

July 2019

Trust in water

PR19 draft determinations

**Yorkshire Water – Securing long-term
resilience actions and interventions**

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PR19 Draft Determinations: Yorkshire Water – Securing long-term resilience 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
Securing long-term resilience	YKY.LR.A1	Required	The company should ensure that its common and bespoke performance commitments associated with operational resilience are clearly defined, sufficiently demanding for the 2020 to 2025 period and the long term, and supported by the right incentives. We expect the company to satisfy the relevant actions set out in relation in the outcomes areas ensuring a line of sight between risks to resilience and package of outcomes.	1 April 2019	Yorkshire Water has not implemented all relevant outcome actions associated with operational resilience, in particular those related to asset health performance commitments.	Intervention required. The company should address any outstanding actions associated with operational resilience from the 'Yorkshire Water - Delivering outcomes for customers actions and interventions' tables, in particular those related to mains repairs, unplanned outage, sewer collapses and treatment works compliance.	Refer to interventions described in the 'Yorkshire Water - Delivering outcomes for customers actions and interventions' tables regarding mains repairs, unplanned outage, sewer collapses and sewage treatment works compliance.

Test area	Action reference	Action type	Action	Date required	Summary of company response to action	Our assessment and rationale	Required interventions
	YKY.LR.A2	Required	The company should provide a commitment that it will, by 22 August 2019, prepare and provide to us an action plan to develop and implement a systems based approach to resilience in the round and ensure that the company can demonstrate in the future an integrated resilience framework that underpins the company's operations and future plans showing a line of sight between risks to resilience, planned mitigations, package of outcomes and corporate governance framework.	1 April 2019	Yorkshire Water has confirmed its commitment to complete the action by 22 August 2019.	No intervention required. The company has complied with the action.	N/A
	YKY.LR.A3	Required	The company should provide a commitment to work with the sector to develop robust forward looking asset health metrics and provide greater transparency of how its asset health indicators influence its operational decision making.	1 April 2019	Yorkshire Water has confirmed this commitment.	No intervention required. The company has complied with the action.	N/A
	YKY.LR.A4	Required	<p>The company should explain how it has taken account of the risks to its financial resilience associated with:</p> <ul style="list-style-type: none"> its high gearing level, and any application of the gearing outperformance mechanism for PR19; maintaining a target credit rating of BBB/Baa2, one notch above the minimum for investment grade; the introduction of the gearing outperformance sharing mechanism; requirements to refinance subordinated debt; and capital for the business raised as debt elsewhere in the corporate group, and outline associated risk management/mitigation approaches identified by the company to provide assurance on long term financial resilience. 	1 April 2019	<p>Yorkshire Water says that it will reduce its gearing from 74% (as at 31 March 2018) to below 70% by March 2021 through a combination of dividend retentions and equity injection. The company says that its rigorous financial resilience assessment takes account of the gearing levels included in its plan. It also says that, if necessary, it will update its financing plan in light of our draft and final PR19 determinations.</p> <p>Yorkshire Water says that it has considered whether a target credit rating of Baa2 for its actual structure (that is only one notch above the lowest investment grade rating) is consistent with financial resilience over the long term. It considers that it should be able to maintain reasonable headroom on key ratios for this rating and notes that it raises the majority of its debt through class A bonds under its securitised structure for which it has a Baa1 credit rating from Moody's.</p> <p>Yorkshire Water has confirmed that it will adopt our default benefit sharing mechanism for high gearing, but states that it plans to reduce gearing to below 70% by March 2021. The company does note that its gearing could be slightly above the 70% threshold in one or two years during the period from 2020 to 2025, before returning below 70%. Nonetheless, the company sets out that</p>	<p>Intervention required</p> <p>The company has provided a Board assurance statement that it has tested the long term financial resilience of its plan and that its plan will allow it to maintain resilience in the long term. The company is responsible for maintaining its long term financial resilience and its proposal to reduce gearing to 70% by March 2021 will provide additional headroom. However, further assurance is required about how the gearing reduction will be achieved, in the context of the draft determination.</p>	<p>In its response to our draft determination Yorkshire Water should provide further assurance about how its planned gearing reduction will be achieved, and regarding the sustainability of targeting a Baa2 corporate family rating that is only one notch above the lowest investment grade rating and below the credit rating targeted for the notional structure. In doing so it should take account of the issues reference in action YKY.LR.C1.</p> <p>In its future reporting Yorkshire Water should undertake suitably robust stress tests to</p>

Test area	Action reference	Action type	Action	Date required	Summary of company response to action	Our assessment and rationale	Required interventions
					<p>it has tested a scenario including the impact of the sharing mechanism, based on the original gearing levels in its PR19 business plan, concluding that it will remain financially resilient.</p> <p>Yorkshire Water says that although it will need to refinance £247m of subordinated debt during 2020 to 2025, this represents a relatively immaterial proportion of the total that will need to be raised for refinancing and investment.</p> <p>The company confirms that capital raised as debt elsewhere in the corporate group would be raised at shareholders' rather than the company's risk. It also says that such capital injections would be for the long-term benefit of customers as they would be expected to reduce interest costs.</p> <p>Yorkshire Water says that its financial risk management approaches include reducing gearing (through dividend retention and capital injection) and restructuring its hedging swap portfolio.</p>		support its long term viability statements.
	YKY.LR.A5	Required	The company has noted the possibility of additional equity investment as a financial risk mitigation measure. Please explain the steps and risk management approaches the company has taken to ensure equity will be available if such support is required, particularly in the context of the high level of gearing.	1 April 2019	<p>Yorkshire Water has provided additional information on the use of equity injection as a risk mitigation measure, saying that, together with dividend retentions and sale of non-regulated businesses, it has been used to reduce gearing. It says that equity injections might also be used in future for investment in response to any financial penalties incurred.</p> <p>The company says that Capital raised as debt elsewhere in the corporate group would be raised at shareholders' risk, rather than the Company's risk, and if injected into the Company it would be for the long-term benefit of customers as interest costs would reduce accordingly.</p>	No intervention required. Although it has not provided specific assurances on the availability of additional equity support, it has referred to recent equity injections as part of actions in response to its own long term financial review at the start of the 2015-20 period and a subsequent third party financial review of the company.	N/A
	Advised actions	Advised	No advised actions.	N/A	N/A	N/A	N/A

Table 2 – Further interventions for draft determinations

Intervention reference	Our assessment and rationale	Interventions
YKY.LR.C1	<p>The Board assurance on actual and notional financeability and financial resilience in the revised business plan was provided on the basis of the assumptions made in the business plan, prior to any interventions we have made in the draft determination and our updated view of the cost of capital. There is evidence of further downward pressure on the cost of capital in very recent market data which will be considered for our final determination.</p>	<p>We expect companies to provide further Board assurance, in their responses to the draft determination, that they will remain financeable on a notional and actual basis, and that they can maintain the financial resilience of their actual structure, taking account of the reasonably foreseeable range of plausible outcomes of their final determination, including evidence of further downward pressure on the cost of capital in very recent market data as we discuss in the 'Cost of capital technical appendix'.</p>

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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