



**PORTSMOUTH WATER LIMITED**

**Water Resources Legacy RCV Allocation  
Initial Submission**

**January 2018**

## Water Resources Legacy RCV Allocation – Initial Submission

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### 1. Purpose

This document updates Portsmouth Water's initial assessment of its wholesale Regulatory Capital Value (RCV) allocation between Water Resources and Network Plus for the forthcoming Periodic Review Process, PR19 based on initial comments from Ofwat.

In particular we have been advised that our submission should have included Table WS12b. This note updates our initial submission.

### 2. Background

As required in the draft Methodology Statement published by Ofwat in July 2017, and confirmed in its final Methodology Statement, December 2017, the Company provide this submission to allow Ofwat to review and provide feedback on our assessment in preparation for our Business Plan in September 2018.

### 3. Summary

We have considered the alternative approach to this allocation suggested in the "Technical Guidance on Water Resources pre 2020 RCV Allocation at PR19," published January 2017. We conclude that an unfocused approach, based on net Modern Equivalent Asset Values (MEAV), is appropriate for Portsmouth Water.

This results in an allocation of the RCV to Water Resources of less than 3% as at March 2020.

We have undertaken cross checks against our Capital Expenditure assessments for recent years and reviewed against our existing tariff structures to confirm this conclusion is consistent with other Company data. We confirm that there is such consistency. This is described further below.

Further we provided data, derived from our Regulatory Accounts and Annual Performance Review, to complete Table WS12b.

### 4. Our Approach

- a. We have first considered the issue of whether a focused approach to allocating the RCV to Water Resources or an unfocused approach is most appropriate, and conclude and agree with Ofwat that an unfocused approach is the most appropriate given in particular the scale of the RCV discount at privatisation relative to the existing MEAV estimates.

Taking the net MEAV at 2020 for water resources of £33.461m relative to the total wholesale net MEAV of £1,245.691m gives a percentage for water resource of 2.69%. Applying this to the assumed RCV of 147.488m we calculate the RCV for Water Resources as at 2020 to be £3.962m.

A focused approach would imply that the net MEAV of £33.461m is allocated to Water Resources which would result in a 22.69% allocation of the RCV.

This second position is not consistent with our cross checks and indeed our view that our water resource assets are relatively simple and small in value given all of the assets we own and operate.

- b. Next, we have considered alternative approaches to determine the unfocused allocation and comment on each in turn below.

The January 2017 Ofwat paper suggested 7 possible approaches which we look at in turn:-

- i. Based on net MEAVs – this is our chosen approach. We have undertaken a desktop exercise to review the revaluation exercise we performed for PR09. We can confirm that, generally, the allocation of assets to each business unit is appropriate.

Given the aggregation of all elements other than Water Resources into Network Plus, we are confident that our starting point, the MEAV exercise for PR09, is a solid foundation for this exercise. The value of our Water Resources MEAV therefore appears sound for this process.

We have rolled this position forward to 2014/15 by recognising any additions/disposals and depreciation adjustments, as reported in our Regulatory Accounts. We therefore conclude that our starting position for this exercise, the 2014/15 MEAV for Water Resources in particular is well founded. This is detailed in Table 6 of this paper.

We have re-assigned our transfer from Havant & Bedhampton Springs from distribution to water resources as required in the 2016/17 guidance. The value of this transfer is £21m (net of depreciation). This was confirmed as the appropriate allocation category following discussions with Ofwat staff in the process of re-presenting our Cost Assessment data for the period 2011/12 to 2016/17 to Ofwat on 30 November 2017.

- ii. We have chosen the net MEAV approach over an approach using gross MEAVs as this is similar to the building block approach to setting prices for customers.

By this we mean that the RCV increases each year to reflect addition to the capital value, but is similarly reduced by the depreciation assumed in determination by Ofwat. Gross MEAVs do not capture the depreciation component and are not consistent with the building block approach.

The table below shows the impact on the 2020 RCV of the two alternative approaches to establish the RCV, using MEAVs, relative to the assumed RCV of 2020 of £147.5m.

**Table 1 – 2020 RCV Allocation options– Net MEAV and Gross MEAV**

£m	Water Resources	Network Plus	Total	Water Resources % of Total
RCV based on Net MEAV	3.962	143.526	147.488	2.69
RCV based on Gross MEAV	5.808	141.680	147.488	3.93

We conclude that the percentage allocated to Water Resources is more accurately reflected in the Net Assessment, given, for example, our recent capital expenditure on water resources, see Table 2 below.

- iii. We also considered splitting the pre privatisation assets at a discount to RCV and allocating the post privatisation assets at full value. Whilst in principle this should give a good position of the value of Water Resources – we find that our asset register in the 1990s in particular is not set up to establish these values with confidence. Typically our asset register did not differentiate the different business units as defined in recent years.
- iv. We have looked at the capital expenditure on water resources reported for AMP5 and AMP6 to date (in outturn prices) and can confirm that the proportion of capital expenditure to Water Resources over the entire period is 3.5% of the total.

**Table 2 – Capital Expenditure on Water Resources**

£m	Water Resources	Capex	Water Resources % of Totex
2010/11	0.080	9.552	0.8
2011/12	0.326	3.951	8.3
2012/13	0.454	10.137	4.5
2013/14	0.537	5.247	10.2
2014/15	0.064	4.979	1.3
2015/16	0.148	9.343	1.6
2016/17	0.275	10.186	2.7
Total	1.883	54.218	3.5

This gives us comfort on our proposed value for water resource assets as you would broadly expect the capital expenditure to be of a similar proportion to the asset value. In particular the recent percentage for AMP6, 2015/16 and 2016/17 for Water Resources relative to total capex, is 2.2%.

- v. We next have considered an approach using projected expenditure. However, we know that a key difference between historical and future assets will be the construction of a significant new water resource asset, Havant Thicket Winter Storage Reservoir (HTWSR) to be commissioned in AMP8. The provisional cost estimate for this project is £90m and will add 60% to the capital value of the business.

It is therefore not an appropriate approach to allocate the pre 2020 RCV with accuracy as it would allocated a significant sum to Water Resources such an approach would be appropriate in a more steady-state situation.

- vi. Further we concluded that an assessment based on forward looking revenue, or Economic Value, would similarly exhibit the same issues as (v) above.

For the reasons given in (v) we have not pursued this – especially as the HTWSR will essentially be funded by a bulk supply tariff, paid for by Southern Water, which has yet to be agreed.

- vii. Finally we have concluded that any hybrid approach, which combines the methodologies listed above, would not be appropriate given our reasoning on each above.

Our strong preference is to use (i) the net MEAV as it gives a consistent view of value across our asset base and mirrors essentially the Ofwat building block approach.

## 5. Table WS12b

Table WS12 has been completed and submitted as requested. This asks for data relating to 2016/17. It has been taken from the audited data from both our Regulatory Accounts, published July 2017, and our Cost Assessment submission to Ofwat on 1 December 2017.

Both of these submissions were audited by either our financial auditors, Saffery Champness or our engineering adviser, Atkins. Our accounts were signed off by the Board in June 2017 whilst the Cost Assessment submission was signed off prior to its initial submission in August 2017.

To complete Section A of Table WS12b, we have looked at the operating costs and current cost depreciation for each business unit, as shown in the table below. Given total wholesale revenue of £33.516m, we can establish the “actual” return on each business unit to be £4.774m, which is allocated to each business unit in proportion to the net MEAV.

**Table 3 – Wholesale Revenue by Business Unit (2016/17)**

£m	Water Resource	Raw Water Distribution	Water Treatment	Treated Distribution	Total
Operating Costs	3.572	0.328	3.949	14.782	22.631
Current Cost Depreciation	0.488	0.284	2.929	2.410	6.111
Implied Return	0.135	0.061	0.176	4.402	4.774
Implied Revenue	4.195	0.673	7.054	21.594	33.516
<i>Revenue split</i>	<i>12.52%</i>	<i>2.01%</i>	<i>21.05%</i>	<i>64.43%</i>	<i>100.00%</i>
MEAV	33.800	15.221	44.030	1102.349	1195.400
<i>MEAV splits</i>	<i>2.83%</i>	<i>1.27%</i>	<i>3.68%</i>	<i>92.22%</i>	

Next we have looked at the three classes of customer reviewed in Table WS12b, all wholesale customers, those where a discount is applied and bulk supplies. Statements are given below on each of these issues.

**Table 4 - Unit cost by Business Unit (2016/17)**

		Water Resource	Raw Water Distribution	Water Treatment	Treated Distribution	Total
Wholesale Revenue	£m	4.195	0.673	7.054	21.594	33.516
Wholesale Volume	MI					53045
Unit cost	£/m3	0.079	0.013	0.133	0.407	0.632
W Rev at discounted rates	£m	0.477	0.076	0.802	2.590	3.945
W Vol at discounted rates	MI					6030
Unit Cost	£/m3	0.079	0.013	0.133	0.430	0.654
Bulk supply revenue	£m	0.022		0.038		0.060
Bulk supply volume	MI					423
Unit Cost	£/m3	0.052		0.09		0.142

In total we “sold” 53,045 MI in the year 2016/17 with an implied unit price of 63.2 pence / m3. This is heavily influenced by the estimate of the volume of water we sell to unmeasured households as shown in the table below.

**Table 5 – Volumes and Revenue by customer class (2016/17)**

	MI/d	MI pa	£m	Unit cost £/m3
Total	145.33	53045	33.516	0.632
Discounted	16.52	6030	3.945	0.654
Bulk supply	1.16	423	0.06	0.142

Our intermediate and large users are the only customers who pay a discounted rate. The unit price for these two groups is 65.4 pence / m3. Our current bulk supply to Southern Water is at a price of 14.2 pence / m3.

This detail has allowed us to determine the water resources / network plus split required in Table WS12b.

As noted elsewhere in this paper we have not chosen to change the implied RCV split and thus Section B has entries of zero of Table WS12b.

Finally in Section C we provide detail of our one water resource scheme which will be commissioned in the period 2020-25 at Worlds End.

## 6. Other Issues we have considered

### a. Definition of Water Resource

The Company has undertaken a desktop study to review the allocation of its PR09 MEAV exercise, undertaken by ARUPs, compared to the Regulatory Accounting Guidelines 4.06 and concludes that, for Water Resources the assessment is well founded. We have not undertaken any historical adjustment to the MEAV exercise other than the re-classification of the raw water transfer highlighted above.

### b. Impact on Wholesale Tariffs

To understand the balance of wholesale tariffs between households and large users and potable and non-potable services, we have provided data in table WS12b.

We consider Water Resources at the Company level and tariffs are not in any way, site specific. We do not for example charge customers receiving water from our River Itchen source at Gates Mill a higher price than customers sourced from bore holes to reflect the asset value of the former being higher.

Further we consider that any differential in tariff between household and large users reflects network issues, not Water Resources. Similarly, if we were to offer a non-potable tariff this would reflect treatment costs, not Water Resources.

The unit price of 63.2 p/m<sup>3</sup> provided in Table 4 is influenced by the implied unit price for unmeasured households in particular. Our large and intermediate customers do pay a discount relative to other measured customers, but including unmeasured implies that large and intermediate users actually pay more per unit of water, not less.

We conclude that the allocation of the RCV to Water Resources does not impact on our wholesale tariffs.

### c. Links to Water Resource Management Plan (WRMP)

The draft WRMP19 was submitted to Defra on 30<sup>th</sup> November 2017. We hope to start consultation in February 2018. This will show a significant increase in water resource assets post 2020, and the assessment of that plan will not impact this exercise to allocate the RCV.

All of the actions proposed in our WRMP 14 will have been completed by 2020 and we have made allowances in our calculation for such activities, for example Farlington Wastewater Recovery Scheme in our RCV assessment for March 2020.

Our consultation with other water suppliers has focused on forward looking new schemes to meet their requirements. We do not believe this issues will affect the conclusions of these options in our WRMP.

### d. Bulk Supplies

By 2020 the Company will have two bulk supplies in operation with Southern Water.

Both have been agreed on a commercial basis under pinned by the principles outlined in this methodology, i.e. an unfocused approach to allocating the RCV.

Future bulk supply tariffs which will apply as of 2023 and 2028 for example will again be commercial agreements and are likely to reflect the cost associated with making the additional water available. Specifically the 2023 tariff will need to reflect the development of Worlds End source, whilst the 2028 tariff will reflect that of Havant Thicket.

We do not believe this issue will affect our current bulk supply tariffs, nor our future arrangements with Southern Water.

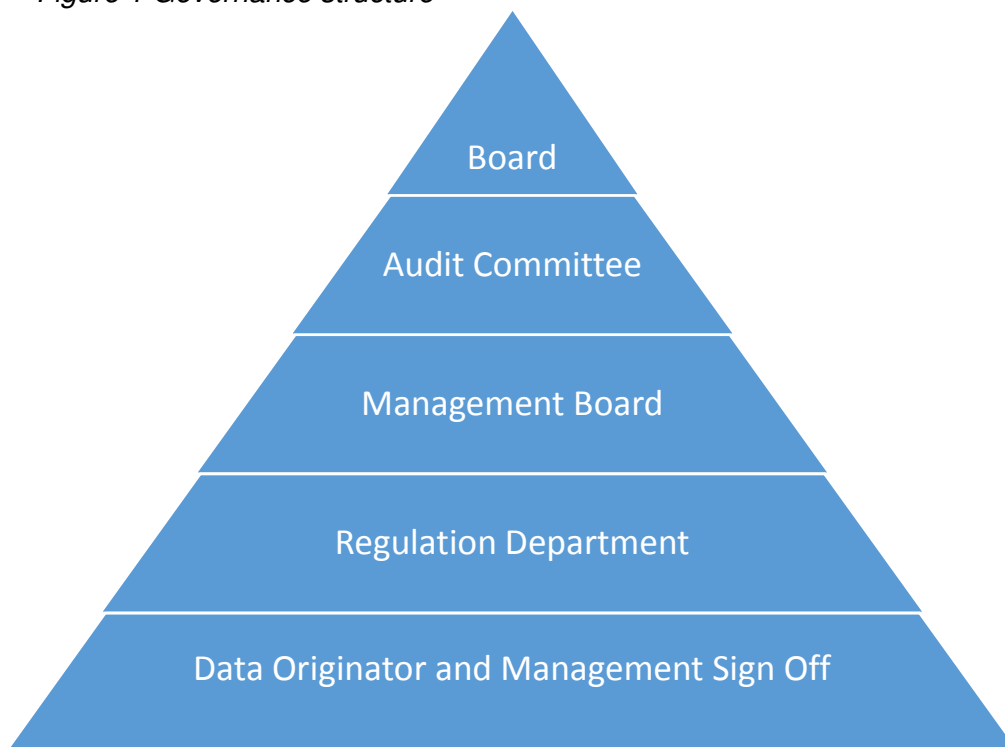
## 7. Assurance approach

This submission is underpinned by our existing assurance framework and processes. Ofwat has acknowledged that Companies and their Boards are best placed to identify the risks, strengths and weaknesses associated with providing data and information as part of regulatory reporting requirements.

The governance, controls and activities that support our regulatory data reporting also underpins the preparation of the tables submitted.

Within the business we have well-established governance and accountability processes in relation to regulatory data submissions. This is shown in Figure 1.

*Figure 1 Governance structure*



Supporting this process is an audit framework designed to both ensure that standards of data quality are being met and allow monitoring and evaluation of the various aspects of our performance.

This involves:-

- having appropriate governance arrangements
- close involvement by our Board in the assurance process
- the right level of independence in the process to provide third party review and challenge.

Our Assurance approach takes into consideration the level of inherent risk involved in this exercise. We assessed this as low. The MEAVs were independently calculated by ARUPs and reviewed by Atkins at that time. This is incorporated into the financial statements and reviewed and signed off by Auditors Saphrey Champness.

Specifically, for this data submission the key assurance processes have been:

- Assessment of the overall underlying data quality and accuracy, including consideration of the risk profile and level of independent assurance to which the data has previously been subject. In particular the underlying asset values have been subject to external assurance by Atkins. The underlying data itself was concluded to be of a high quality and therefore having low risk of material misstatement.
- Assessment of the potential allocation methodologies and appropriate challenge at the executive level by appropriately experienced individuals. The ultimate allocation process chosen is not complex and therefore, the risk of material error in calculations & allocations is judged to be of low risk for assurance processes.
- Consideration of the materiality and, in particular, the sensitivity of the overall allocation and the impact of changes in the definitions of business units.
- Detailed management review, by an appropriately experienced and qualified individual, and challenge of the data submission including re-performance of key calculations.
- Overall analysis to consider the potential impact on the balance of charges between different customer segments.
- Board review and approval including detailed review, at board level, by an appropriately experienced and qualified director with relevant assurance expertise.

## 8. Conclusion

To conclude we address the specific requirements in section 4 of the Ofwat draft Methodology document published July 2017.

1. Our proposed unfocused RCV allocated to Water Resources as at 31 March 2020 is forecast to be £3.962m, 2.69% of the total RCV of £147.488m
2. The 2014/15 net MEAV as per our 2015 Regulatory Accounts, recognising this also includes retail, showing Water Resources as a proportion of total MEAV is given below:-

**Table 6 – MEAV (2014/15)**

	Water Resources	Network Plus	Retail	Total
£000s	11,609	1,125.012	590	1,137,211
%	1.02	98.93	0.05	100.00

3. Detail is provided of how we have moved from the opening position in 2014/15 to the 2020 estimate in the spreadsheet provided.

Specifically we have used our actual 2015/16 and 2016/17 position and budget allowances for capital investment in Water Resources and the company as a whole up to and including 2019/20 and applied to the published RCV as at 2020.

4. An explanation of how the proposed RCV has been established is given in this document. It provides the methodology we have applied to determine the value;

- Discussion of the alternative methods
- The impact on charges

5. Finally we have discussed our view on the impact this assessment has within the WRMP process.

We believe the information we have provided is proportionate to the factors we have considered in making our proposed RCV allocation and our Assurance Statement is attached.

We will publish this document and the Ofwat template on our website and look forward to your feedback.



**Helen Orton**  
**Finance and Regulation Director**  
**31 January 2018**

**Board Assurance Statement on the Allocation of the Forecast RCV at 31 March 2020 to the Water Resources and Network Plus Wholesale Price Controls**

This assurance statement relates to Portsmouth Water's submission on the allocation of the Company's forecast Regulatory Capital Value (RCV) at 31 March 2020 to the proposed Water Resources and Network Plus Price Controls to be determined by Ofwat for the period 2020 – 2025 under the 2019 Price Review (PR19).

It should be considered in conjunction with the Company's submission of Tables WS12 and WS12b and the associated commentary.

The Company is proposing an "unfocused" allocation of RCV at 31 March 2020 based on the share of assets utilised by Water Resources and Network Plus business units, as measured by the net modern equivalent asset values forecast for those business units at 31 March 2020.

Consideration has been given to the issues raised in Ofwat's Technical Guidance on the allocation, issued in January 2017, and the potential future changes in water resources management and expenditure requirements set out in the Company's draft Water Resources Management Plan.

A review of the potential impact on the balance of charges between different customer segments has also been undertaken and its conclusions reflected in the Company's submission.

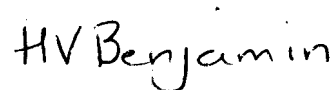
The asset allocation process has been based on that used by the Company for the production of current cost accounting statements and, where necessary, takes into account changes in the definition of business units.

The data underpinning the submission has been subject to appropriate assurance including third party assurance, management review and Board oversight giving consideration of the approach to be adopted and a review of this submission.

On this basis, we are content to provide assurance on behalf of the Board of Portsmouth Water.



**H Orton**  
**Finance and Regulation Director**



**H Benjamin**  
**Non-Executive Director**  
**Chair of the Audit Committee**

**31 January 2018**