Financeability – Yorkshire Water Draft Determination Representation
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Financeability overview

Introduction
This section of our response addresses several actions raised by Ofwat in its draft determination, relating to the financeability and the financing structure of Yorkshire Water. In addition, it includes our further representation on the revised cost of capital published in the draft determination. As we explain, we have significant concerns on the approach taken by Ofwat.

Summary of key findings
The matters that we have covered can be summarised as:

Financeability and return on regulated equity
We are pleased to say that Yorkshire Water remains financeable and financially resilient on an actual capital structure on the basis of representations. However, as a result of Ofwat setting an efficiency challenge substantially beyond what a notionally efficient firm is capable of delivering with a balance of risk that is materially skewed to the downside, when combined with the reductions in the WACC, we cannot have any confidence that the notional company is financeable. This has been considered by the Board of Yorkshire Water and reflected in their assurance statement.

Our response includes a substantial piece of analysis that has been commissioned from Economic Insight. This analysis considered the supporting evidence provided by Ofwat for the need to make a ‘step change’ in efficiency, the distribution of risks resulting from the draft determination for Yorkshire Water and other water companies, and whether there truly has been calibration of return ranges to reflect the reduced cost of capital in the draft determination.

We also include further analysis from First Economics regarding the evidence supporting Ofwat’s proposal to reduce the WACC to 2.19%. Ofwat’s approach has been based on a selective interpretation of data, particularly the equity beta based on observations from too short a period such that recent short-term events are introducing distortions. As a result, the WACC at 2.19% is too low for the notional company to be considered financeable at the desired credit rating.

Our conclusion, supported by the evidence from Economic Insight, is that the efficient company constructed by Ofwat is unachievable and not financeable at the cost of capital published by Ofwat in its draft determination.

Ofwat had requested us to consider the potential for further reductions in the cost of capital, when assessing financeability and financial resilience, which could see a further 0.37% reduction. We have not carried out this analysis due to the conclusions reached on the financeability of the
notionally efficient company at the current cost of capital. We do not wish to comment on hypothetical scenarios given the material uncertainty around the package of costs and outcomes assessed by Ofwat in the draft determination.

Also, we have drawn attention to Ofwat’s benchmark for assessing financeability by the maintenance of investment grade credit ratings and the criteria applied by Moody’s from its published methodology. It is clear that a notionally efficient company cannot be ‘A’ rated and would fail to meet an important criterion, its interest cover ratio, which forms part of an assessment for an investment grade rating.

**Cost of capital**

We have reviewed in detail Ofwat’s approach and assumptions regarding the calculation of the cost of capital, which has fallen to 2.19% from the early view in December 2017 of 2.40%. This has included analysis commissioned from First Economics on a key driver of the reduction made by Ofwat, being the equity beta.

We believe that Ofwat has not followed good regulatory practice and its approach is inconsistent with that taken for PR14 without adequate evidence. In addition, we cannot see any consideration given to the increased risks resulting from Ofwat’s assessment of achievable performance for costs and outcomes.

Consequently, we do not agree with Ofwat’s revised assessment for the cost of capital in its draft determination. We have identified adjustments to correct reasonably for inconsistencies and errors that would result in a cost of capital of 2.64%. In order to be able to progress to an appropriate package of costs and outcomes, we would consider adopting a cost of capital of 2.4%, being the early view from December 2017 and the basis for our Business Plan submitted in September 2018.

**Gearing and default mechanism**

In light of the draft determination, we have reviewed the forecasts in our IAP resubmission to reduce gearing to 70%. Yorkshire Water remains committed to reducing gearing to 70% but our assessment of the draft determination has identified that this could only be achieved over the whole of AMP7 and not by the end of the first year of that period.

As requested, we have clarified how we could deliver the forecast reduction in gearing, which would still require significant shareholder support through the retention of dividends and capital injections into Yorkshire Water.
We continue to accept the application of the financial outperformance sharing mechanism for the sharing of the benefits of high leverage and we forecast that there will be such a benefit to be shared with customers due to the forecast levels of gearing in AMP7.

Since this default mechanism was announced in May 2018, we have seen a substantial increase in risks to efficient performance on costs and outcomes and a reduction in the cost of capital – both of which hinder our ability to reduce gearing rapidly. Therefore, building on the reference to a possible need for a glide-path in Ofwat’s statement on restoring sector balance, we have proposed a glide-path for financial outperformance sharing mechanism with a steady reduction in gearing down to 70% over the whole of AMP7. We have kept this proposal simple in that it seeks a glide path only on the trigger threshold and, if this threshold is breached, it does not seek to mitigate the calculation of any benefit to be shared with customers in line with the default mechanism.

In the context of the draft determination, we believe our proposal maintains an appropriate balance between an incentive to reduce gearing to 70% and accepting the consequence if we fail to maintain a steady reduction in gearing. This updated forecast will be reviewed in the round with the package of costs and outcomes when we receive Ofwat’s final determination and also to take account of financial market conditions.

**Dividend Policy**

As requested by Ofwat, we have provided further clarity on our dividend policy, building on the recognition that it is demonstrating elements of best practice. Specifically, we have confirmed how we will demonstrate annually that the policy will take account of our commitment to customers and the level of performance delivery. We will do this in a transparent manner and this will include any deviation from the policy, such as the retention of allowable dividends to reduce gearing.

**Conclusions**

The conclusion of our analysis of the methodologies, evidence and data used by Ofwat for its assessment leads us to fundamentally question the validity of its expectations of a notionally efficient company and does not support a lower cost of capital to the early view published in December 2017.

We believe that the ‘screws have been tightened’ to the extent that there could well be an adverse impact on investor appetite to finance the investment necessary to ensure Yorkshire Water can deliver on ambitious targets as part of its long-term strategy. Whilst the company will remain financeable with an actual capital structure on the of representations, it may face an increased cost of financing or more stringent conditions that limit its ability to invest for the long-term challenges beyond AMP7.
Financeability and the notional company

Pro-forma reference: YKY.LR.C1

Ofwat feedback

We expect companies to provide further Board assurance, in their responses to the draft determination, that they will remain financeable on a notional and actual basis, and that they can maintain the financial resilience of their actual structure, taking account of the reasonably foreseeable range of plausible outcomes of their final determination, including evidence of further downward pressure on the cost of capital in very recent market data as we discuss in the ‘Cost of capital technical appendix’.

Our response

Introduction

The Board Assurance Statement is shown in ‘YKY DD Representation BAS’.

We have reviewed our financeability and financial resilience using the same approach as taken for the submission of our Business Plan in September 2018 and our IAP resubmission in April 2019. We can confirm that we remain financeable and can maintain financial resilience on an actual capital structure on the basis of our representations. However, as a result of Ofwat setting an efficiency challenge substantially beyond the delivery capability of a notionally efficient firm with a materially skewed balance of risk to the downside and a reduced cost of capital, it is not possible for us to have confidence that the company is financeable on a notional basis.

We note Ofwat’s comments and information regarding further downward pressure on the cost of capital and refer to our specific representation on the reduction to 2.19% in Ofwat’s draft determination. We have not considered any hypothetical scenarios for further reduction down to 1.81%, as indicated by Ofwat would be the position indicated by more recent data. This reflects our disagreement with the recent reduction in the cost of capital and a further reduction is not reasonable nor part of a plausible outcome, due to the increased risks from Ofwat’s draft determination. Therefore, our analysis of financeability and financial resilience has been based solely on Ofwat’s draft determination for cost of capital at 2.19% on an RPI stripped basis and our representations.

Our analysis of financeability has considered Ofwat’s expectation of a notionally efficient firm, including analysis commissioned from Economic Insight, and the use of leverage and coverage metrics in its assessment of financeability. We set out further details and our conclusions in the rest of this response.
Financeability of the notionally efficient firm

With three other water companies, we have commissioned Economic Insight to analyse whether a notionally efficient firm is financeable in light of the ‘step change’ that Ofwat has set as part of PR19. For reference, Economic Insight’s report is shown in Appendix-F1.

This review has considered Ofwat’s financeability duty and the appropriateness of the ‘step change’ when analysing historical performance and proportionality of the PR19 challenge. To put into perspective, when considering past price reviews, the regulatory challenge has increased by an unprecedented 60% for PR19.

The principal points noted are:

- The interests of current and future customers need to be protected when assessing financeability. If an unachievable package of efficiencies and outcomes is set for a price review, such that there is insufficient funding to deliver necessary services and outcomes, then this may harm future customers.

- Any ‘step change’ on efficiency will result from a combination of efficiencies due to productivity gains (also described as ‘frontier shift’) and those due to a need to catch up to equivalent efficiency in a competitive market. In an incentivised framework, it is expected that efficiency changes will be driven principally by productivity gains.

- Economic Insight’s analysis has considered efficiency improvements in water companies against the UK as a whole. It has not been possible to find credible supporting evidence to Ofwat’s assertion that UK businesses are improving efficiencies in the face of cost pressures. Also, whilst there has been some historical outperformance for costs and outcomes, there is no evidence of continual and substantial outperformance nor any evidence that this can be achieved consistently by a company for both categories.

- Therefore, although there were productivity gains in water companies immediately after privatisation, there is no evidence to support the assertion that water companies have fallen behind in the current decade and there is a ‘step change’ required to catch up.

- This analysis of historical efficiencies is supported further by comparing actual returns and the return on regulated equity against allowed returns. Again, there is slight outperformance but no evidence to support consistent and substantial outperformance by water companies. In addition, we note that there are notable differences for individual water companies and that there is a broadly even split between winners and losers. Therefore, again, we do not see any substantive evidence to support the requirement for a ‘step change’.
A number of issues have been identified from analysis of the distribution of risk for the notional firm. This centres around the concept that expected cashflows returns should match allowed return and performance on costs and outcomes. Therefore, performance criteria needed to be considered against the assessment of WACC, together with financeability, and recalibrated appropriately to ensure there is an expectation that a notionally efficient firm achieving the target level of performance is financeable.

The noted issues that challenge this concept are:

- Ofwat’s statement that averagely performing companies would incur penalties on their outcomes.
- Ofwat’s transposition of company assessments of risk, based on company views of achievable performance, onto its view of what can be achieved in its draft determinations.
- Ofwat’s assertion that an efficient firm should face symmetrical RORE risk. This is not borne out by Ofwat’s draft determination where 16 companies had a negative skew and 10 companies had a negative skew greater than 2%.
- The implication that the indicative RORE ranges have not been calibrated to WACC given the changes between Ofwat’s early view and its draft determinations.
- Empirical evidence indicates that expected returns for more efficient firms, including fast track companies, are as skewed to the downside as for less efficient firms.

Therefore, our conclusion from Economic Insight’s analysis is that there is not substantial evidence to support the need for a ‘step change’ and the notional firm construct is so extreme that it cannot exist, since it is beyond what is achievable, and has an unacceptable distribution of risk.

**Leverage and coverage metrics used to assess financeability**

We have considered the target levels for leverage and coverage metrics that a notional company should achieve for a Baa1 credit rating from Moody’s. Whilst ratings are provided by S&P and Fitch, we have focused on Moody’s due to their recent update on the draft determinations.

**Moody’s ratings methodology and criteria**

We have referred to the criteria set out in Moody’s rating methodology for regulated water utilities, issued June 2018, which is shown in Appendix-F2. In addition, we have noted Moody’s commentary, “Ofwat tightens the screw further” issued on 26 July 2019 as shown in Appendix-F3.
This recent commentary considers a hypothetical notional company in line with Ofwat’s assumptions.

Moody’s rating methodology sets out the following leverage and coverage metric ranges for A and Baa rated entities:

**Table 1 – Moody’s rating methodology leverage and coverage metrics**

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<tr>
<th>Rating</th>
<th>A</th>
<th>Baa</th>
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<tr>
<td>Gearing</td>
<td>40%-55%</td>
<td>55%-70%</td>
</tr>
<tr>
<td>AICR</td>
<td>2.5x-4.5x</td>
<td>1.5x-2.5x</td>
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As noted in our response to YKY.LR.A4, we believe greater importance is attached to interest cover ratios, than gearing, as they are a cash-based metric, measured prospectively as well as retrospectively over a period and provide a more realistic view on credit worthiness.

Moody’s has assessed that the Adjusted Interest Cover Ratio (“AICR”) for a notional company would be 1.3x at the RPI stripped WACC of 2.19% announced as part of the draft determination. This would then fall to 1.15x at the lower WACC of 1.81% indicated by Ofwat if more current data was considered.

Therefore, Moody’s analysis indicates clearly that a notional company with 60% gearing would not be able theoretically to maintain the necessary AICR to support an investment grade rating. As noted in Moody’s report this would be an industry issue and so not just specific to Yorkshire Water.

**Ofwat’s use of leverage and coverage metrics**

Ofwat’s financeability assessment uses its own bespoke ratios, rather than those calculated by Moody’s. We consider this approach inappropriate since it is not a proper comparison and Moody’s ratings and criteria are crucial when assessing whether companies can maintain the necessary ratings to raise finance on reasonable terms and in the long-term interests of customers.

Ofwat also appeared to suggest within their IAP that they would be uncomfortable with the level of headroom if companies proposed a rating level below Baa1 from a financial resilience point of view.

“Most companies target BBB+/Baa1/BBB+ […] our assessment requires a need for careful consideration of the evidence and assurance companies provide where a lower credit rating is targeted, because lower credit ratings indicate a lower level of headroom to potential cost shocks”
We note that Ofwat is being inconsistent in this issue by desiring a rating level of at least Baa1 for assessing financial resilience, but then not ensuring that the notional company is financeable at this rating. Furthermore, we note in our representation on WACC that Ofwat has reduced the cost of debt for a 25bp ‘halo effect’ from current indices for A and BBB rated companies, which we believe is not supportable since a notional company clearly cannot achieve a ‘A’ rating and so would be unable to raise debt at a cost that is commensurate with an A rating.

Finally, in addition to not using the correct ratios when making their financeability assessment, we believe there are some modelling errors within Ofwat’s model that overstate the metrics used to make their assessment, including recognising revenues relating to pension deficit repair payments but not the associated costs and the inclusion of business retail profits considerably higher than those within our Business Plan. This is covered in further detail in the financeability analysis shown below.

When we make adjustments to Ofwat’s model to correct for the above errors we achieve an adjusted interest cover ratio of 1.33x in comparison to Ofwat’s 1.4x. We note that this is considerably closer to Moody’s industry wide figure of c1.30 than Ofwat’s.

**Ofwat’s remedies for financeability challenges**

One remedy proposed by Ofwat to address any financeability concerns would be to improve coverage ratios through the use of cost recovery ratios to accelerate revenues. However, Moody’s and Fitch reverse such adjustments when calculating their AICR and this approach is also used for the calculation of coverage metrics when confirming compliance with financial covenants.

An alternative remedy from Ofwat of reducing gearing by dividend retention or capital injection would also be ineffective. We calculate that notional gearing would have to reduce to below 53% to achieve the desired target AICR for Moody’s. Setting aside the obvious issues to reduce the gearing of a notional company, a reduction of this extent would result in a notional company meeting the gearing criteria to be ‘A’ rated but still unlikely to meet the AICR criteria to support such a rating.

**Financeability analysis**

We have conducted detailed analysis to determine whether the company is financeable, based on our representations, for a notional balance sheet and an actual balance sheet basis.

This detailed testing has been conducted on a consistent basis with the previous testing conducted to support our original business plan submission in September 2018 and our revised business plan submission in April 2019.
To determine whether the Company is financeable we have calculated key financial ratios on both a notional and actual basis and then compared those ratios against determined target levels, which are consistent with the target levels assessed within our prior business plan submissions.

The below table summarise the key ratios assessed and the target levels they have been assessed against on both a notional and actual basis.

**Table 2 – Key ratios and target levels assessed on a notional and actual basis**

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<th>Notional target</th>
<th>Actual target</th>
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<td>Adjusted interest cover (&quot;ICR&quot;)</td>
<td>1.50</td>
<td>1.30</td>
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<tr>
<td>FFO to debt</td>
<td>9.00%</td>
<td>6.00%</td>
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Ratios have been calculated using Ofwat’s financial model, with a check being conducted against our own financial model.

Our analysis comparing the output from our own financial model to Ofwat’s financial model has highlighted a couple of modelling discrepancies which we believe are causing the ratios stated by Ofwat’s financial model to be overstated.

These differences are caused by the following factors:

- Accounting treatment of pension deficit contribution payments – Ofwat’s financial model includes the revenue associated with pension deficit payments but does not include the associated cost. This results in an overstatement of ICR’s of c4bp for the average AMP figure
- Business retail EBITDA – Ofwat’s financial model has made a number of changes to our submitted business retail figures, resulting in a significant increase in EBITDA. This results in an overstatement of ICR’s of c3bp for the average AMP figure
- Minor variances in interest costs caused by different assumptions around the opening gearing and the calculation of interest costs on new debt.

**Notional financeability**

As a result of the discrepancies noted above within the Ofwat model, we believe the notional ICR calculated on the alternative (ratings agencies) basis is reduced from 1.40 to 1.33 on an average AMP basis.
In summary, our analysis shows that:

- Average ratios are above target for Ofwat’s key ratios
- Average ratios are below target for ratings agencies key ratios
- Ratings agency ICR is below target in all five years
- Ratings agency FFO to debt is below target in all five years

As the analysis above shows that Ratings Agency ratios will fall below target in all years, we do not believe the notional company is financeable at the desired target level (Baa1 / BBB+)

The notional company could be considered financeable at the next ratings level down (Baa2) which has an ICR target of 1.3 times, but this would be inconsistent with the assumptions made by Ofwat when determining the notional cost of debt, plus Ofwat’s own view within its initial assessment of business plans that a rating of at least Baa1 should be targeted to ensure there is an appropriate level of headroom for any cost shocks.

As a minimum, this will necessitate changes to Ofwat’s cost of capital calculation since the current ratios for the notional company mean that it is not possible for Ofwat to assume that companies will raise new debt at the cost assumed as part of its assessment supporting a cost of capital of 2.19%.

**Actual financeability**

In summary, our analysis (based on our representations) shows that:

- Ofwat’s ratios are comfortably above the target level
- Ratings agency ICR is above target in all five years
- Ratings agency FFO to debt is above target on an average basis
- Our covenanted ICR is above target in all five years

Forecast ratios are above the target level for all ratios; therefore we can conclude that the Company is financeable on an actual basis.

**Financial resilience analysis**

We have conducted detailed analysis to determine whether the company is financially resilient throughout AMP7 and beyond.
This detailed testing has been conducted on a consistent basis with the previous testing conducted to support our original business plan submission in September 2018 and our revised business plan submission in April 2019.

To ensure that the Company is financially resilient we have conducted the following sensitivity analysis:

i) Reverse stress testing – assessing how much headroom is inherent in our target financial ratios

ii) Forward stress testing – Scenarios conducted as part of our long-term viability analysis conducted for our 2019 annual report

iii) Scenarios prescribed by Ofwat as part of “putting the sector back in balance”

Reverse stress testing
Our analysis has shown:

• EBITDA headroom of £30m (£10m above our £20m targeted headroom) against the trigger level of covenanted ratios

• EBITDA headroom of £76m against the default level on our covenanted ratios

• EBITDA headroom of £24m against the ratings agency interest coverage ratio

• Significant EBITDA headroom of c£80m against Ofwat’s two key metrics

• Interest headroom levels are slightly lower than EBITDA headroom levels

• Capex headroom levels are significantly higher than EBITDA headroom levels

Forward stress testing
We have assessed the impact of the four “severe but plausible” scenarios tested within our long-term viability (LTV) statement in our statutory accounts to ensure consistency between our financial resilience assessment and the work undertaken when assessing our long-term viability.

The results of our analysis show that on an average AMP basis:

• We have sufficient capacity within our gearing covenant to fund the LTV sensitivities

• Ofwat’s key ratios remain above target levels for all of the LTV sensitivities
• Our covenanted ratio remains above the default level for all of the LTV sensitivities

• Our ratings agencies ratios for our current ratings fall below target under certain sensitivities.

The results above do not include any remedial measures.

Whilst the analysis shows that ratings agencies metrics could fall below target it is difficult to conclude with certainty what the impact would be on credit ratings as the levels are trigger levels and not default levels. Other factors would come into the assessment such as: trend, reason for cost shock, management response, mitigation put in place, exceptional nature of shock.

Ofwat’s prescribed scenarios
We have performed the sensitivities as required in Ofwat’s methodology without considering any remedial measures.

The results of our analysis show that on an average AMP basis:

• We have sufficient capacity within the gearing covenant to fund all the sensitivities

• Ofwat’s key ratios remain above target against all of the sensitivities except the combined sensitivity

• Our covenanted ratio remains above the default level against all of the sensitivities except the combined sensitivity

• Our ratings agencies ratios for our current ratings fall below target under certain sensitivities

We consider that some of the sensitivities analysed above, in particular the combined sensitivity, are highly unlikely to arise.

The average annual EBITDA impact of the combined sensitivity is £83m. This is considerably higher than any exceptional costs we have incurred historically. In addition, historical analysis conducted by Economic Insight on the actual cost performance of the industry over the first two years of this AMP has also shown that on average the costs incurred by the industry have been comparable with the allowance provided by Ofwat.

Maintaining sufficient headroom to cover the above costs would not enable us to operate as efficiently as we currently do, which would not be to the long term benefit of our customers.

Whilst the analysis shows that ratings metrics could fall below target it is difficult to conclude with certainty what the impact would be on credit ratings as the levels are trigger levels and not default
levels. Other factors would come into the assessment such as: trend, reason for cost shock, management response, mitigation put in place and exceptional nature of shock.

**Mitigating factors**

All of the analysis above has been conducted without taking into account the benefit of any mitigating factors. If any of the above sensitivities were to arise there are a number of mitigating actions, at a strategic level, that could be implemented that would reduce the financial impact of the event. Examples of mitigating actions that would be implemented include:

- **Management action in line with our established approach to risk management and overall resilience** – In the event of any of the sensitivities above occurring Management would immediately seek to reduce the impact through a number of different actions, such as the reallocation of resources, or cost restructuring. The impact of these mitigating actions would be expected to significantly reduce the cost impact in subsequent years, reducing the total impact of the sensitivities above.

- **Impact of insurance and hedging** – We have insurance cover in place that will reimburse us in the event of additional costs arising as a result of specific incidents such as flooding. We also have hedging in place for significant costs, such as electricity. Applying the benefit of insurance claims and hedging would significantly reduce the impact of the sensitivities above.

**Summary of resilience analysis**

The results of sensitivity analysis, before any mitigating actions are taken into account, show that on an average AMP basis:

- We have sufficient capacity within our gearing covenant to fund all the sensitivities.

- Our covenanted ratio remains above the default level under all sensitivities, except for Ofwat’s extreme combined scenario.

- Our ratings agencies ratios for our current ratings fall below target under certain sensitivities

We note that there would be a number of mitigating actions that would be reasonably expected to be implemented to significantly reduce the impact of the sensitivities on the financial robustness of the company. Also, a number of the sensitivities requested by Ofwat are considered unlikely to occur.

The analysis indicates that there could be pressure on current ratings if extreme downside scenarios materialised and no mitigating action was taken. We believe this reflects the increased
risks (as set out earlier in this response) and that there is sufficient headroom in our current ratings to maintain investment grade ratings, as required to meet our financial covenants.

In consideration of the above, we have concluded that Yorkshire Water is financially resilient throughout AMP7 and the following AMP.

**Conclusions**

We believe that Ofwat has not properly addressed the financeability challenges that their draft determinations present to the sector. When making its PR19 determinations, Ofwat is required by law to secure that appointed businesses are able to finance the proper performance of their statutory functions. We do not believe Ofwat has provided sufficient evidence within its draft determinations in support of its conclusions that each company is financeable on a notional basis.

In light of sector-wide notional interest cover ratios being materially below Moody’s target level for a Baa1 rating, we believe it is now incumbent on Ofwat to ensure in its final determination that Yorkshire Water’s appointed business has the cashflows that it needs in order to obtain and maintain comfortable investment-grade credit ratings, pursuant to Ofwat’s duty to secure that companies are able to finance their activities.

Broadly, from the above analysis, if financeability concerns are not addressed as part of the final determination then we believe there is increased risk resulting from Ofwat’s draft determination that raises the prospect of ratings actions across the industry in early 2020.
Weighted average cost of capital (WACC)

Introduction
We have analysed Ofwat’s revised view of WACC and that it may be materially lowered as part of their final determination, due to movements in core data over the last four months.

The water industry is a long-term industry which requires an appropriately stable approach to the management and financing of its assets. We believe strongly that investor confidence will be eroded by repeated revisions of WACC for short-term data movements as Ofwat will be seen to be increasing risk within the industry.

We acknowledge that the requirements for returns (both equity and debt) are lower now than they have been in past price reviews. However, we do not agree with the weighted average cost of capital (“WACC”) of 2.19% (RPI stripped) proposed by Ofwat within their draft determination.

We considered Ofwat’s “early view” of WACC (2.40% RPI stripped) as set out in their PR19 methodology (December 2017) very challenging, with several factors being set below what we considered to be an acceptable range. However, we chose to adopt Ofwat’s “early view” of WACC for our PR19 Business Plan, submitted last September, as part of the overall risk and return package.

Broadly, our lack of agreement with the recently revised WACC results from the following observations and concerns:

- The period over which Ofwat is considering historical data, particularly beta, is too short, resulting in data movements within a very short period having a material impact on the potential WACC. This means exceptional, short-term events (e.g. potential future nationalisation, Brexit uncertainty) can have a significant impact and WACC loses relevance as a measure for allowed return, even over a relatively short period to March 2025.

- We are concerned at the inconsistencies in Ofwat’s approach to determining WACC, when considering changes during PR19, its approach at PR14 and the approach taken for the broader regulated utility sector.

- Ofwat has not accepted the overall risk and return package within our Business Plan and, by reducing WACC further, has introduced significant downside risk through the cost assessment and incentive regime changes implemented within its draft determination for Yorkshire Water and other companies. This is supported by the evidence in an analysis, commissioned from
Economic Insight, into the financeability of a notionally efficient firm, which forms part of our response to YKY.LR.C1.

- The reduced WACC announced as part of the draft determination is a key factor in our conclusions that a notional company is not financeable.

Our assessment of Ofwat's current view of WACC of 2.19% (RPI stripped) and the supporting evidence indicate a more appropriate level of c.2.64% if it is assessed more consistently and with full regard to the increased risks resulting from the draft determination. We are willing to consider maintaining an RPI stripped WACC of 2.4%, Ofwat's early view from December 2017 and the basis for our Business Plan submission in September 2018, as part of an agreed risk and return package.

**Detailed Observations**

Our analysis of Ofwat’s latest view of WACC, including the potential for a further significant reduction to be announced with the final determination, can be broken down into the key components as follows:

**Beta**

We have commissioned First Economics to undertake a detailed assessment of beta and their report is included in Appendix-F4.

First Economics has identified a number of issues regarding Ofwat’s calculation of beta, principally due to relying on a limited evidence base constructed from a very short historical time period. If the draft determination addressed these issues, such that WACC was calculated more consistently and appropriately, then it would result in a beta of 0.80 and a 0.25% increase for WACC from the level announced in the draft determination.

- In summary, analysis by First Economics has highlighted the following points:

  - The selection of a short two-year data period inherently introduces imprecision in estimates and, when assessing the underlying causes of share price movements, Ofwat has not taken account of factors other than changes in systematic risks.

  - It is usual regulatory practice to review beta estimates over extended periods of time to counteract inherent imprecisions from using short-term data (e.g. two to five year). This can be verified by recent academic research for UKRN and Ofgem, as well as a CMA inquiry in 2014.

  - There is an inconsistency with Ofwat’s approach to the calculation of beta for PR14, when effectively ten years of share price data was used for its final determination and short-term trends were disregarded. At that time, Ofwat chose to look through daily volatility and consider
estimates of beta over a longer period. This approach appears to have been turned on its head for PR19 without any substantive support.

We view Ofwat’s approach is in stark contrast to that taken in the regulated utility sector and that chosen for PR14. In light of First Economics’ analysis, we believe strongly for the final determination that Ofwat should revert to estimating beta using a longer data set of at least five years and should provide further evidence to support the conclusions that there have been changes in true betas.

Ofwat has also noted within its draft determination that data rolled forward to June 2019 would result in a lower beta and hence lower WACC of 1.81%. This highlights further the inconsistency and inappropriateness of the approach taken by Ofwat and the impact on investor confidence that is ultimately not in the long-term interests of our customers. We would consider the inclusion of recent data if Ofwat was to use a longer term data set but would note there remains the risk, albeit reduced, of a range of factors impacting share price movements and beta estimates.

**Expected market return**

Ofwat’s proposed total market return is 8.63% in nominal terms. This estimate is largely unchanged from the value that Ofwat put forward in December 2017, even though the accompanying write-up indicates that Ofwat has discarded its “lower for longer” line of reasoning from two years ago.

We consider that the evidence base, relied upon by Ofwat, is faulty in two main respects:

- in common with the other regulators, Ofwat is rebasing long-established benchmarks for UK historical stock market returns to be CPI stripped rather than RPI stripped. It is noticeable in this regard that Ofwat has undertaken only a very superficial examination of the underlying character of historical inflation indices, causing it to reach incorrect conclusions about pre-1950 returns. We believe that the CPI-stripped expected market return in Ofwat’s final determination should be higher than 6.5%.

- Ofwat in its draft determination jumps inconsistently between geometric and arithmetic measures of total market returns. This is especially the case in Ofwat’s so-called ‘forward-looking’ analysis, which appears to be based entirely on inappropriately low geometric averages.

We believe Ofwat should make appropriate corrections to its data and if so then it will find that the returns that investors currently expect from a market portfolio is in excess of 9%. This is estimated to increase WACC by 0.11% from the level in the draft determination.
Risk-free rate

Ofwat’s proposed risk-free rate for the 2020-25 regulatory period is 1.54% in nominal terms. This is a lower value than Ofwat proposed in December 2017, due to a recent switch of focus towards the yields on index-linked gilts rather than the yields on nominal gilts.

We do not believe this approach is appropriate for the following reasons:

• We do not think Ofwat has made adequate allowance for distortions in the UK gilt market, particularly in the market for index-linked government bonds. Ofwat notes the unusually large wedge between the yields on nominal and index-linked gilts but is too quick to attribute the differential to an inflation-risk premium, rather than inflated demand from pension funds and artificially suppressed supply due to quantitative easing.

• Ofwat has not given adequate sense-checks for the use of a risk-free rate that is negative in real, CPIH-stripped terms. Ofwat’s analysis currently results in a negative real risk-free rate (-0.45% CPIH stripped), with more recent data suggesting an even lower rate (-1.00%).

• We note that a negative real risk-free rate is incompatible with economic theory (the “Taylor rule”) and, as such, is unlikely to be sustainable in the medium to long term. Our view is that the risk-free rate for the marginal investor in UK regulated utilities during the 2020-25 regulatory period is likely to be positive in real terms.

Therefore, we believe that the CPI-stripped risk-free rate in Ofwat’s final determination should not be less than 0%. Adjusting the risk-free rate to zero in real terms would increase WACC by at least 0.04%.

Cost of debt

Ofwat’s proposed cost of debt is 4.38% in nominal terms. This is an 80:20 average of a 4.50% cost of embedded debt and a 3.36% cost of new debt, plus a 10 basis points allowance for fees.

The allowance for embedded debt in the draft determination is based on the average yield on two reference iBoxx indices over a period of 15 years, less a deduction of 25 basis points. We note that this is a wholly arbitrary benchmark, not generally relevant to a regulated utility, whose value is highly sensitive to the selected averaging period.

We disagree with Ofwat’s policy of setting a single industry-wide ‘benchmark’ cost of debt that ignores the actual costs that individual companies will unavoidably have to pay in AMP7. In the draft determination, we disagree with Ofwat’s decision to disallow certain components of companies’
interest expenses (e.g. inflation swaps that convert nominal coupons to index-linked coupons) that were prudently entered into at the time of borrowing.

The allowance for new debt is a holding value that will be updated during AMP7 in line with the average yield on two iBoxx indices less a deduction of 25 basis points. Our observations on this component part of the calculation follow from the comments that we make on financeability in our response to YKY.LR.C1, being:

- We do not believe that a company with a notional 60:40 capital structure will be able to issue debt with an A rating, particularly given the level of interest cover for such a company.

- Similarly, given the notional company’s weak financial profile, we cannot conceive how it will be possible for companies to outperform the yield obtain by issuers with comparable credit ratings by 25 basis points.

Therefore, our view is that the cost of debt index should be redefined to reference only the BBB iBoxx index and without any deduction for a “halo effect”. By correcting the rate for the cost of new debt for these inconsistencies, WACC would increase by 0.05%.

**Further WACC reduction for Final Determination**

Ofwat indicated in its draft determination that its estimate of the cost of capital might have been lower than 5.25% (nominal) had it taken account of data up to July 2019.

We note that this in part is Ofwat responding to a reduction in empirical beta estimates. Our observations on this follow the comments we have made above on consistency with the approach at PR14, as well as regulatory good practice more generally, Ofwat should not be placing undue weight on ‘noisy’ spot estimates of beta, but should instead be focusing on the average level of betas over a longer estimation window.

As regards the risk-free rate and the cost of new debt, 2019 is inevitably going to be a turbulent year for sterling markets. Ofwat needs to be cognizant that it is setting price controls out to March 2025 and that market conditions at the point of its final determinations are unlikely to be representative of the conditions that companies are likely to see during AMP7. Once again, this points towards a need for caution, especially recognising that any forecasting error that Ofwat makes on the cost of debt will ultimately be trued up via the new indexation mechanism.
Conclusions

Our review of Ofwat’s revised view of WACC has identified an inconsistent approach and inappropriate basis when considering the increased risks resulting from the draft determination. Therefore, we do not agree with the revision of WACC down to 2.19% on an RPI stripped basis.

Our analysis has identified adjustments to address the points from our review and would result in a WACC that was more consistent with regulatory precedent, prior to assessing the increased risk from Ofwat’s draft determination. The total of these adjustments is 0.45% and would result in an increase of WACC to 2.64% (on an RPI stripped basis).

In addition, we believe that WACC has now been set at a level too low for the notional company to be considered financeable at the desired Baa1 credit rating. Furthermore, this would be likely to lead to downgrade action by ratings agencies across the industry, thereby putting at risk the investment necessary to deliver the standards of service customers expect and leading to increases in interest costs that will not be NPV neutral in the long term.
Return on regulated equity (RoRE)

Pro-forma reference: YKY.RR.C2

Ofwat feedback
We are intervening to reduce the revenue RoRE range to take account of the RFI, in way that is consistent with revenue reporting by Yorkshire Water in its Annual Performance Report.

Our response
We note that Ofwat’s intervention is in accordance with the revised RoRE figures provided by ourselves as part of the PR19 query process.

Within the updated App26 submitted as part of YKY.RR.C5 we have amended the figures to reflect the updated revenue figures as a result of our DD representations.

See our response to YKY.RR.C5 for further detail.

Pro-forma reference: YKY.RR.C3

Ofwat feedback
We are intervening to reduce the C-MeX RoRE range to be consistent with the retail revenue exposure cap of +/-12% as set out in chapter 6 of the company specific appendix.

Our response
We understand the reasoning behind Ofwat’s intervention and have retained the figures within our updated App26.

See our response to YKY.RR.C5 for further detail.

Pro-forma reference: YKY.RR.C5

Ofwat feedback
We expect companies to update their overall RoRE risk range analysis in updated App26 submissions as part of their response to the draft determination. This should take account of the guidance we have provided in the ‘Aligning risk and return technical appendix’ that accompanies our draft determination and ‘Technical appendix 3: Aligning risk and return’ published with the IAP, and the context that achieved cost and outcomes performance has been positively skewed at a sector level in previous price review periods. Companies are strongly incentivised to achieve and outperform regulatory benchmarks. Therefore where companies consider there to be a potential downward skew in forecast risk ranges for returns, we expect companies to provide compelling evidence that this is expected to be in the context of expected performance delivery of the
company, taking account of the company’s reported level of actual performance delivered in 2015-19 and taking account of the steps it is already taking or plans to take to deliver against regulatory benchmarks and mitigate downside risk.

Our response
We have provided an updated App26 table with our representations.

The two key areas which have been amended materially as part of our DD representations are the Totex and ODI RoRE ranges. In both cases there is now a greater negative skew as a result of the interventions introduced by Ofwat within their DD.

The changes result in an overall RoRE range of +2.2% to -7.3% in comparison to Ofwat’s DD range of +4.0% to -5.3% as illustrated by the table below.

<table>
<thead>
<tr>
<th></th>
<th>Ofwat DD</th>
<th>YW Representation</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>High</td>
<td>Low</td>
</tr>
<tr>
<td>Totex</td>
<td>2.0%</td>
<td>-2.2%</td>
</tr>
<tr>
<td>ODI</td>
<td>1.1%</td>
<td>-2.2%</td>
</tr>
<tr>
<td>Revenue</td>
<td>0.3%</td>
<td>-0.3%</td>
</tr>
<tr>
<td>Retail</td>
<td>0.0%</td>
<td>0.0%</td>
</tr>
<tr>
<td>Cmex</td>
<td>0.3%</td>
<td>-0.3%</td>
</tr>
<tr>
<td>Financing</td>
<td>0.2%</td>
<td>-0.3%</td>
</tr>
<tr>
<td></td>
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</tr>
<tr>
<td></td>
<td>High</td>
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<td></td>
<td>4.0%</td>
<td>-5.3%</td>
</tr>
<tr>
<td></td>
<td>2.2%</td>
<td>-7.3%</td>
</tr>
</tbody>
</table>

We believe that the RoRE range within our representations of +2.2% to -7.3% more accurately reflects the current risk and return package within the draft determination and particularly the risks that we are being asked to bear by Ofwat.

Further details on the changes made to each of the figures from those included within Ofwat’s DD are provided below:

Totex
Please see supporting evidence in Appendix-F5 from Economic Insight: “Totex Risk update”.

ODI
As we set out at the Initial Assessment of Plans, the cumulative impact of Ofwat’s interventions present a significant skew to downside risk. We welcome Ofwat’s attempt to model the impact of the draft determination interventions in terms of RoRE, however we note that without transparency of how these values were arrived at, it is impossible to recreate the RoRE ranges presented in the
draft determination. This lack of transparency undermines the purpose of Ofwat’s duty to consult and compromises our ability to adequately respond to the draft determination.

We have continued to adopt the same approach we have consistently taken throughout the price review process to calculating the RoRE ranges: in our September submission, Ofwat’s IAP, our IAP resubmission, Ofwat’s DD and our DD representation. This contrasts with the single estimate Ofwat has provided in the draft determination.

In understanding the draft determination interventions, we have re-estimated the associated ODI RoRE range as +0.3% to -2.7%. This contrasts with the estimates provided by Ofwat of +1.1% to -2.2% in the draft determination. No detailed calculations have been provided to support Ofwat’s position. It appears that a minor adjustment to our April 2019 business plan resubmission RoRE ranges has been made to account for the draft determination interventions. Given the scale of the interventions (over 70 individual interventions) it is difficult to understand how this equates to such a small adjustment in the ODI RoRE range from that previously presented in our re-submitted April 2019 Business Plan of +1.0% to -2.4%.

As set out in our supporting evidence: ‘Financeability of the notionally efficient firm’, it appears that Ofwat has simply transposed the performance risk range we calculated in relation to the performance commitment targets we set (calibrated to the totex plan) in the September 2018 and April 2019 business plan submissions, to the new targets set by Ofwat at draft determinations. It is plainly erroneous to use this approach, particularly when Ofwat’s adjustments to the targets at draft determination are so extreme. Given the materiality of the changes, and the associated financial and reputational implications of performance commitments, it is surprising and unacceptable that Ofwat has not undertaken a proper performance risk analysis.

Following adjustments to the draft determination interventions for a limited number of performance commitments and outcome delivery incentives where we have provided representations, we have re-estimated the RoRE impact as +0.3% to -2.7%.

The ODI RoRE resulting from our position in these representations clearly demonstrates a significant skew to the downside, with extremely limited upside. Given the scale of the performance commitment and outcome delivery incentive interventions, a shift in the RoRE range of this magnitude is expected.

Please see ‘Delivering outcomes for customers – Yorkshire Water Draft Determination Representation’ for further details.
Revenue
We have updated the figures based on the revised revenue figures included within our DD representation.

CMex / DMex
We have made no change to Ofwat’s DD figures

Financing
We have updated the figures to reflect the latest data and interest forecasts available.

Retail costs
We have made no change to Ofwat’s DD figures.
Wholesale Revenue Forecasting Incentive Mechanism (WRFIM)

Pro-forma reference: YKY.PD.A6a

Ofwat feedback

Summary of company response to the action

Yorkshire Water provides more evidence on the previous accounting treatment of costs and the basis of APR submissions in support of the adjustment it made to remove connection charges from the water data inputs and sewer adoptions from the wastewater data inputs in the WRFIM model.

Our assessment and rationale

Intervention required. The claim relates to errors the company made in completing its business plan tables for connection expenditure at PR14 and we consider this to be outside of the reconciliation mechanism's scope.

Our response

In line with the guidance and agreed actions that we received from Ofwat prior to the PR19 process, with regards to the fact that Connection Charges (s45) were not included within our Wholesale Water Revenue Control, the values that should be included within the WRFIM should be sourced from our published APR commentary and not directly from table 2I.

To confirm within the IAP response we submitted evidence that:

- we have a one-sided adjustment within our Wholesale Water Revenue Control through ‘Income from other sources’ for Connection Charges (s45) because the corresponding amount was not included within the Wholesale allowed revenue adjustments.

- we contacted Ofwat during the 2015-16 APR process to explain this issue and it was agreed that the Connections Charges (s45) had not been included within our Wholesale Water Revenue Control.

- we were advised that the revenue control could not be re-opened to rectify this omission and that the APR table 2I could not be made company specific to allow us to exclude the actuals for Connection Charges (s45) that are reported within table 2E.
we were advised to include within our APR commentary the exclusion of the actual for Connection Charges (s45) from table 2I and to include the fact that this adjustment was being made to recognise that Connection charges (s45) had not been included within our Wholesale Water Revenue Control.

this adjusted 2I performance value from the APR commentary was then used to supersede the value that was included within table 2I to show our performance against the Wholesale Water Revenue Control within your published Financial Monitoring Report.

We would also like to state that due to the change in our accounting policy we are now accounting for the grants and contributions as Capital and therefore all of the income is fed through to the totex incentive mechanism as outperformance. This is shared with customers in line with our PR14 sharing rate.

**Pro-forma reference: YKY.PD.A6b**

**Ofwat feedback**

**Summary of company response to the action**

Yorkshire Water does not provide a response on this point.

**Our assessment and rationale**

Intervention required. The company does not provide compelling evidence that the amendment is appropriate and so we are removing the amendment.

**Our response**

We would like to apologise for not submitting a formal response to this action in our IAP response and thank Ofwat for separating out the original action PD.A6 into two clear actions.

In our July 2018 submission ‘Accounting for Past Delivery’, we included within the table commentary for Tables WS13 and WWS13, that we believed the forecast variance for 2018-19 and 2019-20 were due to grants and contributions (which are offset by changes within capital expenditure), and that we were amending the reward and penalty values to zero in WS13 and WWS13 to exclude the impact of grants and contributions and to reflect the impact of the main charges revenues only.

However, we recognise that the WRFIM methodology was published within the PR14 reconciliation rulebook and that the adjustment we made was not necessarily in line with the methodology, so we will comply with Ofwat’s intervention in this regard.
Glide path

Pro-forma reference: YKY.CA.A4

Ofwat feedback
Yorkshire Water confirms that it will apply the default sharing mechanism from our ‘putting the sector in balance: position statement’ if gearing rises above 70%.

Our response

Introduction
Our IAP response statement that we would apply the financial outperformance sharing mechanism was made on the basis that Ofwat would accept our IAP resubmission in the round.

Despite our concerns on the appropriateness of Ofwat’s policy decision to effectively penalise companies with higher gearing, we stated in our IAP resubmission that we would seek to reduce our gearing down to 70% and we would review our financing plan in the round following receipt of the draft and final determinations, and to reflect the evolution of financial market conditions.

As noted within our response to YKY.LR.A4, the interventions introduced by Ofwat in their draft determination mean that it will now be significantly more challenging for us to reduce gearing quickly down to 70% in AMP7. Consequently, our forecast for gearing reduction now indicates 70% gearing at the end of AMP7 and not by the first year of this period.

Our Board is strongly committed to this direction of travel. However, it is important to recognise that there remains considerable uncertainty about future circumstances and the details of the final determination in particular. Hence as a responsible Board fulfilling its fiduciary duties, we will naturally review this forecast again with the final determination and confirmation of the actual cost of capital.

The benefit to customers from our understanding of the application of the financial outperformance sharing mechanism is estimated to be £23m due to the gearing levels forecast in AMP7.

Proposed glide path for gearing reduction
We still intend to apply Ofwat’s financial outperformance sharing mechanism and to offer an additional voluntary mechanism to share any outperformance where we achieve a lower actual cost than notional in respect of embedded debt. However, we believe that the position in the draft determination and conditions in the financial markets mean that a glidepath should be included in the financial outperformance sharing mechanism to ensure that the gearing reduction can be achieved in a sustainable and responsible manner.
In considering practically how we would reduce gearing in the current context, it is important to note that the majority of our debt is of a long-term nature, with instruments typically having a maturity period of at least 20 years. A quick reduction in gearing would result in Yorkshire Water having to decide either (i) to hold gross cash to offset gross debt or (ii) to repay existing debt instruments earlier than contractual maturity dates, calculated at prevailing market rates and resulting in material prepayment charges. We do not believe either course of action would be in the best interest of customers.

This illustrates clearly that the sharing mechanism can encourage short-term decisions to reduce gearing which are not necessarily in the best interest of customers. The introduction of a glide path for gearing reduction would continue to encourage companies to meet the objectives of the financial outperformance sharing mechanism, whilst ensuring the implementation of such steps would be carried out in a sustainable way in the long-term interests of customers.

Therefore, we believe that a glide path for gearing reduction should be introduced to enable this reduction to be achieved in a managed and optimal manner. We have set out below our proposal for a glide path to be introduced and we would welcome the opportunity to discuss this further with Ofwat.

Our glide path proposal summarised as:

- We believe the glide path should cover the full five-year period of AMP7. This would provide the time necessary for Yorkshire Water to implement an optimal strategy that is in the best long-term interest of customers.

- The only amendment proposed to the financial outperformance sharing mechanism is to the trigger level of 70%. We are not proposing any amendment to the reference point of 65% or the calculation of the benefit to be shared with customers. Therefore, if the mechanism is triggered then the charge would be exactly the same as under Ofwat’s default mechanism.

- Our proposal is that the trigger level would operate on a simple, straight-line glide path (instead of the 70% trigger for each year of AMP7 proposed by Ofwat), initially starting at 78% then reducing by 1.6% per annum so that the trigger is at 70% in 2025, in accordance with Ofwat’s mechanism.

- We note that:
– If gearing was only reduced by the retention of shareholder dividends, the glide path proposal would result in exactly the same charge as Ofwat’s default mechanism.

– If we target a reduction in gearing in line with our revised forecast to 70% at the end of AMP7, by a combination of shareholder dividend retention and capital injections, then it is estimated that our glide path proposal would still result in a benefit to customers of £7m.

We believe that the introduction of a glide path on this basis provides an appropriate balance between encouraging gearing reduction and providing Yorkshire Water the time to achieve that reduction in the most efficient and sustainable manner possible for the long-term benefit of its customers.

In summary, Yorkshire Water confirms it will apply the default sharing mechanism and will offer an additional voluntary mechanism to share any outperformance in respect of the cost of embedded debt. We remain committed to reducing our current gearing during AMP7. We believe firmly that the course of action proposed in this document will be in the best long-term interests of our customers.
Gearing reduction

Pro-forma reference: YKY.LR.A4

Ofwat feedback

In its response to our draft determination Yorkshire Water should provide further assurance about how its planned gearing reduction will be achieved, and regarding the sustainability of targeting a Baa2 corporate family rating that is only one notch above the lowest investment grade rating and below the credit rating targeted for the notional structure. In doing so it should take account of the issues reference in action YKY.LR.C1.

In its future reporting Yorkshire Water should undertake suitably robust stress tests to support its long term viability statements.

Our response

Introduction

In light of the draft determination, we have reviewed the forecasts in our IAP resubmission to reduce gearing to 70%. We remain committed to reducing Yorkshire Water’s gearing to 70% but our assessment of the draft determination and our representations have required us to reconsider the detailed profile of these forecasts.

In respect of credit ratings, Yorkshire Water targets a Baa2 corporate family rating from Moody’s and raises principally Class A debt with a Baa1 rating from Moody’s or higher equivalent ratings from S&P and Fitch. Class A debt represents in excess of 80% of Yorkshire Water’s debt portfolio and we forecast Class A debt to remain the principal source of finance for the future. We expect to finalise the licence modification for the definition of issuer credit rating, following the outcome of Ofwat’s consultation on strengthening the ring-fencing framework, which we understand will consider the corporate family rating and other appropriate issue ratings.

Our IAP resubmission, in April 2019, stated that the planned reduction in gearing would be achieved by a combination of retaining shareholder dividends and capital injections, despite our scepticism on the appropriateness of Ofwat’s policy decision to penalise companies with higher gearing. In addition, it was noted that we would review, in the round, our targeted reduction of gearing to 70% after receipt of the draft and final determinations.

We have stated that any capital injections would be funded by our shareholders through the issuance of debt within another group company above the regulated company ring fence, ensuring the financial risks of any additional debt would be borne by our shareholders and the lenders of the debt. The capital injection into Yorkshire Water would be achieved by a repayment of inter-company...
loans, as we continue to simplify our financial structure and improve the transparency of our financing arrangements.

**Review of Ofwat’s draft determination**

As a result of the interventions introduced by Ofwat in their draft determination, we have amended our forecast to reduce gearing to 70% by the end of the AMP7 on the basis of our representations. This reflects the increased risks and potential impact on the ability to attract investor interest and secure finance for the capital injections to reduce gearing. These risks are as follows:

**Cost of capital**

Ofwat has reduced cost of capital as part of its draft determination and indicated that there could be a further, potentially significant, reduction as part of their final determination.

A lower cost of capital results in a reduction in turnover and hence an increase in gearing, thereby adding to the challenge of reducing gearing during AMP7.

Cost of capital, particularly the cost of equity element, also has a direct impact on one of the key credit metrics used to assess Yorkshire Water, being its interest cover ratios (“ICRs”). By reducing the WACC, ICRs are negatively impacted and the intimation of a further sizeable reduction will dampen investor interest to fund the water sector.

We would note that investors in debt markets attach greater importance to ICRs, and similar credit metrics, than gearing. This reflects the fact that ICRs are a cash-based metric, measured prospectively as well as retrospectively over a period, thereby providing a more realistic view on credit worthiness than an asset based measure of the ratio of debt to RCV at set points in time. We believe strongly that ICRs are a better indicator of credit health than gearing. Consequently, we will need to assess ICRs in light of any changes arising from the final determination and to the current cost of capital.

Further detail to cost of capital and the impact on ICRs and financeability is provided in our representation on the reduction to cost of capital and our response to YKY.LR.C1.

**Efficient costs**

Ofwat’s draft determination proposes cost allowances significantly below those proposed within our IAP resubmission. In the event Ofwat maintains its view of efficient costs then we could have to overspend our allowances in order to deliver our performance commitments to our customers.

Any overspend on allowed costs would increase gearing and further challenge our goal to reduce gearing down to 70%. In addition, we note that Ofwat has removed any upfront payments in AMP7.
that would have been used to reduce the scale of the future reconciliation of cost performance at the 2024 price review.

This significant difference between Ofwat’s and the company’s view of efficient costs also introduces further risk evidenced by a significant downside skew to Totex related RoRE ranges. This may impact the ability to attract the necessary investor interest to finance the capital injections to be used to reduce gearing.

Further details on our representations in relation to cost efficiency can be found in ‘Cost Efficiency - Yorkshire Water Draft Determination Representation’.

**ODI risk profile**

Ofwat’s draft determination proposes an incentive regime that is notably skewed to penalty, rather than providing a symmetrical profile.

The introduction of such a downside skew significantly enhances the chance of penalties being incurred, particularly when considered in conjunction with the cost efficiency challenge. Any penalties incurred will have a direct impact on gearing and the negative skew in RoRE ranges will be viewed as an indicator of increased risk of penalties by potential investors.

Therefore, a significant downside skew to ODI related returns is expected to impact the ability of the company to attract the necessary investor interest to finance the capital injections to be used to reduce gearing.

Further details on our representations in relation to ODI’s can be found in ‘Delivering outcomes for customers – Yorkshire Water Draft Determination Representation’.

**Revision to forecast reduction in gearing**

In light of these increased risks, our forecast shows that the reduction in gearing to 70% will be achieved over the whole of AMP7 and not by the end of the first year of this period. We highlight that this forecast has only considered our representations to the draft determination. We have not assessed the scope for gearing reduction in a scenario which reflects Ofwat’s view in its draft determination on efficient costs and delivering bill reductions.

We believe this rephased reduction in gearing to 70% is feasible but not without its challenges. In principle, this gearing reduction could be achieved by:

- Retention of all shareholder dividends for the whole of the period, which would result in our shareholders receiving no dividends for eight consecutive years.
Capital injections totalling £625m, which will be made in three tranches across AMP7 starting in the first year of this period. This piecemeal, risk-managed approach will allow us to optimise our ability to attract investors to finance the capital injections and will be conditional on being able to demonstrate performance of at least the base return.

We have proposed the introduction of a glide path to Ofwat’s financial outperformance sharing mechanism to encourage companies to reduce gearing in a sustainable manner, which will be in the best long-term interest of customers. This will allow us sufficient time to demonstrate that Yorkshire Water can achieve the base returns and provide investors with the necessary confidence to finance capital injections for gearing reduction. Further details on our proposal for a glide path within the financial outperformance sharing mechanism are set out in our response to YKY.CA.A4.

We will review again our forecast and approach to reducing gearing to 70% on receipt of the final determination and Ofwat’s confirmation of any final revision to the current cost of capital. This will also take into account financial market conditions.
Dividend policy

Pro-forma reference: YKY.CA.A5

Ofwat feedback

No intervention but further action needed by Yorkshire Water.

The company provides sufficient evidence of its intention to meet the expectations on dividends as set out in ‘putting the sector in balance: position statement’ but its response lacks detail on how it will demonstrate annually to stakeholders that it has met them.

It provides insufficient transparency as to:

- the specific obligations and commitments to customers;
- the level of performance delivery they will be considered against; and
- how they will impact on dividends.

We expect Yorkshire Water to be transparent about how the dividend policy in 2020-25 takes account of obligations and commitments to customers and to demonstrate that in paying or declaring dividends it has taken account of the factors we set out in our position statement. We expect the company to respond to this issue in its response to our draft determination.

We expect Yorkshire Water to demonstrate that its dividend policy for 2020-25 takes account of obligations and commitments to customers and other stakeholders, including performance in delivery against the final determination. In doing so, the company should refer to the examples of best practice we have identified among companies.

Our response

Our intention for PR19 has always been to have a transparent dividend policy that fully complies with all the expectations set out in Ofwat’s “putting the sector in balance: position statement” and are pleased to note that Ofwat has considered that our policy demonstrates an element of best practice.

We note Ofwat’s request for further clarity on certain areas of our dividend policy and believe the additional information and clarity provided below matches the other areas of best practice highlighted by Ofwat within their “Aligning risk and return technical appendix” document.
The additional areas of clarity provided below need to be read in conjunction with our new PR19 dividend policy which was provided as part of in our Business Plan submitted in September 2018.

- Our base dividend will take account of performance across a range of factors that matter to our customers and other stakeholders.
  - Payment of our base dividend (5% yield) is dependent on performance meeting the commitments within our PR19 plan.
  - Performance will be considered in the round collectively by our Board before any dividend is authorised, to include the following four key areas:
    i) Customer service
    ii) Performance commitments
    iii) Other stakeholder performance (environmental and vulnerable customers)
    iv) Employees
  - The above, in the round assessment, will consider performance against both financial and non-financial incentives.
  - A financeability assessment will be carried out by the Board before the payment of any dividend to ensure the long term viability of the company.

- The specific obligations and commitments we have made to our customers and other stakeholders within our PR19 plan will be considered when considering payment of our base dividend, or any additional dividend for delivering performance in excess of our PR19 plan commitments.
  - Performance will be considered by the Board in the round against the targets set within our PR19 final determination across the four key areas highlighted above.
    i) Customer service: consideration in the round against a number of customer service measures, to include CMex, DMex and other customer related performance commitments.
    ii) Performance commitments: consideration in the round of our performance against key PR19 industry comparative and company specific service commitments; for example leakage, supply interruptions, consumption and water quality.
iii) Other stakeholder performance: consideration in the round of our performance against other key commitments, such as environmental improvements and protections for vulnerable customers.

iv) Employees: pension and health and safety factors will be considered.

- Any additional dividend over and above our base dividend will be specifically linked to ODI rewards earned for service improvements, or outperformance of cost allowances as a result of efficiencies delivered.

• The performance levels against which the obligations and commitments will be considered against will be transparent.

- Performance will be considered by the Board in the round against the targets set within our PR19 final determination.

- Any adjustments to our base dividend will be clearly and transparently explained within our annual reports.

• The calculation of any dividend paid will be transparently detailed within our annual reports

- Dividends paid or declared during any year will be reported within our Annual Performance Report (“APR”)

- The APR will include a note detailing how the dividend has been calculated in accordance with the dividend policy.

- In truly exceptional and unforeseen circumstances, the Board may have to deviate from the dividend policy, such as the retention of dividends to reduce gearing. If this was deemed necessary, a full explanation justifying the change would be provided in the APR.