

# United Utilities response to the Ofwat consultation: How companies should demonstrate long term financial resilience



## Introduction

United Utilities welcomes the opportunity to respond to Ofwat's consultation on how companies should demonstrate long term financial resilience.

In line with our response to the July 2015 consultation "Financial Monitoring Framework", we welcome Ofwat's continued engagement with the industry on an appropriate approach to demonstrating the long term health of the business. We strongly support Ofwat's proposal that companies should follow C.2.2 of the 2014 UK Corporate Governance Code (requiring companies to publish a Long Term Viability Statement (LTVS)) in order to demonstrate their long term financial resilience. We believe that in complying with this section of the Code, as we have already done in our 2014/15 accounts (see Appendix 1), company Boards can take ownership and accountability of their long term financial resilience and risk management performance, in a manner appropriate to them.

Our Board's statements on long term viability are underpinned by a substantial analysis. In line with Financial Reporting Council (FRC) guidance, this considers threats to the company's viability based on a robust assessment of those risks that would threaten the business model, future performance, solvency or liquidity of the group. This includes consideration of risks in severe but plausible scenarios as well as the availability and likely effectiveness of mitigating actions available to the directors to manage such risks.

We believe that the requirements to comply with C.2.2 will ensure that Boards are clearly held to account for their responsibilities and should be capable of providing stakeholders with the confidence they need about the long term viability of the company without adding a significant reporting and regulatory burden on listed companies. A centrally defined approach should be reserved for those companies that fail to demonstrate compliance with C.2.2 of the Code.

We do not agree with the proposal that the LTVS should be subject to third party assurance. This approach could erode what the LTVS actually represents, which is the company's Board of Directors taking full responsibility and accountability for the long term financial viability of the company.

We welcome the clarity provided by Ofwat in section 6 of the consultation as regards looking beyond the regulatory ring fence.

Q1: Do you agree that the proposed approach to companies demonstrating their financial resilience will provide an appropriate level of assurance about each company's long term financial resilience?

**We support Ofwat's advocacy of section C.2.2 of the 2014 UK Corporate Governance Code and believe that this will enable company Boards to take ownership and accountability of their long term financial resilience, in a manner appropriate to them. However, we have some concerns over the proposal to require third party assurance on the Board's long term viability statement. We believe that this could detract from the accountability that only company directors should hold in terms of taking responsibility for their assessment and any consequences thereon. Good corporate governance should not require an auditor's sign-off.**

The 2014 UK Corporate Governance Code introduced section C.2.2 covering the requirement for companies to publish long term viability statements. UUW adopted this requirement early and included disclosures in its 2014/15 annual report and accounts. We understand that United Utilities Group PLC was the first FTSE-100 company to incorporate a long term viability statement in its annual report (see

## United Utilities response to the Ofwat consultation: How companies should demonstrate long term financial resilience

Appendix 1 in this response). United Utilities Water Limited also included a long term viability statement in its accounts and this can be found on page 52 of the 2014/15 U UW accounts.

Our Board's statements on long term viability are underpinned by a substantial analysis. In line with FRC guidance, this considers threats to the company's viability based on a robust assessment of those risks that would threaten our specific business model, future performance, solvency or liquidity of the group. This includes consideration of company-appropriate risks in severe, but plausible, scenarios as well as the availability and likely effectiveness of mitigating actions available to the directors to manage such risks.

We agree with Ofwat's approach, having adopted the LTVS requirements early last year. We think this approach ensures that Boards are clearly held to account for their responsibilities and that it is capable of providing stakeholders with the confidence they need about the long term viability of the company, without adding a significant reporting and regulatory burden on listed companies. Centrally prescribed stress tests and periods should be reserved for use as a remedial measure for those companies that fail to demonstrate adequate compliance with C.2.2.

In adopting C.2.2 we noted that, whilst the Code does not specify a period over which the viability statement should be made, it indicates it should be "significantly longer than 12 months" from the approval of the financial statements. Our view is that a five year period represents a reasonable period of time as a forecast horizon for the key risks and risk mitigations of a regulated water company.

The FRC has recently published its assessment of how early adopters, including UU, have dealt with the new requirements in the 2014 Code<sup>1</sup>:

*"As these changes applied to financial years beginning on or after 1 October 2014, [our] assessment has been on the quality of reporting by early adopters and those September year end accounts which were published by 31 December 2015.*

*Only a small number of companies have chosen to adopt these Code changes early. [...] Among the early adopters' statements, there was some good detail on how the period was chosen and what principal risks were considered and mitigated.*

*The time period covered in these statements varied between three or five years, although one company selected two years to fit with their existing business cycle. Two companies (one each from the FTSE 100 and 250) who will report fully next year have indicated the time period they will use – three and five years respectively."*

We believe that this endorses the approach which we have taken and intend to take in our 2015/16 year end accounts. It may be helpful for the sector as a whole for Ofwat to provide similar feedback.

We do not agree with the proposal that the LTVS should be subject to third party assurance. This approach could erode what the LTVS actually represents, which is the company's Board of Directors taking full responsibility and accountability for the long term financial viability of the company. By gaining third party assurance on this assessment, it may be perceived by some that the directors have divested some of this responsibility onto a third party. This is not in the spirit or letter of the UK Corporate Governance Code; the FRC hasn't made third party assurance a requirement of good corporate governance and, we believe,

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<sup>1</sup> "Developments in Corporate Governance and Stewardship 2015", Financial Reporting Council Annual Report, January 2016, page 10

## United Utilities response to the Ofwat consultation: How companies should demonstrate long term financial resilience

neither should Ofwat. Furthermore, additional assurance work would increase the costs of regulation borne by companies in the form of increased audit fees.

This proposed assurance would also be out of step with what our auditor is currently required to assure in the rest of the annual report and financial statements. Assurance is typically more of a quantitative assessment of a company's affairs whereas the LTVS is more of a qualitative assessment. We believe that it would be difficult to provide meaningful assurance on a company's risk and "thought process". We therefore believe that it would be problematic to provide assurance on a long term viability statement. What matters is that the Board itself is aware of its responsibilities and has taken appropriate steps before making the statement; this is disclosed in our accounts. Should Ofwat not be satisfied with this disclosure then it is always able to make further enquiries of the company, under its regulatory powers.

Q2: Is there anything else that we should be recommending that companies explicitly include in their statement on long term financial viability?

**We do not consider it necessary for company Boards to include anything over and above the requirements of section C.2.2 in their LTVS. We believe that by following the requirements of C.2.2 of the 2014 UK Corporate Governance Code in their statement on long term financial viability, companies should be able to robustly demonstrate their long term financial resilience, to the satisfaction of stakeholders, customers and Ofwat alike. By adding to the requirements of the LTVS, it could undermine the statement itself and the FRC. By prescribing additions, Ofwat could inadvertently place liability onto itself and away from company Boards.**

The Code has been developed by the FRC, the UK's independent regulator responsible for promoting high quality corporate governance and reporting to foster investment. The FRC's intention is to enable UK Boards to demonstrate their company's long term financial resilience. This approach has been deemed sufficient by UK and European regulators respectively in their approach to financial monitoring and stress testing of banks – a sector where the case for disclosure of capital adequacy metrics is significantly more clear cut.

On this basis, we believe that if the Code is sufficient for all other UK listed companies then it should also be sufficient for all WaSCs and WoCs.

Q3: Are there alternative approaches to companies demonstrating their long term financial resilience that Ofwat should be considering?

**We consider the LTVS, as laid out in C.2.2 of the Code, to be the most appropriate method for company Boards to demonstrate their long term financial resilience.**

This is one of the reasons why we chose to early-adopt it in our 2014/15 accounts. The Code lays down a robust framework of corporate governance for all companies to follow, whether listed or not. Ofwat has shown its backing for the Code in past adoption of its contents and spirit; we consider it appropriate that it should continue to do so on this occasion.

## United Utilities response to the Ofwat consultation: How companies should demonstrate long term financial resilience

### Appendix 1

#### **Long term viability statement**

The directors have assessed the viability of the group over a five-year period to March 2020, taking account of the group's current position and the potential impact of the principal risks documented in the strategic report. Based on this assessment, the directors have a reasonable expectation that the company will be able to continue in operation and meet its liabilities as they fall due over the period to March 2020.

In making this statement the directors have considered the resilience of the group, taking account of its current position, the principal risks facing the business in severe but reasonable scenarios, and the effectiveness of any mitigating actions. This assessment has considered the potential impacts of these risks on the business model, future performance, solvency and liquidity over the period.

The directors have determined that the five-year period to March 2020 is an appropriate period over which to provide its viability statement. In making their assessment, the directors have taken account of the group's robust capital solvency position with a debt to RCV ratio of around 60 per cent, its ability to raise new finance in most market conditions, its key potential mitigating action of restricting dividend payments and the protections which exist under the regulatory model that a primary legal duty of UUW's economic regulator is to ensure that water and wastewater companies can finance their functions.<sup>2</sup>

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<sup>2</sup> Extract from United Utilities Group PLC Annual Report and Financial Statements for the year ended 31 March 2015, page 75