
Consultation on financial monitoring framework – a summary of consultation responses

1. Introduction

On 7 July 2015 we published a [consultation setting out our proposals for a financial monitoring framework](#) by which we will monitor the financial stability of the water and wastewater sector in England and Wales.

The purpose of the financial monitoring framework is to enhance visibility and transparency of company financing and capital structures to help ensure that all stakeholders can maintain trust and confidence in the sector.

Interested parties had until 3 August 2015 to respond to these proposals.

We received formal responses to our consultation from 17 regulated water companies, Thames Tideway Tunnel Limited, the Consumer Council for Water and the London Fire Brigade.

In chapter 2 we summarise:

- the key themes of the consultation responses;
- our response; and
- the impact on our proposed financial monitoring framework, highlighting areas where further consultation or additional guidance will be required

Following the closure of the formal consultation period we ran two workshops in October 2015 to explore further some of the questions raised in the written responses to the consultation; the workshops were attended by representatives from 18 regulated companies, along with Bazalgette Tunnel Limited and Moody's Investors Service, Inc.

The purpose of these meetings was to:

- better understand the reasons for any objections to or concerns on our proposals;
- to seek further company views on how companies should demonstrate that they are financially resilient over the longer term; and

- to identify where further guidance would be helpful, including in relation to the definition and calculation of the proposed financial metrics.

In addition we are also arranging discussions with representatives of the leading financial audit firms to discuss their views on how financial resilience should be demonstrated and assured by companies in light of the new requirement under the 2014 UK Corporate Governance Code for companies to include a long-term viability statement in their statutory accounts for accounting periods beginning after 1 October 2014.

Next Steps

We will issue further guidance setting out the financial metrics that we intend to use for financial monitoring purposes by the end of December 2015.

We will also issue a further consultation setting out our proposals for how companies could provide us with assurance in their financial statements, in respect of their financial resilience. We expect companies to publish this information in their financial statements commencing with the financial year ending 31 March 2016. This should include clear and explicit explanations of the processes, including third-party assurance, they have followed in reaching their conclusions.

2. Summary of consultation responses

Overall, there was broad support for the purposes of the financial monitoring framework, particularly in relation to the need for companies to report their financial information in a transparent and consistent way.

However respondents raised a number of concerns about the specifics of the proposals. In particular there were strong objections to the proposed approach of asking companies to demonstrate that they are financially resilient by preparing and publishing the results of forward looking financial projections. Companies also made suggestions about the relevance and calculation of a number of the financial metrics that we are proposing to use when we monitor company performance and resilience.

Theme	Background and summary of consultation responses	Our response
Who is the financial monitoring report aimed at?	<p>We set out the purpose of our financial monitoring work in our consultation.</p> <p>Some respondents requested further clarity about who the financial monitoring report is aimed at as much of the information is already publicly available.</p> <p>There were also comments that the credit rating agencies produce regular comments on the financial position of each company so this would be duplication.</p>	<p>The work that we are proposing to carry out under the financial monitoring framework serves a number of purposes.</p> <p>The financial monitoring report will present information on the companies on a transparent and consistent basis in a way which allows users, including Ofwat, to more easily compare the financial results of companies, to identify industry trends or outliers and to question/challenge the choices made by companies.</p> <p>We acknowledge that not all stakeholders will be interested in the information that is being published and that interested parties will require a reasonable level of financial knowledge to fully interpret the data that is published.</p> <p>We are not intending to replicate or replace the work that is carried out by the credit rating agencies. The need for companies to maintain an investment grade credit rating is an</p>

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		important part of most companies' licenses and the reports produced by the credit rating agencies continue to be an important source of information for stakeholders about the financial resilience of each company.
Responsibility for communication with customers	<p>We set out in the consultation that we intend to publish regular reports on the sector.</p> <p>Concerns were raised that companies, not the regulator, should be responsible for communicating information to their customers.</p>	Our position is that companies continue to be responsible for communications with their customers. The financial monitoring report is not intended to replace this continuing responsibility.
Choice of financial structure	A number of companies were concerned that the financial monitoring report could be used to discourage companies from implementing certain capital structures	<p>The responsibility for the choice of capital structure remains with companies. We are not seeking to impose a particular capital structure on any company.</p> <p>We acknowledge that this will mean that certain financial metrics will differ for each company and that in many cases there are good reasons for this.</p> <p>However, we still believe that there is a value in being able to monitor both company and industry trends.</p> <p>We are asking companies to be transparent about their financial structures, including tax arrangements, and how they assure themselves that that the choice of capital structure is appropriate and that there is not an unacceptable risk of business failure.</p>
Triggers for Ofwat intervention	Companies requested clarification as to the triggers that Ofwat would use for	We do not intend to provide a definitive set of criteria for intervention by Ofwat as this will need to be determined on a case by case basis depending on the individual circumstances.

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	determining when to intervene in a company's finances	The financial metrics that we intend to monitor provide an indicator only and we will need to work with companies to fully understand the circumstances which are leading to our initial concerns before deciding whether or how to intervene.
Explicit statement from Ofwat on financial viability of companies	Respondents to the consultation asked whether Ofwat could include an explicit statement on its view of the financial viability of the industry.	We will aim to include a statement about our view of the resilience of the industry based on the information that is published in the financial monitoring report. Where we have concerns about the finances of any particular company we will discuss these with them before making any public statement.
Frequency of reporting	The consultation asked how often Ofwat should be collecting information from companies and publishing this type of report. Respondents were concerned that the need to provide information to Ofwat on a too frequent basis could place an unnecessary regulatory burden on companies.	Having considered the responses we have received from companies we intend to collect information and publish a financial monitoring report annually. However if we have concerns about the financial position of any of the companies then we will be asking for companies to provide information to us on a more frequent basis.
Which companies should be included within the financial monitoring framework	The consultation asked for views as to whether all regulated companies should be included within the financial monitoring framework. It was a generally agreed that it was appropriate for all regulated companies to be included.	Having considered the responses to the consultation and subsequent discussions with companies during the financial monitoring workshops we confirm that all regulated companies will be included in the financial monitoring regime. We agree that it would be inappropriate to use the same financial metrics to monitor the regulated water and waste

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	<p>Respondents noted that it would be appropriate to use a separate set of financial metrics when looking at the new retail only companies that are likely to be created when the non household retail market opens in 2017.</p> <p>Many respondents felt strongly that the financial monitoring regime should cover only the regulated appointed businesses and that Ofwat should not be looking outside the regulatory ring fence at any other group companies.</p>	<p>water companies and the new retail only companies. A separate suite of financial metrics will be developed for the new retail only companies.</p> <p>We discussed the need to look outside the regulatory ring fence at holding companies during the financial monitoring workshops. We clarified that the purpose of this proposal was not that we were seeking to regulate those companies, but that we saw a need for further transparency about the group ownership and tax arrangements to enable us to make sure that that the regulated companies were not put at risk due to the activities of other group companies outside the regulatory ring fence.</p> <p>The attendees at the workshop welcomed this clarification and indicated that they did not in principle have any significant objections to providing the information relating to ownership and tax structures.</p>
<p>Financial metric calculations and consistency of published information</p>	<p>The consultation included a suite of financial metrics which we were considering using to help us monitor the financial performance and viability of the companies we are monitoring.</p> <p>Respondents set out which metrics that they thought should be included and excluded from the final suite of metrics used for financial monitoring. They also provided comments on the</p>	<p>We have reviewed all the comments received on the calculation of the financial metrics both in the responses to the consultation and in the subsequent financial monitoring workshops.</p> <p>We are now refining both the suite of metrics that we propose to use for financial monitoring purposes and will issue further guidance on the revised suite of financial metrics including clarification as to how they should be calculated before the end of the year.</p>

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	<p>calculation of each metric and provided an alternative calculation of specific metric where they considered that an alternative would be better.</p> <p>Respondents also commented that it was important that information was presented on a consistent basis if meaningful comparisons are to be made.</p>	
<p>Demonstrating financial resilience</p>	<p>The consultation set out a proposal for companies to perform stress testing on their forward looking business plans and to publish the results of those stress tests to demonstrate that they were financially resilient over the longer term.</p> <p>While a number of respondents agreed that companies should be doing this the majority of the respondents objected strongly to the proposals. The main objection was to the requirement for companies to publish the results of the stress tests as they felt that this would be commercially and price sensitive information. The</p>	<p>We continue to believe that it is appropriate that companies should be carrying out this type of stress testing on their business plans to demonstrate that they are financially resilient.</p> <p>However we acknowledge the companies' concerns relating to the publication of the results of stress tests and therefore we will not be asking companies to publish the results of stress tests in 2016.</p> <p>Section C2.2 of the September 2014 UK Corporate Governance Code introduces a requirement that will require all regulated water companies to include a long-term viability statement in their accounts for the year to 31 March 2016, although some companies have adopted it early.</p> <p>Companies will need to include a statement about in their long term viability in their statutory accounts which sets out how the directors have satisfied</p>

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	<p>listed companies were also concerned that it could be seen as a profit forecast,</p> <p>Respondents also raised concerns about the proposal to ask companies to use a standardised set of sensitivities as they felt that it would be more appropriate to tailor any sensitivities to the specific circumstances of each company.</p>	<p>themselves that the company is viable over the longer term and the period over which company Boards are making that assessment</p> <p>We are therefore considering how companies are addressing this new requirement and whether it provides the level of assurance that we consider is required in respect of the long term financial resilience of the regulated companies.</p> <p>In our view the statements that companies make in their financial statements relating to their long term financial viability could provide us with the assurance that we need in respect of their financial resilience, but only if such statements include a clear and explicit explanation of the processes, including third-party assurance that companies have followed in reaching their conclusions.</p> <p>Our work in this area is ongoing and we will consult on a revised approach to companies demonstrating that they are financially resilient over the longer term in due course.</p>