



PR24 DRAFT DETERMINATION RESPONSE HAVANT THICKET



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SECTION 1

OVERVIEW OF OUR REPRESENTATIONS ON HAVANT THICKET



OVERVIEW OF OUR REPRESENTATIONS ON HAVANT THICKET

A. Havant Thicket Cost of Capital

The additional scope to support the alignment works with Southern Water's RAPID scheme will require additional shareholder equity. The current Draft Determination cost of debt is below the efficient cost of debt for a scheme with the characteristics of Havant Thicket when compared to iBoxx benchmark data. Additionally, we believe the current cost of equity is too low to adequately compensate investors. This currently creates a significant barrier to securing investment and our ability to accept the Final Determination.

Havant Thicket Cost of Debt

There is significant alignment on policy, and we are pleased Ofwat support our arguments for the requirement for a bespoke cost of debt for the Havant Thicket scheme. While we support Ofwat's policy proposals in a number of areas, we do not agree with Ofwat on embedded debt costs and liquidity allowances. We have also suggested a refinement to Ofwat's proposal on a bespoke cost of new debt to reflect that a combination of fixed and floating debt will be used to support AMP8 investment. Our representation proposes a bespoke cost of debt for the Havant Thicket price control of 4.29%, 66 bps higher than Ofwat's Draft Determination.

We have proposed amendments to the cost of debt reconciliation models for AMP7 and AMP8 to reflect the bespoke dynamics of the Havant Thicket control. We have proposed additional true up mechanisms for the proportion of new and embedded debt and the proportion of fixed and floating new debt. This will 'future proof' the PR24 cost of capital from changes arising from the planned second Cost Adjustment Mechanism (CAM2) to address a change of scope to the Havant Thicket scheme, by allowing an ex-post correction through the PR29 cost of new debt reconciliation.

Wholesale / Havant Thicket Cost of Equity

We agree the industry cost equity should be applied to both the wholesale and the Havant Thicket controls but share the industry concern that the cost of equity is insufficient to adequately compensate investors for risk and attract new equity.

The Ofwat Draft Determination cost of equity of 4.8%, despite the 27-bps 'aiming up' assumption, is lower than the midpoint guidance recently issued by Ofgem for its RIIO-3 control. This would indicate that the risk in the water sector is lower than the energy sector. We don't think that can be supported given the higher degree of complexity, degree of scrutiny and balance of risk of reward indicating all companies will be unable to achieve the regulatory return based on draft determination targets. The Oxera report on investibility base return on equity needs to be 50 bps higher (30-70 bps range) to adequately compensate equity and attract new investment.

We have submitted our Draft Determination representations in line with the Ofwat Draft Determination cost of equity. However, we maintain the cost of equity needs to be increased at Final Determination to secure the financing requirement in the Portsmouth Water plan and wider industry company plans.

B. Havant Thicket CAM2

To ensure the Portsmouth Water Board and investor are fully informed when evaluating the Final Determination, we require certainty on the proposed regulatory approach to CAM2. Clarity on the approach and recovery mechanism to recover costs for both Portsmouth Water and Southern Water need to be agreed before or with the Final Determination. We are continuing to engage with the Ofwat Major Projects team in parallel with the PR24 process.

Portsmouth Water can demonstrate a successful track record of raising debt and equity to support the Havant Thicket scheme. Assurance undertaken over recent months supports the additional scope is financeable with the appropriate regulatory and shareholder support. Maintenance of Baa2 credit rating is essential to secure required equity but this is at risk if RCV recognition is deferred to PR29.

Our recommendation is as follows.

- The CAM2 cost assessment should follow the same approach as CAM1 process and take place in 2025.
- CAM2 process assesses the increase in costs for both the new scope relating to the alignment works and the changes to the reservoir design in relation to ground conditions.
- ODI dates are reset based on the revised programme reflecting the scope changes.
- An Interim Determination of K (IDoK) clause should be re-introduced into the Portsmouth Water license for the Havant Thicket controls and PR24 should include Notified Items limited to the alignment works, reservoir design changes due to ground conditions, and costs arising from planning. This provides customer, rating agencies, lenders, and investors with confidence in how the CAM will be dealt with rather than leaving a lot of uncertainty.
- To ensure Southern Water can recover the costs from its customers we are recommending use of an Allowed Revenue Direction (“ARD”) under Southern Water’s Condition T (for Havant Thicket) in relation to Southern Water’s Bulk Supply Agreement 2 (BSA2) costs.
- Increased costs agreed in CAM2 are recoverable through an IDoK for Portsmouth Water and recoverable by Southern Water through the Allowed Revenue Direction (ARD) mechanism and reflected in allowed revenue in the following financial year.

SECTION 2

DRAFT DETERMINATION REPRESENTATIONS: HAVANT THICKET WACC



1. HAVANT THICKET WACC: COST OF DEBT

A. What is the issue?

The Draft Determination acknowledges that an adjustment to the allowed cost of debt is required for the Havant Thicket project (reflecting concentrated timing of issuance) and Ofwat has accepted many of our arguments. But, when considered in the round, the proposed cost of debt is some 60 bps below the Portsmouth Water Board and investor expectations. The additional scope to support the alignment works with the Southern Water RAPID scheme will require additional shareholder equity and the current Draft Determination cost of debt is below the efficient cost of debt for a scheme with the characteristics of Havant Thicket, based on comparisons to iBoxx benchmarks.

This is supported by reports from reputed advisors NERA and First Economics. This currently creates a significant barrier to securing investment and our ability to accept the Final Determination.

We agree with the following areas of Ofwat's Draft Determination proposal.

- Use of a company specific adjustment applied to Portsmouth Water cost of debt.
- Use of alternative benchmark index to better reflect the floating debt characteristics used to finance the reservoir - but we think this can be refined further.
- Weighting of share of new debt reflecting the investment profile.
- Ofwat's estimate of issuance and transaction costs on new debt.
- Ofwat's ambition to align the Havant Thicket control with the wider wholesale control approach on cost of debt.

We disagree with the following areas of Ofwat's Draft Determination proposal.

- Use of the standard wholesale Weighted Average Cost of Capital (WACC) cost of embedded debt. The embedded debt that Portsmouth Water has for the Havant Thicket project was raised in 2023 and reflects interest rate conditions as of 2023. The industry allowance, by contrast, is intended to match the interest payable on borrowings dating back more than 20 years and, hence, contains a memory of interest rates over a period of more than two decades.
- Assumption that 100% of new debt is floating through the AMP8 period. This unduly removes the incentive to outperform the cost of debt and potentially will result in a higher cost of debt in the longer term. Over the AMP8 period we have already taken action to mitigate our interest rate exposure, to create cashflow certainty and enable us to manage our debt covenants. We also must refinance our floating debt in 2028 and 2029, but we will be raising more debt earlier in AMP8. With the prospect of increased investment through the alignment works to support Southern Water's water recycling scheme, our financing strategy foresees that floating rate debt will be refinanced earlier in AMP8 with longer term borrowings (either fixed or index linked). With the increased expenditure this is likely to be earlier in AMP8.
- Liquidity costs excluding the cost of holding company financing. We disagree that holding company liquidity cost are funded via allowed equity returns. The allowed return on equity only remunerates equity financing for capital costs that are added to the RCV. Any financing that lenders or shareholders provide beyond the direct financing of RCV-eligible capital costs is not captured in the equity return so it has to be recovered through cost of debt allowance.
- AMP7 cost of debt indexation model reflects notional company assumptions on weighting and proportion of new debt.

B. Our proposed remedy

We are proposing a revised cost for debt for Havant Thicket Control in line with our revised estimate from NERA. We are proposing the cost of debt should be calculated as follows

- **Embedded Debt.** We have calculated embedded debt based on an RCV-weighted trailing average based on guidance from NERA. We believe this best represents the efficient cost of debt, is incentive compatible and consistent with the approach on the cost of new debt and wider underlying principle used for the wholesale cost of debt. This aligns to the principal Portsmouth Water proposed that the cost of debt should be based on the efficient cost of debt for a scheme with the characteristics of Havant Thicket, not a pass through of the actual cost of debt.
- **New Debt.** We agree with Ofwat’s proposal to use an alternative benchmark to capture the floating nature of financing on Havant Thicket, but we think this would create a need to defer securing longer term funding to ensure funding aligned to allowed cost debt and delay our ambition to align our debt structure more closely with the notional company. It also does not align to our financing strategy where we will seek to reduce our exposure to interest rate risk during construction. We are proposing a hybrid approach to calculating the cost of new debt to better reflect the mix of fixed and floating debt. Our proposed cost of debt is:
 - A 50% weighting on the iBoxx BBB 3–5-year index to reflect the use of Revolving Credit Facilities (RCFs) during the construction phase, which is shorter-term variable debt and only partially fixed through derivatives. Debt issued under the “variable” portion would have a return based on the average yield of the index for the charging year in question, i.e. consistent with Ofwat’s proposal of variable debt not relying on an extending trailing average.
 - A 50% weighting on the iBoxx A/BBB 10-year index to reflect the expected portion of debt that will be fixed and longer term, consistent with the sector cost of debt approach. The fixed portion return would be based on an extending trailing average reflecting RCV-based debt issuance (notional issuance), consistent with the proposal in our first report and the proposal on embedded debt.
- **Weighting / Issuance.** Weighting of cost of new debt and issuance costs align to Ofwat Draft Determination.
- **Liquidity.** The liquidity costs on the Havant Thicket scheme are unusual for the sector, due to scale relative to Portsmouth Water and the concentrated construction period, requiring debt to be raised up front. The liquidity allowance should include holding company liquidity costs on the principle that the debt has been raised to support the Havant Thicket scheme. These costs are not recovered through the equity allowance as this is tied to the RCV build-up. The NERA model triangulates the Thames Tideway approach with the Ofwat proposal to base liquidity costs on commitment fees. Both approaches are materially the same, so we have adopted an average of the two approaches.

PR24 / PR29 Reconciliations

PR24 Reconciliation. We have submitted our Draft Determination representation Past Delivery tables in line with the PR19 Rulebook. However, we believe the PR19 Rulebook should be reviewed for the Havant Thicket price control to better reflect the fact that the Ofwat’s PR19 cost of debt indexation mechanism is designed for a notional company with uniform debt issuance.

Given Havant Thicket’s atypical and concentrated debt profile and the fact it issued all its debt (new debt) over AMP7, we proposed an alternative mechanism for PR19 that preserves Ofwat’s overall mechanism but makes the following modifications:

- **New debt weight:** A weight on new debt of 100% (as opposed to 20%) to recognise that Havant Thicket issued all its debt within period, i.e. no embedded debt.

- Extending trailing average: The 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 that needs to be funded occurs towards the end of AMP7, where interest rates will be higher than at the start of AMP7. Our approach to weight years by RCV growth, as a proxy for expected debt issuance, is consistent with Ofgem's approach for Scottish Hydro Electricity Transmission (SHET), a Scottish Transmission Operator, at recent reviews.
- Outperformance wedge: Remove Ofwat's outperformance wedge of 15bps given that Ofwat's wedge was based on industry-wide data or alternatively add the PR19 CSA, whereas Havant Thicket's small issuance size means that it is likely to underperform. In addition, Havant Thicket's debt is likely to be more expensive relative to the rest of the industry because of construction related credit risk, making it more difficult for Havant Thicket to achieve an industry-wide notional rating.

PR29 Reconciliation: Our policy positions are influenced by a desire to future proof policy for the planned changes to the scheme (to be addressed in a second Cost Adjustment Mechanism (CAM2) post the PR24 final determination). The Draft Determination recognises that the scope of the Havant Thicket scheme will be updated to reflect the alignment works with Southern Water Water Recycling and Transfer scheme.

"We propose to allow for the additional scope and costs for the alignment works via a second cost adjustment mechanism. The timing of the cost adjustment mechanism is subject to the outcome of the planning process associated with the changes to the pipeline; this is expected to conclude later in 2024. We will amend the scope of the Havant Thicket price control within the PR19 final determination notice." 4.6.2 Havant Thicket reservoir <https://www.ofwat.gov.uk/wp-content/uploads/2024/07/PR24-draft-determinations-Expenditure-allowances-to-upload.pdf>

The increase cost and extension to the programme will materially impact the dynamics of the Havant Thicket bespoke cost of capital as it will mean changes to the weighting of new and embedded debt and the proportion of fixed and floating debt. We see merits in incorporating these variables in the PR24 rulebook reconciliation mechanism for the cost of new debt. This enables an ex-post true-up and avoids a requirement to revise the Havant Thicket WACC during CAM2 and future proofs the control.

We are proposing the PR24 rulebook reconciliation of the cost of debt:

- Includes a true up for weighing of new and embedded debt.
- Includes a true up for the weighting of fixed and variable debt (suing NERA mechanisms).
- Calculates an updated discount factor (re-baselined Havant Thicket WACC) for use in the Havant Thicket reconciliation model.

PR29 WACC

We support Ofwat's ambition to align the Havant Thicket price control with wholesale WACC in the future, but we believe it is too early to assess whether this policy should be adopted at PR29. The extension to the programme due to the alignment works will mean the programme will not hit the wet commissioning milestone, resulting in uncertainty on the final debt requirement. In addition, and more importantly, it is unknown whether the mismatch between the profile/vintage of the industry's debt book and Portsmouth Water's comparatively short, sharp, burst of financing activity will have unwound, particularly given industry embedded debt will include debt raised during historically 'record-low' pre-2022 market conditions.

We propose that the decisions on whether there is justification for a bespoke cost of debt allowance should be reviewed at each review with the following criteria assessed.

- Construction completed and asset wet commissioned, providing certainty on level of borrowing.
- Evidence of convergence of Havant Thicket borrowings with the industry average debt mix.

- Support that convergence of borrowing is sustainable i.e. assessing refinancing profile to assess sustainability of financing.

Table 1: Havant Thicket Cost of Debt

Parameter	PR24 Submission ¹	Ofwat Draft Determination	Portsmouth Water Representation
PR19 Cost of New Debt (embedded debt)	3.12%	2.76%	3.24%
PR24 Cost of New Debt	3.42%	3.55%	3.60%
Share of new debt	12%	43%	43%
Issuance / transaction costs	0.19%	0.20%	0.20%
Liquidity costs	0.88%	0.34%	0.70%
Cost of Debt	4.23%	3.63%	4.29%

Source: NERA analysis and Ofwat (July 24), PR24 draft determinations: Aligning risk and return - Allowed return appendix, pp.9, 107 and 114.

Note 1: Reflects estimates under a 30 September 2022 cut-off date. These estimates match the NERA first report estimates on cost of debt.

C. Supporting evidence

We commissioned First Economics and NERA to review Ofwat's Draft Determination proposals. First Economics were asked to provide an independent critique of Ofwat and NERA policy proposals. NERA were asked to provide an updated estimate of the cost of debt for the Havant Thicket control considering the Draft Determination policy proposals from Ofwat. The full reports are included as supplementary reports *PRT HT 01 First Economics & PRT HT 02 NERA*

Cost of Embedded Debt

Table 2: PR19 Cost of New Dew Debt (Embedded Debt)

Parameter	PR24 Submission	Ofwat Draft Determination	Portsmouth Water Representation
PR19 Cost of New Debt (embedded debt)	3.12%	2.76%	3.24%

Source: Portsmouth Water and Ofwat (July 24)

Ofwat Draft Determination Response

While NERA's analysis calculates the allowed return for this debt as an RCV weighted trailing average over 2020-25, we consider it reasonable as a starting point to consider whether the allowed return on debt we apply for Portsmouth Water's other wholesale controls appropriately remunerates the control. This involves applying a CSA uplift of 30bps for interest costs to the sector allowance of 2.46% to derive an allowance of 2.76% (real, CPIH). We consider that this base allowed return sufficiently remunerates the company for the cost of embedded debt.

First Economics

Ofwat's allowance for the cost of the debt that Portsmouth Water will be taking into the 2025-30 regulatory period is set in line with the industry-wide allowance for embedded debt costs. This immediately strikes us as a very odd policy choice. The embedded debt that Portsmouth Water has for the Havant Thicket project was set up in 2023 and reflects interest rate conditions as at 2023. The industry allowance, by contrast, is intended to match the interest payable on borrowings dating back more than 20 years and, hence, contains a memory of interest rates over a period of more than two decades.

It would be an extraordinary coincidence if Portsmouth Water's cost of debt exactly matches industry-average embedded debt costs. Absent any evidence that such a coincidence has occurred, we think that Ofwat needs to provide for a bespoke allowance for embedded costs that recognises that the type of debt that Portsmouth Water has raised, and the timing of issuance are specific to the Havant Thicket project. This would bring Ofwat's approach to embedded debt into line with Ofwat's approach to new debt.

Our understanding is that the only fixed interest rate that Portsmouth Water has so far entered into is on a 14-year CPI-linked bond. Consistent with Ofwat's approach generally in PR24, we suggest that the regulatory allowance for this debt should be fixed in line with a benchmark for prevailing market rates at the point of issuance rather than actual cost.

Table 3: First Economics Proposed Cost of Embedded Debt (illustration)

	Weight	Allowed Cost
Embedded Debt	As per the average forecast value of the outstanding principal on Portsmouth Water's CPI bond (A)	iBoxx £ non-financials BBB 10–15-year index in the month of issue plus 30 basis points (fixed)
CPI Linked Debt Issued		29 March 2023
iBoxx £ non-financials BBB 10–15-year index: March 2023 Average		5.75% (A/BBB 10+ 5.37%)
Company Specific Allowance		0.30%
Cost of Embedded Debt (nominal)		6.05% (A/BBB 10+ 5.67%)

	Weight	Allowed Cost
CPIH inflation allowance (long-term assumption)		2%
Cost of Embedded Debt (Real)		4.05%
		(A/BBB 10+ 3.67%)

Source: First Economics and Portsmouth Water

NERA

We understand that Ofwat considers that the sector cost of embedded debt allowance plus CSA of 2.76 per cent is higher than the fixed coupon rate on HT's CPI indexed-linked debt of 2.63 per cent. real. Ofwat's assessment is based on notional financing requirements given the RCV profile in Ofwat's DD (i.e. CAM1: Actual/reforecast).

By contrast, our updated analysis shows that an embedded cost of debt allowance based on RCV weighted trailing average would provide an allowance of 2.94 per cent or 3.24 per cent including the CSA. This is higher than Ofwat's proposed allowance yet lower than our estimate in our 2023 report of 3.41 per cent, reflecting the updated expenditure profile and iBoxx benchmark rates.

The main reason that our approach provides a slightly higher allowance than the coupon cost associated with CPI ILD is that our approach abstracts from the timing of HT's debt cost and instead uses RCV growth as a proxy for debt issuance. Our approach is incentive compatible – i.e. ensures that HT has the incentive to minimise costs – and consistent with standard regulatory practice for assets with bespoke investment and debt issuance profiles. In effect, Ofwat's approach fails to recognise that HT issued debt in a period of relatively low market rate and deprives HT all of the benefits of debt market timing.

In summary, we consider that Ofwat's proposed approach is wrong in principle in that:

- By focusing on HT's CPI coupon cost it does not provide incentives for efficient debt issuance*
- It is inconsistent with Ofwat's proposal for HT's cost of new debt where it proposes to recognise HT specific notional debt issuance profile (in terms of the balance of embedded and new debt) and rating.*

Table 4: NERA Embedded Debt Calculation

NERA Proposed Mechanism							
<i>This calculates the PR19 cost of new debt allowance - i.e. our proposed variation to Ofwat's PR19 reconciliation model</i>							
Summary							
	Units	Fixed Input	2021	2022	2023	2024	2025
New debt portion of RCV	£m, (CPIH, 2022/23 prices)		4.1	9.9	20.1	38.4	72.9
Embedded debt portion of RCV	£m, (CPIH, 2022/23 prices)		0.0	0.0	0.0	0.0	0.0
Allowed cost of new debt	% (CPIH)		0.16%	0.32%	1.56%	2.56%	2.94%
Embedded cost of debt	% (CPIH)	2.42%	2.42%	2.42%	2.42%	2.42%	2.42%
Weighted average cost of debt	% (CPIH)	2.39%		TRUE			
Issuance and liquidity costs	% (CPIH)	0.1%					
Weighted average cost of debt (incl. issuance and liquidity costs)	% (CPIH)	2.49%					
CPIH inflation (long-term assumption)	% (CPIH)	2.00%					
Weighted average cost of debt (incl. issuance and liquidity costs)	Nominal	4.54%					
Debt Portion of RCV							
	Units	Fixed Input	2021	2022	2023	2024	2025
HT RCV (Open)	£m, (CPIH, 2022/23 prices)		0	14	20	48	80
HT RCV (Close)	£m, (CPIH, 2022/23 prices)		14	20	48	80	162
HT RCV (Avg)	£m, (CPIH, 2022/23 prices)		7	17	34	64	121
Notional gearing	%	60%	60%	60%	60%	60%	60%
HT notional debt	£m, (CPIH, 2022/23 prices)		4	10	20	38	73
Proportion of notional debt subject to indexation (year average)	%	100%	100%	100%	100%	100%	100%
HT new debt for return	£m, (CPIH, 2022/23 prices)		4	10	20	38	73
HT embedded debt for return	£m, (CPIH, 2022/23 prices)		0	0	0	0	0
Allowed Cost of New Debt							
<i>This section calculates the AMP8 embedded cost of debt allowance (and also AMP7 true-up for new debt)</i>							
	Units	Fixed Input	2021	2022	2023	2024	2025
Average debt weightings							
Average debt cost weighting 2021	Index		4.08	0	0	0	0
Average debt cost weighting 2022	Index		4.08	5.86	0	0	0
Average debt cost weighting 2023	Index		4.08	5.86	10.21	0	0
Average debt cost weighting 2024	Index		4.08	5.86	10.21	18.29	0
Average debt cost weighting 2025	Index		4.08	5.86	10.21	18.29	34.44
Average debt cost weighting 2021	%		100%	0%	0%	0%	0%
Average debt cost weighting 2022	%		41%	59%	0%	0%	0%
Average debt cost weighting 2023	%		20%	29%	51%	0%	0%
Average debt cost weighting 2024	%		11%	15%	27%	48%	0%
Average debt cost weighting 2025	%		6%	8%	14%	25%	47%
Cost of new debt estimate (yearly)							
1Y Average iBoxx	%		2.16%	2.44%	4.81%	5.75%	5.42%
Outperformance wedge	%	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%
1Y Average iBoxx (adj for outperformance wedge)			2.16%	2.44%	4.81%	5.75%	5.42%
CPIH inflation allowance (long-term assumption)	%		2%	2%	2%	2%	2%
1 year real-CPIH average debt cost			0.16%	0.44%	2.76%	3.67%	3.36%
Allowed cost of new debt (extending TA)							
2021	%		0.16%				
2022	%		0.32%				
2023	%		1.56%				
2024	%		2.56%				
2025	%		2.94%				

Source: NERA

Portsmouth Water Representation

We maintain the methodology proposed by NERA is the appropriate methodology to assess the efficient cost of embedded debt for the scheme. It applies consistent principles to the cost of debt indexation methodology of the PR19 cost of debt and is incentive compatible.

We have considered whether to use First Economics' recommended approach, but we consider again that using a benchmark aligned to Portsmouth Water actual debt issued aligns to a pass through of actual debt costs. We do however note that the calculated benchmark based on First Economics methodology is higher than the NERA methodology as we think is a more robust methodology and is consistent with exiting regulatory principles in the PR19 rulebook and our approach to PR24 cost of new debt.

It is consistent with the principle advocated in our PR24 submission 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. We agree with First Economics that the wholesale cost of embedded debt is not a comparable benchmark.

Ofwat’s justification for adopting the wholesale cost of embedded debt seems largely justified by comparison to the CPI bond issuance but fails to consider significant upfront equity and additional costs to renegotiate covenants required to secure the financing package and reflects too simplistic a comparison.

- The notional gearing in FY24 was materially below the 60% PR19 notional gearing assumption at PR19. If gearing were maintained in line with PR19 notional gearing, we estimate we would need to draw a further £25m on our floating rate facilities. We estimate taking this into account (using Ofwat Draft Determination assumption on embedded debt and cost of new debt) would increase the cost of embedded debt by +20 bps.
- It also does not reflect the £2.45m consent fee and legal costs associated with the renegotiation of covenant ratios with Assured Guarantee, Portsmouth Water’s controlling creditor. This was critical to allow recognition of the Cost Adjustment Mechanism costs in the absence of an IDoK. This has not been reflected in the issuance costs allowance but is an ongoing cost recognised in our financing costs (being amortised over the remaining 9.5 years of the Artesian funding). The amortisation of the consent fee is c.£250k p.a. or +33bps on a £75m CPI-linked bond.
- Taking these two factors into account the cost of embedded debt would be 3.18% (2.65% CPI bond + 0.2% gearing +0.33% consent) vs 3.24% NERA estimate and the 4.05% First Economics estimate.

In conclusion we are proposing a cost of embedded debt of 2.94 per cent or **3.24 per cent including the CSA** as an efficient cost of debt allowance for embedded debt on the Havant Thicket control. We understand Ofwat are concerned about establishing regulatory precedent. An alternative method would be to adopt a variant of the First Economics method by benchmarking embedded cost on the month of issuance of the CPI-linked bond the A/BBB 10–15-year+ benchmark. This is a consistent benchmark with the NERA cost of new debt fixed rate element. We calculate the Cost of Embedded Debt as 3.67% using this methodology.

Cost of New Debt

Table 5: Havant Thicket Cost of Debt

Parameter	PR24 Submission ¹	Ofwat Draft Determination	PW Representation
PR24 Cost of New Debt	3.42%	3.55%	3.60%

¹ Data cut off at September 2022

Source: Portsmouth Water and Ofwat (July 24)

Ofwat Draft Determination Response

Choice of index: While our sector allowance is based on the iBoxx A/BBB £ non-financials 10+ index and this is also featured in NERA’s estimate, for Havant Thicket we instead propose to use the iBoxx BBB £ non-financials 3-5 index. We consider that this is better aligned with the shorter (5-6yrs) tenor of the £250m of floating rate facilities supplying the majority of the new debt for the project. A 'BBB'-rated index will also align better with the likely rating ceiling of Baa2 on borrowing in the construction period.

Form of reconciliation: While NERA's modelling approach uses the extending trailing average from our cost of new debt indexation model to generate an allowed return from outturn data, we consider that the return should be based on the average yield of the iBoxx BBB 3-5 index for the charging year in question. This reflects that floating rate debt interest charges reflect the prevailing interest rate and have no 'memory' of previous years.

Company-specific adjustment: We set out in chapter 5 that we were allowing Portsmouth Water an uplift to its allowed cost of debt over 2025-30. We apply the same 30bps uplift to Havant Thicket's cost of new debt, to give a pre-reconciliation allowance of 3.55%.

First Economics

We agree that Portsmouth Water's current reliance on floating-rate debt warrants a move to a shorter tenor iBoxx index. We also agree with Ofwat's selection of a BBB only index.

Portsmouth Water has informed us that it is considering switching some of its floating rate debt to fixed-rate debt at some point in the next five years, either using swap arrangements or by replacing existing floating-rate debt with fixed-rate loans/bonds upon maturity. Portsmouth Water has also said that replacement debt may be of a longer tenor than the current loans. This appears to be a perfectly reasonable, perfectly normal position for a company to take as a project nears the end of its construction phase. However, in this specific case, there is a risk that Portsmouth Water will feel constrained by Ofwat's use of a 3–5-year benchmark index all the way through to 2029/30 and consider that it is unable to make an otherwise sensible adjustment to its financing prior to the completion of PR29.

It probably makes sense for Ofwat and Portsmouth Water and Ofwat to sit down together and discuss what the optimal financing strategy looks like, thinking particularly from the point of view of the customers that will ultimately be picking up the costs. Ideally, this will result in a shared view of the type of debt that Portsmouth Water should be using over the next five years, which Ofwat can then transpose into its choice of benchmark index/indices. Alternatively, if there is no time left in PR24 for such discussion, or there is no consensus view, Ofwat can consider leaving the choice of reference index open and instead specify a rule that the PR24 iBoxx reference index will match the tenor of actual debt at any given point in time rather lock down on a known, specific reference index upfront.

Ofwat's proposal to refresh and recalculate the value of the benchmark index in full every year is a logical approach in a world in which Portsmouth Water borrows only floating-rate debt. However, if there is reason to think that Portsmouth Water should be considering moving to a different financing mix before March 2030, the full annual refresh acts as an additional distortion to the choices that Portsmouth Water faces as regards its longer-term financing strategy.

As under the previous heading, we think this points in the direction of further dialogue between company and regulator, with a view to either locking down on a different approach at an agreed point in the 2025-30 period or providing for flexibility for there to be an automatic switch to a more fixed allowance if/when Portsmouth Water commits to fixed rates.

We agree that Ofwat's award of an uplift over iBoxx rates should carry across to the Havant Thicket project.

Table 6: First Economics Proposed Cost of Embedded Debt

	Weight	Allowed Cost
New Debt	As per the average forecast value of the debt-financed portion of the Havant Thicket RCV minus amount (A)	iBoxx £ non-financials BBB 3–5-year index plus 30 basis points (refreshes every year) then either: a specified longer tenor index starting from a mutually agreed date plus 30 basis points (fixed) or an automatic switch to an index with a tenor that matches the new tenor on Havant Thicket debt at the point when Portsmouth Water opts to fix rates plus 30 basis points (fixed)

Source: First Economics

NERA

Ofwat assumes that all debt is variable rate debt whereas in fact most debt will effectively be fixed rate debt. We consider there are three issues with this assumption:

- While existing debt facilities are RCF which are ostensibly floating rate, we understand that PRT has adopted an interest management strategy that seeks to minimise cash-flow volatility through floating-to-fixed swaps and has swaps in place to fix around 50 per cent of the floating debt. To be clear, we would not propose that Ofwat recognises the cost of the derivative positions, as this is not Ofwat's practice. Rather, we would propose that Ofwat assumes that a proportion of new debt is issued at a fixed rate.
- In addition to the RCFs, we understand PRT also expects to issue fixed rate debt. In particular, we understand from PRT that, as a result of the likely increase in scope of HT, it plans to bring forward refinancing of the RCF facilities and to seek to refinance these based on fixed rate debt issuance. Under the totex forecasts Ofwat relies on, the fixed portion of new debt (after accounting for c.50 per cent hedging of floating facilities) would be 50 per cent over PR24, aside from the last year where it increases to close to 90 per cent. However, based on PRT's latest forecasts of totex, which account for the increase in scope of HT, the fixed portion of new debt increases to around 90 per cent from FYE 28 onwards.

Overall, our analysis suggests the proportion of fixed: floating debt will be approximately 50 per cent over the PR24 regulatory period based. Ofwat's proposal to treat all new debt as variable rate is also inconsistent with Ofwat's expectation for future price reviews (which will cover the post-construction period). Ofwat explains that HT should be integrated into its sector framework for setting allowed returns as early as reasonably practicable, and that PRT should have due regard to this consideration in its future financing decisions concerning Havant Thicket.

To reflect the balance of expected variable and fixed rate debt, we propose an allowance based on:

- A 50 per cent weighting on iBoxx BBB 3-5Y index to reflect the use of RCFs during the construction phase which is shorter-term variable debt and not only partially fixed through derivatives. Debt issued under the "variable" portion would have a return based on the average yield of the index for the charging year in question, i.e. consistent with Ofwat's proposal of variable debt not relying on an extending trailing average.

- A 50 per cent weighting on iBoxx A/BBB 10 year to reflect the expected portion of debt that will be fixed and longer term, consistent with the sector cost of debt approach and the eventual transition for HT to be incorporated within the sector wide approach. Contrary to the variable portion, the fixed portion return would be based on an extending trailing average reflecting RCV-based debt issuance (notional issuance), consistent with the proposal in our first report.

Table 7: NERA Proposed Cost of Embedded Debt

Summary									
	Units	Fixed Input							
Embedded cost of debt	% (real, CPIH)	3.24%							
Cost of new debt	% (real, CPIH)	3.60%							
Share of new debt	%	43%							
Issuance costs	% (real, CPIH)	0.20%							
Liquidity costs	% (real, CPIH)	0.70%							
AMP8 cost of debt	%	4.29%							

Share of new debt									
	Units	Fixed Input	AMP7 2025	2026	2027	AMP8 2028	2029	2030	
Average year approach									
Opening RCV	£m, (CPIH, 2022/23 prices)		80	162	276	335	352	360	
Closing RCV	£m, (CPIH, 2022/23 prices)		162	276	335	352	360	367	
Notional Gearing	%		60%	55%	55%	55%	55%	55%	
Closing Debt	£m, (CPIH, 2022/23 prices)		97	152	184	193	198	202	
Average debt	£m, (CPIH, 2022/23 prices)			125	168	189	196	200	
Embedded notional debt	£m, (CPIH, 2022/23 prices)			97	97	97	97	97	
New debt average	£m, (CPIH, 2022/23 prices)			27	71	91	98	102	
Share of new debt				22%	42%	48%	50%	51%	

Allowed Cost of New Debt (AMP8)									
Summary									
	Units	Fixed Input	2025	2026	2027	2028	2029	2030	
New debt issued	£m, (CPIH, 2022/23 prices)			27	43	21	7	4	
Fixed proportion of new debt issued	%			50%	50%	50%	50%	50%	
<i>New Debt Issued - Fixed</i>	£m, (CPIH, 2022/23 prices)			14	22	10	3	2	
<i>New Debt Issued - Variable</i>	£m, (CPIH, 2022/23 prices)			14	22	10	3	2	
New Debt Issued - Fixed	£m, (CPIH, 2022/23 prices)			14	35	46	49	51	
New Debt Issued - Variable	£m, (CPIH, 2022/23 prices)			14	35	46	49	51	
Fixed cost of new debt	% (real, CPIH)			3.36%	3.36%	3.36%	3.36%	3.36%	
Variable cost of new debt	% (real, CPIH)			3.25%	3.25%	3.25%	3.25%	3.25%	
Cost of new debt	% (real, CPIH)	3.30%		3.3%	3.3%	3.3%	3.3%	3.3%	

Fixed cost of new debt									
	Units	Fixed Input	AMP7 2025	2026	2027	AMP8 2028	2029	2030	
Average debt weightings									
New Debt issued fixed	£m, (CPIH, 2022/23 prices)			14	22	10	3	2	
Average debt cost weighting 2026	£m, (CPIH, 2022/23 prices)			14	0	0	0	0	
Average debt cost weighting 2027	£m, (CPIH, 2022/23 prices)			14	22	0	0	0	
Average debt cost weighting 2028	£m, (CPIH, 2022/23 prices)			14	22	10	0	0	
Average debt cost weighting 2029	£m, (CPIH, 2022/23 prices)			14	22	10	3	0	
Average debt cost weighting 2030	£m, (CPIH, 2022/23 prices)			14	22	10	3	2	
Average debt cost weighting 2026	%			100%	0%	0%	0%	0%	
Average debt cost weighting 2027	%			38%	62%	0%	0%	0%	
Average debt cost weighting 2028	%			30%	48%	23%	0%	0%	
Average debt cost weighting 2029	%			28%	44%	21%	7%	0%	
Average debt cost weighting 2030	%			27%	42%	20%	7%	4%	

Fixed cost of new debt estimate									
	Units	Fixed Input	AMP7 2025	2026	2027	AMP8 2028	2029	2030	
1Y Average iBoxx	%			5.42%	5.42%	5.42%	5.42%	5.42%	
Outperformance wedge	%	0.00%		0.00%	0.00%	0.00%	0.00%	0.00%	
1Y Average iBoxx (adj for outperformance wedge)	%			5.42%	5.42%	5.42%	5.42%	5.42%	
CPIH inflation allowance (long-term assumption)	%	2%		2%	2%	2%	2%	2%	
1 year real-CPIH average debt cost	%			3.36%	3.36%	3.36%	3.36%	3.36%	
Real-CPIH average debt cost - extending TA	%			3.36%	3.36%	3.36%	3.36%	3.36%	

Variable cost of new debt									
	Units	Fixed Input	AMP7 2025	2026	2027	AMP8 2028	2029	2030	
Fixed cost of new debt estimate									
1Y Average iBoxx	%			5.31%	5.31%	5.31%	5.31%	5.31%	
Outperformance wedge	%	0.00%		0.00%	0.00%	0.00%	0.00%	0.00%	
1Y Average iBoxx (adj for outperformance wedge)	%			5.31%	5.31%	5.31%	5.31%	5.31%	
CPIH inflation allowance (long-term assumption)	%	2%		2%	2%	2%	2%	2%	
1 year real-CPIH average debt cost	%			3.25%	3.25%	3.25%	3.25%	3.25%	

End

Source: First Economics

Based on our/Ofwat's forecasts of iBoxx, our proposed approach would result in a cost of new debt allowance over AMP8 of 3.60 per cent, including PRT CSA of 30 bps, as per Ofwat's approach. This is only 5bps higher than Ofwat's 3.55 per cent in expectations and could be lower than Ofwat's proposed approach ex post. Importantly the use of the two indices reflecting fixed and floating rate portions should ensure that debt costs track the allowance, minimising risk for both customers and HT.

Portsmouth Water Representation

We are supportive of the thinking behind Ofwat's proposal to use an alternative benchmark to capture the floating nature of financing for Havant Thicket.

We see merit in aligning the cost of new debt to the efficient financing of the Havant Thicket but aligning 100% with floating rate benchmarks creates the following issues.

- It does not consider the requirement to manage interest rate risk during construction. Portsmouth Water have already put interest rate swaps in place to hedge 50% of floating rate exposure through peak construction period.
- It creates a short-term disincentive to move closer to the notional company (and the ambition to align the Havant Thicket WACC with the wholesale WACC in the future).
- It will be inconsistent with the capital structure as it evolves with the additional financing required to support scope change to Havant Thicket scheme.

We think the best approach is to adopt a hybrid of the original NERA methodology and Ofwat's Draft Determination proposal. This would entail an equal weighting to align with Portsmouth Water's stated hedging policy to mitigate 50% of interest rate exposure on floating rate borrowings to limit cashflow risk through construction. This proposal has been discussed with Ofwat's cost of capital team and they have indicated they would be open to a hybrid approach.

AMP8 Hedging Strategy

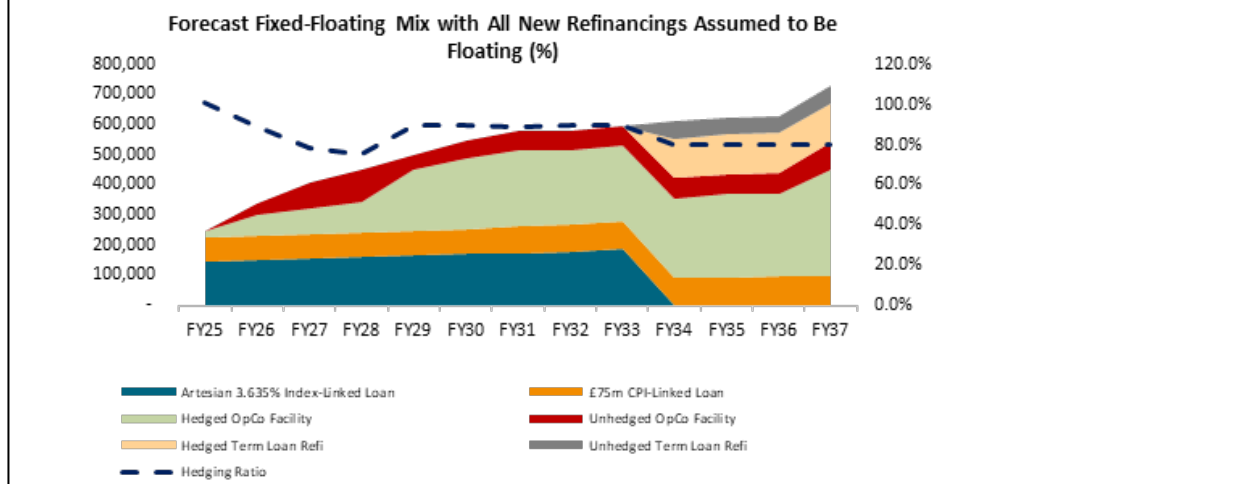
As part of our PR24 submission the Portsmouth Water Board approved an interest rate risk management strategy to hedge interest rate exposure between 80-105% over AMP8 through the construction of Havant Thicket. Initial steps have been taken to achieve this with the CPI-linked loan and forward date interest rate swaps to hedge 50% of the floating rate exposure on anticipate drawing on the floating rate facilities through to 2028.

We have enacted the first step and put interest rate hedging in place through to 2028 based on the anticipated drawing profile based on totex forecast based on the original scope of the Havant Thicket scheme. We renegotiated the profile in March 2024 to reflect the latest totex forecast.

Figure 1: PRT13: 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



Source: Portsmouth Water PR24 Business Plan

Table 8: Latest Interest Rate SWAP Portfolio (SONIA)

Six-month period	Notional	Fixed Rate	Notional	Fixed Rate
	ING	ING	Lloyds	Lloyds
31/3/26	£4.571m	3.080%	£4.571m	3.184%
30/9/26	£24.786m	3.080%	£24.786m	3.184%
31/3/27	£45.002m	3.080%	£45.002m	3.184%
30/9/27	£48.126m	3.080%	£48.126m	3.184%
31/3/28	£49.500m	3.080%	£49.500m	3.184%

Liquidity Costs

Table 9: Havant Thicket Cost of Debt

Parameter	PR24 Submission ¹	Ofwat Draft Determination	PW Representation
Liquidity costs	0.88%	0.34%	0.70%

Source: Portsmouth Water and Ofwat (July 24)

Ofwat Draft Determination Response

Liquidity costs: ... We were not convinced that NERA's use of the 'Liquidity Building Block' approach was appropriate to remunerate liquidity costs faced by Havant Thicket. As a project with significant excess capacity in its arranged RCFs, we considered it more logical that the relevant allowed return for liquidity purposes should be an RCF commitment fee rather than the sector WACC, as used by NERA.

We did not include the commitment fees of holdco RCFs in line with our final methodology policy of excluding the cost of holdco debt from our cost of debt benchmarking. Holdco financing is outside the regulatory ringfence and so bears a component of equity risk which is compensated for in the allowed return on equity.

First Economics

We agree that Ofwat's allowance for issuance costs should be based on the way in which Portsmouth Water has actually borrowed.

We do not agree with Ofwat's stance on holdco facilities.

Ofwat states that parent company support is remunerated via allowed equity returns. However, this is only true if the £m of the parent company's support amount is properly captured on the capital base side of the WACC x capital base calculation. Ofwat's measure of capital base is the RCV. It follows that the allowed return on equity only remunerates equity financing for capital costs that are added to the RCV. Any financing that lenders or shareholders provide beyond the direct financing of RCV-eligible capital costs, by design, is going to be ignored unless Ofwat overlays a separate allowance in a separate line item within its calculations.

This is exactly the logic that Ofwat uses to justify a stand-alone liquidity allowance in its industry cost of capital calculations – i.e. Ofwat does not seek to argue that the cost of maintaining RCFs is compensated for in the allowed cost of embedded/new debt. There is no reason to treat facilities held at holdco level any differently provided that Ofwat makes allowance only for the capital that is needed specifically for the Havant Thicket project.

NERA

We consider that there are two possible approaches to estimating HT's liquidity costs: a theoretical /notional approach (e.g. TTT approach) or reflect the actual liquidity costs incurred by HT. Ofwat rejected the TTT notional approach and instead focused only on the actual liquidity costs. We disagree with Ofwat's rejection of the notional approach and find that both approaches result in similar HT liquidity costs when estimated correctly.

Under the TTT notional approach, we note that:

- Ofwat's principal objection appears to be that HT has a substantive RCF and therefore this should form the basis for the allowance. However, TTT also has a substantive RCF, as the*

common approach to project financing during the construction phase. However, for TTT, Ofwat did not draw on TTT's RCF.

- The TTT approach draws on established precedent by using RCV growth as a proxy for the requirement for liquidity and the associated costs, which provides incentives for HT to minimise such costs. By contrast, Ofwat's reliance on actual commitment costs on undrawn facilities is not incentive compatible.
 - Related to the above, we draw on HT WACC as the cost of providing liquidity consistent with TTT. The marginal cost of capital is the WACC15; the marginal cost is not the cost of RCF debt which Ofwat uses in its calculation.
 - Our approach also means that we do not need to draw distinctions between liquidity facilities that are held at the OpCo and the HoldCo level.
- The TTT approach focusses on the average costs over the entire construction period (AMP7 and AMP8), as the liquidity facilities span more than a single AMP and consistent with the 10-year Havant Thicket price control. By contrast, Ofwat has only examined the liquidity facilities arising from midnight at AMP8.

We have updated our approach based on the TTT for the latest CAM expenditure (CAM1: Actual/reforecast used by Ofwat). We estimate a liquidity cost across the entire construction period (i.e. the average liquidity cost in each year of construction divided by average notional AMP8 debt) of 72bps.

Under an "actual" approach, we agree with Ofwat's reliance on commitment fees reflecting HT's actual borrowings. However, we consider that Ofwat's calculations are understated for two reasons:

- Ofwat fails to recognise HoldCo RCF is used for HT: Ofwat does not include the commitment fee associated with the HoldCo RCF. However:
 - We understand from PRT that the HoldCo RCF was put in place specifically for HT funding, which has far greater uncertainty in the timing of expenditure relative to the Appointed business. We also understand that HT has to have in place such facilities to support its credit rating.
 - Ofwat is wrong to state that parent company support is remunerated via allowed equity returns. The HoldCo RCF costs reflect additional liquidity costs over and above the cost of equity return provided on the regulated equity portion of the RCV, in the same way that Ofwat recognises the cost of the OpCo level RCF. There is no reason to treat HoldCo and OpCo RCF costs differently. Indeed, we note that Ofgem has taken into account liquidity costs held at the group level in determining liquidity/cost-of-carry allowances for energy networks.
 - Including HoldCo RCF costs, Ofwat's estimate of liquidity costs would increase from 34bps to 64bps (keeping all other assumptions unchanged).
- Ofwat fails to recognise costs over the facilities' lifetime: Ofwat approach recognises only the commitment fees over the AMP8 period. But the facilities had to be put in place prior to AMP8 start even if they are only drawn on during AMP8. Therefore, Ofwat should recognise the liquidity costs of the facility taking into account the costs over the facility lifetime, i.e. from FYE 2024 onwards. Including the cost of the facilities over their entire lifetime, we estimate an increase in liquidity costs would from 34bps to 38bps (keeping all other assumptions unchanged).

Correcting for the two issues above, we estimate liquidity costs under Ofwat's actual liquidity costs approach of 69bps.

Overall, we propose a liquidity cost allowance of 70bps which is supported by both a TTT notional approach (72bps), our preferred approach given that it is incentive compatible, and consistent with necessary adjustments to Ofwat's actual liquidity costs approach (69bps).

Portsmouth Water Representation

We agree with conclusions of First Economics and NERA that holding company liquidity costs should be recognised. Our Draft Determination representation includes liquidity cost of 70 bps reflecting the average of the TTT approach and our actual liquidity costs including holding company facilities. It should be noted that the holding company facility is undrawn following receipt of the final £30m tranche of shareholder capital (in addition to £140m received in 2023-24 and pushed down as equity).

PR19 Cost of New Debt Reconciliation

NERA

In our first report we explained that Ofwat's PR19 approach of setting HT's cost of capital at the same level as the industry and subject to the same cost of debt reconciliation was unlikely to sufficiently remunerate HT's cost of debt in light of the material increase in cost since PR19. Ofwat's PR19 cost of debt indexation mechanism is designed for a notional company with a relatively uniform debt issuance. Given HT's atypical and concentrated debt profile and the fact it issued all its debt (new debt) over PR19, we proposed an alternative mechanism for PR19 that preserves Ofwat's overall mechanism but makes the following modifications:

- **New debt weight:** A weight on new debt of 100 per cent (as opposed to 20 per cent) to recognise that HT issued all its debt within period, i.e. no embedded debt.
- **Extending trailing average:** The weights for the allowed cost of new debt trailing average based on HT's RCV growth (as opposed to equal weighting) to recognise that most of HT's RCV growth that needs to be funded occurs towards the end of PR19, where interest rates will be higher than at the start of PR19. Our approach to weight years by RCV growth, as a proxy for expected debt issuance, is consistent with Ofgem's approach for SHET, a Scottish TO, at recent reviews.
- **Outperformance wedge:** Remove Ofwat's outperformance wedge of 15bps given that Ofwat's wedge was based on industry-wide data, whereas HT's relatively small issuance size means that it is likely to underperform. In addition, HT's debt is likely to be more expensive relative to the rest of the industry because of construction related credit risk, making it more difficult for HT to achieve industry-wide notional rating.

Ofwat did not comment on this proposed change to the PR19 reconciliation mechanism in its PR24 DD.

Portsmouth Water Representation

We support NERA's recommendation that the cost of new debt reconciliation calculation should be updated to reflect new debt weighting, and an extended trailing average weighted to the RCV growth profile and to remove the outperformance wedge due to Havant Thicket small issuance size.

The detail of the proposed changes is set out in the appendix to the Portsmouth Water business plan submission. *PRT13.03 Cost of Capital for Havant Thicket (NERA Economic Consulting), section 4.1.3.*

D. Conclusion

Table 10: Havant Thicket Cost of Debt

Parameter	PR24 Submission ¹	Ofwat Draft Determination	PW Representation
PR19 Cost of New Debt (embedded debt)	3.12%	2.76%	3.24%
PR24 Cost of New Debt	3.42%	3.55%	3.60%
Share of new debt	12%	43%	43%
Issuance / transaction costs	0.19%	0.20%	0.20%
Liquidity costs	0.88%	0.34%	0.70%
Cost of Debt	4.23%	3.63%	4.29%

Source: NERA analysis and Ofwat (Jul 24), PR24 draft determinations: Aligning risk and return - Allowed return appendix, pp.9, 107 and 114.

Note 1: Reflects estimates under a 30 September 2022 cut-off date. These estimates match the NERA first report estimates on cost of debt.

We have submitted Draft Determination representations reflect a bespoke cost of new debt of 4.29% compared with 3.63% in Ofwat's Draft Determination.

- We are aligned with Ofwat's proposal on the assessment of the benchmark for floating rate financing, the assessment of the weighting of new debt, and issuance costs.
- We support NERA and First Economics guidance on the approach to embedded debt costs.
 - We have proposed the NERA trailing average methodology as it is consistent with approach on the cost of new debt (fixed element) and aligns to the wider wholesale cost of debt approach.
 - We would support First Economic approach of using 10–15-year benchmark in month of issuance of fixed debt but advocate that either the A/BBB benchmark + CSA or BBB benchmark is used (with no CSA).
- We have proposed a hybrid approach to assessing the cost of new debt to reflect the balance of fixed and floating debt, with a proposed reconciliation mechanism to true up through the PR24 rulebook. This aims to true up for fixed and floating debt and the balance of new and embedded debt to future proof the bespoke cost of debt for changes in financing driven by CAM2 and changes of scope.
- We support Ofwat's ambition to align the Havant Thicket control with wholesale WACC in the future, but we believe it is too early to assess whether this policy should be adopted at PR29. We propose that the decisions on whether there is justification for a bespoke cost of debt allowance should be reviewed at each review with the following criteria assessed.
 - Construction completed and asset wet commissioned, providing certainty on the level of borrowing.

- Evidence of convergence of Havant Thicket borrowings with the industry average debt mix.
- Support that convergence of borrowing is sustainable i.e. assessing refinancing profile to assess sustainability of financing.

E. Business plan tables impacted

Table RR1

Wholesale WACC (ADDN1) Control

RR1

Portsmouth Water

Key inputs														PR24 BP reference
Line Description	Units	DPS	2025-26	2026-27	2027-28	2028-29	2029-30	2030-31	2031-32	2032-33	2033-34	2034-35		
WHOLESALE WACC														
Wholesale WACC - based on assumed structure (nominal) - Equity - nominal (WR)	%	2	6.76%	6.76%	6.76%	6.76%	6.76%	6.76%	6.76%	6.76%	6.76%	6.76%	6.76%	RR1.1
Wholesale WACC - based on assumed structure (nominal) - Equity - nominal (WN)	%	2	6.76%	6.76%	6.76%	6.76%	6.76%	6.76%	6.76%	6.76%	6.76%	6.76%	6.76%	RR1.2
Wholesale WACC - based on assumed structure (nominal) - Equity - nominal (WWN)	%	2	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	RR1.3
Wholesale WACC - based on assumed structure (nominal) - Equity - nominal (BR)	%	2	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	RR1.4
Wholesale WACC - based on assumed structure (nominal) - Equity - nominal (ADDN1)	%	2	6.76%	6.76%	6.76%	6.76%	6.76%	6.76%	6.76%	6.76%	6.76%	6.76%	6.76%	RR1.5
Wholesale WACC - based on assumed structure (nominal) - Equity - nominal (ADDN2)	%	2	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	RR1.6
Wholesale WACC - based on assumed structure nominal - Cost of debt - nominal (WR)	%	2	5.25%	5.25%	5.25%	5.25%	5.25%	5.25%	5.25%	5.25%	5.25%	5.25%	5.25%	RR1.7
Wholesale WACC - based on assumed structure nominal - Cost of debt - nominal (WN)	%	2	5.25%	5.25%	5.25%	5.25%	5.25%	5.25%	5.25%	5.25%	5.25%	5.25%	5.25%	RR1.8
Wholesale WACC - based on assumed structure nominal - Cost of debt - nominal (WWN)	%	2	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	RR1.9
Wholesale WACC - based on assumed structure nominal - Cost of debt - nominal (BR)	%	2	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	RR1.10
Wholesale WACC - based on assumed structure nominal - Cost of debt - nominal (ADI)	%	2	6.38%	6.38%	6.38%	6.38%	6.38%	6.38%	6.38%	6.38%	6.38%	6.38%	6.38%	RR1.11
Wholesale WACC - based on assumed structure nominal - Cost of debt - nominal (ADJ)	%	2	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	RR1.12
Wholesale WACC - based on assumed structure (nominal) - Gearing - nominal (WR)	%	2	55.00%	55.00%	55.00%	55.00%	55.00%	55.00%	55.00%	55.00%	55.00%	55.00%	55.00%	RR1.13
Wholesale WACC - based on assumed structure (nominal) - Gearing - nominal (WN)	%	2	55.00%	55.00%	55.00%	55.00%	55.00%	55.00%	55.00%	55.00%	55.00%	55.00%	55.00%	RR1.14
Wholesale WACC - based on assumed structure (nominal) - Gearing - nominal (WWN)	%	2	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	RR1.15
Wholesale WACC - based on assumed structure (nominal) - Gearing - nominal (BR)	%	2	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	RR1.16
Wholesale WACC - based on assumed structure (nominal) - Gearing - nominal (ADDN)	%	2	55.00%	55.00%	55.00%	55.00%	55.00%	55.00%	55.00%	55.00%	55.00%	55.00%	55.00%	RR1.17
Wholesale WACC - based on assumed structure (nominal) - Gearing - nominal (ADDN)	%	2	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	RR1.18

2. HAVANT THICKET COST OF EQUITY

A. What is the issue?

We are aligned with Ofwat that the cost of equity for Havant Thicket should be based on the appointee WACC. However, we are seriously concerned the 4.8% cost of equity is not sufficient to attract the equity required to support the scope change for the Havant Thicket alignment works.

We recognise that Ofwat has taken steps to strengthen investibility including a 27bps 'aiming up' adjustment within its cost of equity range to set a 4.8% CPIH-real return. However, we share the industry concerns with the investibility approach taken, and significant delivery risk, arising from several issues within the current Draft Determination.

We believe the current cost of equity and balance of risk and reward does not present an investable proposition for investors at an industry level and specifically for Portsmouth Water. This is not our isolated view, it is supported by industry, analysts, and rating agencies.

Focussing on the cost of equity, John Earwaker of First Economics, based on an initial review of our Draft Determinations advised our Board that:

"I'm very clear in my mind that the allowed cost of equity in this DD is too low. The number one point here is that even after some movement in companies' direction Ofwat is offering a lower return than the CMA PR19 methodology would produce if you simply updated the numbers for changes in gilt yields. That is not to say that a different CMA panel would necessarily stick rigidly to the PR19 calculations. But it is a way of showing people that the upward shift isn't particularly generous.

The other thing I keep coming back to is that I could have locked in a 6% yield last week by buying investment-grade bonds. The question that this prompts is: is the additional 80-90 basis point that Ofwat is offering really commensurate with the additional risk that equity investors take on when you invest in water company equity? I can't see how the answer can be 'yes'."

Moodys also have raised concerns on current level of equity returns in a recent publication on the Draft Determination.

"Allowed returns may not be enough to attract equity support for large investment needs."

This view is further compounded when comparing Ofwat's Draft Determination position with Ofgem's recent RIIO-3 Sector Specific Methodology Decision (SSMD). Ofwat's PR24 Draft Determination position is 4.8% with 27 bps 'aiming up' compared with Ofgem's RIIO-3 guidance of a mid-point of 5.11% (range 4.35% - 5.87%). The water sector is at least as risky as the energy sector according to analyst reports and the risks associated with Havant Thicket through construction are arguably even greater than the wider industry.

Again, this is view shared by Moodys in their recent publication.

"The water companies in England and Wales face heightened public and political attention, and tougher performance incentives may prevent them from achieving the allowed returns"

Based on current proposals and our DD representations we anticipate we will need to raise up to a further £85m of equity to support the change in scope of Havant Thicket. We strongly believe the cost of equity needs to be increased AND the balance of risk and reward needs to be addressed before the Final Determination. The current Draft Determination position does not represent an investable proposition.

B. Our proposed remedy

We are not including an individual company remedy in our Draft Determination representation. We support the Water UK representation on investibility. We anticipate that Ofwat will review the cost of equity for updated market data and reflect this in the appointee cost of equity and the Havant Thicket cost of equity.

Investibility remains a key concern, with the associated risk that companies cannot deliver their commitments to customers, community, and the environment.

“The DD responds to public and political concerns over water companies’ performance and service levels, particularly concerning wastewater treatment. However, the draft also increases the risk that sector returns may not be enough to attract the equity funding the companies need to support increasing investment. If the draft is adopted unchanged, we could lower our view of the regulatory framework’s stability, predictability, and supportiveness.” Moodys commentary on the Draft Determination.

We expect the cost of equity should be reviewed against the wider investibility criteria outlined in the Water UK commissioned Oxera report ‘Investibility at PR24’ being:

1. Are Ofwat’s assumptions around how equity financing is delivered realistic, including assumed dividend reductions and/or equity injections?
2. Is the base return set at an appropriate level, such that the marginal investor is incentivised to commit equity capital?
3. Does the calibration of the regulatory settlement provide a ‘fair bet’ for investors, with a symmetric distribution of returns, such that the expected return equals the allowed return?
4. Is the overall risk exposure reasonable?
5. What is the equity being used to finance/fund (e.g. creation of assets versus bill subsidies for current consumers)?

We focus on ‘Is the base return set at an appropriate level, such that the marginal investor is incentivised to commit equity capital?’ in this representation.

C. Supporting evidence

The following reports have been included in the appendices of this document to provide economic and rating evidence on industry concerns on returns and balance of risk and reward:

- NERA: Havant Thicket WACC: Response to Ofwat Draft Determination (**PRT HT 02**)
- Water UK Oxera commissioned report ‘Investibility at PR24’ (**PRT HT 04**)
- Moodys ‘Ofwat’s draft determination increases sector risk’ (**PRT HT 03**)

NERA

“On HT’s cost of equity, Ofwat adopted the industry-wide allowed return on equity of 4.8 per cent (real, CPIH, before retail margin deduction). To assess the reasonability of this estimate, we compared Ofwat’s draft determination with Ofgem’s recent RIIO-3 Sector Specific Methodology Decision (SSMD), as shown in Table 3.1.”

Figure 1: Comparison of Ofgem and Ofwat cost of equity

Table 3.1: Cost of Equity under Ofwat’s PR24 DD and Ofgem’s RIIO-3 SSMD

	Ofgem RIIO-3 SSMD (@55% Notional Gearing and same RfR as Ofwat)		Ofwat PR24 DD (Appointee)
	Low	High	Point Estimate
Notional gearing	55%	55%	55%
Risk-free rate	1.43%	1.43%	1.43%
TMR	6.50%	7.00%	6.58%
Asset beta	0.30	0.40	0.33
Debt beta	0.075	0.075	0.10
Equity beta	0.58	0.80	0.60
Allowed return on equity (pre-uplift)	4.35%	5.87%	4.52%
Equity uplift	n.a.	n.a.	0.28%
Allowed return on equity (post-uplift)	4.35%	5.87%	4.80%

Note: Ofgem’s equity beta calculated assuming 55 per cent notional gearing for comparability with Ofwat’s PR24 draft determination. Ofgem’s risk-free rate also set at the same level as Ofwat’s for comparability.

Source: NERA analysis, Ofgem RIIO-3 SSMD Allowed Return on Equity Early View Summary Calculations and Ofwat PR24 DD Allowed Return Model.

“As shown above, Ofwat’s PR24 cost of equity for HT is in the lower half of the range calculated by Ofgem for its RIIO-3 SSMD, although the water sector is at least as risky as the energy sector according to analyst reports²⁰ and the risks associated with HT are even greater than the wider industry, as we have set out in our earlier report.²¹ We consider that an asset with the characteristics of HT is unlikely to have a lower equity risk than the GB energy sector and the comparison suggests that HT may have difficulty attracting equity capital unless:

- Ofwat fully compensates HT for its expected cost of debt over AMP8, including liquidity costs, otherwise the realised equity return will be even lower than 4.80 per cent for the lower risk Appointed business, and
- Ofwat increases its Appointee cost of equity to ensure at least a comparable return to the energy sector at RIIO-3.”

Oxera

“One reason why regulators value this ‘through the cycle’ approach is that it helps promote regulatory consistency over time. Assuming a more stable TMR may also be more conducive to fairer longer-term outcomes for investors and customers over time. However, while use of a ‘through the cycle’ approach may mean investors are fairly compensated over the long run, this approach risks either under or over-compensating investors at any one point in time.

The implication is that during a period of high real interest rates, a ‘through the cycle’ approach is likely to understate returns required by investors in a price determination. This is exacerbated if a regulator switches approach from setting returns that trend in the same direction as interest rates, to a ‘constant through the cycle’ approach at a low point in the cycle. The evidence suggests that this is what Ofwat has done for the PR24 DD.

In 2005-11, a period that was also categorized by high interest rates, the TMR allowance was between 7.0% and 7.73% (RPI-real). There is a general downward trend in the TMR allowance, which pre-dates the UKRN (2018) cost of capital report. This shows that customers did benefit from a lower cost of equity capital due both to the lower risk-free rate assumption and due to a proportion of the reduction in the risk-free rate also being reflected in a lower TMR.

Since early 2022, the long-term gilt yields have sharply increased, reaching levels last seen during 2004-10 and significantly reducing the gap between Ofwat's allowed TMR and gilt yields. Given that the TMR was between 7.0% and 7.73% (RPI-real) for the period 2005-11, a consistent regulatory approach over time implies an increase in the TMR assumption in PR24, to take account of the higher interest rates.

As this analysis demonstrates, not adjusting the proposed approach presents a material risk that the PR24 cost of equity is underestimated. This is likely to adversely affect the investibility of Ofwat's Draft Determinations, since an investor not yet invested or an existing investor looking to commit more capital would decide not to invest, as the investment will be undercompensated. In turn, this would compromise the sector's ability to finance the investment needed to deliver improvements over AMP8 and beyond.

In the current macroeconomic context, where UK gilts are trading at similar levels to the ones observed in the period 2005-2011, the impact of using a 'through the cycle' estimate of TMR is likely to be material.

Using Ofwat's Draft Determination cost of capital figures, we calculate the impact that an adjustment on the TMR would have on the overall allowance. As discussed in the section above, taking into consideration Ofwat's allowances in the period 2005-11 and adjusting for the RPI-CPIH wedge, a more appropriate TMR range might be approximately between 7.5% and 8.3% in CPIH-real terms, although higher ranges could also be estimated.¹¹⁴ The table below summarises the results of adjusting the TMR range—note that these parameters do not represent an 'Oxera view' of the appropriate WACC or CoE parameters for PR24, but are presented for expositional purposes only.

Table 5.2 The effect of adjusting the TMR estimate on the CoE and WACC

	Ofwat PR24 DD - mid point	Ofwat PR24 DD - point estimate	Assuming lower bound TMR estimate	Assuming upper bound TMR estimate
TMR	6.58%	6.58%	7.54%	8.27%
CAPM CoE	4.52%	4.80%	5.10%	5.53%
WACC	3.46%	3.59%	3.72%	3.92%

Source: Oxera analysis based on regulatory precedents data.

Note: The RPI-CPIH inflation wedge is assumed to be 50bps.

The table shows that the adjusted CoE allowance would be approximately 60-100bps higher compared to Ofwat's mid estimate, and 30-70bps higher than Ofwat's point estimate. This would result in an approximate 10-30bps increase on the WACC allowance. Hence, the consequence of adopting a 'constant through the cycle approach' at what appears to be a low point in the cycle (i.e. high interest rates) is a CoE that is 60-100bps lower than if Ofwat continued adjusting its TMR estimate in line with changes in gilt yields"

Source: Edited commentary from Section 5: Is the base return set at the appropriate level?

Moody's

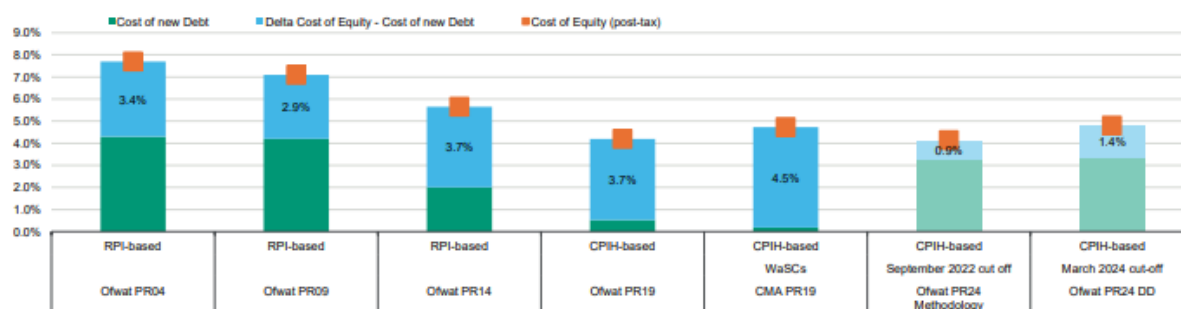
"On 11 July 2024, the UK Water Services Regulation Authority, or Ofwat, published its draft determination, or DD, imposing tough cost and performance targets on the water companies operating

in England and Wales for the five-year period starting 1 April 2025, or AMP8. The DD responds to public and political concerns over water companies' performance and service levels, particularly concerning wastewater treatment. However, the draft also increases the risk that sector returns may not be enough to attract the equity funding the companies need to support increasing investment. If the draft is adopted unchanged, we could lower our view of the regulatory framework's stability, predictability, and supportiveness.

Allowed returns may not be enough to attract equity support for large investment needs. Equity returns are below those proposed for UK energy networks, implying that water companies may be lower risk. However, water companies may struggle to achieve allowed returns, if the DD is adopted as it stands.”

“Ofwat has allowed a CPIH-deflated appointee return on capital of 3.72%, or 3.66% for wholesale activities (Exhibit 9). This is 43 bps above its early view, but at the lower end of our plausible range of 3.6%-3.9%. If these are confirmed at final determination, cash returns will increase by around 50% because the regulator will switch to full CPIH indexation for AMP8. Returns will only increase by a third for companies which benefited from the higher return after appealing to the Competition and Markets Authority (CMA). However, available returns may dampen demand from equity investors, increasing funding costs for the sector's investment needs”

Exhibit 10
Implied equity premium by comparing allowances for cost of equity and cost of new debt



“The lower cost of equity allowance for water companies implies that the overall risk should be lower in the water sector. However, the water companies in England and Wales face heightened public and political attention, and tougher performance incentives may prevent them from achieving the allowed returns. By contrast, energy networks tend to achieve a small benefit from operational outperformance”

Source: Selected commentary from Moody's report 'Ofwat's draft determination increases sector risk'

D. Conclusion

We believe that the current cost of equity is underestimated creating a significant barrier to securing required equity to deliver PR24 plans. Based on Oxera's analysis the cost of equity is understated by c.30-70 bps.

This would increase the cost equity at PR24 Final Determination to 5.32% (5.10% - 5.53% range).

This is more comparable to midpoint guidance on Ofgem RII0-3 SSMD where historically RoRE has been more balanced.

E. Business plan tables impacted

RR1

Our Draft Determination representations are submitted in line with Ofwat Draft Determination guidelines on cost of equity and notional gearing, consistent with approach with PR24 plan submission in October 2023.

RR1 Portsmouth Water													PR24 BP reference
Key inputs													
Line Description	Units	DPs	2025-26	2026-27	2027-28	2028-29	2029-30	2030-31	2031-32	2032-33	2033-34	2034-35	
WHOLESALE WACC													
Wholesale WACC - based on assumed structure (nominal) - Equity - nominal (WR)	%	2	6.76%	6.76%	6.76%	6.76%	6.76%	6.76%	6.76%	6.76%	6.76%	6.76%	RR1.1
Wholesale WACC - based on assumed structure (nominal) - Equity - nominal (WN)	%	2	6.76%	6.76%	6.76%	6.76%	6.76%	6.76%	6.76%	6.76%	6.76%	6.76%	RR1.2
Wholesale WACC - based on assumed structure (nominal) - Equity - nominal (WWN)	%	2	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	RR1.3
Wholesale WACC - based on assumed structure (nominal) - Equity - nominal (BR)	%	2	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	RR1.4
Wholesale WACC - based on assumed structure (nominal) - Equity - nominal (ADDN1)	%	2	6.76%	6.76%	6.76%	6.76%	6.76%	6.76%	6.76%	6.76%	6.76%	6.76%	RR1.5
Wholesale WACC - based on assumed structure (nominal) - Equity - nominal (ADDN2)	%	2	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	RR1.6
Wholesale WACC - based on assumed structure nominal - Cost of debt - nominal (WR)	%	2	5.25%	5.25%	5.25%	5.25%	5.25%	5.25%	5.25%	5.25%	5.25%	5.25%	RR1.7
Wholesale WACC - based on assumed structure nominal - Cost of debt - nominal (WN)	%	2	5.25%	5.25%	5.25%	5.25%	5.25%	5.25%	5.25%	5.25%	5.25%	5.25%	RR1.8
Wholesale WACC - based on assumed structure nominal - Cost of debt - nominal (WW)	%	2	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	RR1.9
Wholesale WACC - based on assumed structure nominal - Cost of debt - nominal (BR)	%	2	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	RR1.10
Wholesale WACC - based on assumed structure nominal - Cost of debt - nominal (ADI)	%	2	6.38%	6.38%	6.38%	6.38%	6.38%	6.38%	6.38%	6.38%	6.38%	6.38%	RR1.11
Wholesale WACC - based on assumed structure nominal - Cost of debt - nominal (ADJ)	%	2	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	RR1.12
Wholesale WACC - based on assumed structure (nominal) - Gearing - nominal (WR)	%	2	55.00%	55.00%	55.00%	55.00%	55.00%	55.00%	55.00%	55.00%	55.00%	55.00%	RR1.13
Wholesale WACC - based on assumed structure (nominal) - Gearing - nominal (WN)	%	2	55.00%	55.00%	55.00%	55.00%	55.00%	55.00%	55.00%	55.00%	55.00%	55.00%	RR1.14
Wholesale WACC - based on assumed structure (nominal) - Gearing - nominal (WWN)	%	2	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	RR1.15
Wholesale WACC - based on assumed structure (nominal) - Gearing - nominal (BR)	%	2	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	RR1.16
Wholesale WACC - based on assumed structure (nominal) - Gearing - nominal (ADDN)	%	2	55.00%	55.00%	55.00%	55.00%	55.00%	55.00%	55.00%	55.00%	55.00%	55.00%	RR1.17
Wholesale WACC - based on assumed structure (nominal) - Gearing - nominal (ADDN)	%	2	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	RR1.18

3. HAVANT THICKET CAM2

A. What is the issue?

The Draft Determination recognises the planned change of scope on the Havant Thicket scheme.

“In addition to the Havant Thicket reservoir project (which Portsmouth Water is delivering), Southern Water is developing the Hampshire Water Transfer and Water Recycling DPC project. This will enable direct raw water transfers from the Havant Thicket reservoir to Southern Water’s Otterbourne water treatment works. It will significantly increase the volume of water that can be supplied from the reservoir, in certain conditions, by up to 90 MI/day (on top of the 21 MI/day already planned).

To facilitate optimal delivery of the Hampshire Water Transfer and Water Recycling DPC project and the Havant Thicket reservoir, changes to the initial reservoir design and substantive alignment works are needed, including a combined tunnel for the two pipelines (the original design required only one). The combined tunnel will mean Southern Water does not need to construct a separate pipeline tunnel for its DPC project. The alignment works and the combined tunnel approach are an increase in scope for Portsmouth Water’s Havant Thicket project. We propose to allow for the additional scope and costs for the alignment works via a second cost adjustment mechanism. The timing of the cost adjustment mechanism is subject to the outcome of the planning process associated with the changes to the pipeline; this is expected to conclude later in 2024. We will amend the scope of the Havant Thicket price control within the PR19 final determination notice.”

Source: Ofwat PR24 draft determinations: Expenditure allowances 4.6.2

The baseline cost allowance for Havant Thicket was adjusted through a Cost Adjustment Mechanism in late 2022 after securing planning and awarding the main works contracts in January 2023. Since that date there are two material engineering changes on the Havant Thicket scheme. These are the alignment works with Southern Water’s proposed water recycling scheme and a redesign of the reservoir embankment to address unforeseen ground conditions. The combined impact is expected to increase cost by c£270m (2022/23 prices base) and delay the programme by a minimum of two years.

The alignment works is new scope, but the change in reservoir design is due to exceptional ground condition issues that could not have been foreseen. The change of design and cost recovery is covered in the Bulk Supply Agreement with Southern Water through an Other Material Change of Circumstance (OMCC) clause.

Portsmouth Water is committed to delivering the alignment works but requires certainty on the following areas ahead of the Final Determination to ensure it can assess whether the scheme is financially viable.

We are seeking clarity on:

- The scope of the cost adjustment mechanism (CAM2). The cost adjustment mechanism (CAM2) needs to incorporate both the changes to scope and changes to the reservoir design in response to unforeseen ground conditions.
- The mechanism and timing of RCV recognition and adjustment to allowed revenues.
- Regulatory comfort to ensure construction programme can be maintained, as Portsmouth Water will be required to make commercial commitments ahead of CAM2.
- Regulatory assurance that costs will be recoverable if Southern Water enters Special Administration Regime.

Following CAM1 Portsmouth Water has financed the increased investment using a shadow RCV and addressed the fact that price limits are not adjusted until PR24 through deploying up front equity. Portsmouth Water will be compensated through an adjustment to the RCV at PR24 included a return based on the PR19 cost of capital.

We do not see a re-run of the approach to CAM1 as feasible.

The PR19 WACC was not adjusted for the higher level of equity or the increase in the cost of debt during AMP7. Portsmouth Water also incurred additional costs as the absence of an IDoK required a consent change with the controlling creditor, Assured Guarantee, to recognise the shadow RCV (at a cost of £2.3m + legal costs).

Portsmouth Water do not think that adopting the same approach is feasible or offers value for money for customers. Deferring recognition of RCV to increase to PR29 would increase the equity requirements to fund the scheme and result in a requirement to renegotiate covenants again. We estimate this could cost a further £5m which would have to be reflected in revenues. There is also additional risk as there is no guarantee Assured Guarantee would accept the proposal (Assured Guarantee have wider exposure across the sector including Thames Water).

Moody's recent announcement on the Draft Determination and potential sector downgrade could put our Baa2 credit rating at risk if increased costs are not adequately compensated. This is a major concern for Portsmouth Water Board and its investors.

“Regulatory and political pressure is unlikely to abate, but final determinations, or FDs, are typically less onerous than drafts as regulators respond to companies' additional evidence. So we expect some changes at the final conclusion of the regulatory process, including FDs from Ofwat, currently expected in December 2024. In the event of appeals to the CMA the process could extend well into 2025. However, the draft determinations create a less supportive framework for the water companies and constrain their ability to earn the allowed return. The regulatory regime's stability and supportiveness, as well as companies' ability to earn a fair return, are key factors under our rating methodology for regulated water utilities.

If the draft framework is confirmed at FD, business risk would increase for the sector and we would consider revising our score for either or both of these factors when assessing companies' credit quality. Against this background, companies would need to strengthen their credit ratios to maintain their current credit quality (see Appendix for further details).”

Source: Moodys report 'Ofwat's draft determination increases sector risk'

While tightening of credit metrics can be addressed either through strengthening of returns or reducing leverage, the amendment to the notch uplift is a key concern given the ceiling on our current rating due to the scale of the Havant Thicket scheme relative to our existing RCV.

We have been carefully assessing the financeability of the scheme to give assurance to our Board and Ofwat on deliverability of the scheme. A recent Moody's Rating Assessment Service assessment of the scheme confirmed we could accommodate the additional scope within our Baa2 rating but if there was significant deferral of RCV recognition and allowed revenues weakened rating headroom.

This was before the potential change in rating guidance reducing the sector uplift by 0.5 notches. Maintenance of our Baa2 rating is critical to ensuring we can raise the equity and debt required to deliver the additional scope. We believe this risk strengthens our arguments that RCV and revenue should be recognised in period through a reopening mechanism. We do not see a gated process similar to other proposals, where RCV is recognised retrospectively, as viable.

B. Our proposed remedy

We are engaging with the Ofwat Major Projects team and the approach to CAM2 is being discussed at Ofwat's Major Projects Committee. We have written to Kate Kendall ahead of the September Major Projects Committee to outline our views on the approach to the CAM process and associated implications for the PR24 Final Determination

Scope of the cost adjustment mechanism (CAM2)

We have made representations that the CAM2 mechanism should be limited to.

- Cost arising from the alignment works scope change including change of programme delivery dates.
- Reservoir design changes required to address exceptional ground conditions. These include the cost of changes to the embankment design due to prevalence of shear surfaces and the associated impacts to address Harwich and Bognor Sands formations.
- Costs arising from planning requirements e.g. additional environmental compensation.

The CAM2 is not a reopener for costs already assessed in the original CAM.

The CAM2 should also reset ODI dates to reflect the agreed efficient programme for.

- Dry commissioning
- Wet commissioning

While we recognise the alignment works and ground conditions design changes are covered by separate commercial and regulatory frameworks it makes practical senses to assess through a single CAM exercise and compensate them through an aligned regulatory mechanism. We have verbal feedback from Ofwat that the Major Projects Committee discussed this issue at July 2024 meeting and reached similar conclusions.

Treating the issues separately risks increasing regulatory complexity, reduced transparency to customers and stakeholders, and ultimately will increase the cost of delivery and financing. A combined approach provides for a more efficient assessment process and supports presentation of a clear financing proposition to investors.

Mechanism and timing of RCV recognition and adjustment to allowed revenues

We can demonstrate a successful track record in securing financing to deliver the reservoir scheme, having secured £170m of capital from shareholders and raising a further £325m of debt facilities. We have engaged Centrus Financial, who supported the previous financing process, to support the financing strategy for the increased scope of the reservoir (full report included in (PRT RR 01)

With Centrus and shareholder support we have also undertaken a second Moody's Rating Assessment Service (RAS) assessment of the implications of the additional scope and funding mechanisms on Portsmouth Water's credit rating. Centrus guidance is it is essential to maintain our Baa2 rating to secure additional funding (debt and equity). This view is supported by our investors Ancala.

Based on the RAS we are recommending the re-introduction an IDoK clause for Havant Thicket with a Notified Item for the allowed scope changes. To ensure Southern Water can recover costs from its customers we are recommending the use of an Allowed Revenue Direction (ARD) under Southern Water's Condition T (for Havant Thicket) in relation to Southern Water's BSA2 costs. This could be delivered through a wording change to Southern Water's Licence Condition T so that it explicitly gave Ofwat the power to change their allowed revenues to enable them to comply with the Havant Thicket Agreement.

This mechanism enables:

- A correction to totex allowances, RCV and allowed revenues in period, and enable Southern Water to recover the cost from its customers.
- It also avoids the requirement for a shadow RCV which would increase financing costs and risk by avoiding the need for a renegotiation of covenants.
- It also provides complete transparency and regulatory certainty to debt stakeholders including Portsmouth Water's rating agency Moody's.

We have considered the viability of financing the scheme if it is compensated at PR29. This is similar to some of gated processes being proposed in other companies' Draft Determinations.

Based on the evidence from our RAS process and a review of the subsequent Moody's guidance on the Draft Determination, we have concluded that this is not viable and would put financeability of the scheme at risk.

The outcome of the recent RAS process supported that Portsmouth Water can deliver the larger project and maintain its Baa2 rating. However, the scenarios tested evaluated the impact of deferral of RCV and revenue recognition. The rating headroom reduces, and the risk of a downgrade increases as more RCV and/or allowed revenue is deferred.

The assessment was before the recent Moody's report signalling potential rating action on the sector. Our assessment is that if Moody's implement their rating action following the Final Determination it puts our Baa2 rating at risk if CAM2 recognition is deferred to PR29. We are planning to run an additional rating assessment scenario to further test this risk.

Regulatory comfort to ensure construction programme can be maintained as Portsmouth Water will be required to make commercial commitments ahead of CAM2

A key benefit of the IDoK mechanism and Notified Item approach is that it provides sufficient regulatory comfort to maintain programme delivery while cost allowances are being agreed. It is also recognised in our debt covenant documents.

We will need to procure pipeline materials and start construction of the embankment before the CAM2 process is concluded to maintain programme and avoid increased cost. This requires Portsmouth Water to make commercial commitments to its supply chain. The materiality of changes to contracts are such that enabling works contracts or comfort letters are neither practical or sufficient to provide the required comfort for our Board, investors, and financial stakeholders, including rating agencies. It is our strong view that reintroducing the IDoK provision and including a Notified Item is the best and most robust way of providing the required regulatory assurance and transparency.

Regulatory assurance that cost will be recoverable if Southern Water enters the Special Administration Regime

We are also seeking assurance that any increased cost associated with the CAM2 assessment are protected in the event of Southern Water entering the Special Administration Regime or alternative assurances costs can be recovered from the customers that benefit from the reservoir asset.

C. Supporting evidence

Moody's potential rating action

We agree with Centrus guidance that maintaining our Moodys Baa2 rating is critical to ensuring we can finance the alignment works and our wider business plan (given we have significant refinancing in 2029, and we need to secure forward starting facilities ahead of refinancing our long-term Artesian financing in 2032). We are very concerned about the prospect of a Moody's downgrade on the stability and predictability of UK Water, particularly given the comparison to assessment of energy and gas sectors. As the available capital is finite the energy sector prospects look more attractive given higher return, better opportunities for outperformance and a higher rated regulatory environment. The full Moody's report is included with our representations in the appendices to this report (**supplementary report PRT HT 03**).

"Separate review of structural features and their level of credit enhancement"

In the context of ongoing sector developments as well as regulatory pressure to de-gear, the DD proposals could also affect our view of the extent of benefit to creditors that structural features of existing financings provide. Where we have incorporated a benefit, this has historically uplifted credit quality by around 1-1.5 notches.

Lower returns, higher operational leverage and much larger investment commitments have reduced issuers' ability to lock up material amounts of cash in a trigger event. This means that the benefit of a distribution block is lower than when these structures were originally put in place. Financial ratio triggers are also not always working as intended and a number of companies already no longer achieve significant rating uplift." p10 UK Water PR24 increases sector risk - Moodys

"Stability and predictability of the regulatory environment"

In May 2018, we amended the score of this subfactor for UK water utilities to Aa from Aaa, when we concluded that the introduction of a high gearing penalty was in response to public and political pressure that – together with introducing more cash flow volatility – would undermine the track record of stable and predictable regulation. In this illustrative example, we show the effect of moving the subfactor score to A.

Exhibit 14 shows how our assessment of the UK water regulatory regime compares with regulatory frameworks for regulated water utilities and electric and gas networks across a selection of different jurisdictions.

Exhibit 14
Summary comparison of scores for stability and predictability of regulatory regimes across a selection of different jurisdictions

Aaa	Aa	A	Baa	Ba
Regulated Water Utilities				
	UK Water (current)	UK Water (potential future)	Italy	China
	US (California; New Jersey; Pennsylvania)	US (Massachusetts, New Hampshire)	US (Connecticut)	
			South Korea	
			Spain	
			Brazil	
Regulated Electric and Gas Networks				
Great Britain (ex OFTOs)	Great Britain (OFTOs)	Belgium - Flanders	Belgium - Wallonia	Kazakhstan
Ireland	Czech Republic	Estonia	Poland	Romania
Norway	Finland	Germany	Slovakia	
US (FERC)	France	Lithuania	Spain	
Australia	Italy	Portugal		
	Netherlands			

Reflects scores as of the date of this report for rated issuers captured under our rating methodologies for [Regulated Water Utilities](#) and [Regulated Electric and Gas Networks](#).
Source: Moody's Ratings

Cost and investment recovery (sufficiency and timeliness)

We had historically scored this subfactor A for most UK water utilities. However, we recently changed our scores to Baa for Thames Water, Southern Water and South East Water because their underperformance is likely to prevent them from earning the allowed return for a number of years. On the basis of the DD, we believe most companies would not be able to earn the allowed return. As a result, the ability to earn a fair return may be impaired for the sector. In our illustrative example we indicate how a change from A to Baa for this subfactor affects the scorecard-indicated outcome.

Uplift for structural considerations

For UK water utilities, we currently score 0.5 notches of uplift for the regulatory ring-fencing conditions, embedded in companies' licences. Any further uplift reflects the presence of additional credit-enhancing features, including distribution block, designated liquidity reserves, share security and creditor step-in rights. For a fully-fledged covenant package we currently apply up to 1.5 notches of uplift. In our illustrative example below for a company with a covenanted structure, we also provide an indication of how changing the rating uplift to 1 notch from 1.5 notches affects the scorecard-indicated outcome.

Illustrative impact on scorecard-indicated outcome

In Exhibit 15, we illustrate the impact of a change in these factor and subfactor scores for three generic companies:

- Company A, exhibiting a typical corporate structure and strong metrics
- Company B, exhibiting a typical corporate structure and weaker metrics than Company A
- Company C, which has a highly covenanted and more leveraged financing structure than Company B

Exhibit 15

Illustrative scorecard-indicated outcomes for factor score changes across our hypothetical sample companies

Regulated Water Utilities Industry	Company A - current		Company A - potential post-change		Company B - current		Company B - potential post-change		Company C - current		Company C - potential post-change	
Factor 1 : Business Profile(50%)												
a) Stability and Predictability of Regulatory Environment	Aa		A		Aa		A		Aa		A	
b) Asset Ownership Model	Aa		Aa		Aa		Aa		Aa		Aa	
c) Cost and Investment Recovery (Sufficiency & Timeliness)	A		Baa		A		Baa		A		Baa	
d) Revenue Risk	Aa		Aa		Aa		Aa		Aa		Aa	
e) Scale and Complexity of Capital Programme & Asset Condition Risk	Baa		Baa		Baa		Baa		Baa		Baa	
Factor 2 : Financial Policy (10%)												
a) Financial Policy		Baa		Baa		Baa		Baa		Ba		Ba
Factor 3 : Leverage and Coverage (40%)												
a) Adjusted Interest Coverage Ratio (3 Year Avg)	1.7x	Baa	1.7x	Baa	1.5x	Baa	1.5x	Baa	1.3x	Ba	1.3x	Ba
b) Net Debt / Regulated Asset Base (3 Year Avg)	60.0%	Baa	60.0%	Baa	70.0%	Ba	70.0%	Ba	80.0%	Ba	80.0%	Ba
c) FFO / Net Debt (3 Year Avg)	10.0%	Baa	10.0%	Baa	9.0%	Ba	9.0%	Ba	7.0%	Ba	7.0%	Ba
d) RCF / Net Debt (3 Year Avg)	8.0%	Baa	8.0%	Baa	7.0%	Baa	7.0%	Baa	6.0%	Baa	6.0%	Baa
Rating:												
Scorecard-Indicated Outcome Before Notch Lift	A3		Baa1		Baa2		Baa2		Baa3		Baa3	
Notch Lift	0.5		0.5		0.5		0.5		1.5		1.0	
Scorecard-Indicated Outcome	A3		Baa1		Baa1		Baa2		Baa1		Baa2	

Source: Moody's Ratings

For all our generic, illustrative examples, **the scorecard-indicated outcome would move down by one notch based on the changes to the factor and subfactor scores.** To maintain the same scorecard-indicated outcome, other factors or subfactors — for example leverage and coverage metrics — would need to be higher.

However, methodology scorecards are simple reference tools and the scorecard-indicated outcome is not expected to match the actual rating for each company. **We believe that, despite our view of increasing business risk, companies can maintain current credit quality if performance allows**

them to earn or exceed allowed returns, or credit metrics strengthen to align with potentially tighter guidance, or both.” P11-12 UK Water PR24 increases sector risk - Moody’s

Moody’s RAS

Centrus conducted an assessment of three scenarios aligned to our Draft Determination representations. **(supplementary report PRT RR 01)**

- Ofwat Draft Determination.
- Portsmouth Water Draft Determination response (excluding change of scope to Havant Thicket.
- Portsmouth Water Draft Determination response + CAM2 proposal.

It also considered the findings of the RAS process and Moody’s latest guidance note.

The key conclusions in relation to the alignment works and ground conditions cost increases are that the scheme is financeable within Portsmouth Water’s Baa2 rating with the right regulatory framework and equity support.

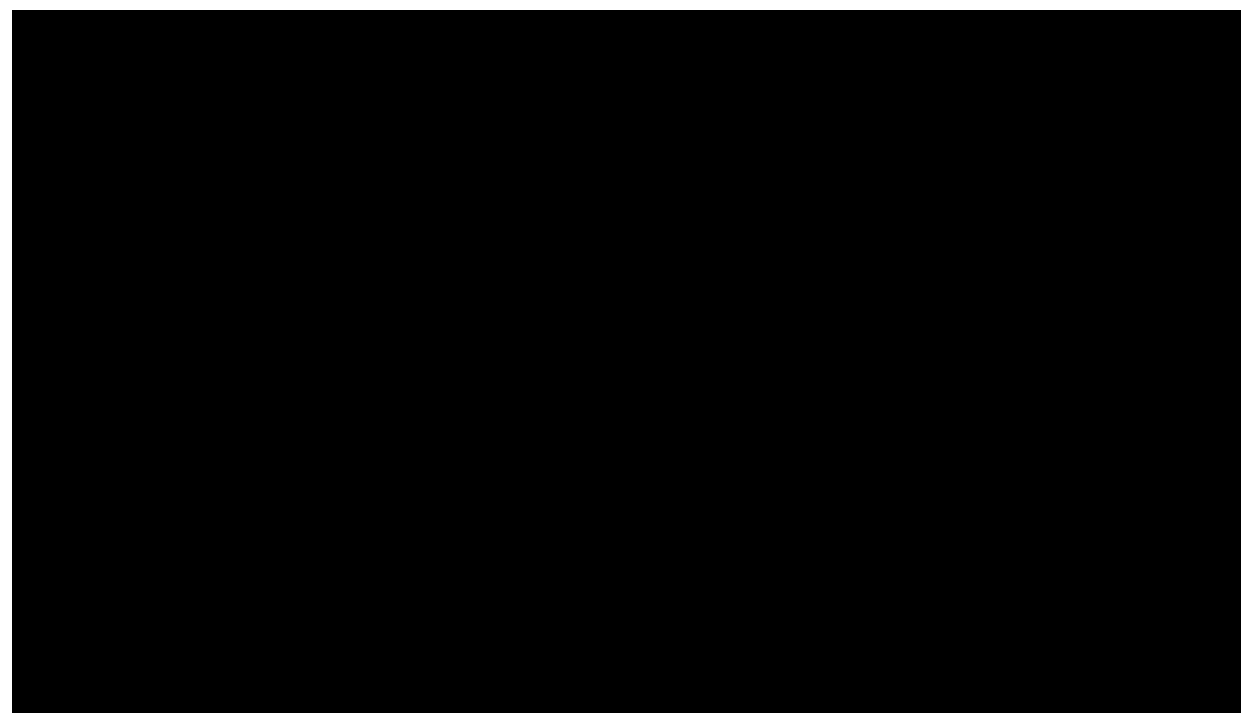
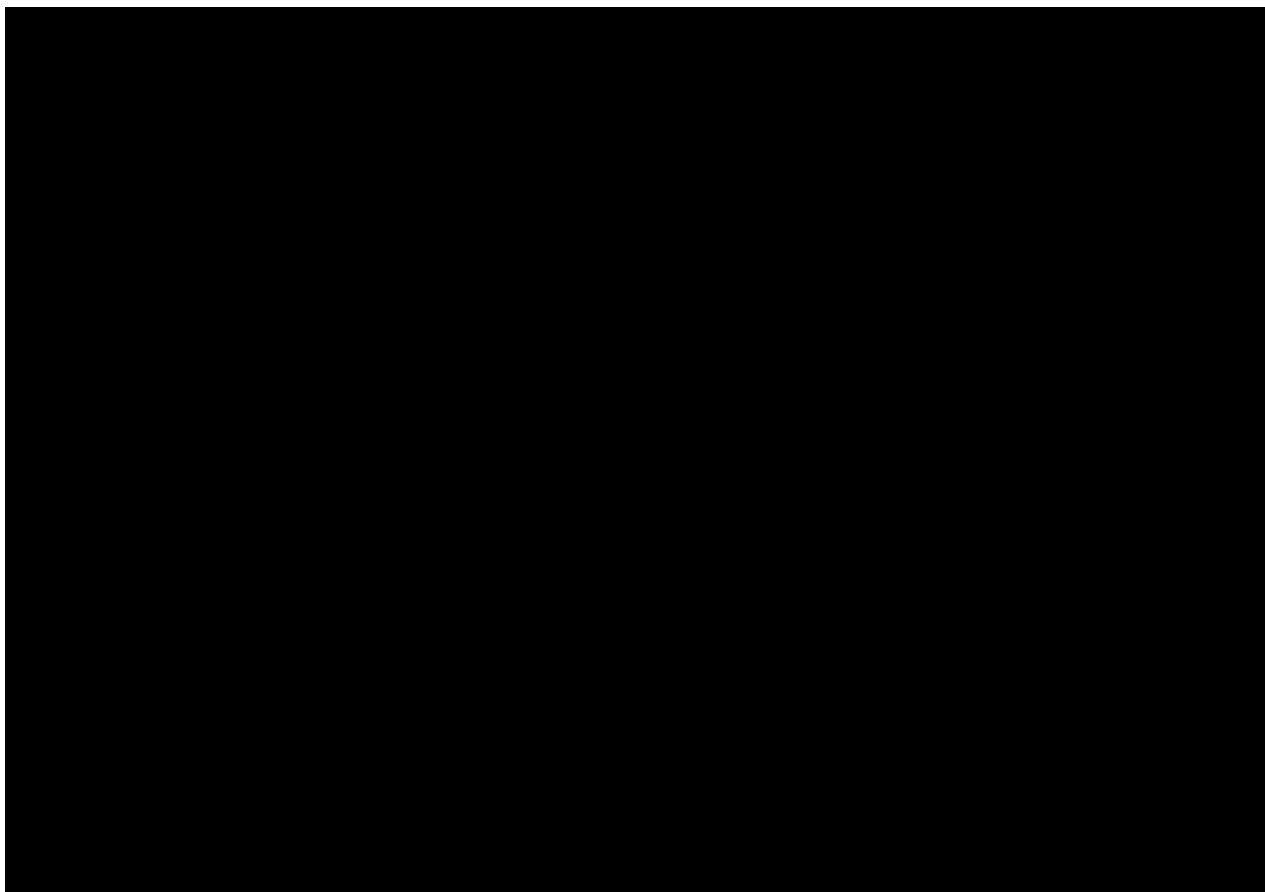
“PW can maintain its Baa2 rating subject to sufficient regulatory allowance and shareholder support. The rating remains sensitive to deferral of RCV recognition, resulting in more equity requirements and deterioration of rating headroom. RAS test under scenario 3, indicated a significant deferral would result in Ba3. A larger or full deferral could result in a downgrade or negative outlook.

If Moody’s implements the proposed changes, Portsmouth Water faces a potential downgrade to Baa3 if costs are substantially deferred to PR29. The increased equity requirements to sustain the rating at Baa2 may become unsustainable given the proposed returns and the timeline for recovery”

Actual Company | Moody’s Scorecard

Under the representations, PW maintains its current Baa2 rating, subject to no change in Moody’s industry view

		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	15.00%	As per the latest Moody’s report on PWL dated 29th July 2024			-->	Aa
	Asset Ownership Model	5.00%				-->	Aa
	Cost and Investment Recovery (Ability and Timeliness)	15.00%		Assumed that these ratings will remain unchanged through-out AMP8. However, Moody’s have indicated that they are considering updating their view on the sector subject to a materially improved FD		-->	A
	Revenue Risk	5.00%				-->	Aa
SCALE AND COMPLEXITY OF CAPITAL PROGRAM	Scale and Complexity of Capital Program	10.00%	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	10.00%	As per the latest Moody’s report on PWL dated 29th July 2024	Assumed this will remain unchanged. The additional equity to remain a low level of gearing is credit positive		-->	Baa
LEVERAGE AND COVERAGE				Base Case		PW DD Rep	PW DD Rep + Alignment
	Adjusted Interest Coverage Ratio (AMP8 average)	12.50%	Baa: 1.5-2.5x Ba: 1.2-1.5x	2.50x	-->	Baa	1.83x --> Baa
	Net Debt / RCV (AMP8 average)	10.00%	A: 40-55% Baa: 55%-70%	56.4%	-->	Baa	56.7% --> Baa
	FFO / Net Debt (AMP8 average)	12.50%	Baa: 10-15% Ba: 6-10%	6.72%	-->	B	5.27% --> B
	RCF / Net Debt (AMP8 average)	5.00%	Baa: 6-10% Ba: 4-6%	3.74%	-->	B	2.52% --> B
Scorecard-Indicated Outcome Before Notch Lift				Ba2		Ba2	Ba2
Notch Lift:				+1.5 notches		+1.5 notches	+1.5 notches
Scorecard-Indicated Outcome				Ba1		Ba1	Ba1
Additional 2-notch adjustment				+2 notch		+2 notch	+2 notch
Actual Rating Assigned				Baa2		Baa2	Baa2



D. Conclusion

Portsmouth Water can demonstrate a successful record in raising debt and equity to support the Havant Thicket scheme. Assurance undertaken over recent months supports that the additional scope is financeable with the appropriate regulatory and shareholder support. Maintenance of our Baa2 credit rating is key, but there is a risk that it cannot be achieved if RCV recognition is deferred to PR29, particularly if Moodys proceed with their sector downgrade after the final determination.

To ensure the Portsmouth Water Board and investor are fully informed when evaluating the Final Determination, we require certainty on the approach to CAM2. Clarity on the approach and the mechanism to recover costs for both Portsmouth Water and Southern Water is needed before or with the Final Determination. We are continuing to engage in parallel with the PR24 process with the Ofwat Major Projects team.

Our recommendation is as follows:

- The CAM2 assessment should follow the same approach as the CAM1 process.
- The CAM2 process should assess the increase in costs for both the new scope relating to the alignment works and the changes to the reservoir design in relation to ground conditions.
- ODI dates should be reset based on the revised programme, reflecting the scope changes.
- An IDoK clause should be reintroduced into the Portsmouth Water's licence for the Havant Thicket control, and the PR24 Final Determination should include a Notified Item limited to alignment works, reservoir design changes due to ground conditions and costs arising from planning.
- Increased costs agreed in CAM2 are recoverable through an IDoK for Portsmouth Water.
- To ensure Southern Water can recover costs from its customers we are recommending the use of an Allowed Revenue Direction (ARD) under Southern Water's Condition T (for Havant Thicket) in relation to Southern Water's BSA2 costs.
- Costs recoverable by Southern Water through the ARD mechanism should be reflected in allowed revenues in the following financial year after the IDoK.

E. Business plan tables impacted

No tables impacted.



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portsmouthwater.co.uk



pr24@portsmouthwater.co.uk



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