BY EMAIL

OFWAT
Centre City Tower
7 Hill Street
Birmingham
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03 August 2015

Dear Sir/Madam

Consultation on financial monitoring framework

We welcome the opportunity to share our views on the financial monitoring framework. We believe that a financial monitoring framework could be helpful in providing stakeholders with more transparent and accessible financial information. We also agree where possible the financial monitoring framework should not place any additional reporting burden on companies and that Ofwat should look to use data that is already available in the regulatory accounts and the annual performance report.

We believe that the financial monitoring framework should take into account, and take advantage of the UK Corporate Governance Code requirements (in particular those in respect of going concern and from this year, long term viability) that already exist for listed companies in the sector, and not seek to duplicate them.

We have concerns about the proposal to publish forward looking data as part of the proposed financial stress tests. As a publicly listed company we are bound by the UKLA listing rules. Publication of forward looking data presents us with additional challenges, as it could be market sensitive, and for certain metrics could be construed as a profit forecast or profit estimate.

We have provided a more detailed response to the consultation questions in the following document.

Yours faithfully

James Bowling
Chief Financial Officer
Severn Trent PLC

Ofwat's consultation on the financial monitoring framework:
Severn Trent PLC, Aug 2015

Information to be published: 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?

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?

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 have summarised our response to questions 1 & 3 in the following table and commentary;

KPI	Q1 Are the financial metrics proposed appropriate?	Q3 Are the financial metric definitions appropriate?
Revenue - Actual vs Final Determination	Y	Note 1
EBIT - Actual vs Final Determination	Y	Note 2
PAT - Actual vs Final Determination	Y	Note 1, 2, 3
Funds from operations - Actual vs Final Determination	Y	Note 2
Regulatory Gearing	Y	Y
Accounting Gearing	Y	Y
Credit rating	Y	Y
Post-tax return on capital	Y	Note 4
Return on regulated equity	Y	Note 5
Return on RCV	Y	Y
Dividend yield	Y	Y
Dividend cover	Y	Y
Retail profit margin	Y	Y
Interest cover	Y	Note 2
Adjusted interest cover	Y	Note 2
FFO/Debt	Y	Note 2
Effective tax rate	Y	Y
Free cash flow (RCF)	Y	Note 2
RCV/Capex	Y	Note 2
Trade creditor days	Y	Y
Average embedded cost of debt	Y	Y
Tenor of debt	Y	Y
Profile of debt	Y	Y
Mix of debt between fixed, floating and index linked debt	Y	Y
Company monitoring category	Y	Y
Principal parent company gearing	Y	Y

Note 1 – Confirmation whether November or year average RPI to be used to inflate the final determination revenue value.

Note 2 - As highlighted in our business plan submission, the Ofwat financial model overstates our funds from operations, because IRE in the income statement is set to be the same as the HMRC tax treatment (where 75% is expensed through the income statement as operating costs). Severn Trent's accounting policy is to expense 100% of IRE through the income statement. For a meaningful comparison to be performed on a number of measures (EBIT, PAT, interest cover, adjusted interest cover, FFO/debt, RCF, RCV/Capex) IRE would need to be expensed at 100% and the income statement and funds from operations recalculated.

Note 3 - As highlighted in our business plan submission, whilst the Ofwat financial model tax calculations were very complex, the model took a broad brush approach to capital allowances. This resulted in differences in tax that we could not reconcile. Therefore, we do not think that comparing the profit after tax from the FD financial model with our reported profit after tax will provide a meaningful metric for determining financial stability.

Note 4 - The definition states that the post tax return on capital is calculated as profit after tax as a % of regulated equity. As this is a return on capital measure we would have expected the measure to be a calculated as a % of RCV. However, changing the definition to a % of RCV would result in this metric having the same definition as the return on RCV measure.

Note 5 - We note that you have taken the FD financial model definition of RORE range which does not include the impact of ODIs, totex performance, financing and SIM. Given the RORE published at FD included the impact of delivery of incentives and external risk factors, we consider the FD definition would be a more meaningful definition to use.

Where the RCV is used in a number of the metrics (Regulatory equity, regulatory gearing, return on regulated equity and return on RCV) we believe further clarity is required in the definitions on whether the RCV used is at year end or year average. Further clarification is also required on whether the RCV used in each metric is the FD published RCV or the RCV as updated and published by Ofwat.

In response to question 2, we believe that it be would be useful to include debtor days in the pilot financial monitoring report reported by retail household and retail non household. Reporting debtor days would provide insight into an operator's management of working capital. As the disclosures in the new annual performance report do not require a working capital table, the information would not be readily available from published data.

Frequency of publication

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?

We agree that the financial monitoring report should be published annually. We would prefer that all additional disclosures should be submitted with the regulatory accounts, but understand that in some situations, for some companies, OFWAT may require further information.

We do not think there is a need for the routine provision of financial information to be more frequent than annual.

Which companies will be included?

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?

In response to question 5, we agree that the framework should consider the inclusion of other small water companies and other licensed businesses including new water retailers.

In response to question 6, our ultimate parent company is Severn Trent plc, and as a listed company we provide transparency in relation to our ownership and capital structures. As regulated monopolies, we believe other water companies should provide equivalent levels of transparency. This should include providing information in respect of the principal holding companies, the ultimate controlling parties of the regulated companies and other key shareholders.

This is in keeping with Ofwat's guidance on board leadership, transparency and governance. http://www.ofwat.gov.uk/regulating/compliance/prs_in1302boardleadership.pdf. We note that details of holding company and ownership structures are provided in the regulatory accounts of privately owned water and sewerage companies and water only companies. We would welcome further extensions to the disclosure requirements of private companies where appropriate to ensure parity with publicly listed companies related to regulated operations.

Further developments – stress testing

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 be we be asking companies to apply a different set of sensitivities?

We would agree that sensitivity analysis may be a useful way for companies to assess their corporate and financial resilience. However we believe that a "one size fits all" approach to stress testing would not be appropriate across companies with different financial structures, different risks and different headroom in their available facilities. Our view is that companies should be responsible for choosing the most appropriate sensitivities to stress test.

In addition, the publicly listed water companies will be required, from this year to publish a viability statement in their annual reports. This will provide an improved and broader assessment by each company of its ability to continue in operation and meet its liabilities, taking into account its current position and principal risks. It is expected that the period assessed will be significantly longer than 12 months, and the company's auditor will be required to comment on the appropriateness of the viability statement.

We believe that this framework for publicly listed companies is sufficiently robust and aligned to Ofwat's objectives for corporate and financial resilience, so as to obviate the need for the proposed prescriptive approach to stress testing and publication of results for those companies.

Furthermore, the publication of stress-test results could also provide market sensitive information and in particular could provide sufficient data from which to derive a profit forecast, which places additional reporting requirements on publicly listed companies.