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Dear Keith

Thank you for the opportunity to respond to your consultation on the Financial Monitoring Framework.

We understand the need to maintain public confidence in the financial resilience of the water industry as a provider of key services to the wider economy. This is a particularly pertinent issue given recent events in the banking sector.

In our view Ofwat can play a useful role in maintaining that confidence by making a routine statement about the existence or otherwise of any systemic financial resilience risk in the sector (as happened as part of the PR14 process), and by being transparent about the means by which you have carried out the assessment. Ofwat's independence from companies will itself give stakeholders greater confidence in this statement.

We would expect Ofwat's analysis to use routinely published annual financial information alongside forward estimates using its knowledge of water company obligations, business plans and service performance. Where these tests result in any concerns then these should be raised with company Boards who should be given an opportunity to explain with further information and/or otherwise take action to reduce an identified risk.

We do not support the proposal for companies to publish their own stress test results. Our view is that this could endanger trust and confidence if the results of these analyses are misinterpreted by less informed stakeholders, or muddy the waters for more informed stakeholders.

We have answered the individual consultation questions in an appendix to this letter.

As ever, if we can be of any further assistance please do let us know.

Best regards

Andy

Andy Pymer
Director of Regulation & Customer Services

Appendix 1 - Response to Financial Monitoring Framework

These responses should be read alongside our covering letter to Keith Mason which forms part of our consultation response.

Q1 Do you think that the financial metrics you are proposing to include in our pilot financial monitoring report are appropriate measures?

Q2 Are there other financial metrics that should be included?

Q3 Do you agree that the definitions are appropriate?

We have given comments against each measure below and suggested some changes and one additional measure.

It would be helpful for Ofwat to be transparent about the driver for each measure proposed and those that it intends to publish. These could be either:

- Financial resilience,
- Comparative Performance

In the latter case, publication of comparative performance information might be appropriate if the purpose is to drive improvements across the industry – however it is important to have a clear understanding of what represents a good outcome; for instance publishing comparative statistics on the effective tax rates paid by companies could be expected to give greater impetus to minimise companies' tax bills.

Measure	Comment	Recommendation
Revenue vs FD	This measure is of limited value in assessing financial risks. Revenue risk over a five year period is low as a consequence of the revenue true-ups in the wholesale and retail household price controls – in particular, in the wholesale control revenue under-recovery in one year will say nothing about the likely level of revenue in the following years. Care needs to be taken when assessing accounting values against FD allowances as the latter include capital contributions from developers. Care should also be taken in assessing indexation, given that wholesale revenue allowances are indexed by November RPI. Publication as a metric of financial stability	Calculate but do not publish

Measure	Comment	Recommendation
	may act as a disincentive for companies to agree deferral or non-take up of full price limits to reflect stakeholder concerns about performance issues.	
EBIT - Actual vs FD	EBIT includes assessments of depreciation (Current cost or Historic cost?). Depreciation had no direct impact on price limits and therefore it is less useful as a measure of performance against FD than other measures.	Remove
Profit after tax – Actual vs FD	Given the different capital structure assumed for the FD and the different capital structures of the companies this will not give useful information - either as a comparison to the FD or as a comparison amongst companies	Remove
FFO – Actual vs FD	This is probably the most useful measure to compare with the FD as it does not suffer from the shortcomings above - it is the most simple means to assess whether the company is controlling its expenditure against the FD. Although arguably an even simpler measure of totex v FD would be even more simple (see below) A more useful measured might be adjusted FFO v FD - in this calculation the wholesale revenue is adjusted to be the FD allowance so any under or over-recovery of wholesale revenues in the year is stripped out.	Keep or replace with "adjusted FFO" or Totex v FD below
Totex vs FD	This would be a more simple means to assess whether the company is controlling its costs. Totex should be that which has been implicitly allowed by Ofwat, given the company's final menu choice.	Add
Regulatory Gearing		Keep
Accounting	Does not add anything to the measure of	Remove

Measure	Comment	Recommendation
Gearing	regulatory gearing.	
Credit Rating		Keep
Post Tax Return on Capital	This appears to be a measure of return on regulated equity not return on capital. This seems surplus information if we are also publishing RORE and return on RCV. Differences between companies will be largely driven by the level of gearing.	Remove
Return on Regulated Equity	This is potentially a useful measure of comparative performance, but should be amended to be a more pure measure of regulatory performance - i.e. it should exclude the transitory impacts of revenue differences but include gains and losses from underlying totex and ODI performance with appropriate sharing as per company menu choices. Assessing financing under or outperformance is more problematic given the assumed notional capital structure in the FD. It may be more simple to measure this in relation to a notionally geared company and therefore exclude financing performance which can be captured elsewhere.	Amend
Return on RCV	A generally well understood measure of financial performance	Keep
Dividend yield	It is not clear to us how this measure contributes to an understanding of financial stability given the other measures of total return that are proposed to be published.	Remove
Dividend Cover	As above	Remove
Retail profit margin		Keep
Interest Cover	These ratios are calculated by credit rating agencies and inform their credit ratings	Calculate but do not publish

<table>
<tr><th>Measure</th><th>Comment</th><th>Recommendation</th></tr>
<tr><td>Adjusted Interest Cover</td><td rowspan="2">which are publicly available. Each agency has a different method of calculating these, and placing another method within the public domain risks reducing rather than increasing transparency.</td><td>Calculate but do not publish</td></tr>
<tr><td>FFO/Debt</td><td>Calculate but do not publish</td></tr>
<tr><td>Effective tax rate</td><td>We are not clear how this measure explains financial robustness.

The potential incentive qualities of publicly comparing company effective tax rates should also be considered carefully.</td><td>Remove</td></tr>
<tr><td>Free Cash Flow</td><td></td><td>Keep</td></tr>
<tr><td>RCF /Capex</td><td></td><td>Keep</td></tr>
<tr><td>Trade Creditor Days</td><td>The incentive qualities of publishing this measure as a comparative statistic should be considered carefully</td><td>Remove</td></tr>
<tr><td>Average embedded cost of debt</td><td></td><td>Keep</td></tr>
<tr><td>Tenor of Debt</td><td></td><td>Keep</td></tr>
<tr><td>Profile of Debt</td><td></td><td>Keep</td></tr>
<tr><td>Mix of Debt</td><td></td><td>Keep</td></tr>
<tr><td>Company Monitoring Category</td><td>This measure could be misconstrued in a way that reduces trust and confidence in this context, in particular because there will be a suggestion that the monitoring category is directly linked to financial performance and stability.

While an absence of an unqualified audit statement will obviously impact on the monitoring category as we understand it the monitoring category assessment is far wider than this.</td><td>Remove or replace with a simple statement about whether company financial auditors qualified their audit opinion in any way.</td></tr>
</table>

Q4 Do you agree that the financial monitoring report should be published each year with additional information from companies only when required?

Yes, and within this Ofwat should make a clear statement each year about its assessment of systemic financial risks faced by the sector and the need or otherwise for regulatory intervention noting and explaining with analysis any differences in its assessment with reference to that made (and supported by PwC) at PR14. Ofwat could further improve trust and confidence by being transparent in the way that it has carried out its assessment.

Q5 Are there any other companies that we should be including within the financial monitoring framework?

Not in published data.

Q6 How far outside of the regulatory ring fence should we 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?

It is reasonable for Ofwat to consider the financial strength of companies outside of the regulatory ring fence as part of its duties to protect consumers. This should take the form of analysis of publicly available information and conversations with company management if there are concerns, or if data is not readily available. There is no need in our view to publish this information.

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 to publish the results?

We do not agree that companies should be required to publish forward looking stress test data.

However while it is for company Boards to determine appropriate financing strategies (and this principle should not be undermined) we can see that Ofwat could play a useful role in maintaining stakeholder confidence in the financial resilience of the sector. This could be by conducting its own risk-based tests, being transparent with stakeholders on the way that it has performed and will perform these tests and the actions it has or would take if there were any concerns.

It follows that the level of engagement required between Ofwat and the company should be risk based, taking into account Ofwat's already extensive knowledge about companies' current financial performance, knowledge of the company's upcoming obligations and current operational performance levels compared to their commitments. In particular we agree with Ofwat's recent statements that sometimes there are occasions when a phonecall with company management will suffice to raise a potential concern. This seems to be an area where that approach would be most beneficial - not least because waiting for a formal stress test to occur at a later date before taking action would actually reduce Ofwat's ability to intervene in the interests of customers at an earlier stage.

We understand that in the Banking sector where there are systemic risks to the wider economy of company failure and where trust and confidence has been severely damaged in recent years there is a case for specific stress test targets and the results of these to be placed in the public domain. It is not clear that there is a valid comparison between the water and banking sectors not least because Ofwat has explicitly not set targets for financial stability by which the sector is to be judged.

We are therefore concerned that the impact of publishing additional data provided about stress tests:

- on a comparative basis without its full context,
- where the definition of the metrics themselves may conflict with the data analysis conducted by more informed financial stakeholders, and
- without well understood targets by which to judge companies' financial stability

could simply be misinterpreted by less informed stakeholders and act to confuse informed stakeholders. This will act to undermine rather than build trust and confidence in the sector.