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Your Ref:

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Company Monitoring Framework Response
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Dear Sirs

Consultation on the Framework for Monitoring Company Performance

Sutton and East Surrey Water welcome your consultation on creating a new framework for providing assurance that the performance information reported by companies is accurate and reliable. We agree that providing such information on a consistent basis can make a significant contribution to maintaining trust and confidence in a company and the sector as a whole. Investors and other professional, informed stakeholders rely upon information reported by companies in making judgements about relative performance and value, and have a right to expect companies to have mechanisms in place to assure the reliability of the information they publish. Our Board attaches great importance to being able to provide such assurance.

Risk based approach

Sutton and East Surrey Water have been strong supporters of the move to a more proportionate and risk based compliance regime and have embraced the opportunity for the Board to take full responsibility for the quality of performance data reported to Ofwat and other stakeholders. We regard the opportunity to take full ownership of assurance requirements, to enable the Board to provide its own assurance statement, as a vital enabler for achieving this important change in perspective. Specifying the scope, form and materiality of third party assurance has been key to enabling our Board to target assurance on areas appropriate to the risks we face. We therefore welcome the principle in your consultation of allowing companies in either the Self Assurance or Targeted Assurance categories to have the freedom to determine all, or the major part, of their assurance programmes based on their own assessment of the risks associated with different performance measures. We agree that publishing the programme (and a summary of the outcome of the assurance) will provide additional assurance to users of the performance information. We make some specific comments on the approach to the three different categories below.

We would like clarification of the process for determining the assurance programme for "areas of weakness" for companies in the Targeted Assurance category (and feel it would also be helpful for the Prescribed Assurance programme required of one company). Your consultation suggests that "For areas of weakness companies [in the Targeted Assurance category] will be required to publish assurance plans *that follow our guidance* in a similar way as prescribed companies, but only in the targeted areas". However, it is not clear how your guidance will be communicated, other than through commenting on the draft assurance plan published by the company. Having made the decision to allocate



each company into one of the three assurance categories, Ofwat needs to advise each company what the guidance is that they need to follow in either the “areas of weakness” or more generally. This honest and straightforward dialogue with a company will ensure that these areas are addressed (alongside any other areas identified by the company’s Board) in the draft assurance programme.

Assurance for different categories

Your consultation observes that “there is room for improvement in the general quality of data made available across the sector....This is reflected in the small number of companies being allocated to the self-assurance category in our initial assessment”. In fact, the only companies in the self-assurance category are those granted Enhanced status in the PR14 risk-based review. For all other companies, the link between having to provide additional evidence on aspects of their original PR14 Business Plans (which were the subject of the risk-based review) and future assurance requirements for performance reporting is not clear. In particular, the information provided in Business Plans was largely forward-looking and the additional evidence required normally related to how the future expenditure or performance proposals had been determined. Assessment of reported historic performance was in many cases considered adequate (or more than adequate), and in all cases overall Board assurance was assessed as adequate. The proposed monitoring framework is actually focused upon historic performance reporting, which was deemed adequate or more than adequate for a number of companies at the risk-based review which are now categorised as requiring Targeted assurance. The areas of historic performance reporting that have been deemed as “areas of weakness” therefore need identifying.

For companies in the **Self-Assurance** category, your consultation identifies three “further requirements, beyond the base requirements” that they will be expected to provide. The “base requirements” need to be specified – for the benefit of companies in all categories. The specification of how the three “further requirements” are met should be for Boards to determine – otherwise “Self Assurance” effectively becomes a short-form of “Prescribed Assurance”. For example, the prescribed text for existing Risk and Compliance Statements includes confirmation by the Directors that the Company has, in their opinion, “sufficient processes and systems of internal control to fully meet its obligations”. We consider that this assurance statement encompasses – and goes beyond – an “explicit sign off” on the assurance processes used to provide confidence on the accuracy and reliability of reported performance information. Similarly, how companies comply with the other two “further requirements” – of providing “full transparency on the audit procedures” and “a summary of the outcome of the assurance that has been undertaken” – should be for Boards to determine. This will also enable companies to agree with their financial auditors the scope of the disclosures they make from audit reports addressed to the company.

For the single company currently in the **Prescribed Assurance** category, your consultation states that you “need to intervene to make sure that companies produce appropriate assurance plans”, but then suggests a process under which your intervention is initially limited to commenting on the assurance plan the company has produced (with further intervention “if a company clearly has not responded appropriately to the comments”). This is a circuitous and unnecessarily protracted approach to agreeing an assurance plan and is not consistent with a commitment from companies and regulator alike to have “grown up” conversations about areas of concern. You have already satisfied yourself on the general and widespread weaknesses that require a company to be subject to Prescribed Assurance, so the remedies you have in mind for addressing them should be communicated to the company in advance of it drawing up and consulting on a draft assurance programme. This might enable a timetable along the lines included in your consultation to have a chance of working – but it would be preferable to aim for the publication of the draft assurance plan earlier (say by the end of November – at the

same time as Interim Results are published), allowing a company longer than two weeks to respond to stakeholder comments on its draft assurance plan and providing an opportunity for a final intervention before year end assurance procedures commence. So a revised timetable might look something like:

- By 1 December – company publishes draft assurance plan for consultation
- By 1 January – stakeholder comments submitted to company
- By 1 February – company responds to comments and publishes final assurance plan
- By 1 March – Ofwat specifies the form of any further “intervention” if not satisfied with final assurance plan

For companies in the **Targeted Assurance** category, the same timetable would work, although the scope of the assurance programme for consultation may be confined to the identified “areas of weakness”. It should be recognised that a company subject to Targeted Assurance – or indeed a company in the Self Assurance category – will in any case have a wider assurance programme covering its reporting programme and not just any “areas of weakness”. The company may choose to publish this programme in advance of it being undertaken, and may invite comments on the programme – but that is a choice for the company. The formal requirement for consultation should be confined to the “areas of weakness” for Targeted Assurance companies.

The consultation also asks whether companies in the Targeted Assurance category should publish “an assessment of risks, strengths and weaknesses, to be used to target more prescriptive assurance requirements”: Such an assessment would clearly have a broader scope than the assurance plan designed to address only the “areas of weakness”, and would duplicate or expand upon the Risk Management sections of a company’s Strategic Report in its Annual Report. It is not clear from your consultation whether a similar assessment is required from any company in the Prescribed Assurance category. This can be avoided if you are explicit about the areas you expect to be included in an assurance programme in advance of a draft being published by the company. It still leaves a company the discretion to include additional areas of potential weakness identified from its own internal risk assessment processes within the scope of its assurance programme – whether the published part or the wider programme which it may determine does not need to be consulted upon.

Your consultation also asks whether the level of prescription for targeted areas should be the same as for the prescribed assurance category. Honest and straightforward conversations demand that both parties be explicit about their expectations. You should be explicit up front about the scope and depth of assurance you require for both targeted and prescribed assurance – and whether you consider they should have the same or differing degrees of prescription. Companies can then decide how to respond – either accepting your requirements, deciding to go further, or potentially even challenging them. Such transparent, honest and robust dialogues will, in themselves, contribute to building trust and confidence in this area.

Moving between categories

The reliability of performance information will not be sufficient in itself to maintain trust and confidence: the level of service provided by water companies, their contribution to society and their overall standards of behaviour will have a much greater influence on how they are perceived by all stakeholders, including customers. The distinction between company performance in these areas and the reliability of information the company provides needs to be taken into account in designing the assurance framework and its associated incentives.

Your consultation includes a number of examples of behaviours that are likely to lead to reductions in trust and confidence, but might have no direct relationship to the accuracy and reliability of performance data reported by a company. A company that does not meet its performance commitments, for example, may have outstanding assurance processes that underpin its reported performance. The fact that reported performance is poor ought not to determine the level of assurance needed or the criteria for movement between different categories of assurance. These ought to be determined entirely by the reliability of information provided. The framework for assurance ought therefore to recognise the possibility of a company moving from more prescribed assurance arrangements to greater reliance on self-assurance even when reported performance has not improved or performance commitments have been missed. The PR14 control framework – and in particular the Output Delivery Incentives that companies have accepted – provide the agreed incentives for achievement of performance commitments. The suggestion implicit in this consultation – that there be additional reputational (and potentially cost) incentives in the form of more prescriptive assurance requirements for a failure to meet performance commitments – was not part of the package that companies signed up to in accepting PR14 Final Determinations.

In fact, many of the examples of events leading to reductions in trust and confidence – and therefore triggering more prescriptive assurance – have nothing to do with the reliability of information provided on historic performance. The proposed remedy, therefore, is unrelated to the cause of the reduction in trust and confidence, and will do nothing to address the issue of concern being targeted. If interventions by the regulator are required, for example, to address a company's response to casework considered by Ofwat or compliance with its own Code on Board leadership, transparency and governance, such interventions need to be targeted at the areas requiring intervention (for example, by additional reporting on the areas covered by casework, or additional disclosures on Corporate Governance in the company's annual report) rather than on assurance procedures relating to performance reporting.

In contrast, the examples of criteria that might be used to allow a company to move to less prescriptive forms of assurance generally focus on having addressed identified areas of weakness and avoiding any further instances of concerns being raised over the accuracy and reliability of performance reports. These criteria therefore seem appropriate.

The implication of this more targeted and proportionate definition of criteria for moving between assurance categories is that:

- Movements between categories happen annually, after an assessment of performance against criteria relevant to providing assurance on performance reporting;
- Movements should be based on absolute rather than relative assessments, as the initial categorisation to Targeted or Prescribed Assurance categories have been based on specific or general "areas of weakness" that needed to be addressed. Once addressed, the categorisation should be reviewed – regardless of what has happened to relative performance for other companies. The expectation must be that overall standards will improve (otherwise the incentives are not working), but companies should not face the prospect of remaining in Targeted or Prescribed assurance categories, despite having addressed the issues that resulted in them being placed there in the first place, simply because standards have improved across the industry;
- Annual assessments should be applied to movements both up and down the assurance categories; applying an arbitrary two year cycle for reassessing any company in the Prescribed category has no evidential justification; and

- Incentives on assurance requirements should be confined to issues with the provision of accurate and reliable performance information. If interventions are needed to address issues arising from different concerns, they ought to be focused on the areas triggering the concern rather than on this completely unrelated area. More work might therefore be needed in this area.

Concluding Remarks

Sutton and East Surrey Water have found your consultation helpful in highlighting some important principles for addressing any concerns you may have with company performance and behaviour. These are issues we should be prepared to debate and approach through the sort of honest and straightforward conversations we agree are appropriate for a mature but changing regulatory environment. We remain keen to make an active contribution to such debates, and to set standards of performance and behaviour that contribute to trust and confidence in the industry. As always, we would welcome any request to explore or amplify any points made in this response at your convenience.

Yours faithfully



John Chadwick
Finance and Regulation Director