Our response to Ofwat’s initial assessment of plans (IAP) feedback

We submitted our PR19 business plan to Ofwat in September 2018. Ofwat reviewed the plan and published its initial assessment in January 2019. The assessment included a series of actions for Yorkshire Water to complete by 1 April 2019. This document summarises our response.

Ofwat placed Yorkshire Water in the slow track category. Ofwat found that parts of our plan were high quality and that other parts needed further work or additional evidence. We value the feedback provided and have considered it carefully with our Board and the Yorkshire Forum for Water Customers (The Forum).

In our response we have made a number of important changes:

- Adjusted our plan so that we are now able to propose a **stable bill** (that means that before inflation, the bill will not increase from 2019/20 prices). This means that customers in Yorkshire will have a decade of stable or falling bills.
- Increased the company-funded support for customers who are struggling to pay their bills.
- We are starting work to reduce our gearing and plan to keep it below 70% from 31 March 2021.
- Highlighted that it may become possible to re-phase our large environmental programme, leading to a **further bill reduction** prior to the final determinations later in 2019.
Our response also explains that there were two important areas in which we did not agree with all of Ofwat’s feedback:

- On costs, we were surprised by Ofwat’s feedback about the extent of what it thought was inefficiency. Having looked in detail at the feedback, we believe that the approach used has not completely recognised the impact of our ambitious targets to improve performance and our large environmental programme. So, we have provided additional high-quality evidence to explain these issues and suggest ways to better separate efficiency from activity.

- On performance commitments and financial incentives, we were surprised by the extent to which Ofwat has made changes to its PR19 methodology. Ofwat’s approach risks creating a disconnect between the targets set and the costs allowed, as well as reducing the importance of what our customers have told us. It is simply not possible for any company to deliver major changes in performance without incurring additional costs. So, where Ofwat does want to change its policy and requires companies to meet different performance standards, this must be considered alongside the efficient costs of doing so. Again, we have provided additional high-quality evidence to help explain these issues.

As with the development of our original plan, we have engaged actively with the Forum throughout and would like to thank Forum members for their ongoing involvement and support.

We have re-tested our plan with our customers and are pleased to report that 88% support our plan (an improvement on 2% from our original plan). Customer engagement also shows that 84% find it affordable (an increase of 18% from our original plan).

Our response has been developed with the active involvement of our Board, challenging us to respond positively to Ofwat’s feedback wherever possible, and providing high-quality evidence where we disagree with the feedback. Changes to the plan have been fully assured and the Board has also updated its Board assurance statement.

1. About this document

This document forms part of our regulatory price review process (PR19). In September 2018 we submitted our PR19 business plan to Ofwat, our economic regulator. The PR19 plan contains our proposed service levels and costs for the period 2020 to 2025 and it is set in the context of our long-term strategy. You can find our PR19 business plan and our long-term strategy on our website.
Ofwat has reviewed the PR19 plans for all companies and in January 2019 published its initial assessment (IAP). Ofwat placed each company into one of four categories, exceptional, fast track, slow track and significant scrutiny. This was dependent on Ofwat’s view of the overall quality of each plan.

Yorkshire Water was placed in the slow track category, this means that some parts of our plan have been assessed as high quality and in other areas Ofwat has asked us to look again, either amending our plan or providing further evidence to support the original plan. This section has been created to explain how we have developed our response and what the response contains. The section covers:

- The role of our Board and the assurance of our IAP response.
- How we have approached our review of the feedback, changes we have made and areas where we have provided additional evidence to support our plan.
- The next steps we, and regulators, need to take to finalise our Water Industry Environment Programme (WINEP).
- How our response provides what we believe is the best plan for our customers and the environment.

2. Our Board support and the assurance of our IAP response

As with our PR19 plan our Board’s aim is to produce a high-quality IAP response that meets the expectations of customers in delivering the services they need, now and in the future, at a price they can afford to pay.
Our Board has been accountable for the leadership and preparation of our IAP response. To lead the discussion on the development of the plan our Board has conducted several workshops. The workshops were used to challenge management and satisfy our Board that the IAP response meets the expectations of customers and all other stakeholders. Our Board used the workshops to ensure the IAP response continues to follow its strategy for addressing the long-term challenges of climate change, population growth, all round resilience and long-term affordability.

Our Board has applied robust assurance in the preparation of the IAP response. Good assurance needs to be provided at the right time, be proportionate to the level of risk identified, ask the right questions and assess the quality of evidence supporting the statements made. Our assurance approach is risk based and aligned to the ‘three levels of assurance’ framework. This is best practice and is set out in Yorkshire Water’s published Assurance Plan for 2018 -19.

To satisfy our Board that the plan is accurate, high quality and accessible, all elements of the plan including data are subject to our Board's robust assurance process. Our Board confirms that:

- Our assurance has followed the three levels of assurance as set out in our published Assurance Plan.
- The assurance process includes audit checks and challenges by data providers, data managers, senior managers, directors and its independent technical auditors (Jacobs) and financial assurers (Deloitte).
- All data changes and action responses have been subjected to review and sign-off through our internal level 1 and 2 assurance activities. This has tested completion and compliance of the information submitted in the IAP response submission.
- Independent level 3 assurance activities have been focussed on testing the most significant areas of data change and supporting evidence. Similarly, we have subjected the more significant IAP actions to independent assurance.
- Findings from these assurance processes have been fully reviewed and actions necessary to allow submission implemented. The process and outcome of the assurance activities have been reviewed by the Board Audit Committee, which has separately advised the Board on the sufficiency of the assurance.
3. How we have approached our review of the feedback, changes we have made and areas where we have provided additional evidence to support our plan.

We value the feedback we have received from Ofwat and have considered it very carefully with our Board and the Forum. In considering our response we have thought carefully about what is in the best interests of our customers and in line with the promises that we have agreed with them in our PR19 plan.

Ofwat has given each aspect of the plan a red, amber or green score. Of the 9 IAP test areas Yorkshire Water scored 3 green areas and 6 amber. We have focused on the 6 overall IAP amber score areas, grouping the actions into the following themes:

a) Increased support for customers who are struggling to pay their bills.
b) Further improving our financial resilience and building trust and confidence in the sector.
c) Delivering best value for customers through cost efficiency.
d) Managing the health of our assets.
e) Our performance targets and the associated package of incentives.
f) Our approach to direct procurement for customers.

This section steps through each of these areas, providing an overview of our analysis and the response to the actions raised.

a) *Increased support for customers who are struggling to pay their bills.*

*Ofwat’s feedback:* Against the test ‘addressing affordability and vulnerability’ Ofwat noted that our PR19 plan contained high-quality initiatives to address overall affordability. Ofwat asked us to look again at the levels of support for customers who are struggling to pay their
bills. Ofwat also challenged us to be clearer about how we have tested our long-term bill profile with our customers to ensure that they find it acceptable.

Our response: We have shared the feedback with our Board and the Forum, reflecting very carefully and challenging ourselves to do more for customers who find themselves in vulnerable situations. We are amending our plan with the following actions:

1. Support of customers struggling to pay their bills

We will increase the number of households receiving direct support by 2025 from our current position of 26,000 households to 83,000.

This will be made possible by increasing the company contribution to the social tariff from the current level of £2.5 million for 2015 to 2020 to £10 million for the period 2020 to 2025. We did also ask customers if they were willing to increase the level of support funded through our prices, but they preferred not to. An additional 60,000 households will be helped through flexible payment options, third party advice and targeted home visits.

We offer 8 assistance schemes designed to support customers, either to prevent them falling into debt or to help them get back on their feet if they do.

2. Plan acceptability and our long-term bill profiles

We have carried out additional acceptability testing. **88% of customers support the plan and 84% find it affordable** – this is an increase on the previous research. We have carried out additional customer research regarding our long-term bill profiles. **72% of customers find the bill profile up to 2030 affordable.**

3. Our 2020 to 2025 bill profile

Our average bill profile has been adjusted as part of the IAP review process, in response to new information we now have regarding some of our targets. This has moved the average bill from a proposed increase of around £3 a year to **no real increase** (excluding inflation) over the period.

**This is excellent news for customers, who will receive better service for the same average costs as now.**
b) Further improving our financial resilience and building trust and confidence in the sector.

Ofwat’s feedback: Ofwat required a series of actions to ensure that Yorkshire Water meets the expectations set out in its ‘putting the sector back in balance’ publication. Ofwat has also challenged us to be even more transparent about our corporate and financial structures and resilience. We do publish information in our annual performance report (APR) but Ofwat would like additional information about how our financial and corporate structures impact on our financial resilience.

Our response: We are committed to help improve trust and confidence in the sector and so we have looked hard at what more we can do in this area. We have made the following adjustments to our PR19 plan:

Aspects of financial resilience and building trust and confidence in the sector

1. Executive pay policy

Ofwat states that our plan demonstrates high quality in the round in respect to executive pay. We confirm that any future changes to the policy will be published in our annual performance report (APR).

2. Dividend policy

We have confirmed that we are committed to adopting all the expectations on dividends for 2020-25 as set out in Ofwat’s “Putting the sector in balance” publication. This will build even greater confidence that our dividend policy is transparent, considers the long term and is fair.

3. Our projected gearing for 2020 to 2025

We will take steps to reduce our gearing and will target to reduce our gearing below 70% by 31 March 2021. We will also include Ofwat’s default financial sharing mechanism in our PR19 plan. Following receipt of draft and then final determinations, we will review the package in the round and if necessary fine tune our financing plan to reflect the determinations and financial market conditions.

We believe that these actions will resolve the concerns raised by Ofwat and demonstrate our continued drive to improving trust and confidence in the sector.
c) Delivering best value for customers through cost efficiency.

Ofwat’s feedback: Ofwat’s historical efficiency modelling found Yorkshire Water to be the second most efficient company in our water price control and the fourth most efficient in our wastewater price control. This confirms that we are an efficient company and is also in line with the results of the regular benchmarking that we undertake ourselves.

In contrast, looking forward, the results of the cost analysis carried out by Ofwat is that it believes that our forecast costs are about 18% more than Ofwat’s view of an efficient company for our wholesale area. Ofwat found our residential retail price control to be 27% more efficient than its baseline making us the frontier company in that area.

Our response: We were very surprised by this feedback because of our strong track record for efficiency built up over 20 years. Yorkshire Water’s average bill is consistently below the industry average levels. We have also applied the same stretching efficiency targets for PR19 as we have for previous plans.

Our long track-record of cost efficiency has been achieved by responding to all changes based on good evidence, following sound economic principles and tailored to specific circumstances. We do not believe that Ofwat’s initial challenges have achieved these elements. The main concern for us is that Ofwat’s approach puts at risk the promises we have agreed with our customers. It is not in customer’s interests to place efficient companies in a position that they cannot meet commitments due to insufficient funding.

Having looked in detail at the feedback, we believe that the approach used has not completely recognised the impact of our ambitious targets to improve performance and our large environmental programme. So, we have provided additional evidence to explain these issues and suggest ways to better separate efficiency from activity.

The table below summarises the key areas of the cost challenges in the IAP feedback where we have the most concern. We have provided Ofwat with detailed, high quality evidence to support our position that these costs relate to efficient expenditure to meet demonstrated requirements and so should be allowed. If you would like to review this evidence, it is available on our website.
15% reduction in leakage covered in base expenditure: Our evidence demonstrates that our ambitious leakage reduction plan is not funded within Ofwat’s cost baseline. We also conclude that Ofwat’s approach to assessing leakage enhancement costs penalises the most ambitious companies. This is inconsistent with Ofwat’s stated objectives and provides the wrong incentives.

The impact of WINEP on our base expenditure does not appear to be recognised through the Ofwat financial modelling process: We believe that the requirements of WINEP means that some elements of base maintenance must be brought forward to meet the WINEP requirements. We believe that circa £140m of costs have not been attributed to WINEP in Ofwat’s IAP review. We have provided substantial additional evidence on this point.

We recognise that enhancement expenditure modelling is a difficult area, but we are concerned regarding the outcomes of Ofwat’s approach: We do not believe that the decisions regarding efficient unit costs for some activities fully reflect the work we need to do to deliver the promises we have made to our customers. Where this is the case we have supplied substantial additional evidence to support our position.

We have concerns around the evidence used by Ofwat to determine real price effects and frontier efficiency assumptions.

We have carefully considered Ofwat’s forecasts and we have concerns regarding both some of the evidence used and the approach followed. To address this, we have provided further evidence in two expert position papers found in Appendix YKY.A1-1 and YKY.A1-2.

Our response to the feedback in the IAP on costs has been considered very carefully with the Board and the Forum. We are providing additional evidence as opposed to adjusting our costs only where we have robust evidence to do so and where we firmly believe that it is in the best interests of our customers.

We will continue to challenge ourselves to provide the best service at the lowest possible costs. We are concerned that the IAP assessments methods have penalised an efficient company with an ambitious service improvement plan and a large environmental programme. These penalties jeopardise our ability to deliver on those plans.
d) Managing the health of our assets

Ofwat’s feedback: Ofwat found that overall, Yorkshire Water provided performance commitments that were appropriate and well evidenced, with stretching service levels. Ofwat has asked for more evidence to support some of our proposed service levels.

Our response: We have long-term plans in place to maintain the health of the assets. We take the health of our assets extremely seriously and currently use a basket of measures (reflective of the specific nature of our assets) to ensure that our assets are maintained in the most cost-effective way for our customers. After engagement with our Board and the Forum we are taking the following actions:

**Investing at the right time:** To ensure that we invest in the right places, at the right time, we consider the impact of potential asset failures on the services our customers receive. For example, we are repairing many more leaks – this does not impact directly on the service customers receive. However, interrupting the water supply does impact on our customers, so even though we are repairing many more leaks, we are reducing the number of times we interrupt supplies by working differently.

**Reporting consistency:** For example, Ofwat has asked us to exclude sewer collapses that are found proactively as other companies do not includes these in their reporting. We have adjusted our reporting to put it in line with other companies. We have also supplied additional evidence to support of our long-term targets.

**Abstraction incentive mechanism (AIM):** Ofwat has asked us to provide further evidence to prove that we do not have any water abstraction sites that would qualify under AIM. We have worked closely with the Environment Agency (EA) to supply additional evidence confirming that we do not have any abstraction sites that require AIM.

Yorkshire Water is a resilient company, evidenced by our performance during the extreme cold and the prolonged drought experienced in 2018. We were noted by Ofwat regarding our preparation for, and response to the “beast for the East”. Also, the prolonged drought condition experienced in Yorkshire did not impact on the service our customers received.
We have provided details of our approach on asset health and the specific tools we have developed for this in IAP response YKY.OC.A1-A52: Delivering outcomes for customers.

e) Our performance targets and the associated package of incentives.

Ofwat's feedback: Overall, Ofwat concluded that our performance commitments (PCs) and outcome delivery incentives (ODIs) are ‘appropriate, well evidenced and stretching’ and make for a “high quality plan”. Ofwat has however requested a significant number of amendments to our PC and ODI package and we have reviewed these carefully.

Our response: Overall, we were surprised by the extent to which Ofwat have made changes to the PR19 methodology. Ofwat’s approach risks creating a disconnect between the performance targets set and the costs allowed as well as reducing the importance of what our customers have told us. It is simply not possible for any company to deliver major changes in performance without incurring additional costs. So, where Ofwat does want to change its policy and require companies to meet different performance standards, this must be considered alongside the efficient costs of doing so. Again, we have provided additional high-quality evidence to help explain these issues.

If we were to implement all Ofwat’s changes, the PC and ODI package would no longer reflect what our customers have asked of us. It would be harmful to customers and the company because it materially changes the balance of the package as evidenced by our return on regulated equity (RoRE) range modelling. This is a complicated area and if you would like to read more about this please go to our detailed document IAP response YKY.OC.A1-A52: Delivering outcomes for customers.

We have considered each of Ofwat’s amendments individually and then looked at the PC and ODI package as a whole to understand the impact. This has allowed us to identify the changes that can be made without material distortion of the overall package. Where changes have a material impact we have provided further detailed evidence supporting either a compromise position where we adopt as much of the proposal as we can without distorting the overall package, or the original position.

f) Direct procurement for customers (DPC)

Ofwat’s feedback: Ofwat has stated that Yorkshire Water provided limited evidence that we have fully considered DPC.

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1 Yorkshire Water: Test question assessment page 3.
Our response: We are committed to finding the best delivery models that keep costs low for our customers and this is an area where we believe that we can learn from the approach taken by other companies. We have fully reviewed our process in line with that required by Ofwat and we are taking forward a ‘fast learner’ approach by embedding an improved process, not just for the PR19 process but for the long term. We have reviewed our original analysis using external experts and have re-confirmed that, at this time, we do not have a qualifying scheme.

4. The next steps we, and regulators, need to take to finalise our Water Industry Environment Programme (WINEP).

Our original PR19 plan contained circa £900 million of expenditure to deliver the environmental improvements required by the WINEP programme. Much of the programme was predicated on the expectation that a number of rivers in Yorkshire would be designated to a higher environmental standard in December 2018. As these designations had not yet occurred when we submitted our plan in September 2018, we followed Ofwat’s PR19 methodology and classed these as ‘amber’ items and included a ‘WINEP uncertainty mechanism’ that would allow these costs to be removed if the designations did not occur.

We understand that these designations are still anticipated to be made but, at the time of writing, they have not occurred. We have not been able to make changes in our IAP response as the end of the financial year has not yet passed. However, when the designations do happen, the rivers must be compliant to the new standard within seven years’ time which will likely now go beyond the PR19 period. We are working closely with the Environment Agency and Defra to establish when the designations are planned. As a result of this we still have uncertainty in this area and we are looking at how the WINEP investment should be re-phased as a result of the delay. We will continue to work with our Board, the Forum, Ofwat, the Environment Agency and Defra in April to confirm this re-phasing and this should further reduce our average bill for the period 2020 to 2025 as some of these costs will move into 2026. We began this period (2015 to 2020) with a bill reduction and then stable bills. Our revised stable bill for 2020 to 2025 means that, before the WINEP re-phasing, customers in Yorkshire will see a decade of stable or falling bills.
5. How our response provides what we believe is the best plan for our customers and the environment.

Our PR19 plan was developed through a step change in the nature of our conversations with our customers, making sure that we really understood what they want and expect. It built on our strong track record of efficiency whilst improving the services that matter most to our customers.

We have reviewed Ofwat's feedback carefully with our Board and the Forum. We have concluded that in some areas we should provide additional evidence and in other areas we should amend our plan to make it even better for our customers.

This means that we have been able to adjust our average bill profile so that before inflation, it does not increase even through the services we are offering deliver significantly more value to our customers. We will triple the number of households that are supported through our social tariff, alongside all the other support that we already have in place. This support emphasises using data to identify and support customers before they fall into debt.

We have further improved Ofwat's assessment of our financial resilience through targeting a reduction in our gearing and we have further taken steps to ensure that we comply with all aspects of the outcomes of Ofwat's work on transparency and trust.

Where we believe our costs are appropriate we have provided further evidence as to why we believe that is the case and we have re-tested the acceptability of our plan, now and into the long term, with our customers.

Our plan is the start of a step change for us, moving into a sustainable, demand management future, working with our customers and stakeholders to deliver the best
outcomes for Yorkshire. Our six capitals approach will allow us to monitor and report back on our success in improving our long-term sustainability as well as our affordability, as the two are intrinsically linked.

6. Conclusion

We would like to thank the Forum for its continued engagement and support in the PR19 process and all our customers who have been involved in the research that supports our plan. We have also re-tested our plan with customers and are pleased to report that 88% support our plan (an improvement on 2% from our original plan). Customer engagement also shows that 84% find it affordable (an increase of 18% from our original plan).

We have listened carefully to Ofwat’s feedback and, following Board and Forum engagement, we have made key changes that improve our plan and bring additional benefits to our customers.

We will continue to look carefully at the costs and timing of our WINEP programme and wish to constructively engage with Ofwat and other regulators ahead of the draft determinations to ensure that these costs are phased in a way that reflects the designation timescales and therefore spreads the costs fairly for our customers.