YorkshireWater

Final submission

3 February 2021

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1. Introduction

1.1.1 YWS has kept this final submission short. It reinforces the paramount need for the CMA to deliver a final determination that will, in setting the correct bill level for YWS to charge, protect its current and future customers in both the short and long-term, thereby reflecting customers' wishes, which have been very clearly communicated during PR19 and this redetermination.

1.1.2 Its focus is on the financeability imperative: the Provisional Findings (**PFs**) re-established some of the balance that was clearly missing from Ofwat's final determination (**FD**). That balance has been lost in the CMA's recent January Working Papers[1] – to such an extent that the notional firm is highly unlikely to be financeable. It is critical that the CMA addresses this, through the WACC and through correcting the asymmetry in the risk/return equation that results from a very apparent costs/outcomes disconnect.

1.1.3 To fail to do this will lead to increased costs for customers over the longer-term and will exacerbate already existing concerns about investor confidence in the UK water sector. These are precisely the sources of harm that brought YWS to the CMA in the first place.

1.1.4 The CMA must also address the cost/outcomes disconnect that remains unresolved. Targeted improvements in service levels have remained significantly underfunded or entirely unfunded, for example in relation to leakage and internal sewer flooding respectively. In relation to internal sewer flooding, the regional differences between Yorkshire and other areas of the country have still not been recognised. YWS also remains significantly underfunded in relation to its statutory WINEP programme.

1.1.5 YWS urges the CMA to use this opportunity to reset the dial in these and other important regards so that YWS is able to deliver what its customers want in the PR19 period and secure necessary capital to have the confidence to make the right decisions for its customers now and for the

[1] CMA, Water Redeterminations 2020 – Cost of Capital – Working Papers Executive Summary, Water Redeterminations 2020 – Choosing a point estimate for the Cost of Capital – Working Paper (the **Point Estimate Working Paper**), and Water Redeterminations 2020 – Cost of Debt – Working Paper (the **Cost of Debt Working Paper**) (all 8 January 2021); CMA, Water Redeterminations 2020 – 2019/20 data for base cost models – Working Paper (13 January 2021); CMA, CMA, Water Redeterminations 2020 – Leakage Enhancement Totex Allowances – Working Paper (15 January 2021) (together, the **January Working Papers**).

future. YWS believes it is of the utmost importance, both for this redetermination but also PR24 and beyond, that regulation is forward-looking rather than being disproportionately focussed on historic events which bear little to no relevance to the important challenges facing water companies now and in the longer-term.

1.2 Keeping YWS's customers in focus

1.2.1 Throughout PR19 and the redetermination process, YWS has strived to keep the customer voice front and centre. Contrary to recent suggestions by Ofwat that the customer voice is being supplanted ("*submissions made to the CMA have increasingly been dominated by the well-resourced company and investor voice, on occasion to the exclusion of other perspectives*"[2]), which YWS strongly refutes, YWS has made its strong customer focus clear to the CMA since the beginning of this redetermination, and that focus remains today. The views of YWS's customers were not properly reflected by Ofwat and that will also be true of the CMA if it does not reverse the positions taken in the January Working Papers.

1.2.2 As a Member of the Yorkshire Forum for Water Customers (the **Forum**) explained to the CMA at the customer challenge groups hearing in May 2020:

> "*there was one heck of a lot of consultation, research, evaluation, engagement, face-to-face, qualitative, quantitative. There were shedloads of it. So, there was no shortage of that. We really did interrogate the understandability of the discussions that were going on so people were not disadvantaged. We interrogated head of comms as well as evaluation. It was really important that, when we engaged in that conversation with our customers - and we are customers as well - that we were on a level playing field as far as we could possibly be…in Yorkshire, we have been flooded. We understand the implications of climate swings. This we get. We may not be in boardrooms but this we experience at the kitchen table. So, when 30,000-plus individuals are engaged in a conversation and they are perfectly capable of saying, "We do not want to pay a lot of money but, actually, if it is the trade-off between that and having a decent future and having the right level of investment, then we actually want that before we want a*

[2] Ofwat, 'Cost of capital – final response to working papers' (27 January 2021) (**Ofwat's Final Response to the WACC Working Papers**), paragraph 1.5.

rock-bottom price", I think we ought to listen to them and not assume that they are not well enough informed to be able to create that perspective."[3]

1.2.3 That extensive consultation informed YWS that its customers wanted a resilient, sufficiently funded water supplier that is enabled and empowered to undertake investment to meet the challenges of the future, including, but not limited to, the impacts of climate change and other environmental challenges. Its customers also want affordable bills.

1.2.4 YWS's customers supported the PFs with the Forum commenting:

> "*Following extensive discussions with YWS the Forum supported the decision of YWS's to reject the final determination (FD) from Ofwat due to the likely harm it would cause to long term resilience and intergenerational fairness for customers.*
>
> *The Forum agreed that the risk the company was exposed to in Ofwat's FD was too great and would lead to unintended consequences such as a reduction in the planned resilience position of the company by 2025.*
>
> *As we stated in our response to the provisional findings, 'The CMA has made adjustments to Ofwat's allowed rate of return to reflect market evidence and best regulatory practice with a view to ensuring continued investment in the sector; and reduced, to some extent, the companies' exposure to financial risk to achieve what it considers to be the right balance between incentivising out-performance and ensuring that the companies can finance themselves and comply with all relevant statutory duties.'*
>
> *The Forum does not believe that this will cause harm to customers. YWS needs to attract responsible and long-term investment to enable it to continue to invest at a reasonable rate and address the many pressures facing it through climate change and population growth. The average bill presented by the CMA is well within the limits of what customers stated they would support for the service levels that the CMA is proposing that YWS should provide.*"[4]

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3 Customer Challenge Groups Hearing Transcript (27 May 2020), pages 37-38.

4 YWS, Reply to Ofwat's Response to the PFs (16 November 2020), paragraph 1.1.3.

1.2.5 **YWS is committed to delivering a reduction in customer bills over AMP7, which would be achievable were the CMA to adopt its PFs**.[5] YWS has heard and acted upon its customers' voices asking for "*a decent future and [...] the right level of investment*", in addition to bill reductions, and the CMA must reverse its positions taken in the January Working Papers to enable YWS to deliver that.

1.3 Balancing risk and return

1.3.1 In light of the support of its customers for the PFs, YWS has been disappointed to see the provisional changes to the overall package on which the CMA is consulting. Based on these changes alone, YWS considers that the CMA may have lost sight of the right levels of investment and the overall balance of YWS's redetermination. Furthermore, as mentioned above, YWS has not had sight of the overall package and how it will remain balanced. As YWS stated in its Response to the PFs, the package designed by the CMA in the PFs would leave YWS with limited headroom in a downside scenario and the downside risk skew of the package creates a material penalty risk for YWS. YWS described in its responses the impact that the January Working Papers have had on the financeability of the notional company, shifting the balance of the overall package firmly back towards the downside. Critically, when taking the material errors concerning the cost of debt and the other detrimental conclusions of the January Working Papers into consideration, **YWS is highly unlikely to be notionally financeable**.

1.3.2 YWS has shown in its responses to the January Working Papers that important components of the CMA's reasoning are incorrect or incomplete. YWS is concerned that the conclusion reached in the 2019/20 Data Working Paper[6] departs without good reason from well-established regulatory precedent in excluding the latest data from its analysis. In addition, the Leakage Working Paper[7] diverges from the key economic foundation that marginal benefit should be suitably funded by marginal costs. YWS considers that the conclusions as set out in the

[5] YWS, Reply to Ofwat's Response to the PFs (16 November 2020), paragraph 2.4.3(d).

[6] CMA, Water Redeterminations 2020 – 2019/20 data for base cost models – Working Paper (13 January 2021) (**the 2019/20 Data Working Paper**).

[7] CMA, Water Redeterminations 2020 – Leakage Enhancement Totex Allowances – Working Paper (15 January 2021) (**the Leakage Working Paper**).

January Working Papers have not adequately taken into consideration the evidence before the CMA.

1.3.3 YWS addresses below and in **Annex 1** points from Ofwat's Final Response to the WACC Working Papers[8] on cost of debt that are false, misleading in material respects or demonstrate a misunderstanding of YWS's position. YWS would urge the CMA to pay close attention to the contents of Annex 1 in this regard.

1.3.4 As the CMA closes its consultation period in this redetermination, it is imperative that the CMA takes **proper account of all the evidence before it** and **visibly** demonstrates that it has done so in its Final Determination. It is evident that, were the CMA to adopt the January Working Papers' conclusions in its Final Determination, it would not discharge its statutory responsibilities. The CMA **should therefore step back from the approaches it has taken in each of the January Working Papers**, and should seek to set sound precedents based on the best available theory and evidence, as required by this redetermination and to benefit the regulation of the water industry and other sectors for the future.

1.3.5 Accordingly, YWS would again urge the CMA to make use of all of the statutory time available to it before issuing the Final Determination in order to ensure the Main Parties' consultation rights and the CMA's duties are fully and properly observed.

1.4 Outline of the remainder of this paper

1.4.1 **Section 2** considers critical financeability considerations in light of the recent proposed changes in the CMA's January Working Papers.

1.4.2 **Section 3** provides a summary of the detrimental impact of the CMA's January Working Papers should the matters consulted on be adopted in the CMA's Final Determination. In this regard, YWS refers to the further Monte Carlo analysis it has commissioned specifically to examine the impact of the reduction in each of the WACC and allowed costs for leakage in isolation, and, as noted above, has provided at **Annex 1** a critique of Ofwat's submissions on cost of debt in Ofwat's Final Response to the WACC Working Papers.

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[8] CMA, Water Redeterminations 2020 – Cost of Capital – Working Papers Executive Summary, Water Redeterminations 2020 – Choosing a point estimate for the Cost of Capital – Working Paper (the **Point Estimate Working Paper**), and Water Redeterminations 2020 – Cost of Debt – Working Paper (the **Cost of Debt Working Paper**) (all 8 January 2021) (together, the **WACC Working Papers**).

2. Critical financeability considerations

2.1.1 This section does not seek to revisit the detailed points raised in YWS's responses of 13, 18 and 27 January[9] to the WACC Working Papers, nor in YWS's responses to the 2019/20 Data Working Paper and the Leakage Working Paper. However, as stated in YWS's responses to the January Working Papers, the CMA's changes will in and of themselves have a materially detrimental impact on the 'package in the round'.

2.1.2 Furthermore, YWS remains concerned that those papers only address certain aspects of the price control, and, as YWS has no visibility of how those aspects will ultimately relate to the remaining components of the price control, there is the potential for the package to be more unbalanced still than would appear to be the case now.

2.1.3 Therefore, YWS sets out key points on two areas of particular significance for financeability:

(a) the long-term challenges facing the water sector and the need for forward-looking regulation; and

(b) the impact of the January Working Papers on YWS's financeability and investor sentiment.

2.2 The long-term challenges facing the water sector and the need for forward-looking regulation

2.2.1 As noted by YWS throughout this redetermination process,[10] resilience, in its broadest sense, was one of the core reasons for rejecting Ofwat's FD. This reflected what YWS considered to be Ofwat's failure to determine an 'in the round', balanced package, that achieved the right balance between the long-term challenges facing the water sector and

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[9] YWS, Preliminary Response to CMA's Cost of Capital Working Paper (13 January 2021) (**Preliminary Response to WACC Working Papers**); YWS, Initial Response to CMA WACC Consultations (18 January 2021) (**Initial Response to WACC Working Papers**); and YWS, Final Response to CMA WACC Consultations (27 January 2021) (**Final Response to WACC Working Papers**) (together, the **WACC Consultation Response**).

[10] See, for example: YWS, Initial Response to WACC Working Papers (18 January 2021), paragraph 1.1.3; YWS, Response to the CMA's provisional findings of 29 September 2020 (27 October 2020) (the **PFs Response**), paragraph 1.1.1; YWS, CMA Main Party Hearing Transcript (28 July 2020), page 8 (Liz Barber: "*So, we are here because of a gap. A gap in resilience, customer interest and financeability*"); YWS, Response to Ofwat's Reply (27 May 2020), paragraphs 1.1.14 and 1.1.59; and YWS, Statement of Case (2 April 2020) (the **SoC**), paragraphs 9-10.

setting fair customer bills for the forthcoming five-year price review period.

2.2.2 Although YWS considered that the PFs were very challenging, YWS supported the CMA's recognition of the longer-term challenges facing a long-cycle infrastructure company[11] and the important underlying conclusion that financeability could not be achieved with a short-term solution every five years.[12]

2.2.3 In stark contrast, Ofwat continues to demonstrate a serious lack of recognition as to the impact of its FD on the long-term financeability of the water sector. For instance, in certain areas, Ofwat's approach during PR19 and the redetermination process has involved an excessive focus on certain parameters and selective interpretation of data.[13] In so doing, YWS continues to be concerned that Ofwat has, at times, lost sight of the fact that the FD is supposed to be an overall package that must be considered 'in the round' and with a view to long-term resilience.

2.2.4 The PFs represented a step forward from Ofwat's FD in recognising these longer-term challenges. This was not just important for the immediate determination of a WACC point estimate for the current price control period, but also for longer term financeability that would retain and attract capital in the sector in the future.

2.3 The impact of the January Working Papers on financeability and investor sentiment

2.3.1 Since the PFs, material uncertainty has been introduced by the January Working Papers, and YWS considers that the individual proposals within them would have a significantly detrimental impact on the overall finely-balanced package described in the PFs, both in terms of the financeability analysis of the package in the round and the impact on investor sentiment.

2.3.2 YWS notes that Ofwat has referred to two Moody's reports in its response to the WACC Working Papers in seeking to undermine confidence in YWS's financing decisions.[14] However, as explained throughout the PR19

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[11] See, for example, YWS, PFs Response (27 October 2020), paragraphs 1.1.1 and 2.2.1-2.2.5.

[12] See, for example, YWS, PFs Response (27 October 2020), paragraphs 2.2.1-2.3.8 and 3.1.1.

[13] For instance, when analysing MARs for listed companies. See, for example: YWS, Response to Ofwat's Reply to the PFs (16 November 2020), Annex A.

[14] Ofwat, WACC Consultation Response (27 January 2021), paragraph 5.7 and associated annexes.

redetermination,[15] there is no evidence to support these assertions regarding YWS's actual structure and, moreover, this is irrelevant to the regulatory test at issue i.e., **the financeability assessment <u>for a notionally efficient company</u>**. In any event, as YWS has also consistently highlighted,[16] YWS accepts full responsibility for its capital structure which it has managed proactively and prudently over time together with its shareholders.

Financeability of the package in the round

2.3.3 In addition to YWS's concerns with the parameters of the WACC, as explained in YWS's WACC Consultation Response, there have been fundamental omissions by the CMA in relation to its analysis of risk asymmetry.[17] YWS therefore urges the CMA to carefully consider its Monte Carlo risk analysis when reaching its Final Determination, which was originally performed by Economic Insight in 2019, updated for Ofwat's FD, again for the CMA's PFs, and most recently to address the CMA's proposals in the January Working Papers (see further in **Section 3** below). Based on the changes in the January Working Papers alone, the Monte Carlo analysis shows that **YWS is highly unlikely to be notionally financeable**.

2.3.4 Furthermore, YWS's Final Response to the WACC Working Papers highlights that, unless YWS's concerns regarding the CMA's WACC Working Papers' proposals on cost of debt are addressed, YWS believes that it would not be possible for the notional financeability cross-check to confirm that the CMA's point estimate for WACC would be consistent with a strong investment grade rating of Baa1/BBB+.[18]

Dampening of investor confidence

2.3.5 On investor sentiment, Ofwat has referred to a supposed 'wall of money' that is available for investment in UK water assets, due to their inherent characteristics and attractiveness to long-term investors.[19] This

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15 See, for example: YWS, PFs Response (27 October 2020), paragraph 4.1.2; YWS, Response to Ofwat's Reply (27 May 2020), paragraph 2.18.4.

16 YWS, Replies to Ofwat Further Submissions, 24 July 2020, page 33.

17 YWS, Final Response to WACC Working Papers (27 January 2021), Introduction-Section 4 and Paper 4.

18 YWS, Final Response to WACC Working Papers (27 January 2021), paragraph 2.1.9.

19 For example, Cost of Capital Hearing Transcript (20 January 2021), page 56 (David Black: "*We have **not yet seen any lack of appetite** from companies for investment*"); and pages 59-60 (David Black: "***Every price review, we have seen companies with a big appetite to invest**.*

suggestion is reflected in Ofwat's statement at the 20 January roundtable on cost of capital (the **Roundtable**) that: "*whether companies are poor-performing or not, companies can put £1 on the ground and get back £1.20 when they sell out, with virtually zero risk.*"[20]

2.3.6 YWS does not agree with this characterisation of investor sentiment in the water sector, and it does not accord with YWS's experience. It is also directly contradicted by statements that Ofwat made during the Roundtable that investors are unwilling to put equity in to support water companies if this is needed.[21] It is simply unrealistic to consider that investors would make investments in the water sector irrespective of developments in the regulatory environment, and irrespective of the risk profile associated with those potential investments. It is also well accepted that the allowed return plays a critical role in ensuring that much needed investor support will be forthcoming.

2.3.7 This is further demonstrated by responses to the WACC Working Papers from two pension funds (i.e., exactly the type of investor that Ofwat considers would supposedly exhibit unrelenting interest in the sector):

(a) **OPTrust:** "*We can only speak for ourselves but our decision to **exit our equity interest in Thames Water** was in large part because of the **direction of travel in regulation in the sector**, which we assessed resulted in **materially increased risks** combined with an outlook of **insufficient returns on capital** to warrant us maintaining our investment in Thames Water.*"[22]

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*[...] We have companies coming forward at the existing WACC saying they **would like to invest more**. They are even willing to carry the financing costs for that investment to 2025. So, really quite fantastic signals that companies see PR19 returns as being very attractive indeed, and we have seen an **investment appetite to buy water companies** as well*").

20 Cost of Capital Hearing Transcript (20 January 2021), pages 59-60 (David Black).

21 Cost of Capital Hearing Transcript (20 January 2021), pages 137-138 (Jonson Cox: "*The other thing we have observed is that it is often argued by companies that their investors will put more equity in if they get into difficulties. This just does not happen in the real world, largely because the structure, the investor fund life and the difficulty of getting underlying ultimate investors to put money in when it is needed all work to make that very difficult*").

22 OPTrust, Response to WACC Working Papers (27 January 2021), page 1, see link (emphasis added).

(b) **USS:** "*We would note that USS has not made an equity investment in the water sector since 2017 due to the* ***perceived misalignment of risk and regulatory return****.*"[23]

2.3.8 YWS has already noted the impact of Ofwat's price review process on investor confidence leading up to the FD.[24] The corrosive impact of Ofwat's approach on investor confidence is also very evident in the downgrading applied to Ofwat's own rating and companies in the sector.

2.3.9 The dampening of investor confidence indicated in the submissions from OPTrust and USS is also reflected in other recent investor submissions to the CMA – in particular, that of the Global Infrastructure Investor Association (**GIIA**), whose members hold stakes in ten of the privately-held regional water companies in England and Wales, that supply over 50% of the UK population's water supply.[25]

2.3.10 The GIIA submission points to the importance of regulation in enabling the "*extensive investment*" that is needed to meet the impact of resilience challenges. Commenting on the WACC Working Papers, GIIA notes that "*[t]he revised approach to the WACC in particular will act to* ***significantly dampen the incentive to invest in the UK, at the precise moment when global investors' perception towards the UK is at a point of heightened sensitivity*** *following the UK's departure from the European Union, and whilst there is a pressing need to redefine the investment proposition for UK Plc more broadly in the context of a new international trading regime and as a means to support the recovery to the Covid-19 crisis and associated economic downturn.*"[26]

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[23] USS, Response to WACC Working Papers (27 January 2021), page 2, see link (emphasis added).

[24] See, for example, YWS, 'Yorkshire Water Draft Determination Representation – Financeability' (August 2019), see link, page 5 ("*We believe that the 'screws have been tightened' to the extent that there could well be an* ***adverse impact on investor appetite*** *to finance the investment necessary to ensure Yorkshire Water can deliver on ambitious targets as part of its long-term strategy*"); page 17 ("*We believe strongly that* ***investor confidence will be eroded*** *by repeated revisions of WACC for short-term data movements as Ofwat will be seen to be increasing risk within the industry*"); and page 19 ("*Ofwat has also noted within its draft determination that data rolled forward to June 2019 would result in a lower beta and hence lower WACC of 1.81%. This highlights further the inconsistency and inappropriateness of the approach taken by Ofwat and the* ***impact on investor confidence*** *that is ultimately not in the long-term interests of our customers*").

[25] GIIA, Response to WACC Working Papers (18 January 2021) (**WACC WPs Response**), see link.

[26] GIIA, WACC WPs Response, page 2 (emphasis added).

2.3.11 The CMA's proposed change in thinking in the WACC Working Papers is also misaligned with both the strategic objectives in the National Infrastructure Commission's (**NIC**) recent National Infrastructure Strategy, which expresses the UK Government's commitment to supporting private investment,[27] and the goal of the newly established Office for Investment, namely to encourage investment from the international investor community in supporting the delivery of government's strategic priorities.[28]

2.3.12 GIIA concludes that the PFs were "*better aligned with the interests of customers both now and in the future, compared to the approach taken by Ofwat*",[29] and that "*the optimum balance has not been successfully struck in these revised proposals*".[30] GIIA is now "*firmly of the view that the revised approach that the CMA is proposing to the cost of capital and cost of debt* ***significantly increases the risk of new and existing investment being diverted away from the UK in future****, directly contradicting the stated intention by the CMA in its PF's to set the cost of capital at a level that ensures continued investment in the sector.*"[31]

2.3.13 In light of all of the above, YWS appreciates the CMA's recognition at the Roundtable that *"there is a lot at stake*" in relation to WACC.[32] Given the highly significant and wide-reaching impacts of the CMA's Final Determination, it is therefore critical that the CMA ensures that

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27 GIIA, WACC WPs Response, page 2. The NIC strategy paper states "*the government remains strongly committed to supporting private investment and maintaining the UK's status as a leading global destination for private investment*" – HM Treasury, National Infrastructure Strategy, (November 2020), see link.

28 Office for Investment, (November 2020), see link.

29 GIIA, WACC WPs Response, pages 1-2.

30 GIIA, WACC WPs Response, page 5.

31 GIIA, WACC WPs Response, page 3 (emphasis added). Moreover, GIIA writes that, while investors have hitherto been supportive of the Net Zero initiative (on the premise that the CMA's redetermination would improve upon the WACC and cost of debt levels in Ofwat's FD, providing sufficient incentives to encourage investment), "*if the CMA's final decision on the WACC remains at the level implied in the two working papers, then we understand that investors are unlikely to be able to support these enhanced levels of investment.*"

32 See following extract of Kip Meek's closing remarks from Cost of Capital Hearing Transcript (20 January 2021): "*We will of course consider any such submissions alongside all the evidence in argument that has been submitted before reaching a decision. I recognise there is a lot at stake here. We all recognise that out [sic] duty is to look after customers. To come to a decision that answers all the considerations that have been raised today and that reflects the consumer interest*" (pages 154-155).

conscientious consideration is given to these submissions on financeability and the balance of risk and return before making its final decision.

3. The detrimental impact of the CMA's most recent provisional decisions

3.1 The detrimental impact of the CMA's provisional decisions in the WACC Working Papers

3.1.1 YWS has set out its detailed comments and concerns regarding the CMA's WACC Working Papers in its WACC Consultation Response. In particular, YWS noted its concerns regarding the lack of an economic rationale for the CMA's point estimate of the cost of debt, and hence WACC, and that therefore it would not be possible for the notional financeability cross-check to confirm that the CMA's point estimate for WACC would be consistent with a strong investment grade rating of Baa1/BBB+.[33]

3.1.2 If the CMA does not address these concerns in its Final Determination, then YWS considers the CMA's benchmark would not represent a realistic characterisation of the mix of debt for an efficiently-financed company, and would create perverse incentives (and additional refinancing risk for companies and customers) as it would encourage the issuance of shorter-tenor debt.

3.1.3 In addition, YWS has reviewed Ofwat's Final Response to the WACC Working Papers in detail and, in **Annex 1** to this response, YWS sets out its key observations on the errors in Ofwat's submissions on the cost of debt. YWS would like to draw the CMA's attention to the following main observations in particular:

(a) it is not possible to reconcile Ofwat's views on a 15-year collapsing average with the water sector's debt profile, nor to understand Ofwat's assertion that regulatory design will not impact future tenor at issuance;

(b) Ofwat seeks to justify the stranding of pre-2009 debt with a retrospective view of market conditions and by normalising supposed distortions without adequate evidence;

(c) Ofwat persists in failing to take into account that the majority of debt raised by higher-geared water companies has been at

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33 YWS, Final Response to WACC Working Papers (27 January 2021), paragraph 2.1.9.

ratings of Baa1 or higher, and continues to assert incorrectly that the notional company cost of debt should be lower than the sector average; and

(d) YWS has noted a number of points concerning Ofwat's analysis and supporting evidence, which raise serious doubts as to the soundness of Ofwat's conclusions when considered against APR data and water companies' performance in raising debt.

3.1.4 In contrast to these material flaws in Ofwat's submissions, YWS provided the CMA with an improved methodology in its WACC Consultation Response which was an improvement on that in the WACC Working Papers in that it captures an expanded range of debt instruments and also passes a cross-check to the actual industry cost of debt.[34] YWS considers that this approach, together with a more appropriate 20-year lookback period, would result in a more representative notional cost of debt that would ultimately be in the interests of both companies and their customers.

3.2 Monte Carlo Analysis

3.2.1 In its WACC Working Papers, the two most material changes consulted on by the CMA (relative to the position in the PFs) relate to a reduction in the WACC and a reduction in the leakage funding. Specifically, the CMA has proposed:

(a) a reduction of 0.3% to the WACC; and

(b) a reduction of £65.10 million to YWS's leakage funding allowance.

3.2.2 YWS provided an updated Monte Carlo analysis in its WACC Consultation Response that overlaid the changes consulted on by the CMA in the WACC Working Papers.[35] This analysis showed that YWS is highly unlikely to be notionally financeable if the position in the WACC Working Papers flows through to the Final Determination (noting that the same analysis previously undertaken in relation to the PFs showed that YWS <u>was</u> notionally financeable, albeit with little headroom).

3.2.3 YWS has undertaken further analysis, specifically to examine the impact of the reduction in each of the WACC and allowed costs for leakage in isolation. This analysis shows that both have a broadly similar impact on

34 YWS, Final Response to WACC Working Papers (27 January 2021), section 3.

35 Annex 01 (YWS, Final Response to WACC Working Papers): Economic Insight, 'Financeability of the notionally efficient firm: a bottom up analysis. Update to reflect CMA working papers' (27 January 2021).

YWS's financeability, with the impact of the reduction in the WACC being marginally greater than the impact of reduced leakage funding. Specifically, relative to a modelled RoRE of 3.88% associated with the CMA's PFs (which YWS considered <u>was</u> consistent with it being financeable on a notional basis), the updated Monte Carlo analysis associated with the CMA's WACC Working Papers shows:

(a) a RoRE of just 3.56%, if the WACC reduction is modelled in isolation; and

(b) a RoRE of 3.58%, if the reduction in leakage funding is modelled in isolation.

3.2.4 Two key points follow from this:

(a) Firstly, both the WACC and leakage funding are material to the overall balance of risk of the package. Therefore, should the CMA adopt the position in the WACC Working Papers, it is highly unlikely that YWS will be notionally financeable.

(b) Secondly, because the WACC (by definition) is set with respect to the notional firm, the fundamental problem under the CMA's WACC Working Papers is one of notional financeability. That is to say, even if the CMA retains its view that an element of the funding gap on leakage is due to inefficiency, YWS will remain unfinanceable on a notional basis, because of the unduly low WACC.

3.3 The detrimental impact of provisional decisions in other areas of the redetermination

3.3.1 In addition to the WACC Working Papers, the positions adopted in the 2019/20 Data Working Paper and the Leakage Working Paper are also detrimental to YWS being financeable on a notional basis, compounding other adverse features of the PFs.

2019/20 Data Working Paper

3.3.2 YWS strongly disagrees with the CMA's proposal to not take into account the 2019/20 data and considers the 2019/20 Data Working Paper to be one-sided. The justification for excluding the 2019/20 data from the base cost models relies on an unevidenced notion that there has been material base expenditure brought forward from AMP7 into AMP6. The position is compounded by the complete lack of robust assessment of (i) the suitability of data in other years that appear atypical (e.g. lower activity ones); (ii) the downward bias resulting from the omission, as well as from disregarding a full AMP performance; and (iii) alternative ways of mitigating these issues. The CMA has also given no indication as to whether it will continue to use the 2019/20 data to set the service performance targets and, if so, how it intends to address the inconsistency and disconnect between service targets and their related costs. Omitting the 2019/20 data results in a material and quantifiable bias in YWS's cost allowance and an inherent inconsistency with its service commitments.

3.3.3 YWS therefore reiterates its request that the CMA include the 2019/20 data in its base cost models.

Leakage Working Paper

3.3.4 The CMA has correctly identified that the step-change from AMP6's leakage targets (based in the Sustainable Economic Level of Leakage (**SELL**)), to AMP7's targets (which go far beyond those levels), requires enhancement funding. YWS agrees with the CMA's view expressed in the Leakage Working Paper that the full reduction in leakage (47Ml/d) should be funded.[36]

3.3.5 However, as YWS has expressed in its response to the Leakage Working Paper, the CMA has reached an incorrect conclusion on the level of enhancement funding attributable to YWS's leakage reductions, as a result of its failure to assess YWS's evidence correctly.[37] As detailed there, the use of an assumed industry upper quartile unit cost and the inconsistent and deficient analysis of YWS's evidence has led to a mistaken conclusion that YWS's enhancement claim was too high.

3.3.6 YWS does not consider that Ofwat's response to Q11 of RFI033 presents any new evidence in support of its position. However, YWS would remind the CMA that it has submitted extensive evidence in its submissions throughout this redetermination[38] to support the view that its base costs are insufficient to deliver its AMP7 Performance Commitments, which greatly exceed the SELL. While YWS does not wish to restate those points

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36 YWS, Response to Ofwat's Reply to the PFs (16 November 2020), page 75 and Table 2.

37 YWS, Response to Leakage Working Paper (25 January 2021), page 3.

38 See, for example: YWS, SoC (2 April 2020), paragraphs 32-35; YWS, Reply to Ofwat's PFs Response (16 November 2020), paragraphs 4.26-4.27; Annex 11 (YWS, Response to Ofwat's Reply): Oxera, 'Addressing Ofwat's Response to Yorkshire Water Services' Statement of Case' (26 May 2020); YWS Response to RFI012, page 1; YWS PFs Response (27 October 2020), paragraph 6.7.1; YWS Reply to Ofwat's PFs Response (16 November 2020), paragraph 5.3; YWS response to RFI018A, page 1; YWS response to RFI020, page 1.

here, it trusts that Ofwat's response to RFI033 will be read together with YWS's representations on this issue.

3.3.7 On a proper evaluation of the facts and evidence, the CMA should grant YWS's enhancement claim of £94.7m and YWS requests that it does so.

Other detrimental provisional decisions

3.3.8 As the CMA is aware from YWS's submissions since the PFs, there are other areas where the CMA's PFs would increase the downside risks in the CMA's overall package. Two significant examples include YWS's extensive WINEP programme, which in the PFs remains significantly underfunded,[39] and YWS's internal sewer flooding Performance Commitment, which is unfunded and will result in significant penalty.[40] YWS is disappointed that the CMA has not undertaken further consideration of these important areas by producing working papers. In addition to the impact on overall financeability, YWS would also point to the dangerous precedents created by the underfunding of (i) statutory programmes and (ii) required step-changes in performance, respectively.

[39] YWS, PFs Response (27 October 2020), paragraph 5.2.

[40] YWS, PFs Response (27 October 2020), paragraph 6.8.

Annex 1: YWS response to Ofwat statements on cost of debt from the WACC Consultation

Issue	Comment in Ofwat's Final Response to WACC Working Papers	YWS's observations
Use of a 15-year collapsing average	"It is a reasonable expectation that we would continue to use a 15 year trailing average as the starting point for our assessment at PR24 (and would need a good reason to change)." [Para 3.6]	This statement perfectly captures why YWS is concerned with the CMA's proposed 15-year collapsing average. Ofwat is saying here that it will start from the position that its base case allowance for PR24 need contain no recognition of pre-2010 interest costs and gradually lose all memory of pre-2015 interest rates. It is impossible to reconcile Ofwat's statement with the £ billions of pre-2010 and pre-2015 debt that the industry will be taking into the AMP8 period. In light of Ofwat's position, YWS impresses on the CMA that its benchmark must genuinely be a benchmark – i.e. a realistic characterisation of the mix of debt that an efficiently financed company would take into each regulatory period – given the precedential value of its Final Determination.
	"Neither would we agree with the general principle that average tenor-at-issuance above 10 years, but lower than historical levels, should be viewed with concern." [Para 3.10]	YWS would be surprised if the CMA were to share Ofwat's indifference to the impact that regulatory design has on the tenor of debt that companies issue. It is not in customers' interests for regulation to incentivise companies to issue shorter-term debt and to expose both customers and shareholders to higher refinancing risks.
	"The median [tenor-at-issuance] of all the years in the 2000-2020 period from Figure 3.1 is 16.8 years." [Para 3.16]	Ofwat's proposed median of 16.8 years is the median of the 20 data annual points in Figure 3.1. YWS's analysis is that the median tenor-at-issuance of the actual underlying bonds is significantly greater than 20 years. This discrepancy comes about because companies issued more debt in some years (especially during the years when debt was issued with longer tenors) and less debt in other years (especially during the years when debt was typically issued with shorter tenors).

Issue	Comment in Ofwat's Final Response to WACC Working Papers	YWS's observations
		YWS also notes that Ofwat's analysis includes all bonds issued across the period, even those that have already matured and been refinanced. This results in shorter tenor debt being counted multiple times, skewing average data downwards.
	"… the simple average is clearly distorted by the ultra-high tenor issuance in 2005-2008 - likely due to a period of historically atypical yield curve inversion." [Para 3.16]	YWS does not agree that historical tenor-at-issuance is "distorted" by borrowing from the period 2005-08. Rather than characterise 2005-08 debt as an anomaly that can be normalised away, the £12 billion of long-tenor debt issued in this period is a key plank in the industry's efficient financing mix. The CMA should not strand efficiently incurred pre-2009 debt costs via the use of a 15-year collapsing average.
	"A 15 year trail represents an evolutionary change from the 10 years used at PR14 that fairly balances the interests of companies with longer and shorter refinancing cycles." [Para 3.16] "At the roundtable, the company side characterised the use of a 15 year trailing average as being 'retrospective' by disallowing a significant amount of debt that was previously allowed in price reviews and deemed efficiently-incurred. This is at best misleading." [Para 3.18]	A brand new regulatory design that gradually loses all memory of pre-2009 interest rates is not an evolutionary change from Ofwat's PR14 approach. There is no reason why the CMA or Ofwat should strand efficiently incurred pre-2009 long-term debt.
	"Figure 3.2 breaks down the proportion of outstanding GBP-denominated bond issuance into control period of issuance." [Para 3.20]	YWS notes Figure 3.2 shows that more than half of the industry's embedded debt was originally issued by companies before 2010. It is therefore clear that the CMA's proposed 15-year collapsing average does not give a realistic characterisation of the mix of debt within the sector.

Issue	Comment in Ofwat's Final Response to WACC Working Papers	YWS's observations
	"Wessex Water has a nominal interest rate of 4.02%, but 34% of its outstanding GBP-denominated bond debt is from 2000-05, compared with 26% for Anglian and 11% for Yorkshire Water. In other respects Wessex Water has characteristics similar to the notional company." [Para 3.21]	Ofwat continues to suggest that variances in reported interest rates are due to high gearing, but has not supported these claims with any evidence. Figure 3.2 does not reflect the full portfolio of company debt, and YWS notes that iBoxx rates have fluctuated significantly within the 5-year periods; therefore, it is not possible to draw the conclusions that Ofwat seeks to make. YWS notes Ofwat has proved nothing by selectively picking one company out of 17. Wessex Water has a number of characteristics that are not similar to the notional company and that specifically contribute to its lower cost of debt, such as: • all of its debt has been raised at an A3 rating; and • it has a high proportion of EIB debt.
Actual industry cost of debt	"We summarise below in table 3.1 the various exercises that use robustly-sourced data to calculate reference points for the efficient cost of debt, using actual cost data." [Para 3.22]	The range formed by Ofwat's various WaSC median figures is 4.34% to 4.73%. (NB: As YWS has previously explained, the median provides the best proxy for the 'typical' company in the sector.[41]) These figures should be adjusted upwards for the following factors: - the inclusion of large WoCs within the median dataset; - the 5-10 bps uplift that the CMA identifies in paragraph 168 of its Cost of Debt Working Paper; - exclusion of all liquidity / revolving credit facilities that are covered by the CMA's separate 10 bps liquidity allowance; and

[41] YWS, Final Response to WACC Working Papers (27 January 2021), Paper 2(A), paragraphs 4.1.3(b) and 4.2.1.

Issue	Comment in Ofwat's Final Response to WACC Working Papers	YWS's observations
		- reinstatement of inflation swap costs, on the basis that inflation swaps are simply a tool that companies use to create synthetic index-linked debt. YWS also notes that the 4.34% figure at the bottom of Ofwat's range has not been adjusted for inflation. Correcting for inflation would increase the median to 4.63%. YWS has not had access to all of the data that would enable it to make the required adjustments to Ofwat's range. However, YWS is confident that its proposed cost of embedded debt allowance of 4.82% will fall within a properly calibrated cross-check range. YWS therefore considers that Ofwat's Table 3.1 calculations support the proposed composite benchmark design that YWS proposed in YWS's Final Response to WACC Working Papers (see Paper 2(A): The Cost of Embedded Debt – **Paper 2(A)**).
	"We include 'Floating-adjusted' APR-led approach – sensitivity 2' as disputing companies suggest data as at 31 March 2020 is unduly influenced by company use of revolving credit facilities to address Covid-19 liquidity risks. In fact, the underlying data suggests that in each of the years, floating rate debt has averaged more than 10% of total debt issued by water and sewerage companies." [Para 3.22]	As previously noted,[42] YWS considers that the adjustment for liquidity / revolving credit facilities needs to extend beyond an adjustment for the exceptional March 2020 COVID-related drawdowns to include all of the regular drawdowns that companies make of their credit facilities in normal times. These standing facilities constitute a significant proportion of the 10% of "floating-rate debt" that Ofwat cites. For example, YWS has explained previously that it had £325m of drawn liquidity facilities as at 31 March 2019.[43] The CMA can safely assume that many other companies will have been in a similar position and that the 10% figure therefore significantly overstates the amount of RCV that is financed by floating-rate debt instruments.

[42] YWS, Final Response to WACC Working Papers (27 January 2021), Paper 2(A), paragraphs 4.2.7 – 4.2.8.

[43] YWS, Final Response to WACC Working Papers (27 January 2021), Paper 2(A), paragraph 4.2.7.

Issue	Comment in Ofwat's Final Response to WACC Working Papers	YWS's observations
		YWS also notes that, within this approach, Ofwat has failed to adjust for the CMA's inflation assumptions. Correcting for inflation results in a WaSC median of 4.63%, significantly higher than the 4.34% Ofwat presents.
	"We estimate that swap costs inflate the average WaSC cost of debt benchmark by around 20-30bps." [Para 3.24]	YWS does not agree that swap costs "inflate" the industry average cost of debt. YWS has explained previously that inflation swaps simply provide a means of creating index-linked debt by synthetic means.[44] The cost of these swaps ought therefore to be included in any actual cost of debt calculation in an exactly analogous way to the cost of regular index-linked debt, even if such financing happens to now have an all-in cost of debt that is different from fixed-rate debt.
	"...using interest rates implied by yield-at-issuance rather than coupon rates lowered the average interest cost of our outstanding bond sample by 8bps." [Para 3.24]	YWS does not recognise this analysis. YWS's examination of its own debt confirms that yield at issue was, on average, higher than the coupon.
	"The weighted-average cost of debt reflects sector gearing of 70%, vs. the notional assumption of 60%. Gearing is a known driver of risk and hence higher yield, as recognised e.g. by credit rating agencies." [Para 3.24]	YWS has explained previously that rating, not gearing, is the primary driver of interest costs.[45] The vast majority of debt issued by higher geared companies had a credit rating of Baa1 or higher at issuance.

[44] See, for example: YWS, SoC, paragraph 230; YWS, Reply to Ofwat's PFs Response (16 November 2020), paragraph 2.18.19 and Annex 7, Centrus, Yorkshire Water Debt Portfolio Review (May 2020).

[45] See, for example: YWS, Initial Response to WACC Working Papers (18 January 2021), paragraph 3(e)(ii); YWS, Post-Hearing Submission (17 December 2020), paragraph 2.3.5(b)(ii) and Annex 07 (Reply to Ofwat's Response), Centrus, Yorkshire Water Debt Portfolio Review (May 2020).

Issue	Comment in Ofwat's Final Response to WACC Working Papers	YWS's observations
		More generally, YWS notes that Ofwat has stated to the contrary elsewhere in its submissions that actual industry debt is, if anything, skewed towards the top of an A to BBB range.[46]
	"In practice floating rate debt tends to be priced at a margin above LIBOR. We propose that a conservative assumption would be 6 month LIBOR + 100bps" [Para 3.24]	YWS does not agree with Ofwat's unevidenced view. At the point of issue there is theoretically no reason why the cost of a fixed rate bond should be materially different to an equivalent floating rate bond. On this basis, YWS supports the CMA's use of a 6-month trailing benchmark iBoxx index rate of 2.53%.
Floating rate and EIB debt	"Given that all but one of the companies have a share of floating-rate borrowings and that the March 2020 sector average was around 15%, it seems reasonable to reflect this widely-held instrument in both index-led and balance sheet-led benchmarks." [Para 3.27]	YWS agrees that it is appropriate to recognise the cost of floating-rate debt within an expanded composite cost of debt benchmark. However, Ofwat is overstating the weight that such debt should be given for the reasons set out under previous row headings above. YWS considers that the correct weight for floating-rate debt after excluding all liquidity facilities and outliers is no higher than 6%.
	The company side has criticised the CMA's suggestion that an appropriate 'matching adjustment' to the 20 year collapsing trailing average would be around 40bps to reflect EIB and floating rate debt. It was proposed that the maximum defensible adjustment would be 20bps, based on their own analysis.	YWS disagrees with the concept of a "matching adjustment". However, YWS provided the CMA with its calculations of the effective adjustment that the CMA should be looking to make to an iBoxx-only benchmark (i.e., 13 basis points) in Paper 2(A) of the Final Response to WACC Working Papers, having previously provided the CMA with a very similar calculation in December 2020 following YWS's post-PFs hearing.[47]

[46] See, for example: Ofwat, 'Initial response to Cost of Capital Working Papers' (18 January 2021), paragraph 3.11.

[47] YWS, Post-Hearing Submission (17 December 2020), Annex 1.

Issue	Comment in Ofwat's Final Response to WACC Working Papers	YWS's observations
	Despite requesting it on 20 January 2021, companies have not yet shared this analysis with us." [Paras 3.28-3.29]	
	"Irrespective of its merit however, the matching adjustment should consider factors more widely than the impact of these two types of debt." [Para 3.29]	YWS agrees with this statement. YWS notes, in particular, that it is necessary to make allowance for the higher all-in cost of pre-2012 index-linked debt vs pre-2012 fixed-rate debt following the unexpected shift up in RPI inflation in 2011 – see Paper 2(A) of the Final Response to WACC Working Papers.
Cost of new debt allowance	"In our initial response to the cost of capital working papers, we referenced bonds issued by companies with credit ratings that are comparable to that assumed for the notional structure, since our final determinations. These eight instruments suggest consistent outperformance in a range from 13-40bps after controlling for tenor and credit rating… We note even more striking outperformance from the issue of £300m of fixed-rate bonds yielding 0.875% by United Utilities on 25 January." [Para 3.22]	YWS considers that Ofwat's analysis is selective, focussing only on Moody's ratings Moreover, it conflates one agency's view of the estimated cost of a notch (S&P), with another agency's actual rating (Moody's). Dŵr Cymru, for example, has an A rating with Fitch. Adjusting for this rating would result in underperformance. Ofwat's analysis also incorrectly uses Moody's corporate family rating (CFR), rather than the appropriate class A rating for the debt issued. • Thames Water, for example, has a Baa1 class A rating. Adjusting for Ofwat's error shows outperformance of only 4bp on their 20-year bond. • Anglian Water, for example, has an A3 class A rating. Adjusting for Ofwat's error would result in underperformance of 11 bps. YWS also notes that the recent UU bond issued at 0.875% was issued at an A3 rating with tenor of 8 years; therefore significant outperformance would be expected reflecting the higher rating and short tenor. YWS remains of the view that the Thames Water 20-year bond issued at Baa1 provides the cleanest comparison to the notional benchmark. This demonstrates immaterial outperformance of c4 bps.

Issue	Comment in Ofwat's Final Response to WACC Working Papers	YWS's observations
Share of new debt	"Under the specific scenario of debt issued at a constant rate each year, with identical tenors, and over a period of time equal to the tenor, we agree that average tenor at issuance will be twice the weighted-average years to maturity. This is not, however, the case for the water sector's actual issuance, given the range of different tenors and variable rate of sector issuance. Average tenor-at-issuance cannot therefore be safely assumed to be double the weighted-average years-to-maturity" [Para 3.35]	YWS agrees that, in reality, it will not be the case that debt is split exactly 50:50 around the average number of years to maturity. The 50:50 split is a rough approximation. However, this should not detract from the point that YWS has been making since October 2020[48]: namely that it is an outright error to assume that all of a company's debt will have matured once the average number of years to maturity expires. YWS notes that Ofwat makes no defence of its faulty N=T/M formula.
	"In terms of the contribution of RCV growth, we consider that the CMA's addition of 3.9% to the end-of-period 33% may be an underestimate of the appropriate figure." [Para 3.37]	YWS notes that 3.9% was the figure originally provided by Ofwat. YWS has also identified two errors within Ofwat's analysis in Table 3.2, which overstates the proportion of new debt: • Ofwat has double counted the impact of RCV growth in lines D and G; and • Ofwat's calculations do not reflect the impact of accretion on existing index-linked debt Ofwat's calculations also do not reflect the impact of notional gearing reducing from 62.5% to 60.0%. YWS has also highlighted within Paper 2(B) of its Final Response to WACC Working Papers (**Paper 2(B)**) that actual Business Plan data, updated for the lower cost allowances within Ofwat's FD, showed a range for the new debt proportion of 12% to 15%.

[48] See, for example: YWS, Final Response to WACC Working Papers (27 January 2021), Paper 2(B): Proportions of New Debt and Embedded Debt); YWS, Preliminary Response to WACC Working Papers (13 January 2021); and YWS, PFs Response (27 October 2020), Table 1.

Issue	Comment in Ofwat's Final Response to WACC Working Papers	YWS's observations
	"The CMA voiced interest in understanding whether weight should be placed on point estimates of the new debt share implied by company forecasts. We concluded for PR19 final determinations that this data implied a 15% average share of new debt and have shared this calculation with companies as part of the query process. We note from the timing of companies' revised business plan data (which were submitted in April 2019) that forecasts of debt issuance would have been influenced by our provisional decisions on allowed totex for our initial assessment of plans in January 2019. At our initial assessment of plans stage, we allowed £48.8bn, while at final determinations, this figure increased to £49.7bn. This indicates that company forecast debt issuance profiles based on the former figure may understate companies' plans to issue new debt over 2020-25." [Para 3.39]	As noted during the Roundtable,[49] Ofwat is incorrectly comparing FD totex allowances to its IAP allowance. The data is taken from company Business Plans which are based on companies' totex submissions, not the IAP allowance. YWS highlighted in Paper 2(B) of its Final Response to WACC Working Papers that companies' revised Business Plans of April 2019 proposed significantly higher levels of totex than Ofwat went on to include in its FD. This resulted in an overstatement of new debt issuance in AMP7. Please see Table 3 in Paper 2(B) of YWS's Final Response to WACC Working Papers.

[49] CMA, Cost of Capital Roundtable Transcript (20 January), pages 41-42.