

July 2019

Trust in water

PR19 draft determinations

**Yorkshire Water – Aligning risk and return
actions and interventions**

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PR19 Draft Determinations: Yorkshire Water – Aligning risk and return actions and interventions

Following our initial assessment of plans, we categorised two types of actions for slow-track and significant scrutiny companies:

- required actions for companies which in general were required for draft determinations (or final determinations for some aspects of past delivery); and
- advised actions for companies to do by a specific date but that are not required for our draft determinations.

Table 1 below sets out the required and advised actions, a summary of the company's response to the action, our assessment of the company's response, and any further interventions we are making as part of the draft determination.

Each action has a unique reference. The prefix 'YKY' denotes the company Yorkshire Water. The central acronym references the test area where the action has been identified, please see the 'PR19 draft determinations: Glossary' for a key to these acronyms. Actions whose numbers are preceded with an 'A' denote required actions and actions whose numbers are preceded with a 'B' denote advised actions.

Table 2 below sets out any further interventions that are not resulting from an action which we are making as part of the draft determination.

Each further intervention that is not resulting from an action has a unique reference. The prefix 'YKY' denotes the company Yorkshire Water. The central acronym references the test area where the action has been identified, please see the 'PR19 draft determinations: Glossary' for a key to these acronyms. Intervention numbers are preceded with a 'C'.

For all other documents related to the Yorkshire Water draft determination, please see the [draft determinations webpage](#).

Table 1: Yorkshire Water's response to required actions and interventions for draft determinations

| Test area | Action reference | Action type | Action | Date required | Summary of company response to action | Our assessment and rationale | Required interventions |
|--------------------------|------------------|-------------|---|---------------|---|--|------------------------|
| Aligning risk and return | YKY.RR.A1 | Required | The gross margin increase for wastewater 5-50ML users in 2020/21 causes average forecast bills to increase by more than the 1.0% cap, as applied at PR16. The company should re-profile the increase in this year to ensure this cap is not breached. | 1 April 2019 | The company provides evidence that its forecast bill increase was 0.92% and did not exceed the 1.0% cap. The company has amended its notional cost of debt allowance input to the financial model to be consistent with our 'early view'. | No intervention required. Yorkshire Water has completed the action. The company has provided sufficient clarification that its proposed gross margin increase for wastewater users 5-50ML in 2020/21 does not result in an increase in the average customer bill for this group of more than 1%. | N/A |
| | YKY.RR.A2 | Required | The notional cost of debt allowance input used is 4.37%. The company should amend the notional cost of debt allowance input to 4.36%, as per our final methodology 'early view'. | 1 April 2019 | The company's resubmitted financial model features an assumption for the notional cost of debt of 4.36%, consistent with the PR19 Final Methodology 'early view'. | No intervention required. Yorkshire Water has completed the action. The company has included an assumption aligned with our 'early view' cost of debt for 2020-25. | N/A |

| Test area | Action reference | Action type | Action | Date required | Summary of company response to action | Our assessment and rationale | Required interventions |
|-----------|------------------|-------------|---|---------------|---|---|------------------------|
| | YKY.RR.A3 | Required | The company has targeted a credit rating for its actual corporate structure that is one notch above a minimum investment grade. The company should provide further evidence and Board assurance to support its view that this is reasonable for the financeability of the actual company given the proposed investment and the funding requirement. | 1 April 2019 | <p>The company states that the targeted credit ratings are appropriate to be able to confirm that the company is financeable on an actual basis.</p> <p>Following the submission of the PR19 business plan the company provides evidence that the Board has taken the decision to further strengthen financeability and financial resilience by planning to reduce gearing below 70% by March 2021. The company includes confirmation from the Board that it is supportive of this and the company has provided an additional Board statement to confirm this view.</p> <p>Please see the Yorkshire Water initial assessment of plans document for the detailed response.</p> | <p>No intervention required.</p> <p>Yorkshire Water has completed the action. We note that the target credit rating for the actual structure at Baa2 (Moody's) is the family credit rating for Yorkshire Water which takes account of the covenant and security package for its financing arrangements. The company sets out that the specific protection mechanisms for Class A debt allow it to issue debt at Baa1 (Moody's) and it expects this to be the main source of debt to fund future investment.</p> | N/A |
| | Advised actions | Advised | No actions are advised. | N/A | | | |

Table 2: Further interventions for draft determinations

| Intervention reference | Our assessment and rationale | Interventions |
|------------------------|---|--|
| YKY.RR.C1 | Yorkshire Water's approach to setting PAYG rates is to recover operating expenditure and infrastructure renewal expenses. Our assessment of efficient totex in our draft determination has resulted in a change to the mix of opex and capex in totex. | We are making a technical intervention to align PAYG rates to Yorkshire Water's stated approach of recovering operating expenditure for each year for each wholesale control. |
| YKY.RR.C2 | We considered the RoRE risk range for revenue included by Yorkshire Water in its business plan submission to be excessive, taking account of the Revenue Forecasting Incentive (RFI) for 2020-25. | We are intervening to reduce the revenue RoRE range to take account of the RFI, in way that is consistent with revenue reporting by Yorkshire Water in its Annual Performance Report. |
| YKY.RR.C3 | We assess Yorkshire Water's C-MeX RoRE range to be wider than the maximum range implied by the cap on retail revenue exposure of +/-12%. | We are intervening to reduce the C-MeX RoRE range to be consistent with the retail revenue exposure cap of +/-12% as set out in chapter 6 of the company specific appendix. |
| YKY.RR.C4 | We are intervening to align the RoRE risk ranges for outcome delivery incentives in our risk and return assessment with the ranges determined under our Outcomes framework. This approach seeks to take account of covariance in performance on individual outcome delivery incentives. | We are intervening to align the RoRE risk ranges for outcome delivery incentives in our risk and return assessment with the ranges determined under our Outcomes framework. |
| YKY.RR.C5 | We expect companies to update their RoRE risk range analysis in response to the draft determinations. | We expect companies to update their overall RoRE risk range analysis in updated App26 submissions as part of their response to the draft determination. This should take account of the guidance we have provided in the 'Aligning risk and return technical appendix' that accompanies our draft determination and 'Technical appendix 3: Aligning risk and return' published with the IAP, and the context that achieved cost and outcomes performance has been positively skewed at a sector level in previous price review periods. Companies are strongly incentivised to achieve and outperform regulatory benchmarks. Therefore where companies consider there to be a potential downward skew in forecast risk ranges for returns, we expect companies to provide compelling evidence that this is expected to be in the context of expected performance delivery of the company, taking account of the company's reported level of actual performance delivered in 2015-19 and taking account of the steps it is already taking or plans to take to deliver against regulatory benchmarks and mitigate downside risk. |

Ofwat (The Water Services Regulation Authority) is a non-ministerial government department. We regulate the water sector in England and Wales. Our vision is to be a trusted and respected regulator, working at the leading edge, challenging ourselves and others to build trust and confidence in water.

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