

## **The Northumbrian Water response to the Ofwat consultation on the financial monitoring framework**

### ***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?***

Most measures are derived from the regulatory accounts, and they are all recognisable financial metric terms.

The only metric we believe is not appropriate is the principal parent company gearing measure. This measure is not part of the regulatory accounts and is outside of Ofwat's regulatory remit. There are different capital structures employed across the sector and we do not feel it appropriate for Ofwat to attempt to normalise or determine a 'correct structure' as this is a decision for each company and its shareholders.

Any suggestion that Ofwat will start looking outside of the regulatory ring fence would undermine the confidence of investors in the ring fence and point to the removal of protections which they currently place comfort on. This could have a direct consequence on the cost of capital, thus increasing costs to customers without any identified benefits.

### ***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?***

These are sufficient – they cover all the metrics used by Ofwat to assess financeability in the PR14 Final Determination.

### ***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?***

The definitions will need more clarity before publication. References to tax need to confirm whether this is just current taxation or the current and deferred tax charge. Similarly, references to retail profit margin needs to clarify whether this covers all retail or just household or non household.

The use of non accounting terms such as pay as you go (PAYG) and run off rates in price controls may mean that metrics based on accounting data (e.g. opex and depreciation) are not directly comparable with the final determination metrics. In PR14, varying PAYG was a method which allowed companies to ensure financeability. It would be unfortunate if a strict accounting approach meant that this flexibility was overridden.

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***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?***

An annual financial monitoring report would not add to the regulatory burden, as it would be based on the annual regulatory accounts that companies already produce. Requesting further information when required may be appropriate but such requests require justification and should be proportionate.

Any recurring requirement for more frequent financial data would be a significant increase in the regulatory data burden and costs. It would increase the costs of collection and assurance and require frequent Board sign off. We have not seen any evidence of the benefits of such a requirement.

We are concerned it would be a reversal of the actions taken by Ofwat as a response to the Gray review<sup>1</sup> and would run contrary to Ofwat's strategy of targeting only the areas where it is necessary and proportionate to do so.

***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?***

***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?***

Ofwat should not be looking outside the regulatory ring fence. Its current powers are sufficient for it to carry out its duties. Interactions with holding companies are regulated through the requirements of RAG5 and Condition K of the licence, both of which are sufficient to ensure the financial independence of the regulated company, as evidenced by Wessex Water withstanding the collapse of its then owner Enron.

Furthermore we are not clear why Ofwat believes it should go beyond its current remit. No justification has been provided for such a significant change in the consultation paper. If Ofwat doubts the strength of its own regulatory ring fence then it should consult on strengthening the ring fence; however any such doubts would be highly disconcerting for equity and debt investors who place great confidence in the ring fence.

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<sup>1</sup> [https://www.gov.uk/government/uploads/system/uploads/attachment\\_data/file/69442/ofwat-review-2011.pdf](https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/69442/ofwat-review-2011.pdf)

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***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?***

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

We are concerned that Ofwat is proposing that companies annually publish their financial plans, along with the impacts of a number of stress testing scenarios.

This would add substantially to the regulatory burden and costs which are ultimately borne by customers, effectively creating an annual business plan submission process, rather than the once in five years approach taken currently.

Publication of such reports would have commercial consequences – they would be price sensitive for publically quoted companies for example. As such, they would require a great deal of assurance and Board scrutiny before they could be released. This increase in the annual regulatory burden and consequent increase in the costs of preparation and assurance would be significant. The consultation paper does not set out an adequate justification for the additional reporting burden and costs.

Any stress tests would have to vary by company and capital structure employed. The exposure to interest rate and inflation risks are different depending upon capital structure and risk appetite for shareholders depending upon what the investment horizon is for each shareholder group.

We suggest an alternative and more proportionate approach might be to review historical performance and assess the marginal impacts of each of the sensitivities set out in the consultation. This would be much less intrusive and burdensome but would still allow the financial risks to be considered.

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### Conclusion

The proposals in this consultation would significantly increase the regulatory burden. Such an increase requires detailed justification, such as a Regulatory Impact Assessment in order to demonstrate that Ofwat is targeting only the areas where it is necessary and proportionate to do so.

The Ofwat policy “Delivering proportionate and targeted regulation – Ofwat’s risk based approach”<sup>2</sup> describes a Gateway assessment that covers the following tests:

#### **Best Placed?**

*Does the matter fall within Ofwat’s jurisdiction?*

*Does Ofwat have an obligation to act?*

*Is Ofwat best placed to act?*

#### **Benefits**

*What are the benefits to consumers?*

*What are the benefits to the regulatory regime?*

*Is the proposal a good fit with Ofwat’s strategic direction?*

#### **Costs**

*What are the costs to Ofwat?*

*What are the costs to companies?*

*How can the costs be reduced?*

*What are the prospects for success?*

#### **Choice of tool**

*Is the choice of regulatory tool the right one?*

***Do the benefits of the work outweigh the costs and risks?***

The consultation as currently formulated does not appear to consider any of these areas, in particular, there are no assessments of the benefits or costs of the proposals.

We suggest that Ofwat carries out such a Gateway assessment of these proposals in accordance with its risk based approach. We would be happy to provide our views as part of that process.

Northumbrian Water  
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<sup>2</sup> <http://www.ofwat.gov.uk/content?id=3d782004-775a-11e1-8f0b-193f8de7b1cb>