



The voice for water consumers  
Y corff sy'n rhoi llais i ddefnyddwyr dŵr

# **CCW's response to the Competition and Markets Authority about Yorkshire Water's referral of its 2019 Ofwat Final Determination**

**Date: 11 May 2020**

## **CCW submission on Yorkshire Water's CMA Referral**

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### **1. Introduction**

1.1 The Consumer Council for Water (CCW) is the statutory consumer organisation representing household and non-household water and sewerage consumers in England and Wales. We welcome the opportunity to submit our views to the Competition and Markets Authority (CMA) on Yorkshire Water's appeal against Ofwat's Final Determination (FD).

1.2 CCW draws the evidence on which it bases its views and opinions from a range of sources:

- Daily contact with hundreds of water customers who contact us for advice and support.
- A programme of research that engages customers so we can understand their views, including longitudinal tracking studies of both household and non-household customers, and recently an online panel of customers.
- An independent view of the Weighted Average Cost of Capital (WaCC) and a report on water companies' financial performance.
- Data which water companies are required to share with us relating to their own handling of customer complaints and their own performance on a range of key measures.
- Regular contact, through our teams and our Board members, with every water company, following structured agendas to understand their work.
- Active membership of the Customer Challenge Groups that each water company is required to maintain as part of the price review process.
- Playing a major role in the sector-wide arrangements for policy and strategy making across England & Wales.

- Being a statutory consultee on many aspects of the work of the sector, particularly those relating directly to the interface with customers including those living in circumstances of heightened vulnerability.
- 1.3 In our submission, CCW draws on evidence of customers' opinions (and the credibility of this evidence) and data to show how well the company has served its customers.
- 1.4 While CCW is not equipped to offer solutions to some of the more technical arguments on cost assessments and modelling, we do offer:
- A view on the required outcome for customers; and
  - A view on both the quality of the customer evidence used to underpin Ofwat's and Yorkshire Water's arguments, and how well this evidence was taken into account in both parties' decision-making.
  - A view on the appropriate range for the WaCC.

## 2. Executive Summary

2.1 Through the 2019 Price Review, CCW has consistently challenged water companies and Ofwat to:

- Ensure that decisions on prices and service delivery reflect credible evidence of consumers' views and expectations; and
- Deliver a package of prices and service improvements that serves the needs of current customers, whilst making progress in improving the resilience of water and wastewater services in the longer term to help serve future customers.

2.2 CCW believes consumers' views should strongly influence the CMA's review and that the company should be challenged on efficiency. We also know that customers expect any bill changes to be fully justifiable. Customers want resilient, efficient services now and in the future, however the balance of bills between current and future customers must be appropriate.

2.3 Overall, Ofwat's Final Determination for Yorkshire Water reflects customers' priorities and provides a good service package for customers with high levels of acceptability. A high proportion of Yorkshire Water's customers thought that Ofwat's Draft Determination proposals were acceptable. 91% of uninformed customers and 89% of informed customers said the plan was either "acceptable" or "very acceptable."<sup>1</sup>

2.4 We consider that the high levels of acceptance of the price and service levels in Ofwat's Draft Determination means that customers would also be happy with the Final Determination. CCW wants to be certain that the investment allowed to address flooding in Hull is right and that Yorkshire Water's leakage target delivers on the commitment it has made to its customers.

2.5 Ofwat has expressed concern that Yorkshire Water is inefficient<sup>2</sup>, specifically in respect of wholesale wastewater expenditure, and issued a letter in July 2019<sup>3</sup> to

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<sup>1</sup> <https://www.ccwater.org.uk/research/our-draft-determination-acceptability-research/>

<sup>2</sup> [Ofwat: Reference of the PR19 final determinations - cross cutting issues Table A1.3](#)

<sup>3</sup> <https://www.ofwat.gov.uk/wp-content/uploads/2019/07/20190703-letter-to-Richard-Flint-Yorkshire-Water.pdf>

intensify its challenge. We would like to see the CMA apply the same high level of challenge in terms of efficiency in fulfilling its duty to protect customers.

2.6 Delivering investments efficiently is something consumers expect their company to be doing. It is right, for Ofwat to apply a strong efficiency challenge on consumers' behalf. If the CMA concludes that Ofwat's approach to efficiency is sound, and investment in resilience would not be delayed, then customers' views suggest that the Final Determination should not change.

2.7 On this basis, the key points from our assessment of Yorkshire Water's statement of case are as follows:

- We strongly welcome Ofwat's challenge to all companies on efficiency. Companies should be encouraged to be as efficient as possible, but without compromising their ability to deliver a high-quality service for the benefit of customers.
- We welcome the intervention to deliver stretching Performance Commitment targets on sewer flooding, sewer collapses and pollution incidents, areas where Yorkshire Water is a poor performer and customers deserve better services. 89% of customers in our Draft Determination acceptability research found the proposed service improvements acceptable so we would not want to see a reduction in these commitments.
- We expect the CMA to ensure that the assessment of costs required to deliver sewer flooding solutions to the people of Hull is correct. Customers would expect Yorkshire Water to deliver an efficient solution that will address the extreme risk of flooding faced by the people of Hull and its surrounding areas.
- Our evidence points to a significantly lower Weighted Average Cost of Capital (WaCC) than that suggested by the company. Ofwat's WaCC is roughly at the midpoint of the range Economic Consulting Associates (ECA) recommended in the report we commissioned in 2017 and the update in 2018<sup>4</sup>. We believe our evidence supported a

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<sup>4</sup> ECA update report for CCW - link [here](#)

lower WaCC than Ofwat concluded, in particular, we think that there was scope for a lower equity beta.

- Customers are sceptical of the potential impact of Outcome Delivery Incentives (ODIs) on bills. Yorkshire Water has gained in the region of £25m for its sewer flooding performance in 2015-20 despite being one of the worst performers in this area. Any changes proposed to caps, collars or ODI design should be for the benefit of customers and not a protection mechanism for companies against penalties for poor performance. Customers must only pay rewards for truly exceptional service.
- CCW is disappointed that Yorkshire Water is now expected to deliver only a 15% reduction in leakage after making a commitment to deliver a 40% reduction (from 2017 levels). This has raised customers' expectations of a more substantial improvement in a high priority area of service.

2.8 We note that the regulatory system contains significant protections for companies. In terms of the current coronavirus pandemic we expect Ofwat to deal with this consistently for all companies once the full effects can be determined. Therefore, we do not think the current pandemic should have a bearing on the CMA's redetermination.

## Our response

### **3. Current Performance**

- 3.1 CCW's Water Mark<sup>5</sup> assessment shows how well water companies are performing in the areas that matter most to their customers.
- 3.2 Yorkshire Water is our fourth-ranked Water and Sewerage Company (WaSC). We classify its water and sewerage services as good and it is above industry average for its complaints performance and customers' satisfaction with value for money, an area where the whole industry still needs to improve.
- 3.3 However, the company's operational performance is not good as it is failing to deliver in those areas of service that customers say are among their highest priorities. CCW rates Yorkshire Water poorly for sewer flooding (internal and external), leakage and supply interruptions. These are all areas in which customers expect Yorkshire Water to deliver significant improvement in 2020-25.
- 3.4 Ofwat's latest Service Delivery report shows that Yorkshire Water is delivering average performance, ranking the company tenth out of 17 WaSCs and Water Only Companies (WOCs). Yorkshire Water is placed in the lower quartile for its performance on wholesale totex, leakage, internal sewer flooding and pollution incidents.
- 3.5 These assessments by CCW and Ofwat demonstrate where the company needs to improve and where customers will expect to see efficient levels of expenditure set to deliver these necessary improvements for AMP7.

### **4. Customer Support**

- 4.1 CCW carried out its own research of Ofwat's Draft Determinations to understand what customers thought about the price and service levels that they would deliver. **A high proportion of Yorkshire Water's customers thought that Ofwat's Draft**

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<sup>5</sup> <https://www.ccwater.org.uk/households/company-performance/>

**Determination proposals were acceptable. 91% of uninformed customers and 89% of informed customers said the plan was either “acceptable” or “very acceptable.”** Given this high level of acceptability for the price and service levels, it is reasonable to think that customers would also find the Final Determination acceptable. **It is important that the CMA ensures that it only departs from Ofwat’s Final Determination if it finds that Ofwat’s efficiency challenge is flawed and puts in jeopardy the delivery of customer priorities.**

- 4.2 It is vital that customers find the outcome of the price review acceptable, to improve perceptions of fairness and value for money, and to help improve the legitimacy of the industry in customers’ eyes.
- 4.3 Ofwat, who awarded it a ‘B’ in its business plan assessment, called Yorkshire Water’s customer engagement “*high quality with convincing evidence*”.
- 4.4 **CCW also considers that Yorkshire Water’s research and engagement programme was generally of good quality.** The company was particularly successful at engaging seldom heard/hard to reach customers. Yorkshire Water demonstrated an effective use of a wide range of customer engagement techniques including more innovative approaches such as observed behaviour and exploring how wider experiences and attitudes influence behaviours.
- 4.5 There was a clear thread in Yorkshire Water’s Business Plan demonstrating where the company’s research and customers’ priorities had informed the company’s Five Big Goals through its Total Value Impact Assessment approach.
- 4.6 CCW was also satisfied with the company’s approach in triangulating its various sources of evidence. Yorkshire Water followed the guidelines set out in CCW’s *Defining and Applying Triangulation* report and commissioned its own report on triangulation by Aecom, which the company used to develop its Decision Making Framework. This allowed Yorkshire Water to clearly demonstrate how customer evidence informed its Outcomes, Performance Commitments (PCs) and Outcome Delivery Incentives.

- 4.7 However, we did have concerns with some of Yorkshire Water's research. Companies were expected to demonstrate clear customer support for both the principle and the range of ODI payments before they are included in price determinations. **We do not believe that the research Yorkshire Water carried out for its business plan achieved this, as customers' views of the principles of ODI payments was not tested.** We outline our concerns on the research used to support Yorkshire Water's Cost Adjustment Claim for sewer flooding below (See paragraph 38) and on the research regarding delivery of its Water Industry Environment Programme (WINEP), commitments (see paragraph 28).
- 4.8 Yorkshire Water's customer research on its original business plan revealed it had 86% customer acceptability. The company has reported this as an uninformed sample, which is CCW's preferred approach as we feel that it most closely replicates the experience of most customers who will not receive much information about the price review process. However, we had some concerns about Yorkshire Water's sample as we believe the amount of supporting information provided to customers makes this more of an "informed" than an "uninformed" sample.

## **5. Cost Efficiency/Totex**

- 5.1 **Customers expect company operations, asset maintenance, resilience investment and statutory commitments to be delivered to the required standard at an efficient cost to achieve value for money. Given the level of customer support for the Draft Determinations, the CMA's redetermination should only vary from Ofwat's Final Determination if the CMA concludes that Ofwat's approach is flawed.**
- 5.2 Over the last five years, Ofwat has ranked Yorkshire Water as less efficient than its peers on wholesale wastewater costs. This is the area where there is the most substantial disagreement between Ofwat and the company in the Final Determination. CCW agrees that it is appropriate for there to be a strong efficiency challenge to move the company to a comparatively more efficient position.

- 5.3 Where companies have previously been inefficient compared to their peers, CCW agrees that it is appropriate for there to be a stronger efficiency challenge to move the company to a comparatively good position. Customers are likely to take a dim view of a company that spent money inefficiently in the past being allowed a further cost allowance without such a challenge. We agree that Ofwat's baseline should be higher than in the past to challenge companies to improve.
- 5.4 Ofwat's PR19 methodology shows how its benchmarks of service performance and cost efficiency enable it to set Performance Commitment targets that address past poor performance, whilst driving companies to become more efficient. Ofwat's initial submission to the CMA says that *'Overall this demonstrates that it is possible for a company to have both upper quartile outcome performance and upper quartile cost efficiency at the same time'*. **We agree with Ofwat that customers should not pay for inefficiency. Nor should Performance Commitments be easy to outperform. We would like the CMA to reflect this in its redetermination.**
- 5.5 Companies should not be allowed enhancement costs where evidence shows that its required improvements can be delivered fully and efficiently within a base cost allowance, as otherwise this may result in customers paying twice.
- 5.6 Therefore, we look to the CMA's redetermination to challenge the company to deliver its commitments efficiently, whilst ensuring that the company's customers will receive the improvements they expect and support.
- 5.7 It is important that the CMA's assessment also shows that any allowed enhancement costs are based on credible evidence. The case for asset investment should be based on a convincing assessment of risk. Any allowed 'enhancement' investment should provide customers with value over and above what the 'base' allowance provides for. Customer support alone cannot justify such investment if it does not offer value for money.

## 6. Key Investment Schemes:

- 6.1 **Hull & Haltemprice Flood Resilience** Hull and the surrounding areas experienced significant flooding in 2007 and 2013 and the population remains disproportionately at risk of suffering further flooding to homes and businesses.
- 6.2 Yorkshire Water's Business Plan and the company's subsequent representations to Ofwat set out the various challenges facing the Hull area when it comes to mitigating flood risks. Flooding in Hull can come from numerous sources – fluvial, pluvial, tidal and ground water.
- 6.3 CCW encouraged companies to use PR19 as an opportunity to improve their service to their “worst-served” customers. That is, those customers who remain at risk of repeated service failures, which have not been addressed by investment to date. Yorkshire Water has established the Living With Water Partnership to work with other local stakeholders (including the Environment Agency, Hull City Council, East Riding Council, charities, schools and the general public) to develop integrated, community-driven solutions to the flooding in Hull and the surrounding areas.
- 6.4 Yorkshire Water's research demonstrated that reducing flooding is a high priority for customers. In its *Outcomes* research, customers ranked reducing internal sewer flooding as the fifth highest performance commitment (out of 49). **Customer support for the investment in Hull increased when customers understood that the cost to them would be around 40p a year. Yorkshire Water's *Cost Adjustment Claim* research found that almost half of their customers were happy to pay this – with the figure rising to 71% for customers in East Yorkshire.**
- 6.5 **CCW is supportive of Yorkshire Water's planned work and the way in which the company is working with both stakeholders and customers to deliver it.**
- 6.6 Ofwat has allowed a £16.4m adjustment to base expenditure instead of the £28.6m enhancement expenditure that Yorkshire Water said it needs to deliver its planned resilience schemes. Ofwat has accepted that Hull is around five times more likely to

suffer from flooding than other cities in Yorkshire, but the Final Determination does not make clear why Ofwat does not consider this to be appropriate for an enhancement cost allowance.

- 6.7 **We expect the CMA to ensure that the assessment of costs required to deliver solutions to the people of Hull is correct. We expect Yorkshire Water to deliver an efficient solution that will address the extreme risk of flooding faced by the people of Hull and its surrounding areas.**
- 6.8 **Water Industry National Environment Programme (WINEP): Phosphorous Removal (P-removal).** P-removal makes up the majority of Yorkshire Water's large WINEP programme. The company has demonstrated that it has a significantly larger programme than other companies do, but has chosen to deliver it within AMP7 rather than phasing delivery over two price control periods. We believe customers are supportive of this decision. The company needs to improve its environmental performance quickly as the Environment Agency currently ranks its performance as joint lowest of all WaSCs.
- 6.9 Customers gave environmental improvements a high priority in Yorkshire Water's customer engagement work. The *Frontier Initiatives* research, which sought to understand what was of most interest or importance to customers, found that general environmental benefits were a particular motivation for younger customers. Older customers valued environmental improvements more where they specifically affected their own experiences. The environment had the second highest level of customer support of Yorkshire Water's Big Five long-term goals (behind Water Supply). **Yorkshire Water's acceptability research showed that 86% of customers were supportive of paying more for delivery of the WINEP programme as opposed to 77% without the WINEP programme, although the research did not ask customers if they favoured spreading the cost over the longer term.** The company has chosen to address the P-removal programme in AMP7 (2020-25) rather than electing to phase delivery into the next AMP so that they can deliver further improvements more quickly.

**6.10 Unlike some other companies, Yorkshire Water did not ask customers about its specific preferred solutions for delivering its WINEP commitments.**

Therefore, while Yorkshire Water favours a Biological Nutrient Removal (BNR) approach, which incurs higher upfront costs but is less chemically intensive, there is no evidence that customers support this solution over another.

**6.11 We note that the gap between Ofwat and Yorkshire Water on costs for P-removal at Final Determination was £113m. CCW would like the CMA's redetermination to assess if the programme can be delivered efficiently within the costs allowance given. The company has not demonstrated clear customer support for its preferred BNR solution.**

## **7. Outcome Delivery Incentives (ODIs)**

7.1 CCW's research in 2015 confirmed that customers have concerns about the principle of companies receiving financial rewards for delivering services. Our Draft Determination acceptability research for PR19 also demonstrated that levels of acceptability drop by 13% when customers begin to understand the impact ODIs may have on bills.

7.2 We also have concerns that ODIs are benefitting companies even when performance is not strong. Ofwat has stated that Yorkshire Water is now the worst performing company on sewer flooding and has made the third worst improvement in performance on this area since the beginning of AMP6. Despite this, the company will achieve outperformance payments in the region of £25m for internal sewer flooding for its performance during 2015-20. Yorkshire Water also expects to achieve around £12m in outperformance payments relating to its Pollution Incidents performance in AMP6 despite having caused 11 serious category incidents in 2018. The current ODI applies only to the less serious category 3 incidents so we welcome the move for the new common Performance Commitment to measure all incidents. However, these examples highlight CCW's concern that the ODI system is rewarding companies for less than exceptional performance.

- 7.3 Yorkshire Water did not test the principle of ODIs with their customers, as it considered that Ofwat had embedded their usage in the process. Customers were only asked where incentives should be placed; they were not given an opportunity to reject their usage entirely. CCW remains of the opinion that ODIs have the potential to prompt a significant customer backlash and damage the legitimacy of the industry when customers understand the impact they can have on bills. This is particularly true if rewards are paid to companies for relatively poor performance.
- 7.4 Yorkshire Water claims that there is a downside skew to the risk it faces, leaving it exposed to significant penalties. In view of customers' concerns over ODIs, CCW supports the changes made by Ofwat to the use of caps, collars and deadbands. Ofwat has placed a collar on the Internal Sewer Flooding ODI to protect the company against significant penalties in an area where it is an industry outlier. Any further changes in this area should be for the benefit of customers and not a protection mechanism for companies against penalties.

## 8. Performance Commitments

- 8.1 Performance Commitments should be stretching, reflect customer priorities and developed based on extensive evidence of customers' views collected during the development of the Business Plan.
- 8.2 CCW felt that Yorkshire Water's original business plan needed to be more ambitious so that its customers would receive at least the same level of service as customers of other companies. **As such, we supported Ofwat's intervention to set targets to bring Yorkshire Water in line with other water and sewerage companies for Internal Sewer Flooding, Pollution Incidents, Sewer Collapses, Leakage, Water Supply Interruptions and Mains Repairs, all of which are very high customer priorities.**
- 8.3 **Internal Sewer Flooding:** CCW was disappointed with Yorkshire Water's original internal sewer flooding target in its business plan, as the company is an outlier on sewer flooding and needs to improve its services to its worst served customers. In

the 2018-19 Ofwat Customer Experience Survey, Yorkshire Water had the lowest Service Incentive Mechanism (SIM) score for customer satisfaction with wastewater services when compared to other water and sewerage companies (WaSCs). CCW challenged Yorkshire Water to improve its wastewater services and reduce the high level of customers complaining to CCW regarding internal sewer flooding.

- 8.4 When asked to prioritise the company's Performance Commitments, customers in the company's Outcomes research ranked internal sewer flooding as the fifth most important (out of 49).
- 8.5 We have some questions about Yorkshire Water's £105.9m claim relating to cellared properties. The evidence provided indicates that the Yorkshire Water region has a significantly higher percentage of cellared properties than other areas. However, we question whether the sample of 20,000 customers nationwide is sufficiently robust. The researchers only conducted 110 interviews in the Yorkshire Water region, which would indicate a margin of error in the region of +/- six-percent on the 14% of properties in the region said to have cellars.
- 8.6 The MORI poll in question is also over 20 years old, so it is quite likely that circumstances have changed since it was carried out. We would expect the percentage of cellared properties to have decreased as new housing is generally built without cellars. It is also possible that different cellar usage – i.e. waterproofing of the cellar to allow the use as an extra room - could affect the impact of sewer flooding. Either waterproofing prevents ingress, or it makes the impact more severe since the room is in use.
- 8.7 Yorkshire Water's *Cost Adjustment Claim* research found limited support for the investment to address sewer flooding in cellared properties among customers. It was ranked sixth out of seven cost adjustment claims with only 22% of customers saying they would be happy to pay the c.£12 a year cost. 57% of customers were unhappy.
- 8.8 **Leakage reduction: CCW is concerned that the 15% leakage reduction target in Ofwat's Final Determination for Yorkshire Water does not deliver the scale of improvement in service that customers have been led to expect.**

- 8.9 Yorkshire Water's Board announced publically in 2017<sup>6</sup> that its ambition was to reduce leakage by 40% by the end of 2025 and promised to invest money gained through efficiency savings in delivering a "head start" on this commitment ahead of the AMP7 period. Yorkshire Water officials advised stakeholders that this target was not dependent on specific funding at PR19.
- 8.10 Customers have consistently expressed high levels of support for tackling leakage. In Yorkshire Water's *Understanding Customer Aspirations for Performance* research in 2017, customers were concerned about the amount of water wasted through leaks and stated that the company should be in the top half of industry performers, at the very least. This level of support for improvements led to Yorkshire Water's announcement of its 40% reduction target.
- 8.11 In Yorkshire Water's *Outcomes* research, leakage and the time taken to repair leaks were ranked seventh and fourth respectively (out of 49) when customers were asked about the relative importance of Yorkshire Water's Performance Commitments.
- 8.12 Initial acceptability testing found 96% customer support for the Water Supply Big Five Goal (including the 40% leakage reduction). When further research was conducted following Ofwat's IAP (Initial Assessment of Plans), the Water Supply Big Five Goal (containing a revised 25% leakage reduction) had 97% support from customers.
- 8.13 Yorkshire Water's *Cost Adjustment Claims* research, reducing water lost through leaks had the second highest level of customer support for investment (out of the seven claims), although this support dropped slightly when customers understood the likely impact on bills (c£24 a year).
- 8.14 Based on the latest forecasts (268ML/day in 2019-20) a 15% leakage reduction delivered by Yorkshire Water between 2020 and 2025 would mean an overall reduction of around 24% (compared to the 40% reduction commitment made in relation to the baseline in 2017). CCW believes that customers would expect to see

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<sup>6</sup> <https://www.yorkshirewater.com/news-media/2017/leakage-reduction-plan/>

a reduction much closer to the original 40% commitment, but that they should not pay more than has been set out in Ofwat's Final Determination in order to achieve this.

8.15 **Drinking Water Contacts:** Water Supply has the highest customer support out of Yorkshire Water's five Big Goals. In Yorkshire Water's *Cost Adjustment Claims* research, maintaining drinking water quality had the highest level of customer support for investment and as such CCW expects Yorkshire Water be focussed on delivering a high level of service against this goal. We were supportive of Ofwat's interventions to set a more stretching target.

8.16 Yorkshire Water has stated that there are specific regional circumstances that make it more difficult for it to achieve the target set by Ofwat. The specific circumstances are that Yorkshire Water has a high proportion of upland water and predominantly cast iron pipes, both of which lead to discoloured water. CCW questions whether there is sufficient evidence to support the claim that poor performance in this area is due to exceptional circumstances. For example, the prevalence of cast iron mains could indicate historic underinvestment in replacement or lining of the mains.

## **9. Weighted Average Cost of Capital (WACC) and overall financeability**

9.1 **We do not support Yorkshire Water's WaCC in its Statement of Case.** We disagree that the company requires such a significant increase above Ofwat's WaCC to achieve financeability when:

- We do not believe that customers should pay for an increased cost of financing due to financing decisions a company made in the past. Companies should carry the risk associated with such financing decisions.
- We agree with Ofwat that it is inappropriate, in principle, to use a company's actual cost of debt financing as a starting point for estimating its efficient cost of financing.

- 13 of the 17 regulated water companies in England and Wales have accepted the Ofwat WaCC as part of their Final Determination 'package'.

- 9.2 **Our evidence<sup>78</sup> points to a significantly lower WaCC than that suggested by the company. Our consultants - Economic Consulting Associates (ECA) - recommended a WaCC in the range 2.65% -3.31% (real CPIH; appointee). Ofwat set its WaCC at 2.96% (real CPIH; appointee) in its FD, roughly at the midpoint of the ECA range.**
- 9.3 While we welcomed Ofwat's WaCC, as it was within ECA's recommended range, we believe evidence supported a lower WaCC. In particular, we think that there was scope for a lower equity beta as Ofwat's estimate is higher than we would expect for a monopoly industry. We are also mindful that Ofwat has repeatedly overestimated financing costs at successive price reviews, which has led to outperformance of regulatory assumptions. This has been noted in our research on water company financial performance and by the Public Accounts Committee<sup>9</sup> and National Audit Office<sup>10</sup>.
- 9.4 While rating agencies have reviewed companies' credit metrics in the light of the Final Determination, all companies remain investment grade.
- 9.5 We understand and support Ofwat's financeability assessment based on a notional capital structure. It is not for Ofwat to use financeability levers to support the credit metrics of companies' actual capital structures, particularly for those companies adopting significantly higher gearing than Ofwat's notional capital structure. As Ofwat indicates, it is companies and their investors rather than customers that should bear the risk of a company's choice of its actual capital structure to the extent that it departs from Ofwat's notional capital structure.
- 9.6 The use of the notional efficient firm to assess financeability is also supported by Economic Insight in its report for four water companies. It concludes that "*it is*

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<sup>7</sup> ECA report for CCW - link [here](#)

<sup>8</sup> ECA update report for CCW – link [here](#)

<sup>9</sup> <https://publications.parliament.uk/pa/cm201516/cmselect/cmpubacc/505/505.pdf>

<sup>10</sup> <https://www.nao.org.uk/report/the-economic-regulation-of-the-water-sector/>

*appropriate to assess financeability with respect to the notional firm and, relatedly, it is for the regulator to determine or identify what the notional firm is able to achieve with respect to efficiency (both costs and outcomes)”.*

9.7 We agree that Ofwat’s financeability assessment should reflect no out/under performance. As Ofwat suggests, companies and their investors should bear the consequences of inefficiency and underperformance in delivery of their obligations and commitments to customers.

9.8 Of the 17 companies in the sector, Ofwat used financeability levers for 12 of them. We recognise that Ofwat’s use of the ‘pay as you go’ (PAYG) ratio and run-off is similar to approaches that other regulators use. From a consumer perspective, it is important that advancing revenue in this way is Net Present Value (NPV) neutral. We would be concerned if customers effectively paid twice in the current and subsequent price control periods.

9.9 We support Ofwat’s gearing benefit sharing mechanism. We think a consistently-applied mandatory gain share mechanism where companies’ level of gearing is higher than Ofwat’s nominal gearing assumption is appropriate. This would see 50% of the gearing benefit shared with customers. We note that of the six companies whose gearing was higher than 70% in 2018-19, four have accepted Ofwat’s Final Determination.

## **10. Conclusion**

- 10.1 CCW feels that the Final Determination is a good package for customers because:
- It reflected customer priorities and is generally based on sound evidence. We are supportive of the interventions Ofwat has made to improve targets for PCs where Yorkshire Water is currently a poor performer.
  - The bill change is acceptable for customers. There are no significant differences between the Draft and Final Determinations, and as our research shows that the vast majority of customers found the Draft Determination acceptable, many customers are likely to find the Final Determination acceptable.

- CCW wants to be certain that the investment allowed to address flooding in Hull is right and that Yorkshire Water's leakage target delivers on the commitment it has made to its customers.
- We question Yorkshire Water's £105.9m claim relating to the risk of sewer flooding in cellared properties as sample of 20,000 customers may not be sufficiently robust to support this proposal.
- We now turn to the CMA to ensure that the approach to efficiency is sufficient, without hidden customer detriments and allows Yorkshire Water to deliver its promised customer priorities.

10.2 If the CMA concludes that Ofwat's approach to efficiency is sound, and investment in resilience would not be delayed, then the Final Determination should not change.

## **Enquiries**

Enquiries about this consultation should be addressed to:

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