



Our review of our processes and procedures for when a company may be in financial distress

About this document

This document sets out the results of our review of our processes and procedures when a company may be in financial distress and the steps we will be taking to address the lessons coming out of that review. It also describes the context in which our review took place.

Introduction

Our shared vision for the water sector in England and Wales is one where customers, the environment and wider society have trust and confidence in vital public water and wastewater services. To help maintain this trust and confidence we need to be ready to step in if service providers fall short and this may include where companies experience financial distress and may ultimately fail. In these circumstances we have a role to protect customers to ensure they continue to receive water and wastewater services. We need to be sure that we are ready to do so and this is what our review tested.

However, if companies are corporately and financially resilient, then they should not experience financial distress and therefore there will be no need for us to step in. We explained in our recent [consultation](#) on Ofwat's new role in resilience, stemming from the duty which we gained through the Water Act 2014, that companies need to be financially and corporately resilient. To help them do this, companies should consider all risks that have the potential to place service provision at risk. This includes their financial structure and how any associated risks might change over time. Companies are responsible for managing the risks to trust and confidence in provision of their services, including the risks to the delivery of the outcomes customers and society expect, and the ways they deliver these.

Our regulatory framework ensures that risks are borne by those best able to manage them, for example companies are best placed to manage the risks to delivery of services to customers and investors should manage the risks of the investment decisions they make. This allocation of risks means that customers should not be

exposed to risks which they cannot manage. The special administration regime, and other protections within water company licences, helps to protect customers from the risk of company failure by ensuring the continued delivery of services. Our review tested how we react when a company is experiencing financial distress with the prospect that it may need to be subject to special administration.

Background

Companies in any market may find themselves in a position where they experience financial distress. Financial distress may be linked to operational issues which the company is facing, for example if the company faces a major operational problem this may require additional financial resources to address. Equally if a company is suffering from financial problems this may lead to underinvestment in operational assets which may lead to operational issues.

It is possible that a company may fail as a result of the financial problems which it is facing. Ofwat is not required to prevent water companies getting into financial distress or failing in all circumstances. Financial distress and the failure of companies is just part of the normal operation of markets. If we were required to prevent companies failing in all circumstances, this could mean, for example, that inefficient companies were maintained to the detriment of their customers. We interpret our duties to mean that we only need to ensure that efficient companies are able to finance their functions, not any company.

However given the position of monopoly water companies in England and Wales, it is not possible for most customers to switch to competitors as they would do in other markets if the company from which they are receiving a service ceases to operate. We therefore have role to play to protect customers where a company is in financial distress or ultimately goes out of business, to ensure that customers continue to receive a service which they cannot get from elsewhere.

The special administration regime should ensure that customers are protected in the event that a company fails. The purpose of the special administration regime is not to keep a company in business but rather to ensure that the provision of services to customers is maintained. This is important because it ensures that investors bear an appropriate level of risk in relation to the decisions that they make about the companies in which they invest. They have choices, for example, over who they choose to manage the company and the company's capital structure.

The existence of the special administration regime also helps reduce the risk to tax payers that they will have to bear costs relating to a failed company. This is because

its purpose is to transfer a water companies' business to new owners rather than requiring the government to intervene to fund and run the business.

How does the special administration regime work?

The process for special administration is set out in the Water Industry Act 1991. It can only be used where a company¹ either:

- fails to meet its legal obligations and does not or cannot take remedial action; or
- is unable to finance its functions due to, for example, poor decisions by its management, significant unexpected changes to its costs (a 'cost shock') or an inability to raise or refinance its capital as required.

In these circumstances, the Secretary of State, Welsh Ministers or (with appropriate consent) Ofwat can ask the High Court to appoint a special administrator to oversee the running of the company. The purpose of the special administration arrangements is to transfer the company's business as a going concern (and to carry out the functions of the company in the interim). This differs from the standard administration regime, which applies to all companies, where other options are available including the company's assets being sold and the operations of the company terminated. Special administration is also different from standard administration in that it can be used where a company has not met its principal duties as well as for financial reasons. We have never had to use the special administration arrangements to date.

Ofwat's statutory role in the special administration process is that, as explained, it is able to ask the High Court to appoint a special administrator (if the Secretary of State, or Welsh Ministers as appropriate, agree). However beyond this role we would expect to work closely with any special administrator to help ensure the customers continue to be protected both in the short and long-term.

While the special administration regime should mean that there is no or limited immediate impact on customers, there can be a disruption to planning for the future and to investment meaning that there could be a longer term impact on customers. There are therefore reasons to avoid special administration if possible and

¹ The special administration regime only applies to the monopoly water companies in England and Wales, including new appointees, and also to Water Supply Licensees holding a combined licence (that is a licence to provide both retail services and to put water into supply) which are deemed to have a water supply that is designated as a being strategic (although this does not apply to any companies at the moment).

appropriate but this does not mean maintaining an inefficient company that would otherwise fail.

It is not inevitable that a company which is in financial distress will enter special administration. It is likely that there will be a period where it is in financial distress but still operating independently. There may be actions that can be taken which would reduce the likelihood of a company entering special administration. We would expect the company's management to take actions to resolve the problems which it is facing and so avoid special administration. Our role would be to closely monitor the company to ensure that the actions which the company is taking are appropriate and effective, that customers continue to be protected and that the situation is not deteriorating. We may also have a role in working with a company to support it in pursuing alternatives to the special administration where this is in the long-term interests of customers.

What other protections are there for customers in this area?

The special administration regime fits into a wider set of protections set out in companies' licences. Companies are required² to financially 'ring fence' their regulated business from any other activities they or the wider group of which they are part carry out. This helps reduce the risk to customers of negative impacts from outside the water company and will help ensure continuity of service in the event of company failure elsewhere in the group. In the event of a failure of the wider group the water company should be able to be transferred to a new owner while minimising the impact on customers. The success of this measure is proven, for example by the fact that Wessex Water Services was able to continue to operate and be transferred to new owners despite the collapse of its parent company, Enron, in 2001.

Companies are also required to certify that they will have available sufficient financial resources and facilities to enable them to carry out their regulated business for at least the next 12 months. This is important because if a company is unable to do this it can give a warning that there are issues at the company which may require us to step in to help protect customers.

Companies' are required to have, at all times, sufficient rights and assets (other than financial resources) available so that a special administrator would be able to

² The requirements in this area vary between companies although all companies have some minimum requirements in this area.

manage the business. They are also required to certify this annually in their accounts. This helps ensure that in the event of special administration, the provision of services to customers can continue without interruption. The financial ring-fencing measures set out above should also help a special administrator in transferring the business to new owners.

How can we identify where there may be issues at companies?

We are putting in place a [financial monitoring framework](#) to enable us to identify whether there is an appropriate level of corporate and financial resilience within regulated water companies and that the service to customers is not being put at risk by companies' choice of capital structures or financing arrangements. We explained as part of our [methodology](#) for the 2014 price review that work we carried out showed that there was no systemic risk arising from companies' choice of capital structures. This work was supported by a [report](#) by PricewaterhouseCoopers. However we recognised that new risks may emerge and that it was important to continue to monitor company financial structures.

The financial monitoring framework should allow us and others to identify systemic risks to the sector at an early stage so that we can work with the sector to ensure that these risks are eliminated or mitigated. It should also allow us to identify issues at particular companies in a timely manner so that action can be taken to minimise the impact on customers. This should help reduce the risk of contagion such that an issue at one company begins to have knock on impacts on other companies and causes sector wide problems.

The key to this framework and other expectations that we have of company reporting is transparency. Transparent reporting means that not only are we able to identify issues at companies but other stakeholders are able to do so too. We also expect companies to be proactive in reporting issues to us and, where appropriate, other stakeholders. This, together with companies taking full ownership of issues, should increase the chances of us, or other stakeholders, being able to address issues at an early stage, where necessary.

Why and how did we carry out our review?

In order to help maintain trust and confidence in vital public water and wastewater services we need to provide reassurance to the sector's stakeholders that we are prepared for the possibility that a water company could experience financial distress.

We explained in our [forward programme for 2015-16](#) that we would ‘Test and improve a system for handling water companies that are in financial distress’. It has been several years since we last tested our procedures and the review we have recently conducted was part of routine ‘good housekeeping’ to ensure that those procedures remain up to date and fit for purpose.

Our review concentrated on the procedures which we would adopt when we become aware that a company is in financial distress up to the stage where it may be necessary for a company to enter special administration. We did not test the process of special administration itself, which is set out in legislation as explained above.

In order to properly assess our procedures we engaged Deloitte to help us to design and carry out a simulation exercise during March and April 2015 to test our internal procedures. We also used a small group of industry experts to assist us with the exercise. The exercise simulated a company being in operational and financial distress. We involved a number of individuals and groups across Ofwat (including the chairman, the board, the chief executive and our senior leadership team) who played their parts as they would if reacting to a real situation.

The exercise tested, amongst other things:

- our internal guidance for use when a company experiences financial distress and may be heading for special administration;
- the options available to us where a company experiences financial distress; and
- our capacity, systems and processes for responding effectively to a crisis.

Once we had completed the exercise we reviewed what had taken place in order to identify if there were any lessons we could learn which would help improve our procedures and make them more resilient.

What are the findings of our review?

The exercise demonstrated that our capacity, systems and processes for responding to a company in financial distress are fit for purpose. It demonstrated some areas of particular strength in our approach, including:

- the provision of clear direction from the chief executive and chairman;
- early engagement with a company experiencing distress and a process for ongoing engagement;
- good internal governance on communications; and

- the provision of clear and concise internal briefings.

We also identified a number of learning points from the exercise, including the particular importance of:

- having information on the overall risk environment faced by companies;
- clear points of contact between us and companies to allow them to identify significant issues (and companies having clear trigger points for when they need to contact us);
- good flows of information from the companies to allow us to act appropriately and proportionately;
- clearly communicating our expectations of what information companies will have in the event that they experience financial distress;
- having quick and easy access to specialist advice; and
- having good internal communications and guidance.

The specific learning points are listed in the table below together with the actions which we are taking to address these points.

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Learning point	Action being taken	Status
<p>We need to ensure that we have the right information to help us understand the risk to resilience that is created from financial distress among companies.</p>	<p>We consulted on proposals for the financial monitoring framework under which we will monitor the financial stability of the water and wastewater sector in England and Wales.</p> <p>This will mean that we have the appropriate information to help us identify risks.</p> <p>The company monitoring and reporting toolkit we have implemented for reporting from 2015-16 onwards should mean that companies have appropriate, properly assured information available about their operational performance to help us identify risks to delivery.</p> <p>Transparency of this information, which we are helping to facilitate, is also important because it provides an opportunity for stakeholders to draw our attention to potential risks which the company may not have highlighted.</p>	<p>Complete</p>
<p>It is important to maintain a good flow of information from companies so that we can take proportionate and appropriate action based on an accurate view of each company's position. It also important that companies have clear trigger points for when they need to contact us.</p>	<p>Our strategy is to develop our relationships with companies and other stakeholders. This is to encourage ongoing dialogue such that companies and others are encouraged to proactively identify potential and actual issues so that they can be dealt with in an appropriate and proportionate way. We will ensure that there are clear points of contact such that companies can alert us to any important issues in a straightforward way.</p>	<p>Ongoing</p>

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	<p>We are also updating our internal guidance to be clear about what tools and powers we can use to ensure that we get good quality and timely information from a company in financial distress, especially in a situation where, for whatever reasons, a company's co-operation is not forthcoming or it has incentives not to provide such information (for example where the incentives for investors will be to seek to protect the value of their investment).</p>	<p>Complete by March 2016</p>
<p>We need to ensure that companies have the right information readily available for use in the event that they experience financial distress and be clear about what this information is – this includes information that we may need as well as information that a company may need to share with its customers and other stakeholders.</p>	<p>We will assess whether we should place explicit requirements on companies to hold certain types of information by considering, for example, whether licence requirements might need to be strengthened in this area.</p>	<p>Complete by March 2016</p>
<p>It is important that we have good information on the overall risk environment faced by companies so that we can understand the significance of any incremental risk posed by a particular event or events.</p>	<p>The information which we are collecting through the financial monitoring framework will help provide this information.</p>	<p>Complete by December 2015</p>
<p>We need to update and refine our internal guidance, which sets out the steps we need to take, and options we have, when a company is in financial distress ahead of it entering special administration (if</p>	<p>We are currently updating our guidance to ensure that it is up to date and fit for purpose.</p>	<p>Complete by December 2015</p>

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this is the ultimate outcome).		
We need to have an internal group of people that can be kept on standby to ensure a prompt and co-ordinated response should we become aware of a company being in financial distress.	We are in the process of identifying appropriately qualified people internally to fill this role.	Complete by March 2016
We need to refine our external communication protocols to ensure they will work as we would like in the event of a company being in financial distress.	We will review the relevant protocols to ensure they work in the event of company being in distress.	Complete by December 2015
It is important to have good internal communications so that the right people are kept informed in a timely manner – this can also help ensure a consistent external message.	We will address this as part of our wider update on internal guidance as set out above.	Complete by December 2015
We need to ensure that we have ready access to appropriate external professionals to provide us with advice when a company is in serious financial difficulty and for potential appointment as special administrators.	We will take steps to ensure that we have access to appropriate external advice.	Complete by March 2016
We need to update the Memorandum of Understanding (MoU) between Defra, the Welsh Government, HM Treasury and ourselves, which establishes a framework for co-ordination	We will work together with all parties to the MoU to review and update it as appropriate.	Complete by March 2016

Learning point	Action being taken	Status
between the parties, to ensure it remains fit for purpose.		

Next steps

We are in the process of working through the actions which we have identified to address the learning points from the exercise and are aiming to complete these within the timescales set out in the table above.

We will share the outcomes of our review and the learning points arising from it with Defra, Welsh Government and HM Treasury.

We will keep our arrangements and processes in this area under review and consider the need for any changes which may be needed in the future.

If you have any queries about this document further please email FinanceAndGovernance@ofwat.gsi.gov.uk