Strategy & Regulation

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Financial Monitoring Framework Response
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30 July 2015

Dear Sir or Madam

Consultation on financial monitoring framework

Thank you for the opportunity to respond to your consultation document 'Consultation on financial monitoring framework' published on 7 July 2015.

We agree that it is appropriate for companies, Ofwat and key stakeholders to understand the key risks faced by the sector, the impact of financial performance and to ensure that financial structures remain fit for purpose over time.

We fully support the principle that companies should take ownership for their choice of financial structure and agree that companies should provide absolute transparency regarding those arrangements. In our annual financial statements, for example, we go beyond what is required by existing disclosures, providing details of holding company structures and how dividends are utilised within the group[1].

We note that the regulatory ring fence and approach to financing within the sector has been proven to be resilient over the 26 years since privatisation. It has held firm when faced by a wide variety of financial stresses, including the collapse of Enron (owner of Wessex Water), a severe global financial crisis, wide variations to – and rates of change of – interest rates and inflation, ever-more stringent legal requirements from UK and Europe (requiring significant investment) and extreme weather events.

Unless Ofwat has identified material deficiencies within the current framework as part of its recent simulation exercise[2] we believe that it is important not to undermine its approach to financing as to do so would risk eroding accountability within the sector. This is why we are sceptical about the need for additional monitoring mechanisms and regulatory interventions in this regard. We consider these issues in more depth below, together with our views on the key metrics set out in the document.

[1] Thames Water Utilities Limited Annual Report and Financial Statements 2014/15, page 33
[2] Letter from Keith Mason to Nick Fincham 'Assurance on adequacy of financial capital', July 2015

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a) Stress testing

A key principle underpinning regulation in the sector is that it is the responsibility of companies to determine their own capital structure and financing arrangements. These structures are tested rigorously by the rating agencies and are subject to financial ring-fencing arrangements required by company licences. This is an important component of an incentive-based regulatory framework which allows investors and companies to bear the risks and take the rewards of their adopted approach.

Companies pay considerable attention to both short and long-term financing, ensuring that business plans strike an appropriate balance between customers and investors. A critical part of that assessment process is to secure and maintain an investment grade credit rating, to ensure continued access to efficient sources of finance and compliance with both licence and covenant conditions. Several companies have ratings obligations that exceed the minimum within the licence.

Companies and credit rating agencies are in regular dialogue regarding financial plans and their resilience to cost shocks, assessing risks and running scenarios such that the rating agencies can publish their forward-looking assessment of the overall credit risk for each company.

The rating process considers a wide ranging view of financial and non-financial risks and sets out in clear, independent terms, the financial risk of companies on a forward looking basis, with a built in early-warning system associated with negative outlook and credit watch flags. The process is undertaken by recognised experts, applied on a consistent basis and supported by effective commentary. It is one of the key pieces of information used by stakeholders and investors to assess the financial status and risk of a company and has effectively underpinned the £45bn of debt currently held across the sector.

The effectiveness of the rating process is informed by confidential and commercially sensitive information provided by companies to the rating agencies. This supports the quality of risk assessment and sensitivity analysis undertaken in a way which would not be achieved if it were carried out in the public domain. Companies typically maintain ratings from more than one agency – each methodology is slightly different which helps to reinforce the robustness of the rating process.

It is not clear what additional benefit would be secured by requiring companies to run a separate stress-testing process, which may not be reconciled simply to the rating and may serve instead to confuse stakeholders. By establishing its own testing process for companies to follow, Ofwat may undermine the value of the existing, market-tested, rating process, and increase uncertainty for investors. This is likely to have adverse consequences on ratings and cost of debt within the sector which would not be in the ultimate interests of customers.

We would therefore advise Ofwat to be cautious about introducing a new stress-testing reporting requirement as we believe that sufficient reliance can be placed on the existing credit rating process which is designed to assess the financial risk of companies.

b) Interaction with listing rules

Companies are required to act and report within the terms of the licence and relevant listing rules (for both equity and debt). Listing rules make it onerous to announce anything which is deemed to be a forecast of earnings and place constraints on this. Companies may therefore be reluctant to publish the results of stress testing, which effectively includes an earnings forecast.

Company concerns in this regard would include:

- the additional assurance burden necessary (e.g. in preparation of a supporting 'Accountants Report') to demonstrate that forward-looking statements are made with due care and attention to meet duty of care obligations and ensure consistency with the terms of listing rules; and
- commercial sensitivity with regard to earnings forecasts which may be particularly sensitive for retailers and new entrants.

In addition we note that the new requirements under the UK Corporate Governance Code[3] require the directors to complete a 'longer term viability statement' and that "*the statement should be based on a robust assessment of those risks that would threaten the business model, future performance, solvency or liquidity of the company, including its resilience to the threats to its viability posed by those risks in severe but plausible scenarios.*" It recommends use of robust qualitative and quantitative analysis and that stress and sensitivity analysis will often assist directors in making a soundly based statement.

We therefore consider that the objectives set out by Ofwat within the consultation with regard to understanding and stress testing financial structures in the longer term against a range of potential risks can instead be met through a combination of the existing credit rating process and the disclosures of the new longer term viability statement required by the UK Corporate Governance Code (which will be applicable to both year end and interim financial statements going forward).

c) Looking beyond the regulatory ring fence

It is not clear what additional information Ofwat may require from holding companies or shareholders outside the regulatory ring fence, nor the nature of potential interventions which Ofwat may seek to make. We would welcome Ofwat's commitment to consult further if (i) it requires additional information from holding companies or shareholders; or (ii) it seeks to extend its powers outside the existing regulatory ring fence, being clear upon the legal basis for which it proposes to do so.

[3] The UK Corporate Governance Code, The Financial Reporting Council (September 2014)

In principle it should not be necessary to look beyond the regulatory ring fence given its robust terms and strength (as tested within the sector in the past). TWUL directors must have sole regard to TWUL's obligations, with there being no obligation to pay a dividend, for example, if this would be inconsistent with achieving that aim.

Notwithstanding this principle, we believe that information which we currently disclose in our TWUL Annual Report[4] regarding the ownership, financial structure and use of dividends within the Kemble Water Holdings Group – and that published separately within the Group accounts – should provide sufficient information to inform Ofwat if it considers it necessary to look beyond the regulatory ring fence.

We consider that Ofwat should be clearer on how it will assess when it *"need[s] to intervene to protect the interests of customers"*[5] and the form, content and legal basis of such action it proposes to take, both inside and outside the regulatory ring fence, as a result of the conclusions it draws from analysis of the information it collects from the proposed financial monitoring process.

<u>d) Key metrics</u>
The key metrics proposed within the consultation are appropriate, although it would be helpful to tighten up the wording of the definitions in several areas to ensure that comparisons to the FD and across companies can be undertaken on a fully consistent basis – further details are set out in the Appendix to this letter.

<u>e) Conclusion</u>
As noted above, a key principle underpinning regulation in the sector is that it is the responsibility of companies to determine their own capital structure and financing arrangements. Companies should continue to act within licence terms and maintain an appropriate credit rating – and it follows that it should be for companies to take action where necessary rather than for the regulator to establish a process to step in to make interventions on the company's behalf.

The proposals set out within the consultation therefore risk eroding the accountability of companies to manage their own finances and capital structure.

Please do not hesitate to contact me or my team if you have any questions or comments on our response.

Yours sincerely

Nick Fincham
Director of Strategy & Regulation

[4] Thames Water Utilities Limited Annual Report and Financial Statements 2014/15 pages 33-36
[5] Consultation on financial monitoring framework, Ofwat (July 2015), page 4

Appendix 1: Company response – detailed 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?

Company response

Yes, with the exceptions noted below we agree that the financial metrics set out in the consultation are appropriate given the purposes of the consultation.

We would question whether the accounting definition of gearing is relevant to all regulated companies given the primary focus upon regulated gearing within sector financing rating and price control processes. Similarly, trade creditor days are not typically used when assessing the financial risk of companies within the sector.

Whilst we strongly agree that retail licensees should be subject to equal scrutiny, several metrics are not relevant for new Retail entrants (particularly RCV-based metrics). Similarly, the significantly different nature of these businesses means that several metrics are not meaningfully comparable for new retail entrants compared to companies with a wholesale business.

We note within the consultation that Ofwat intends to make use of existing data provided within regulated accounts where possible. Whilst the financial metrics included in the consultation can, in the majority of cases, be calculated from published data, they are not in all cases disclosed as such within the accounts (or as now defined). Ofwat should consider updating the regulatory accounting disclosure guidance for companies to include a summary table of these metrics once content and definition is finalised.

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?

Company response

No, the suggested metrics appear comprehensive.

We note, however, that the list of definitions in Appendix 2 defines "*Analysis of financial instruments, including SWAPs*", as being "*Analysis to include – nature of swaps, start and finish dates, interest rates, mark to market value etc*.". This is not included in the list of KPIs shown in Appendix 1. We would welcome clarification as to whether financial instruments are proposed to be part of the monitoring framework. Companies already provide significant detail regarding financial instruments in their accounts, which are available should Ofwat wish to include it in the monitoring framework report. However, this type of analysis doesn't easily fit into a report of KPIs comparable across the industry.

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?

Company response

We are pleased that Ofwat has provided definitions for the key metrics, although we believe that it would be helpful to tighten the wording of the definitions in several areas to ensure that comparisons to the FD and across companies can be undertaken on a fully consistent basis. To facilitate this, we have provided both a list of generic points which relate to the metrics as a whole, and a table containing comments related to specific metrics.

General comments

- It would be helpful if the definitions were clearer on whether for each metric the data should be drawn from current cost or historic cost accounts and whether data should relate to the appointed business only, or to the legal entity.
- Several metrics (e.g. gearing, interest cover, adjusted interest cover) appear similar to those typically included in company financial covenant requirements. However, as the definitions suggested by Ofwat are different to those in the covenants. This may cause confusion. For this report, comparability between companies may outweigh the benefit of consistency with the covenant requirements (given that companies will have different covenant requirements). However, if stress testing is undertaken then the most appropriate reference point would be covenant targets in order to understand risk of default.

Specific comments

Comments on specific metrics are summarised in the following table:

Table 1: Metric definitions

Metric	Comment
Revenue - Actual vs Final Determination	It would be helpful to confirm that by defining the metric to reflect appointed revenue, this excludes capital contributions (which are within the wholesale price control, but not within appointed revenue) and whether TTT IP revenue is included or excluded. The metric refers to the allowed revenue as set out in the final determination, inflated from a real to nominal basis

	using actual RPI. This raises a number of questions: • by allowed revenue does this mean the revenue within the price controls (i.e. including capital contributions, but excluding third party revenue), or the appointed revenue on a consistent basis with the definition in Pro-forma 2I of RAG3.08?; • how is the allowed revenue inflated from a real to nominal basis? Does it use actual November RPI for revenue from customers, in line with the licence requirements, or does it use year average RPI? Are Retail revenues assumed not to be inflated by RPI?; and • the Household retail revenue defined in the FD is noted as 'indicative, as allowed revenue will depend on actual customer numbers' (Note 4 to Table A5.8 of Final price control determination notice: company specific appendix - Thames Water). As such will the allowed household retail revenue be flexed to take account of actual customer numbers?
EBIT - Actual vs FD	The definition indicates that the final determination EBIT will be extracted from the financial model. This raises a number of questions: • Does this imply that the comparison is on a historic cost, rather than a current cost basis (as the financial model only generates financial statements on a historic cost basis)?; • Is the financial model to be re-run and reissued by Ofwat to reflect the actual capital structure, rather than the notional capital structure reflected within the PR14 final determination?; • Which financial model will be used for Thames Water? The model excluding the TTT IP will not have the correct Retail margins, whereas the model including the IP only reflects an estimate of the IP pass-through revenue, and with an incorrect accounting treatment used in the model (where cash outflow to the IP is assumed to be within the P&L whereas the correct accounting treatment is to build up a capital prepayment in the balance sheet during the construction period); • The definition indicates that the figure from the financial model will be inflated from a real to a nominal basis using actual RPI. Given that the financial statements in the financial model are only presented in nominal prices, does this mean that the financial model will be re-run with updated RPI data? We note that this will generate

	different K factors from those allowed in the final determination. Using this revised financial model to compare to the actual data may therefore be inconsistent; • The financial model is a tool used by Ofwat to determine the wholesale price controls and help assess financeability of the appointee. As such it does not form part of the final determination. Both EBIT and profit after tax reflect items not included within the final determination (for example, depreciation, and the allocation of totex between opex and capex). As such, to extract these from the model as if reflecting the final determination is misleading. A comparison to the financial model output at EBIT and PAT levels may therefore not provide meaningful data, as it is not clear what the extract from the financial model represents, nor is it part of the final determination. Given that it is not part of the final determination, it is unlikely to have had the same level of challenge as the items that were included within the final determination, which may reduce the robustness of the comparison and its value as a result. • We think that in comparing to the FD Ofwat should focus on the key components of the price control, namely revenue, totex, ODIs (as covered in the performance report) and retail margins. However, it may still be helpful to consider absolute levels of EBIT and PAT in context of company financial health.
PAT- Actual vs Final Determination	Our comments and concerns regarding this comparison are covered in the section above.
Funds from operations- Actual vs FD	It is not stated in the definition how the FD comparator will be derived. On the assumption that it will be extracted from the financial model, as adjusted for RPI, the same issues as noted above under EBIT are relevant.
Regulatory gearing	This may not be consistent with covenant definitions, as the net debt appears to follow statutory account definitions, rather than covenant definitions. However, data required to calculate the ratio will be available to Ofwat (net debt from pro-forma 1E of RAG3.08 and the RCV).
Post-tax return on capital	This is defined as post-tax profit as a percentage of regulated equity. Regulated equity is defined as RCV less net debt. We note that this is significantly different to the current definition of post-tax return on capital (which uses current cost post-tax profit as a percentage of total

	RCV). Is it intentional for this to reflect just the equity component of RCV, rather than the full capital value of the RCV? Clarity over historic cost or current cost basis should also be confirmed. We also note that the definition of regulated equity is different from that used in the following ratio, 'Return on regulated equity', see below.
Return on regulated equity	Contrary to the definition of regulated equity used in the post-tax return on capital, here it is defined as the equity component of the RCV assumed in the notional capital structure. Using different definitions for the same term may confuse some users. The definition of the return due to shareholders is not clear. It refers to the regulatory building blocks, but does not define how these relate to actual performance.
Return on RCV	By using the % to the full RCV, this is comparable to the post-tax return on capital as currently defined.
Dividend yield	We note that this references regulatory equity, defined as RCV less actual net debt.
Retail profit margin	We expect that this should be derived directly from pro-forma 2A within RAG3.08. However, it would be worth confirming if the revenue component is all appointed revenue (thus deriving a net retail margin) or retail-only revenue (thus generating a gross retail margin).
Interest cover	We note that the definition is different to the definition used for our covenants. The differences are primarily related to working capital where the definition here excludes working capital movements, whereas our covenant definition includes them.
Adjusted interest cover	The same comments with regard to definition noted above for interest cover are relevant here.
FFO/Debt (Funds from operation after payment of interest/net debt)	We note that as drafted the definition is likely to be different to the S&P calculation of this ratio, due to the specific adjustments that S&P make, for example with regard to accretion on index-linked debt and pension deficit repair payments.
Effective tax rate	It would be helpful for the definition to clarify if deferred tax is included.
RCV/Capex	The name for this ratio appears incorrect, as the definition refers to RCF / Capex (rather than RCV / Capex), where RCF refers to the residual cashflow, or free cashflow. It is not clear where the capex data will be collected from (for example does it include grants and contributions, is it on a cash basis or a booked capex basis?).
Trade creditor days	The definition just refers to trade creditors. Is it intended to exclude capital creditors? The definition refers to 'annual expenditure', although it is not clear where this

	data will be collected from.
Principle parent company gearing	If this data is to be collected a precise definition should be provided. For example should it be calculated by reference to RCV (in line with regulated entities) or equity? Is the focus on the consolidated group position or on the parent company itself? If 'equity' is the measure does this include all accounting reserves? If so, of the parent company, or of the consolidated group?

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?

Company response

Our view is that a yearly reporting cycle would be appropriate, drawing from information published in company accounts and annual reports. Whilst it may be appropriate, on an exceptions basis, to request information more frequently, we think this should be limited to specific cases where potential issues have been identified with specific companies through the yearly assessment process.

Interim accounts may allow some metrics to be refreshed, however we do not consider that it would be proportionate to require all companies to provide/disclose a full suite of data within the interim statements unless there is evidence of financial concern at the sector level.

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?

Company response

Our view is that the process should focus upon legal entities, as this is how rating agencies and investors assess companies, their financial performance and risk. In the case of companies where wholesale and retail activities are combined within one legal entity then the assessment should be at the combined, company, level without attempting to analyse this between wholesale and retail components. This approach would be consistent with that adopted by Ofwat for its financeability assessment at PR14.

We set out below our comments regarding the ambit of the reporting process outside the regulatory ring-fence. We support inclusion of all regulated companies, including retailers, within the reporting process.

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?

Company response

The strength of the ring fence has been tested within the sector in the past and has been shown to be robust. In TWUL's case its directors are obliged to have due regard to TWUL's ability to meet its obligations, and there is no obligation on its directors to pay dividends – dividends are discretionary and subject to compliance with the terms of the dividend policy as framed within the terms of the licence. It should not be necessary, therefore, to look beyond the regulatory ring fence given the robust terms of that ring fence as set out within the company licence and relevant statutory provisions.

We already make substantial disclosures within the Annual Report and Financial Statements for TWUL regarding both the ownership and financial structure of Kemble Water Holdings Group (including TWUL and the holding companies) together with details of how the TWUL dividend is utilised within the group.

We believe that information of this nature, together with that published separately within the Group accounts (which are also in the public domain) should provide sufficient information to provide transparency and visibility of the overall financial and capital structures of the regulated companies and the groups of which they are a part.

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?

Company response

We agree that it is essential that financial resilience is tested against a range of potential risks and that the effect of company financial structures are understood. However, we have concerns that the stress testing process proposed within the consultation would undermine and/or duplicate the existing credit rating processes and disclosure requirements under the UK Corporate Governance Code and these concerns are set out in detail within the response below.

Rather than implement a new reporting process along the lines suggested within this consultation we believe that reliance can be placed on the existing credit rating process which is designed to assess the financial risk of companies. Companies and rating agencies are in regular dialogue regarding financial plans and their resilience to cost shocks, assessing risks and running scenarios such that the rating agencies can publish their forward-looking assessment of the overall credit risk for each company.

The rating process considers a wide ranging view of financial and non-financial risks and sets out in clear, independent terms, the financial risk of companies on a forward looking basis, with a built in early-warning system associated with negative outlook and credit watch flags. The process is undertaken by recognised experts, applied on a consistent basis across the sector and supported by effective commentary. It is one of the key pieces of information used by stakeholders and investors to assess the financial status and risk of a company.

It is not clear what additional benefit would be secured by requiring companies to run a separate stress-testing process, which may not be simply reconciled to the rating and may serve instead to confuse stakeholders. By running its own testing Ofwat may undermine the value of the rating process which is likely to have adverse consequences for the rating or cost of debt within the sector.

By the nature of our financing we are required to demonstrate compliance with up to five years of forward ratios. Clearly all stake holders may perform their own stress testing on our published data. However its follows from the points raised above that it would not be appropriate to publish this analysis – which would be akin to a shadow rating.

Furthermore there may be a reluctance to publish the results of stress testing, which effectively also includes a medium term forecast of earnings as well as key ratios for the following reasons:

- the need, cost and time associated with meeting Directors obligations on publication of financial forecasts, which is likely to require a supporting Accountants Report to meet duty of care obligations and, potentially, the terms of Listing Rules; and
- commercial sensitivity – such forecasts (in particular regarding earnings and post-tax returns) are commercially sensitive and may, in the case of retailers, act contrary to the principles of competition or to discourage market entry.

In addition, the rating process already provides comfort over group/holding company financeability, and stakeholders can draw additional comfort from consideration by the rating agencies of holding company financing within their overall assessment of regulated company ratings.

We also note that required disclosures with regard to going concern are being strengthened, effective for accounting periods commencing on or after 1 October 2014 (thus applicable for the year ending March 2016 and forthcoming interim accounts) – as set out in the UK Corporate Governance Code and associated guidance issued by the Financial Reporting Council ("FRC").[6] In particular companies will be required to disclose a 'longer term viability statement' in which the directors should explain – taking account of the company's current

[6] The UK Corporate Governance Code, The Financial Reporting Council (September 2014) and Guidance on Risk Management, Internal Control and Related Financial and Business Reporting, The Financial Reporting Council (September 2014)

position and principal risks – how they have assessed the prospects of the company, over what period they have done so and why they consider that period to be appropriate.

The FRC guidance states that directors should *"state whether they have a reasonable expectation that the company will be able to continue in operation and meet its liabilities as they fall due over the period of their assessment, drawing attention to any qualifications or assumptions as necessary. This statement is intended to express the directors' view about the longer term viability of the company over an appropriate period of time selected by them".*[7]

Whilst the FRC guidance does not set out a standard time period to be covered by the statement it does say that it should be significantly longer than one year and should take into account factors including the nature of the business and its investment and planning periods.

The FRC guidance states *that "the statement should be based on a robust assessment of those risks that would threaten the business model, future performance, solvency or liquidity of the company, including its resilience to the threats to its viability posed by those risks in severe but plausible scenarios*".[8] It recommends use of robust qualitative and quantitative analysis and states that stress and sensitivity analysis will often assist directors in making a soundly based statement.

In combination we believe that the existing credit rating process plus the additional reporting requirements for a longer term viability statement under the UK Corporate Governance Code will provide Ofwat and other key stakeholders with sufficient information to be able assess industry financial resilience and risks to customers posed by companies' financial structures and to identify whether and when further intervention may be necessary.

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

Company response

For the reasons set out above we do not believe that it is necessary for companies to set out additional stress testing as reliance can be placed on the existing forward-looking credit rating process and new going concern disclosures.

[7] Guidance on Risk Management, Internal Control and Related Financial and Business Reporting, The Financial Reporting Council (September 2014), Appendix B, paragraph 1 on page 19

[8] Guidance on Risk Management, Internal Control and Related Financial and Business Reporting, The Financial Reporting Council (September 2014), Appendix B, paragraph 4 on page 19