YorkshireWater

Annex 1: Post-Hearing Notes

A. Clarifications on Costs, Outcomes and Overall Stretch

1. During the hearing the CMA asked several questions in the connected areas of costs, outcomes and overall 'stretch'. The following paragraphs address certain topics where – following further consideration after the hearing – we felt that the key points were perhaps being lost in the mass of detail and range of arguments presented to the CMA.

The appropriateness of costs and outcomes targets is not determined by the relative level of 'stretch' compared to PR14 – the real issue is that Ofwat has not calibrated the price control to reflect the costs and outcomes that would arise in a competitive market

2. During our hearing the CMA asked several questions relating to the scale of the 'stretch' on costs and outcomes at PR19. For example, Mr Meek said the CMA had heard evidence that some firms had outperformed on historical outcomes, whilst underspending on totex, and asked what might be inferred from that.[1]

3. Although the term 'stretch' is in common usage, it does not have any specific meaning. It is important to consider this in the context of the fundamental objective of regulation, which is to deliver the costs (prices) and service levels that would arise in a competitive market.[2] The implication of this is that the appropriateness or otherwise of Ofwat's cost and outcomes targets is not determined by whether the 'stretch' is high or low relative to PR14 (or by historical company performance) on individual components of the price control. Rather, the question before the CMA is whether, in totality, Ofwat has calibrated the control to reflect the costs and outcomes that would arise in a competitive market. This is crucial, because it is the calibration of the price control overall that ensures the expected return for an efficient firm is equal to its allowed return (which is necessary for the financing duty to be fulfilled).

4. On this key matter, and reflecting on points raised in our hearing, the proper interpretation of the facts that have been presented to the CMA is critical.

    (a) We are concerned that Ofwat's published RoRE risk ranges may have provided the CMA with a false impression that Ofwat has calibrated the control appropriately to deliver an even balance of risk (for an efficient firm) whereas, in fact, Ofwat has undertaken no proper analysis. On this matter, YWS notes that Ofwat has made a further submission regarding its approach to calibrating incentives.[3] This appears to us to be an attempt to create an impression that Ofwat did, in fact, undertake a proper risk-based calibration of the overall package of incentives. Evidence submitted by YWS shows this not to be the case.

[1] YWS Hearing Transcript, p.134, lines 8-11.

[2] i.e. consistent with the efficiency frontier.

[3] 'PR19 – calibration of incentive package', Ofwat.

(b) We are also concerned about the discussion of isolated examples of outperformance (most obviously, totex under-spend and outcomes performance in relation to specific metrics) and consider that this both creates a misleading impression and serves as an unnecessary distraction from the key issue of whether Ofwat has calibrated the overall control correctly. As explained in our earlier submissions, there can be little doubt that it has not.

The appropriateness of Ofwat's choice of benchmark must be informed by the degree of confidence in its models and no reliable information about the 'leniency' of the efficiency challenge at PR19 can be drawn from this choice

5. Mr Cohen explored a hypothesis that Ofwat's decision to set the base totex cost efficiency benchmark with reference to the 3rd or 4th ranked firm at PR19 was perhaps 'lenient', in the sense that it could have chosen the 1st ranked firm.[4] This hypothesis might imply that Ofwat's decision may: (i) provide YWS with headroom in its cost allowance to make efficiency gains that could be invested in improving outcomes; and (ii) be more lenient than previous decisions.

6. Here, the CMA will appreciate that it is important to be mindful of the distinction between 'what' YWS is being benchmarked against and 'how' Ofwat is doing this. Put simply, YWS is being benchmarked against Ofwat's view of the efficiency frontier, just as at all previous price controls; it is just the 'how' that Ofwat has changed.

7. If a regulator was minded to set the '1st ranked' firm as the standard to be adopted under any efficiency model, without adjustment, this would definitely be setting a benchmark that is 'beyond' the true efficiency frontier. This is due to inherent modelling imperfections, which means Ofwat's models can never fully isolate 'inefficiency'.

8. At PR19, Ofwat has addressed this by taking the 3rd and 4th ranked firms to represent the frontier. (In previous price controls, Ofwat addressed this issue in a number of different ways. Specifically, up until PR09 the benchmark company had to pass a number of criteria to be selected.[5] Having done this, Ofwat then made a number of further adjustments that significantly reduced the size of the implied 'raw' efficiency gap.[6])[7]

9. YWS is being benchmarked to the efficiency frontier at PR19; a point at which, by definition, trade-offs between costs and outcomes must occur. Secondly, no reliable inferences as to the 'leniency' of the efficiency challenge YWS has been set at PR19 can be drawn from the choice of benchmark company.

10. Any discussion of the choice of benchmark must recognise that this cannot be an arbitrary choice but should be fully informed by the degree of confidence that is possible in the cost

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[4] YWS Hearing Transcript, p.51, lines 15-17.

[5] Competition Commission. (2012). South Staffordshire Plc/Cambridge Water PLC merger inquiry: A report on the completed acquisition by South Staffordshire Plc of Cambridge Water PLC.

[6] For example, this included scaling down the OPEX model residuals by 10% for water and 20% for wastewater, setting a cost reduction target to close 60% of the resulting efficiency gap, and then using a 5-year glide path to spread the efficiency challenge. For example, see 'Setting price limits for 2010-15: Framework and approach.' Ofwat (2008) for a description of Ofwat's method at PR09.

[7] Ofwat's approach at PR14 is addressed in Oxera's paper at Response Annex 11.

models used. As evidenced previously, the quality of the PR19 cost models does not compare well with other regulatory applications (e.g. RIIO-ED1 or the CMA's models for Bristol Water at PR14). However even with the benefit of these superior model properties, less severe benchmarks were still chosen than Ofwat has used at PR19.

11. YWS notes that Ofwat has made a further post-hearing submission to the CMA regarding cost / quality relationships, which Ofwat states supports its view that: *"the relationship between quality and cost is complex, and that high quality is not necessarily associated with high costs."*[8] The evidence submitted by Ofwat in support of this statement, which consists of a very limited review of empirical and theoretical literature, does not in any way overcome the issues identified here. By ignoring any relationship between cost and quality in its modelling, Ofwat cannot correctly estimate efficiency benchmarks whether they be frontier or upper-quartile. Spot examples for actual firms are not informative because those firms will not be perfectly efficient.

12. In relation to the point on leniency, we are also especially troubled by one point put to us by Mr Meek, namely that "*at an industry level, we understand that Ofwat's aggregate TOTEX allowances are very close to the sum of companies' business plans.*"[9] Related points were also raised, which suggested an impression that the scale of the efficiency challenge may be lower than in the past. These suggestions emanate from Ofwat's submissions but are demonstrably incorrect. Specifically:

    (a) The gap between Ofwat's allowed totex in the FDs and that proposed by companies in their original Business Plans was, in fact, £4.8bn. We understand this to be the largest such gap during the history of water regulation. Although there was a degree of attenuation of this gap between the draft and final determinations, the average business plan gap remained at 6%, compared to 0% at PR14.

    (b) Moreover, the efficiency challenge incorporates both cost savings and outcomes performance gains. Seen through this lens, it is plainly non-credible to suggest that PR19 represents a reduced efficiency challenge relative to the past. This is also without taking into account the large increase in the frontier shift applied by Ofwat. In fact, the costs-outcomes efficiency challenge for YWS is larger in PR19 than it has been historically, as illustrated by the 'spider diagram' we presented to you during our initial presentation.

Following the application of Ofwat's cost-efficiency challenge, companies are in a position where trade-offs between costs savings and outcomes improvements must exist

13. Mr Cohen also asked: (i) whether it was strictly true that firms could not improve outcomes without incurring costs; and (ii) if YWS's relative efficiency was relevant to this.[10]

14. In principle, firms could improve outcomes without incurring costs if they are able to make catch-up efficiency gains and/or can achieve productivity gains over time. However, in practice, Ofwat's methodology returns the entirety of these efficiency gains to customers in

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[8] 'The relationship between costs and quality – examples from the rail and health care sectors', Ofwat.

[9] YWS Hearing Transcript, p.136, lines 18-21.

[10] YWS Hearing Transcript, p.48, line 2 and p.49, line 3.

the form of lower prices, and therefore they are not available to invest in improving outcomes too.

15. It follows that a company's ability to invest in improving outcomes (at no additional cost) is unaffected by its relative efficiency. Put another way, once Ofwat's total efficiency challenge is applied, based on the firms it considers represent the efficiency 'frontier' (as above), it puts companies in a position whereby a trade-off between cost savings and outcomes improvements must exist.

16. In YWS's case, this problem is especially acute, because the limitations of Ofwat's modelling results in an efficiency challenge that is too high, as set out in YWS' previous submissions. The logical conclusion of this that Ofwat in effect pushes YWS beyond the point of making trade-offs between costs savings and performance improvements to a point where YWS must in fact scale back performance to live within the costs it has been allowed.

The costs of improving service quality are not recognised in Ofwat's base cost allowances

17. We were asked whether the costs of improving service quality are already included in the modelled cost allowance, to the extent that companies were improving service quality in the modelling period.[11] We would like to reiterate that the costs of improving service quality are not recognised in the modelled cost allowances because: (a) the cost models do not include measures of service quality; (b) Ofwat's cost benchmark firms did not systematically achieve the service quality levels associated with Ofwat's PR19 targets in the cost assessment period; and (c) deficiencies in Ofwat's models due to misspecification and errors evidenced in our Statement Of Case and Response compromise the identification of the relative position of firms.[12]

18. We were also asked whether there are other mechanisms to include the costs associated with improving service quality, beyond the base expenditure modelling.[13] Although companies made cost adjustment claims and requested enhancement expenditure for improving service quality, the process was ineffective. This is because Ofwat has rejected a significant proportion of enhancement expenditure relating to service quality improvements, with the non-evidenced based justification that an implicit allowance for service quality improvements was included within the base models. This contributed to the disconnect between costs and outcomes that we articulated in our earlier submissions.

19. In view of the foregoing, we would respectfully submit that it is essential for the CMA to consider carefully the relationship between costs and outcomes and approach the redetermination in a way that avoids the disconnect between the two evident in Ofwat's Final Determination.

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[11] YWS Hearing Transcript, p. 45, lines 8–11.

[12] It should also be noted that majority of costs to improve service are not 'one-off' costs (as suggested by Ofwat in its hearing – see Ofwat Hearing Day One Transcript pp.28-18), but rather a combination of: investment in short-lived assets (such as telemetry) used to better target and identify where service failures have occurred (or will occur), requiring regular maintenance and replacement (i.e. every 5-7 years) to maintain their efficacy, and; (ii) increased activity to manage risk and repair assets where service issues are identified.

[13] YWS Hearing Transcript, p. 46, lines 13–16.

B. Further thoughts on finance-related matters

Notional company cost of debt, credit rating and gearing

20. In paragraph 235 of our Statement of Case we explained that our primary objection to Ofwat's use of an A rating benchmark within its formula for calculating the cost of new debt was that: *"[Ofwat's] modelling shows interest cover which is wholly incompatible with a sector-wide A rating"*. For the avoidance of doubt, this observation pertains to the position of the notional company. Ofwat targeted a Baa1/BBB+ rating in its FD. Ofwat's own modelling showed that a majority of notional companies would fall short of that target rating. It follows that Ofwat could not reasonably assume in its final determination that companies will be able to raise debt at costs commensurate with an A rating.

21. During the hearing Mr Muysert explored the hypothesis that if a company's credit rating were to come under pressure, the solution to the problem might be for the company to reduce its leverage.[14]

22. We would advocate extreme caution with any notion that one could set the cost of capital for a notional company with gearing of less than 60% by reference to the way in which companies may manage their actual capital structures.

23. All of the equity-owned companies in the England & Wales water industry currently have debt-to-RCV ratios exceeding 60%. Going forward, we can think of no logical reason why an efficiently financed water company needs to maintain an equity cushion worth more than 40% of its RCV, which would be the equivalent of more than £30 billion of equity capital at industry level.

24. In our assessment, Ofwat's 60:40 capital structure already misrepresents the way in which the (actual rather than notional) industry finances itself. Our view is that any further downward adjustment to the gearing ratio would give rise to a situation in which the CMA ends up estimating the cost of capital for a highly/more contrived, theoretical company that bears little resemblance to the water companies operating in the sector.

Household retail margin

25. Mr Muysert also tested the proposition that Ofwat could have over-estimated the household retail margin.[15]

26. We would suggest that the 1% margin does not constitute excess profit. It is our view that Ofwat's finding to the contrary in its final determination was based on a 'back-of-the-envelope' return on capital calculation. Ofwat has previously acknowledged that *"return on capital analysis … may omit the full amount of retail capital employed"*.[16] For this reason, Ofwat has said that return on capital calculations should be only used as a "cross-check" on margin benchmarking work and, in particular, should be *"used only to check that the margins indicated in the benchmarking are not too low"*.[17]

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[14] YWS Hearing Transcript p.17, lines 15-23.

[15] YWS Hearing Transcript, p.34, lines 14-20.

[16] Ofwat (2014), Setting price controls for 2015-20 – risk and reward guidance.

[17] Ofwat (2014), Setting price controls for 2015-20 – risk and reward guidance.

27. We consider that Ofwat reached incorrect conclusions in its return on capital analysis as a consequence of omitting to make allowance in its calculations for:

(a) intangible assets – i.e. the capital that Ofwat recognised in its calculations was limited to fixed assets and financial capital and did not take account of intangible assets like software; and

(b) peak working capital requirements – Ofwat focused in its analysis on average debtor days and did not make proper allowance for the additional financial capital that companies have to hold to manage fluctuations around the mean (e.g. of the sort that companies have faced since March this year).

28. Ofwat also made a number of errors in its calculations of the cost of capital:

(a) working capital financing costs – Ofwat assumed that working capital could be financed fully via debt. This implies an unrealistic overall retail capital mix of approximately 15% equity and approximately 85% debt. We consider that it is much more realistic to assume that working capital is financed in part by retained earnings/equity, implying a cost of capital equal to the appointee WACC; and

(b) retail business corporation tax – the retail margin is a pre-tax margin that is given to cover both financing costs and corporation tax payments. However, Ofwat costed up the required retail return using the vanilla WACC, which excludes any kind of allowance for tax. The correct WACC to use is the nominal pre-tax WACC of 5.60%.

29. If the CMA were to correct for these omissions and errors, it would observe that the 1% margin provides investors with an after-tax return that is in line with the appointee cost of capital. This shows that there is no need for the CMA to make a retail margin deduction, nor is there any need for the CMA to revisit the calculation of retail profit.

Gearing outperformance sharing mechanism (GOSM)

30. We consider the helpful discussion of our actual financing arrangements demonstrated the incorrectness of Ofwat's assertion that we require lower returns than other companies because investors *"take benefit of the difference between the cost of equity and the cost of debt for the actual proportion of gearing that is above Ofwat's notional assumption"*.[18] Nor do we believe that the CMA should have any reason to find that a securitised company with our debt:equity mix presents additional risk to customers.

31. We observe that Ofwat expressed in its hearing that it has concerns regarding the balance of risk between customers and investors, investors continuing to benefit from high gearing at a cost to customers, a lack of financial resilience, using financeability as a route to obtain increased costs, and an insufficient focus on operations relative to financing. We consider that these concerns are misplaced. In addition, Ofwat demonstrated a clear misunderstanding of the nature and role of derivatives.

32. We have previously submitted evidence to address any suggestions concerning the inappropriateness or otherwise of our financing structures, and to clarify inaccurate assertions concerning our financing approach. We are extremely surprised by Ofwat's most recent comments given our current financing arrangements have been in place for eleven years and all notable changes in YWS's gearing have been consented to by Ofwat. In addition, we would

[18] See SoC paragraph 249.

note that Ofwat has made no reference to the recent licence modifications for water companies, which are designed to strengthen the regulatory ringfence and increase customer protections.

33. Whilst we agree in principle that there must be a point at which the risks of financial distress start to outweigh the benefits of utilising debt financing, it is clear that this risk is negligible for water companies, and our current gearing falls well short of this point of inflection. We note that Ofwat has adduced no evidence during the course of the inquiry to support its assertions to the contrary.

34. We maintain our view that the GOSM approach and formula is fatally flawed and, more generally, that the CMA should have no reason to differentiate the revenues that it allows companies with different capital structures.

35. In addition, it is our view that any policy intervention (such as GOSM), in relation to actual gearing or penalties derived from actual gearing is clearly not in the long-term interests of customers or the industry more widely. In particular, consideration would need to be given to the available sources of equity-backed capital that could be used to reduce gearing and the investability concerns noted previously in our SoC.

36. There are also wider considerations. A current example is the "Green Economic Recovery", which is being promoted (by DEFRA, EA, DWI, CCW and Ofwat) to accelerate investment within or into AMP7. Any potential investment under this scheme would increase gearing, attracting additional cost under the GOSM for any company with gearing close to, or above 70%. This would make the scheme far less attractive for a high proportion of companies within the sector, reducing the prospect of achieving the desired investment and helping with the post-Covid recovery.

C. Answers to outstanding queries

Low pressure ODI rates

37. Ms Fletcher asked for our view on whether the penalty and reward rates of £139,000 per property per year for the Low Pressure Performance Commitment were justified, as they seemed to be out of line with the ODI rates of other companies for this measure.[19]

38. We understand why the CMA has sought clarity on this point, but would suggest that there is a strong economic justification for the penalty and reward rates:

    (a) As low pressure has not been standardised as a common PC across the industry, direct comparisons with other companies are not straightforward. In particular our ODI rate may superficially appear large compared to other companies simply because we are measuring different things. For example: a number of companies with lower ODI rates for similar PCs measure acute low pressure i.e. low pressure over a short time scale; whereas YWS measures chronic low pressure i.e. low pressure that affects customers in the long term. The companies that measure acute low pressure apply penalties and rewards on a 'per day' basis when individual events occur. When such penalties and

[19] YWS Hearing Transcript, p.73, lines 1-6.

rewards are aggregated annually, the ODI rates for the relevant companies per property are in a similar range to the YWS rates.[20]

(b) The low pressure ODI rates directly reflect the value that customers in the Yorkshire region place on avoiding low water pressure. We apply a range of economic valuation techniques in our customer research. The results of these surveys are similar, showing that our customers are each willing to pay £0.11 to £0.12 (pence) per property per year to reduce low pressure. The similarity of the valuation between different techniques suggests the results are very reliable and are also consistent with our research findings that customers place a high 'non-use' value (i.e. value of things that they themselves are not using or experiencing) on services such as low pressure, internal sewer flooding and supply interruptions. In other words, customers are willing to pay small amounts to prevent the possibility of any low-pressure failures, rather than just valuing their own direct 'use' of the services.

39. That the ODI rates are not unreasonable is also apparent when one considers the target that we are aiming to achieve. YWS has consistently performed at the frontier of the industry for reducing low pressure and is proposing to deliver a further 20% improvement from already very high levels of service. The ambitious target aims to allow only 12 properties in the region to suffer from chronic low pressure, whereas other companies have set targets in the hundreds or thousands of properties.[21] As the ODI is a function of both the range of performance available and the incentive unit rate, if YWS delivered 100% service (i.e. zero properties with chronic low pressure) the maximum reward it could earn would be £1.66m. Compared to other companies who have poorer levels of service (and therefore a greater range over which to earn rewards), YWS has a modest ODI potential.

40. Finally, as with all other elements of the price control, we would caution against looking at each element in isolation and re-emphasise the need to look at the position at a package level.

Growth

41. Mr Cohen asked whether we were concerned about Ofwat's unit-rate growth adjustment and requested our view on the fact that Ofwat had reduced the allowance of companies with below average costs by only half of what was implied by this.[22]

42. In its final determination Ofwat made an adjustment to its modelled cost allowance to account for differences in forecast population growth between the historical period and AMP7. It assessed the population growth forecast in Yorkshire for AMP7 to be lower than the historical average growth rate in the sector and made a downward adjustment to our modelled allowance of £34.7m. As noted by Mr Cohen, this adjustment represents half of the reduction implied by Ofwat's analysis.

43. Ofwat made this adjustment out of concern that its models did not contain growth-rate cost drivers. Given the uncertainty inherent in this post-modelling approach, Ofwat prudently applied only half of the assessed adjustment where negative. However, as explained in our

[20] For example, Severn Trent Water has a low pressure ODI rate of £464 per day for each property, which aggregates to £170,000 per year.

[21] An industry comparison is available here: https://discoverwater.co.uk/water-pressure.

[22] YWS Hearing Transcript p.55, lines 7-8 and 14-17.

submissions,[23] Ofwat's analysis is based on the ONS dataset rather than the more realistic growth assumptions that we used to build our Business Plan, meaning that it under-predicts future expenditure. We therefore continue to question the validity of Ofwat's simplistic approach, and the negative adjustment that results from it.

Points addressed in RFI011

44. Finally, we would like to comment on two queries raised in our hearing – one on the acceleration of £137 million of WINEP expenditure and one on the RPE assumptions in the Business Plan – that have largely been addressed in our response to RFI 011. However, we wish to clarify in addition here that:

(a) In response to Mr Cohen's query,[24] the movement of WINEP expenditure from AMP8 to AMP7 does not account for any of the difference between Ofwat and YWS's view of efficient enhancement costs for P-removal. The difference is solely explained by the flaws in Ofwat's enhancement cost models.[25]

(b) The focus on the frontier shift assumptions of YWS during our hearing and in RFI011 seem to us to be somewhat beside the point. The key points are the significant uncertainty underpinning the identification of the benchmark companies and assumptions of these benchmark firms in Ofwat's enhancement modelling – this is where the potential for double counting occurs.[26]

D. What we would like the CMA to do

45. In Ms Barber's introductory remarks at our hearing, she highlighted two gaps – a gap in the regulatory approach followed, and a gap in the outcome it produced. It is the combination of the two that has brought YWS to the CMA, and we believe that it is important that the CMA addresses both gaps in its redetermination.

46. The gap in outcome reflects the material flaws that we identified in our Statement of Case. Viewed solely in terms of costs, the expenditure gap at FD was in excess of £360m. We believe that a very substantial part of this gap could be addressed by the CMA with relatively straightforward changes, all strongly supported by the available evidence. Crucially, such changes to cost allowances and incentives would allow us substantially to mitigate the harm of Ofwat's Final Determination while at the same time allowing customer bills to fall relative to PR14 in real terms.

47. We fully appreciate that it is for the CMA to determine what to remedy in the final determination and how to do so. We believe, however, that the evidence provided to the CMA (by both YWS and Ofwat) clearly justifies the inclusion of four elements in its redetermination.

48. ***First***, we ask the CMA to reconnect costs and outcomes – principally by allowing the efficient costs of the improved service levels targeted. As we explained in Section 12 of our Response, we believe that with the important exceptions of internal sewer flooding and mains repairs, cost-based solutions provide the most tractable remedies for the CMA to consider. In our

[23] SoC, paragraph 198 and Response, paragraph 3.55.

[24] YWS Hearing Transcript, p.110, lines 7-12.

[25] As explained, for example, at Response paragraph 3.63.

[26] See, for example, SoC paragraph 201.

response to RFI 012, we explained that on leakage alone the missing enhancement costs are close to £100m.

49. To reconnect costs and outcomes, we also ask that the CMA recalibrate the performance targets for internal sewer flooding and mains repairs to account for a delivery profile that recognises the unique circumstances in the Yorkshire region and a feasible speed of delivery. As we explained in Section 12 of our Response, by the end of AMP7, the target we proposed in our DD Representations would still provide a reduction from 2019-20 outturn figure of 51% on internal sewer flooding. On mains repairs, our DD Representation target would show only a small increase against the 2019-20 outturn despite the target to reduce leakage by 15%. If the weather-related transient effect in 2019-20 is excluded, there would be a reduction of 19%.

50. ***Secondly***, we ask the CMA to follow the evidence regarding the efficient costs necessary to meet our obligations and targets. There are a number of aspects to this:

(a) Providing efficient funding for the statutory WINEP programme – Ofwat belatedly included a flawed explanatory variable in one model, but then triangulated with two models that remained deficient resulting in a cost shortfall in excess of £100m;

(b) Follow the evidence to a balanced view on the appropriate efficiency benchmark and frontier-shift/RPEs – the cost models used are not sufficiently reliable to safely support Ofwat's more stringent benchmark. Ofwat's approach on frontier-shift and RPEs outreaches their flawed evidence in respect of both the quantum and breadth of effect, with the unwarranted application on both enhancement costs and unmodeled base costs. A balanced view here would reduce the cost shortfall by circa £50m;

(c) Adjust for the efficient costs of meeting future growth, unwinding the impact of Ofwat's overly-simplistic and unsound approach to move these between enhancement and base costs against its own regulatory accounting guidelines;

(d) Provide efficient funding for the innovative solutions proposed in Hull that pioneer a new way of working for the industry and have already achieved global recognition (accompanied by the ODI that we addressed in our response to RFI012a); and

(e) Follow the evidence provided on the costs of the Industrial Emissions Directive and address this via a reconciliation mechanism at PR24.

51. ***Thirdly***, we ask the CMA to reconnect risk and return via a number of steps:

(a) Reflect our customers' views and values in the delivery incentives and ensure the overall package of incentives is balanced and encourages realistic and stretching performance improvements rather than creating unmitigable and substantial penalties;

(b) Reconnect risk and return with a WACC based on a consistent, balanced view of market evidence and a recognition of the systematic risks created from the approach to performance incentives and totex sharing mechanism incentive rates that reflect the corrected relative position of our business plan and efficient costs; and

(c) Ask that the redetermination gives a transparent assessment of the package as a whole – in line with our comments above – with consideration of the uncertainty around each key building block concurrently, so that current and future investors can see an appropriately balanced position for the notional company, providing confidence on the near and long-term investability of the redetermination.

52. ***Finally***, we ask the CMA to correct several clear regulatory errors:

(a) Unwind Ofwat's inappropriate adjustment to the PAYG ratio – take the opportunity provided by using a balanced view on efficient costs to remove the need for an artificial financeability solution, and revert to the natural rate;

(b) Remove the flawed Gearing Outperformance Sharing Mechanism, for the reasons explained above; and

(c) Follow the evidence provided on the WRFIM error and implement the solution Ofwat guided the company towards, which was understood by YWS when it took the decision to invest its AMP6 outperformance to achieve upper-quartile performance for the benefit of customers in AMP7 and beyond. In addition, we have noted that if our WRFIM claim was accepted then there would be a reduced requirement for accelerated revenues to achieve notional financeability and customer bills would not be impacted.

53. We believe that these changes would result in the company being tasked to deliver a number of very stretching performance improvements, but crucially receiving the efficient costs of doing so alongside a balanced package of incentives without the material downside skew that Ofwat failed to identify.

54. Customers will remain comprehensively protected by the suite of ODIs (including the additional ODI proposed on Hull). Customers will see a fall in bills from PR14 levels, yet future customers are protected from generational cross-subsidies. Resilience of Yorkshire's water systems will be protected through levels of infrastructure investment that will safeguard long-term sustainable service. In short, the price control will then deliver exactly what it should.

E. Final thoughts on asset health

55. We have consistently tried to keep the focus of these redetermination proceedings on the real issues of importance, and to avoid getting drawn into Ofwat's attempts to distract attention from these issues through some of its more intemperate and poorly evidenced assertions. It is therefore with regret that we feel compelled to respond to some of the statements made by Ofwat during its hearing, particularly in connection with our performance on asset health.

56. The CMA has our evidence on our asset health investment and operational performance, and we do not propose to rehearse that in detail here. However, we must point out that it is impossible to reconcile [✂] statement that we are *"in trouble operationally"* with the fact that we have – as recognised by Ofwat – maintained a stable asset health position over the last 5 AMPs.[27] Our evidence also highlighted the strength of our performance during a number of significant weather events in recent years.

57. [✂] claims to have *"seen enough evidence"* of *"more than a few guns that are smoking"* to contradict both our evidence and Ofwat's own previous recognition of our performance.[28] We

[27] Ofwat Hearing Day Two Transcript, p.29, lines 5-6.

[28] Ofwat Hearing Day Two Transcript, p.29, line 4.

note however that none of this has been shared with the company, nor it would appear with the CMA. Nor has Ofwat made any mention of such evidence during the previous four years of the price control process, or indeed any of the annual performance reporting cycles during that period.

58. As [✂] stated in her letter to [✂], we recognise and appreciate the difficulty of the job Ofwat performs and the level of effort that it has put into PR19. We can also understand the additional pressure placed on the Ofwat team as a consequence of so many companies having chosen to challenge the product of that already lengthy process by seeking a redetermination. That is indeed unfortunate, and we hope that some of the suggestions Ms Barber made about the future of regulation can prevent it from happening again.

59. However, we do not consider that such additional pressure justifies the manifestly false assertion that YWS is a poorly run company,[29] nor the offensive suggestion that water customers would look unfavourably on paying returns to shareholders because they were foreign.[30] . This is deeply unhelpful with regards to investor perceptions of the sector and their trust and confidence in the quality and robust evidence-based nature of the regulatory regime.

60. YWS is a well-run company, as shown by our performance, our cost efficiency, and our responsible stewardship of our assets, all of which reflects our commitment to deliver for our customers and meet the future challenges faced by the industry. As a regulated business, we would hope that our relationship with Ofwat could be one of partnership, with each of us working collaboratively to achieve the outcomes that our customers and both organisations want, and that our discussions could be based on a foundation of mutual respect, with due regard given to the objective facts and evidence before us. As Ms Barber promised in her letter, we will continue to do all we can to try to achieve this.

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[29] Ofwat Hearing Day Two Transcript, p.29, line 13.

[30] Ofwat Hearing Day One Transcript, p.60, lines 7-9: *"I think, if you spoke to customers and asked them if they would prefer to pay higher returns to foreign shareholders, for example – it is not a question put to them – would they prefer their bill to be higher for that reason?"* This is comment is distinct from the discussion of non-UK investors in the context of customer benefit from taxation, which arose on the second day of Ofwat's hearing: Ofwat Hearing Transcript Day Two, p.12, starting at line 12.