



PR19 draft methodology
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By email to: water2020@ofwat.gsi.gov.uk

Dear Sir / Madam,

Consultation on the Methodology for the 2019 Price Review

Thank you for inviting Yorkshire Water to contribute to the consultation on the methodology for the 2019 price review (PR19) published on 11 July 2017. We have considered the detailed proposals in the main consultation document and reviewed the supporting appendices and data tables.

I am pleased to confirm that our overall response to the proposed methodology is positive.

We recognise and welcome the challenges that Ofwat is setting for all companies, with a very clear requirement to deliver step-changes in service performance, efficiency and innovation, and to do so in a sustainable and resilient long term context. These are all essential elements to ensure that we continue to enjoy customer support as we adapt to meet the challenges ahead and ensure that we do as much as we can to support customers who may experience vulnerable circumstances. We also welcome the re-shaping of the plan assessment process to increase focus on innovation and ambition. Yorkshire Water is committed to delivering a high quality, ambitious and innovative business plan for PR19.

Although the PR19 Business Plan is not due for submission for a further year, we are already working hard with the richly diverse community that we serve to co-create and co-deliver our plans for PR19 and beyond. Indeed, we believe that we have already achieved some notable successes with customer participation and innovation.

Our approach to the management of fats, oils and greases in Bradford Moor¹ has helped support a local community centre via the revenue from the biofuel created from recovered oil and ghee. At the same time, it has almost completely eliminated sewer blockages in the area, allowing us to reduce operational costs.

¹ [Link: Yorkshire Water - Bradford Moor 'fats to fuel' project](#)

In the Calder Valley, we have developed a natural flood management plan² with the local community partners, to benefit communities which had suffered the Christmas 2015 floods. Over a 10-year period, this will see the planting of up to 200,000 trees on our land and the restoration of around 43 hectares of peatland with sphagnum moss. These initiatives will create natural flood protection, slowing rain-water runoff to reduce downstream flooding in areas such as Todmorden, while at the same time lessening the risks of hydraulic overload in our sewers.

In addition to our focus on innovation and customer participation, we have also been focusing strongly on our service delivery. The medium-term challenge that we have set ourselves is to replicate our existing excellence in almost all areas of cost efficiency and become recognised as one of the leaders on service delivery as well. In this regard, we do have some observations about how the methodology could be improved further.

Areas of further improvement in the methodology

To ensure that the methodology provides the strongest possible platform to encourage innovations and performance improvements that are sustainable into the long term, it is important that the right balance between risk and reward is achieved and that all stakeholders recognise that it has been achieved. We have **identified three areas** where we believe that further consideration should be given prior to the publication of the final methodology statement in December 2017. In these areas, we believe that the approach suggested will not deliver the most benefit for customers over time.

Different circumstances between companies

The first area is that the methodology risks not giving appropriate recognition to different circumstances between companies. This could impact on both the approach to outcomes and the assessment of cost efficiency.

The proposed approach on outcomes does not appear to allow for the possibility that economic service levels on specific performance measures differ between areas. There were a number of questions about differences between companies in the November 2016 outcomes framework consultation, and it would be helpful to have sight of the questions and responses that were submitted.

Our reading of the consultation document is that the methodology also proposes to discourage companies from seeking cost adjustment claims around the cost efficiency modelling. Since we do not yet have any insight on how the econometric models will be formulated and how the results of the aggregate models will be triangulated with the results from the more granular models, this is also an area of concern. The suggestion that companies should submit any special cost factor claims early and without having seen any information on the model formulation or results also risks creating the unintended outcome of an inefficient process.

For both outcomes and cost efficiency, we recognise that undue focus on different circumstances could be seen as creating excuses for management inaction. To ensure this is not the case, there should be an appropriate evidential bar to challenge the need for such

² [Link: Yorkshire Water - Gorpley natural flood management](#)

factors to be included and to challenge companies to find ways around such differences where they do exist.

A presumption from the outset that a “one size fits all” approach is appropriate, may risk creating a distorted picture on true cost and service efficiency. The incentive strength of the methodology and the balance between risk and reward will not be well served if neither efficient or inefficient companies are reliably identified.

We do have a specific suggestion regarding the approach on outcomes.

Between draft and final determinations at PR14, a three-part test was applied to evidence on different circumstances covering whether a factor was a material driver of performance, was outside of management control and whether there was a materially different impact between companies.

These are sensible tests and could form the basis of a useful additional step in the methodology to test whether there are sufficiently important differences in the economic service levels for specific performance measures to make some adaptation necessary. This additional step could be undertaken soon after the methodology is confirmed, building on the valuable work being done on the convergence of measures.

Even if the additional step concluded that no adaptation was required, the exercise will improve confidence amongst all stakeholders that the methodology is soundly based. We also think that it could be structured in a way to provide substantial cross-learning between companies, helping to initiate further valuable innovations and frontier-shifts on these measures.

Efficiency and service performance

The second area to improve is the suggestion in the methodology consultation that customers have already funded both upper quartile efficiency and upper quartile service performance. We do not believe this presents a complete picture of the PR14 determination.

The performance commitments (PCs) based on comparative analysis were necessarily introduced by Ofwat only at a late stage in the PR14 process. As a result, the PCs were not a holistic part of company business plans, supported by detailed optioneering of totex solutions and benefitting from fully detailed consultation with customers.

There is also a contrast between the specific measures used in the PR14 determinations and those being consulted upon for PR19. We welcome the comprehensive consideration of the detailed measures that has been undertaken, but the results further highlight some of the accepted limitations of the PR14 comparative analysis. Our acceptance of those PR14 PCs was enabled by the sensible provisions for caps and collars which provided customers, companies and shareholders alike, with a measure of protection against unforeseen consequences.

We fully understand and support the “deliver more for less” challenge that underpins the methodology. However, we believe that a non-specific assertion that customers have already funded upper quartile service levels is overly simplistic and will undermine confidence that the methodology achieves the necessary balance between risk and reward.

In particular, a suggestion that companies have previously been funded to deliver upper quartile leakage is not supported by the approach adopted at PR14. This included the application of a specific Risk Based Review test to question the justification for any company that proposed to target leakage below sustainable economic level of leakage (SELL).

Transition periods

The final area where we suggest that further improvement would deliver a better result for customers is the impact of the suggestion that there should be no transition periods, with companies expected to deliver the fully stretched performance levels from the start of the five-year price control period.

In section 4.3.7 of the consultation, the text refers to not having transition periods for four common performance commitments - water quality compliance, water supply interruptions; internal sewer flooding; and pollution incidents. Since these are important performance issues for our customers and there is a fairly high degree of read across from the PR14, we consider that this is a reasonable approach for these four commitments. However, section 2.6 of Appendix 2 to the consultation appears to suggest that there should be no transition periods on any performance commitments.

The use of totex in the methodology does result in an equalisation of the financial incentives in respect of operational and capital based solutions to improve performance. However, it does not impact on the different time horizons necessary to deliver different types of solutions in an efficient manner. The absence of transition periods will therefore require undue emphasis on the speed of response which will tend to create a bias towards operational solutions and reduce time for potential innovations to be developed.

Over the medium-term, this could act to increase costs that would require funding. And in the near-term, it risks creating an unavoidable penalty on companies, impacting on shareholder views of the balance between risk and reward. As a result, we believe that there is a strong case for appropriate transition periods to be included, particularly where performance commitments are covering new areas or some time is needed to plan and implement the necessary solutions.

Further feedback and suggestions

As we indicated at the outset, we are strongly supportive of the aims of the methodology and most aspects of its suggested approach. Despite our three areas of suggested improvements outlined above, the great majority of our responses in the detailed pro-forma signal our agreement. There are only three further points of detail on which express disagreement.

1) Practicalities of direct procurement.

We support Ofwat's proposals ensuring companies consider using the direct procurement for customers (DPC) approach to deliver large scale projects and schemes efficiently. We do believe there are elements of the approach as described which add complexity and may limit the potential for direct procurement to be exploited in full to benefit customers.

We recognise the potential for bioresources needs to be serviced by an emergent market, but it may limit innovative opportunities to exclude bioresources related projects from those suitable for DPC.

Although we recognise the need to attract competition into the tender process under DPC, we believe excluding the appointee from being able to bid into the tender process could lead to instances where a non-optimal contract is awarded.

Ofwat note that where a tender process fails to secure a successful commercial bidder the appointee would deliver the project in-house in a 'last-resort' capacity. Where the appointee had developed a bid already this would expedite the delivery of the project and could minimise costs that would otherwise be passed onto customers in the next business plan.

So rather than a prohibition on in-area bidding, we believe that a better solution for customers is to require companies to be able to demonstrate independence between the staff running the tender process, and those constructing the in-area tenders. We are confident that this could be achieved and demonstrated to prospective bidders.

2) Indexation of retail costs.

In relation to the preferred approach not to index the retail controls to a measure of general inflation, we believe this approach cannot be managed by all companies. We agree that input price pressures should be net of productivity gains, but should a company be efficient against the frontier and against external retail residential retail and debt management benchmarks its ability to offset labour input price pressures is limited. This may not be the case for inefficient companies.

Going forward, we recognise that as part of our focus on efficiency and innovation, it is likely that the proportion of costs represented by labour costs will decrease over time. We review our operating model continually to ensure the optimal level of cost to serve is achieved for all customers.

Even after retail innovations are considered, the proposed three year duration of the price control means that labour costs are likely to remain a significant part of retail service costs throughout the control period.

3) Not including a "no harm" principle in early determinations.

We were disappointed to see that the intention is currently not to include a "no harm" principle for recipients of early determinations. This will have a materially adverse impact on the benefit that an early determination should bring by allowing a company to press ahead with the future business plan.

An early determination which did not provide certainty on any of the cost of capital, assessment of efficient costs or details of the performance commitments/incentives is a determination in name only. Companies and their shareholders seeking to start delivery of their plan would be exposed to substantial risks until the full set of determinations were completed.

In conclusion, we are strongly supportive of the objectives of the methodology and many of its detailed components. Yorkshire Water is committed to delivering a high quality, innovative and ambitious plan in response. We believe that a positive response to our three suggested improvements and the small number of detailed points would allow the objectives to be realised in a way that maximises customer benefit and balances risk and reward over the medium-term.

We have provided responses to each of the specific consultation questions separately in the spreadsheet template that was provided. Our current thoughts on the potential candidate projects that may be suitable for a DPC approach are included in our response to question 1 under section 7 within the response template provided. In addition, we have made some observations and suggestions to the draft data tables within the template.

Finally, we have noted Ofwat's initial observations about individual components of the cost of capital. We believe that it would be premature to comment on individual components until Ofwat have made holistic proposals about the overall cost of capital.

Should you have any queries regarding any elements of our response, please contact me at wendy.kimpton@yorkshirewater.co.uk.

Yours faithfully,



Wendy Kimpton
Head of Regulation