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Kirstin Baker
Chair
Special Reference Group – Water PR24 Price Redeterminations
Competition and Markets Authority

By email: waterPR24references@cma.gov.uk

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Dear Kirstin

I am writing in response to the invitation for submissions from third parties on the issues raised in the Ofwat references to the CMA and the subsequent statements of case of the five disputing companies.

Yorkshire Water is a water and sewerage company regulated by Ofwat. We supply 5 million people within 2.3 million homes. Our region is large, spanning West Yorkshire, South Yorkshire, the East Riding of Yorkshire, part of North Lincolnshire, the majority of North Yorkshire and parts of Derbyshire. Our vision is to create a thriving Yorkshire, right for customers and right for the environment.

On 18th February 2025, Yorkshire Water informed Ofwat that it would not be requesting a referral to the CMA of its PR24 final determination issued on 19th December 2024. This came after extensive deliberations by the Yorkshire Water Board (the Board).

The Board's decision not to seek a redetermination by the CMA was a finely balanced one as the Board was not satisfied with several key elements of Ofwat's process and final determination. The Board's decision was taken in the round and was not on the basis that there was an overall endorsement or acceptance of Ofwat's approach.

In particular, the Board considered that Ofwat's allowed return for AMP8 was wholly inadequate given the level of risk the company faces. There was broad agreement amongst Board members that they may have supported a referral to the CMA in respect of Ofwat's allowed cost of capital if the water sector had the same tailored appeals framework that exists in other regulated sectors.

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As you are aware, we sought a redetermination at PR19 and as such we are acutely aware of the disruption and management attention involved in such a review. It was the view of the Board that, on balance, the uncertainty associated with the redetermination process meant it would be better for the business to focus immediately on delivering its investment programme for AMP8 and the associated service and environmental improvements for our customers.

This does not mean that we accept all of the arguments used by Ofwat in reaching its decisions on the allowances which Yorkshire Water should receive. Indeed, if the PR24 framework were to be repeated at PR29, we have no confidence that it would lead to an acceptable outcome for Yorkshire Water or our consumers. We hope that the CMA proposes workable solutions to the issues raised at PR24 such that the same issues are not repeated, thereby avoiding costly appeals in future.

Basis of this Response

We are responding to this call for third party views as we believe that the CMA has an opportunity to address some of the flaws with Ofwat's PR24 approach as part of the ongoing redeterminations. The CMA is in a position to make recommendations and changes that should shape Ofwat's approach on certain issues both within AMP8 and at the next price review.

We have several wider concerns, beyond PR24 that we will be raising separately in our response to the recent call for evidence by the Independent Water Commission into the water regulatory framework being led by Sir Jon Cunliffe. The remainder of this letter focuses on areas raised in companies' statements of case where we had particular concerns throughout the PR24 process and at final determination, and where we believe issues were not fully resolved.

Investability

Ensuring the water sector is attractive to investors is crucial to delivering the service and environmental outcomes expected by our customers, and for the industry to comply with its legal obligations.

We had significant concerns with the approach taken by Ofwat at final determination, particularly related to its approach to assessing the baseline returns for investors (WACC) but also in the balance of risk and return around this baseline which is skewed to the downside for AMP8.

Despite an aiming up element on cost of capital, the equity return on offer to investors is only marginally above other types of asset classes with far lower risks, such as investment grade corporate bonds. Yet, the potential return carries significant downside risk given the significant uncertainty around the large enhancement programmes, challenging performance commitments and related potential penalties, together with Ofwat's measures to restrict dividends, and the clear rise in reputational risk for those operating in the sector in the UK.

We would welcome the panel recognising that the equity return on offer in Ofwat's final determination does not reflect current market returns or the risk that investors are exposed to and providing recommendations to the extent it is able to.

Asset Health

Asset health is a pressing issue within the industry, and we echo the concerns made in the statements of case from the disputing companies that PR24 does not provide for sufficient investment to enable the industry to begin addressing this.

a) The base cost models do not account for the sustainable level of capital maintenance required to maintain asset health across the industry.

   The models are based on historic expenditure and do not wholly account for underlying drivers of maintenance expenditure. As set out in companies' statements of case, the sector has not been able to secure the allowance to replace assets at the required rate to maintain long-term asset health and resilience and therefore this historic approach is not reflective of future needs. The starting point of these models has not been demonstrated by Ofwat to be in steady state. Indeed the introduction of the econometric models came at a time when companies were incentivised to maintain or improve service performance whilst reducing bills, which led many companies to postpone maintenance activity which was not considered to be time-critical and focus on other issues in the consumer interest.

   Whilst base expenditure has increased over time, (companies have been overspending base allowances set at PR19) this has predominantly been to deal with other factors rather than investing in asset health. Base increases have been due to above-inflation changes to inputs (such as energy/materials), operating and maintaining the additional assets associated with previous enhancements and most importantly driving the additional service improvements required through the stretching performance commitment targets that Ofwat has assumed can be achieved through base.

   Base expenditure has been focused on these issues, essentially delivering core services, compliance and minimising penalties rather than proactively investing in capital maintenance.

b) Where Ofwat's final determination did recognise additional need for investment, and made cost adjustment allowances (mains repairs / meter replacements) it has made incorrect assumptions on what has been funded previously, and what could reasonably be considered 'implicit' in the base cost allowances (which were incredibly stretching in the first place resulting in companies outspending them).

Under its Totex and Outcomes regime Ofwat gave companies a set of performance commitments and Totex allowances, incentivising companies to achieve the targets within those allowances. It is now retrospectively assigning output expectations, that were not set at the time, to these allowances.

We recognise that the base models contain some implicit funding for asset replacement, in that capital maintenance is part of historic expenditure. However, in the case of mains renewals, Ofwat's decision on what is implicitly funded is incorrect. The base model allowances were developed using the upper quartile efficient company over the last five years and hence only reflect the rates of replacement during that period (our plan calculated this at 0.2% per annum up to 2022/23).

With little justification, Ofwat also refused to update its analysis to reflect the latest available data (despite including it in the base models) which would have reduced this implicit rate further (and thereby permitted additional allowance for companies to achieve the target rate).

c) The adjustments made at PR24 were limited to an isolated set of asset health requirements (namely, water mains replacement) and ignored other critical assets, even though the maintenance funding for these assets suffers from the same issues. The final determination sets out a roadmap for Ofwat activity beginning in 2025 to develop a sector understanding of asset health for a range of asset classes. We are engaging fully with this process and believe it has the potential to deliver some improvements in AMP8 and for the PR29 process. However, it does not provide companies with confidence that the required additional investment will be forthcoming or that the errors made in assessing mains replacement allowances will not be repeated.

   There was significant evidence provided by companies at PR24 that investment is needed now (for example our cost adjustment claim for water non-infrastructure assets) and we agree with the position taken by the companies seeking a determination, that this process could have begun 4-5 years ago.

We would encourage the CMA to reconsider the above during the ongoing redetermination process, and make clear recommendations to Ofwat on how these issues should be addressed through its framework for Enhancing Asset Health due for completion in 2026. This should include a view of what can be considered to have been funded historically, and an approach to assessing what is implicitly funded through base going forward. It is also important that Ofwat considers the practicality of delivering a significant programme of asset health work over the years to come. For example, our plan proposed starting a programme of investment in our water non-infrastructure assets in AMP8 because we wanted to deliver the work gradually to avoid supply risks associated with concentrated delivery of the same work.

Frontier Shift Efficiency

Frontier shift efficiency is intended to capture the rate of efficiency improvements that the most efficient companies in the industry can achieve from improvements in operational activity and new technology. Ofwat has set a frontier shift efficiency of 1% per annum at PR24 which is applied as a reduction on base and enhancement allowances.

We support the comments made in the respective statement of case documents that Ofwat's frontier shift efficiency assumption is unreasonable. We set ourselves a challenging 0.7% assumption in our PR24 business plan which was at the upper end of the 'plausible range' set out by Economic Insight in its independent report to the water industry. This report has been updated and provided to the CMA.

Ofwat's approach is flawed for several reasons:

a) A similar assumption has been made in the previous price reviews and not materialised for the industry, despite the financial penalties companies face if they fail to deliver productivity improvements.
b) UK-wide productivity growth has been stagnant (near zero) for over a decade.
c) There is no evidence that UK-wide productivity is likely to grow over the next five years or that the water sector can materially outperform the wider economy
d) Step changes in service levels, at no extra cost also imply efficiency improvements.

In relation to the final point, we note that Ofwat has allowed companies some enhancement expenditure in order to meet stretching performance commitment levels. However, Ofwat has also typically assumed that companies can deliver significant improvements in performance through base allowances, without providing evidence that such improvements are achievable. This equates to a significant, implicit efficiency challenge.

We are concerned that Ofwat and other economic regulators are using previous decisions as precedent in this area rather than engaging with the available evidence and considering the current context. We would welcome the panel reviewing the evidence independently of regulatory precedent and recommend an evidence-based process for assessing frontier shift going forward, which can be used by Ofwat at future price reviews.

Setting Performance commitment targets

The final area we would like to raise is Ofwat's approach to setting performance commitment targets. Firstly, Ofwat assumes that for several performance commitments all companies can achieve the same targets with the same cost allowances. However, simple comparisons across companies do not take into account relevant regional factors that may drive performance or customer preferences. That is, some companies may be better able to achieve stretching performance commitment levels on account of their operating environment (e.g. density, topography, climate) or historical enhancement expenditure allowances than others.

Ofwat recognises that there are differences between companies when setting cost allowances through explanatory variables and cost adjustment claims used in econometric modelling. There is, however, no recognition of the true level and extent to which companies differ. As a result, Ofwat's approach misses the fact that company-specific differences can lead to material variations in performance levels.

Without accounting for these variations, that often cannot be meaningfully addressed through investment, the resulting performance commitment levels will lead to excessive and unreasonable stretch to companies whose performance is negatively impacted by these factors and insufficiently stretching performance commitment levels to those that are not.

Secondly, our view is that cost is intrinsically linked to service, and that Ofwat has not fully developed an evidence base that links its performance commitment levels with its base cost allowances.

We worked with Oxera to set out several approaches in our draft determination representation that Ofwat could consider to assess 'what base buys'. i.e. what level of service performance companies could reasonably deliver through the base allowances. Some of the proposed approaches were simple and aligned with Ofwat's approach to estimating the post-modelling adjustments (e.g. for asset health), such that they could have been readily incorporated into the final determination, yet were not. Other approaches were more sophisticated and could better capture company-specific characteristics, thereby better addressing some of the issues raised in our first point .

https://www.yorkshirewater.com/media/0ikdb12r/yky-pr24-ddr-16-ce-oxera-cost-outcomes-disconnect-appendix-1.pdf

We would welcome the panel reviewing the cost/service link where it is raised as part of the redeterminations and to set out a view of how Ofwat can improve this area ahead of the next price review.

Summary
We acknowledge the significant movement by Ofwat between draft and final determinations for Yorkshire Water. These movements were important to our decision, in the round, not to request a referral to the CMA of our PR24 final determination.

However, we consider that it is not sustainable in the long term for Ofwat's PR24 approach to be repeated in future price reviews. We therefore welcome the CMA's independent assessment of the issues raised in this letter, and by the companies in their statement of case documents.

Together with the upcoming findings of the Independent Water Commission, this has the potential to set out a more sustainable direction for the industry, restoring investor confidence and public trust in the sector in the coming years and providing better outcomes for our customers.

Yours sincerely,

[redacted]

Tim Hawkins
Strategy & Regulation Director