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Financial Monitoring Framework Response
Ofwat
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Dear Sirs

South West Water's response to the consultation on financial monitoring framework

We are pleased to have the opportunity to respond to Ofwat's formal consultation on financial monitoring framework.

We support Ofwat's aim of ensuring information to stakeholders is transparent and the importance of the regulator to monitor corporate and financial resilience within regulated water companies.

The consultation reflects some of the changes required in the 2014 UK Corporate Governance Code which companies, in particular, those in a listed group, would be required to implement for statutory reporting purposes and align with Ofwat's board and governance expectations.

The consultation includes a number of proposals for financial monitoring of companies for the next regulatory period. The key areas proposed include;

- financial monitoring and key metrics
- sensitivity analysis and stress testing of financial plans.

We agree that company performance should be monitored against the expectations and financial allowances within their own Final Determinations, however do not believe this should be used for comparative purposes as the financial structures, and thus financial performance and resilience of companies, differs across the industry. In addition, we do not support the monitoring of other financial measures, outside of those for regulatory or price setting purposes, which may contradict statutory reporting and which again are not comparable across companies.

We think the consultation could have set out the current arrangements that are inherent in the legislative and licence framework for the industry more clearly. The financial resilience of individual companies and the industry as a whole is also a topic related to the current Resilience duty consultation. We think discussion at a workshop of this framework would help in considering the role and scope of the financial monitoring framework.

In responding to this consultation we have addressed the specific questions raised, included in Appendix 1, but have also considered the proposals against the background of changes in the UK Corporate Governance Code and the potential impact of these proposals on companies with listed status.

Financial Monitoring and KPI's
We think it is right that Ofwat consider a suite of tools to monitor company performance against a business plan and that this consultation specifically proposes it's approach to monitoring financial performance resilience and seeks to identify financial and structural risks within water companies.

There is, however, a range of financial reporting requirements which are already included within statutory reporting and these have established definitions/guidelines. We therefore think it is important that any additional financial monitoring considers the requirements which are already set out within the UK Corporate Governance Code and other statutory reporting, so that any regulatory monitoring does not cut across or contradict the reporting which is already completed by companies.

The definitions and approaches within the financial metrics proposed may differ from those that are appropriate for individual companies. In particular, they may differ from those which are of significance to companies as a result of their financial structures or financial covenants.

It is clear that Ofwat will require financial information and metrics comparing performance against the final determination (as previously outlined in the consultation for regulatory reporting), and we support that such information should be provided under the blanket of regular reporting. There are other metrics, again which are clearly reflecting targeted performance outlined in the 2015-20 Final Determination, such as return on regulated equity (RoRE) and regulatory gearing, which we anticipate companies' would already be planning to include in annual reporting going forward.

Whilst we agree that historical information and performance should be reported on an annual basis for 2015-20, the metrics and expectations for the previous regulatory period (2010-15) were considerably different and pilot reporting for 2014/15 would place an additional burden on companies and may not appropriately reflect the financial position established for the new regulatory period.

Stress Testing
Annually South West Water is required to review the company's going concern position for statutory purposes, and for regulatory purposes ensure we have adequate resources to continue its operation under Licence condition F. In making those assessments the company considers the key financial performance indicators, expectations for future performance, a review of cash and committed borrowing facilities and consideration of the company's strategic business model. This detailed analysis already includes stress testing of our financial projections to ensure a robust financial position into the future.

Going forward the UK Corporate Governance Code will require companies and directors to make a viability statement within the statutory annual report. This includes a broader assessment of long term solvency and liquidity and the long term planning and performance of the business, in addition to shorter term going concern requirements. There will also be a requirement to report how a company has considered its viability and provide greater detail on the nature of the stress tests completed to make these statements. The Corporate Governance Code, however, does not prescribe the stress tests that companies would be required to perform as the sensitivities will vary depending on each company's view of future financial performance – and for listed companies there are restrictions on the level of forecast information which can be disclosed under listing rules.

Therefore, we support the need to include stress tests for companies, but would propose that these are aligned with the requirements of the UK Corporate Governance Code and do not prescribe the risks and metrics which should be tested during these reviews. In addition, how these are then applied to the individual metrics or KPI's of a company should again be dependent on their view and perspective of the key financial metrics and how these should be reported to provide a longer term view of financial performance.

Summary
We support the aims of Ofwat to improve transparency and confidence in financial reporting and in particular our performance against the regulatory contract (Final Determination). We do, however, feel there is already considerable reporting for statutory purposes in a number of these areas and planned changes in the regulatory reporting requirements will provide stakeholders with a large proportion of this information. We are unclear how providing this financial monitoring and comparing companies across the industry will increase the stakeholders views of financial performance and resilience and may lead to confusion where financial metrics (and in particular differences in definitions) may cut across or contradict statutory reporting requirements or financial covenants.

Stress testing companies' financial plans and identifying key sensitivities is an important part of ensuring strong financial performance and resilience for any company, however, we feel the nature and extent of these stress tests should not be prescribed and the level of reporting should be aligned with the requirements of the UK Corporate Governance Code.

The introduction of the viability statement from next year will provide improved disclosure and reporting in this area, and we would propose that companies are given the opportunity to implement these statutory requirements for 2015/16 and Ofwat then considers if further regulatory reporting and disclosure is needed following this.

We set out in Appendix 1 to this letter our detailed responses to the specific consultation questions.

We look forward to discussing our response with you.

Yours faithfully

Iain Vosper
Regulatory Director

QUESTION RESPONSES APPENDIX1

Q1. Do you think the financial metrics we are proposing to include in our pilot financial monitoring report (see appendix 1) are appropriate measures?

We have the following comments on the financial metrics in the consultation:

- **Revenue vs final determination** – whilst comparisons for revenue (or other financial measures) against the final determination would seem appropriate, it must be clear that retail revenues, costs and profits are not linked to RPI, which could complicate the comparators to the FD.
- **EBIT / PAT** – this was not reported in the FD published documents (the financial model does not contain realistic IFRS depreciation as it was not used for price setting), therefore, comparisons at this level would not be appropriate.
- **Accounting gearing** – we do not think it is useful to include this in addition to RCV gearing as it is not a metric used in setting prices or assessing regulatory performance.
- **Post tax return on capital** – there is no longer a requirement to produce current cost accounts (CCA). Any metrics should be directly linked to regulatory reporting and accounts requirements and not require additional information to burden companies reporting requirements.
- **RORE** – the definition for this would need to be clear, particularly whether average net debt and average RCV are used and if gearing should be assumed at the FD notional level of 62.5% to allow for a consistent comparison between companies.
- **Dividend yield** – is this calculated on year average or year end numbers (we suggest year end as standard).
- **Retail margins** – the information should be derived directly from regulatory accounts reporting rather than being requested separately.
- **Parent company gearing** – Parent Company gearing would depend on the nature and structure of the Group and therefore would not provide any useful comparative information. Ofwat has no duties that relate to the provision of this information.

Appendix 1 of the consultation contained an analysis section. It was not clear what this was intended to convey and this section was not referred to in the consultation document.

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

No. We are not convinced that the case for a pilot monitoring report was adequately set out in the consultation, other than reflecting analysis that could be undertaken on a standard basis by Ofwat based on regulatory accounts submissions.

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 need to generally be more specific, in particular when referring to RPI, what form of RPI indexation is proposed (average, tariff year or year end).

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 additional information should only be requested from companies when required. This should be either based on a process that reviews certificates of adequate resources or other emerging information. It is not appropriate to ask for financial information more frequently than annual or for plan information outside of price review processes.

We do not think that financial monitoring information in excess of regulatory accounts submissions should be included within the financial monitoring report.

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?

Given the activities and structures within Groups can vary significantly, we do not believe financial monitoring of holding companies is appropriate. The financial monitoring report should only focus on regulatory reporting information on appointed businesses and for non-appointed activities within a Appointed business covered by a Licence of Appointment or retail Licence.

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 the principal holding companies, the ultimate controlling parties of the regulated companies or other key stakeholders?

Ofwat have no duties that allow consideration outside of the regulatory ring fence except for the specific items within Licence Condition F in terms of the compliance of the appointed business with its obligations (e.g. trading with holding companies and sufficient resources). Therefore, we believe that the financial monitoring framework should be considered from the perspective of the Licence, and any proposals should be considered a formal change to the Licence or regulatory accounting requirements as the Licence currently requires.

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 actual capital structures and expenditure plans, and to publish the results?

The consultation was not clear. It appears to suggest that this is carried out as part of business planning, but also suggests annual company reporting with annual accounts. These are very different types of documents and experience suggests it is not appropriate to mix these two processes.

Sensitivity and stress testing of company financial forecasts and projections are already reviewed when considering a company's statutory going concern status and when providing confirmation in line with Licence requirements. Companies would need to consider the level of disclosure in this area to ensure it is not contrary to the UK Corporate Governance Code.

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

As previously noted, company considerations of stress testing and sensitivities of financial projections are already made when assuming the going concern assumptions for statutory reporting.

In addition, the UK Corporate Governance Code is increasing the reporting in this area. It does not, however, prescribe the metrics or sensitivities and these will inevitably differ from company to company. Therefore, it would be better for companies to determine the metrics and sensitivities used in assessing future viability, and enable companies to align with the UK Corporate Governance Codes, without placing an additional burden for company reporting.