

United Utilities response to Ofwat's consultation on company monitoring framework

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1 INTRODUCTION

United Utilities Water (Uuw) is pleased to have this opportunity to respond to Ofwat's consultation on the proposed company monitoring framework for the 2015-20 period. We note that the consultation covers both views on the nature and requirements of the monitoring framework, and on the process for categorising companies and moving them between assurance categories.

2 CONSULTATION QUESTIONS

Question 1: Do you agree that companies in the self assurance category should provide explicit sign off on the assurance that has been provided?

We agree that explicit Board sign off on the assurance provided should be a base requirement for all companies to promote stakeholder trust.

Question 2: 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 assurance process should be transparent to give stakeholders and customers' confidence that the information reported is accurate and reliable. The framework used by companies to assure reported information should be transparent, as should any material issues, which are identified through this framework that could affect final reporting.

We do not however, believe that it would be necessary or beneficial to publish detailed audit reports and internal assurance outcomes in their entirety. The quantity and often technical nature of the assurance activity carried out in year could easily be misinterpreted and may reduce stakeholder confidence in regulatory reporting. To drive best practice in the industry it is important that management is able to expose, review and address areas of weakness in a timely manner without having to publish disproportionate amounts of detail.

We agree that where a company fails to address areas of weakness in a timely manner or if the issue will impact the accuracy and reliability of information reported at the end of the year then the company needs to be transparent, sharing a summary of the outcomes and proposed actions to address any issues identified through the assurance process, with the relevant stakeholders. Depending on the type and severity of the issue this may mean sharing additional information and agreeing an action plan, directly with a Regulator or with the Customer Challenge Group (CCG).

With regard to how this transparency could be accomplished. We believe that it is important that the information published is appropriate for the relevant stakeholders, both in content and format. We set out in our PR14 Measurement and Assurance document (Reference RD006) our proposals for transparent reporting to stakeholders. A similar approach could be applied to assurance. Annual performance reporting could include a customer friendly assurance summary, the content of which would be agreed with the company's "CCG" before publication online.

Question 3: 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?

The monitoring framework aims to increase customer and stakeholder confidence and trust therefore it is important to engage with customers when developing assurance requirements. If companies are to have open and honest conversations with stakeholders about performance then it is important that the assurance plan is also transparent and that stakeholders are given the opportunity to help to shape this plan.

We believe that the assurance framework and high level plan should be shared with the company's CCG and published on the company's website. It is important that the level of detail shared should be relevant to the stakeholder and proportionate to the risks associated with the data. Depending on the severity and the type of issue identified it may be appropriate to share more detailed information directly with relevant stakeholders and work with them to develop an action plan.

For example, if a material weakness or risk associated with water quality data was identified this would be highlighted to the DWI and the company would work closely with the DWI to agree an action plan to mitigate the risk, as currently happens.

Additionally if a material weakness or risk associated with the delivery or assurance of our reported outcome performance commitments was identified this would be highlighted to our CCG (YourVoice) and we would work with them to develop an action plan to manage or mitigate the risk.

In addition to the prescription agreed with relevant stakeholders, we believe that it would be useful to companies and to stakeholders for Ofwat to set minimum prescribed assurance requirements for each of the different sections of the performance summary report and for any ad hoc information requests made during the period. A defined set of minimum assurance requirements would help inform discussions with stakeholders and provide a benchmark for the categorisation of companies and to help balance stakeholder expectations.

Question 4: Do you consider the outline approach that we have set out to be practicable, or can you suggest improvements?

In principle we consider that the consultation paper's proposals that all companies must provide full transparency of audit procedures along with a summary of the outcome of assurance and explicit Board sign off on the assurance provided, is practicable. We also believe that the process and the required consultation exercises should be able to form part of the annual review timeline.

The consultation proposes that targeted and prescribed companies should publish a statement of risks, strengths and weaknesses each Autumn. Targeted and prescriptive assurance companies are then also required to publish assurance plans for stakeholder comment. We have assumed the assurance plans would be published shortly after the Autumn statement although this is not specified in the consultation. Further time would then be required for consultation, any necessary revisions required to accommodate customer and/or Ofwat requirements and then implementation of the assurance plan. The detailed timing of this work will need some further consideration but as part of this we believe that Ofwat should set a back stop date for completion and publication of the risk statement.

Question 5: 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?

As set out in our response to question 3 above we think that it would be useful to companies and to stakeholders for Ofwat to set minimum prescribed assurance requirements for each of the different sections of the performance summary report as well as for any ad hoc information requests made during the period. A defined set of minimum assurance requirements helps to inform discussions with stakeholders and to provide a benchmark for the categorisation of companies and to help balance stakeholder expectations.

We do consider that this default prescription could be minimal, with companies consulting on the specific detail of their assurance requirements with stakeholders. It is also important that Ofwat recognises the high potential cost burden that can be associated with external assurance and should consider this carefully before prescribing external assurance requirements. We believe that requirements for additional third party assurance – above and beyond that already required for reporting to the company's Board – should very much be the exception, rather than the rule and where utilised it should build on internal assurance and reporting using a risk based approach to focus on key issues.

We believe our current approach is appropriate for regulatory reporting going forward into AMP6 and is aligned with the principles set out in the assurance technical appendix ('Setting price controls for 2015-20: Draft price control determination notice: technical appendix A9 – assurance, monitoring and reporting obligations'). For UUW the process for capturing and assuring our existing regulatory data is underpinned by the "three lines of defence" assurance process.

In the first line of defence management has accountability for developing and maintaining sound processes, systems and controls in the normal course of their operations.

In the second line of defence the Economic Regulation Team has accountability for providing the framework and governance for regulatory reporting.

The third line of defence provides independent audit and assurance activity through UU's corporate audit team and via external assurance.

The form of assurance should be based on the content and associated risk. For self-assured and targeted companies we believe that making the assurance process, outcome summary and assurance plans transparent to customers and stakeholders should be sufficient to build confidence and trust, without requiring additional external assurance.

We believe that more specific prescription, from Ofwat, should only be necessary, where an individual company has either not complied with its agreed assurance plan, or where Ofwat considers that this plan is insufficiently robust to adequately protect and provide confidence to customers. We also believe that it may be appropriate for Ofwat to prescribe more specific assurance requirements, if they consider, as a result of their comparative reporting, that companies are not adopting common assumptions or reporting processes. In these circumstances it may be appropriate for a common more prescriptive approach, or intercompany audit process, to be implemented.

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Question 6: 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.

We do think that companies in the targeted category should be required to publish an assessment of risks, strengths and weaknesses in their assurance process and that this should be used to target the more prescriptive assurance requirements.

The assurance plan to address these risks should reflect the materiality of the potential risks involved and include cyclic assurance to maintain the accuracy and reliability of reported information and focused activity to address specific weaknesses and/or high risk areas. The assurance process and plan should cover both the reporting of historic information and risks associated with future reporting requirements. We agree that companies, in conversation with stakeholders, are best placed to identify where the risks, strengths and weakness arise however it is helpful to have the minimal assurance requirements defined to reduce ambiguity.

We also think that all companies, not just those in the targeted category, should publish this report. Even if self-assured companies have identified no new risks in the year, publication of the report would appear appropriate to demonstrate best practice and that their self-assurance categorization remains appropriate.

We also believe that Ofwat and other stakeholders or regulators have a role to play in identifying areas that could require more prescription, through looking at comparative information across the industry, specific issues that may arise or through the broader (horizon scanning) processes.

Question 7: 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

In principle we think that companies subject to prescribed assurance should have a higher base level of prescription than targeted companies, if they are to provide the same level of confidence to stakeholders.

We think that both categories of company should have the opportunity to consult with stakeholders on their specific assurance requirements. If Ofwat then believe that it is beneficial to step in, then they should do so with this decision being based upon the perceived adequacy of the company's specific proposals, rather than the initial categorisation of the company.

Question 8: 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 think that the default level of prescription for areas that are not targeted should be the same for targeted companies as for self assurance companies.

Question 9: 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 think that it is important that companies should be able to identify issues through their routine assurance, monitoring and control activities and highlight these issues to Ofwat, other regulators or customer bodies. We also think that once issues are identified, action plans and specific assurance requirements should be agreed with customers or other stakeholders, which should address these issues.

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We therefore do not think that it would be appropriate to automatically move companies to a tighter assurance category immediately an issue comes to light. We think that it would be more appropriate to assess the adequacy of the proposed assurance and then whether the action and assurance plans which are put in place are effective in managing the risk and if issues. With companies being downgraded if the assurance plan is inadequate or if issues still remain in the year end reporting and in the Autumn assessment of risks, strengths and weaknesses.

We believe that assurance requirements and potential changes in categorisation should be proportionate to the risk that regulatory reporting data is not reliable and accurate. An overly punitive mechanism could discourage the transparent behaviour Ofwat is seeking to encourage by dissuading companies from highlighting risk issues for fear of the reputational impacts of a downgrade in assurance category. It is also important that stakeholders are able to keep a significant risk under review and that the process is dynamic so that Ofwat can step in if the company is failing to manage the risk.

With regard to the examples, although we agree with the overall approach outlined on page 17 and 18 of the "company monitoring framework – further consultation", we do not think that all the examples listed are appropriate.

The purpose of the company monitoring framework is to give customers and other stakeholders confidence that the information provided by companies is accurate and reliable. Some of the examples used, however, focus on a company's ability to meet performance commitments and legal obligations rather than on the reliability of their reporting.

We think that companies risk based review processes should highlight areas which are either not meeting their performance expectations or are borderline between meeting or failing these expectations. Having been identified, these areas can then be subject to additional scrutiny and assurance. For example more, detailed assurance could be required for outcomes which are borderline between reward and penalty, than for penalty only outcomes, where the performance levels are firmly above the performance commitment.

As long as companies have adequately reflected the materiality of these risks in their assurance plans, we do not then feel that it would be appropriate to move companies into targeted or prescribed assurance criteria. There are existing mechanisms in place to penalise and/or prosecute companies for not meeting their performance commitments or other obligations. In certain circumstances it may also not be in either the company's or its customers' interests to overspend to meet the performance commitments imposed by the FD. Therefore it would be inappropriate to seek to downgrade companies' assurance plans on the basis of performance levels that are potentially in customers' interests.

Question 10: 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?

We think that it is appropriate for companies to be able to move up from the prescribed to targeted category to self assurance if stakeholders are confident the areas of risk and weakness in the reporting process have been addressed. The publication of assurance plans allows stakeholders to challenge the plan and the assurance outcome summary should confirm whether historic assurance actions have been completed.

An annual comparative assessment, with the opportunity to improve the categorisation, acts as an incentive to companies and a useful indicator to stakeholders when assessing the efficacy of companies' assurance activities. To ensure the assessment and categorisation of companies is

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transparent we think it is important that Ofwat publishes the assessment criteria. This makes it easier for companies to have informed discussions with stakeholders and drives higher standards within the industry. As we set out in our response to question 9 the assessment should focus on assurance and the companies' ability to accurately report reliable data. There are existing mechanisms to incentivise performance.

Question 11: 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?

We support the proposal for an annual review and consider that it should provide scope for companies to move both up and down.

The proposed company monitoring framework provides the opportunity to assess and challenge companies' ability to report reliable and accurate information. An annual relative assessment acts as an additional incentive to improve reporting and assurance across the industry and in itself would help to generate trust and confidence in the sector regardless of whether companies are moving up, down or staying in the same category.

Question 12: Do you think that it is appropriate for companies to spend at least two years in the prescribed assurance category?

We agree that it is appropriate for companies to spend at least two years in the prescribed assurance category. This is because in order to be categorised as requiring prescribed assurance there should have to have been significant failings with a company's ability to give stakeholders confidence in the reporting process. Two years is an appropriate amount of time to demonstrably address significant issues, complete the necessary assurance and re-build stakeholder trust.

Question 13: 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?

We agree that if implemented appropriately the overall package of proposals could lead to appropriate incentives for companies.

We think that to maximise the effectiveness of the monitoring framework, it should focus on assurance and reporting and that companies should not be downgraded for their relative performance or expenditure levels, both of which are covered by existing reporting and incentive mechanisms.

We think that the framework should be relatively light touch, and that the information which is required to be made transparent, should be focused on information which could potentially impact on year end reporting rather than exposing management information used to target specific in year activities and improvement programmes.

We think that the proposals would act as a strong reputational incentive to companies whilst building and supporting trust and confidence in the industry. Companies would need to be able to change categorisation if the evidence supported this reclassification.

Other comments

Although we are not intending to challenge our initial categorisation as a “targeted assurance” company, the basis on which Ofwat claims to have made the categorisation contains some errors. In particular, in observation “B”, Ofwat states that UU “*later revealed a significant error in its initial pensions deficit calculation*” whereas there was no error in the initial pensions deficit calculation and, further, all the relevant information on our pensions calculation was provided with our initial business plan submission in December 2013. Indeed, Ofwat had been advised of the nature of our representation on pensions ahead of the submission.

Ofwat also states that its categorisation has been influenced by the approach taken to cost allocation at PR14. However, on any reasonable view, the adjustments ultimately made in response to Ofwat's letter of 30 July 2014 could not be considered material.

Finally, we believe that assessment under observation “F”, “Compliance with Obligations”, may require further refinement. The fact that a case is open does not imply that the company is not in compliance with its obligations. Furthermore, in the specific case referred to, the duration of the case – and therefore whether it is currently open or closed – is a matter which is very much outside of UUW's control.

Despite this, we recognise and welcome that Ofwat has made efforts to provide transparency on how it has arrived at its categorisation decisions.

Given the powerful reputational incentives associated with both the categorisation of the company and any comments Ofwat wishes to provide in support of its decision, we consider that it is important and appropriate that such comments should be provided to companies for comment prior to a decision being released in public. This will ensure that the risk of future material misstatements about company actions or issues is minimised.