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Company monitoring framework consultation  
response  
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Our ref:

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Dear Sir,

#### **COMPANY MONITORING FRAMEWORK – FURTHER CONSULTATION**

We are pleased to provide our response to the company monitoring framework consultation. We fully support the objective of a monitoring framework that provides transparency on water company performance in the widest sense so that this builds trust and confidence in the sector.

We support the approach Ofwat set out in the consultation, because it places the onus on company Boards to understand their obligations, how these are met and the quality and transparency of the data published to support this process. Fundamentally, we see no distinction between this process and the wider risk management and assurance processes that should be central to best practice governance and decision making of the Board of any organisation. The importance of water companies, both as major regional employers and as suppliers of essential public services and infrastructure only emphasises the necessity of a monitoring framework.

The consultation is also right to request reporting of information in an annual performance report (or equivalent) as a minimum expectation. Ongoing engagement and dialogue on the value of water company activities with customers and stakeholders is also needed. Our WaterShare framework, an integral part of the commitments made by the SWW Board in the PR14 business plan, is designed to ensure that our performance is transparent and the benefit to customers of the measures we take are clearly understood. It considers factors beyond formal regulatory performance mechanisms as this reflects a context that our Board has always considered. WaterShare will therefore form part of our ongoing self assurance framework.

## Integrated Assurance Framework

As a “self assurance” company, South West Water will continue to employ an effective and rigorous risk management and assurance process. We would expect that all companies will need to follow such processes and there will be a lot of commonality between the internal processes of “self” and “targeted assurance” companies.

Ensuring that risks continue to be effectively managed and mitigated requires that changes in circumstances, including strengths and weaknesses, should be considered when defining the assurance framework for performance reporting.

South West Water’s existing risk and assurance processes are embedded into the management of the Company and are designed to ensure risks are promptly identified, updated on a regular basis and appropriate mitigation is in place to suit the risk appetite. The methodology for identification and mitigation of risk is similar at individual business unit and corporate levels.

South West Water’s integrated assurance plan ensures, utilising a risk based approach, that an appropriate balance of varied providers of assurance dependent on the assessed risk and complexity of assurance requirements. The integrated assurance approach includes:

<p>1<sup>st</sup> line of defence Management</p>	<ul style="list-style-type: none"> <li>• Performance reviews</li> <li>• Local quality control</li> <li>• ‘Sense checking’</li> <li>• Annual certification and ‘sign off’ of submitted data</li> </ul>
<p>2<sup>nd</sup> line of defence Policy setting and compliance checking</p>	<ul style="list-style-type: none"> <li>• Business management systems internal audits</li> <li>• Policies and culture (e.g. whistle blowing)</li> <li>• QA and ISO internal reviews</li> <li>• Risk Manager Internal Reviews</li> </ul>
<p>3<sup>rd</sup> line of defence External scrutiny</p>	<ul style="list-style-type: none"> <li>• Group Independent Internal Audit</li> <li>• Financial audit</li> <li>• Technical audit</li> <li>• Quality regulators (including ISO external reviews)</li> <li>• Business management systems external audits</li> <li>• Other external assurance providers</li> </ul>

This risk based integrated assurance framework is applied to all areas of the business, including all key projects as they arise. The mix of assurance methods used is reviewed by the South West Water Audit Committee, which is responsible for ensuring robust and comprehensive assurance frameworks are in place to support Board assurance and compliance requirements.

In any significant area or project where assurance is required over submitted data, information certificates will be prepared by those responsible to confirm that the submission is robust and all material issues have been addressed.

Independent internal review is used to ensure that processes are robust and adhered to.

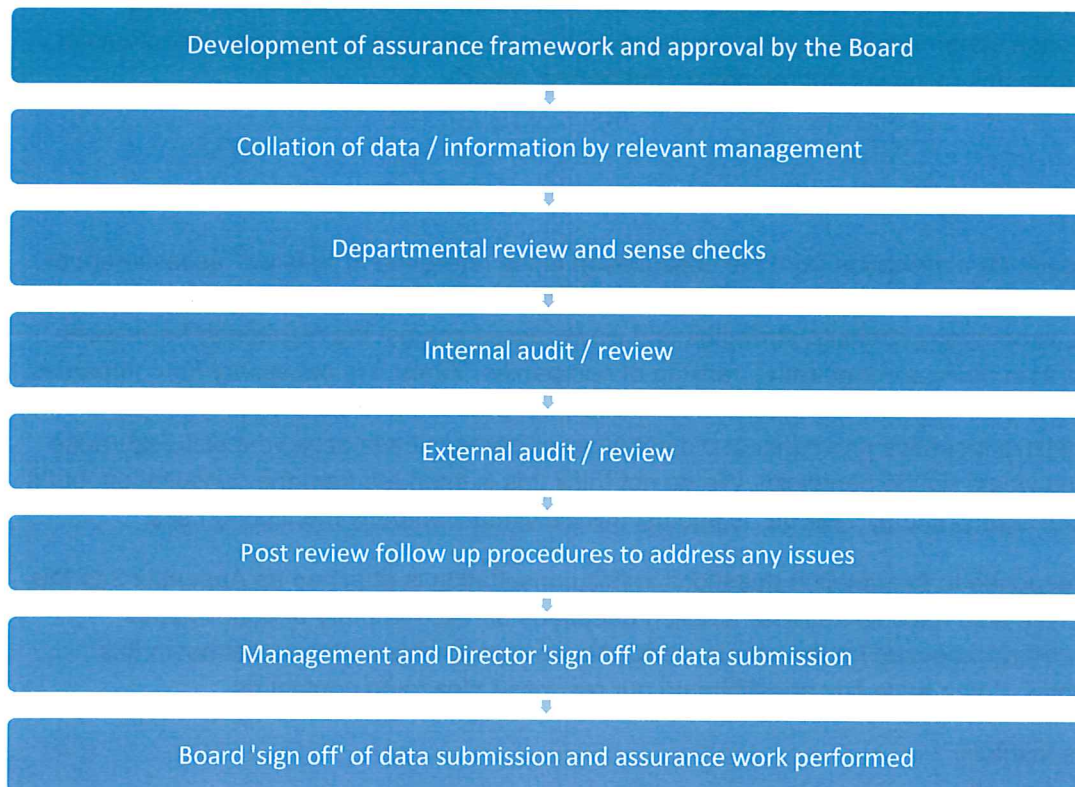
External review and audit processes are utilised whenever significant data is provided by South West Water externally (such as PR14 business plan, 2015/16 tariffs and Company Annual Performance Reporting). The allocation of assurance work between external providers (including financial and technical auditors) is based upon the content of the data submission and multiple providers of external assurance are engaged on the same project as required. The professional credentials of the third party assurance providers are considered in detail to ensure they have the relevant knowledge and experience.

Robust feedback processes are established to ensure that issues or queries raised during internal and external assurance processes are followed up to ensure that any changes required or follow up work is completed as appropriate.

In addition to strategic leadership provided by the Board, for significant projects a Steering Group is formed to give direction, monitor project delivery and issue regular updates to the Board.

For all key projects and data submissions, the Board confirm in their opinion that assurance provision, governance and internal systems of control have been sufficient.

The following diagram summarises the typical assurance approach taken in any significant project and annual reporting:



A recent practical example of the integrated assurance approach is shown in appendix 1, which summarises the approach undertaken when developing the risk assessment and assurance framework for 2015/16 tariffs and charges.

## **Assurance for 2015-20**

We agree with Ofwat's process of companies changing risk assurance categorisation – in particular downward review when significant issues emerge and promotion based on an Autumn review of company revised risk assessments. We think the categories indicated by Ofwat are useful in setting out the broad areas that companies should consider, namely:

- quality of business plans and regulatory data submissions
- adequacy of assurance over data submissions
- arrangements for monitoring, assurance and reporting of outcomes to customers and stakeholders
- regulatory accounts reporting
- charges
- compliance with legal obligations ( open casework and ongoing strategic cases, or volume of cases indicating systematic issues where Ofwat are the enforcement authority such as Licence, Water Act and Competition Law). This is specifically relevant where Ofwat have to make the regulatory decision to open a case (e.g. mis-reporting, or wider concerns arising from complaints) or have specific duties
- Ofwat principles of Board leadership and governance adherence

For companies in the “self assurance” category, the consultation suggests that companies should provide a summary of assurance reports. In line with the Charges assurance statement, we think it is more helpful and transparent for stakeholders for the Board assurance statement to describe the framework for the assurance, with any exceptions or risks from this being set out (alongside the annual report).

## **Clarity on Context**

One point for clarification from the consultation is the reference to “relative” assessment of companies. For risk based assurance we think that it is important that relative in this context refers to company absolute strengths and weaknesses against the monitoring framework, rather than being a comparative ranking of companies. Whilst it is necessary for companies to review their approaches against best practice as part of the assurance process, a competitive incentive process that did not allow all companies to achieve a self assurance ranking would not be beneficial. We do not think this is intended from the consultation, but it is worth clarifying that “relative” is against the individual company monitoring risks.

Our response to the detailed questions in this consultation is attached as Appendix 2 to this letter. We also have some more detailed questions on the summary of performance parameters proposed for the annual performance report, which are also set out in this appendix. If you have any questions on our response please do contact us.

Yours faithfully



Louise Rowe

Finance Director

## APPENDIX 1

An example of how we develop our assurance framework from a project design phase can be seen from the preparation for 2015-16 Charges. The movement from one to four price controls was identified at an early stage of PR14 as a change that could affect a number of principal business risks that the Board monitors, not just formal compliance with price controls and turnover reporting, wider legal obligations (e.g. from Competition Law), but also potential consequential impacts that arise from accompanying billing system changes. The range of risks potentially impacted mean that a formal project with a steering Board was created. Assurance processes for the project as a whole well as for specific regulatory outputs (such as the Board sign off of the Charges submission) were therefore built into the project design.

Final external assurance from financial auditors was planned in a way that could directly be measured against the internal information that was provided to the Board. For critical aspects of the process, which in terms of tariffs are inevitably complex calculations including cost, volume and customer information, "review and recommend" assurance processes are carried out in advance in order with auditors in order to define what audit procedures are appropriate to allow the Board to provide assurance certification. Other technical assurance processes (both internal and external) provide additional information to support the definition of the ultimate procedures.

For tariffs, this process developed a hierarchy of measurable tariff rules against which assurance could be provided. This covers not only regulatory rules and compliance issues that must be met, but also risk and opportunity management factors that the Board also wishes to consider in setting tariffs – for tariffs this includes potential trade offs between incidence and bill change effects in future years, cost reflectivity and customer preferences for tariff simplicity.

The information included in the risk assessment and assurance framework for tariffs included not only specific regulatory and legal requirements, but other metrics that if not met could result in customers or stakeholders calling into question the legitimacy of company decision making or the effectiveness of the regulatory framework in protecting customers' interests. Transparency over what the assurance has checked and what this specifically means is important to the process, rather than risking generalised statements that nothing specifically incorrect has been identified if the role of the audit within the company's overall risk management framework had not been identified. A similar approach in preparing our PR14 business plan supported our inclusion of measures outside of the specific regulatory framework, such as the 2014/15 tariff freeze and the development of the WaterShare framework.

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The diagram below shows the rules that must be met and those that should be met without a mitigation plan, plus other indicators the Board could consider and justify (this reflects the framework and not the final set of indicators presented to the Board as part of approving 2015-16 charges).

Tariff rules	Water Wholesale	Wastewater Wholesale	Household retail	Non-household retail	END USER
<b>Compliance with Revenue Controls (Single Year)</b>	Should	Should	Must	Must	
Consider revenue profiling adjustments:					
<i>Demand</i>	Could	Could			
<i>WaterShare</i>	Could	Could			
<i>Prior years</i>	Could	Could	Should	Should	
<i>Headroom</i>	Could	Could	Could	Could	
<b>Compliance with Revenue Target in revenue controls</b>	Must	Must	Must	Must	
<b>Bill changes and impacts</b>					
Ofwat - bill stability impact assessment					Should - 5%
SWW - average bill less than RPI					Must - RPI%
SWW - individual tariff changes less than RPI	Could - RPI%	Could - RPI%	Could - RPI%	Could - RPI%	
SWW - customer bill increase less than RPI					Could - RPI%
SWW - customer bill increase less than £20 where above RPI					Should - £20
<b>Individual tariff rules</b>					
SWW-Wholesale standing charges - reflect metering/connection costs	Could	Could			Should from 2017. Incidence effects management
Non-household charges higher for Ofwat allowed Open Water costs	Must	Must			
Assessed charges based on average volume for household size	Should	Should	Should		
WaterSure based on average household bill	Must	Must	Must		Must
Infrastructure charges capped by RPI	Must	Must			
Social tariffs recovered from domestic customers			Must		
SWW-Dual service less than or equal to sum of single services			Must	Must	
All tariffs have to be positive	Must	Must	Must	Must	
<b>Large user tariffs</b>					
Higher than Long Run Marginal Costs	Must	Must			
Tested against other competition tests in order to determine level (tariff corridors)	Should	Should			
<b>Differentials between customer groups</b>					
Measured/Unmeasured tariff differential	Should	Should	Should	Should	SWW methodology and thresholds. Incidence effects management
Surface water drainage tariff calculations - foul vs surface water drainage	Should	Should			SWW methodology and thresholds - 2p/m3. Incidence effects management
Comparison between trade effluent and sewerage charges for domestic strength		Must			5p/m3 tolerance
SWW - Household and non-household test for equivalent volume	Could	Could	Could	Could	Could - 5% or £20 tolerance. Adjust fixed variable wholesale/retail charges if out of tolerance.
<b>Competition compliance</b>					
Non-household gross margin sufficient				Must	Test against FD14
Access prices based on wholesale charges	Must	Must			
Special agreements based on a clear methodology	Must	Must			
Non-default tariffs based on cost/risk change from default				Should	Until level playing field separation

## APPENDIX 2

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

South West Water operates an integrated assurance framework, which provides the Board with the comfort that principal risks and uncertainties are being mitigated. Such assurance comes from a variety of sources so a framework needs to identify all types of assurance to enable a full evaluation of the conclusions drawn by all auditors, inspectors and reviewers from both internal and external providers. SWW has a number of different assurance providers utilising independent internal sources of assurance as well as external expert assurance providers.

In many areas (such as charges and tariffs) we already provide explicit sign off via the Board, which relies upon the Board having assurance over the area in question.

We believe that it is reasonable for companies to continue to provide these forms of assurance sign off (i.e. compliance statement) having gained sufficient assurance (whether internal or external).

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?

It would be reasonable to expect transparency within the assurance process, such that details of assurance work that has been performed would be made available to Ofwat upon request. Further the sign off discussed in Q1 should include a statement that sufficient assurance has been obtained to enable the Board to provide sign off. Any material differences should be reported on an exception basis.

Full details of assurance work, including the processes and procedures used however would be impractical to require to be published, not least because many external assurance providers would not commit to perform the work if this were the case.

Instead, we think that, except for areas of targeted or prescribed assurance, the Board should describe their overall framework, any specific exceptions or risks and provide a general description of the assurance processes used to reach these conclusions. Our Board Assurance submission at PR14 is an example of this approach.

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

There is already dialogue in many areas with external stakeholders (such as the Environment Agency) as to the level of information which is required. This dialogue sometimes extends into assurance requirements.

Any consultation regarding assurance plans with stakeholders could be significantly impacted if the interest or expertise of the stakeholders in the water company's assurance procedures is limited. Companies should include the strengths and weaknesses of this form of consultation within their risk assessments where it is material to their assurance approaches.

Therefore, whilst we do not think consultation exercises are without merits, Ofwat should also propose minimum assurance requirements for water companies in the prescribed category and also consider their assurance plans.

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

There are a number of practical challenges present within the consultation plans, not least concerning interest and expertise and time commitment required from stakeholders to make the plan work. In part this reflects that assurance and risk assessment should be an on-going process, but specific details need to be flexible and change for emerging circumstances. So whilst consultation on a broad approach to the timetable Ofwat set out might be reasonable, the detailed implementation needed within that financial year could not be consulted on to be effective within that timeframe.

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?

The level of prescription required to protect customers is likely to depend on the weaknesses which have led to a company being included within the prescribed category.

If the reasons for a company being prescribed relate to a number of related failings in a limited area, then it would be logical to assume a high level of prescription in these areas, whilst a lower level of prescription in other areas.

A minimum assurance set of requirements could be produced for companies within the prescriptive category, however these would need to be supplemented by specific circumstantial based requirements.

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.

Companies within the targeted category should perform an assessment of risks, strengths and weaknesses, to be used to target their assurance work effectively. This assessment should include evaluation of the outputs of Ofwat's classification work.

The publication of a full risk assessment would seem out-of-line with the targeted approach, as by categorisation within the targeted category there may only be limited areas of assurance weakness, which may already be identifiable. If company risk management approaches are fully formed, it should not be onerous to complete a general risk assessment across all key company risks.

It would however be reasonable for water companies within the targeted category to discuss and agree their assurance plans with Ofwat on any specific assurance issues.



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

It seems reasonable that the prescription required would be the same in targeted areas as for companies in the prescribed assurance category, however within both categories requirements should be assessed on their own merits taking into consideration the rationale for the categorisation and risks assessed.

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.

Logically, given the rationale published for the categorisations, the prescription for these areas should follow the prescription that would occur within the self assurance category. Companies may not agree with Ofwat that the targeted assurance areas are or were an issue, and therefore dialogue and transparency on this is worthwhile. Self assurance processes provide companies with the opportunity to present the context for their risk management processes and plans.

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?

We believe that it is important that Ofwat are made aware when material assurance issues arise, and that companies report on actions taken and improvements in assurance processes made in these areas. These factors should then be considered as part of an annual review process of whether a movement between categories is required. There must therefore, be a process in place which allows for discussion between Ofwat and the water company, for example to analyse issues and ensure the requirement to move to a tighter assurance category is correctly assessed. Companies need the opportunity to demonstrate that risks are being managed and mitigated through their risk management framework, as otherwise there may be a focus on regulator rather than customer and other stakeholder expectations on the company.

A notice period observing cycles of reporting and stakeholder communications should be observed.

Q10. Do you think that 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 reassessment?

So long as a company can demonstrate it has improved sufficiently in areas of weakness identified in the initial assessment process, we believe a full relative reassessment would not be necessary to be performed.

Given the initial assessment has been performed based on companies being assessed against specified criteria, rather than specifically in a ranking order against each other, the updated position against those criteria should be considered and actions taken to address weakness and new issues identified.

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

We believe that following any assessment, identification of issues, or improvements made by water companies it should be possible that companies are able to move both up or downwards within the classification.

We do not however view that an annual relative assessment is desirable or beneficial to the water companies or stakeholders as they are liable to lead to a focus on the position within the annual assessment rather than a proper risk based assurance approach.

We do however recognise that a level of periodic review to ensure initial judgments made by Ofwat remain applicable could be considered necessary. An annual process for promotions with relegation based on specific issues or assessments provides the best balance.

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

We do not believe a minimum threshold period to be placed in the prescribed category acts as an incentive to make prompt and quick progress to improve. We do think that companies should be required to demonstrate their improvements to Ofwat before moving out of the prescribed category, however the minimum time limit would not be helpful. In practice, it may be necessary for at least two years of prescribed assurance in order for sufficient reporting to have occurred to provide confidence that problems have been resolved. Therefore although practically two years may be the minimum time period, there is no reason why Ofwat needs to constrain the process specifically on this point.

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?

Assurance for reporting during 2015-20 will to a large extent have similar requirements to the past. Key changes reflect the main developments in the regulatory framework for the industry. The PR14 programme challenged companies to take ownership of this, in particular in how Outcome Delivery Incentives were developed and this should naturally inform the reporting and assurance framework that companies now put in place. Our Outcome Delivery Incentives were developed using a set of criteria that included the impact on ongoing communication, legitimacy and risk management. It is important that companies continue to consider these factors based on experience of applying the PR14 incentive framework in practice.

Incentives may vary between each company. For example for listed companies, city stakeholders may pay attention to the categorisation, however for others the categorisation may be less important.

The key incentive is the confidence that companies who understand their risk and opportunities are more likely to present business plans that meet customer and stakeholder needs. They are also more likely to be able to take advantage of general market and regulatory framework incentives, such as Outcome Delivery Incentives and retail market engagement. Specific incentives are not required for meeting basic expectations of

customers and stakeholders in performance and performance reporting. In general, it will be disappointing if most companies are not in self assurance categories once they have considered their risk management approaches post PR14. The future market and price review challenges clearly require enhanced focus on risk management processes by companies so the Ofwat expectations should not be seen as onerous in this context.

#### Questions on Annual Performance report: Summary of performance parameters

We outline below a number of questions for further discussion on the proposed summary of performance parameters suggested by Ofwat with the consultation:

1. **Regulatory financial reporting** –the specific approach to calculating RORE will need to be defined. We would recommend setting the denominator to the notional average RCV each year (i.e. 37.5% of the outturn average RCV). This would ensure consistency of actual RORE calculations with PR14 and comparability across the industry (to avoid RORE varying just due to differences in company financial structures). This is important for maintain investor confidence in the sector.
2. **Price control and other segmental reporting** – Ofwat will need to define profit margin for retail (gross or net? We assume gross)
3. **Performance commitment summary** – is this in units (ie performance commitments and not just ODIs. What is the difference between Total earned and notional accrued? Forecasting an AMP6 reward and penalty goes beyond what would normally be included in annual performance report – no other forecast data is reported. As this goes beyond assurance on performance and we consider forecasts should not be included.
4. **Other regulatory information** – the actual RCV would be the same as the FD? The use of a shadow RCV here would need further development to define a methodology to be used consistently between companies.
5. **Current Costs** - Why are current cost dividend cover and PBT/PAT being used, given that current cost regulatory accounts are not specifically being prepared? IFRS dividend cover may be of more use to stakeholders.

