

# Executive summary – Yorkshire Water Draft Determination Representation

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## Contents

Contents	2
Overview of our response	3
The unattainable benchmark of Ofwat's notionally efficient firm	4
Concerns raised at the IAP stage:	5
Moving forward	7
Our representation	8
Conclusion	12

## Overview of our response

We have considered the draft determination (DD) carefully and, as a matter of principle, we support Ofwat's drive to challenge, enable and incentivise the industry to meet the key pressures facing the sector. The growing impact of a changing climate, a growing population and the evolving service expectations of our customers means that companies must adapt to deliver the required levels of service and resilience at an acceptable cost. Our PR19 plan is set within the context of our long-term strategy which focuses on precisely these challenges. We have identified the need to move towards a demand management culture and identified 5 big goals to demonstrate how we are delivering our strategy and 95% of our customers supported these goals.<sup>1</sup>

The plan that we submitted in September 2018 was ambitious; it included an upfront cost efficiency of 16% and industry leading levels of stretch in key service areas. We were both surprised and disappointed at the difference between our own and Ofwat's view of efficient costs, especially considering that Ofwat's own models found us once again to be broadly efficient in our current and historical costs. As set out in Sections 2 and 3 below, we believe that Ofwat's approach in relation to cost efficiency is unsound since Ofwat has used an unattainable benchmark to measure efficiency – Ofwat's definition of the 'notionally efficient company' – which we do not consider to be based on robust evidence. This approach disproportionately penalises companies which are already efficient and creates serious financeability risks. This in turn could create issues that cause harm to our customers in the form of higher bills over time.

Against this background, our Board has carefully considered the DD and we have discussed it with the Yorkshire Forum for Water Customers (the Forum) which is supportive of our representation. When we built our PR19 plan we paid close attention to what our customers wanted, what our environmental obligations were likely to be and the methodology that Ofwat required all companies to follow. Our aim remains to achieve a final determination that allows us to deliver the services and outcomes that our customers want, at a price that is acceptable to them, without jeopardising the wellbeing of future generations.

This document is structured as follows. Firstly, we will explain why Ofwat's position on cost efficiency is based on an unattainable benchmark – the 'notionally efficient firm'. This creates a risk of imposing a plan which is not financeable in reality and of negatively impacting current and especially future customers. Secondly, we recap the three core concerns we have raised at the Initial Assessment of Plans (IAP) stage and which we believe still remain unaddressed. Then, in order to find a workable solution which will allow us to focus on continued delivery for our customers, we outline the key changes that we propose to make to our business plan in response

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<sup>1</sup> <https://www.yorkshirewater.com/biggoals>

to the DD. Finally, we will make some concluding remarks on how we have approached the overall DD response.

## The unattainable benchmark of Ofwat's notionally efficient firm

Ofwat has set an overall efficiency challenge, reducing allowed costs and increasing the targets on performance commitments, that is substantially beyond what a notionally efficient firm is capable of delivering as Ofwat has ignored the trade-offs between costs and performance. As a result, companies face a balance of risk that is materially skewed to the downside and even an efficient firm faces an expected return that is below the level of allowed return. In our representation we include a paper written by an independent firm of economists - Economic Insight. This paper concludes that "... the efficiency step change is not supported by theory or evidence – meaning that the notionally efficient firm is likely not financeable".

In addition, we have concerns about the approach Ofwat has used in setting the cost of capital. We have reviewed Ofwat's approach and assumptions regarding the calculation of the cost of capital, which has fallen to 2.19% from an early view of 2.40% in December 2017. This has included analysis commissioned from First Economics on a key driver of the reduction made by Ofwat.

Ofwat's approach on the WACC is based on a selective interpretation of the evidence, with the equity beta based on observations from too short a period meaning that recent short-term events are introducing distortions which are not good predictors for the future. As a result, the WACC at 2.19% has now been set at a level too low for the notional company to be considered financeable at the desired credit rating. Overall, these two issues mean that there cannot be any confidence that the notional company is financeable, and this is reflected in our Board Assurance Statement.

Our Board Assurance statement confirms that, based on our representation package and the information available at this time, we are financeable on an actual basis. Given the significant increase in the risk the company is assuming in this representation and the short period of time Yorkshire Water has been given to make these representations, this assurance will be under continuing review in the period from now to the Final Determination. Should additional information come to light which affects this statement, the Board will draw this to Ofwat's attention and may need to modify or withdraw this assurance.

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.

## Concerns raised at the IAP stage:

As we stated in our response to the IAP, we were surprised and disappointed by Ofwat’s initial assessment of plans in relation to its view of our cost efficiency. We considered Ofwat’s position very carefully and responded to the action points raised. We provided substantial additional evidence in areas where we had material concerns regarding Ofwat’s’ approach. The three key areas of concern are summarised below:

### Difficulties with the cost modelling

We have consistently been assessed as efficient in previous price reviews, and also provided an upfront efficiency of 16% on the original submitted plan. Table 1 demonstrates that YW has consistently been assessed as efficient in previous price reviews. This is in stark contrast with the significant difference between Ofwat and our view of efficient future costs:

**Table 1 – Yorkshire Water efficiency ratings awarded by Ofwat at previous price reviews.**

	Pre PR09	PR09	PR14
<b>Water opex</b>	Band A	Band A (upper)	94.3% totex
<b>Water capex</b>	Predominantly Band A	99.5%	
<b>Wastewater opex</b>	Band A	Band A (lower)	99.5% totex
<b>Wastewater capex</b>	Band A	93%	

Notes:

*Pre PR09 comparative efficiency assessments were used annually.*

*In PR09 opex remained under comparative efficiency and CIS used for capex. YKY was the only WaSC assessed as efficient in both services.*

*In PR14 the industry moved to totex and menu regulation.*

However, Ofwat’s view fails to adequately recognise these facts by placing undue weight on a simple comparison of the change in projected costs between PR19 and PR14. As a result, and as we evidenced in our IAP response, we believe that the nature of the modelling used in assessing our future efficiency has the unintended consequence of penalising companies with a strong track record in efficiency, that have ambitious service improvement plans and/or that have large environmental programmes (e.g., as a result of the Water Industry National Environmental programme (WINEP)).

### Cost and outcomes are disconnected

The second substantial issue is the disconnect between costs and outcomes. Ofwat’s position is based on an assertion that more stretching performance commitments should not cost customers

more money. It is plainly not true for the major changes in performance being sought in the targets imposed by the DD interventions. Such a belief could only possibly be justified if the cost modelling approach fully considered the alignment of costs and service delivery. In other words, like in other industries, an efficient company (as Yorkshire Water has been deemed in the past) can only achieve higher service levels by incurring additional costs. As evidenced in the Economic Insight report we submitted with our IAP resubmission, Ofwat's approach does not properly consider this trade-off<sup>2</sup>.

Ofwat's approach is based on a policy position which is not supported by any evidence. With the increased emphasis on comparative Performance Commitments (PCs) and Outcome Delivery Incentives (ODIs) compared to PR14, this has greatly magnified a flaw in the price review approach that was previously identified by the CMA in its PR14 determination for Bristol Water<sup>3</sup>.

This disconnect is borne out of an excessive focus on lowering bills and on lowering costs in the current price review period. Although this could seemingly offer a short-term benefit to current customers in the form of an immediate (but unsustainable) bill reduction, this approach creates a very serious and real risk of causing harm to future generations of customers. Indeed, this approach jeopardises the company's ability to invest more in the long-term future of the asset base in a way that spreads that costs evenly between all of the generations that will benefit from the investment.

We are also concerned at Ofwat's decision to move away from the long-established position of regarding growth related expenditures as part of enhancement. It is further evidence that Ofwat is placing undue focus on short-term rather than medium-term developments. One immediate impact of this unsound change is on our detailed plans to improve resilience for Hull & Haltemprice. We have provided a detailed case study on this as part of our responses to the IAP action on resilience.

This project is clearly atypical – the whole point of the approach is to break the mould and adopt innovative solutions for the unique challenges faced. But Ofwat's treatment of growth means that the funding for this innovative project has been disallowed. So, the removal of proposed £28.6m investment achieves a small short-term reduction in bills, but at a cost of inhibiting innovation and preventing improved resilience. These run directly counter to Ofwat's claimed ambitions in the methodology.

## Methodology, evidence and data

The third substantial issue arises from the approach taken regarding the methodology, evidence and data. We are greatly concerned with the extent to which Ofwat has disregarded its own

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<sup>2</sup> 'Maximising customer benefits from the outcomes framework' *Economic insight* (2018)

<sup>3</sup> 'A reference under section 12(3)(a) of the Water Industry Act 1991.' *CMA* (2016) page 284.

methodology, especially on outcomes, without providing adequate reasoning or evidence. Ofwat has not sufficiently considered the views of customers on priorities and incentive rates. Our industry leading consultation exercise on performance commitments (PCs) and outcomes underpinned the detailed logic behind the proposed set of upper quartile common PCs, and these were embedded into the detailed design of company business plans.<sup>4</sup>

The late changes to both targets and incentive rates made at the IAP stage and again in the DD undermine the economic logic of the ODI framework as articulated by Ofwat, moving away from the original optimised alignment of marginal costs and value to customers. These interventions have not been justified by any supporting evidence or consideration of potential detrimental effects or unintended consequences. Ofwat does not appear to have held itself to the high standards it has demanded from YWS's submissions and this has resulted in Ofwat drawing unevidenced and unjustified conclusions whilst disregarding substantial contrary evidence.

This also extends to the reliability of the data used for a number of the key comparative metrics. The convergence project greatly improved the detailed comparability of the reported measures for the common Upper Quartile (UQ) PCs. Conversely, the extent of the issues identified around companies' existing reporting practices and associated plans to align with the converged method clearly indicate that comparisons on other metrics cannot be relied upon; a risk which Ofwat appears to have ignored.

## Moving forward

As has been demonstrated in our representation, we have significant reservations about the soundness and quality of the DD. However, our priority is to focus on delivering our plan for our customers and, in that spirit, we have sought to find a workable compromise for this price review.

Whilst we remain concerned that the approach Ofwat has taken disproportionately affects historically efficient companies like Yorkshire Water, we have looked hard to see where we could assume a higher level of risk to allow us to bridge the gap between our view of efficient costs and Ofwat's proposed cost allowances in the DD, for the sake of achieving this workable compromise. We have identified the key upper quartile performance commitments as an area where we will tolerate the absence of costs from our determination to create consistency with Ofwat's stated policy position. Elsewhere, we have submitted additional evidence to support the efficiency of our proposed costs.

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<sup>4</sup> Ofwat's 'customer engagement policy statement and expectations for PR19' (May 2016) and 'Delivering water2020, our final methodology for the PR19 Price Review' sections 2 and 4 (December 2017) and associated appendices.

To be completely clear, this proposal has been made because we wish to resolve the impasse created at IAP and DD stages, not because we agree with Ofwat's policy positions. The removal of required costs from our cost allowances inevitably leads to an increase in risk for the company. To mitigate these increased risks, we have reviewed our plan and the balance of investment led or operationally led activities. This will alter the balance of fast and slow money. In doing so we have achieved a position such that, despite increased risk and on the basis of the information available, the company is financeable on an actual basis. We will continue to stress test our proposal and will inform Ofwat if that position changes. This is now a very finely balanced position and can only work as a package. In other words, the position proposed in this representation would not be sustainable or financeable in case Ofwat makes further negative adjustments to our costs and outcomes package or further reduces the WACC in of the final determination.

## Our representation

This section provides an overview of the key decisions we have taken in response to the DD. In order to focus on delivering our plan for our customers, our approach has been to understand how we could reduce the size of the gap between the two views of efficient costs, while still achieving the level of performance required by our customers. To achieve this, we have moved away from our ambitious central case plan to a variant that adds significant further stretch, and therefore risk, across a wide number of elements of our plan. We have worked hard to establish mitigations against the increased risk position and in all our revisions we have put service delivery, and long-term resilience and reliability as our primary considerations.

In addition, where elements of the cost gap are driven by aspects that relate specifically to Yorkshire Water, we have looked hard at the costs again and made adjustments where new information has emerged since we submitted the plan last September. In all other areas we continue to believe that our plan is as efficient and ambitious as possible and reflective of what our customers want and, therefore, we have provided further evidence to support our position.

There are three key areas where we have made changes:

### Upper quartile service areas

We have considered Ofwat's feedback in relation to the funding of upper quartile performance in key areas: leakage, interruptions to supply, sewer flooding and pollution, we also propose to adopt a similar position on external sewer flooding. We do not agree that these costs are fully funded in the existing base allowance or can be met purely through driving further efficiencies and we believe that meeting these challenges within the base allowance asks disproportionately more of companies that are historically efficient. This is, however, an area where we are willing to find a workable compromise to avoid an impasse which would not benefit our customers. At this point, we

want to focus on what we can do to achieve these extremely stretching targets. We are willing to assume additional risk by tolerating the absence of these costs in our final determination by removing £300m from our enhancement expenditure and still deliver the following service improvements:

- Improve leakage by 15%
- Reduce pollution events by 41%
- Reduce interruptions to our customers water supplied by 25%
- Reduce internal sewer flooding events by 49%
- Reduce external sewer flooding events by 25%

This is especially challenging for us because we are starting from a position of already being assessed by Ofwat as efficient on our water base funding. We will also achieve an efficient base position in waste water (from Ofwat's perspective) through a further £10m catch up efficiency. In doing so, we have increased our risk significantly and we have sought to mitigate this risk through reviewing our plan and the balance of investment led or operationally led activities. This will alter the balance of fast and slow money to enable us to meet further assumptions regarding the levels of additional efficiency that can be achieved.

It is important to us that, in assuming this additional risk, other areas of the cost gap and other areas of our representation where we have provided additional information are carefully considered by Ofwat. Otherwise, Yorkshire Water would be tasked with delivering a plan which is not achievable and would face far greater efficiency challenges than the industry at large, especially given our already efficient starting point.

### **Water Industry National Environment Programme (WINEP)**

We remain of the view that the impact of WINEP on Yorkshire Water has not been fully recognised in the DD. The DD's notes that Ofwat has not yet reviewed all of the evidence submitted by Yorkshire Water. This has created a large degree of uncertainty as to how WINEP expenditure will be treated by Ofwat at a late stage of the process. In order to ensure that a proper consultation is carried out on this critical element of the price review, we believe that Ofwat should set out its views on this evidence formally (as a supplementary DD) and give YWS the opportunity to respond prior to reaching its final decision.

In the meantime, based on dialogue and query responses from Ofwat we have reconsidered the apportionment of the WINEP costs between base and enhancement expenditure and have

submitted a revised position that ensures that the apportionment accounts for costs already allowed in base and reallocates the remaining costs to enhancement funding (as per Ofwat’s guidance).

### Asset health

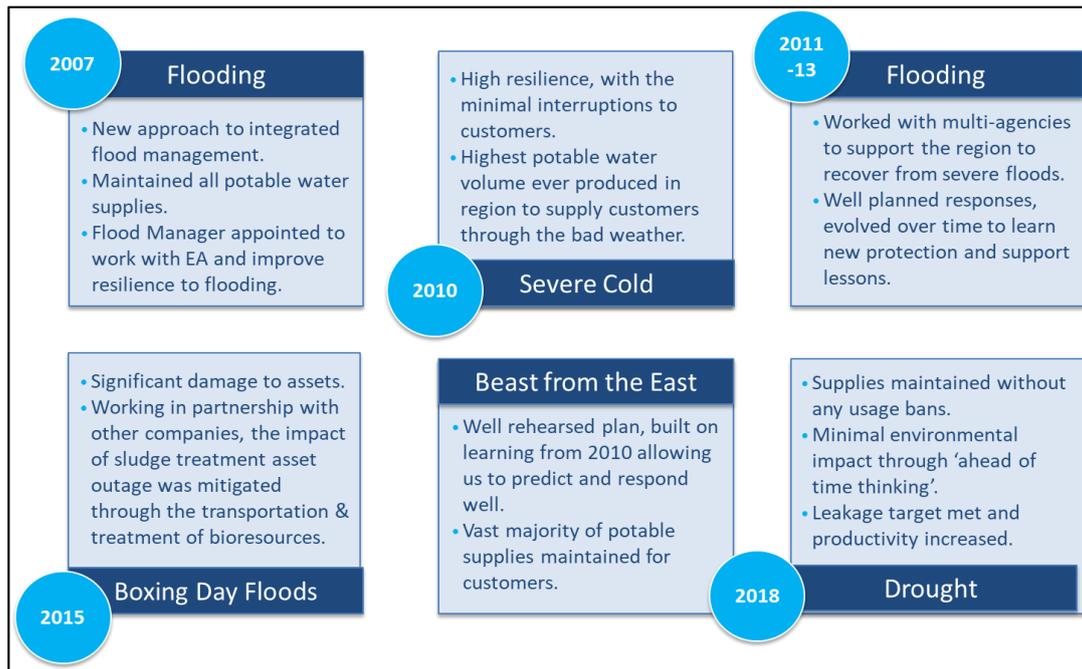
For the last 13 years, we have managed our asset health through a basket of measures referred to as stability and reliability. This measurement process considers a wide range of asset health indicators to provide an overall assessment of how well we are looking after the assets on which the people of Yorkshire rely. Table 2 demonstrates our record using the stability and reliability measurement process:

**Table 2 – Stability and reliability performance 2005 – 2018**

	AMP 4					AMP 5				
	2005-06	2006-07	2007-08	2008-09	2009-10	2010-11	2011-12	2012-13	2013-14	2014-15
WW Networks	Marginal	Stable	Stable	Stable	Stable	Stable	Stable	Stable	Stable	Stable
WW Quality	Deteriorating	Deteriorating	Stable	Stable	Stable	Stable	Stable	Stable	Stable	Stable
W Networks	Stable	Stable	Stable	Stable	Stable	Marginal	Marginal	Stable	Stable	Stable
W Quality	Stable	Stable	Stable	Stable	Stable	Stable	Stable	Stable	Stable	Stable
	AMP 6									
	2015-16	2016-17	2017-18							
WW Networks	Stable	Stable	Stable							
WW Quality	Stable	Stable	Stable							
W Networks	Stable	Stable	Stable							
W Quality	Stable	Stable	Stable							

Overall, we have reported a stable assessment across all areas, with some relatively short-lived variances on individual measures that have been corrected. The assessment method correlates well with the performance of the company overall. This method is fit for purpose as it enabled Yorkshire Water to perform well even when we have been tested by extreme weather events. For example, there have been two periods of intense cold over the last 10 years, in 2010 and 2018. In both of those situations we performed well and were noted by Ofwat as performing well in its review of the “Beast from the East” in 2018. We have also experienced prolonged periods of very dry weather, the most recent of these also being in 2018. Despite the dry period being officially recognised as a drought our regional water grid made sure that there were no water restrictions in Yorkshire.

Figure 1 summarises how Yorkshire Water has performed in relation to a number of national extreme weather events.



**Figure 1 – Our response when tested by extreme weather**

We are acutely aware – as we have always been – that appropriate focus will need to remain on the impact on customers of the health of our assets, for example the interruption to the water supply to repair a main impact much more on customers than the act of us carrying out that repair itself.

However, we consider that Ofwat's new methodology leads to a disproportionately penalising outcome for Yorkshire Water which is not justified. We note that the move is a break from the more holistic measurement techniques, which have worked well in the past. We believe the set of measures chosen by Ofwat is too narrow to accurately portray a company's overall true asset health position. Indeed, for PR19 Ofwat has implemented a revised method for measuring asset health using a very small number of single indicators to compare asset health across the industry. This is not reflective of how costs and performance have previously been assessed and creates very significant challenges. The measures in question, particularly for below ground assets, mean that it takes considerable periods of time and investment to change performance and to move the dial visibly in a limited number of metrics against a significant penalty mechanism. This may lead companies to focus their investment just in these areas as opposed to considering asset health and customer impact in the round, with potential detriment for customers.

Whilst we remain of the view that this method suffers from a number of flaws that disproportionately penalise Yorkshire Water based on previous assessment methods, we are, in our endeavour to reach a conclusion to the impasse at the DD stage, acting to comply with Ofwat's feedback.

We are willing to adopt Ofwat's amendments to our PC targets for the asset health measures. However, due to the disconnect between costs and outcomes, and to mitigate the additional risk the

company is already accepting, we are proposing adding collars to restrict the totality of the risk exposure for the company. Without these protections, we cannot commit to achieving these PC targets.

## Conclusion

The Board of Yorkshire Water has concluded that the position in Ofwat's draft determination is not financeable on a notional or actual basis. Accordingly, if the DD position were to become Ofwat's final decision, there would be a real risk of a failure to take due account of the statutory financeability and consumer protection obligations set out in the Water Industry Act 1991.

Nevertheless, in order to avoid an impasse, and without prejudice to our views on Ofwat's position in the DD, this representation response is intended to strike a balance between areas where we are willing to make changes to our business plan in the spirit of compromise (going beyond the position supported by the evidence), such as upper quartile funding, and areas where we must maintain our position in order to mitigate the additional risk we have taken on and remain financeable. We have made representations in areas where:

- The final position was not fully established at DD, such as WINEP where Ofwat is still assessing the evidence.
- The position has changed due to amendments we have made to our plan in order to find a workable solution to avoid an impasse which would not benefit our customers.
- We believe that there is new evidence to respond to Ofwat's DD view.

In responding to Ofwat's position and partially closing the gap between our view of efficient costs and Ofwat's, we have had to assume an increased position of risk against what was already an ambitious plan. We have made changes in the areas of asset health and upper quartile service measures and have reflected the revised risk position in our financeability assessment and some of the penalties and rewards associated to the areas where the risk has increased. At the same time, we have sought to mitigate this increased risk to ensure that long-term resilience and reliability are not compromised.

Our Board has provided a Board Assurance statement detailing our position regarding our representation: based on the data available we are financeable on an actual basis only against our representation package. Given the significant increase in the risk the company is assuming in this representation (when compared with the original business plan and the IAP response) and the short period of time Yorkshire Water has been given to make these representations, this assurance will be under continuing review in the period from now to the Final Determination. If new information

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emerges this will be drawn to Ofwat's attention and the Board may need to modify or withdraw its assurance.

We believe that the proposal we are making in these representations represents the best compromise possible in the current circumstances. We urge Ofwat to consider it carefully. In the spirit of cooperation, we are entirely available to discuss it with Ofwat at the earliest possible opportunity.

Finally, on a point of detail, we can confirm that in line with Ofwat's guidance in the query response on 16 August 2019, we have included the business retail control in our business plan, pending completion of the exit. The response document for action YKY.CA.B1 provides details of our approach in this regard.

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