7 performance. We make pragmatic suggestions for a more reasonable approach which takes as a start point the best performance achieved in AMP7, with a glidepath that delivers a 2029-30 target that is broadly in line with the Draft Determination. See *PR24 Draft Determination Response - Outcomes*.

- Removal of the opportunity for even the best companies in the sector to avoid **C-Mex** penalties, which is unreasonable and will not incentivise the high-quality customer services that companies should be delivering for customers. We clearly illustrate the weaknesses in Ofwat's proposed approach in PR24 Draft Determination Response: Delivering outcomes for customers and the environment. Until more detailed work is undertaken, we propose that Ofwat retains the AMP7 model. See *PR24 Draft Determination response – Outcomes*.

We make detailed representations on each of these key issues, as well as a number of other important, but less material issues. In each case we provide further evidence and propose what we believe are workable remedies for the Final Determination.

Overall, taking the proposed allowed cost of equity and the associated risks implied by the Draft Determination, the package as a whole is not one that we could accept. Significant changes, including in those areas set out above are required for the Final Determination.

Our priority is to deliver the right plan for our customers, our communities and the local environment. We believe the business plan that we submitted in October 2023 remains the right one, as demonstrated by our customer acceptability testing, and we have therefore not made significant changes in response to the Draft Determination. Changes to the WACC, new regulatory requirements in relation to PFAS, Ofwat uplifts for mains replacement, climate change resilience and net zero have been incorporated, leading to an increase in customer bills of £5 a year on average, compared to our Business Plan. Nonetheless our bills remain by far the lowest in the sector and we are increasing the help we give to those customers with affordability concerns.

We are committed to delivery of our plan, and we will continue to engage with Ofwat constructively between now and the Final Determinations to move from a Draft Determination position that we could not accept, to a Final Determination that will enable us to do so.

B. Structure of our Response

Our response is structured in line with Ofwat's Draft Determination. We focus only on the most material issues in our response. Separate documents are provided for the following areas:

- Delivering Outcomes for Customers and the Environment
- Expenditure Allowances
- Aligning risk and return
- Havant Thicket

Actions relating to each of these areas are included within these documents. These include our high-level proposals in relation to Ofwat's climate change resilience Draft Determination allowance.

We include in our response an additional investment case in relation to PFAS, which reflects proposed changes to the DWI's regulatory approach since submission of the business plan. In addition to this business case, we face elevated risks at a number of other treatment works and we support the conclusions of the joint industry work by Jacobs on identifying appropriate uncertainty mechanisms to manage these risks in AMP8 (See PRT RR 04 - PFAS Uncertainty at PR24).

We have also completed Ofwat's Draft Determination response tracker and updated data tables. A commentary on data table changes is provided. Given the time available, we have only updated data tables to reflect 2023-24 actual performance and specific plan updates (e.g. meter costs moving in to base). Where we do not make representations on specific issues, but Ofwat's Draft Determination decisions are different to our plan we retain our original business plan proposals

Data table changes have been subject to third party assurance from our technical assurer Jacobs and financial auditor KPMG. Jacobs have also reviewed our key representations. Assurance in relation to financial resilience has been provided by Centrus Financial.

The Board has been closely involved in the shaping of our response, through our PR24 steering group and the full Board. They have challenged our plan, support proposed changes to our dividend policy and have reviewed the assurance work, including assurance on financial resilience.



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