

January 2016

Trust in water

Consultation on how companies should demonstrate long-term financial resilience

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About this document

This document considers the proposals of the Water Services Regulation Authority (Ofwat) about the way in which regulated water and wastewater companies should demonstrate that they are financially resilient over the longer term.

In July 2015, we consulted on our proposals for the financial monitoring framework that forms part of a suite of company monitoring tools which Ofwat has put in place.

In that consultation, one of our proposals was that regulated companies should stress test their financial plans and publish the results of those stress tests to demonstrate that they are financially resilient over the longer term. The responses to the consultation raised a number of concerns relating to the publication of that type of information. We subsequently held a number of workshops with companies and other stakeholders where we considered alternative approaches to demonstrating companies' long term financial resilience. This consultation considers an alternative approach and seeks comments from interested parties on these proposals.

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1. Responding to this consultation

We would welcome any comments on this document. Please email them to FinanceAndGovernance@ofwat.gsi.gov.uk or post them to:

Demonstrating Financial Resilience Consultation Response
Ofwat, Centre City Tower
7 Hill Street
Birmingham
B5 4UA

The closing date for this consultation is **25 February 2016**. We will publish responses to this consultation on our website at www.ofwat.gov.uk, unless you indicate that you would like your responses to remain unpublished.

Information provided in response to this consultation, including personal information, may be published or disclosed in accordance with access to information legislation – primarily the Freedom of Information Act 2000 (FoIA), the Data Protection Act 1998 and the Environmental Information Regulations 2004. If you would like the information that you provide to be treated as confidential, please be aware that, under the FoIA, there is a statutory ‘Code of Practice’ which deals, among other things, with obligations of confidence.

In view of this, it would be helpful if you could explain to us why you regard the information you have provided as confidential. If we receive a request for disclosure of the information we will take full account of your explanation, but we cannot give an assurance that we can maintain confidentiality in all circumstances. An automatic confidentiality disclaimer generated by your IT system will not, of itself, be regarded as binding on Ofwat.

2. Executive summary

Our vision for the water sector in England and Wales is one where customers, the environment and wider society have trust and confidence in vital public water and wastewater services. We oversee how the sector is performing and seek assurance that service providers are engaging with customers and delivering the services that they want and can afford. We also have a primary duty in respect of enabling the industry to be resilient, including financially resilient, over the longer term.

We have put in place a suite of financial monitoring tools, including the financial monitoring framework, which we consulted on in July 2015.

In that consultation we set out some initial proposals for testing the long term financial resilience of companies. We initially proposed that companies prepare and stress test forward looking projections and that they publish the results of those stress tests.

In the responses to the July 2015 consultation companies agreed with the need for these but indicated that they had significant concerns about publishing this type of data due to it being commercially confidential or even price sensitive in nature.

We have considered the feedback we have received on our initial proposals and have held workshops and discussions with companies and other stakeholders to consider other ways in which companies can demonstrate that they are financially resilient over the longer term.

This document sets out our revised proposals for how companies can demonstrate that they are financially resilient.

We continue to believe that it is appropriate for companies to undertake stress testing on their financial plans. We are not however proposing that they publish the detailed results of these stress tests. Instead we propose that companies include an explicit statement in both their statutory and regulatory accounts setting out the processes undertaken to enable Boards to make both informed decisions at year-end that companies are financially resilient and to document a robust long-term viability statement.

We are seeking stakeholders views as to whether these revised proposals, combined with the other aspects of the company and financial monitoring framework, will provide the assurance that we need that companies are financially resilient over the longer term.

We are proposing that companies should include the first statement of this type in both their statutory **and** regulatory accounts for the 2015-16 financial year.

3. Questions for consultation

Throughout this consultation we have raised a number of specific questions which we have summarised here. As well as responses to these specific questions, we welcome stakeholders' views on the issues and matters we raise in this document.

Q1 Do you agree that the proposed approach to companies demonstrating their financial resilience will provide an appropriate level of assurance about each company's long term financial resilience?

Q2 Is there anything else that we should be recommending that companies explicitly include in their statement on long term financial viability?

Q3 Are there alternative approaches to companies demonstrating their long term financial resilience that Ofwat should be considering?

4. Introduction

In July 2015 we published a consultation on our proposed [financial monitoring framework](#) which forms part of a suite of company monitoring tools which Ofwat has put in place.

In that consultation, we suggested that regulated companies stress test their business plans and publish the results of those stress tests to demonstrate that they are financially resilient over the longer term, including where appropriate looking at the tax and other financial arrangements between regulated companies and other members of the groups to which they belong.

The results of this type of stress testing reveal how sensitive companies' plans are to the financial assumptions used when preparing them. They also reveal how much financial headroom exists within companies' plans (i.e. how much would a company's financial position change before it would breach the financial covenants that are included in its borrowing documents or is unable to maintain an investment grade credit rating).

We received a number of [responses](#) to that consultation which raised concerns relating to the publication of that type of information, particularly for the listed companies. The main concerns were in relation to the commercial sensitivity of this type of information or that it could be seen to be a profit forecast which would breach the listing rules for the listed companies.

We subsequently held a number of workshops with companies and other stakeholders to gain a better understanding of their concerns relating to the original proposals and to discuss alternative approaches to demonstrating companies' long term financial resilience.

We have taken on board the responses to the financial monitoring framework consultation and the subsequent discussions that we have held with companies and other stakeholders. We still believe that it is appropriate for companies to be stress testing their forward looking plans, to demonstrate that they are financially resilient, however we acknowledge the concerns that have been raised in connection with the publication of the results of these stress tests. Therefore we do not intend to ask companies to publish detailed results from the sensitivities undertaken along with their 2015-16 Annual Performance Report (APR).

Instead we are seeking views on an alternative approach to demonstrating long term financial viability which is set out in this document and which we propose to apply from the 2015-16 APR.

5. Long Term Viability Statement

The [UK Corporate Governance Code \(September 2014\)](#) (the “Code”) – published by the Financial Reporting Council (FRC) introduced a new requirement for “Premium Listed”¹ companies for accounting periods beginning on or after 1 October 2014.

In the interest of good practice and good corporate governance we expect regulated companies to comply with the Code and follow the same reporting procedures.

For most of the regulated companies this will apply for the first time for the 2015-16 financial year, although some companies have decided to adopt it earlier.

Section C (Accountability) of the Code sets out the principle that the board of each company should “...present a **fair, balanced and understandable assessment** of the company’s position and prospects”, and paragraph C.2.1 says that “directors should confirm in the annual report that they have carried out **a robust assessment of the principal risks facing the company** – including those that would threaten its business model, future performance, solvency or liquidity – describe those risks and explain how they are being managed or mitigated”.

Paragraph C.2.2 goes on to state that: “Taking account of the company’s current position and principal risks, the directors should **explain in the annual report how they have assessed the prospects of the company, over what period they have done so and why they consider that period to be appropriate**. The directors should state whether they have a reasonable expectation that the company will be able to continue in operation and meet its liabilities as they fall due over the period of their assessment, drawing attention to any qualifications or assumptions as necessary.”

Alongside the Code, the FRC’s [Guidance on Risk Management, Internal Control and Related Financial and Business Reporting \(September 2014\)](#) (the “Guidance”) further considers the requirements of the Long Term Viability Statement and clarifies that while “reasonable expectation” does not mean certainty, the board’s assessment will need to be justified such that;

- the length of the assessment period should be determined, taking account of a number of factors, including without limitation: the board’s stewardship

Note: 1: “When admitting equity securities on the Main Market, companies have the choice of three routes to market – a Premium (formerly Primary) Listing, a Standard (formerly Secondary) Listing and an Admission via the High Growth Segment. A Premium Listing is only available to equity shares issued by trading companies and closed and open-ended investment entities. Issuers with a Premium Listing are required to meet the UK’s super-equivalent rules which are higher than the EU minimum requirements. A Premium Listing means the company is expected to meet the UK’s highest standards of regulation and corporate governance....”
Source: London Stock Exchange

responsibilities; previous statements they have made, especially in raising capital; the nature of the business and its stage of development; and its investment and planning periods. Except in rare circumstance the period of assessment should be significantly longer than 12 months from the approval of the financial statements;

- the statement should be based on a robust assessment of those risks that would threaten the business model, future performance, solvency or liquidity of the company, including its resilience to the threats to its viability posed by those risks in severe but plausible scenarios. Such an assessment should include sufficient qualitative and quantitative analysis, and be as thorough as is judged necessary to make a soundly based statement;
- the directors should consider the individual circumstances of the company in tailoring appropriate analysis best suited to its position and performance, business model, strategy and principal risks. These should be undertaken with an appropriate level of prudence.

In our view the Guidance together with the requirements of the Code, as described, for companies to document the processes which enable the board to make an informed decision at the year-end and to make a credible long-term viability statement could be used to provide stakeholders, including Ofwat, with the assurance needed that the company's management have considered the longer term viability of the company both within and beyond the then current price control period, and have satisfied themselves that each company is financially resilient and will be viable over the longer term.

In making this type of statement we would expect each company's management to:

- prepare a forward looking plan;
- to stress test that plan, using an appropriate set of sensitivities, including stating why they have selected the sensitivities that they have used;
- to make a statement about how far forward they have looked and why they consider that period to be appropriate; and,
- to outline any action that management would need to take in the event that the situations used for stress testing were to result in an unacceptable level of deterioration in the company's financial metrics.

We would not expect companies to publish the detailed results of the stress tests, however we do consider it important that companies make an explicit statement about the processes that they have followed, disclose the risks assessed and over what period and to confirm that the Board have satisfied themselves that the company is financially resilient. We also expect the assessments of financial resilience to be appropriately assured.

For most companies, we expect that the type of analysis described would be carried out as part of the regular dialogue that companies have with investors or the credit rating agencies in connection with their need to maintain an investment grade credit rating and given the new requirements of the Code we do not see this proposal as being unreasonably onerous.

We do not intend, at this point in time, to specify the scope of the stress tests or how far forward we would expect Boards to be looking when making their long term viability statement. Company Boards' will be responsible for determining the approach that they will take.

In the responses to our July 2015 consultation, companies commented that a one size fits all approach to determining appropriate sensitivities was not appropriate as each company would face a specific set of risks.

Therefore, at this stage, we propose to leave the choice of sensitivities to individual companies, but we would expect that companies provide a detailed explanation as to why they consider that the sensitivities they have selected are appropriate. We would also expect companies to select sensitivities that provide a suitable test of the key risk areas that each company faces, which is likely to include amongst other things inflation, interest rates and costs.

However, if following the publication of the first set of long term viability statements, we feel that the approach companies have taken is not suitably robust then we will consider the need to provide more prescriptive guidance in the future.

See Appendix 1 for an illustration of how the proposals might work in practice.

We are therefore asking respondents to this consultation to answer the following questions.

Q1 Do you agree that the proposed approach to companies demonstrating their financial resilience will provide an appropriate level of assurance about each company's long term financial viability?

Q2 Is there anything else that we should be recommending that companies explicitly include in their statement on long term financial viability?

Q3 Are there alternative approaches to companies demonstrating their long term financial resilience that Ofwat should be considering?

6. Looking outside the regulatory ring fence

In our consultation on the [financial monitoring framework](#) published in July 2015 we included a question about how far we should be looking outside the regulatory ring fence.

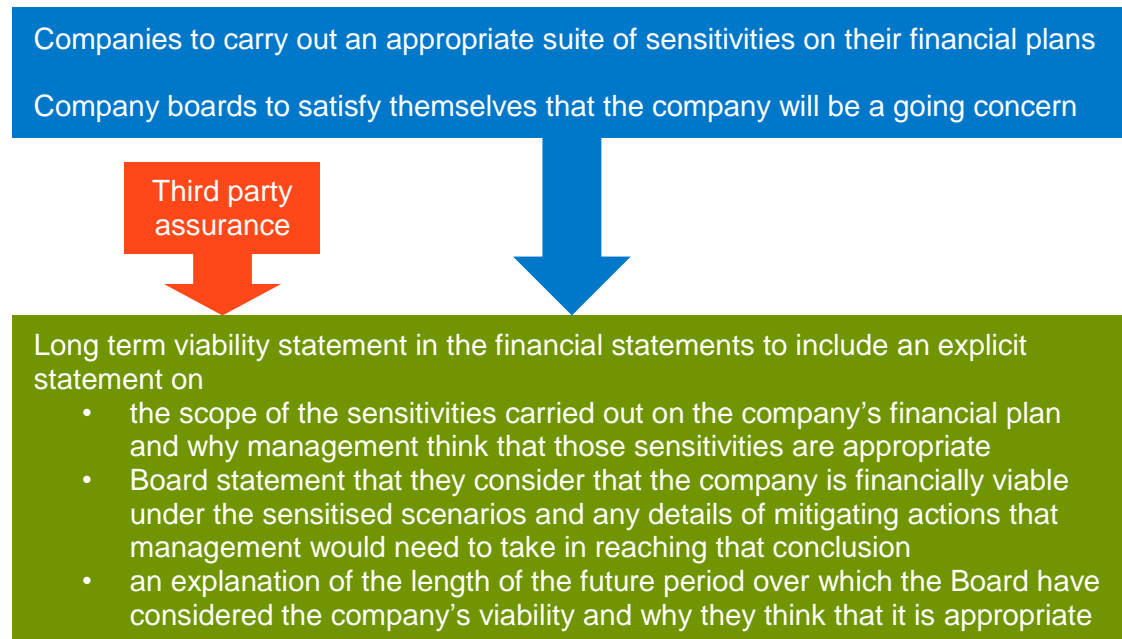
We want to clarify that we did not intend to imply that we were asking companies to provide us with full details of the long term plans for the entirety of each group to which the regulated companies belong or that we would be asking them to stress test their long term plans at group level.

We are however asking companies to provide greater transparency about their group tax structures and any intergroup financing arrangements that they have in place. The purpose of this request is to enable both Ofwat and other stakeholders to identify whether these arrangements or the activities of any other group companies are likely to have a potentially negative impact on the financial position of the regulated companies.

We discussed this with companies during the recent company workshops and have now [asked](#) for further information on companies' tax and financing arrangements as part of the APR, and have provided [additional guidance](#) concerning the disclosures we are seeking companies to make.

Appendix 1 – Illustration of long term viability statement proposals

Proposals for forward looking review



Ofwat (The Water Services Regulation Authority) is a non-ministerial government department. We regulate the water sector in England and Wales. Our vision is to be a trusted and respected regulator, working at the leading edge, challenging ourselves and others to build trust and confidence in water.

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