

PORTSMOUTH WATER Ltd
CUSTOMER CHALLENGE GROUP (CCG)
MEETING HELD ON TUESDAY 12 NOVEMBER 2013

PRESENT: Paul Barfoot (Portsmouth Water) In Part, Heather Benjamin (Portsmouth Water) In Part, Charles Burns (FSB), Amy Denford (Secretary), David Guest (Independent Chairman), John Havenhand (Consumer Council for Water), David Howarth (Environment Agency), Douglas Hunt (Atkins Independent Reporter), Derek Kimber (Gosport Borough Council), Mike Kirk (Portsmouth Water) In Part, Terry Lazenby (Portsmouth Water) In Part, Chris Manning (South Downs), Simon Oakley (Chichester District Council), Kirk Phillips (Winchester City Council), Rod Porteous (Portsmouth Water) In Part, Milo Purcell (Drinking Water Inspectorate) In Part, Nick Sheeran (Portsmouth Water) In Part, Gareth Simmonds (Portsmouth Water) In Part and Neville Smith (Portsmouth Water) In Part.

Action

1. Apologies:

Traci Baker (Hampshire Chambers of Commerce), 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), Karen Gibbs (Consumer Council for Water), Richard Harris (West Sussex Hospitals Trust), Marge Harvey (East Hampshire District Council), Douglas Kite (Natural England), 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 22 October 2013

The minutes were taken as a correct record and approved by the CCG.

The following actions were reported on:

CCG Discussions on the Draft Business Plan and CCG Report

Doug Hunt confirmed that he had issued a revised version of the CCG Report following the points raised at the last meeting.

Feedback and Questions to Company following CCG Discussion

Neville Smith confirmed that the Company have produced a variation – up/downside on Outcomes and Incentives that will be discussed later in the meeting.

Gareth Simmonds confirmed that the ODI's and KPI's would be provided later in the meeting.

Gareth Simmonds confirmed that the key parts of the narrative had been extracted and will be provided to the CCG later in the meeting.

Neville Smith advised that the Draft High Level Business Plan had been issued to the CCG ahead of the meeting and a copy was also included for information in with their papers for the meeting.

Neville Smith confirmed that there would be an update on financeability later in the meeting.

Red Flags for Business Plan/Ten Key Messages for Business Plan

It was noted that there was an inaccuracy in the minutes of the meeting held on 22 October 2013 and it was Douglas Kite not Derek Kimber who questioned

why environment was not amongst the ten key messages. The Secretary agreed to amend this.

Nick Sheeran confirmed that environment had been included in the ten key messages.

DWI View on Company's Water Quality Risks

At the last meeting Milo Purcell advised that the DWI declined to support both the Eastergate and Westergate Schemes requesting sight of robust validation of proposals and for the Company to demonstrate the benefit of each solution. Neville Smith advised that since that meeting the DWI has confirmed their support of these Schemes.

David Howarth advised that the Environment Agency had sent their report on the Company's Business Plan. Neville Smith confirmed that the Company had also responded to the Environment Agency.

Customer Preferences

Nick Sheeran confirmed that his paper detailing Customer Preferences and how they have informed the Company's Outcomes was circulated with the minutes of the last meeting for the CCG to consider.

Paul Barfoot confirmed that he had formally replied to Jon Stuart regarding his question regarding the failure of Smartsources.

3. Technical Assurance

Doug Hunt circulated an updated Technical Note providing a summary of the current findings of the assurance process that Atkins has undertaken for Portsmouth Water's PR14 Business Plan submission.

Doug Hunt provided the CCG with technical assurance on the Company's Cost Efficiency.

Simon Oakley asked if staff costs were included.

Doug Hunt confirmed that staff costs were included in Operational Cost Efficiency, however, he clarified that the technical assurance he was currently providing was in respect of Capital Cost Efficiency. He added that in terms of challenge the Company's Operating Cost Efficiency was 'bullet proof'. In PR09 Ofwat classed them as the most efficient in the Industry, they have outperformed during that period and are using that outperformance to keep bills down by 7% and passing those efficiencies onto their Customers which they don't have to.

Kirk Phillips questioned if the CCG are expected to take a view on the Company's Capital Cost Efficiency within their Report to Ofwat.

Doug Hunt advised that he was unsure if it was within their remit. However, the challenge to make is on whether the Company's proposals on Capital Cost Efficiency are sufficient or could they cut costs.

John Havenhand commented that from Doug Hunt's Technical Note he concluded that there did not seem to be a lot of scope to cut costs.

Doug Hunt confirmed that was right, if the Plan is refused the Company would need to review the level of Capital Maintenance.

John Havenhand commented that to cut costs now would build problems for the future.

Simon Oakley asked if during the research Customers were informed that they could expect a continual improvement / maintenance of assets in return for a bill increasing by RPI?

Doug Hunt confirmed that yes; bills will be inline with inflation and will finance capital expenditure.

John Havenhand asked for the word 'assumed' to be removed from the following sentence within the Technical Note; 'This has implications when the results are being used to rank preferences according to 'willingness to pay', as higher cost items with a larger benefit can usually be *assumed* to tend to attract a higher WTP.' He commented that any views / reports should be based on facts not assumptions. Doug Hunt agreed he would reword this.

DH

Doug Hunt advised that his Technical Assurance Notes will form part of the CCG Report.

Milo Purcell commented that Ofwat had changed their methodology on how it measures Opex and Capex. The new model is trying to bring the two together to alter the balance and the way the Company allocates work to Opex/Capex. He asked Doug if this change has resulted in the Company changing their approach to activities. He advised that he doesn't believe it has but thinks totex has introduced uncertainty.

Doug Hunt advised that the only change made was in respect of Metering. The Company now included this within Capital Costs and agreed that Totex has introduced a big uncertainty. He explained that Totex has exceptional items to strip out which can cause problems because if they are not accepted by Ofwat this could drastically change the Company's position.

David Guest agreed but advised that it was outside the remit of the CCG and would be up to Ofwat to decide

Doug Hunt suggested commenting on this within the CCG Report.

Milo Purcell asked if the Company's Technical Programme is aligned with that of the long term.

Doug Hunt confirmed that yes; their proposal is inline with the long-term modeling and will include a clear statement to that effect in the Report.

NJS and PAB joined the Meeting

4. Customer Research Sub-Group Feedback

Doug Hunt circulated a Technical Note following the Sub-Group meeting held on the 8 November 2013.

Peer Review

Doug Hunt advised that the Peer Review Report by Accent was discussed at the Sub-Group meeting and it was generally agreed that it supported the approach and methods that have been adopted by MVA. He explained that this was expected as the Company had generally used methodologies that are currently used as standard within the Water Industry.

John Havenhand commented that inaccuracy comes in when research is used to inform incentives, rewards/penalties.

Nick Sheeran confirmed that Ofwat expects the Company to do just that. John Havenhand advised that if that was what Ofwat wanted he didn't have a problem with it.

Kirk Phillips commented that he did not feel it necessary to include the Accent Report as an appendix in CCG Report. He thought it would be sufficient to just note in the Report that it had been completed.

John Havenhand advised that he was reassured that Accent found the same uncertainties with MVA's Research as the Sub-Group.

Doug Hunt advised that he disagreed with Accents' Conclusion, although it may be academically correct, in terms of finding out customers' views the research was acceptable.

John Havenhand agreed that you Shouldn't always follow the science but use judgement.

Acceptability Testing

Doug Hunt advised that the Acceptability Testing results were overwhelmingly high and highlighted that almost all Domestic Customers consider the Company's Draft Business Plan to be acceptable in its entirety, as do the vast majority of Business Customers.

Milo Purcell commented that the results of the Acceptability Testing make it difficult for Ofwat to challenge.

Outcomes

Doug Hunt advised that the Sub-group challenged MVA's Methodology on Outcomes and asked the Company to provide further information in relation to the following two questions:

1. Does the research provide support for the inclusion of the monetary outcome delivery incentives (ODIs) that are being proposed?
2. Can the Company justify the level of financial rewards that are being proposed based on this research?

Nick Sheeran advised that MVA had responded and he will circulate later in the meeting.

NJS

John Havenhand requested wording be put in the CCG Report that the Methodology was agreed and results needed to be taken with caution.

Kirk Phillips thought the word caution was too heavy and asked for 'a degree' of caution to be included along with a statement commending the Company's effort and innovation.

Doug Hunt suggested including a statement that confirms that whatever proposals there were to come up with methodology it has been acceptability tested to a high standard and therefore the only challenge left is how it is translated into Incentives.

Nick Sheeran advised that the research highlighted that Customers do believe the Company should have penalties/rewards for under/over performance.

Milo Purcell expressed that he was anxious bringing together the testing of Outcomes and developing Incentives. Does not want the CCG's confidence in the Company's Outcomes to be undermined. CCG Report needs a strong

statement to say there is evidence that Customers support Outcomes but its just the matter of the Company's performance in delivering Outcomes.

Paul Barfoot advised that there will be an item on Incentives later in the meeting for them to challenge.

NJS and PAB left the Meeting

5 - 6 CCG Draft Report & Discussions on the Draft Business Plan

Doug Hunt issued the latest version of the Draft CCG Report for comments. He took the CCG through the Report section by section and highlighted key items.

He advised that he would add development of incentives to the bullet points within Section 2.2.

Kirk Phillips questioned if Customers were asked to comment on Incentives.

Doug Hunt was unsure and confirmed that it was something Ofwat asked for. He advised that there was an item on Incentives later in the meeting and it may come to light then.

Doug Hunt was of the opinion that the CCG didn't seem confident in WtP and asked if this should be commented on within Section 2.3 of the Report?

David Howarth expressed that he didn't feel qualified to make such a criticism.

John Havenhand commented that although not qualified they could recognise that the Company followed good practice nevertheless judgement needs to be made.

Chris Manning advised that the Accent Report highlighted WtP was difficult and didn't have any better ideas. Therefore the research MVA completed is as good as we can expect.

David Howarth commented that the Peer Review has therefore done the job that CCG are not qualified to do.

Doug Hunt advised that he will include in the Report that the Peer Review didn't have any better ideas.

Doug Hunt raised an issue that came out of the Sub-Group about the Acceptability Testing including leading questions. He informed the CCG that the Company first informed Customers that they had the lowest bills in England and Wales before asking if they found a bill only increasing by inflation acceptable.

John Havenhand confirmed that the Sub-Group did challenge this but were satisfied with the Company's response that Customers need to be informed to be able to answer.

Simon Oakley asked what the RPI increase was going to be spent on.

Doug Hunt advised that the Business Plan is put together in real cost terms. Therefore, RPI is to allow for future cost increases on what they have to pay for e.g. wages, construction, power.

Kirk Phillips commented that RPI can also be negative so should it say the bill will be plus or minus RPI.

Doug Hunt advised that Customers will effectively be getting a bill with a hedge

against inflation input costs.

Doug Hunt confirmed that he would add some more to Section 2.4.2 on the challenge made on RPI.

David Howarth expressed concern that the Research seems to disconnect from the Company's proposals. He commented that the Research highlighted Customers were willing to have an increase in bills for improvement. However, the affordability priority is that the Company only increasing bills at a rate no higher than RPI. Where's the link, 'golden thread'?

Doug Hunt advised that there is inherent tension between WtP/Preferences and has commented on this within Section 2.4.2 of the Report as follows;

'On the face of it this would appear to indicate the Portsmouth has not proposed a Business Plan that is in line with customer preferences, as greater improvements could have been proposed in areas such as leakage whilst maintaining bill increases to within the amounts that were allowed for in the aggregate WTP. However, it is clear from the evidence that the Company presented to the CCG that the need to ensure asset stewardship (in the form of some increases in non-infrastructure capital maintenance costs) and meet statutory obligations meant that only modest service measures improvements could be considered without rises in bills beyond RPI inflation. This meant that there was an inherent conflict between the aggregate results of the WTP studies and the interpretation of the affordability priority. The CCG therefore has some differing opinions on this point, which are highlighted below in relation to the interpretation of leakage and water efficiency preferences.'

David Howarth reiterated his concern and commented that he felt the Company were listening to Ofwat rather than what the Customer wants.

John Havenhand agrees but commends the Company in using their judgement not to increase Customer bills. He confirmed that the Acceptability Testing shows that Company got it right.

Doug Hunt summarised that the Company made a judgement call and has come up with a Plan that is acceptable to their Customers.

Charles Burns asked if the CCG should include in their Report that they accept a bill with an increase no greater than RPI but hope it to be less.

Doug Hunt advised that if the Company outperform they will give this back to their Customer.

Simon Oakley asked if there should be a comment in their Report regarding the use of RPI and noting that it is an unstable measure of income.

Doug Hunt advised that it was not within the CCG's remit to challenge Ofwat's measuring mechanism. However, challenge can be made on efficiencies and he will make that clear in their Report.

Doug Hunt enquired if the CCG were satisfied with the leakage preference.

David Howarth commented that they can't blame the Company for position/decision made.

John Havenhand suggested adding the wording 'Company's judgement' as it was the research informing the decision as opposed to direct link.

Doug Hunt asked if the CCG were happy with the Company's interpretation of Customer priorities

Leakage
Water Softening
Water Efficiency
Metering

Potential service measures improvements relating to customer contacts, hosepipe bans, interruptions to supply and enhanced cross-subsidies to vulnerable customers were found to be of a lower priority within the stated preference surveys, so enhancements to these service measures were not considered to be a customer preference.

David Guest asked for clarification on where social tariffs for vulnerable Customers were included in the Business Plan. Doug Hunt noted to ask the Company.

Doug Hunt advised that he didn't think there were any areas of concern outstanding in Section 3 and asked for the CCG's consensus that it would be closed off as agreed. The CCG were in agreement.

Doug Hunt commented that the only outstanding item is for the Company to provide final KPI's and ODI's and he would ask the Company for those later in the meeting.

David Howarth commented that the two Outcomes on being attractive to Investors and Health and Safety were not generated from Customer Engagement. They were driven by Stakeholders and the Company. He noted that they were both valid and good but suggested it would be worth noting in the Report that the CCG are supportive of these even though they had not arisen from Customers, in case Ofwat challenge them.

Doug Hunt advised that the CCG had broadly agreed the scope for Section 4 and it would include high level Assurance taken from Atkins Technical Assurance Notes.

Doug Hunt asked David Howarth and Milo Purcell if the EA and DWI Letters could be summarised in Section 4.2.2 and appended to the Report. They both confirmed that this would be acceptable.

Doug Hunt advised that the Capital Programme proposed is essentially to maintain service levels as they are for AMP6 inline with Incentives. He asked the CCG if he could confirm they are happy with this and he would comment on in Section 4.2.1, the CCG confirmed they found this acceptable.

David Howarth raised concern over Section 4.2.3 on Affordability and Value for money commenting that he felt uncomfortable and that it was outside the remit of the CCG. He advised that the CCG can confirm from the Research and evidence provided by the Company that Customers view it as value for money.

Doug Hunt noted that he needed to include in Section 4.3.1 Milo Purcell's earlier statement that the five year Plan aligns to the long term view.

Doug Hunt asked if the CCG felt they had received enough information to complete Section 4.3.2 on Balancing Risk.

David Guest commented that the Company advise they do have a Risk Register in place.

Kirk Phillips suggested asking the Company for a copy.

Milo Purcell advised that the Company have discussed Risks with the CCG indirectly in respects of water quality, water resources and operational issues.

He feels the CCG have sufficient evidence to say they have interacted with the Company on Risk during the Engagement Process. He suggested a comment be made in the Report that the CCG explored and challenged risks throughout the process.

Simon Oakley suggested noting in the Report that RPI is a risk.

Doug Hunt advised that if the Company start to encounter risks as a result of RPI they could approach Ofwat to change mechanism. He also commented that the Business Plan itself is a risk process.

Milo Purcell left the meeting.

Portsmouth Water Representatives joined the meeting: Paul Barfoot, Heather Benjamin, Mike Kirk, Terry Lazenby, Nick Sheeran, Gareth Simmonds and Neville Smith

7. Update on Financeability

Nick Sheeran circulated a paper updating the CCG on financeability and providing clarification on the assumptions made.

Doug Hunt questioned the efficiency being 1.85% in year two. Nick Sheeran explained that was coming off the Company's computer mainframe currently costing £400k per annum. He advised that they only put some of the saving through due to potential risks and cost of new systems.

John Havenhand asked what the implication of the Cost of Capital being higher than Ofwat expected.

Nick Sheeran confirmed that as previously advised it could be potential red flag with Ofwat but the Company feels they are telling Ofwat a good story regarding Cost of Capital, e.g. possible refinancing and not taking legacy efficiencies from previous AMP.

John Havenhand asked what if Ofwat don't agree, what's the Plan B?

Neville Smith confirmed it would result in a reduced service and Nick Sheeran added the Company would have to cut Capex.

8. Incentives / Penalties / Values

Gareth Simmonds circulated a paper on the Company's Financial Incentives. He advised that the Company decided the following Outcomes would have incentives;

Leakage
Water Efficiency
WFD

David Howarth raised concern that expressing leakage as a percentage was inaccurate as a performance measure as it was influenced by other components of water balance e.g. large Customers.

Gareth Simmonds confirmed the Company can translate the percentage to an absolute target as the percentage was just used as part of the WtP exercise.

John Havenhand asked if these financial rewards / penalties were really an incentive.

Gareth Simmonds agreed they were relatively small amounts, however, Ofwat outline what should be financial or reputational incentives. These financial

areas are those customers have prioritised.

Neville Smith advised that the penalty doesn't necessarily drive the Company but the reputational the same as SIM.

David Howarth highlighted the water efficiency incentive had no reward.

Gareth Simmonds commented that it was difficult to measure accurately and therefore the Company didn't feel comfortable having a reward on that basis.

Simon Oakley asked who will be measuring these.

Gareth Simmonds confirmed that the Company Self Report and External Assurance is provided to the Board.

9. **Outstanding Actions for Company and CCG**

Doug Hunt raised the following outstanding questions that CCG had for the Company to enable them to complete their Report.

How are social tariffs for vulnerable Customers included in the Business Plan?

Paul Barfoot advised that the Company are currently looking at and plan to follow Southern Water's model being piloted from 1 October. The Company feels it's important that Customers can save on both bills through one application.

David Guest asked if the Company can give the CCG comfort that risks have been evaluated.

Neville Smith advised that it doesn't expect anything to arise, however, should a new obligation arise the Company can get approval to get an increase. If Ofwat want to reduce Cost of Capital because of embedded debt the Company may be at risk. However, there is a substantial effect clause in licence that could be exercised.

David Guest commented that the CCG had not been privy to mitigation plans.

Neville Smith reassured the CCG that the Company does have Risk Registers, Risk Assessments and Emergency Plans.

David Guest advised that CCG had discussed this but decided how the Company mitigates risk was not within their remit.

Simon Oakley commented that RPI poses a risk.

Neville Smith agreed that if RPI became negative it would cause problems if it continued.

Nick Sheeran circulated MVA's response to the Sub-Groups challenge as promised earlier in the meeting.

Timetable

Doug Hunt informed the CCG that he planned to send the Final Draft CCG Report to Members by Monday 18 November 2013. He would allow one week for Members to make comments/representations and an additional week to finalise the Report and add the relevant appendices ready for submission to Ofwat on 2 December along with the Company's Business Plan.

Terry Lazenby on behalf of Board thanked the CCG for their input and felt the Company had a better Business Plan for it.

Action

David Guest also thanked the Company for cooperation and information aiding the CCG throughout the process.

Neville Smith advised the CCG that a revised version of the High Level Business Plan was included with their papers for information.