

PORTSMOUTH WATER Ltd
CUSTOMER CHALLENGE GROUP (CCG)
MEETING HELD ON TUESDAY 11 MARCH 2014

PRESENT: Charles Burns (FSB), Amy Gallop (Secretary), Karen Gibbs (Consumer Council for Water), David Guest (Independent Chairman), David Howarth (Environment Agency), Derek Kimber (Gosport Borough Council), Mike Kirk (Portsmouth Water), Terry Lazenby (Portsmouth Water), Simon Oakley (Chichester District Council), Kirk Phillips (Winchester City Council), Nick Sheeran (Portsmouth Water), Gareth Simmonds (Portsmouth Water) and Neville Smith (Portsmouth Water).

Action

1. Apologies:

Traci Baker (Hampshire Chambers of Commerce), Paul Barfoot (Portsmouth Water), Heather Benjamin (Portsmouth Water), Hugh Caley (Carillion), Daire Casey (West Sussex County Council), David Collins (Havant Borough Council), Cllr Paul Dendle (Arun District Council), Keith Evans (Fareham Borough Council), Richard Harris (West Sussex Hospitals Trust), Marge Harvey (East Hampshire District Council), John Havenhand (Consumer Council for Water), Douglas Hunt (Atkins Independent Reporter), Douglas Kite (Natural England), Chris Manning (South Downs), Rod Porteous (Portsmouth Water), Milo Purcell (Drinking Water Inspectorate), Ian Rawson (KWS - Defence) Tim Richings, Jon Stuart (Havant & District Citizens Advice Bureau) and Rob Wood (Portsmouth City Council).

2. Minutes & Actions of Meeting Held on 12 November 2013

Incentives / Penalties / Values

David Howarth requested the minutes be reworded from David Howarth raised concern that expressing leakage as a percentage was '*unfair*' to '*inaccurate as a performance measure*'.

The minutes were taken as a correct record subject to the above amendment and approved by the CCG.

3. Ofwat Assessment

Neville Smith advised the CCG that Portsmouth Water had not been prequalified for Enhanced status and were in the Resubmit / Standard Category.

However, he confirmed that there were many facets of the Plan that Ofwat thought were excellent and generally good for Customers, specifically there were some good initiatives and costs in wholesale were strong. Ofwat were also pleased in the way that Portsmouth Water engaged with Customers.

There were however a number of areas where they had questions and needed further information and dialogue. These were:

- Outcomes for Customers
- Allocation of Costs between Household and Non-Household
- Uplift in our Average Cost to Serve for Inflation
- Legacy Items – Calculations

Neville Smith circulated and discussed Ofwat's Summary of their Risk Based Review Test.

David Guest advised that Ofwat have arranged a Workshop for CCG Chairs on Monday 24 March which should provide more detail.

Neville Smith advised that the Company needs to better understand the scoring method used in the Results of Ofwat's Risk Based Review which will be published on 4 April 2014. Following this the Company will need to decide if further Customer Research will be required before resubmitting their Plan on 2 May 2014 for a Draft Determination.

He further advised that the CCG will need to review the revised Business Plan and provide a short Report to accompany the Company's Resubmission.

Neville Smith confirmed that the Company would provide the CCG with a short report following 4 April and meetings were provisionally agreed for the 10 and 23 April, depending on whether further Customer Research will be required.

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4. **Ofwat Revised Risk and Reward Guidance**

Nick Sheeran advised the CCG that in January 2014, Ofwat announced that, following their initial review of the submitted Plans in terms of risk and reward, it was clear that these were not in alignment with market evidence and that they would be issuing further guidance on risk and reward, including their view on the cost of capital and other key financial parameters.

He further advised that there was also a change to the process. Ofwat stated that in March 2014, any Companies that pass their tests for Costs, Outcomes, Affordability and Board Assurance would pre-qualify for Enhanced Status. The Boards of these Companies would then have to decide whether to accept the Risk and Reward Guidance and in doing so gain Enhanced Status. The Business Plan of any pre-qualified Company that chooses not to accept the Guidance would instead be assigned as Standard and follow the Standard review process.

The revised Timetable was then outlined as follows;

10 March - Announcement of pre-qualified companies

17 March - Deadline for pre-qualified Companies to accept Risk and Reward Guidance and submit revised Business Plans

4 April – Announcement of results of Risk Based Review for all Companies

Nick Sheeran confirmed that as previously mentioned Portsmouth Water did not pre-qualify for Enhanced Status.

Nick Sheeran circulated a paper comparing the key financial parameters in Ofwat's Risk and Reward Guidance published in January, to what was included in Portsmouth Water's Business Plan submission.

He informed the CCG that the Company had run these revised parameters through their Financial Model to assess their impact on the Business Plan. However, the result is that without other changes to its Plan it is likely that Portsmouth Water would not produce adequate financial ratios. This will be discussed in more detail later in the meeting under the item, Implications for the Business Plan.

Nick Sheeran further advised the CCG that in Portsmouth Water's Business Plan, they provided a package of measures which included the key parameters and shareholders gave up the benefit of a number of Legacy items such as the rewards for the efficiencies they achieved. However, he confirmed that under

the new Ofwat Risk and Reward Guidance, it is extremely difficult for the Company to give up these Legacy items. The difference is the cost of debt allowed by Ofwat and the Company's actual cost of debt is clearly an issue. He advised that at previous Price Reviews Ofwat allowed a Small Company Premium to reflect the fact that small Companies cannot acquire debt at the same rates as the large Water and Sewage Companies. However, the new guidance from Ofwat only allows for a Small Company Premium if the Company can justify that there are benefits to the Customer which offset the additional cost of the Small Company Premium. This will be discussed in the next item, Small Company Premium.

5. **Small Company Premium**

Nick Sheeran circulated a paper to the CCG explaining that a Small Company Premium represents an uplift in the allowed Weighted Average Cost of Capital for a Company to reflect the fact that smaller Water Only Companies face higher borrowing costs than larger Water and Sewage Companies due to their smaller size. This uplift in the Weighted Average Cost of Capital gives these smaller Companies an increase in the Revenue which they would otherwise be allowed. He confirmed that in the last Periodic Review Ofwat allowed a Small Company Premium of 0.2% to 0.4% depending on the Company's size.

He further advised that Oxera produced a Report as part of the PR14 process proposing a Small Company Premium in the range 0.4 – 0.7%.

He confirmed that Ofwat's Risk and Reward Guidance required smaller Companies to demonstrate that they face a higher cost to raising finance and that there is an offsetting benefit to Customers.

Nick Sheeran informed the CCG that six of the small Water Only Companies have commissioned Oxera to consider Customer benefits of the small Water Only Companies, in order to respond to Ofwat's call for evidence. He discussed in detail Oxera's conclusions and advised that based on this Report Portsmouth Water can make a very good case to justify a Small Company Premium.

6. **Implications for the Business Plan**

Nick Sheeran circulated schedules demonstrating to the CCG the implications of accepting Ofwat's revised Risk and Reward Guidance in the four scenarios outlined below;

Scenario 1 – Base Case Plan (as submitted to Ofwat in December 2013)

Scenario 2 - Base Case revised for new Ofwat Guidance

Scenario 3 - Base Case revised for new Ofwat Guidance – but with inclusion of Small Company Premium (no reinstatement of legacy items). i.e. as per Scenario 2 above

Scenario 4 - Base Case revised for new Ofwat Guidance - but with reinstatement of legacy items. i.e. as per Scenario 3 above (no Small Company Premium)

Scenarios 1 and 2 produced ratios which the Company believed were inadequate. Scenarios 3 and 4 produced ratios for 2015-2020, which were adequate, as a result of legacy items, but were marginal in the long term.

In summary Nick Sheeran advised that the resubmission would include an argument for a Small Company Premium or failing this have the Company's Legacy Items reinstated to ensure the Company is Financeable using Ofwats revised Risk and Reward parameters.

Kirk Phillips raised concern over what would happen if Ofwat rejected both options.

Neville Smith advised that there would be detailed discussions with Ofwat but ultimately the matter could potentially go to the Competition Commission to decide.

David Howarth suggested increasing the Company's Weighted Cost of Capital by enhancing the Rewards on their Outcome Delivery Incentives.

Gareth Simmonds confirmed this would be discussed in detail in the next item.

7. **Outperformance / RORE Range / Outcome Delivery Incentives**

Gareth Simmonds informed the CCG that Ofwat's Risk and Reward Guidance stated that the proposals in Companies Business Plans provided little incentive for outperformance and consequently depend upon higher Weighted Average Cost of Capital's to provide Investors returns.

He further advised that since Ofwat are proposing a single Industry Weighted Average Cost of Capital, for consistency, which requires a similar scale of incentives across the sector, they are expecting to see Companies propose stronger Outcome Delivery Incentives in their revised Plans. They believe that, given the lower cost of capital, it is appropriate for Companies to have the opportunity to earn a return for delivering outcomes that Customers value.

He reminded the CCG that the Company proposed 5 Outcome Delivery Incentives that were financial, relating to;

- asset conditions of pipes
- asset conditions of water treatment works
- leakage
- water efficiency
- delivery of environmental schemes

He advised that based on the Customer Research all of these had penalties associated with them and the incentive for leakage and the environment had rewards if the Company outperformed.

He informed the CCG that the Ofwat guidance suggested the Company's Outcome Delivery Incentives should give the opportunity of an upside of greater than 1% on return on regulated equity. However, he advised that this would mean completing further Customer Research or re-interpret the current results. At this stage the Company do not believe it is practical to undertake further Customer Research.

Karen Gibbs informed the CCG of Research completed by CCW on Outcome Delivery Incentives. It was agreed the results would be circulated to the CCG with the Minutes of this Meeting.

KG

She advised that the Research consisted of six Focus Groups to test the

concept of rewards and penalties to incentivise Companies to outperform. She confirmed that there was a negative response from Customers who found it hard to understand how Companies receiving rewards would benefit them. They were suspicious of these incentives and felt the Company should be striving to provide the best level of service regardless. Accumulating credits for a future price review left Customers feeling uncertain and were incredibly sceptical, concluding that this was a way for the Company to make returns not necessarily improvements.

Karen Gibbs further confirmed that there was slightly more support for Companies to be penalised for missing targets.

She advised that the six Focus Groups were household Customers and Business Customers were contacted by Telephone.

Karen Gibbs expressed that she thought it was a good theory to drive costs but left too late in the Price Review process.

8. Impact on Customers

Neville Smith advised the CCG that if Ofwat do not allow either the Small Company Premium or the reinstatement of Legacy Items then the Company will need to cut costs to ensure it's financeable. Reluctantly this may mean cutting mains renewals, which does improve cash flows and ratios but may impact service in the longer term. The Company needs Ofwats final judgement to decide the way forward.

Discussion was held on other ways of cutting costs. The CCG made the following suggestions;

- Refinancing Debt
- Enhancing Outcome Delivery Incentives
- Freezing Pay Increases
- Sharing Utility Services
- Outsourcing

Neville Smith appreciated the CCG's and advised that refinancing debt was not feasible, and the other suggestions would not get the Company near the figure Ofwat are expecting.

9. Next Steps / Timetable

Ofwat will announce the Results of their Risk Based Review on 4 April 2014. Meetings were provisionally agreed for 10 and 23 April 2014, pending the Results on 4 April and whether the Company needs to complete further Customer Research.

2 May 2014 Company will resubmit Business Plan to Ofwat for a Draft Determination.

10. Any Other Business

There was not any other business.