Financial Monitoring Framework Response
Ofwat
Centre City Tower
7 Hill St
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Dear Sirs,

Consultation on financial monitoring framework

We welcome the opportunity to respond to your publication, ‘Consultation on financial monitoring framework’.

We have structured our response into two parts. Firstly we have set out general observations in relation to the objectives of the financial monitoring framework. The second part of our response sets out our response on the questions raised in the consultation.

General observations

We note that the objectives of the financial monitoring framework, in summary, are to:

- Enhance visibility and transparency of financial and capital structures in the sector
- Enable Ofwat to monitor the financial stability of the businesses it regulates
- Enable Ofwat to identify financial or structural risks that may impact on the ability to deliver for customers
- Enable Ofwat to determine when to use regulatory tools available to intervene to protect the interests of customers

Taking these objectives in turn:

Enhance visibility and transparency of financial and capital structures in the sector

In principle we are supportive of this ambition and we agree that the provision of some financial key performance indicators (KPIs) in a tabular form may allow *“external parties without sophisticated financial resources”* to access data which may otherwise be difficult to identify within the Statutory and Regulatory Accounts.

However, we do feel that any such data should be consistent with that which is already publically available. We also think that some of the proposed measures are complex and inconsistent with the objective of engaging stakeholders without *“sophisticated financial resources”.*

Enable Ofwat to monitor the financial stability of the businesses it regulates

We are supportive of the basic concept, but question why specific requirements were not dealt with within the revised Regulatory Accounting Guidelines and the new pro-forma tables. Further, there are metrics in the new financial KPIs which we do not believe are valid or relevant to the objective (set out below).

We believe that a more targeted approach to the provision of data in addition to that provided within the already published sources may be more effective to enable Ofwat to monitor financial stability.

Enable Ofwat to identify financial or structural risks that may impact on the ability to deliver for customers

We note the consultation helpfully acknowledges that at the point of the price review there were no systemic structural risks.

Our main concern in respect of this objective is that we do not consider that the metrics requested for the financial KPIs assist in providing any further insight into financial or structural risks. The proposed metrics suggest that gearing is the only financial or structural risk contemplated, and do not take account of any of the mitigating factors that are likely to be available with covenanted structures.

Perhaps more importantly there are structural risks which one may consider equally important as gearing for which data is not being specifically collected and compared, for example:

- Unfunded pension obligations
- Excessive use of synthetic derivatives
- Interest rate swaps with mandatory breaks
- Foreign exchange exposures
- Equity volatility exposures

We think that the identification of financial and structural risks is something that rating agencies are well placed to carry out. It seems to us that this third party insight, coupled with the existing requirement for companies to notify Ofwat should they be unable to certify the availability of sufficient financial resources for at least the next 12 months, provides strong protection for customers.

We do not agree that the stress testing proposed by Ofwat will achieve the stated objective and we have significant doubts that the publication of any such data will provide meaningful insight.

Enable Ofwat to determine when to use regulatory tools available to intervene to protect the interests of customers

We assume that the intention to include the gearing levels of the principal parent company is intended to be part of the analysis for intervention. As set out earlier, we question the presumption that gearing is the primary risk. The approach ignores other HoldCo issues. One might, for example, consider that a HoldCo which had significant exposure to overseas operations may have more underlying risk than a HoldCo whose sole activity is ownership of a regulated business.

We question the value of collecting relatively limited Holdco data that is unlikely to give much insight into when to intervene.

The Enron collapse was barely predicted by anyone, despite the data available within the public domain, but more importantly had virtually no downward contagion to the water business that they owned. One might conclude that the customer protections already in place have been subjected to extreme tests and have been proven adequate.

Specific questions raised by the consultation

Q1 – Do you think that the financial metrics we are proposing to include in our pilot financial monitoring report are appropriate measures?

We consider the metrics to be included to be appropriate except as follows, where we don't agree with their use or we are unsure over the definition:

Profit after tax – Actual vs. Final Determination	We are not comfortable with this metric. We accepted a final determination for revenue "in the round", not a model which we had significant issues with, particularly around interest and tax treatments. Comparisons such as this are merely likely to reflect differences between business plans and the FD model, or intra-AMP changes made by companies in the light of better information. It is difficult to see how such a comparison could provide useful explanation to an observer without a lot of commentary from the company (also probably requiring input from Ofwat).
Funds from Operations – Actual vs. Final Determination	The definition says we should use "net cash generated from operations" as set out in Proforma 1D. We cannot find that definition, there appears to be "cash generated from operations" and "net cash generated from operating activities". We would not want to use the latter for the same reasons as above.
Accounting Gearing	We believe that this metric should only be used for reporting entities which cannot demonstrate a regulatory gearing.
Return on Regulated Equity	We believe that this is one of the more complex metrics which will have little benefit to a less sophisticated stakeholder and we would like further guidance on the definition, particularly the use of the regulatory building blocks.
RCV/Capex	We believe that this is a typographical error on the table, the definitions use RCF not RCV. We are unclear why the units are £m.
Average embedded cost of debt	We are unsure as to whether interest paid is a cash or P&L value.
Principal parent company gearing	We do not believe that accounting gearing is a reasonable measure

As a general point, we assume that all data relates to appointed activities, some definitions are clear, some are not.

Q2 – Do you think that the financial metrics we are proposing to include in our pilot financial monitoring report are appropriate measures?

Please see our answers for Q1, to the extent that they are also relevant to this question.

In addition we note that the definitions include *"analysis of financial instruments"* but the requirement to provide the information does not appear to have made it onto the table. We would have thought that in the context of other data that is being collected, its inclusion was sensible.

Further, we believe that the debt and gearing data which is being collected, to the extent it is reported, should be put into context. Accordingly we would propose that the reporting units be required to include covenant trigger and default levels. The point being that a secured covenanted structure may have a higher gearing than one which is not, but its headroom to default may be greater.

Q3 – Do you agree that the financial metric definitions set out in Appendix 2 are appropriate? Are there alternative definitions that we should be considering? If so, why?

Please see our answers for Q1, to the extent that they are also relevant to this question.

In general, we believe that to the extent that the secured covenanted structures already have a requirement to publish similar data, e.g. gearing, the definitions used in producing that assured data should be substituted for those used in Appendix 2.

We believe that this would provide consistency with other data in the public domain and better reflects the actual risk that the reporting unit is exposed to.

Q4 - Do you agree that the financial monitoring report should be published each year with additional information being requested from companies only when required, or should we be asking all companies to provide financial information to us on a more frequent basis?

We believe that the best approach would be to collect a reduced data set annually with the option to collect additional specific and relevant data based on trigger events, such as a change in credit rating status as suggested in our General comments.

We believe that this broadly correlates with the 4th paragraph of consultation chapter 5, Frequency of publication.

Q5 – The financial monitoring report will focus on the regulated companies and their holding companies, including retailers. Are there any other companies that we should be including within the financial monitoring framework?

We believe that the monitoring report should focus on the appointed business results for entities within the regulatory ring fence, extended to the secured covenanted ring fence where one exists.

Q6 – How far outside the regulatory ring fence do you think we should be looking? Should the scope of the financial monitoring framework include more information in respect of principal holding companies, the ultimate controlling parties of the regulated companies or other key shareholders?

We believe the applicable scope should be as per our answer to Q5.

We do not believe that there is any evidence that the extension of the financial monitoring framework provides any benefits to customers.

Q7 – Do you agree that we should be asking companies to carry out stress testing by way of sensitivities on their business plans, based on their actual capital structures and expenditure plans, and to publish the results?

Our concern with this proposal is the possibility that publication of results could be construed as providing forward looking market information, this is problematic for those with listed debt or equity.

As is acknowledged in the consultation, stress testing is routinely undertaken by rating agencies and we already have a licence obligation in respect of our rating.

We consider that the protection offered to customers by the licence requirement, linked to our suggestion that additional information is provided to Ofwat in the event of a credit rating change, should be sufficient to provide protection to customers.

Q8 – Are the sensitivities proposed appropriate, or should we be asking companies to apply a different set of sensitivities.

We do not believe that sensitivities should form part of the financial monitoring framework.

Yours sincerely,

Christopher Offer
Acting Director of Regulation