

Our ref: JC/LAT/Ofwat

Your ref:

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Financial Monitoring Framework Response  
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Dear Sir

### **Consultation on the financial monitoring framework**

Sutton and East Surrey Water welcome your consultation on the scope and nature of financial performance and resilience information that Ofwat should require from 2015/16 onwards. We agree that the industry should be providing financial as well as other performance information that helps build trust and confidence in the sector. We have pursued this objective through our promotion of an integrated report on all aspects of our performance in our Annual Report.

The publication of an annual report on the financial performance of the industry as a whole is a significant gap in the transparency of performance that we agree is essential. We therefore welcome the reintroduction of such a report by Ofwat. We support many of the more detailed proposals in your consultation.

There are however elements of the proposals included in your consultation that we consider retrograde or misplaced, and would therefore urge you to reconsider.

One of the major achievements in enhancing the regulatory regime for the water industry in England and Wales over the last few years has been the renewed emphasis on the role of company Boards in taking ownership of their company's performance and future plans. We have sought to leave behind a "compliance with regulatory requirements" mentality in favour of a commitment to "serve the best interests of our customers". A critical element of this transformation has been the requirement for Boards to provide assurance on reported data, combined with a freedom for Boards to determine the scope and nature of the assurance that they would require before providing an assurance statement themselves.

Aspects of the proposed financial monitoring framework cut across – and in our opinion, undermine – the advances achieved in recent years. This is particularly the case with the requirement for Boards to publish details of the scenarios and stress tests they have considered before providing their statements on the adequacy of financial and other resources. This transfers responsibility for assessing adequacy of resources from the Board to the user of the financial information provided. We move from a statement that "the Board consider there are adequate resources in place" to a statement that "the Board has conducted the following tests, which indicate that under these circumstances, there will be adequate resources available". We consider this a retrograde – and unnecessary – development. We have consistently supported improvements to transparency and have welcomed many of the initiatives Ofwat has taken on



the development of a monitoring framework and assurance process. However, we do not believe that publication of the results of specified stress tests will provide meaningful information for our stakeholders.

Your consultation also raises the prospect that Ofwat will, in certain circumstances, seek “to look beyond the regulatory ring fence, at the financial stability, financing arrangements, tax structuring and other arrangements entered into by holding companies or shareholders”. The consultation recognises that consideration will need to be given to how Ofwat will obtain such information and whether Licence conditions will need to be changed to achieve this objective. We do not believe that there is any evidence to indicate that this is necessary to protect the interests of customers. Indeed, the available evidence confirms the strength of the existing regulatory ring-fence, which has been a cornerstone of the regulatory regime in England and Wales. The failure of Enron had no detrimental impact on the customers of its subsidiary, Wessex Water.

The requirement for the Boards and management of appointed businesses to act solely in the long-term interests of those businesses, regardless of the interests of any associated companies or shareholders, is fundamental to the way in which appointed businesses are regulated. Giving consideration to matters determined by associated companies or shareholders are fundamental changes to a regime that has proved resilient to significant challenges. It certainly should not form part of a consultation on financial monitoring arrangements for appointed businesses – especially one with such a short consultation period. If this step is to be further contemplated, it must be the subject of a major, independent consultation on the principles of the regulatory regime and not be a minor element in a routine consultation on the practical operation of the financial monitoring regime. We therefore urge you to reflect on the implications of your proposals and ultimately withdraw them.

Our detailed responses to the specific questions raised in your consultation are included in the appendix to this letter. As always, if there are any aspects of this response that you would find it helpful for us to clarify – or you would like to discuss in more detail – please do not hesitate to let us know. In the first instance please get in touch with Joanna Campbell, Economic Regulation Manager ([JoannaC@waterplc.com](mailto:JoannaC@waterplc.com), 01737 785 692).

Yours faithfully



John Chadwick  
Finance and Regulation Director

## Appendix 1: Response to 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 believe the list of metrics is too long, lacks structure and strays into areas that are not currently within the remit of the regulator.

The primary purpose should be to assess the financial health and risk profile of the appointed (regulated) business. Metrics should therefore be for the appointed business as a whole.

The purpose of publishing a single metric (margin) for Retail activities is not clear. Neither is it clear whether this should be for household and non-household Retail activities combined or purely for the non-contestable activities (household only post-2017).

Comparisons with Final Determination assumptions are neither necessary nor helpful for this primary purpose. Whilst comparisons may be required in companies' annual performance reports, they will be provided with explanatory context, which it is difficult to envisage being replicated for all companies in an industry overview report. Many comparisons will also be misleading as Final Determination allowances are based on notional Balance Sheet structures and performance reports will reflect actual structures. Profit after tax, for example, will vary from Final Determination assumptions whenever actual financing structures differ from notional assumptions used for price setting purposes, and any headline comparisons will potentially mislead any other than an expert reader (who will be able to undertake their own comparisons if needed).

We do not understand why trade creditor days have been selected from working capital, when debtor days will be of equal, if not greater, interest to the informed reader. Neither constitutes a KPI for a broad industry overview.

"Principal parent company gearing" is not a matter for this regulatory report without a broad-ranging debate on the scope of the regulatory regime.

**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?

We have already indicated that we consider the proposed list too long to be helpful. It should be shortened and tested before any further additions are considered.

**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?

Cashflow metrics will not necessarily agree with the detailed calculations undertaken by credit rating agencies, who each take their own approach to interest cover and gearing calculations. Given that the primary financeability measure is the credit rating issued on the company, attempts to replicate in a stylised form for all companies the detailed calculations performed by the rating agencies provides little additional benefit and has the potential to mislead. These metrics ought therefore to be dropped in favour of a simple statement on the rating carried by each company.

The definition of "return on regulated equity" refers to the "equity component of the RCV assumed in the notional capital structure". All other actual financial measures (including the definition of "regulated equity" itself) are based on actual rather than notional capital structures. This definition therefore either needs correcting, or an explanation provided for the departure

(together with the justification for collecting additional information not already included in regulatory accounts).

Average tenor of company debt cannot be calculated where the company has irredeemable preference shares (counted as debt rather than equity).

The analysis required for financial instruments needs completing and “..etc” removing.

**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?

The report does not need be published more than once per year. We agree that the report's content should be based on information that will be provided in annual performance reports. The most important feature of the annual report will be to re-establish a regular routine for its preparation and publication, including providing an opportunity for companies to verify their data and any company-specific statements (albeit that opinions will be those of Ofwat and cannot be subject to verification).

Good regulatory practice would establish the criteria for requesting further information before any requests are made (with a focus on the benefit to stakeholders of the additional information requested). If further information is required the aim should be to make a single request at a predetermined time during the year. Frequent and unexpected requests for information create avoidable additional costs for data collection and assurance.

**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?

The financial monitoring framework should apply to regulated businesses only, including retailers. Comparability across companies is a key aim of the report, and consideration needs to be given to the comparability of information on retail functions. The easiest way of doing this is to have a separate section covering non-household retail information from 1 April 2017.

It cannot be assumed that the report will cover holding companies until a proper consultation on going beyond the regulatory ring fence has been undertaken.

**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 believe that there is any evidence to indicate that this is necessary to protect the interests of customers. Indeed, the available evidence confirms the strength of the existing regulatory ring-fence, which has been a cornerstone of the regulatory regime in England and Wales. The failure of Enron had no detrimental impact on the customers of its subsidiary, Wessex Water.

The requirement for the Boards and management of appointed businesses to act solely in the long-term interests of those businesses, regardless of the interests of any associated companies or shareholders, is fundamental to the way in which appointed businesses are regulated. Giving consideration to matters determined by associated companies or shareholders are fundamental changes to a regime that has proved resilient to significant challenges. It certainly should not form part of a consultation on financial monitoring arrangements for appointed businesses – especially one with such a short consultation period.

If this step is to be further contemplated, it must be the subject of a major, independent consultation on the principles of the regulatory regime and not be a minor element in a routine consultation on the practical operation of the financial monitoring regime. We therefore urge you to reflect on the implications of your proposals and ultimately withdraw them.

**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?

This aspect of the proposed financial monitoring framework cuts across – and in our opinion, undermines – the advances in Board ownership of assurance achieved in recent years. It transfers responsibility for assessing adequacy of resources from the Board to the user of the financial information provided. We move from a statement that “the Board consider there are adequate resources in place” to a statement that “the Board has conducted the following tests, which indicate that under these circumstances, there will be adequate resources available”. We consider this a retrograde – and unnecessary – development. We have consistently supported improvements to transparency and have welcomed many of the initiatives Ofwat has taken on the development of a monitoring framework and assurance process. However, we do not believe that publication of the results of specified stress tests will provide meaningful information for our stakeholders.

We do not think the proposal to publish this further piece of information creates additional benefit to stakeholders. As the consultation recognises, those stakeholders most interested in this type of information - investors, funders and credit rating agencies – are already provided with relevant information targeted at their individual needs. An attempt to create a “one size fits all” framework for assessing the quality of Board assurance on company financeability helps no stakeholder.

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

We do not support the approach proposed by this consultation for the reasons already outlined. Boards should continue to have the freedom to determine the assurance they require before providing their annual statements of adequate financial (and other) resources and this should not be diluted by regulatory prescription of the details of assurance to be undertaken.