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Dear Sir or Madam

Putting the sector back in balance: Consultation on proposals for PR19 business plans

Thank you for inviting Yorkshire Water to contribute to the consultation on proposals to make targeted amendments to, and clarifications of, the methodology for the PR19 price setting process, including the proposal to require companies to share financing outperformance from high gearing.

In the implementation letter to company CEOs, dated 13 April 2018, Rachel Fletcher confirmed the common goal to have a thriving water sector that holds the trust and confidence of customers and wider society, and a belief that recent service failures and the corporate behaviour of some companies has damaged that trust. We understand the proposals in this consultation are part of the programme of work to rebuild trust in the sector, as outlined in Rachel's letter.

Yorkshire Water is committed to engaging and working with our customers and the wider public about how we define our role in providing critical public services that can be trusted.

We recently published our long term strategic direction document which explains the detailed customer research we have undertaken to determine priorities for customers whilst facing into the big challenges of climate change, population growth and ever more rigorous environmental protection. In our strategic direction document, we have outlined our five big goals that will inform and shape our PR19 business plan alongside Ofwat's themes of great customer service, resilience in the round, affordability and innovation.

With regard to the specific proposals in questions we wish to highlight two specific areas:

Sharing of financing outperformance

We are fully supportive of a regulatory framework that shares the benefits we have achieved with our customers – this is integral to incentive regulation. The regulatory framework initiated at PR14 and now enhanced for PR19, ensures we focus on what is most important for our customers, the environment and wider society as a whole. It does so by providing incentives for companies to outperform the regulatory settlement and for the associated benefits to be shared with customers.

When it comes to 'outperformance' from financing arrangements, however, we disagree that this creates value, over and above the cost of capital, to be shared. Financial economic theory tells us that what matters is the intrinsic riskiness of the cash-flows that a firm generates and says that, all other things being held equal, a swap of debt for equity or of equity for debt principally alters the allocation of risk among investors rather than affects the overall pricing of the firm's capital.

The most famous articulation of this line of thinking is the Modigliani-Miller theorem. The theorem states that, under certain simplifying assumptions, the value of a firm is unaffected by how that firm is financed.

With this in mind, we believe that further consideration needs to be given to the relationship between equity at risk and the return earned on that equity. We want to avoid ending up in a situation that has unintended consequences on the attractiveness of the sector to the investor community and ultimately impacting our current and future customers.

If outperformance from financing arrangements can be identified it should be for companies to propose the specific levels of sharing as part of their business plans. Any such proposals should take into account the benefits customers already receive from higher gearing, such as a lower taxation charges reflected in bills and enhanced service as a result of reinvestment.

Financial resilience

We fully support the principles and intentions behind the proposal for financial resilience testing and agree that it is for the Board of each company to identify, assess and manage the principle risks relevant to that company. We also see merit in a minimum set of scenarios that should aid comparability across the sector.

We ask Ofwat to consider, however, the parameters or quantum for a common suite of scenarios. In particular, we consider that more thought needs to be given to the probability or riskiness of the assumptions to those underpinning the assumed cost of capital. In other words, the level of risk quantified in the scenarios should be commensurate with the level of risk inherent in the cost of capital. We would welcome the opportunity to work with Ofwat in identifying the appropriate parameters for a suite of scenarios.

We welcome the other proposals for dividend policies and the performance related elements of executive pay to be linked to the delivery of services for customers, and we will be including details of our policies regarding these matters in our business plan submission.

We have responded to each of the consultation questions in the attached table 1, and have aimed to do so from a current and future customer benefit perspective.

We would be pleased to discuss matters further should you consider this may be of benefit.

Yours faithfully,

Liz Barber

Liz Barber
Director of Finance, Regulation and Markets

Table 1

Yorkshire Water response to the consultation: Putting the sector back in balance - proposals for PR19 business plans

Q1.	*Do you agree that companies should be required to propose mechanisms for sharing financing outperformance in their business plans, and that we should assess such mechanisms in the IAP?*
A1.	Whilst we agree that companies should be seeking to share genuine financing outperformance with their customers, current economic theory does not support the proposal included within this consultation. Even so, when assessing any potential financing 'outperformance' in relation to high gearing it is important to consider the benefits already received by our customers and any additional costs incurred by ourselves in order to deliver these benefits for our customers. In particular, we believe that any mechanism that seeks to share financing outperformance in relation to high gearing should reflect the following, at least: • Outperformance already shared with customers through mechanisms such as a reduced tax allowance • The impact of re-investment to improve service for customers on a company's gearing • The actual cost of debt experienced by companies used to finance above notional gearing levels i.e. class B debt
Q2.	*Where adequate mechanisms are not offered in business plans, do you agree we should intervene to impose a sharing mechanism, to ensure customers will receive an appropriate level of benefit from companies with highly geared structures?*
A2.	We do not agree with the proposal to impose a sharing mechanism for one specific area of our plan. Our plan should be assessed in totality, with the overall risk and reward being assessed for the plan as a whole. If Ofwat do not consider there is a fair and appropriate allocation in overall risk and reward between company and customer, then Ofwat already has the requisite mechanisms to intervene as it sees appropriate. We do not consider an assessment can, or should, be made at an individual item level.
Q3.	*Do you have views on our proposals for the design of the outperformance sharing mechanism for highly geared structures? Do you agree that the calculation should be on a nominal basis and take account of the actual, rather than notional, cost of debt?*

A3.	We reiterate that we fully support the principles of incentive regulation and that genuine outperformance is shared between company and customers. The proposal as it currently stands, however, departs significantly from established economic theory that has underpinned the cost of capital assessment since privatisation. In view of the significance of this departure, we suggest that a full and comprehensive impact assessment is performed to identify a financing outperformance mechanism that does not materially impact key stakeholders in a way which may ultimately impact customers. For example, should such a mechanism be introduced it may take into account the movement in equity beta that occurs when the gearing of a company changes, or explain and evidence why a departure from current economic theory and its application is appropriate. Additionally, any such mechanism, we suggest, should include adjustments to reflect the items identified in our answer to Q1, which is not exhaustive. As requested, in relation to the calculation of the cost of equity / cost of debt differential we would make the following comments: • We agree that using the company's actual cost of debt is more appropriate as this more accurately reflects the actual costs associated with the additional debt. In order to most accurately reflect these costs, we consider the company's actual cost of class B debt should be used, rather than the overall cost of debt, as the debt in excess of the notional level will predominantly be class B debt. • We do not have a preference for using a real or nominal rate, but note that if a nominal rate is used then a consistent inflation rate should be used to ensure any changes in inflation do not impact the calculation. As currently proposed, inflation risk will be included within the mechanism as the cost of equity includes a fixed long-term inflation assumption, but the actual cost of debt but will use an actual inflation rate.
Q4.	*Do you agree that companies should explain their approach to dividend policy in their business plans and that our IAP assessment should assess both transparency and how the policy takes account of factors which include obligations and promises to customers, delivery of service to customers, financial resilience and employee interests?*
A4.	In recent years we have sought to be as transparent as possible in relation to the dividends paid to our investors; therefore, we agree with this proposal.

Q5.	*Do you agree that companies should explain their approach to any performance related element of executive pay in their business plans and that our IAP assessment should assess both transparency and that policies for awards of any performance related element of executive pay demonstrate a link to exceptional delivery for customers?*
A5.	We agree that companies should explain in their business plans their proposals for the performance related elements of executives' pay and by reference to their published remuneration policies. It should be expected that customer service performance metrics play a prominent role in the design of executive remuneration, specifically short and long-term incentives, and that the assessment of performance against delivery for customers should be transparent. However, it must remain the duty of the company's Remuneration Committee to determine the specific remuneration policy, balance between fixed and variable reward, metrics and targets appropriate at the time, in line with the relevant Committee's Terms of Reference. We agree that in its assessment of plans, Ofwat should assess such proposals for a commitment to transparency about the performance elements of executive pay and that policies for awards of such pay demonstrate a link to exceptional delivery for its customers.
Q6.	*Do you agree with our proposed revisions to extend the confidence and assurance test area to include trust and with the revised wording of question 3 of this test area?*
A6.	We agree with this approach.
Q7.	*Do you have any comments on the additional clarification of our approach to financial resilience in the IAP?*
A7.	We agree with the principle of using a suite of common scenarios to help the assessment of financial resilience. However, the levels proposed within the consultation document are very extreme and potentially incongruent with the level of risk implied in the cost of capital assessment. We recommend further work is undertaken in this area and would welcome the opportunity to work with Ofwat in developing appropriate scenarios.

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