Consultation on financial monitoring framework

Southern Water's Response

Southern Water's response to Ofwat's consultation on its proposed financial monitoring framework

Introduction and summary of our response

We are pleased to be able to provide you with our response to the consultation on your proposed financial monitoring framework.

We share the ambition set out by Ofwat in the consultation that companies' choice of capital structure should not impact the trust and confidence of customers and stakeholders. Ofwat and the regulated companies have made significant progress over the last eighteen months in developing an agreed set of board leadership, transparency and governance principles, for both operating companies and holding companies, which promote trust and confidence in the sector through increased transparency and explanation of companies' governance and ownership structures.

We agree with Ofwat that the proposed publication of a common set of financial measures, in one document, for all companies in the sector will provide increased visibility of the sector's performance, ownership, and capital structures for customers and stakeholders. This additional transparency should further contribute to building trust and confidence in the sector. The three broader aims of the framework identified by Ofwat would, however, be better addressed by other means. The three other objectives being to enable Ofwat to:

- monitor the financial stability of the businesses that it regulates
- identify financial and structural risks which may impact on service delivery over time and prove harmful to customers
- help determine when it needs to use the regulatory tools available to it to intervene to protect customers' interests.

We understand the importance that financial stability and risk management play in delivering for our customers and stakeholders. However, there are already significant restrictions and covenants placed on companies through their licences, the Companies Act and the aforementioned governance principles. We therefore consider a more effective and proportionate implementation of these objectives would be through a continuation of Ofwat's active engagement with Credit Rating Agencies, Boards, INEDs, Shareholders, Debt Investors and other relevant stakeholders. This group of financial stakeholders already possess significant expertise that allows them to monitor the financial risks and stability of both companies and the sector as a whole. The results of this "horizon scanning" could then be used by Ofwat, where necessary, to direct the use of its regulatory powers.

The current proposals would significantly increase the regulatory burden on both Ofwat and the sector, and risk duplicating rather than adding to existing financial risk assessment.

We would instead request that Ofwat develops and consults on a set of principles/circumstances where it anticipates it may need to intervene and make use of its regulatory powers and the nature of interventions that could be considered.

Response to the consultation questions

Regulatory accounts format and requirements

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?

The performance of the majority of companies in the sector is already measured by the credit rating agencies for use by our creditors. Bringing this type of information together for all companies within the sector, by publishing this information in a single document, would provide greater transparency on the sectors financial performance.

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?

The metrics proposed appear appropriate.

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 do not believe that gearing as defined as Net Debt/Equity is appropriate for the sector. The sector measures gearing on the basis of Net Debt/RCV. This is applied to both operating companies and holding companies.

The post-tax return on capital is also a different definition from that currently used – current cost profit after "current" tax.

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?

Agree.

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?

We agree with the current scope of the proposed report. We do not believe other companies should be included. The more companies that are included the harder any relevant comparison to be made between companies given the differences in capital structure, scale and complexity. Whilst we support transparency in relation to company ownership and governance we feel that focus should be on the appointed businesses.

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 and the sector have recently developed governance principles in relation to holding companies. As stated in Q5 we fully support the transparency of holding companies with respect to ownership and governance but we do not consider that the extension of economic regulation beyond the appointed business is appropriate.

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 believe that transparency of the financial resilience of all companies in the sector is important to customers and stakeholders.

Currently, it is the responsibility of company Boards and their Executive to decide on a company's capital structure and its approach to risk management.

We believe that this is an important principle which should not be undermined or weakened.

Therefore, rather than specifying stress testing scenarios to be completed and published by all companies we would instead propose that Ofwat requires all companies to be transparent about the stress testing they undertake. This approach would ensure greater information is placed in to the public domain, enhancing transparency, whilst avoiding any shift in responsibility for financial risk management away from companies and on to the regulator.

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

We refer you to the answer to question 7 above. We would, however, agree that the sensitivities identified do capture the key high level business risks that companies in the sector face. That said, any sensitivity analysis would not capture the impact of mitigation activity by a company and so in and of themselves can provide no more than an indicative view of the ultimate impact on a company's financial position.