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anglianwater

Anglian Water Services Ltd
Lancaster House
Lancaster Way
Ermine Business Park
Huntingdon
Cambridgeshire
PE29 6YJ

Tel 01480 323906

www.anglianwater.co.uk

Keith Mason
Senior Director of Finance and Networks
Ofwat
Centre City Tower
7 Hill Street
Birmingham
B35 4UA

3 August 2015

Dear Keith

Consultation on financial monitoring framework

This letter comprises our response to Ofwat's consultation on a financial monitoring framework and your letter of 22 July 2015.

We acknowledge that Ofwat wishes to put in place a framework for monitoring the financial strength of the companies that it regulates. We are pleased that the report it proposes to publish will be based on information already published by companies without increasing the reporting burden on companies. However, we have concerns that the way in which the information is reported may be misunderstood by stakeholders. Comparisons of performance between companies and, for each company, with the performance projected by Ofwat in setting its price controls, is not straightforward. Without substantial explanation spurious conclusions might be drawn and confidence in the sector may be damaged. As an example, stakeholders may note the differences between companies in terms of gearing levels. It will be particularly important for Ofwat to describe fully the protections that securitised companies have in place in their particular financing structures.

Ofwat's proposal that we publish the findings of the proposed stress tests would require the disclosure of price sensitive projections. Financial stress testing is already performed by the ratings agencies who publish the results of their assessments for the benefit of interested stakeholders without disclosing price sensitive information.

I would also make the following broader comments on Ofwat's proposals:

Over recent years Ofwat has challenged companies to do better in explaining to stakeholders their performance and their corporate structures. We have worked hard to respond to this challenge through enhanced disclosures in our annual report and accounts and we expect to continue improving our narrative commentaries in compiling our annual performance report for 2015-16. We agree with Ofwat's position that responsibility for communicating with customers and other stakeholders lies with companies and are concerned if the proposals in this consultation mark a reversal of this policy.

In proposing this framework, Ofwat is seeking to identify companies that it deems to hold an unacceptable financial risk where it might need to intervene to protect customers. However, we are not clear what the triggers for intervention might be. Neither are we clear about how Ofwat's new approach reconciles with its long-standing policy – repeated in the consultation document – that company management retains the responsibility for determining each company's financing structure and for managing actual company performance. Ofwat has said in the past that it will not protect poorly managed companies from failure and has relatively recently tested the special administration regime that exists to protect water customers in the event of company failure.

We would be disappointed if the introduction of the financial monitoring framework were to discourage companies from introducing efficient financing arrangements, such as the one we adopted in 2002, which has resulted in lower bills for our customers for over a decade.

We attach in Appendix 1 responses to the specific questions in the consultation and, in Appendix 2, responses to the questions raised by your letter of 22 July.

Yours sincerely,

Jean Spencer

Jean Spencer
Regulation Director

Appendix 1 – Responses to specific consultation questions

Q1 *Do you think that the financial metrics we are proposing to include in our pilot financial monitoring report (see appendix 1) are appropriate measures?*

We have a general concern with the financial metrics Ofwat is proposing to include in its financial monitoring report. For the reasons set out below we know there will potentially be substantial differences between our actual performance and 'FD performance' that are unrelated to whether we are performing better or worse than was projected by Ofwat. The reporting as proposed will invite spurious conclusions and potentially unwarranted concerns.

Firstly, differences between assumptions used by Ofwat in setting price controls and calculations used by companies mean that comparisons with the FD will either be misleading or require detailed explanation. For example:

- Ofwat's financial model calculates historic cost depreciation in a very simplistic way (straight line depreciation with a single asset life for infra and non-infra assets) while actual accounting HCD is calculated for a large number of individual assets with a range of asset lives and is inevitably different. Furthermore, our actual depreciation charge in the Regulatory Accounts from 2016 will include the impact of our fixed asset revaluation, which was not accounted for in the Ofwat financial model;
- interest calculations in the Ofwat financial model are based on Ofwat's modeling and assumptions;
- the FD was calculated on a notional structure and we report on an actual basis.

Metrics that will be affected by this issue include EBIT, profit after tax and FFO. Strictly speaking there is no FD for EBIT; it simply formed part of the financial model used to set price controls.

Secondly, differences in accounting policies between companies means that comparisons might also be misleading or require detailed explanation.

We also note that a number of the proposed metrics are measures of profitability. As such, we wonder how they contribute to the objectives of a financial monitoring framework. Metrics in this category include post-tax return on capital, return on regulated equity, return on RCV, dividend cover and effective tax rate.

Finally, we stress the importance of detailed explanations and commentary within any report. For example, the report needs to describe the full set of protections securitised companies have put in place within their financial structures.

Q2 *Are there any other financial metrics that you consider should be included in the pilot financial monitoring report or that should be considered for future reports?*

No.

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?*

We have set out in our answer to question 1 some of our general concerns about the proposed metrics. Overall, we consider it would be more meaningful to concentrate accounting ratios on at the level of EBITDA and above and cash ratios for interest ratios

Below we make some further specific comments about individual metrics:

- Accounting Gearing - given the inclusion of regulatory gearing, we suggest that accounting gearing adds little or no value to users;
- Earnings Before Interest and Tax (EBIT) – Actual versus FD - for the reasons set out in our answer to question 1, we believe EBITDA would be a better comparison due to the impact of depreciation;
- Credit Rating - to allow comparability across companies and assist users of the data, we suggest that the credit rating to be used is specified, rather than at the discretion of individual companies. Of all of the proposed measures this is one of the few that has any relevance to assessing financial robustness and provides consistency across different ownership and financial structures;
- Dividend cover -to be meaningful, we suggest dividend cover is expressed using free cash flow;
- Interest cover - this should take account of net interest;
- Adjusted interest cover - the rating agencies monitor this using FD regulatory depreciation/actual net interest paid;
- RCV/Capex (should read FCF/Capex) - needs to clarify that capex should be cash capex;
- Principal parent company gearing - to be a meaningful metric, we suggest that this is calculated as net debt (of principal parent) / RCV. Guidance should be given as to the Principal parent to ensure consistency amongst companies;
- Movements through interest and opex should be adjusted to exclude non cash IAS 39 fair value movements in order to understand the underlying results.

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 agree that, so far as possible, the report should be compiled from information already published by companies without the need for additional reporting. We do not see a case for publishing a report more often than annually.

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 feel the framework should be extended to all companies who supply water and sewerage services, including small suppliers.

Q6 *How far outside the regulatory ring fence do you think that 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 think the framework should apply to the regulated entities only.

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?*

Extensive stress testing of companies' business plans is carried out by the rating agencies. We are concerned how stakeholders might interpret differences between the results of stress testing carried out to Ofwat's specifications and the ratings agencies' findings.

The ratings agencies publish their findings but do not share confidential information provided by the Companies. We oppose the proposal to require publication of the results of stress testing as the forward looking projections would be price sensitive information. It would also avoid the potential problem of conflicting with ratings agencies' findings described above.

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

We think the proposed sensitivities are appropriate.

Appendix 2 – responses to question raised by Keith Mason's letter of 22 July

What sensitivity testing you currently carry out to provide assurance on the annual statement of capital adequacy that you make to us (to comply with clause 6A.2A of Condition F of your licence) with your regulatory accounts? What is the relationship between this statement and compliance with your dividend policy?

We currently make the following assessment in the capital adequacy statement:

'The financial strength of the Company is recorded in the statutory financial statements for the year ended 31 March 2015. Cash flow projections for the forthcoming year have been prepared and subjected to sensitivity analysis using various downside scenarios. This analysis has shown that it is reasonable to believe that facilities will be sufficient for the next twelve months.'

The sensitivity analysis referred to in the above sentence is based on the sensitivities we perform for the annual dividend and the going concern board papers as discussed below:

In our annual dividend board paper we undertake sensitivity analysis, prior to our Directors taking decisions as to the level of dividend to be declared and this takes account of our forward looking credit metrics. Specifically, we confirm that against a range of credible scenarios we expect to meet our covenanted credit ratios through to the end of the AMP period, and stress to see what level RPI would need to fall to in order to cause us to breach our covenants on the basis of the proposed dividend. We reverse engineer to identify what level of RPI would cause us to breach our target levels, and make a commercial judgment on that basis.

In our semi-annual going concern board papers we review the headroom to all our financial covenants. We identify why we consider that is appropriate, and also review the level inflation would need to fall to before we might experience headroom breach. We take a judgement on inflation forecasts (which we monitor monthly) to decide if the headroom is sufficient. As 55% of Anglian Water debt is hedged to inflation, we undertake appropriate stresses, based on levels of RPI and economic forecasts, to demonstrate going concern status.

We provide a covenant compliance certificate to our key financial creditors confirming that our credit ratios will be met through to the end of the AMP. This is signed by two of the independent non executive directors as well as two executive directors.

We also undertake stress testing on the share valuation model which provides additional support to our assertion of capital adequacy.

What are your thoughts on our proposals for sensitivity testing and publication of results?

We are very concerned about the publication of results in respect of sensitivity testing, as we would expect sensitivity testing to be on a forward looking basis. This is not required by our financiers. Moreover, we could not accept the risk that third parties (in particular investors or potential investors) might seek to rely on forward looking financial analysis. It follows that any forward looking data would need to be accompanied by extensive disclaimers. We currently undertake sensitivity analyses for the rating agencies, but it is on a confidential basis, and they do not publish anything without the Company confirming that no confidential information has been inadvertently disclosed. We perform different levels of sensitivities for each rating agency, and typically using their advised levels of RPI and interest rates in constructing a base case. We do not publish forward looking covenant ratios, but are aware that a number of the other securitised companies do.

What are your views on whether the statement of capital adequacy could be extended to cover a period longer than one year and, if so, how long a period could be covered?

As we are not a listed company, we do not report in accordance with the strict requirements of the UK Corporate Governance. However, we have updated the Anglian Water Services Corporate Governance Code such that it now includes a provision which mirrors the wording of condition C2. This new provision applies for 2015-16 reporting so was not addressed in the 2014-15 ARA.

At this stage we have yet to discuss and agree with the Board the format and contents of the statement that will be made in our 2016 ARA. However, in order to satisfy the new requirement we are likely to have to refer to the testing that goes out to the end of the current AMP period. We cannot look beyond the current AMP period until the PR19 Draft Determination has been published. However, going beyond the current 12 month period currently required to demonstrate going concern status would be based on a series of stated assumptions.