United Utilities response to the Ofwat Consultation: Financial monitoring framework

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United Utilities welcomes the opportunity to contribute to Ofwat's consultation on the financial monitoring framework.

We recognise the value of a financial monitoring framework that increases trust and confidence in the sector. We support Ofwat's drive for more accountability and transparency around corporate governance in the sector and advocate a risk-based and proportionate approach which does not impose an additional regulatory burden where it is not required. We welcome Ofwat's statement that it is not seeking to place an unnecessary burden on companies to provide additional information to it unless it adds value to customers and other stakeholders.

We look forward to reviewing the pilot financial monitoring report in September 2015 and further details on Ofwat's proposed approach to sensitivity and stress tests. We set out below some of the key elements of our response, followed by our detailed comments on the specific questions raised in the consultation. If you would wish to discuss any aspect of our response in more detail, then please do not hesitate to get in touch.

Comparable financial data
In order to ensure that the report provides greater transparency it is essential that its historic analysis is based on a foundation of high quality data that is comparable between companies. If data is published in a common format, but relies on inconsistent calculations, there is a risk that disclosure of information could misinform stakeholders, rather than provide transparency. Given this, we believe there is scope to improve the definitions of financial metrics in several areas and provide a number of suggestions this regard. We believe this will improve the comparability of data and therefore the value of the report.

Annual frequency of reporting
We believe that the most appropriate frequency for the report is annual, in line with the existing regulatory reporting and assurance cycle. Publishing interim financial information aligned to the requirements of the financial monitoring framework would be a separate and burdensome exercise. It also may prove difficult to reconcile, for example, half year metrics to the annual figures published in the company's Final Determination.

We would suggest that Ofwat's financial monitoring resources could potentially be better targeted in higher priority areas than interim announcements from companies which already report information which meets or exceeds the standards required for FTSE-100 listed companies.

Role of stress testing
We believe that a requirement that all companies comply with C.2.2 of the UK Corporate Governance Code (requiring them to publish a Long Term Viability Statement) would deliver more analytical rigour, greater Board ownership, more appropriate accountabilities, a lower regulatory burden and more accessible information for stakeholders than centrally-defined and universally applied stress testing requirements.

We believe that centrally-defined and universally applied stress testing requirements have limited compatibility with the principle of Boards taking accountability for their company's risk management performance. By their nature, standardised stress tests are not targeted towards the specific risks facing the company, limiting their value as a diagnostic tool.

The 2014 UK Corporate Governance Code introduced section C.2.2 covering the requirement for companies to publish Long Term Viability Statements. UUW adopted this requirement early, in its 2014/15 accounts. Our Board's statements on long term viability are underpinned by a

substantial analysis. In line with FRC guidance this considers threats to the company's viability based on a robust assessment of those risks that would threaten the business model, future performance, solvency or liquidity of the group. This includes consideration of risks in severe but plausible scenarios as well as the availability and likely effectiveness of mitigating actions available to the directors to manage such risks.

We recommend that all companies in the sector should be directed to comply with the requirements of C.2.2. This approach would ensure that Boards are clearly held to account for their responsibilities and should be capable of providing stakeholders with the confidence they need about the long term viability of the company without adding a significant reporting and regulatory burden on listed companies. Centrally defined and imposed stress tests should be reserved for those companies that fail to demonstrate compliance with C.2.2.

Ofwat should also recognise that detailed publication of forward looking stress test results for listed companies would amount to publication of a company-endorsed profits forecast. This is in contrast to the well-established principles of how UK listed companies interact with public capital markets and would present a range of compliance and regulatory issues under the Listing Rules and Takeover Code, making it unacceptable to listed companies.

If publication of a universally applied stress testing regime were required – which we believe would not be proportionate – then a summary approach to publication should be adopted. Any forward looking stress test results should only be disclosed on the basis of a "traffic light"/ banding approach - such that detailed results resembling a profit forecast are not released into the public domain – or, alternatively, should be based on historic rather than forecast data.

These approaches have been deemed sufficient by UK and European regulators respectively in their approach to financial monitoring and stress testing of banks – a sector where the case for disclosure of capital adequacy metrics is significantly more clear cut.

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 majority of the proposed financial metrics appear appropriate (on a historic basis) but would benefit from more explicit definition. Bringing them into line with credit rating agencies' definitions will increase their utility and reduce the regulatory burden on companies.

Whilst in 'headline' terms the proposed historic financial metrics look acceptable (with the exception of "Analysis of financial instruments, including SWAPs"), we believe that the ratios and related definitions need to be more fully defined (see our comments on Question 3 and the enclosed Appendix).

The exact form of the financial metrics may need to vary according to what the primary purpose of the analysis is and who the main audience is.

- If the purpose is to inform investors then the metrics and definitions should be aligned to those used by the credit ratings agencies.

- If the purpose is to monitor performance against the Final Determination, then the data should be presented on a like-for-like basis taking into account, for example, differing price bases and differences in the basis of preparation (nominal vs real.)

In particular, clarification is required as to whether ratios are to be calculated on 1) an 'underlying' basis, 2) a regulatory reporting basis, 3) on a basis comparable to the Final Determination and, if so, 4) whether this should be exclusive or inclusive of any AMP5 legacy adjustments.

Many companies and credit ratings agencies (such as Moody's and Standard & Poor's) often use and place more emphasis on 'underlying' measures of operating profit or profit after tax in their annual reports and published company results. Such 'underlying' measures typically look through the accounting impact of fair value movements on debt and derivatives and non-recurring one-off items and are intended to give a more meaningful measure of business financial performance. Intra-group loans may also complicate the assessment at the regulated level for many companies in the sector.

Additionally, there are a number of accounting options and judgements involved in regulatory reporting that can cause certain elements of companies' published results to be non-comparable, which will have a consequential effect on the financial metrics. For example: fair value movements on financial instruments may be materially different depending upon the hedge accounting treatment chosen. The treatment of derivatives needs to be clarified throughout as this has the potential to materially impact a number of key ratios.

Ensuring that the financial metric definitions are clear and consistent across the industry is important when producing rigorous sector analysis. Differences in definition from credit rating agency norms may be confusing for investors. Definitions need to be clear to help investors understand the basis of measurement, relative to their own approach.

As a listed company, third party analysts already perform a great deal of analysis on UU's metrics. The analysis proposed by Ofwat could contribute towards a broader understanding of the position for other companies across the sector if the underlying data is prepared consistently with that already in the public domain and applied to publicly listed companies. If data were not prepared on this basis then this would significantly detract from Ofwat's objectives and reduce the usefulness of the report.

As a listed company we publish significant financial and operational performance information at the half and full year results. In addition, we already provide industry-wide comparisons, along with Ofwat and the Environment Agency, for a range of operational metrics to place our performance in context and help analysts assess any potential implications for value during the current and at the future price review. Producing additional analysis will improve sectoral understanding, but only if it is consistent with these existing analyses and published datapoints.

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?

Consideration should be given to including pension deficit balances alongside the metrics in the report.

This is because credit ratings agencies typically include this in their calculations of net debt and including this would enable stakeholders to see the relevant information for all companies in one report. Balance sheet metrics should reflect IFRS pension deficit balances but cashflow metrics should reflect deficit contributions on a funding basis.

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 the majority of the financial metric definitions are capable of amendment to produce consistent data and enable meaningful comparison and analysis by Ofwat and other stakeholders.

In the attached appendix we have detailed suggested changes and requests for clarification on the calculation of certain ratios and definitions. We believe that these will aid the production of consistent information. It is important that all financial information and ratio calculations are provided on a consistent basis across all companies to enable genuine ‘like-with-like’ comparisons to be made and industry-wide analysis to be reliably conducted. Failure to establish a consistent basis of calculation may mean that the intention to provide increased transparency is undermined. Consistent presentation of metrics prepared on an inconsistent basis will tend to leave stakeholders misinformed, rather than better informed.

Whilst we refer you to the appendix for full details, we would stress that clarification on the following is particularly important:

- use of ‘underlying’ versus ‘regulatory reporting’ basis;
- treatment of derivatives; and,
- carrying value (which may contain FX / fair value movements) versus nominal amount of debt.

We believe that the presentation of credit ratios, calculations and underlying definitions should be more closely aligned to those used by the credit ratings agencies, Moody’s and Standard & Poor’s. This will provide consistency and alignment with metrics which the credit market is already familiar with as well as reflecting more accurately the actual credit risks being faced by the company.

Further, Ofwat may wish to signal that the design of metrics may change as rating agency calculations and related definitions evolve (for example, arising from changes to credit ratings methodologies).

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 have no concerns with providing the information on an annual basis as this is part of our usual annual monitoring process. Being annual, it would also fit in with our third party assurance processes (if required by Ofwat), thereby being relatively cost efficient.

We note that in the consultation, Ofwat suggests publishing an updated financial monitoring report for companies which, like United Utilities, publish interim financial information. Whilst we do publish interim results, these are done on a statutory, not regulatory, accounting basis.

Publishing interim financial information aligned to the requirements of the financial monitoring framework would be a separate and burdensome exercise. It also may prove difficult to reconcile, for example, half year metrics to the annual figures published in the company's Final Determination.

We would suggest that Ofwat's financial monitoring resources could potentially be better targeted in higher priority areas than interim announcements from companies which already report information which meets or exceeds the standards required for FTSE-100 listed companies.

It would be helpful for Ofwat to clearly define from the outset in what circumstances additional information might be required. For example, is the intention that additional information would be required based on concerns about the metrics reported falling outside of certain predetermined parameters?

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?

Ofwat should appropriately define the holding company for each individual company in the sector.

For the purposes of this monitoring report, we believe that Ofwat should appropriately define the holding company for each regulated company. This should be done on a company-by-company basis so as to adequately capture group financial metrics and any 'dependencies' on the appointed business. Depending upon the nature of the individual group structure, visibility of intra-group financing and hedging arrangements might also be desirable. This should enable Ofwat to better understand the structural risks of each company and, therefore, the sector.

We assume that Ofwat will publish analysis on all regulated companies. The tables in Appendix 1 of the consultation only reflect metrics being published for WaSCs. Given that the intention of the framework is to maintain trust and confidence in the whole sector, we presume that Ofwat will publish metrics and analysis on all regulated companies, both WaSCs and WoCs.

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?

The report should extend beyond the regulatory ring fence only insofar as it enables Ofwat to adequately capture group financial metrics and any 'dependencies' on the appointed business. Each company should therefore be assessed in light of its own group structure/controlling parties (see response to question 5 above).

We would welcome clarity of the instrument(s) that Ofwat intends to use to require information which extends beyond the regulatory ring fence.

For UU, as a publicly listed company whose principal activities are the regulated water and wastewater business, it would seem appropriate to primarily focus on the appointed business with some information provided at the ultimate parent group consolidated level. For other companies in the sector, there might be a need to look at intermediate holding companies as well. The experience of Wessex Water and the failure of its ultimate parent Enron suggests that there could be an argument not to look at ultimate controlling parties or other key shareholders, as such analysis may not assist in understanding the appointed business' risks.

In regard to analysing tax structures of groups, as a general proposition, we are not supportive of the proposals for Ofwat to review holding company tax structuring. Tax policy, and how a group is able to structure its tax affairs, is a matter for Government to decide and for companies to respond to in a responsible manner. Provided the company is conducting its tax affairs in accordance with the law, then this does not appear to be a matter for individual sectoral regulators.

Should Ofwat be regarded as "investigating" group tax structures, this may give rise to an impediment to future foreign direct investment in the sector. In addition to this, key elements of the typical water sector / infrastructure fund tax structuring, such as quoted Eurobonds, have recently been considered by Government. Its conclusion was that no specific changes to the current regime were required.

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 a requirement that all companies comply with C.2.2 of the UK Corporate Governance Code (requiring them to publish a Long Term Viability Statement) would deliver more analytical rigour, greater Board ownership, more appropriate accountabilities, a lower regulatory burden and more accessible information for stakeholders than centrally-defined and universally applied stress testing requirements.

If, contrary to this recommendation, Ofwat preferred to use a standardised sensitivity analysis, then publication of detailed results of forward looking forecasts would constitute a profit forecast and would therefore not be acceptable to listed companies. Where publication is required, this should be on a "traffic light" or "banded" basis for forward looking forecasts or, alternatively, tests should be prepared based on historic data. These levels of disclosure have been deemed sufficient for UK and European bank regulation (respectively) when the case for disclosure in the financial services sector is considerably more clear cut.

We believe that centrally-defined and universally applied stress testing requirements have limited compatibility with the principle of Boards taking accountability for their company's risk management performance. By their nature, standardised stress tests are not targeted towards the specific risks facing the company, limiting their value as a diagnostic tool.

The 2014 UK Corporate Governance Code introduced section C.2.2 covering the requirement for companies to publish Long Term Viability Statements. UUW adopted this requirement early, in its 2014/15 accounts. Our Board's statements on long term viability are underpinned by a substantial analysis. In line with FRC guidance, this considers threats to the company's viability based on a robust assessment of those risks that would threaten the business model, future performance, solvency or liquidity of the group. This includes consideration of risks in severe, but plausible, scenarios as well as the availability and likely effectiveness of mitigating actions available to the directors to manage such risks.

We recommend that all companies in the sector should be directed to comply with the requirements of C.2.2. This approach would ensure that Boards are clearly held to account for their responsibilities and should be capable of providing stakeholders with the confidence they need about the long term viability of the company without adding a significant reporting and regulatory burden on listed companies. Centrally defined and imposed stress tests should be reserved for use as a remedial measure for those companies that fail to demonstrate compliance with C.2.2.

We consider that the most valuable and meaningful sensitivity tests are those which are long term and consider the full balance of risks and mitigations, such as those required for C.2.2. By their very nature, however, these tend to involve the largest degree of specificity and judgment and will be the most difficult to compare "side by side." This is why it is important that the accountability for compliance sits with each company's Board.

In adopting C.2.2 we noted that, whilst the Code does not specify a period over which the viability statement should be made, it indicates it should be "significantly longer than 12 months" from the approval of the financial statements. Our view is that a five year period represents a reasonable period of time as a forecast horizon for the key risks and risk mitigations for a regulated water company.

The factors considered in the analysis presented to the Board this year included:

- the company's projected budget and business plan;
- projected financial indicators, credit metrics, credit ratings and headroom on debt covenants and the forward looking liquidity position of the company;
- existing and potential credit facilities and refinancing options forecast to be available to the company;
- other potential headroom provided by actions such as deferral of dividend payments or re-profiling investment expenditure;
- the economic and regulatory environment in which the company operates;
- the mitigating effects of insurance cover; and
- the impact, estimated at varying degrees of severity, of the manifestation of the top ten risks the company faces as identified through the company's ongoing risk assessment activity.

The broader scope and extended timeframe for the long term viability statement mean that it is more akin to an assessment of capital adequacy than the narrower liquidity test currently set out in Condition F of the company's licence. Even so, the long term viability statement is more accessible to most stakeholders - particularly customers and their representatives - and provides them with the confidence they need without adding a significant reporting and regulatory burden on listed companies.

We support Ofwat's drive for more accountability and transparency around corporate governance in the sector and would advocate a risk-based and proportionate approach which does not

impose an additional regulatory burden where it is not required. We therefore recommend the following approach:

- Ofwat should require that all companies establish compliance with C.2.2 from the UK Corporate Governance Code and that they should publish an annual long term viability statement covering a period of at least five years.
- Where companies find that there are material issues arising, it should publish a description of these and the remedies they are employing to mitigate the risks.
- All companies, whether publishing a clean report or not, should be on notice that they may be required to provide Ofwat with the analysis undertaken in support of the long term viability statement.
- Ofwat itself could then require access to the specific results either on a uniform basis across the sector or, more proportionately, on a targeted basis following a risk assessment.
- In the event that significant issues are discovered which Boards have not already adequately addressed, this will provide an opportunity for Ofwat to act and report on the action taken, contributing to trust and confidence in the sector.

We consider that the approach set out above ensures that Boards are clearly held to account for their responsibilities and that sufficient, appropriate and accessible information is provided in public and to the regulator in order to facilitate trust and confidence.

If, contrary to these recommendations, Ofwat decided that specific defined stress tests should be conducted by all companies on a non-targeted and non-risk assessed basis, then it should be mindful of the specific difficulties this presents for companies which are listed on the public equity markets. Publication of the detailed results of forward looking stress tests on metrics such as FFO/Debt would be unacceptable to listed companies as they would effectively amount to publication of a forward looking profit forecast. This would not only be inconsistent with well-established principles of how UK listed companies interact with public capital markets – it would also present a range of compliance and regulatory issues under the Listing Rules and, in a defence situation, the Takeover Code.

Accordingly, if they were required – which we believe would not be proportionate - any forward looking stress test results should only be disclosed on the basis of a “traffic light” or banding type approach such that detailed results capable of being interpreted as a profit forecast are not released into the public domain. More detailed results could be made available to Ofwat if required and on the basis that release to any third party would not be allowed, based on commercial sensitivity considerations. One further alternative means of publication would be to conduct and publish stress tests based on historical data. Whilst this would not be a forward looking assessment, it would avoid the complications associated with publication of a profit forecast.

The two approaches outlined above (traffic lights and a historical approach to stress testing) have been deemed sufficient by UK and European regulators respectively in their approach to financial monitoring and stress testing of banks – a sector where the case for disclosure of capital adequacy metrics is significantly more clear cut.

Finally, in the event that Ofwat were to require publication of standardised stress test results in whatever form then this must only be undertaken if there is confidence that results from different companies are comparable and calculated on the same basis. If results are presented in a common format, but reflect underlying differences in calculation, then the effect of publication would be to leave stakeholders misinformed. In our response to Ofwat’s consultation we have highlighted a number of areas where metrics would benefit from additional definition. However, our overarching view is that the potential for non-comparability of results tends to further support

the case for the precise approach to stress testing to be the one that Boards believe is most appropriate to a company's particular circumstances.

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

As stated in our response to Question 7 above, by standardising the sensitivities to be tested, Ofwat would transfer some of the responsibility of good governance away from company boards and on to themselves. It may also increase the chance of ignoring company specific risks from the analysis.

Should Ofwat insist on a standardised sensitivity analysis, then we would make the following observations about the magnitude and/or definition of some sensitivities, as set out below.

The proposed totex sensitivity (10% increase) could be considered extreme by historical standards. In order to gather more meaningful results, we suggest that this level be reconsidered.

Clarification from Ofwat would be required around the interest rate sensitivity. It is currently unclear whether this would be a general e.g. 1% uplift "across the board" or if it should take into account existing interest rate fixes.

More generally, Ofwat may wish to consider the relevance of work published recently by the Systemic Risk Centre (SRC) at the London School of Economics. In July 2015, it published work specifically about the problems associated with the financial services sectoral regulators relying on a uniform set of models to forecast risk[1]. This work has relevance beyond the financial services sector and has crossover to any regulated industry, including ours. The report states:

> *"[…] in practice it would seem that all models are simplifications of the real world, which means that they are wrong by definition […]. If the authorities pick one modelling approach over another, they may be backing the wrong horse […].*
>
> *For this reason, it is generally better for financial institutions to develop their own models internally, subject to regulatory scrutiny. This is more likely to lead to a healthy competition in model design and more protection for the financial system, because model quality will improve over time.*
>
> *If the authorities end up backing a given risk model, and some years down the road when the next crisis happens, analysts may find that a key contributor to the crisis was the wrong model promoted by the authorities."*

As should be apparent from our response, we endorse this approach of individual companies developing their own risk models and analysis in preference to an approach imposed centrally by Ofwat.

[1] http://issuu.com/lsesrc/docs/src_final_july_2015?e=17950101/14294828
"Risk models: harmonisation or heterogeneity?", pages 23-24, Systemic Risk: What research tells us and what we need to find out, Systematic Risk Centre, July 2015

APPENDIX

Detailed below are the financial metrics and their definitions, as suggested by Ofwat in the consultation. Next to each, we have proposed what we consider to be a more suitable metric and/or definition. We believe that these are required to produce consistent information.

To the extent that some of these measures appear in the regulatory accounts already, we would also encourage Ofwat to keep the calculations aligned (on the same basis) to avoid additional impact on companies.

Ofwat suggestion		UU proposal
Financial metric	**Definition**	**Definition**
Revenue – actual versus final determination	Total appointed revenue for the year compared with allowed revenue as set out in each company's final determination, which has been inflated from a real to nominal basis using actual the Retail Prices Index as published by the ONS ("RPI"). The difference will be presented as value in £m and as % compared with the final determination value.	We presume that because this is regulatory accounting revenue (as opposed to IFRS) therefore revenue is unaffected by revenue recognition issues, e.g. letters to the occupier.
Earnings before interest and tax (EBIT) – actual vs final determination	Total earnings before interest and tax for the regulated business taken from the regulatory company accounts compared with the equivalent figure from the final determination financial model, inflated from a real to nominal basis using actual RPI. The difference will be presented as value in £m and as % compared with the final determination value.	EBIT may be affected by a company's choice of accounting treatment. Ofwat could therefore consider adjusting for this type so that the metric is comparable across companies.

Profit after taxation – actual vs final determination	Total profit after tax for the appointed business taken from the appointed company accounts compared with the equivalent figure from the final determination financial model, inflated from a real to nominal basis using actual RPI. The difference will be presented as value in £m and as % compared with the final determination value.	Profit after taxation may be affected by the choice of accounting treatment. Most materially of these, as this metric is post finance expense, it is likely that this metric will include fair value gains / losses which can be significant. Removing them should improve the utility of the metric. Therefore the reported value could be adjusted for such items, to produce an 'underlying' metric as opposed to reported. This would be more in line with credit ratings agencies' metrics. This metric may also be impacted by AMP5 legacy adjustments. To be comparable, the actual and Final Determination figures should treat AMP5 legacy adjustments consistently.
Funds from operations (FFO) – actual vs final determination	Funds from operations should be calculated as net cash generated from operations as set out in Proforma 1D in regulatory accounting guideline (RAG 3.08) adjusted to remove the impact of changes in working capital.	This metric could be brought in line with credit rating agencies' methodology, which differs from Proforma 1D. An underlying finance expense is deducted as opposed to cash interest (although for Moody's this doesn't include indexation on index linked debt, for Standard and Poor it does. Therefore this will be materially different depending upon which financial ratio uses it). Also current tax expense is deducted as opposed to tax paid. Again, FFO may be affected by the choice of accounting treatment. Ofwat could therefore consider adjusting for this type of item so that the metric is comparable across all companies.
Net debt	Net debt is defined as set out in Pro forma 1E to RAG 3.08 and is the net of all debt and cash balances. It excludes any amounts due in respect of retirement benefit scheme obligations.	Reported debt balances can include both FX and fair value movements. The effect is such that balances may not be comparable between companies with differing accounting treatments nor reflect the post derivative economic value due to be repaid on swapped debt. This metric could replicate rating agencies' methodology, i.e. eliminating any FX and fair value movements included in debt carrying values by either adding certain derivative balances (those in fair value hedge relationships plus cross currency swaps) or overwriting the carrying value with the swapped amount due to be repaid.
Regulated equity	Calculated as Regulated Capital Value as updated and published by Ofwat ("RCV") less net debt.	See proposals on "net debt" definition above
Regulatory gearing	Calculated as the ratio of net debt to RCV.	We would suggest replicating rating agencies' methodology, i.e. treating any pension deficit and operating leases as debt. Also see comments on "net debt" definition above

Accounting gearing	Calculated as the ratio of net debt to total equity (share capital and reserves).	See proposals on "net debt" definition above.
Credit rating	Credit rating (corporate family where available) issued by a recognised credit rating agency.	Requirement should be to list *all* solicited long-term ratings for the appointed business along with the outlook/watch status. We would recommend against reporting subordinated debt ratings.
Post-tax return on capital	Profit after tax for the appointed business for the year as % of regulated equity.	See proposals on "profit after tax" definition above See proposals on "regulated equity" definition above.
Return on regulated equity	Return due to shareholders/equity component of the RCV assumed in the notional capital structure. The return due to shareholders is calculated as profit before interest and tax calculated using the regulatory building blocks less tax less (cost of debt x average net debt).	It is not clear what the reference to "regulatory building blocks" refers to in the context of reporting against historic accounts. If it is intended that company reported "profit before interest and tax" is in some way adjusted for Final Determination price setting building blocks then further guidance on specific adjustments may be needed. See proposals on "profit after tax" definition above for comments on defining adjustments for tax. We assume that 'cost of debt' refers to the allowed cost of debt used in setting the appointed business WACC at PR14. If however this is meant to be a company specific actual cost of debt, then we believe this should be the post derivative cost of debt excluding fair value impacts. We assume that 'average net debt' refers to the notional net debt assumption used in setting the appointed business WACC at PR14. If this is calculated as assumed gearing applied to RCV then we have no further comment. If however this is meant to be company actual average net debt then our proposals above relating to "net debt" equally apply here.
Return on RCV	Profit after tax for the appointed business for the year as % RCV.	A more usual definition of "Return on RCV" is calculated using "operating profit" less "tax charged" instead of "profit after tax". This is the definition used for ROCE, reported as part of the PR14 process. Our proposals above relating to "EBIT" and "Profit after tax" equally apply here. It would also be helpful to have a clear statement on whether year average or year end RCV values should be used within the calculation.

Dividend yield	Total dividend declared in the year as a percentage of the regulated equity at the year end.	We suggest that this is for the appointed business only
Dividend cover	Profits before dividends for the year divided by dividends declared.	We suggest that this is for the appointed business only We would like a fuller definition of "Profits before dividends". If this is comparable to the definition of "profit after tax", please see our comments made on "profit after tax" above.
Retail profit margin	Retail earnings before interest and tax as a percentage of revenue.	We believe that NHH retail profit margin could be classed as commercially sensitive information and should therefore not be disclosed.
Interest cover	Funds from operations before payment of interest/ interest paid.	We would advocate replicating Standard & Poor's methodology; see comments on "FFO" above.
Adjusted interest cover	Funds from operations before payment of interest less regulatory depreciation/interest paid.	We would advocate replicating Moody's methodology. Moody's do not use "interest paid" as the denominator but an underlying interest expense with fair value movements stripped out and indexation on index linked debt added back. "Regulatory depreciation" may require a stricter definition around whether this is both pre- and post-2015 RCV run-off. The comparability and ease of producing this metric will be impacted by the run-off rates which companies have individually chosen in AMP6. We presume that no "IRC" type regulatory charge is deducted because Ofwat are using IRE as a proxy to IRC. In this case, any difference in IRE expense/capitalisation treatment between companies becomes important. See comments on "FFO" above. Ofwat should be aware that Moody's calculation may materially change in the future when Moody's clarify how they propose to remove the impact of 'fast' money through the PAYG ratio.
FFO/debt	Funds from operations (as defined above) / year average net debt.	We would advocate replicating Standard & Poor's methodology. In particular, indexation on index linked debt should be deducted from FFO and any pension deficit (post tax) and operating leases should be added on to net debt. This also should be "year-end" as opposed to "year average" net debt. See comments on both "FFO" and "net debt" above.

Effective tax rate	Tax charge for the year as a % of profit before taxation	We would appreciate confirmation as to whether this will be total tax charge (i.e. current and deferred tax), or simply the current tax charge. An effective tax rate based on cash or just current tax would be a more useful metric and we would advocate amending this definition accordingly.
Free cash flow (RCF)	Post interest FFO (as defined above) less dividends paid	We would advocate replicating Moody's methodology, in particular by adding back IRE to FFO. See comments on "FFO" above.
RCF/Capex	Free cash flow / capex	We think a fuller definition of capex may be helpful. For instance, whether IRE should be included or excluded. See comments on "RCF" above.
Trade creditor days	Calculated as trade creditors/ (annual expenditure) x 365 days.	We think a more comprehensive definition of "annual expenditure" would be helpful to aid comparability of this metric.
Average embedded cost of debt	Interest paid on debt / average debt balance	To align this metric with existing analysis, we think that this could be changed to be the cost of debt post the economic effects of derivatives, i.e. both interest paid on debt and debt balances should be post the economic impact of derivatives. In calculating the debt balance all FX and fair value movement inherent in reported amounts should be stripped out. See comments above on "net debt". If this is being calculated separately for fixed, floating and index linked debt then "interest paid" appears appropriate. However, if this is calculated as one cost of debt over all types of debt then it is better expressed as "underlying interest expense" rather than "interest paid". Otherwise, the proportion of index linked debt will skew the result and make it non-comparable across companies with different proportions of index linked debt.
Tenor of debt	The average term of the company's net debt.	We assume that the purpose of this metric is to understand the companies' refinancing risk (as opposed to the duration of any interest rate fixing). On this basis, we believe that this is better prepared on a gross debt basis. However, if this metric is intended to identify the duration of any fixed interest rates, then a different metric may be needed, incorporating the impact of derivatives.

Profile of debt repayments	Percentage of net debt which is due to be repaid within one year, in 1 to 2 years, 2 to 5 years and in more than 5 years	We believe that this is better prepared on a gross debt basis, as cash is typically short-term.
Mix of debt between, fixed rate debt, floating rate debt and index linked debt.	Percentages of total debt which is fixed rate, floating rate and index linked	We believe that this metric could be improved by stating it after the economic impact of derivatives. In addition, in calculating the percentage of debt that is fixed, floating or index linked this could be improved by basing it on an underlying value of the debt as opposed to carrying value (i.e. any embedded FX and fair value movements should be stripped out of the carrying value of net debt – see comments on “net debt” above).
Analysis of financial instruments, including SWAPs	Analysis to include – nature of swaps, start and finish dates, interest rates, mark to market value etc.	This metric may be rather impractical to report and covered by other information already provided elsewhere. Where relevant, the impact of derivatives should be embedded in the financial metrics (as recommended above). In addition, UUW which has over 100 derivatives, the details of which are not (and should not be made) public. We also have other types of derivatives which could be inadvertently captured in this metric, but would not aid the analysis. For example power derivatives, which could be classed as a financial instrument under this definition.
Company monitoring category	The company’s assurance category as defined by Ofwat’s company monitoring framework.	No comments