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PR19 final determinations

Yorkshire Water – Aligning risk and return final decisions

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In our draft determinations we published the 'Aligning risk and return actions and interventions', the 'Securing long-term resilience actions and interventions' and the 'Securing confidence and assurance actions and interventions' document for each company. This set out the required and advised actions in our initial assessment of plans, a summary of the company's response to the action, our assessment of the company's response, and any further interventions we made as part of the draft determination.

This document sets out the decisions we are making for the final determination in response to representations received from companies on our draft determinations and changes for the final determination that are not resulting from representations received. We set out our response to thematic representations and representations from other stakeholders within the 'Aligning risk and return technical appendix' and the 'Allowed return on capital technical appendix'. Our 'Allowed revenue appendix' for the company is published alongside this document. These documents are intended to be fully consistent. In the event of any inconsistency, the other documents listed above take precedence over this document.

Table 1 below sets out the action/intervention reference, our assessment and rationale for the draft determination, a summary of the company representation, our assessment and rationale for the final determination and our decisions for the final determination.

Table 2 sets out any further decisions that are not resulting from an action and/or representation which we are making as part of the final 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 '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. Draft determination interventions not resulting from an initial assessment of plans action are preceded with a 'C' and new interventions for the final determination not related to a previous action are preceded with a 'D.' For all other documents related to the Yorkshire Water draft determination, please see the final determinations webpage.

Table 1: Yorkshire Water - Representations in response to the draft determination

Test area	Actions/intervention reference	Action	Our intervention for the draft determination	Summary of company representation	Our assessment and rationale for the final determination	Final interventions in the final determination
Risk and return	YKY.RR.A1	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.	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%.	Representation made. Yorkshire Water exited the business retail market on 1 October 2019.	The company has exited the business retail market, so we have not set price controls for business retail functions as part of PR19.	No business retail functions price controls set as part of PR19 for Yorkshire Water.

Test area	Actions/intervention reference	Action	Our intervention for the draft determination	Summary of company representation	Our assessment and rationale for the final determination	Final interventions in the final determination
Risk and return	YKY.RR.A2	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'.	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.	No representation made.	No change for the final determination.	N/A.
Risk and return	YKY.RR.A3	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.	No intervention required. 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.	Representation made. The company provides representations that the Board is unable to provide assurance that the company is financeable under the draft determination on the notional or actual structure. The company states the efficiency challenge is substantially beyond what a notional company can deliver with a balance of risk and return that is materially skewed to the downside. When the reduction in the WACC is considered, the Board is unable to provide confidence that the notional company is financeable. The company provides its assessment based on target ratios set out in Moody's recent commentary (26 July 2019) that the adjusted interest cover ratio is consistent with Baa2 The company states it places greater weight to interest cover ratios than gearing, as it is a cash-based metric provided a more realistic view of credit worthiness. The company maintains it target credit rating for the actual capital structure of Baa2. It states that based on the represented plan the actual company structure is financeable with the financial ratios above the target level for Baa2 throughout 2020-2025.	No change for the final determination. We retain our overall approach to the assessment of financeability. We carry it out in our financial model, on the basis of the notional capital structure on which we derive our allowed return on capital and we assume each company is able to achieve the benchmarks in our determinations. Consistent with the PR19 methodology and our approach in the draft determination, we advance revenue from future customers where a financeability constraint arises to ensure the final determination is financeable on the basis of the notional capital structure.	We discuss our assessment of financeability in the 'Yorkshire Water final determination' and the basis on which we consider Yorkshire Water's final determination to be financeable on the basis of the notional capital structure.

Test area	Actions/intervention reference	Action	Our intervention for the draft determination	Summary of company representation	Our assessment and rationale for the final determination	Final interventions in the final determination
				The company states that the use of cost recovery ratios to accelerate revenues to improve notional financeability would be ineffective as credit rating agencies reverse these adjustments when calculating their financial ratios. It also states that reducing gearing by dividend retention or capital injection would also be ineffective as their assessment shows that gearing would need to be reduced to 53% to achieve Moody's calculation of AICR of 1.5x.		
Risk and return	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.	Representation made. The company provides representations on the Ofwat calculation of opex and capex and states that £180m should be moved from capital to operating expenditure.	Change for the final determination. A number of companies and stakeholders have made similar representations in relation to the proportion of operating expenditure in cost allowances and the determination of PAYG rates. We set out our response to thematic representations in the 'Aligning risk and return technical appendix'.	Taking account of company representations, we have revised our approach to the calculation of the mix of operating and capital expenditure following our totex interventions. In order to calculate the mix of operating and capital expenditure we follow the approach set out in 'Securing cost efficiency technical appendix'. We set out how we apply the technical intervention in the 'Aligning risk and return technical appendix' and we have published our calculation of the PAYG rates for each company alongside our determinations. We set out the specific interventions we make for Yorkshire Water in relation to notional financeability in the 'Yorkshire Water final determination' document.
Risk and return	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.	No representation made.	No change for the final determination.	N/A.

Test area	Actions/intervention reference	Action	Our intervention for the draft determination	Summary of company representation	Our assessment and rationale for the final determination	Final interventions in the final determination
Risk and return	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.	No representation made.	Change for the final determination.	See YKY.RR.D4
Risk and return	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.	Representation made. In its representation on the draft determination Yorkshire Water set out a view that it still faces significant downside risk on totex and ODIs.	Change for the final determination.	See YKY.RR.D4
Risk and return	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	Representation made. Yorkshire Water provides updated views on RoRE risk ranges in its representation. It says that the two key areas which have been amended materially are the totex and ODI RoRE ranges, with a greater negative skew in both cases as a result of the interventions introduced in the draft determination. Yorkshire Water considers that the RoRE risk ranges it sets out in its representation more accurately reflect the current risk and return package. We present our assessment of the RoRE risk range provided by the company in its representation in the 'Yorkshire Water company specific appendix' which presents a material downward skew to the overall risk range relating to totex risk and outcome delivery incentives.	Change for the final determination.	See YKY.RR.D4

Test area	Actions/intervention reference	Action	Our intervention for the draft determination	Summary of company representation	Our assessment and rationale for the final determination	Final interventions in the final determination
			benchmarks and mitigate downside risk.			
Securing confidence and assurance	YKY.CA.A5	On dividend policy the company is required to confirm that it is committed to adopt the expectations on dividends for 2020-25 as set out in 'putting the sector in balance: position statement' to include: • clear Board commitment to publish detail on dividend policies in the APR and to signal changes to stakeholders; and • commitment to transparency about how the dividend policy in 2020-25 takes account of obligations and commitments to customers for the dividend policy that is applied in 2020-25 and when determining dividends. Please provide an update on the steps you are taking to fully meet the expectations as set out in our putting the sector in balance position statement.	No intervention but further action needed by Yorkshire Water. We expect Yorkshire Water to be transparent about how the dividend policy in 2020-25 takes account of obligations and commitments to customers and to demonstrate that in paying or declaring dividends it has taken account of the factors we set out in our position statement. We expect the company to respond to this issue in its response to our draft determination. We expect Yorkshire Water to demonstrate that its dividend policy for 2020-25 takes account of obligations and commitments to customers and other stakeholders, including performance in delivery against the final determination. In doing so, the company should refer to the examples of best practice we have identified among companies.	Representation made. The company provided some additional information in response to our action. The company sets out how its dividend policy for 2020-25 will take account of obligations and commitments to customers and other stakeholders, including performance of delivery against the final determination. The company has also provided further information on how performance delivery will impact on dividends paid. The company also confirmed that payment of its base dividend is dependent on performance meeting the commitments within its PR19 plan.	Change for the final determination. We have updated our assessment of the reasonable base dividend for water companies in 2020-25 as set out in the 'Aligning risk and return technical appendix'.	We expect Yorkshire Water to be transparent when explaining its dividend policy and reporting on dividends paid over 2020-25, to demonstrate how it has delivered on the commitments in relation to its dividend policy and to ensure it meets the expectations we set out in 'Putting the sector in balance' as updated in 'Aligning risk and return technical appendix'.
Securing confidence and assurance	YKY.CA.A6	On executive pay the company is required to confirm that it is committed to adopt the expectations on performance related pay for 2020-25 as set out in 'putting the sector in balance: position statement' to include: • commitment to report how changes, including the underlying reasons, are signalled to customers; and • commitment to publish the executive pay policy for 2020-25 once it has been finalised. Please provide an update on the steps you are taking to fully meet the	No intervention but further action needed by Yorkshire Water. There remain a number of details to be finalised, for example the final weightings of the target metrics and review of the long term incentive plan. Once finalised, we expect Yorkshire Water to provide an update in its response to the draft determination to demonstrate that it is committed to meet the expectations we have set out in 'putting the sector in balance: position statement'.	No representation made. However, in response to a query the company states until it receives the final determination it is unable to confirm what the targets will be both on target performance and stretch performance. It did confirm that it will ensure that its performance related executive pay policy demonstrates a substantial link to performance delivery for customers, underpinned by stretching targets through 2020-25.	Change for the final determination. Yorkshire Water states that it is committed to meet the expectations set out in our 'Putting the sector in balance: position statement'. However, based on our calculations, the overall percentage of alignment of incentives to customers falls short of the 60% we highlighted as evidence of good practice amongst the companies we regulate in our document, 'PR19 draft determinations: Aligning risk and return technical appendix'. We therefore consider that there is scope	We expect Yorkshire Water to be transparent when explaining and reporting the application of its performance related executive pay policy over 2020-25, to demonstrate how it exhibits a substantial alignment to the delivery of service for customers and meets the expectations we set out in 'Putting the sector in balance' as updated in 'Aligning risk and return technical appendix'.

Test area	Actions/intervention reference	Action	Our intervention for the draft determination	Summary of company representation	Our assessment and rationale for the final determination	Final interventions in the final determination
		expectations as set out in our putting the sector in balance position statement.	We expect the company and its remuneration committee to ensure its performance related executive pay policy demonstrates a substantial link to performance delivery for customers through 2020-25 and is underpinned by targets that are stretching. Trust and confidence can best be maintained where stretching performance is set by reference to the final determination and taking account of stretching regulatory benchmarks (for example delivery of upper quartile performance) and should include a commitment that it will continually assess performance targets to ensure targets will continue to be stretching throughout 2020-25. We expect the company to report transparently, in its annual performance report, about further updates to the development of its policy that will apply in 2020-25.		for the company to improve on this position.	
Tax	N/A	N/A	N/A	Representation made. Yorkshire Water provided updated tax information to reflect the change in forecast capital allowances as a result of our view of totex in the draft determination.	Change for the final determination. We set out in our draft determinations that our interventions in other areas may have impacted on forecast levels of capital expenditure, but the resulting impact on allowances used for the calculation of taxation had not been reflected. Where these changes result in significantly different inputs for capital allowances or tax deductions, companies could raise this as part of its representations on the draft determination.	We reflect the updated capital allowance information on tax provided by Yorkshire Water in our final determinations.
Securing long-term resilience	YKY.LR.A4	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	N/A	Representation made. Yorkshire Water says it remains committed to reducing gearing to 70% but now expects this to be by 2025	No change for the final determination We consider that our determinations are financeable for an efficient company with a notional capital	We will closely monitor changes in levels of the company's gearing, credit ratings and other key financial metrics during 2020-25 to test that adequate steps are being taken by management and

Test area	Actions/intervention reference	Action	Our intervention for the draft determination	Summary of company representation	Our assessment and rationale for the final determination	Final interventions in the final determination
		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. 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. In its future reporting Yorkshire Water should undertake suitably robust stress tests to support its long term viability statements.		instead of 2021. It says this still requires significant shareholder support through the retention of dividends and capital injections into Yorkshire Water. Yorkshire Water says that, although it targets a Baa2 corporate family rating from Moody's, it principally raises Class A debt with a Baa1 rating or higher equivalent ratings from S&P and Fitch. It says that Class A debt represents in excess of 80% of its debt portfolio and forecasts Class A debt to remain its principal source of finance for the future. Yorkshire Water provides assurance that it has carried out both forward and reverse stress testing of its financial resilience and aligned its assessment with its Long Term Viability Statement. It says that it has considered the impact of Ofwat's prescribed scenarios. Reverse stress testing considers the available headroom above rating and covenant requirements. Yorkshire Water says that under some scenarios, ratios fall below requirements for its current ratings. However, it comments that combined stress scenarios are unlikely to arise and reduced ratios would not automatically lead to a downgrade. With other factors being taken into consideration. Yorkshire Water says that, having considered mitigation measures available, it concludes that the company is financially resilient and will remain so during 2020-25. Yorkshire Water has committed to assess it financial resilience beyond	structure. However, there is also a need for companies to ensure that that they are financially resilient under their actual structures. We have not accepted all of the company's representations and the allowed return is lower in the final determination reflecting market expectations on the cost of finance. Therefore, on account of Yorkshire Water's high level of gearing, the cost of capital in our final determinations that is lower than the draft determinations and limited headroom in its credit ratings, the company may need to take steps to improve its financial resilience in 2020-25 and to bring forward its proposal to achieve 70% gearing by 2025.	that financial resilience is being maintained. In its future reporting, we expect the company to explain clearly in its long term viability statement how the Board has identified and assessed the potential risks to its financial resilience and the mitigating actions it is taking to address those risks. Yorkshire Water has committed to assess it financial resilience beyond 2025 in its next long term viability statement.

Test area	Actions/intervention reference	Action	Our intervention for the draft determination	Summary of company representation	Our assessment and rationale for the final determination	Final interventions in the final determination
				2025 in its next long term viability statement.		
Securing long-term resilience	YKY.LR.A5	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. 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.	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.	Yorkshire Water states that capital injections totalling £625m will be made during 2020-25, with the first of three tranches in the first year. It says that capital injections are through the issuance of debt within another group company above the regulated company ring fence, with associated risks borne by its shareholders. Yorkshire Water says it will continue to simplify its financial structure and improve the transparency of its financing arrangements.	See intervention for YKY.LR.A4.	N/A
Securing long-term resilience	YKY.LR.C1	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.	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 'Allowed return on capital technical appendix'.	Yorkshire Water provides assurance that the company remains financeable and financially resilient on an actual capital structure on the basis of representations. However, it says that two factors in the draft determination (cost allowances and cost of capital) mean it cannot be confident that the notional company is financeable, and this is reflected in its Board Assurance Statement.	See intervention for YKY.LR.A4.	N/A

Table 2: Yorkshire Water – Changes to the draft determination that are not in response to an action or representation

Test area	Actions/intervention reference	Our assessment and rationale for the final determination decision	Decisions for the final determination
Allowed return on capital	YKY.RR.D1	We have revised our assessment of the allowed return drawing on market data up at 30 September 2019 and taking account of revisions to our approach following our assessment of representations. We have revised our assessment of the required retail margin deduction down from 0.11% to 0.04%, reflecting our view that the double-counted component of return in the household retail margin has reduced since PR14. We set out the basis for the allowed return on capital in our 'Allowed return on capital technical appendix'.	The sector allowed return on capital for the appointee price controls in our final determinations is 2.96% – CPIH deflated (1.96% – RPI deflated), 23 basis points lower than in the draft determination. The sector allowed return on capital for the wholesale price controls in our final determinations is 2.92% – CPIH deflated (1.92% – RPI deflated), 16 basis points lower than in the draft determination.
Gearing outperformance sharing mechanism	YKY.RR.D2	In our final determinations, we have amended our gearing outperformance sharing mechanism to contain a glidepath. We explain this in the final determination 'Aligning risk and return technical appendix'.	We have changed the trigger from a fixed trigger of 70% in the draft determination to a glide path which will start at 74% for the year 2020-21 and will reduce by 1% each year, ending at 70% for the year 2024-25 in the final determination.
Financeability	YKY.RR.D3	We consider that Yorkshire Water's final determination is financeable based on the allowed revenues which include a reasonable allowed return on capital. The final determination is sufficient to ensure it will be in a position to deliver its obligations and commitments to customers.	We discuss our assessment of financeability in the 'Yorkshire Water final determination' and the basis on which we consider Yorkshire Water's final determination to be financeable on the basis of the notional capital structure.
Return on Regulatory Equity (RoRE) - Financial Risk Assessment	YKY.RR.D4	We have revised our approach to assessing RoRE risk ranges for five of the risk areas set out in the PR19 methodology to take account of changes we have made in our final determinations to address concerns raised by companies on the overall level of stretch in our draft determinations, and evidence on past performance that we have observed in the sector. Our approaches are set out in the 'Aligning risk and return technical appendix' and the risk ranges for Yorkshire Water are set out in the 'Yorkshire Water final determination'. Taking account of changes in our final determination, the RoRE risk ranges at P10 and P90 confidence limits in our final determinations are, in most cases, more symmetrical than the risk ranges represented by companies. Our view of risk ranges also indicates more scope for outperforming companies to earn higher returns, but also for underperforming companies to receive lower returns.	The final determination risk range reflects the following interventions that we make for all companies: • The totex range is our assessment of the plausible range based on evidence of the historic sector performance and taking account of the company's cost sharing rates that apply in its final determination. • The financing cost risk range is based on our assessment of the range for a notional water company including both embedded and new debt. • The ODI risk range has been determined under our Outcomes Framework. • The C-MeX risk range is calculated as 12% upside and 12% downside of residential retail revenue, reflecting the cap and collar limits for this incentive. • The D-Mex risk range is calculated as 6% upside and 12% downside of developer services revenue, reflecting the cap and collar limits for this incentive.
Financial Risk Assessment – Uncertainty Mechanisms	YKY.RR.D5	We are including a PR24 reconciliation mechanism for business rates in our final determination for Yorkshire Water along with all other companies because: • There is uncertainty about business rates costs because the Valuation Office Agency (VOA) will be carrying out revaluation exercises during 2020-25, and increases (or decreases) in cost levels could be material.	In each case, the cost variance to the company's PR19 cost allowance will be subject to a 75 (customer share):25 (company share) symmetrical sharing rate in the totex reconciliation at PR24. This means that the company will still be incentivised to manage costs efficiently, whilst receiving appropriate protection against material cost increases. Conversely, customers will receive a benefit if outturn costs are lower

Test area	Actions/intervention reference	Our assessment and rationale for the final determination decision	Decisions for the final determination
		• Companies can only exercise limited control over cost levels by engaging with the VOA and, possibly, by considering the business rate implications of asset development choices. We are also including a PR24 reconciliation mechanism for Environment Agency abstraction licence costs in our final determination for Yorkshire Water along with all other companies serving England because: • The Environment Agency expects to consult on changes to its basis for setting abstraction licence fees during 2020 meaning that there is material uncertainty about company cost levels in 2020-25. • Companies can only exercise limited control over cost levels by engaging with the consultation process and providing accurate information when required for licence fee setting purposes.	than the allowance levels we have set. Details will be set out in the PR19 Reconciliation Rulebook.

Ofwat (The Water Services Regulation Authority) is a non-ministerial government department. We regulate the water sector in England and Wales.

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