

13 Views of Portsmouth

Contents

	<i>Page</i>
Introduction	175
Portsmouth's overview of the determinations	175
Interests of users	178
Financial issues	179
Key expenditure differences	187
Forecast demand	195
Infrastructure charges	197
Other evidence	198

Introduction

13.1. In the course of our inquiry we put to Portsmouth a number of issues relating to the Director's determinations in respect of the company, on which we invited its comments. We also asked the company to tell us what value of K and what level of infrastructure charges it needed in order to secure the proper carrying out of its functions. In addition, we invited its response to evidence we had received about the determinations from the Director, the Southern CSC and third parties and which we had put to the company in summary form as part of the issues letter. In this chapter we summarize, first, Portsmouth's views on the determinations and the issues raised by them and its views on the Director's approach to his determinations. We end by summarizing the company's response to the evidence from the Southern CSC and third parties.

Portsmouth's overview of the determinations

13.2. Before turning to the issues themselves, Portsmouth summarized its position in the following terms. It said that it was the water company with the lowest charges in the country. It operated with the lowest level of costs, was recognized as being among the companies with the highest level of efficiency and had an excellent record of serving its customers. Yet the determination by the Director had resulted in one of the harshest Ks for any water company. In seeking a determination by the MMC, Portsmouth aimed to rectify a number of erroneous projections and assumptions made by the Director in his determination of K which would result in a financially unsustainable situation. Portsmouth sought a K which was more in line with that of the rest of the industry. With charges that did not increase by more than the average for the industry, Portsmouth's customers would not be seriously disadvantaged and Portsmouth could continue to operate to the satisfaction of its customers and investors.

13.3. Portsmouth said that it believed the Director's determination of K would put it under severe pressure to engage in cuts in service standards in order to maintain financial viability. Furthermore, Portsmouth thought it likely that the financial pressures imposed by the Director's determination would have a material adverse effect on its financial prospects. Having now seen in detail the evidence which the Director had produced to support his K determination, Portsmouth believed it was possible to identify for the MMC a relatively small number of factors which accounted for most of the differences

between it and the Director. In the mass of detail generated by the reference, it was worthwhile focusing on these issues. The relevant factors were:

- (a) Revenue projections: the Director had used a demand forecast which assumed [*] per cent a year growth in measured commercial demand from 1994/95 to 1999/2000 and [*] per cent a year thereafter. This was in contrast to a historical trend which showed an average rate of decline of [*] per cent a year. Portsmouth had analysed again the prospects for commercial demand in its area of supply and believed that a [*] per cent a year decline represented a realistic projection of future demand prospects, although it carried considerable risk compared with the historic [*] per cent annual decline.
- (b) The use of the higher demand forecast by the Director had led him to predict revenue under his determination of K that was £[*] million a year higher by 2004/05 than Portsmouth expected given its more realistic projections. This discrepancy amounted to more than [*] per cent of annual revenue after ten years, or more than [*] of current annual operating profits.
- (c) Operating costs, efficiency and real price effect (RPE) assumptions: the Director's operating cost projections had made use of 1992/93 as a base year, which the company had argued was unrepresentative for a number of reasons. Of a difference in operating expenditure projections of £[*] million a year that arose by 2004/05, £[*] million a year was accounted for by the different views which the company and the Director took on the issue of efficiency and the impact of a general increase in real wages in the economy. The Director was seeking efficiency gains beyond those that were necessary or could be achieved without any detriment to levels of service, in order to keep wage costs in check. Being already rated as one of the most efficient companies in the industry, Portsmouth believed its scope for future efficiency gains was much more limited than the Director had assumed. In particular, the company challenged the Director's view that it was possible for the company fully to absorb the impact of rising real wages within a constant total wage bill.
- (d) The application of the principle of comparative competition: Portsmouth believed that, even on the basis of the Director's evidence, the company had been given a K which assumed that its profitability would decline in real terms [*]. This was despite the fact that the company was already less profitable than average compared with the industry and had been repeatedly classified as extremely efficient. Portsmouth believed this contradicted the objective of utility regulation to promote efficiency through replicating the functioning of a competitive market. In such a market, Portsmouth's excellent performance should result in at least average profits and profit growth.

13.4. Portsmouth argued that the proposals for K put forward by the company were modest and its projected levels of operating profit were in fact lower than those assumed by the Director. It followed also that the level of profits sought by the company would not be considered excessive by the Director. The difference, therefore, lay not in the overall level of profit thought acceptable, but in the projections of revenue and costs which underpinned the determination. The MMC were now in a position to satisfy themselves of the reasonableness of the projections presented by Portsmouth, and to ensure that the obligations contained in the 1991 Act were properly applied.

The duties of the MMC

13.5. Portsmouth highlighted a number of the MMC's statutory duties which it considered important.

The need to secure a reasonable return on capital

13.6. The first of these was their statutory duty under section 2(2)(b) of the 1991 Act to have regard to the ability of water companies to 'secure reasonable returns on their capital'. In order to perform

*Details omitted. See note on page iv.

their statutory duties, it was essential that when considering the ability of Portsmouth to finance the proper carrying out of its functions, the MMC should have regard to the specific wording of section 2(2)(b) and should, as a result, consider the ability of Portsmouth to secure a reasonable return on its capital. The wording emphasized the need to have regard to the interests of investors and their need to secure a reasonable return on capital and to balance this against consumer interests. In its December 1994 submission *Portsmouth Water's performance since 1989 in the context of the reform of the privatization of the water industry*, Portsmouth had referred to the 1989 paper published by the DoE entitled *Principles of K Setting*. This paper had placed particular emphasis, in determining K, on the importance of ensuring that proper regard was taken of the need to ensure that water undertakers were able to generate returns on capital which would persuade investors to make and retain investments. The issue of reasonable return on capital was particularly relevant to Portsmouth, with its significant needs for refinancing existing debt in the next five years. It was therefore very important to give due weight to this aspect of the company's financing requirements.

13.7. Portsmouth said that there had been a complete change in the regulatory framework that governed the operation of the former SWCs. From a system of dividend controls and control on the level of reserves-which required only a small equity base-the SWCs had moved into a world of price controls. This system granted increased commercial freedom but also carried with it a considerable commercial risk. Together with increased expenditure required to meet new obligations this necessitated a strengthening of the capital base of all water companies. In the case of the former WAs, this had happened through a major debt write-off, and in a number of cases through generous grants (the so-called green dowries), which let these companies move into the private sector with little or no gearing. In the case of Portsmouth and other SWCs, it happened through the acceptance of a fairly steep increase in operating profits and retained earnings, leading over five years to an increased capital base. Any attempt to undo these arrangements would reverse this development and threaten Portsmouth's ability to finance the proper performance of its functions.

Protecting the interests of consumers was not the only relevant duty under section 2(3)

13.8. Portsmouth's submission to us placed considerable emphasis on the concept of effective competition referred to in section 2(3)(e) of the 1991 Act.

13.9. The MMC were required, Portsmouth said, to determine an appropriate adjustment factor and infrastructure charge for the company having regard to all the duties set out in Part I of the 1991 Act, including all the duties set out in section 2(3). It would be an incorrect interpretation of their duties if the MMC were to have regard principally to the duty relating to the interests of consumers in respect of charges set out in section 2(3)(a), and to read this as more important than the other duties in section 2(3), including the provision relating to effective competition in section 2(3)(e).

13.10. There was no order of priority to be implied in subsection (3). This issue had been discussed during Parliamentary discussion on the clause. Attempts during the committee stage to give an order of priority to these duties had been specifically rejected by the Minister then responsible, Mr Michael Howard. The MMC should have proper regard to all the secondary duties in subsection (3), including that concerning effective competition.

13.11. Portsmouth said that it did, however, acknowledge the concern of consumer bodies, industry representatives and members of the public, particularly over the level of charges in the water industry. It accepted that it had a responsibility towards achieving cost reductions through continued efficiency improvements, and towards customers who found it difficult to meet their financial commitments within very tight budgets. In Portsmouth's view these concerns were best met by a water undertaking that had a proud history of serving its customers with a high-quality service at low cost to them. The fact that Portsmouth had the lowest level of charges of all water supply businesses in the country, was the lowest-cost water business, and yet had a record of high standards of service and customer satisfaction was evidence of its commitment to meet the concerns of its customers.

Facilitating effective competition

13.12. In view of the emphasis placed on the duty to facilitate effective competition in Portsmouth's submissions, the company was particularly concerned that the MMC should address this issue. It was the duty which the Director's determination most seriously failed to respect, by imposing one of the harshest K settlements on the company with the lowest costs and charges, one which delivered a high quality of service to its customers but whose profitability was well below industry average.

13.13. The performance of Portsmouth was a model of how a company in a regulated environment should be allowed to succeed. The regime was one where superior performance—that resulted in benefits to customers—deserved to be rewarded, not penalized. Portsmouth's performance was superior by any yardstick.

13.14. Respect for the duty to facilitate effective competition could not be consistent with a determination which forced Portsmouth's profits down still further until it rapidly reached a position where it was no longer able to finance the proper performance of its statutory functions by earning a reasonable return on capital.

Redetermination not arbitration

13.15. Whilst it accepted that the MMC might wish to examine the methodology and assumptions used by the Director, Portsmouth said that it should be borne in mind that the MMC's role was not simply to assess the reasonableness of the Director's methodology and position, but rather it was required to carry out its own determination of an appropriate K using whatever methodology and assumptions it considered appropriate, in the light of the particular circumstances of Portsmouth. In considering whether the Director's determination was sufficient to enable Portsmouth to carry out its functions properly, the MMC should not limit their role to that of adjudicating between the Director and the company, but should rather carry out their own determination.

Interests of users

13.16. Turning to the issues themselves, Portsmouth addressed, first, the suggestion that, despite the current relatively low charges, users were unwilling to pay the higher charges as sought by Portsmouth, and that higher charges could give rise to problems of affordability.

Portsmouth's low charges

13.17. Portsmouth said that its current average household bill was £67 a year. The K proposed by Portsmouth would result in an annual increase of only 74p above the rate of inflation to the average household bill. Portsmouth recognized that some of its customers did have genuine problems of affordability. However, its current average household bill was already the lowest in the country, 27 per cent lower than Southern's average water bill, and the proposed increases were substantially below the level of increases that the Director had authorized for other companies with much higher existing levels of charges. It was, therefore, highly likely that the problems of affordability were, and would remain, much less significant in Portsmouth's supply area than in most other parts of the country.

Affordability and levels of service

13.18. Portsmouth noted that many of the comments made to the MMC by the Southern CSC on affordability (see paragraphs 12.31 to 12.34) appeared to relate to the sewerage charges levied by Southern Water, or to be directed at the average national level of water charges or water charges in the Southern region generally, rather than being focused on Portsmouth's charges.

13.19. Whilst it was a matter of regret to Portsmouth that 47 of its customers considered that its charges were too high, the fact that such views were expressed by only 47 out of a total customer base of 260,000 was a reflection of Portsmouth's position as a low-cost, low-bill supplier. The increase in charges was required to maintain services at their current level, not to improve them. Overall, customers had expressed a high level of satisfaction with Portsmouth's services in the Market Plan survey.

Responses to payment difficulties

13.20. In Portsmouth's experience, the instance of genuine problems of affordability in the Portsmouth supply area was low and most of the bad debt problems encountered by the company had been situations of 'won't pay' rather than 'can't pay'. Nevertheless, Portsmouth was sensitive to cases of genuine payment difficulties and offered a range of interest-free payment options including once annually, twice half-yearly, up to eight monthly instalments by direct debit, and monthly, fortnightly or weekly instalments. These options greatly assisted customers to meet their bills.

Financial issues

Initial value

13.21. We first asked Portsmouth what was the appropriate initial value for the company, and why the initial value adopted by the Director would adversely affect the ability of the company to finance its functions.

13.22. Portsmouth said that it believed, to finance its functions, it required a K more in line with the industry average. The very serious implications of the Director's determination of K for the company resulted not primarily from the initial value chosen by the Director, but from the unrealistic revenue and cost assumptions he had adopted. It was the view of the company that the MMC's determination had to be based on reasonable and defensible projections of Portsmouth's revenues and costs over the period 1995/96 to 2004/05. Portsmouth had submitted evidence which illustrated that the assumptions used by the Director were not reasonable.

13.23. In order to support an acceptable operating profit profile, a capital value for the company was required which was consistent with the regulator's target rate of return. Such a capital value would enable the MMC to relate their determination back to the approach adopted by the Director. The calculation of this capital value was highly sensitive to the assumptions used, in particular to the level of capital expenditure allowed. For modelling purposes, Portsmouth had estimated the capital value using the Director's methodology, but based on the company's submission to the MMC. This capital value was as shown in Table 13.1.

TABLE 13.1 Capital value for Portsmouth

	<i>£ million</i>		
	<i>March 1995</i>	<i>March 2000</i>	<i>March 2005</i>
Required capital value	[<i>Figures omitted.</i>	
The Director's determination		<i>See note on page iv.</i>]

Source: Portsmouth.

13.24. To generate acceptable operating profits under the projections used by the company, the capital value in the Director's methodology needed to be approximately [*] per cent higher than the level set by the Director. The small size of this discrepancy showed how sensitive the methodology was to the fixing of capital value.

*Figure omitted. See note on page iv.

13.25. If capital expenditure assumptions used for financial projections were different from those contained in the company's submission, the appropriate level of the capital value had to be recalculated. Because of the paradox of the Director's approach, Portsmouth required a higher starting capital value if future capital expenditure was disallowed, so that, overall, an adequate level of earnings could be established.

13.26. Portsmouth said that the Director had recognized the degree of subjective judgment involved in determining initial values for WoCs. Initial values had been adjusted for some companies if the Director considered that their financial ratios required this. It was this approach which had led independent financial analysts to refer to a 'substantial fudge factor in the methodology'.

13.27. Portsmouth said that it had provided ample evidence to demonstrate that it was less profitable than the average for the industry as a whole. This was shown in Figures 13.1, 13.2 and 13.3. Despite this evidence, the Director had implied that the company was more than averagely profitable. The company believed this demonstrated the sensitivity of the results for Portsmouth to the particular initial value chosen, and that the Director must have set Portsmouth's capital value lower, relative to its true capital value, than the average for the industry as a whole.

Rate of return

13.28. We asked Portsmouth what was a reasonable rate of return on new investment and hence on total assets valued as appropriate.

13.29. Portsmouth said that it would be instructive for the MMC to compare the Director's financial projections for the company and those proposed by the company in its submission. These showed that the level of current cost operating profit considered adequate by the Director was in fact higher than that proposed by Portsmouth in its own submission to the MMC. While the whole basis of the company's submission was that it did not believe the levels of profit assumed by the Director were in fact attainable under his determination of K, Portsmouth invited the MMC to note that on the basis of the evidence provided by the Director there appeared to be no dispute between the company and the Director over the appropriate level of profit for Portsmouth, only over the relevant assumptions which needed to be incorporated in the financial projections, in order to ensure that this level of profit could be achieved in practice.

13.30. So far as the rate of return on new investment was concerned, Portsmouth said that it must earn the full and appropriate weighted average cost of capital (WACC) on all new investment. The advice received by the industry as a whole, and put to the Director in a series of submissions in 1993, was that the appropriate WACC for a water-only undertaking was 8.5 per cent in real terms after business taxes.

13.31. However, it was the view of Portsmouth that ultimately the company's ability to continue to finance its functions depended upon the rate of return that it was permitted to earn on all its investments, not just on the new investment. Therefore it was not possible to assess the rate of return permitted for the company as a whole in isolation from the decisions made regarding the capital value of the company for regulatory purposes.

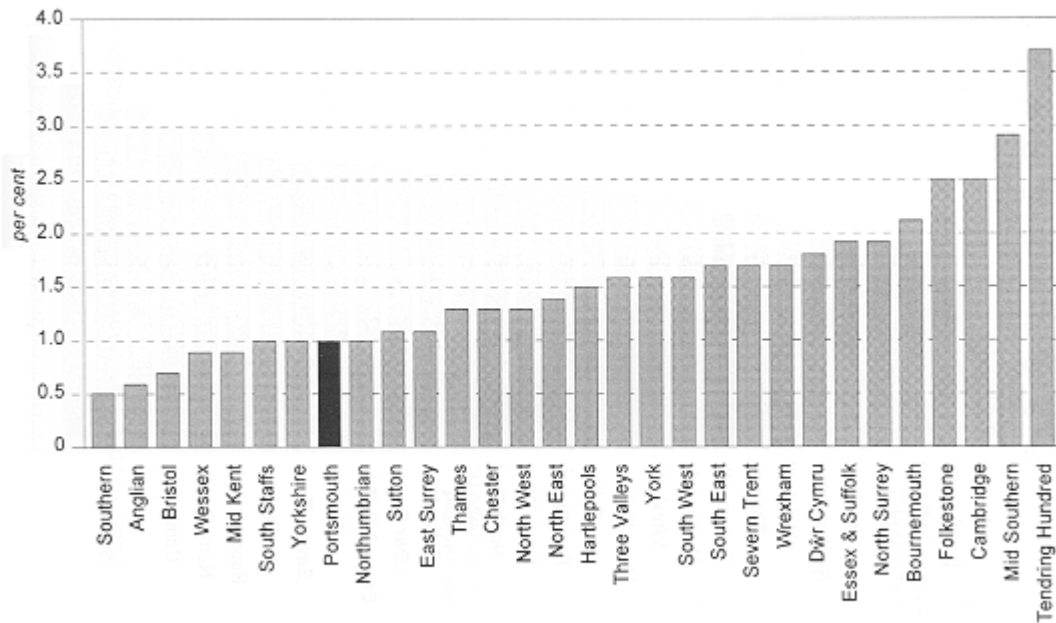
13.32. At 31 March 1994 the net value of Portsmouth's assets measured on a current cost basis stood at £517.85 million. Current cost operating profit in that year was £5.57 million. This represented a rate of return on assets-paid for by private sector investors and currently providing the Portsmouth area with its water services-of less than 1.1 per cent a year in real terms.

13.33. The capital value set by the Director for Portsmouth for March 1995 was £[*] million, less than [*] per cent of the true cost of the assets of the company. It was clear, therefore, that the apparent rate of return which the company was said to be earning on its regulatory value was extremely sensitive to the precise value decided upon by the Director. Any similarity between this capital value and a market value did not constitute evidence supporting the determination of a particular capital value, because of the entirely circular nature of the link between the earnings that the company was permitted by the regulator and the value which the market placed on the company's shares.

*Figures omitted. See note on page iv.

FIGURE 13.1

Current cost operating profit of WaSCs and WoCs/fixed assets, 1993/94*

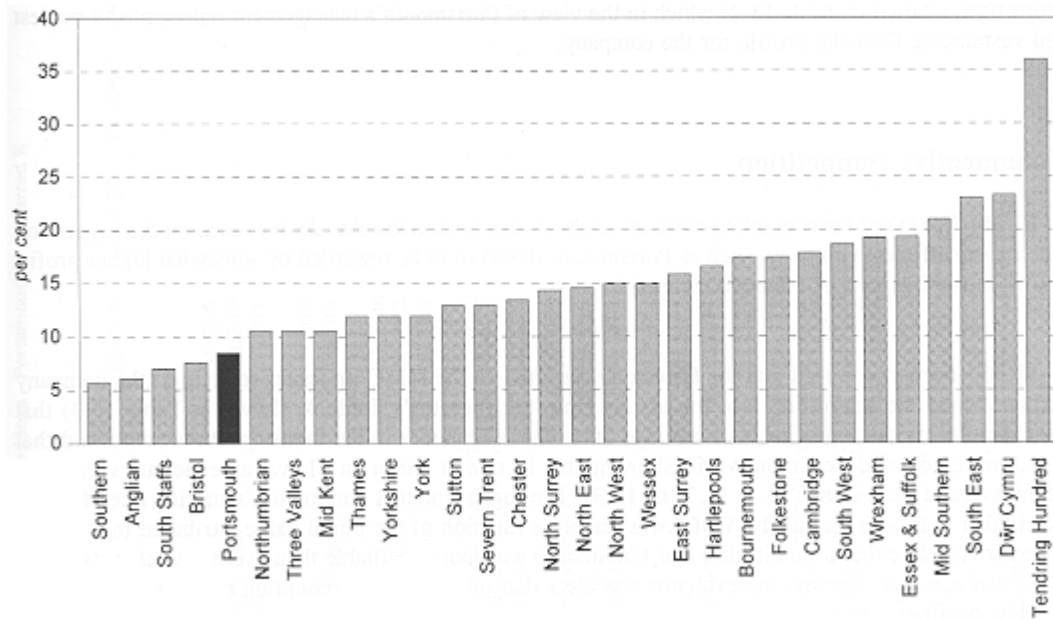


Source: Regulatory Accounts, 1993/94.

*All profitability figures for WaSCs refer only to water supply.

FIGURE 13.2

Current cost operating profit of WaSCs and WoCs/
connected population, 1993/94*

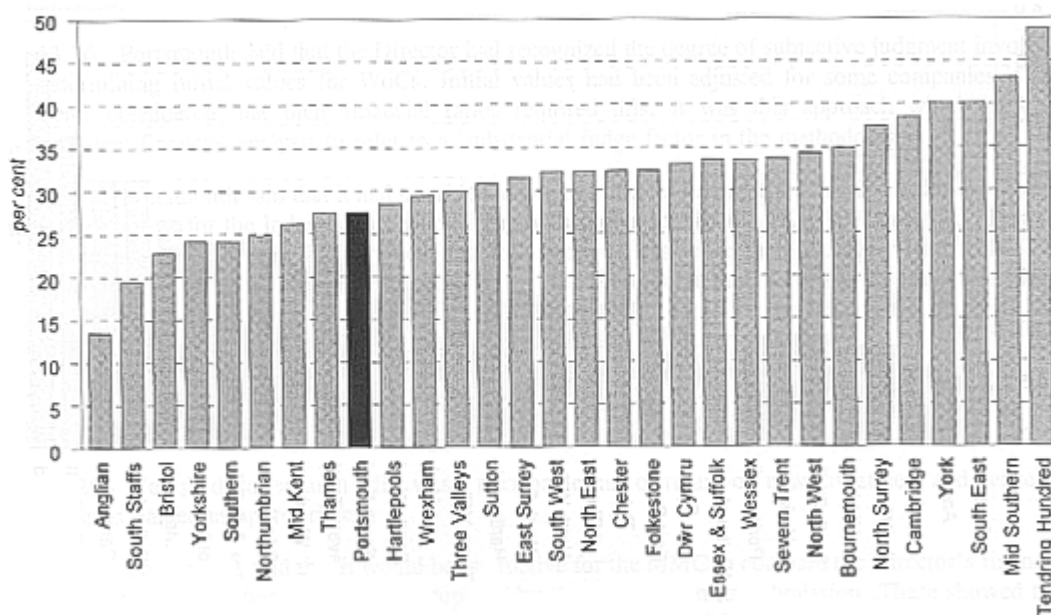


Source: Regulatory Accounts, 1993/94 and Centre for the study of Regulated Industries, *The UK Water Industry, Charges for water services 1994/95*.

*All profitability figures for WaSCs refer only to water supply.

FIGURE 13.3

Historic cost operating margin of WaSCs and WoCs, 1993/94*



Source: Regulatory Accounts, 1993/94.

*All profitability figures for WaSCs refer only to water supply.

13.34. Clearly the company would not consider arguing that it should be allowed to earn the WACC on the full replacement value of its assets. However, because of the circularity of the Director's capital value/rate of return approach, the company had made a submission to the MMC based on financial projections (shown in Table 13.2) which in the view of Portsmouth's management represented a modest and sustainable financial profile for the company.

Comparative competition

13.35. We asked Portsmouth to what extent the determination should take into account the suggestion that a more efficient company, such as Portsmouth, deserved to be rewarded by somewhat higher profitability in the interests of effective competition.

13.36. Portsmouth said that the Director's response to the MMC on issues relating to the company had contained the suggestion (see the extract from the Director's Table 4, shown in Table 13.3) that Portsmouth was more profitable on average than other companies in the industry. Portsmouth said that it had presented evidence to the MMC showing that its rate of return on all available measures was well below average (see Figures 13.1, 13.2 and 13.3). The suggestion that Portsmouth's starting rate of return was higher than average for the WoCs was merely a function of the initial value attributed to it by the Director. It was either an indication that Portsmouth was more profitable than average or that its initial value was too low. Because the evidence was clear that on all proper accounting measures Portsmouth was less profitable than average, the only conclusion was that the Director had set the company's initial value at a lower level than had been the case for the industry as a whole. [

Details omitted. See note on page iv.

]

TABLE 13.2 CCA profit and loss-Portsmouth's preferred K

	1993/94	1994/95	1995/96	1996/97	1997/98	1998/99	1999/2000	2000/01	2001/02	2002/03	2003/04	2004/05
K	-	[
Total turnover	25,355											
Total operating costs	(19,265)											
Operating profit	6,091											
Other income	304											
Profit before interest	6,395											
Net interest	(1,548)											
Financing adjustment	282											
Profit before taxation	5,129											
Tax on profit on ordinary activities	(938)											
Net extraordinary items after tax	0											
Profit for the year	4,191											
Preference dividends	(270)											
Ordinary dividends	(2,100)											
Retained profit for the year	240											
Ratios:												
Interest cover	4.13											
Ordinary dividend cover	1.99]
												per cent
CCA operating profit/CCA net assets (%)	1.70	[
CCA operating profit-tax/CCA net assets (%)	1.44											
% change in operating profit												
% change in PBI												
% change in PAT]

Figures omitted.
See note on page iv.

Figures omitted.
See note on page iv.

Source: Portsmouth.

13.37. Evidence later provided, shown in Table 13.3, demonstrated that the Director's own determination was based on the assumption that Portsmouth's profitability would fall relative to the sector. This confirmed the view expressed in Portsmouth's submission that the Director had given a determination which caused the company's profitability to deteriorate relative to the sector.

TABLE 13.3 Extract from the Director's Table 4: post-tax returns on capital

	<i>per cent</i>	
	<i>Portsmouth</i>	<i>Industry</i>
1995/96-1999/2000	[<i>Figures omitted.</i>
2000/01-2004/05		<i>See note</i>
2004/05		<i>on page iv.]</i>

Source: OFWAT.

13.38. Portsmouth said that it was crucially important for the MMC to respect their obligation under the 1991 Act to promote effective competition; the Director's determination had clearly failed to do this. An optimally designed regulatory system would make the price cap of a particular firm contingent on the performance of other firms. In particular, the worse the performance of rival firms, the more favourable should be the price cap on any particular firm. Thus, an optimal regulatory system should reward firms with lower than average supply costs by giving them a less harsh price cap and in consequence a higher than average rate of profit. Because a superior performance earned a higher return, this system would provide an incentive for firms to reduce costs in terms of both operating and capital expenditure.

13.39. If the regulatory system failed to provide a higher rate of profit to firms with lower costs than to firms with higher costs, the regulatory system was not operating in the public interest. Such a system would provide no incentives for firms to reduce operating or capital costs. If it were the case that firms with high costs actually secured a higher rate of profit, then such a system would in fact provide perverse incentives: it would benefit firms to raise costs rather than to lower them. Such a system could not be operating in the public interest.

13.40. Portsmouth said that the evidence produced in the company's submission showed clearly that, despite being ranked as one of the most efficient water companies in the country, Portsmouth's level of profits was below average and had consistently been so under the regulatory regime. Furthermore, the evidence provided by the Director showed the latest K determination implying that, even under the Director's inaccurate assumptions, Portsmouth's financial position would worsen further relative to the sector. Such an outcome of the regulatory process was clearly at odds with the objective of achieving a socially optimal regulatory regime. It contradicted the aim of replicating a competitive market where a company with the excellent performance of Portsmouth would expect to be considerably more profitable than average.

13.41. Portsmouth's own proposals in its submission were modest. It sought a determination which would allow it to maintain its current level of operating profit, which was not high by industry standards, in recognition of its superior efficiency. This was in contrast to the forecasts presented in the Director's analysis, which showed Portsmouth's operating profit declining in real terms over the ten years of the determination and in relation to the whole of the industry.

Financial indicators

13.42. We asked Portsmouth what other financial indicators might be appropriate in assessing projected performance and whether those implicit in the Director's determinations were reasonable. We also asked whether there was more scope for borrowing than assumed by either the company or the Director.

13.43. Portsmouth said that it accepted that historic cost interest cover and dividend cover were appropriate indicators to be used as a cross-check on assessment of the operating profit profile to judge the company's financial viability.

13.44. The values of financial indicators quoted in the Director's modelling were meaningless, and therefore no guide to the viability of the company. The Director's evidence merely served to prove Portsmouth's arguments on this matter.

13.45. First, the Director's results ignored the historical facts. Portsmouth's regulatory accounts clearly showed that the company's dividend cover in 1992/93 stood at 2.45, not [*] as suggested by the Director. Therefore, the Director's own modelling drastically exaggerated the cover ratios of the company even in the starting years, for which the facts were already established.

13.46. Secondly, the Director's modelling assumptions also illustrated a lack of realism, with ratios for interest and dividend cover rising to absurd levels. The reason for this was that not only were the assumptions about projected costs and revenues in the Director's modelling unrealistic [*Details omitted. See note on page iv.*]. In consequence, the cash flow and financial ratios stated by the Director bore no relation to the actual ratios which would be generated by a given set of operating cash flows. The cash balances implicit in the Director's calculations were merely a product of unrealistic modelling assumptions.

13.47. As for whether there was more scope for borrowing than assumed by the company or the Director, that could imply one of two possibilities. Either it was possible that additional borrowing could be used to reduce the level of K required, or, if the K determined by the Director produced an insufficient cash flow, the shortfall could be met by additional borrowing.

13.48. In answer to the first question, K could not be influenced by changing the level of borrowing assumed. K was set to allow the company operating profits which represented an adequate rate of return on its regulatory capital value. The cash flows implied by this K, and hence the borrowing required by the company, were then automatically determined by the Director's model.

13.49. In answer to the second question, if K generated insufficient cash flow, [*Details omitted. See note on page iv.*], it would not be possible to borrow to cover the shortfall, because potential lenders would be deterred by the very poor financial projections.

Dividends

13.50. We next asked Portsmouth if a lower level and growth of dividends than assumed by the company [*] would adversely affect the company's ability to finance its functions.

13.51. Portsmouth said that it agreed entirely with the Director that the level of dividend assumed for modelling had no effect on the return on capital implied. Hence the K determined by the Director and the K proposed by Portsmouth were unaffected by the different assumptions made about dividends. There was therefore no direct link between what was a modelling assumption and the company's ability to finance its functions. However, in order for the MMC's financial modelling to generate meaningful financial ratios as a cross-check on the adequacy of its K determination, it was necessary for it to assume a consistent and meaningful level of dividend in its modelling.

13.52. Portsmouth said that it had demonstrated in its submission that its level of profits was low relative to the average of the industry as a whole, and that its current dividend cover ratio (based on a dividend of £2.1 million) was in line with the rest of the sector. This comparison is reproduced below.

	<i>Dividend cover (x)</i>	
	1993	1994
(a) Historic cost accounts		
Free-standing WoCs	2.60	2.50
Independent subsidiary WoCs	2.26	2.26
Controlled subsidiary WoCs	1.92	2.38
Controlled subsidiary WaSCs	<u>2.14</u>	<u>2.08</u>
Portsmouth	<u>2.45</u>	<u>2.37</u>

*Details omitted. See note on page iv.

TABLE 13.4 Cash flows implied by the Director's determination-out-turn prices

	<i>£ million</i>										
	1994/95	1995/96	1996/97	1997/98	1998/99	1999/2000	2000/01	2001/02	2002/03	2003/04	2004/05
Net cash inflow from operating activities	[
Net interest and dividend payments											
Taxation paid											
Capital expenditure and mains renewals											
Net [*] cash flow before redemptions											
Redemptions											
Share redemptions											
Debenture redemptions/loan repayments											
New loans											
Total cash requirement											
Interest cover											
Dividend cover]

Figures omitted. See note on page iv.

Source: Portsmouth.

*Details omitted. See note on page iv.

Note: The cash flow table reflects the financing requirements under the Director's K of -1.5, using Portsmouth's projections of costs.

Dividend cover (x)

	1993	1994
(b) Current cost accounts		
Free-standing WoCs	1.78	1.90
Independent subsidiary WoCs	1.50	1.60
Controlled subsidiary WoCs	1.62	2.16
Controlled subsidiary WaSCs	<u>1.62</u>	<u>1.60</u>
Portsmouth	<u>2.03</u>	<u>1.79</u>

13.53. Given the fact that Portsmouth's dividend policy was in line with the sector as a whole and the absolute level of profits was also well below average, Portsmouth could see no justification for the Director having assumed a considerably reduced level of dividend payments in the financial modelling.

13.54. Furthermore, it was the view of the company that the Director's position was internally inconsistent on two counts. First, the Director had stated publicly in his *Cost of Capital* consultative document that he would consider a current cost dividend cover of 1 as a lower bound for his financial ratios, yet Portsmouth's modelling of the Director's position showed current cost dividend cover of an absurdly high level of between 4 and 5. Such a cover ratio implied that the level of dividends was patently inconsistent with the level of profits of the company, and hence the other financial ratios generated by the modelling were meaningless.

13.55. The second inconsistency in the Director's assumption on dividends was that it was not consistent with his own assumption of capital values and the WACC. Given the capital value of £[*] million set by the Director, the value implied for the company's equity could be calculated; this, it was easy to show, was completely inconsistent with an annual dividend of £[*] million, given the Director's own cost of capital assumptions. Portsmouth's assumption of £[*] million a year was much closer to a consistent level of dividend for the Director's capital value.

13.56. There were a number of additional reasons why a lower level and growth of dividends should not be assumed for the purpose of K modelling. First, while the lower dividend would make the dividend cover ratio appear satisfactory, it would do nothing to resolve the underlying problem created by the unrealistic assumptions in the projections of cost and revenues. [

Details omitted. See note on page iv.

]

13.57. In 1989 the DoE had set out its thinking on the principles and methodology for setting the adjustment factor. That paper stated:

In the light of Clause 7, the rate of return appropriate to investment in water undertakings must be at the centre of the approach to the setting of K. The ability of undertakers to raise funds to finance their activities will be crucially dependent on their generating the returns which would persuade investors to make and retain investments. These returns would depend in turn on the returns which were available on other investment opportunities, and in particular those where the riskiness attached to the forms of the underlying assets is similar to that of the water utilities.

Key expenditure differences

13.58. We invited the company to comment on each of the key expenditure differences between itself and the Director over a five- and ten-year period respectively. Portsmouth said that the focus of the MMC's attention should not be on the difference between the Director's position and that put forward

*Figures omitted. See note on page iv.

by Portsmouth, but rather should be directed to forming its own view on the appropriateness of the costs estimated by Portsmouth. Secondly, any analysis of costs should cover the full ten-year period. Thirdly, the MMC's assessment should be based on the revised figures submitted by Portsmouth in its submission of October 1994, rather than on the original figures in the SBP which, as the MMC were aware, had been the subject of subsequent modification by the company.

Expenditure on low flows

13.59. We asked Portsmouth about the need for expenditure to meet low river flows, disallowed by the Director but which Portsmouth believed the NRA might insist on; and whether any such expenditure could be financed by an interim determination at a later date if necessary.

13.60. Portsmouth said that this capital cost was required to replace supplies, which would be lost if the NRA carried out its declared objective to reduce Portsmouth's licence to abstract water at its Northbrook source and to cease abstraction at the Hoe source, each being located in the Upper Hamble. In these circumstances, as well as investigation and development of new boreholes in the Lower Hamble, the company would have to construct a new pumping station and treatment works and lay a new trunk main, in order to distribute the treated water to customers.

13.61. The question of whether the modification or revocation of an abstraction licence could in principle constitute a Relevant Change of Circumstances which would entitle a water company to seek an interim determination of its adjustment factor had been the subject of discussions between the DoE, the NRA, OFWAT and the water industry (the quadripartite process). During the quadripartite process it was apparently agreed by the parties that revocation of an abstraction licence could be treated as a Relevant Change of Circumstance. However, Portsmouth was still only entitled to seek an interim determination if the costs associated with the Relevant Change of Circumstance exceeded a fairly high materiality threshold linked to Portsmouth's turnover. Although the additional costs that it would incur in securing an alternative source would be significant (over £2 million), Portsmouth thought it was highly unlikely that they would be sufficiently high to entitle it to obtain an interim determination.

13.62. Portsmouth said that, even if the expenditure qualified in principle for an interim determination, the company also had a number of concerns relating to the process of obtaining an interim determination. First, evidence from past determinations showed that the process was extremely time-consuming. Secondly, the Director had great freedom to exercise his judgment on the levels of expenditure which he would take into account, and could introduce other factors to offset the impact of the Notified Item or Relevant Change of Circumstance. Thirdly, should the expenditure fail to meet the materiality threshold, the process of 'logging-up' was by no means as clear as it might seem. In particular, if the company were to benefit, then the new Director in 1999 would have to adopt the same rate of return methodology for setting K as had been used in 1994. The extent of the changes in methodology from 1989 to 1994 indicated that there could be no guarantee that this would happen.

Operating and capital costs

13.63. We next asked whether the operating or (less importantly) capital costs projected by Portsmouth, including the assumption as to the increase in real wages over time, were too high. We asked, conversely, why the company regarded the assumptions made by the Director to be unattainable.

13.64. Portsmouth said that this topic covered a broad range of issues. For clarity, Portsmouth had produced a table (Table 13.5) which set out the major differences between the operating cost projections of the company and the Director. This table showed clearly that by far the most important issues in quantitative terms were the different view taken by the company and the Director on the scope for future efficiency gains in annual operating expenditure, including the extent to which the company could be expected to absorb the impact of increasing real wages within a constant total wage bill. In total, the Director was seeking efficiency gains amounting to £[*] million a year by 2004/05. The company accepted that certain efficiency gains could be achieved, but in total the Director's target exceeded the level which the company believed achievable by £[*] million a year by the end of the period. This compared with a total difference between the company and the Director of £[*] million a year.

*Figures omitted. See note on page iv.

TABLE 13.5 Operating cost projections, differences between the Director and Portsmouth

	Ports- Director mouth		Annual differences											Total annual difference (£'000)	% of operating profits		
	£'000	£'000	Actual					Assumptions									
			Computer costs	Bad debt provision	Periodic Review and MMC appeal	NRA abstraction	Base correction	Other items	Efficiency	RPE employment	Pension cont and expenses	Digital mapping	Other items	Rounding diffs etc			
1992/93	14,242	[<i>Figures omitted. See note on page iv.</i>														
1993/94	14,583]]
[

Figures omitted. See note on page iv.

]

Source: Portsmouth.

Operating costs

13.65. Portsmouth said that the left-hand portion of Table 13.5 showed the differences in operating cost projections arising up to the financial year 1994/95, where Portsmouth's cost figures were based on actual costs incurred and committed costs for the future, that could be verified from the company's regulatory accounts. The right-hand portion of the table identified the main differences in projections for the period from 1995/96 to 2004/05.

Actual differences, 1992/93 to 1994/95

13.66. Portsmouth said that, as could be seen, by 1994/95, the total difference between the Director's cost projections and those made by Portsmouth amounted to only £64,000. Although the projections appeared to be similar to 1992/93, they masked some substantial increases and savings.

(a) Base correction

13.67. Portsmouth said that the Director's base correction referred to his acknowledged error by his staff in the start figure for 1992/93, which for some reason appeared to have been corrected in his own figures in 1995/96. This error was acknowledged in the company's meeting with the Director on 1 July 1994 at which the final K was discussed.

(b) Savings

13.68. The savings in 1993/94 and 1994/95 represented a combination of cost reductions which might prove to be temporary-arising from such matters as favourable weather conditions and its effect on demand, pumping costs, and repairs-and permanent reductions resulting from efforts during the latter part of 1993/94 and 1994/95. The saving from the reduction in the bad debt provision was regarded by the company as permanent and reflected Portsmouth's strenuous efforts to reduce its debtor position since 1992/93. In addition, the company had identified a number of other savings, including a saving in materials and consumables arising from a review of the company's stores systems. The company said that it would urge the MMC to retain a consistent attitude to these projections. It would be inappropriate to strike out additional costs incurred legitimately after 1992/93 only to take account of cost reductions not envisaged at that time. Other companies, in agreeing to the Director's K determination for them, would, of course, have been allowed to retain the full benefit of any cost savings in 1993/94 and 1994/95 to offset against the efficiency target determined by the Director.

(c) Computing

13.69. In 1993/94 Portsmouth had introduced a replacement mainframe computer. The replacement computer was required because Portsmouth had expected to be in need of an upgrade at around mid-1993/94 as new systems were expected to have fully utilized the existing machine capacity and response times had been deteriorating, leading to the risk of a significant increase in the number of customer calls lost and a decrease in operating efficiency. Furthermore, as a result of the overload of the existing computer, systems development/enhancement work was being impaired. Users had noticed a deteriorating service. The company commissioned a report on the existing machine usage in 1993 to ascertain whether the machine was being managed in an optimal way and to recommend how to resolve problems. The report established that it was necessary to upgrade, and ICL was requested to provide a set of options for the company. The company accordingly believed the inclusion of the additional computing costs in the K-setting projections was valid and fully justified.

(d) NRA abstraction charges

13.70. Portsmouth said that there were known significant increases in charges for 1995/96 and future years, which could be verified with the NRA. Portsmouth's real (ie 1992/93 prices) increase in

base charges were approximately £197,000 a year from 1993/94 for which the Director had stated in his submission that he had allowed £[*] a year from 1995/96 (ie £[*] million over five years). This discrepancy was simply another error which the company had pointed out to the Director. Until now it had had no way of confirming whether or not it had been corrected. The Director appeared to have received the necessary information from the NRA, but to have misinterpreted its impact on Portsmouth.

Differences in assumptions, 1995/96 to 2004/05

13.71. [

Details omitted. See note on page iv.

] In fact, the Director had assumed a number of very significant cost reductions which the company did not believe were achievable.

(a) Efficiency and real price effects for labour

13.72. The Director had set an efficiency target for Portsmouth of [*] per cent a year on total operating costs from 1995/96 to 1999/2000, increasing to 1 per cent a year from 2000/01 onwards.

13.73. The Director's efficiency target implied an efficiency gain of approximately £[*] million by 2004/05. Portsmouth had argued in its submission that the scope for reducing operating costs was extremely limited, except through reduction in manpower levels. [

Details omitted. See note on page iv.

]

13.74. Portsmouth did not believe such a target was achievable for a company which was already acknowledged to be one of the most efficient in the industry. The company believed a more realistic target was a reduction of 0.25 per cent a year in total operating costs (or approximately 0.5 per cent a year from manpower costs). This would lead to annual savings of £[*] by 2004/05. Thus the Director's efficiency target was shown in Table 13.5 to impose a burden on the company of £[*] by 2004/05 over and above the level considered achievable by it.

13.75. The Director's efficiency target was, in fact, even more stringent than implied by the percentage targets he had set. This was because the Director was assuming that, in addition to his efficiency target, Portsmouth would absorb the full effect of increasing real wages over the ten-year period. The Director's efficiency targets simply assumed away the issue of the increasing cost of labour (RPEs) which had a significant impact on all sectors. Portsmouth was not able to exempt itself from the competitive pressures in the labour market which inexorably drove wages up in real terms over time.

13.76. The trend for average wages to rise more than inflation had been established in the UK since at least the mid-19th century. In the long run, real wages had been rising for over a century at approximately 2 per cent a year. Official CSO and Department of Employment data showed that real earnings across the whole economy had risen on average 2.1 per cent a year since 1963. As wage-driven costs (salaries, and hired and contracted services) typically accounted for half of a water company's operating expenditure, the wage component of the RPE on its own would add [*] to real operating expenditures.

13.77. Portsmouth could not exempt itself from this global trend. If the company were to start paying its employees below market rates, this would soon be reflected in the quality of staff the company was able to retain or recruit. The effect, after five or ten years, of paying below market wages would be significantly to downgrade the average quality of labour resources employed by companies. This was apparent to Portsmouth by virtue of its long experience as an employer of staff and direct labour. Portsmouth said that, since the demise of National Service Conditions, it had worked hard to re-establish sound employee relations based on a new package of conditions. Service to customers was now greatly aided by the employees of the company being of a high standard in terms of commitment, ability and training, and the parties now enjoyed stable relationships. However, Portsmouth said that it had to

*Details omitted. See note on page iv.

recognize that it was essential to keep up with market-driven pay rates in order to maintain the position it had striven to reach. [

Details omitted. See note on page iv.

]

13.78. Given that the company was small, and highly efficient, with no unnecessary tiers of management to cut, and that this situation had arisen to a considerable extent by tight control of manpower—the largest controllable cost—the implication was that its starting point for 1995/96 was already at or near the minimum consistent with current levels of service. This fact was further confirmed by Portsmouth's relatively low ratio of employees to customers. Given these indisputable facts, and the extreme likelihood that there would be a real price effect on wages in the future (as there always had been over any reasonable time-span in the past), the suggestion that the company's manpower costs could be kept constant in real terms by reducing manpower was beyond the realms of reason.

13.79. Portsmouth maintained that for the levels of service it currently provided, employee numbers and costs were at or near the minimum level. Future savings due to technological advances were unlikely in the water industry environment. The suggestion that there would not be a future RPE on wages flew in the face of past facts and economic sense. Thus the assumption that manpower costs for the company could be kept constant by a compensating reduction in numbers was totally beyond the bounds of reasonableness. Whilst the company accepted the need for assumptions in making projections, they must be reasonable assumptions.

(b) Pension contributions and expenses

13.80. Portsmouth said that for the two years 1995/96 and 1996/97, the Director had not taken into account the suggestion that Portsmouth should retain half of the benefit arising from the pension expenses and contribution holiday.

(c) Digital mapping

13.81. Portsmouth explained that digital mapping was a development which was forced on the company by the New Roads and Street Works Act 1991. The enhancement was required to provide better-quality information for both the regulator and the company itself; for the latter, there would be benefits to be gained by linking the digital mapping system via the mainframe computer to the Computerized Street Works Register (CSWR) required under the New Roads and Street Works Act 1991; this was currently being implemented by the Department of Transport, the highway authorities and the utility companies.

13.82. The company therefore had an obligation to link to the CSWR and in order to comply with this obligation in a cost-effective manner it would be necessary to develop software links from digital mapping, via the company's mainframe computer to the CSWR. Other benefits would result from such links to the mainframe, including better identification of mains requiring renewal because of bursts or poor condition and issuing customers with warning notices of supply interruptions due to planned maintenance.

(d) Other operating cost items

13.83. This column contained a number of smaller or short-term costs. They included the costs of establishing a new charging scheme, which was necessary under existing legislation abolishing the use of rateable values by the year 2000 (1995/96 and 1996/97, £130,000); a further rating assessment, possibly bringing the water industry into the conventional rating system, to take effect in 2000/01 onwards (£169,000 increase); some additional staff (five staff from 1995/96 onwards, a further five from 1999/2000 and a further eight from 2004/05 onwards) associated with work arising from the New Roads and Street Works Act 1991 requirements, an increase in the number of customers, and increased

laboratory work; and allowance for Periodic Review costs of £90,000 in 1998/99 and £90,000 in 2003/04 only.

Capital costs

13.84. Portsmouth contended that its capital cost projections were no more or less than any prudent company would plan for in order to meet its obligations over the next ten years. This contention was shared by the independent reporter when he had certified the SBP, and by the Director in some of the principal areas of expenditure. The company believed the reductions applied by the Director were arbitrary and unsupported.

13.85. So far as mains renewals were concerned, the Director had stated that he accepted the broad level of expenditure planned. In fact, he had made a small downward adjustment to allow for what he considered would be capital efficiency.

13.86. Again, on maintenance (non-infrastructure) the planned expenditure and its peaked profile had been accepted broadly by the Director, again with some downward adjustment for capital efficiency.

13.87. So far as compliance expenditure was concerned, the Director had rejected the claimed capex in respect of low flows in the River Hamble because it had considered that the costs exceeded the benefits. However, it was plain that the NRA did not regard itself as bound by this decision and was very likely to enforce licence reductions. This in turn would trigger new resource pumping stations, treatment works and trunk main scheme, the costs of which had not been allowed by the Director. The company found itself caught between the opposing views of two regulators, a most unsatisfactory position.

13.88. The Director had accepted the company's planned investment in PAH control and reduction of risk of cryptosporidium in River Itchen treated water. The estimated expenditure in each case was very small compared to the whole programme, being £720,000 and £306,000 (at 1992/93 price base) respectively.

13.89. Finally, Portsmouth said that it did not accept the Director's contention that capital efficiencies of 1 per cent a year were valid. The company's procurement methods were already very streamlined, with minimal involvement of design consultants and no use of management contracts. The nature of the planned investment was such that it was fairly standard engineering work and did not involve new treatment processes where innovation might lead to savings. The corrosive nature of soils in the area meant that iron pipes had to be replaced rather than relined to provide structural integrity; this greatly limited the scope for savings from use of trenchless mains-laying technology.

Pension contributions

13.90. We asked Portsmouth to comment on the prospects for continuation of the current pension contribution holiday, in particular whether it could be extended considerably longer than the Director had assumed even at a significantly lower level of profitability of the company; and whether the benefits of that 'holiday' should be shared between users and the company, as long as it lasted.

13.91. Portsmouth said that it did not control or decide whether pension contributions were to be made or whether the contribution holiday should continue. These decisions lay with the Trustees on advice from the actuary. Clearly the personal liabilities placed on the Trustees would give rise to their wishing to act in the most prudent manner consistent with their duties as Trustees. [

Details omitted. See note on page iv.

]

13.92. The arguments in favour of the company's retaining some of the benefit of any pension holiday were, first, that the situation had arisen because of a unique course of action and was therefore akin to an efficiency measure; secondly, other companies' charges allowed for pension contributions and Portsmouth should be allowed to retain this comparative advantage; and for as long as the holiday

continued and because it arose from a unique course of action, it constituted an efficiency initiative which could not be copied by another company.

13.93. In the Portsmouth projections, the company was seeking to retain only 50 per cent of these efficiencies for the two years 1995/96 to 1996/97. In this way, both customers and shareholders benefited from the savings on a 50:50 basis. After those two years, Portsmouth could not be certain that the Trustees would be in a position to permit a continued contribution holiday or to meet the administration costs. The company did not feel it was prudent to offer to share a benefit which it could not guarantee would arise. Therefore, the projections from 1997/98 onwards included the full employer's contribution. The company said that it noted from the Director's evidence that the Director appeared to have agreed with it on this issue.

Growth expenditure

13.94. We asked Portsmouth whether it had made excessive allowance for investment to meet growth in demand. The MMC understood that this had been reduced from the levels put forward in the SBP but still exceeded the allowance made by the Director.

13.95. Portsmouth said that the estimates in the SBP for investment to meet growth in demand had been built up on a scheme-by-scheme basis, the method and the results being certified by the independent reporter. The investment was no more than any prudent company would allow. The principal categories of investment were:

- (a) reinforcement mains to allow the distribution system to carry increased flow rate with no detriment to the pressure experienced by customers;
- (b) security links, the bulk of expenditure being on schemes to reduce the reliance of an increasing number of customers on sources where there were potential risks of pollution, and a smaller proportion of expenditure being needed to reduce the number of customers affected by supply interruptions due to burst mains;
- (c) extension of one service reservoir to provide sufficient capacity for diurnal and seasonal demand fluctuations and to give a short-term reserve of stored water in the event of a failure of a source or pumping station;
- (d) additional groundwater source investigation and commissioning to provide a standby supply of water in the event of loss of sources due to pollution incidents (see also (b)) and also to aid operational flexibility and reduce abstraction of more expensive water from the River Itchen; and
- (e) the above categories (a) to (d) would serve to maintain standards at current levels as demand grew. In addition to these categories of work, the company would also, of course, have to carry out mains-laying on new housing developments. The costs of such work were generally offset in part by contributions by the developer to the company's costs. In each case, the contribution or cost was met by the developer.

13.96. The assumptions made in the SBP had all been built up carefully, from first principles in a manner certified by the independent reporter. In the case of (a) and (b), computer models for all the company's principal mains networks had been used to simulate the effect of increased demand on pressures and to confirm the suitability of the proposed reinforcement and security link mains to meet new demand and provide back-up supplies respectively.

13.97. Expenditure over the ten years in the categories (a) to (e) was as shown in Table 13.6. In the case of (a), expenditure shown was that appropriate to the lower level of demand projections. The level of expenditure needed in the other categories was not affected by the flatter demand projections.

TABLE 13.6 **Portsmouth's growth expenditure, 1995/96 to 2004/05**

	1995/96- 1999/2000	2000/01- 2004/05	Total 1995/96- 2004/05
(a) Reinforcement mains to maintain satisfactory pressures as demand increases	[
(b) Security links:			
(i) pollution			
(ii) bursts			
(c) Service reservoir extension			
(d) Additional groundwater source development			
(e) Mains on new developments			
]

*Figures omitted.
See note on page iv.*

Source: Portsmouth.

13.98. The company believed this level of expenditure to be the minimum necessary to meet its obligations in a prudent manner, taking into account all possible savings arising from the reduced demand forecasts in the company's submission.

Forecast demand

13.99. We asked Portsmouth what allowance should be made for the future growth or decline in demand from commercial metered customers, and the effect of this on financial projections.

Portsmouth's demand forecasts and their financial implications

13.100. Portsmouth said that its forecasts of measured commercial demand had been set out in its submission to the MMC. The Director's determination had been based on an error in the company's original SBP, assuming that measured commercial demand would rise at [*] per cent a year until 2000 and then [*] per cent a year thereafter. The company had in its SBP drawn the Director's attention to the error and highlighted it by way of a sensitivity case based on a [*] per cent decline in measured commercial demand.

13.101. In contrast to this, actual commercial demand had declined by [*] per cent a year since the early 1970s. Portsmouth had further attempted to draw the Director's attention to this discrepancy before he had reached his determinations, but despite being assured that all the company's concerns were being dealt with, no adjustment was made to the demand figures finally used to determine K. Portsmouth noted that in the Southern CSC's evidence to the MMC, the high forecast growth in commercial demand was also called into question.

13.102. Portsmouth said that it had now carefully reconsidered the issue of demand forecasts and believed the most prudent assumption for business planning was to assume a continued [*] per cent a year decline in measured commercial demand. With a K of -1.5, this meant that the Director's determination overstated revenue by £[*] million a year in 2004/05 compared with the prudent estimate made by Portsmouth. This was an overstatement of [*] per cent. Clearly the financial consequences of the cumulative shortfall in revenue would be very serious for the company, [*Details omitted. See note on page iv.*]

13.103. Portsmouth referred to Figure 5.2 (commercial demand in Portsmouth), which it said demonstrated the company's projections in their historical context.

13.104. Portsmouth said it was conscious that the forecasts of measured commercial demand were an important part of its application to the MMC for a review of its K. Therefore, in support of its position, the company had commissioned two independent studies of the prospects for the local economy, one from Richard Harris, Professor of Local Economy Studies at the University of Portsmouth, and a second from PA Cambridge Economic Consultants (PACEC), one of the UK's

*Figures omitted. See note on page iv.

leading regional and local economic forecasting units. Copies of these two papers had been provided to the MMC.

13.105. Portsmouth believed the two reports added strongly to the weight of evidence supporting its case that the prospects for measured demand growth were consistent with the [*] a year used in the company's submission, and nothing like the [*] per cent assumption adopted by the Director.

13.106. PACEC's paper used its employment forecasts to project commercial demand growth which endorsed Portsmouth's range of 0.5 to -2 per cent a year and derived a central figure of [*] a year for the change in measured commercial demand. This was slightly higher than Portsmouth's projection in the company's submission to the MMC. However, as noted in PACEC's paper, the forecast was not weighted for the risk of the loss of Admiralty demand altogether. Such a loss was a possibility over the forecast period. In addition, approximately 30 per cent of the non-Admiralty commercial industry in the area was defence-related. Therefore the company still considered it prudent to use a central forecast for projecting revenue which assumed a [*] in demand.

The PACEC paper

13.107. The key findings of the PACEC paper were:

- PACEC's report was based on sectoral employment forecasts for the Portsmouth area using its own regional forecasting model. These were then used to project water demand use, on stated assumptions regarding continued efficiency trends in water use.
- The Portsmouth region was shown to have a higher than average historical dependence on the manufacturing and other services sectors, and a lower than average concentration of banking and business services.
- Employment had grown more quickly in the Portsmouth area from 1981 to 1991 than in the country as a whole, but more slowly than in the rest of the South-East. The sectoral shift in employment during this period showed a significant move in the composition of economic activity from manufacturing to services.
- Employment growth in the Portsmouth area was expected to average 0.54 per cent a year from 1994 to 2005. This was an improvement on the performance of the local economy during the recession, but slower than the average 0.66 per cent a year over the period 1981 to 1991, which already included the partial effects of the recession beginning to bite at the beginning of the 1990s.
- Admiralty employment was projected to continue to decline slowly, but not at the rate at which it had fallen in the 1980s. All employment growth was forecast to come from the service sectors (10.6 per cent total growth from 1994 to 2005) with industrial employment declining by 5.4 per cent decline over the period).
- In both manufacturing and service sectors, water consumption per employee was shown to have fallen since 1981, reflecting increased efficiency of water use.
- On the assumption of relatively stable levels of economic activity related to the Admiralty, measured commercial water demand was projected to fall at 0.5 per cent a year. This figure was derived from the shift in sectoral structure of the local economy, the relative intensity of water usage or manufacturing and services, and a continuation in the historic trends of increasing efficiency of water use.
- The report noted that the switch of economic activity to services significantly reduced the potential for future water demand growth.

*Details omitted. See note on page iv.

The University of Portsmouth paper

13.108. The key findings of the University of Portsmouth paper were:

- In the 1970s and 1980s the Portsmouth region had performed better than the national average in terms of the growth in gross domestic product and employment. (It should be noted that during this period commercial water demand had fallen significantly, indicating significant reductions in water use for a given level of output or employment.)
- In recent years the Portsmouth area had been affected significantly by the run-down in defence-related activities and by the recession.
- Forecasts for economic growth were put at 1.52 per cent a year from 1991 to 1996 and 2.17 per cent a year thereafter.
- These rates of growth were low by historical standards. In the period 1974 to 1979 growth in gross domestic product averaged 2.43 per cent a year, from 1950 to 1985 it had averaged 2.74 per cent a year and from 1986 to 1990 3.92 per cent a year.
- Growth was expected to come disproportionately from the business and financial services sector and from the distribution, hotels and catering sector.

13.109. Hence, Portsmouth maintained, both papers showed that in addition to a slow-down in the average rate of economic growth, the Portsmouth area of supply was expected to experience a continued shift away from manufacturing and other sectors with more intensive water usage, and towards services with lower levels of water use. They therefore supported Portsmouth's contention that measured commercial demand would continue to decline.

Infrastructure charges

13.110. We then turned to infrastructure charges and asked Portsmouth to comment on the appropriateness of restricting such charges to recovering local network costs.

13.111. Portsmouth said that analysis of its revised demand projection showed that the increase in distribution input over the next ten years resulted solely from new household customers being supplied with water. Without these new household customers, there would be a reduction in distribution input.

13.112. For every new customer connected, an increment of additional demand would be imposed on the company's supply system. This comprised water resources, water treatment, pumping stations, service reservoirs, trunk mains and local distribution mains. All these components had finite yields, volumes or hydraulic capacities. Plainly, every increment of additional demand imposed by each new customer would need to be conveyed to that customer through each of the above components, and, if any component's existing capacity was as a result exceeded, it would need to be increased to the appropriate level by capital investment in the necessary works.

13.113. The Director's contention that infrastructure charges should apply only to local distribution networks was clearly flawed, because it made no allowance whatever for the increased load placed on all the other components of the supply system by additional demand.

13.114. We asked Portsmouth to comment on the extent to which the costs of other facilities were recovered from users from other charges over the life of the assets.

13.115. Portsmouth said that it believed, because of the Director's methodology, none of the cost of facilities covered by the infrastructure charge was recovered through other charges. This was because the Director's determinations of K allowed the company to earn a given rate of return on its capital value, from which income from infrastructure charges was deducted as capital contribution. If income from infrastructure charges exactly matched expenditure on supplying new customers, the net impact of the expenditure on the capital value of the company would be zero. Hence the level of current cost oper-

ating profit allowed by the Director's methodology would be unchanged and the only additional revenue that would be permitted in the K methodology would be to cover the small increase in opex associated with new customers. As a result, Portsmouth received no net revenue from new customers through recurrent charges to contribute towards the additional expenditure.

13.116. We asked Portsmouth to explain the basis of the costs it had put forward, including the source of demand growth (increased development or per capita consumption) assumed.

13.117. Portsmouth said that it had given a detailed breakdown of growth capex costs in the response to the issue about growth expenditure (see paragraphs 13.94 to 13.97).

13.118. A breakdown of the changes in demand categories over the ten years to 2004/05 was as shown in Table 13.7.

TABLE 13.7 Portsmouth's changes in demand categories, 1995/96 to 2004/05

	<i>million litres per day</i>
Change in demand from existing household customers due to increased per capita consumption	[
Change in demand from measured non-household customers	
Decline in leakage	*
Total change existing customers and network	
Demand from new household customers	
Overall change in distribution input]

Source: Portsmouth.

*Figures omitted. See note on page iv.

This demonstrated that the increase in distribution input only occurred because of new household customers. Were it not for them, distribution input would in fact fall.

13.119. We asked Portsmouth what would be the costs if confined to the local distribution system. Portsmouth said that if the costs to be used as the basis for infrastructure charge determination were restricted to the local distribution system, the required investment over the ten years would result in a standard amount (by which infrastructure charges are calculated) of £218. However, as already stated, the company did not believe this was the correct basis for setting the infrastructure charge.

13.120. Finally, we asked Portsmouth to comment on the effect of the lower level of infrastructure charges, as proposed by the Director, on the required value of K. Portsmouth said that its financial modelling for the submission to the MMC, as well as in the SBP, was based on a standard amount of £200 in line with the charge set by the Director. However, the impact of the infrastructure charge on K was small. If the standard amount were to be reinstated at the level of £400 requested by Portsmouth, the company estimated that a reduction in K of approximately 0.1 per cent a year would be possible.

Other evidence

13.121. We now summarize Portsmouth's response to the evidence which we received in the course of the inquiry from the Director (see Chapter 10) and the Southern CSC and other third parties (see Chapter 12) respectively and which we had put to the company for comment.

*Figures omitted. See note on page iv.

Response to the Director's views

13.122. In its response to the issues letter, Portsmouth set out in some detail the areas where it disagreed with the Director's approach and findings. Portsmouth said that the Director's evidence to the MMC (as summarized by the MMC and put to the company in the issues letter) contained many assertions with which it profoundly disagreed and some information which had not previously been made available to it. The summarized evidence revealed for the first time material errors in the Director's modelling for Portsmouth which it had not been possible to detect from previous information made available to it. The errors meant that the operating profits on which the Director had based his judgment were materially overstated. As a result, Portsmouth could not understand how the Director could consider himself in a position to make judgments about the financial viability, or otherwise, of Portsmouth under his determination of K. Portsmouth's main concerns are summarized below.

Methodology

13.123. Referring to the Director's overall methodology, Portsmouth said that it did not dispute that the Director had carried out his determinations for Portsmouth in a manner consistent with the approach applied to other companies. The Director had recognized that a significant part of his duties was the need to ensure that Portsmouth earned a reasonable rate of return. However, the Director's evidence made no mention of his other duties expressed in section 2(3) of the 1991 Act. It was not clear whether he had taken any note of his other legal obligations under the Act, in particular the need to promote effective competition.

Demand

13.124. Portsmouth said that it appeared that the Director had relied solely on the demand forecasts included in the SBP in making his demand assumptions, and had failed to adjust for the errors in those forecasts subsequently reported by the company to the Director.

13.125. Portsmouth said that if, as it believed had now been established, the Director had ignored the facts on this issue, then the single largest difference between it and the Director was now known. While pleased with the outcome, Portsmouth said that it was profoundly disturbed by the implications which this had for the integrity of the Director's methodology and the diligence with which Portsmouth's position had been reviewed. Portsmouth believed the Director's lack of openness regarding the process of his determination had prevented the company from helping him to avoid making such an important mistake.

Financial issues

Key financial ratios

13.126. Portsmouth said that the Director had asserted that 'key financial ratios projected on the basis of his determination were more favourable than those projected in the SBP'. Portsmouth assumed that the Director was referring here to gearing, interest cover and dividend cover, in which context the above comment was disingenuous and profoundly misleading. Portsmouth had demonstrated that its dividend policy was wholly normal and in line with the sector. [

Details omitted. See note on page iv.

] Credible financial projections required plausible assumptions, *inter alia* on dividend levels, Portsmouth said, and the Director had failed to see that his underlying figures were unrealistic.

13.127. Portsmouth said that the Director's profit forecasts contradicted both the known facts about Portsmouth and a number of statements and figures provided in the Director's determination. Furthermore, the Director's profits forecasts appeared to be significantly overstated. Portsmouth said that it felt extremely alarmed about the inaccuracy of the Director's modelling and the fact that these figures were used to make judgments about the financial position of the company.

13.128. The key errors in the Director's figures were that operating costs were understated for 1992/93 by £142,000; current cost operating profit for 1994/95 had been overstated by almost [*], thus massively exaggerating the company's operating profitability in the Director's convergence methodology; infrastructure renewals charges from 1995/96 onwards were significantly understated, compared with the information in the Director's determination of K; and current cost depreciation charges from 1995/96 were significantly lower than would in fact be incurred, even given the Director's capital expenditure assumptions.

Capital value

13.129. Portsmouth observed that it was helpful of the Director to acknowledge that there had been a greater degree of approximation in respect of the calculation of the WoCs' capital value than that of the WaSCs. It agreed that market values were not appropriate for valuing the WoCs, because they were either unavailable, or the market in WoC shares was too thin for the price to be a reliable guide to the value of the company at that time.

13.130. Portsmouth believed the outcome of the Director's approach was extremely sensitive to the assumption made over the level of capital value. This was shown by the fact that the capital value consistent with Portsmouth's submission was not very different from the value derived by the Director, even though the overall conclusion of the company's submission was different.

13.131. Portsmouth believed the Director's average ratio of 50:100 for the relationship of market value to indicative value for the WaSCs masked considerable variation between the companies. Furthermore, it had never been made clear to companies exactly how this calculation had been carried out, and Portsmouth had suggested to the MMC that it seek further clarification of these points from the Director.

13.132. The Director had made reference to adjusting capital values in the light of the financial ratios and to the fact that no such amendments had been considered necessary in the case of Portsmouth. Given the objections raised by the company to the credibility of the ratios in the Director's modelling, it was difficult to understand how these ratios could possibly have been used to come to any judgment at all about capital values. Moreover, the Director's recognition that 50 per cent of indicative value was subject to modification in the light of resultant financial ratios highlighted the arbitrary nature of his approach. It was this that had led independent analysts to refer to the 'substantial "fudge" factor in the methodology'.

13.133. The whole industry had expressed the view that the Director's approach to setting initial value was wrong, Portsmouth said. Indicative value had been part of the basis on which the company had agreed to transfer to the new regulatory regime and it believed it was improper for the Director to undo part of the original 'agreement' between the company and the Secretary of State. The Director's apparent view that he could not be fettered from writing down capital values for water companies at some future date implied that there was no security for investors in the present regulatory regime.

13.134. Portsmouth said it noted that the Director himself had stated that indicative values were not intended as capital values at the time of flotation. If that was his view, then it was difficult to understand the link he had made between indicative value and market value in setting the initial values for WoCs in the latest K determination.

13.135. The fact that indicative values exceeded market values indicated either that the market discounted earnings from water companies at a much higher rate than the Director had sought to allow for in his determinations or that the markets did not believe the Director would stick to the terms of the original regulation. In either case, however, the fact that the market value was less than indicative value was no justification for reducing the regulatory value. Such an argument was entirely circular.

13.136. The values referred to by the Director were determined by the market in the light of the indicative values set by the Secretary of State in 1989. They could not then be used as an excuse to reduce the regulatory values still further. This was a circularity to which the Director had admitted in the past, but which, Portsmouth said, he had conveniently forgotten to mention when making the irrelevant comparison of indicative value with market value for Portsmouth.

*Figures omitted. See note on page iv.

13.137. Moreover, Portsmouth said, the Director had given an entirely misleading impression by stating that the company was floated in September 1990. It was not floated, only converted to plc status. This had important implications for the market values implied for the company at that time. Because there was no flotation, the shares in the company were not marketed and there was very little trading in the shares. As a result, unlike the WaSCs at privatization, the price of Portsmouth's shares at that time could not be interpreted in any way as a considered and true market valuation of the company. Furthermore, the Director's net debt calculation for the company was not correct. Only a small proportion of the cash in its balance sheet should be netted off against debt. The existence of surplus cash at 31 March each year arose because the company had a July to June charging year. Surplus cash at 31 March largely represented water charges collected in advance which were needed to meet operating costs between 1 April and 30 June, where there was a net cash outflow. The cash did not represent excess borrowing.

13.138. The Director had not answered the charge of circularity. Market values of the WaSCs did indeed represent a price 'paid between a willing buyer and seller', but such a price already took into account the regulatory package, including the original indicative value.

Cost of capital on new investment

13.139. Portsmouth made a number of detailed criticisms of the Director's approach to the company's cost of capital on new investment.

13.140. Portsmouth said that any discussion of the cost of capital was essentially meaningless without an understanding of the capital value on which the company was allowed to earn a rate of return. The premium of 0.75 per cent for small company risk was low by comparison with the market as a whole. Although the Director had purported to make allowance for headroom in the company's cost of capital, any such allowance was immediately cancelled out by the unrealistic assumptions made on demand and operating costs.

13.141. Commenting on the Director's convergence methodology, Portsmouth reiterated its view that the financial ratios stated in the Director's modelling were meaningless, and therefore could not be used to make judgments about the need or otherwise for front-loading of K. Again, unless a meaningful level of dividend were to be included in his financial modelling, the financial ratios and cash flows generated were useless for the purpose of assessing the financial viability or otherwise of the company. It was illogical for the Director to argue on the one hand that dividends and interest were irrelevant while on the other refusing to incorporate in the cash flow model consistent assumptions which reflected reality, and without which his financial ratios were rendered spurious.

13.142. As to dividends, the Director had asserted that Portsmouth had increased its dividend in 1993/94 by 40 per cent over the previous year without providing adequate justification for this increase. This statement was wrong. In fact, profits attributable to ordinary shareholders had increased by 35 per cent in 1993/94. The dividend increase of 40 per cent was therefore only slightly higher and reflected the fact that in the previous year, Portsmouth's dividend cover of 2.45 times was still somewhat higher than that of its peer group in the water industry.

13.143. The Director had also asserted that, compared with other quoted WoCs, the increase in Portsmouth's dividend had been particularly marked. That statement was misleading, since dividend increases by WoCs since 1989 reflected their historic highly-g geared capital structure as well as changes in profits. In fact, Portsmouth's dividend increases had not been exceptional relative to the industry; the key point was that the level of dividends was consistent with both the level of profits and industry norms. The Director's decision to reduce the level of dividend in his modelling resulted in dividend cover ratios which made a mockery of his own assertion that a current cost dividend cover of one was a reasonable limit for a water company.

13.144. Furthermore, the use of Brockhampton's dividend as a pretext to reduce the dividend assumed for Portsmouth ran contrary to the Director's own assertion that the ownership of water companies was not relevant for regulation. Portsmouth paid a dividend to Brockhampton that was in line with industry norms and represented a figure which could be met with sustainable cover ratios. The fact that Brockhampton chose to pay a lower dividend reflected the priorities of Brockhampton's shareholders.

13.145. Turning to the question of interest, Portsmouth said that the Director's underestimate of the company's indebtedness arose from a misinterpretation of its cash balances and a significant understatement of the cost of its borrowing. The company had fixed-term, fixed-interest borrowing and therefore the interest charges in respect of existing borrowings were accurately forecast in Portsmouth's projections. In the company's view, the Director's net interest calculations were significantly understated because of the assumptions on interest rates and the unrealistic cash flows which were a reflection of the unrealistic revenue and operating cost projections. In addition, the Director's arbitrary decision to slash the projected level of Portsmouth's dividends produced a major cumulative distortion in the cash flow.

13.146. Finally, commenting on company performance and comparisons, Portsmouth said that the Director had correctly stated that the company had calculated a number of ratios based on water company historic cost accounts to show that it was less profitable than its peers and had a modest cost base. Portsmouth said that it noted with great interest the fact that the Director had not denied that the ratios calculated were consistent with its claims. Rather, he had said that historic cost accounts were irrelevant. Portsmouth said that it found that attitude surprising. By and large, the financial markets paid no attention to current cost accounts, focusing solely on historic costs accounts. The accounting standard on CCA was withdrawn in 1988, having been suspended in 1985.

13.147. Portsmouth considered the Director's reluctance to consider the implications of evidence which supported the company's position to be wholly unsatisfactory. However, it had highlighted in its submission to the MMC a number of current cost measures which confirmed that, on the measure preferred by the Director, Portsmouth was still shown to be significantly less profitable than the average for the industry as a whole.

The tariff basket

13.148. Portsmouth said it acknowledged that the Director had taken account of the company's unusual charging year in his determination of K.

Overall performance and key indicators

13.149. Referring to the Director's projections, Portsmouth said that it was interesting to note that the Director's assessment of an appropriate level of profitability for the company was in fact higher than that sought by the company in its submission to the MMC. This reinforced the company in its view that the financial objectives were modest and reasonable. The key issue was whether the assumptions underlying the costs and revenues were realistic or not.

13.150. On dividends and cover ratios, Portsmouth said it noted that the Director's projections showed CCA dividend cover in excess of [*] times throughout most of the ten-year period. The company reiterated the absurdity of this assumption, given that it conflicted with the facts as to the prevailing level of dividends and the Director's own observation that CCA cover should not fall below one, and given that it ignored the whole theory of current cost accounting, the purpose of which was to identify a level of profit which might indeed be wholly distributable without undermining the financial viability of the business.

13.151. Portsmouth also noted that the projections suggested that the company would accumulate burgeoning cash balances over the review period. Again, it was extraordinary that the Director should consider this a comforting sign, rather than reflecting that it might suggest some error in the modelling assumptions, as the company had repeatedly argued.

13.152. Referring to a further forecast (see Table 13.8) based on figures produced by the Director, showing a comparison of financial indicators for Portsmouth, all the WoCs and the water industry as a whole, Portsmouth said it appeared that it had started K2 with interest cover and gearing broadly in line with the other WoCs. By the end of K3, the company's ratios were expected to be vastly superior, even though its profitability was shown to be less than the average for the sector. The reality, as the company had persistently argued, was that the Director's projections were worthless.

*Figure omitted. See note on page iv.

TABLE 13.8 Comparison of financial indicators for Portsmouth, all WoCs and total industry

	1992/93			1995/96-1999/2000*		
	Portsmouth	WoC	Industry	Portsmouth	WoC	Industry
HCA interest cover	[3.6	9.1	[
HCA dividend cover	‡	2.5	3.3		<i>Figures omitted.</i>	
HCA gearing		45.7	13.7		<i>See note on page iv.</i>	
Post-tax return on capital (%)†]	11.4	12.7]
	2000/01-2004/05*			2004/05		
	Portsmouth	WoC	Industry	Portsmouth	WoC	Industry
HCA interest cover	[
HCA dividend cover					<i>Figures omitted.</i>	
HCA gearing					<i>See note on page iv.</i>	
Post-tax return on capital (%)]

Source: MMC from data provided by the Director.

*Unweighted average.

†As valued by the Director.

13.153. As regarded the financial ratios quoted in Table 13.8, having been told that its calculations of relative profitability were irrelevant because they were based on historic cost accounts, Portsmouth now found that the Director himself was relying on financial indicators based on historic cost accounts. The inconsistency of this approach was both familiar and unsatisfactory to the company.

Tax

13.154. Portsmouth said that ACT was a down-payment by a company in respect of its own corporation tax liability, the payment of which happened to be triggered by the payment of dividends. It was complete nonsense to suggest that in some way this could be considered as personal tax and therefore excluded from the calculation of post-tax returns. The Director's logic would suggest that if the company simply stopped paying dividends it could increase its post-tax returns.

Supply/demand balance

13.155. As to the costs of meeting growth in demand, Portsmouth said that it had to meet a set level of service for pressure and the certified computer analysis of the mains network had shown what reinforcement mains were required for satisfactory pressures at the originally forecast levels of demand in the SBP. This work had been re-examined to determine the lesser extent of reinforcement mains needed at the flatter demand forecasts and the lower costs involved had been allowed for in the company's revised capital expenditure forecasts.

13.156. The Director's determination also took no account of the company's need to develop security links to guard against loss of supplies due to pollution of three groundwater sources in a common aquifer in the east of the company's area, develop groundwater sources to restore any loss of output experienced at the sources just mentioned, extend one service reservoir to provide adequate storage for the customers served and lay new mains on the housing estates to be developed over the next ten years. The scale of these elements of growth expenditure was unaffected by the slower rate of increase in demand.

13.157. The Director had given no rationale for his figures on water available for supply, and had ignored Portsmouth's careful, comprehensive and certified analysis. The Director also appeared to have ignored what the reporter had said in his certifying report and this had led him to err in stating that the difference between his assessment of growth and that of the company was due to the inclusion of low-flow river expenditure. In fact, that expenditure had all been included in the category of 'capex compliance'.

‡Figure omitted. See note on page iv

Quality functions

13.158. Portsmouth said that the Director's statement that the costs of the River Hamble scheme were apportioned between 'capex compliance' and supply/demand balance were incorrect. All costs for this scheme were allocated to 'capex compliance', as they were considered to represent a quality enhancement in accordance with the Director's own definition.

Capital productivity

13.159. Portsmouth said that the Director had been wrong to assume that the company could make further capital expenditure efficiency savings to the same degree as larger companies. Portsmouth had to deal directly with contractors who actually did the work, whereas larger companies often had a utility arm. Portsmouth's planned capital investment involved straightforward, traditional engineering work, with little opportunity to reduce costs. All design and contract document preparation was done in-house with the exception of service reservoirs built on a design and construct basis. The potential for economy in mains renewals had been fully realized, and in any case the size of contracts was typically smaller than would be involved in a larger company.

Cost base

13.160. The Director had not, Portsmouth said, published the basis for his 'standard costs'. He had asked for properly certified costs from companies, but then apparently disregarded them and used his own opaque methodology. Neither the company nor the industry had accepted these standard costs, and their basis had never been made clear. In particular, the standard above-ground schemes for which the Director had asked companies to prepare costs were almost wholly unrepresentative of Portsmouth's capital programme. It was for that reason that the company opted not to submit costs.

Response to Southern CSC'S views

13.161. Portsmouth said that it had co-operated fully with Southern CSC since its inception, working with it in the interests of its customers. Levels of service, customer care and efficiency had been improved, as acknowledged both by Southern CSC and OFWAT, yet Portsmouth had successfully maintained its position of having the lowest water charges in the country.

13.162. Portsmouth was accordingly dismayed that Southern CSC's submission had portrayed a rather negative view of the relationship, which was at odds with Portsmouth's experience in the past. Southern CSC's submission included a number of specific statements and assertions, sometimes supported by examples. The company strongly rebutted a number of these examples, many of which applied not to Portsmouth but to Southern or other companies in the Southern area.

Portsmouth's infrastructure charge

13.163. Portsmouth said that many of Southern CSC's comments related to general trends in the Southern region. These generalizations did not apply to its own specific circumstances where investment in new capacity was solely due to new customers. It did not follow that customers paid for growth through infrastructure charges and higher bills. Infrastructure charges reduced the overall level of other charges. Furthermore, new customers would increase Portsmouth's total revenue if the value of the company's assets also increased. This increase would only occur when the value of the infrastructure charge failed to cover the cost of connecting new customers to the system. This was because revenue from infrastructure charges was treated as a deduction from capital value.

Expenditure

13.164. Portsmouth said that Southern CSC was right in saying that the majority of customers surveyed by the company did not want any discretionary investment for improvement in water or service quality if that might increase their water bills. The company had demonstrated, however, that there was a short-term peak in above-ground asset maintenance expenditure required to keep levels of service at the current standard. Investment for this was needed and it was easy to foresee the severe condemnation of the company by Southern CSC if serious supply problems for large numbers of customers occurred because the company had failed to maintain adequately its source pumping stations. In fact, of those customers who responded to the Market Plan, 76.63 per cent said that they were satisfied with Portsmouth's proposals. The programme of investment preferred by the company and the majority of customers consulted was included in the SBP, which was certified by an independent reporter.

13.165. It was untrue that total demand for water was not growing, as suggested by the Southern CSC. Portsmouth still anticipated an average increase in water put into distribution of 0.6 per cent a year as a result of growth in new customers and increasing per capita demand amongst existing domestic customers. Additionally, investment in growth was not, as claimed by the Southern CSC, restricted only to new resources; reinforcement mains, security links and back-up sources might also be required, as well as routine laying of mains on new development sites.

13.166. The Southern CSC had contended that there was no demand from new customers for supply security. The company had no doubt, however, that if a pollution incident were to occur and large numbers of customers experienced poor or no supply because of lack of security measures, the company would be severely censured for lack of foresight.

13.167. As to the restriction of Portsmouth's abstraction licences by the NRA, Portsmouth said that the Hamble source investment proposal had been jointly promoted by the company and the NRA. The need for expenditure on the Hamble was necessary in the light of NRA statements of intent. Southern CSC was not in a position to know the details of what the NRA had told the company about this matter. Southern CSC's comments were at odds with the intentions expressed to the company by the NRA.

Performance targets

13.168. Portsmouth said that it was at a loss to understand Southern CSC's criticisms of the information provided by it on performance targets. Portsmouth's standards of performance were assessed by OFWAT and reported on annually in the Level of Service Report. No indication of dissatisfaction had ever been received from Southern CSC concerning this information. Indeed, in a letter to Portsmouth in November 1993, the Southern CSC had said that it found the Service Target Report to be 'very clear and helpful'. Nor had Southern CSC contacted the company to request further information. Portsmouth was quite happy to provide extracts from the Annual Return and clarification, but could not justify the costs which would be incurred by provision of an entirely separate report specifically for Southern CSC.

Efficiency

13.169. Portsmouth said that Southern CSC's response on efficiency was thoroughly confused. Portsmouth had achieved significant efficiency savings but could not isolate itself from the trends in the wider economy.

13.170. Portsmouth had largely completed efficiency measures in its labour force by 1989 including the reduction of its staff from 381 in 1980 to 300 in 1990. It had to pay competitive rates to recruit and retain staff. Since 1989 the company had been expected to increase its activity significantly in a number of areas, including a 20 per cent increase in the number of customers billed directly, many new payment methods and a doubling in laboratory testing. All this had been achieved with only a modest increase in employment numbers (from 300 in 1990 to 316 in 1994). The company had submitted a separate note to the MMC entitled *Employment and productivity trends at Portsmouth Water plc* which demonstrated the improved service provided by the company from 1990 to 1994.

13.171. While agreeing that there was still scope for some improvement in efficiency levels, Portsmouth was disappointed that Southern CSC had not included any reference to the many improvements which it had made over the past few years, including those made as a result of 'milestone' targets, agreed following meetings with Southern CSC. Milestones are improvements for the company to make by set dates. Portsmouth had provided a number of examples of milestone targets, including establishing a register for elderly and disabled customers, the introduction and publicity of special services for such customers, staff training in how to deal with customers with disabilities, a new telephone and queuing system, the production of a water quality leaflet and increased choice of payment options. In addition, in the area of debt recovery, Portsmouth had taken a number of initiatives which were intended to help customers who were falling into debt, and to encourage customers generally to seek the help of the company if they were experiencing payment problems. The Southern CSC had actually commended this initiative, which had assisted the company in achieving a company/customer debt to turnover ratio which was one of the lowest in the industry, while debt write-offs were kept to a minimum.

13.172. Historically, Portsmouth had had a low level of disconnections, and disconnection would always remain a last resort.

13.173. Portsmouth had not been slow to respond to suggestions for improvement made by Southern CSC where such improvements would benefit customers whilst not jeopardizing the company's policy of keeping charges as low as possible. The company had an optional metering scheme, including a free survey, flexible siting and installation by the customer's own plumber if preferred. However, despite reconsidering its tariffs on numerous occasions, it had not been able to accept Southern CSC's recommendation on the level of the standing charge for measured customers.

13.174. Portsmouth acknowledged that it had failed to inform Southern CSC of its change of date of sending bills and that many customers did not realize that the date had changed. An apology had been given to Southern CSC immediately and a notice placed in local newspapers clarifying the position for customers. Generally, however, information requested by Southern CSC was forwarded within the set time-scales and often within a few days of the request. So far as the Market Plan was concerned, Portsmouth had carried out the exercise as promptly as it could consistent with the proper consultation of its customers. The Southern CSC was advised at all stages of the exercise. Portsmouth recognized customer resistance to price increases for further service improvements, and as a consequence made no allowance for further improved services in its SBP or its submission to the MMC. The company said that it believed it had reflected its customers' preference in its proposals, and noted that the market research showed 98 per cent satisfaction with current levels of service.

Other points

13.175. Portsmouth said that it was obviously concerned about the issue of affordability, but that the Southern CSC's comments did not appear to refer specifically to Portsmouth. Rather, the region being referred to was the Southern CSC's region, of which Portsmouth was only one part. Nowhere in the Portsmouth region were charges amongst the highest in the country, as suggested by the Southern CSC.

13.176. The Southern CSC's statement that 'considerable efficiency gains could be made' was, Portsmouth said, clearly unsubstantiated. The issue of the UWWTD, while it might affect Portsmouth's customers through sewage bills paid to Southern, had no effect on Portsmouth's water bills.

13.177. Referring to future charging methods, Portsmouth said that it welcomed Southern CSC's recognition that metering was not cost-effective for it at the moment. But it did not accept Southern CSC's criticisms. It had commissioned a separate study which showed conclusively that widespread domestic metering would be the least economic option for dealing with increased demand. Therefore, it did not consider it prudent investment to install meters in new properties as a matter of course. Furthermore, the evidence that metering significantly reduced consumption in the long run was not conclusive. Market Plan research had shown that the majority of customers surveyed were against metering.

13.178. The choice of which method of charging for water would be adopted after 1999 was largely outside the company's control. The industry was currently waiting for an announcement from the

Secretary of State. However, Portsmouth was concerned to adopt a method of charging in future which had limited incidence effects and was cost-effective.

13.179. Finally, commenting on criticisms of its dividend policy, Portsmouth said that it had justified its policy exhaustively. Portsmouth said that the facts showed that dividends were prudent, consistent with the level of profitability and consistent with the company's peer group. As to what Brockhampton chose to do with its income from Portsmouth, that was outside the scope of the regulatory environment. However, two specific imputations by Southern CSC needed to be corrected. First, the reference to 'customers who had not had real increases in their own incomes' did not take account of the modest growth in real income which such people did experience over the long term; this had been the experience over the past decades, including during the past recession. [

Details omitted. See note on page iv.

]

Response to third party views

13.180. Noting the various comments which the MMC had received from third parties, Portsmouth said that it acknowledged the concern of consumer bodies, industry representatives and members of the public, particularly over the level of charges in the water industry. It accepted that it had a responsibility to achieve cost reductions through continued efficiency improvements and to customers who found it difficult to meet their financial commitments within very tight budgets. These concerns were best met by a water undertaking that had a proud history of serving its constituency with a high-quality service at low cost to its customers. Complaints over excessive water charges could not apply to the company which had the lowest levels of charges, was the lowest-cost business and yet had a record of standards of service and customer satisfaction that were evidently superior to the average.

13.181. Portsmouth welcomed the fact that prices were set to increase less than in the previous five years for the industry in general. Nevertheless, it was unreasonable for Portsmouth, operating with the lowest level of costs in the industry and with a record of high efficiency, to face even higher cuts in revenues than average through having been given the second worst K.

13.182. For customers who found that they could ill afford increases in water charges, there were a number of payment options and customer service improvements which the company had introduced to assist them. They had been introduced, even though this had resulted in a modest increase in staff numbers and an increase in the administrative burden on staff.

13.183. Finally, it was important for aggrieved customers to realize that there were a number of obligations that the company faced which entailed increases in costs. As one consumer body had commented, a massive capital investment programme had been necessary after privatization 'to enable companies to achieve higher standards for both drinking water and waste water treatment'.

G D W ODGERS (*Chairman*)

P A HODGSON

T P HUGHES

D J JENKINS

G F OWEN

G WHITTINGTON

A J NIEDUSZYNSKI (*Secretary*)

28 June 1995