

January 2019

Trust in water

PR19 initial assessment of plans: Yorkshire Water company categorisation

About this document

In '[Delivering Water 2020: Our final methodology for the 2019 price review](#)' (the methodology) we said that we wanted all 17 regulated water and wastewater companies to produce high-quality, ambitious and innovative business plans, pushing forward the performance and efficiency of the sector for customers. To encourage this we developed the initial assessment of business plans (IAP) process. The IAP was designed to incentivise all companies to produce well-evidenced plans that reflect their customers' preferences and priorities and are efficient.

We explained that the IAP would:

- assess company business plans against nine key test areas that reflect our PR19 themes and the strategic policy statements of the UK and Welsh Governments and help make sure companies deliver for customers, the environment and wider society;
- assess company business plans against three key characteristics (quality, ambition, and innovation); and
- categorise company business plans into four categories (significant scrutiny, slow-track, fast-track, or exceptional).

Following the submission of companies' business plans on 3 September 2018, we have carried out an extensive and detailed review of these plans. This review has been carried out in accordance with our methodology. More details on our overall approach to the initial assessment of business plans and our key findings by test area are set out in the 'PR19 initial assessment of plans: Summary of test area assessment'. The results of the review of all 17 business plans are summarised in the 'PR19 initial assessment of plans: Overview of company categorisation'. Our assessment is based on the information the company submitted to us as part of its business plans for the period 2020-25. The documents we have published are available on our [website](#).

This document sets out our assessment of Yorkshire Water's business plan submission under the IAP. It explains our assessment of the company's plan in the round at an aggregate level and our assessment across each of the nine test areas as set out in our methodology.

This document and the actions in the 'Yorkshire Water: Actions summary table' should be read in addition to the 'PR19 initial assessment of plans: Overview of company categorisation' document.

1. Overview of Yorkshire Water's categorisation

Our assessment of the plan

We set high expectations for water companies at PR19. We pushed them to go further than ever before, improving efficiency, customer service and resilience. We asked them to share financing gains with customers and to ensure that their dividend and executive pay policy is aligned to delivering for customers. We asked them to look well beyond the five-year price review period to meet the needs of future customers and protect and improve the natural environment. We indicated in our PR19 methodology that the bar is high, and our Initial Assessment of Plans is the categorisation of company plans against those high expectations at this stage of the price review process. Where our expectations have not been fully met, we will continue to work closely with companies during the draft and final determination stages.

We categorise Yorkshire Water as slow-track. This categorisation is made after an in the round consideration of our assessment of Yorkshire Water's plan across the nine test areas and the overall level of intervention in the plan required to protect the interests of customers. Our grades for each of the test areas are set out in Table 1 below.

Yorkshire Water performs well on customer engagement as it demonstrates the use of innovative techniques including behaviour experiment methods. It also demonstrates good use of markets to provide water and wastewater services.

The company also performs well on accounting for past delivery with sufficient evidence that it has put measures in to deliver its 2020-25 plan. Its past performance in outcomes, deliverability of planned costs and customer complaints is good, and it provides sufficient evidence that its plan includes appropriate measures to improve in areas where its performance falls short.

However, it falls short of high quality in other areas. Our concerns include:

- **cost efficiency** - at the company level its costs are around 18% above our view of efficient and justified costs;
- **affordability and vulnerability** - it proposes a 3.5% bill increase with inconsistencies in the data it provides to demonstrate customer acceptability and it offers relatively low levels of support for customers who struggle to pay;
- **accounting for past delivery** - it has relatively poor performance on asset health with insufficient evidence it will resolve these issues quickly;

- **delivering outcomes for customers** - it proposes a package of performance commitments and outcome delivery incentives some of which is not well evidenced;
- **aligning risk and return** - there is insufficient evidence to support its choice of target credit rating for its actual capital structure, in the context of the investment programme and debt raising needs; and
- **confidence and assurance** - it does not have appropriate gearing outperformance sharing arrangements, despite forecasting gearing above 70%.

Given the scale and scope of these concerns, the plan requires a level of material intervention to protect customer interests. We therefore categorise Yorkshire Water’s plan as slow-track.

An overview of our assessment of the business plan in relation to the nine test areas and our grades for each test area are set out below. Our detailed assessment of the test areas is provided in the ‘Yorkshire Water: Test area assessment’ and ‘Yorkshire Water: Test question assessment’.

Table 1: Overall test area assessments

Test Area	Our assessment
Engaging customers	B
Addressing affordability and vulnerability	C
Delivering outcomes for customers	C
Securing long-term resilience	C
Targeted controls, markets and innovation	B
Securing cost efficiency	C
Aligning risk and return	C
Accounting for past delivery	B
Securing confidence and assurance	C

A = High quality, ambitious and innovative plan with evidence that overall is sufficient and convincing

B = High quality plan, not sufficiently ambitious and innovative to be exceptional with evidence that overall is sufficient and convincing

C = Concerns with the plan: Plan falls short of high quality and/or evidence is insufficient and/or unconvincing in some areas

D = Substantial concerns with the plan: Plan falls significantly short of required quality and/or little or no evidence, or no convincing evidence

Engaging customers

Yorkshire Water’s business plan is high quality with convincing evidence of its customer engagement.

The company provides convincing evidence of the effective use of a wide range of customer engagement techniques including more innovative approaches such as behavioural experimental methods. It provides evidence of its high quality approach to implementing customer valuation techniques including the use of behavioural economics techniques. It provides mostly convincing evidence of its engagement with its customers on both the business plan and on longer-term issues.

Addressing affordability and vulnerability

Yorkshire Water's business plan falls short of high quality with insufficient evidence provided on its approach to affordability and vulnerability.

There are some inconsistencies in how it reports data on whether its customers find the 3.5% bill increase for the period 2020-25 affordable. There is insufficient evidence to demonstrate that it has customer support for its long-term bill profile. It does not sufficiently demonstrate a high quality approach in helping customers who struggle to pay. It proposes a modest increase in customers who receive its social tariff by 2025 and has not confirmed the level of cross-subsidy that will be available to its customers.

There are some aspects of high quality for this test area in the company's plan. For example, it proposes a high quality approach to addressing vulnerability which includes setting two stretching performance commitments.

Delivering outcomes for customers

Overall, across the delivering outcomes for customers test area, the evidence Yorkshire Water provides to support its proposed performance commitments and outcome delivery incentives within its business plan falls short of high quality.

Its relative performance on asset health is poor amongst the sector and it provides insufficient evidence that it will resolve this in an appropriate timeframe. It does not clearly demonstrate how it will protect customers from the impact of outperformance payments that exceed expectations. It does not sufficiently evidence its approach to setting its outcome delivery incentive deadbands, caps and collars. Its enhanced outperformance payments, in some instances, exceed customer willingness to pay with limited evidence to justify this approach.

However, the company's plan does provide sufficient evidence that some of its performance commitments are appropriate and stretching. For example, it proposes a supply interruptions target that is forecast upper quartile. It also proposes a high

level of stretch relative to historical performance on leakage, internal sewer flooding and per capita consumption for the period 2020-25.

Securing long-term resilience

Yorkshire Water's plan falls short of high quality as it has not provided sufficient evidence of long-term resilience in certain areas.

We are not convinced that the company has considered all relevant factors associated with maintaining long-term financial resilience in the context of its high-level of gearing. However its plan does provide high quality evidence of a systems-based approach to the assessment of risks, the identification of interdependencies, and in its approach to the natural environment.

Targeted controls, markets and innovation

Yorkshire Water's plan is high quality across the targeted controls, markets and innovation test area.

The company provides good evidence to support its bioresources strategy. It demonstrates good use of markets across its water and wastewater networks with a variety of innovative examples demonstrating a long-term approach to managing drainage and wastewater.

However on water resources, concerns that we raised with Yorkshire Water's draft water resources management plan have not been addressed appropriately. There is limited evidence that the company has the right culture to deliver results for its customers and the environment through innovation. The company provides limited evidence to demonstrate a high quality review process of suitable schemes for direct procurement for customers, with no assurance of this process provided.

Securing cost efficiency

Yorkshire Water's base and enhancement costs are not efficient when compared to our view of efficient costs. At a company level its costs are 18% above our view of efficient costs. Both its wastewater and water base and enhancement costs are inefficient.

The company proposes an ambitious leakage programme, however its leakage unit costs are less efficient than the industry benchmark. The company proposes three cost adjustment claims, however only one was of reasonable quality for a partial pass for adjustment.

However in residential retail its costs are around 27% more efficient than our baseline making it the frontier company in this area.

Aligning risk and return

Yorkshire Water's plan falls short of providing convincing and high quality evidence in the area of aligning risk and return.

The company's plan does not provide sufficiently convincing evidence to support its target credit rating for its actual company structure in context of the investment programme and debt raising needs.

However its plan does include high quality aspects such as it is based on our 'early view' cost of capital and, in the round, retail margins. It provides convincing evidence to support the board's statement that the company is financeable on its notional structure and to support its choice of pay as you go (PAYG) and regulatory capital value (RCV) run off rates. The company has carried out a high quality assessment of risk for the notional company in its return on regulated equity (RoRE) analysis.

Accounting for past delivery

Yorkshire Water's plan demonstrates high quality overall in the accounting for past delivery test area.

The plan provides high quality evidence on deliverability in the areas of outcomes, costs and customer complaints. The company has or is forecast to deliver 78% of performance commitments with financial outcome delivery incentives in 2015-20. The company is forecasting to spend in line with its allowances for 2015-20. The company has good performance in relation to customer complaints handling. It is already meeting CCWater's 2020 household customer complaints target, and has a low and falling total numbers of household customer complaints.

The plan falls short of high quality for deliverability in relation to major incidents. The company had three major incidents between 2015-2018 and did not provide sufficient evidence on the lessons learnt from these, or the measures to improve performance.

Securing confidence and assurance

Yorkshire Water's business plan falls short of providing sufficient evidence to demonstrate confidence and assurance.

The company's Board provides assurance statements in the majority of areas requested. However an insufficient number are supported by sufficient evidence of the Board's challenge and assurance process.

The company does not provide sufficient evidence that it will meet our expectations as set out in our 'Putting the sector in balance' position statement. The company's proposals on executive pay are generally high quality. The company forecasts that it will remain highly geared but in its plan it proposes a mechanism that is likely to result in customers not sharing in any gearing outperformance benefits during the 2020-25 period. On dividend policy the company provides insufficient detail on the customer measures that will be considered when determining dividends and does not provide a commitment on future transparency.

2. Next steps and overall timeline

Actions for the company are set out in 'Yorkshire Water: Actions summary table'.

The next part of the process will be the draft determination, followed by the final determination, as set out in the table below.

Date	Milestone
1 April 2019	Revised business plans submitted
18 July 2019	Draft determinations published
30 August 2019	Representations on draft determinations due
11 December 2019	Final determinations published
1 April 2020	Price controls for 2020 – 2025 come into effect

Appendices

The appendices below can find be found on our [website](#).

- Yorkshire Water: Test area assessment
- Yorkshire Water: Test question assessment
- Yorkshire Water: Actions summary table
 - Yorkshire Water: Delivering outcomes for customers detailed actions
 - Yorkshire Water: Accounting for past delivery detailed actions
 - Yorkshire Water: Securing confidence and assurance detailed actions
 - Yorkshire Water: Direct procurement for customers detailed actions

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