

Company monitoring framework – further consultation

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Thank you for the opportunity to respond to your further consultation on proposals for a company monitoring framework. Our response is in two parts:

- the executive summary sets out our key points; and
- our detailed response considers the specific questions and issues raised by Ofwat in the consultation.

Executive Summary

We are supportive of Ofwat's vision to maintain and build trust and confidence and recognise that the company monitoring framework will play an important part in realising that vision.

We share Ofwat's view that assurance is a critical element of reporting, and that the adaptation of the Annual Performance Report to cover the additional information on ODIs and costs relevant to PR14, along with the move to IFRS reporting, provides an opportunity for a new monitoring framework to be put in place.

In broad terms we agree with the approach Ofwat is taking and consider that having guidelines which companies should demonstrate they meet, which link assurance to transparency, particularly with regard to customer challenge groups is an appropriate framework.

However we have identified four areas where we believe additional clarification would be beneficial. They are outlined below.

Distinguishing between compliance and assurance

We would welcome greater clarification of the aims and scope of the Company Monitoring Framework to ensure that there is a distinction made between compliance and assurance.

Compliance involves a proactive review of the risks that a company faces in relation to delivery of its overall performance, along with the mitigating action a company will take to test such risks and address any non-compliance found. Assurance is typically used to build confidence and trust that what a company reports is reliable, accurate and complete, be it good or poor performance that is being reported. As such assurance is a retrospective action to verify data after the event; although assurance may help to highlight incidents of non-compliance, it is not in itself a remedy for it.

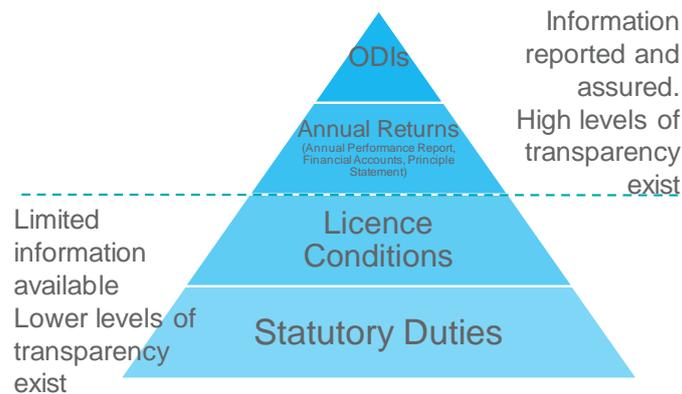
We believe in the framework that it is important to have a relationship between the cause and effect of actions taken. For example, if a company does not meet its performance commitments (effectively a non-compliance) but has excellent assurance processes and a high degree of confidence in the information it reports, moving the company down into a different assurance category – with more prescriptive and transparent assurance requirements - would not in itself address the issue. We believe it is the improvement activity that will address the performance issue rather than more prescriptive assurance.

Transparency

We strongly agree with the need to be open and transparent with our customers about the services we offer and the standards of performance they can expect from us. However we also recognise that it is important to ensure that any publication we place in the public

domain is fair, balanced and understandable. It can be detrimental to the confidence and trust of our customers and stakeholders if publications are perceived to be inaccessible or unduly complicated.

We believe it is timely to review the overall compliance hierarchy to ensure we are meeting customers' needs with regards to confidence and trust whilst avoiding overly burdensome and complicated performance assurance and reporting. We recognise the criticality of ODIs but we also recognise that we hold many other duties and obligations to customers which are not as always as transparent to stakeholders as they could be. Below we have included a simple diagram to try to illustrate this point.



We believe there is a pivotal role for the Customer Challenge Groups (CCGs) in providing an 'expert' audience role by scrutinising the details of our risk based compliance plans, findings from our assurance activities and oversight of any subsequent mitigation identified. For our wider customer base we would seek to publish clear and understandable information in a summarised format that we believe would provide more transparency than detailed documents.

This would not negate the requirement for stakeholder involvement and scrutiny but rather allow information to be better tailored to the respective audience requirements. We therefore believe that as a general principle:

- The more detailed, technical information is provided to a targeted, 'expert' audience such as the Customer Challenge Groups (and Ofwat where requested), allowing for scrutiny of the entire compliance framework throughout the year and flexibility to update plans in response to emerging risks or the challenges from the CCG and Ofwat.
- Companies publish an agreed 'assurance' summary as part of their Annual Performance Reports (potential as part of section 4 'additional regulatory information' under the proposed requirements). This would allow customers and stakeholders to clearly relate the risks to the performance, the assurance carried out and the response of the company to the identified issues – in the context of their reported performance.

Assurance requirements

We believe it would be helpful if the consultation could take account of materiality. In the past, high importance was sometimes placed on small, immaterial issues which are unlikely to be important to customers but consume significant levels of resources to respond to. We would suggest that some wording is introduced around materiality to try and avoid this situation in future.

For a small number of companies, the ODI reward and penalty mechanism will be administered on an annual basis. In AMP adjustments to customers bills will be through the Principal Statement process. Currently the consultation does not mention the Principal Statement process. As this process will also require assurance and is intrinsically linked to our performance and other reported data we believe that this should be recognised within the framework.

Moving between categories

We would welcome further clarity relating to items which are not directly in the control of the company e.g. the number of open strategic cases. The consultation currently indicates that a company with a number of open strategic cases could face a downgrade in category. Clarity relating to movement between categories and 'no fault' outcomes or protracted speed of resolution would be beneficial.

Furthermore we would also welcome clarity on the immediacy of any downgrading. The consultation document appears to suggest that a downgrade is 'immediate' but in discussions at the recent workshop Ofwat clarified that the intention is for discussions, and consideration of a company response to a situation to be taken into account before any downgrade. We believe that this should be made explicit in the guidance.

Detailed response

Self assurance

Q1 Do you agree that companies in the self assurance category should provide explicit sign off on the assurance that has been provided?

Q2 Do you agree that the assurance process, and the outcome of that assurance process, should be transparent? Do you have any suggestions of how this could be accomplished?

We agree that the board (and/or audit committee) should sign off on the assurance that has been provided (Q1).

In relation to the transparency of procedures and outcomes, we agree that this is a good principle. However, it will be important that information is provided in a way that is meaningful and accessible to customers (as we explain in our executive summary) and that consideration is given to the following:

- Assurance providers are likely to be agreeable to companies sharing procedures at a general level, but are unlikely to welcome detailed publication of methodology, specific tests or detailed outcomes of work. Assurers will have engaged with companies, generally in a way which limits the publication or otherwise sharing of reports with a wider audience, particularly ‘public’ access to such documents.
- The more information published about how and what assurance procedures will be undertaken, the less effective those procedures are (as those being audited could try to ensure nothing raises a red flag, if they have advanced knowledge of procedures), therefore a careful balance between ensuring transparency by sharing what procedures are undertaken and maintaining the value of your assurance must be maintained.
- As the financial statements and regulated accounts at the appointee level carry the standard assurance wording of ‘fairly presents’, it is assumed that the framework for additional disclosures only applies to items outside of that assurance. It would be beneficial if this point is made explicit in the framework, particularly if Ofwat’s intention is that procedures and/or more detailed findings for the financial statutory audit should also be provided to stakeholders and/or Ofwat.
- If other areas which do not fall under this statement are to be assured, an agreed wording of the assurance statement which is to apply to the other areas could be agreed, ideally drafted by the assurance providers. This will ensure that water companies are able to obtain such a statement and help to avoid a situation where a requirement for a statement is later set that assurance providers were not prepared to sign off on (even with a clean audit), or statements made regarding assurance to fell short of Ofwat’s expectations.
- We believe that procedures and findings should be reported to and discussed with the CCGs and provided (if requested) to Ofwat. It would be helpful if that framework set out what should be shared and how. For example, if Ofwat require visibility of the full audit report and findings, this should be clarified at the outset so that agreements with providers can be structured in such a way as to allow this, preventing any issues

such as occurred during PR14. It is suggested that Ofwat discuss this issue with the assurance providers to ensure a position is reached which is acceptable to all sides.

Prescribed

Q3 Do you agree that a company in the prescribed category should consult on its assurance plans with stakeholders? If not, what approach to prescribing assurance would you suggest?

Q4 Do you consider the outline approach that we have set out to be practicable, or can you suggest improvements?

Q5 Do you think that our guidance could be minimal or do you think that it is necessary for us to define a high level of prescription to protect customers?

We agree that companies should consult on the areas of assurance that will be provided, and in particular the focus of such assurance. (Q3). In line with our earlier comments about transparency, we do not agree that detailed plans should be 'published' but do agree that they should be provided to the CCG and Ofwat for comment and review.

In relation to the proposed approach(Q4), we suggest the following would help to make arrangements more practical to implement.

- Audit procedures will cover the period from 1 April, and could occur throughout the year. Requiring that plans should be 'published' (see comments above) two months before use would therefore mean agreement before the start of the year. This does not seem practical, and may result in a delay to the audit program. Procedures should be performed at the point they are most effective, rather than a set point in time.
- In the workshop Ofwat suggested a timetable for targeted companies that required initial consultation period from July – November of the year being audited. This seems to be a better solution for prescribed companies as well, particularly in the first year of this process. In addition it is suggested that plans should be reviewed by the external assurers in light of events between the date the framework was set and the final audit work is carried out to cover any issues or risks that may occur in that period and be required in addition to the agreed plan.
- A more fluid period, within the window set out above would seem a better approach than only allowing two weeks for the company to respond to any stakeholder views. If there are many issues raised, as might be expected if a company is in the prescribed category, the limited two week response window could result in a plan which is not fully considered and therefore Ofwat quickly reach the intervention stage.
- More clarity about in which circumstances Ofwat would intervene and how would be beneficial. For example, would there be a formal process for stakeholders to apply to Ofwat for an intervention, or is this intervention based on Ofwat's view of the adequacy of the company response? We believe that Ofwat should set out what criteria would be used for the assessment and what the intervention would be (for example, prescribe required procedures) to ensure this is a fair and transparent process.

Therefore, we suggest that the procedure is similar to above, but rather than publish audit reports and audit plans, these are provided to the CCG (and Ofwat if required). This would mirror the process used for the audit committee and be in line with accepted good governance procedures. The auditors attend audit committee meetings during discussions of the audit and could also join the CCG for such discussions.

As noted in the executive summary, a summary of the risks, assurance plan, assurance findings and company response could be published alongside, or as part of, the annual performance report - providing a clear, non-technical view which would be accessible for all customers and stakeholders.

Given the intervention step set out in the guidance, it would not seem necessary for additional prescribed requirements to be defined at this stage (Q5). However, as noted, we do believe that Ofwat should set out in more detail how the intervention process would work.

Targeted

Q6 Do you think that companies in the targeted category should publish an assessment of risks, strengths and weaknesses, to be used to target more prescriptive assurance requirements? If not please suggest how we should target the areas that require more prescriptive assurance.

Q7 Do you think that the prescription for targeted areas should be the same as for the prescribed assurance category? If not please suggest how assurance should be prescribed.

Q8 Do you think that for areas that are not targeted that the prescription for these areas should be the same as the self assurance category? If not please suggest how assurance should be prescribed.

We agree that an assessment of risks, strengths and weaknesses could be used to target more prescriptive assurance requirements (Q6) and that this should be informed by consultation with the CCG (and Ofwat). As noted above, we have some reservations as to whether a detailed assessment would allow for meaningful consultation with broader stakeholders and rather a summary of the findings could be shared as part of the annual performance report.

We agree (Q7) that we could publish a summary of audit procedures if relevant (given the comments above in relation to Q4). We believe that a structure as we propose (See Q4 response) for prescribed procedures is appropriate for the targeted assurance areas.

Similarly, for areas not targeted, (Q8) it seems appropriate that the procedures as for a self-assured company (given the comments above in relation to Q2) would apply.

Movement between categories

Q9. Do you think that companies should move to a tighter assurance category immediately an issue that reduces trust and confidence comes to light, rather than wait for an annual review? Do you think that the examples which we have provided are appropriate?

Q10. Do you think it is appropriate that companies can move up from the prescribed to targeted category or targeted to self assurance category without the need for a positive relative assessment?

Q11. Do you think that an annual relative review is unnecessary? If you think Ofwat should undertake an annual relative assessment, do you consider it necessary for moving companies both up and down or only in one direction?

Q12. Do you think that it is appropriate for companies to spend at least two years in the prescribed assurance category?

Movement down

Ofwat has proposed a series of criteria for moving between categories for assurance. In addition, it proposes that movement down is 'immediate' but that movement up would only be possible annually (Q9). We believe that:

- a distinction should be made between assurance and compliance (performance) as outlined in the executive summary above.
- the consultation should take into account what is and is not directly in a company's control.
- the framework should provide further definition of what is meant by 'adequate' and 'appropriate' to ensure transparency and fair treatment, and avoid failures due to misinterpretation.
- companies should be given the chance to respond and demonstrate that the response is appropriate before Ofwat consider any downgrade.

Taking each of the examples which would result in a downgrade in turn:

The **first** example for a downgrade appears reasonable.

The **second** example confuses performance with assurance. If a company is failing to hit a performance target, and has reported such a failing (and assured the data before reporting such), then it is not clear why this should result in a company downgrade to more prescribed assurance. The outcome is not a consequence of poor assurance – introducing a further assurance requirement would not address the root of the issue. We would suggest that the appropriate mitigation would be the development and scrutiny of an improvement plan by the CCG. We would support this approach being extended to 'risk of not meeting statutory obligations'.

Whilst we recognise that the rationale for applying greater scrutiny where companies' performance is poor is valid, as the cause of the poor performance is unlikely to be an assurance issue, additional assurance should not be the focus of a response from the regulator.

The **third** example Ofwat provides relates to strategic cases. However, the criteria do not refer to;

- the impact of the strategic case (e.g. is it a case brought which had an impact on 10 properties or 10,000);
- the outcome of the cases (the findings may be in the companies favour); and

- the fact that the length of time taken to close a case may be entirely out of the companies control, and may be several years.

We believe the guidance would benefit from an amended criterion that takes into account the impact, scale and outcome of the case along with how the company responded. This would ensure the companies are not unduly penalised particularly where a case remains open for long periods outside of the company's control and that appropriate actions are taken against companies that are not responding adequately to underlying issues which are generating multiple cases.

The **fourth** example appears appropriate and takes the outcome of the case into account as well as the approach the company takes in its response. Additional guidance on what Ofwat consider a good and a poor response would be helpful.

The fifth example for a downgrade, relating to compliance with its own code appears reasonable.

The **sixth** example relates to charges, and compliance with 'the rules'. This would benefit from further review once the 'rules' are defined. Similarly we believe this is a compliance issue not an assurance issue.

In relation to the **penultimate and final** points, we believe that consideration should be given as to how stakeholders views are 'weighted' to ensure concerns raised are proportionate in nature and evoke the appropriate response.

Relative assessment across the industry

We agree with Ofwat's proposal, that each company is assessed individually. This would allow all companies to be in the 'self assured' category should they achieve this level. However, we recognise the value in Ofwat highlighting examples of good practice that could identify areas where companies could improve further (even when they are in the self assured category).

Time in the prescribed category

In the circumstances that an endemic or systemic issue has been identified we would consider this timescale appropriate (Q12). However, if a company was moved to prescribed for a specific incident (the guidance suggests a strategic case which was poorly addressed may cause this), then a swifter move up to targeted assurance may be appropriate. For example, if the additional prescribed assurance did not identify further issues.

Overall package of proposals

Q13. Do you agree that the overall package of proposals leads to appropriate incentives for companies? Are there ways you consider that these incentives could be improved?

As we have highlighted above, the guidance would benefit from greater distinction between compliance (performance) issues and assurance. We believe that linking additional assurance to poor performance could create a perverse incentive to actually ignore or hide issues to avoid a downgrade into a lower category for assurance. Whilst we consider this risk is slight, it serves to highlight the need to ensure the response to poor performance

addresses the underlying issues rather than reaffirming what is already established. We would be supportive of linking poor performance to improvement plans scrutinised and overseen by the CCG.

Finally, in order for the monitoring framework to be fully effective, we believe it is important for the areas of uncertainty outlined above to be clarified and for Ofwat to provide clear guidance which it will follow as part of this process. We would welcome greater clarity on the roles and responsibilities placed on other stakeholders (such as CCGs and assurance providers) in discharging any reliance or requirements placed upon them. Currently the framework only sets out the requirements for companies.