Consultation on financial monitoring framework

Introduction and general comments

This is Bournemouth Water's response to Ofwat's consultation on its proposed financial monitoring framework. Subject to the comments made in this response we are broadly supportive of the proposal.

The proposed framework will be a useful tool for Ofwat to communicate its view on the long term financeability of companies. However, it is important that it is clearly labelled as 'Ofwat's view' and that any opinions expressed on the financeability of particular companies are clearly caveated as Ofwat's opinions and not specific directions for companies. The Board is responsible for deciding the appetite for financial risk, taking into account the requirements of stakeholders including the shareholder and it is their duty to satisfy their shareholders and other associated parties of their financeability by using methods required by these parties.

When publishing the framework it must also be clear on a further two matters. Firstly, that the information presented is on the regulatory accounts and does not represent a total 'company' view for which investors would typically refer to a company's statutory accounts. We are not clear on the extent that Ofwat has already engaged the investor community on the value to it of the proposed framework. Without incorporating feedback from investors there is a risk that the usefulness to stakeholders of the framework will be compromised.

Secondly, there are still variations on interpretations of accounting treatment which can lead to significant differences between companies in how they recognise some areas of income or costs. Analysts would take account of this in their review of performance; therefore any Ofwat publication must make this potential disparity clear to the reader.

Our responses to the specific questions raised follow.

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 broadly agree that they are.

The revenue comparison provides a transparent indication on whether companies are collecting too much or too little from their customers. An opex comparison would be useful, as this would provide a clear comparison with a company's actual operating cost base versus Ofwat's view of an efficient company based on their PR14 econometric modelling.

However comparisons of EBIT and profit with FD assumptions are not particularly useful, as they are affected by real life depreciation and interest, which may be significantly different from Ofwat's FD assumptions. (i.e. it may be Ofwat's PR14 assumptions that are causing any variance). In our view both measures of return are adequately covered by a number the other ratios (RORE, ROCE etc).

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?*

While not specifically related to financeability, a comparison of tax incurred versus the FD assumptions would be a useful metric. Customers effectively fund the tax burden of a company through the revenue setting processes, and this comparison would inform stakeholders whether customers were over/under funding this element.

For completeness any differences caused by variation in PBT, and for example, any differences caused by tax planning arrangements should be reconciled.

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?*

They are acceptable for finance professionals, but for clarity could also have an outline equation accompanying the description (the current 'Calculation' column is a little wordy). If it is Ofwat's intention for both finance and non-finance professionals to utilise the report, then a short description of exactly what/how some of the metrics show what they are intending to show would be useful. For example, Interest Cover currently has a note saying 'measures ability to pay interest costs'. This could be expanded significantly.

There appears to be an inconsistency with the definition of RORE which states in Appendix 2 that this is based on notional equity whilst page 12 states that the metrics will be based on actual capital structure.

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 the report should be published once a year and additional information should only be requested when required. However, Ofwat may find that to understand any different bases of measurement a process will be required for validating the results with companies before they are published.

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?*

There is no value in monitoring holding companies when the regulated business may only be a small part of that business and may not even be reported separately, as was the case with our previous owner Sembcorp.

While we support the principle of including regulated retailers this may need further consideration as monitoring may not tell the 'whole story' if the organisation is supporting the low retail margins with value added services. In this case the financeability of the total company may be different to the regulated element alone.

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 do not think that Ofwat should be routinely moving outside its remit and do not see the relevance of including information about principal holding companies when its duty is to ensure that the regulated companies are financeable.

However if Ofwat's own risk-based analysis raises significant concerns that a regulated company is at risk then we see no reason why further information and assurance should not be requested.

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?*

Testing for the purposes of the financial monitoring framework should only be conducted on data that is in the public domain and on no other data.

Notwithstanding this, companies should have stress and scenario testing as part of their planning processes, and we agree that it is reasonable to request information.

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

We are concerned that publishing 'standard' sensitivities will create risk that data may be misinterpreted. While Ofwat proposes that companies will be expected to explain results that indicate a potential issue we are not convinced that this will avoid any potential reputational damage even if the situation is, in reality, secure.

Our preferred option is for companies to propose and use their own sensitivities. As the financial monitoring framework relates to actual data this seems the most appropriate approach. While it could be argued that it reduces comparability for benchmarking in our opinion it will increase transparency.

Summary

To summarise while we broadly support the proposal for a financial monitoring framework that provides a regulatory view, we

- are concerned that the analysis will not provide a true insight on the financeability of a company and must therefore be clearly shown as being 'Ofwat's view'
- do not think that anything other than data in the public domain should be used
- believe that the framework should be confined to the regulated companies and not move outside the regulatory ring fence unless concerns are significant enough to warrant it
- support companies using their own sensitivities rather than standardised ones.

Bournemouth Water
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