



YorkshireWater

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Our reference

Your reference

Dear Sir or Madam,

## Consultation on financial monitoring framework

Thank you for the opportunity to respond to the above consultation.

We welcome the proposal for a financial monitoring framework and associated report, and agree with the aims of the financial monitoring framework. That is, to:

- Monitor the financial stability of regulated businesses;
- Identify financial or structural risks that may impact on the companies' abilities to deliver for customers; and
- Determine when the Regulator needs to intervene to protect the interests of customers, using the regulatory tools available.

Our responses to the specific questions posed within the consultation are attached to this letter. We would, however, like to draw your attention to our views on two particular issues.

### 1. Scope of monitoring

We agree with Ofwat's suggestion that "initially, the financial monitoring framework will focus only on the regulated entities" (p15). We would go further and propose that, rather than being on an initial basis only, as a matter of routine, the report should concentrate on regulated entities within the regulated ring-fence.

Our view is that a more effective method to achieve the aims of the monitoring framework is to take a two stage approach.

- Stage 1 is routine monitoring of the ring-fenced regulated entities. This, in conjunction with existing assurance statements and transparency required in other reporting areas, will enable the identification of "trigger" levels and events that could necessitate the Regulator to look outside the regulated ring-fence.

- Stage 2 would only occur in exceptional circumstances, should a trigger or event give the Regulator the need to consider companies outside of the regulated ring-fence.

This approach, whilst achieving the objectives of the monitoring framework, has the additional benefits of preventing regulatory creep and limiting the regulatory burden, both important aims in themselves.

## **2. Stress testing and publication of results**

Yorkshire Water carries out stress testing exercises on its actual balance sheet as a matter of course during its strategic and business planning processes. This is a complex area and the interpretation of the results requires careful consideration.

We welcome the opportunity to provide and share the results of the stress testing with the Regulator, as we have in the past, e.g. in relation to our Whole Business Securitised conversion. We consider, however, that consideration of the results out of context together with the technically complex nature of the analysis could lead to misinterpretation of the results. This in turn could have unintended consequences for companies and therefore the details of stress testing should not be placed in the public domain. Stress testing must always be considered in context, i.e. likelihood of occurrence, past experience, management track record, financial structure (including covenanted protections). It is difficult to convey this context within a comparative report.

The two areas mentioned above, albeit briefly, would benefit greatly from further discussion with companies and other stakeholders and further research. The short timescales for responding to this consultation prevent us from doing this in isolation. We encourage Ofwat to work together with companies and relevant stakeholders to further develop this area.

Yours sincerely,



PP  
Adrian Kennedy  
Director of Regulation  
Yorkshire Water.



**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?**

We agree that the metrics (as outlined in appendix 1) are an appropriate set of financial measures, except for measures outside of the regulatory ring-fence i.e. 'Principle parent company gearing'.

**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?**

We agree that the proposed financial metrics are appropriate and, at this stage, we would not propose that any further financial metrics were included in the pilot or future reports.

**Q3 Do you agree that the financial metric definitions set out in appendix 2 are appropriate? Are there any alternative definitions that we should be considering? If so, why?**

We agree that the proposed financial metric definitions as set out in appendix 2 are appropriate.

**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 support the proposal for the financial monitoring report being published each year and for any additional information being requested from companies as required. At this stage, we would not propose providing financial information more frequently than annually.

**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?**

The financial monitoring report should focus on regulated entities only for the reasons set out in our covering letter.

**Q6 How far outside the regulatory ring fence do you think 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 stakeholders?**

The financial monitoring report should focus on regulated entities only for the reasons set out in our covering letter.

**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?**

Yes, companies should be carrying out appropriate stress testing of their business plans. We set out in our covering letter why these should not be published.

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

The sensitivities being proposed appear to be arbitrary. We encourage further research to determine which sensitivities are appropriate, at both an industry level and also an individual company level, to ensure the sensitivities are relevant to different risks and different capital structures.