South East Water's Response to Ofwat's Consultation on Financial monitoring framework

July 2015

This paper sets out South East Water's views in response to Ofwat's recent consultation on Financial monitoring framework.

1 INTRODUCTION

The following document provides South East Water's response to the 'Financial monitoring framework'.

2 GENERAL COMMENTS ON THE APPROACH

Ofwat sets out that the purpose of the creation of a financial monitoring framework is to provide interested stakeholders with more transparent and accessible financial information about the regulated water companies and trends in financial developments within the sector as a whole.

Within the consultation document, Ofwat refer to customers, public interest representatives and investors as being potentially interested stakeholders. We believe it would be helpful to gain a clearer understanding of which particular group of stakeholders are the primary audience for this report. This is because the needs of each of these groups are likely to be very different and consequently the content and style of the report has to be adapted depending on which audience is being primarily addressed. It is our belief that as each group of stakeholders will possess a different level of financial sophistication, it is unlikely that one report will be able to meet the requirements of each group.

It should be noted, that Ofwat used to publish a "Financial Performance and Expenditure Report". This report included financial information for the industry at both an aggregated and company level and included a number of the KPIs that are now proposed to be included in the new framework. The report was last published in 2009/10 as Ofwat moved towards a risk based approach. In ceasing the publication of this report, Ofwat would appear to have taken the decision that the report's cost outweighed its benefit. It would be helpful to gain a clearer understanding of why Ofwat's view on the publication of such data has now changed.

It should also be noted that there are already a significant number of regulatory tools in place to assist Ofwat in delivering the objectives of the proposed Financial monitoring framework and that Ofwat should be mindful of not placing regulated companies under further burden in the production of financial KPI's.

In particular, the regularly tools already comprise, but are not limited to:

- As part of the corporate governance enhancements, companies now publish comprehensive details of their group structures on their websites
- Most companies are required to make annual disclosures in their regulatory accounts concerning their access to financial and management resources
- The statutory accounts of companies are prepared on a going concern basis and from 2016 will need to include statements on viability and confirmation that the Directors have carried out a robust assessment of principal risks. For a capital intensive industry such as the water industry this will undoubtedly include risks surrounding financing and capital structure
- Most companies are rated by at least two rating agencies and their reports are available to stakeholders; and

- Licences contain clear Condition P undertakings for controlling parties to provide all information a regulated company requires

We also have concerns over whether the inclusion of any new debt based metrics would assist Ofwat in the objective to "better monitor each company's performance against our final determinations". This is because determinations are based on notional gearing structures, with a notional cost of debt split on a notional basis between embedded and new debt, and with fixed rate debt reduced to a real cost of debt based on a forecast of inflation. Conversely, company data is based on actual capital structure and actual costs of debt.

We also do not agree that the "creation of a database of accessible public information" will "encourage companies to improve their performance, and it will allow easier comparisons with the performance of other utilities". It is our view that comprehensive benchmarking already takes place in the industry and is a key feature of the price control process. Companies and stakeholders are able to access statutory and regulated accounts of other companies, along with rating agency reports, analyst reports of listed companies and details of public debt issuances. This comprehensive data is used by companies to influence their performance. Ofwat publishing a database of accessible information is unlikely to motivate companies further.

3 ANSWERS TO SPECIFIC CONSULTATION QUESTIONS:

Below are responses to the specific questions in the consultation.

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?

No. We note that Appendix 1 contains 26 measures which appears excessive and if most of these were to be reported in the pilot report they would all need comment, making for a lengthy and potentially unfocussed report.

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

No. Please refer to the answer provided for Q1.

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 believe that KPI's where used, should be detailed with precision. For example, in which price basis are figures provided, are pensions presented on the basis of the final determination approach (contributions) or the differing regulatory accounts approach, and whether FFO used in the FFO/ debt ratios is net of indexation.

Ofwat will be aware that there are already some differences between the calculation of certain ratios between companies' covenants and the various rating agencies and we would encourage Ofwat to adopt a methodology that is already in use and widely understood.

It should also be noted that there will be significant differences in some of the metrics depending on the financial structure adopted by the companies. In order for the comparisons to be meaningful, explanations will need to be provided, for example dividend yield should increase with gearing so a basic comparison of this metric with no mention of gearing will not be meaningful.

Q4.Do you agree that the financial modelling 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?

Publishing the report annually is fine. Additional information can be requested and provided on an ad-hoc basis.

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 modelling framework?

All water companies, including retailers should be included.

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 shareholders?

Ofwat should clarify on what basis and in the performance of which of its powers and duties under the "relevant provisions" of the Act it would require holding companies to provide information and the nature of the information it would seek to obtain. Ofwat should also consider and explain what information it believes it would not be able to obtain directly from regulated companies or what accounting and financial information is not publically available and how it would propose to require holding companies which are not domiciled in the UK nor subject to English law to provide such information.

There are already provisions in the instrument of appointment on ring fencing, cross default and on arms' length trading which address risks relating to companies financing structures. We also believe there is sufficient information already provided to Ofwat by regulated companies or available to Ofwat through financial statements, regulatory accounts and rating agencies reports. Condition P sets the framework for information that can be obtained by companies from their ultimate controllers and UK holding companies and for what purpose. Ofwat should rely on this condition to require information it may need where specific circumstances justify it. We believe that unless there are exceptional circumstances the financial modelling framework should not extend beyond the regulated companies.

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?

We are not supportive of companies being required to conduct mandated sensitivity analysis and publishing the results.

Our Board as part of their assurance process in making the annual statement of capital adequacy, places particular reliance on the work undertaken by management to support the going concern statement in the statutory accounts. This work includes the production of a comprehensive memorandum based on the FRC's "Key questions for Boards" which is reviewed by the Board. The memorandum includes the impact of certain sensitivity scenarios on our key financial ratios. The nature of the sensitivity scenarios included within the memorandum is dependent on the position of the business at the particular point in time and thus could vary from year to year. In 2015, we ran the following sensitivity scenarios: 0% RPI, operating costs higher by 5%, capex overrun by 10% and a revenue reduction of between 5% and 10%.

We do not believe that mandated sensitivity testing would strengthen this existing process in anyway and is unlikely to substitute for more specific scenario testing by companies.

It is our view that publication of the mandated sensitivity testing could easily mis-identify issues and lead to adverse and unnecessary attention and questions from stakeholders.

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

Please refer to the answer provided for Q7.