Appendix 13h: Sharing mechanism

YorkshireWater

Contents

Mechanism to share outperformance with customers

Meeting Ofwat's stated requirements

This appendix explains how Yorkshire Water will meet the new requirements set out in Ofwat's position statement on 31st July 2018. The approach also includes an element to meet Ofwat's existing requirement for a mechanism to protect customers in the (unlikely) event that ODI payments turns out to be much higher than the expected RoRE range for ODIs.

The new sharing mechanism will cover six elements:

1. Calculation of the element that Ofwat deem to be financial outperformance associated with higher gearing, that is to be shared with customers;
2. An additional voluntary mechanism to share outperformance if the company can achieve an actual cost of embedded debt below the notional cost of debt;
3. Recognition of the sharing of outperformance and investment in direct benefits for vulnerable customers that the company has already included in the business plan in response to the PR19 Methodology;
4. The way in which we will worth with the Yorkshire Forum for Water Customers (YFWC) to agree how best the various benefits should be shared with customers;
5. The backstop mechanism to protect customers against unexpectedly high ODI payments;
6. An explanation of how the elements will work together and the timings for the various calculations. We also provide an illustrative example to help explain the expected impacts.

Details of the approach to the sharing mechanism have been revised after comments from the YFWC, and YWFC are supportive of the overall approach taken.

Element 1 – calculation of the deemed financial outperformance associated with higher gearing

Although the Ofwat position paper does not mandate a specific form of mechanism, Ofwat require that any mechanism calculates benefits equivalent to the illustrative mechanism in the position statement. The simplest way of meeting the new requirement is therefore to follow the illustrative mechanism.

Since Yorkshire Water will have gearing above the 70% trigger level, the deemed benefit to be shared will be calculated as the difference between actual gearing and the 65% (from the notional gearing and 5% deadband) multiplied by the difference between our actual cost of debt and the cost of equity stipulated by Ofwat as part of the PR19 methodology.

In line with the Ofwat Statement of Position, we will not offset the reduction in bills that Customers will receive because of the difference between actual gearing and the notional gearing used in the methodology.

As suggested by Ofwat, the position for this mechanism will be assessed at the end of 2024-25. Element 4 below explains how any resulting sum will be reinvested to maximise the benefit for customers.

Element 2 – voluntary mechanism to share outperformance on the cost of debt

In the event the that cost of embedded debt achieved by the company during the five-year period should prove to be less than that allowed by Ofwat as part of the PR19 Methodology, the net benefit will be calculated. 50% of the net benefit will be reinvested for the maximum benefit of customers via the mechanism set out in Element 4.

Element 3 – recognition of the sharing of outperformance already included in the business plan

Following publication of the PR19 Methodology Consultation, Yorkshire Water developed a plan to dramatically improve performance on leakage and other common performance commitments. This approach was agreed and announced in November, and confirmed following publication of the final methodology in December.

Ofwat consulted on new policy requirements for leakage and other common PCs in PR19 that were to be met at the start of PR19 (i.e. without any transition period). By making use of totex outperformance achieved during PR14 to fund the investments necessary to start improving performance, the company was able to gain the agreement of both the YFWC and shareholders to reinvest their respective shares of the totex outperformance. The total new investment was £260m, so shareholders agreed to share £130m of outperformance to deliver improved performance for customers. The work to improve performance is starting immediately and is inextricably linked to the PR19 Methodology and PR19 Business Plan.

This reinvestment approach was designed around the PR19 Methodology, but the introduction of the new requirement from Ofwat has a direct retrospective impact. In seeking to deliver the best possible outcome for our customers, our gearing is 3.6 percentage points higher because of the reinvestment.

As a result, we propose to view the sharing that has already taken place as an offset to the deemed benefits that accrue under element 1. The numerical impact of this is explained as part of element 6.

Our business plan also proposes that Yorkshire Water will provide direct funding of the Watersupport social tariff in the sum of £1m per annum. This will allow support to be provided to some 6,000 customers each year.

At present, the company is one of relatively few that provide direct funding for the social tariff or related charitable schemes. As such, we propose to view this funding as a second offset. Ofwat's statement of position did not require any particular form of benefit sharing mechanism, and so we think it is entirely reasonable to take this approach.

Element 4 – mechanism to reinvest any benefits

Where there is an aggregate benefit to be shared with customers across elements 1, 2 and 3, the company will engage with the Yorkshire Forum for Water Customers and the Online Panel to decide how best the amount should be reinvested to benefit Yorkshire Water customers.

The company will develop efficiently costed options focused on improving customer service and developing new capabilities that will be necessary to meet future challenges. These may include elements such as further customer service enhancements, additional support to customers potentially at risk of becoming vulnerable, additional measures to encourage reductions in water consumption or increases in water recycling, schemes to promote customer participation or schemes to promote the further development of new markets or partnership working. An equivalent bill reduction will also be one of the options offered.

The options will be presented to customers via a route agreed with the YFWC for their comment and preference ranking. The feedback will then be discussed with the YWCF to identify the options to be implemented. Item 8 of the current terms of reference for the Forum already makes provision for this dialogue:

> *"The Forum will advise and challenge Yorkshire Water on how to deal with the financial impact of over- or under-performance against outcome commitments."*

Element 5 – backstop mechanism to protect customers against unexpectedly high ODI payments

After following the usual annual process for determination of in-period ODIs, aggregate ODI outperformance payments in excess of 1.25% of RoRE will not be claimed as an immediate uplift on customer bills. The excess will be held in a notional pot used to smooth customer bills. Aggregate ODI underperformance in subsequent years will result in bill reductions for customers after any previously accumulated outperformance set aside in the notional pot has been exhausted.

Should there be an accumulated position in the notional pot, this will be considered as part of the true-up at the end of the five-year period. The company will consider whether any remaining sum in the notional pot should be claimed and discuss this with the Forum. This consideration will ensure that the sums reflect true outperformance rather than some form of windfall gain. If the sum is to be claimed, there will also be consideration of how it should be applied. Options considered will include additional reinvestment under element 4, a reduction in gearing, a performance bonus for all staff, or an additional dividend payment.

Element 6 – How the elements will work together and an illustrative worked example

Element 5 (backstop mechanism) will be present in each year of the five-year price control period, but will only become active when ODIs that are determined in-period (almost 90% of the total) show aggregate ODI outperformance payments in excess of 1.25% of RoRE. The other elements will all be applied at the end of the five-year period in 2024-25.

The worked example below illustrates how the overall mechanism could work. The example assumes that the two offsets discussed in element three are applied:

- Benefits shared via reinvestment of totex outperformance – split between fast and slow money as per the additional investment;
- Direct funding for social tariff.

In the next five-year period, the offsets together are likely to exceed the deemed outperformance due to high gearing for the next AMP, meaning that there would be no additional distribution to customers. Were the mechanism to be extended into the following AMP (and assuming no additional offsets and an unchanged level of gearing), the fast money offset would fall away and there would potentially be a net benefit of £6m p.a. to be distributed to customers.

Illustrative worked example

			Total p.a.	Sharing p.a.
Actual gearing		75%		
Notional + deadband		65%		
'Excess' gearing		10%		
RCV	£m	7,000		
RCV * excess gearing	£m	700	700	
Cost of equity		4.01%		
Cost of debt		1.33%		
Equity:Debt differential		2.68%	2.68%	
Sub: Benefit sharing	**£m**		**19**	**9**
Reinvestment #	£m	(260)		
Slow money	£m	(156)	(4)	(2)
Fast money	£m	(104)	(21)	(10)
Sub: Benefit sharing	**£m**		**-**	**(3)**
Vulnerable tariffs	£m		(1)	(1)
Sub: Benefit sharing	**£m**		**-**	**(4)**

Note: The illustrative example above uses realistic figures for gearing, RCV and Ofwat's early view on the allowed cost of equity. However, the calculation of benefits may change slightly when the actual figures are incorporated and Ofwat confirms its view on the allowed cost of equity.