Information notice

IN 18/04: March 2018

Expectations for companies in issuing long term viability statements

The Board of each water and wastewater company is responsible for ensuring that they are financially resilient and should be able to demonstrate how they have assured themselves that this is the case, providing this assurance both to Ofwat and their wider stakeholders. Ofwat issued an ‘Information Notice’ IN16/03 in March 2016 on ‘Expectations for companies demonstrating long term financial resilience’. Following a review of the long term viability statements that companies published in 2017, we identified significant inconsistencies in the level of detail provided by companies and in most cases the information provided did not fully explain the procedures that had been followed. This information notice sets out further guidance for all companies in England and Wales in respect of the approach that they should take when preparing and publishing a statement on long term financial viability. The aim is to ensure that all companies are applying appropriate rigour in making their assessment and that the information provided to stakeholders is suitably robust. This guidance is applicable to the statements that companies need to include in their statutory accounts and annual performance report for the 2017-18 financial year and in subsequent years.

Background

Ofwat’s vision for the water sector in England and Wales is one where customers, the environment and wider society have trust and confidence in vital public water and waste water services.

In addition to our primary duties to protect the interests of consumers and to secure companies properly carry out, and are able to finance the proper carrying out of, their functions, Ofwat now has an additional primary duty, introduced by the Water Act 2014, to further the resilience objective. This focuses on the long-term resilience of water and wastewater services to meet the needs of consumers in the long term. Resilience includes companies being financially resilient – ‘the extent to which an organisation’s financial arrangements enable it to avoid, cope with and recover from disruption’. The Board of each company is responsible for its efficient operation, for ensuring that the company is resilient. Company investors, not customers must bear the risks associated with the company’s choices in relation to capital and financing structures. In terms of financial resilience we expect companies to have an appropriate level of funding (both debt and equity) in place to provide them with the flexibility that they need to deal with issues when they arise.

We use various tools, including the financial monitoring framework, to monitor the resilience of companies. We expect companies to include a clear and transparent statement in their annual performance report each year which confirms that the Board considers that the company is financially viable over the long term. Where companies include this statement in their statutory accounts, an appropriate reference to that statement may be included in their annual performance report rather than repeating it in full.

These requirements are consistent with the UK Corporate Governance Code and build on the related Guidance on Board Effectiveness. We note that the UK Corporate Governance Code specifically applies to UK listed companies and the Guidance on Board Effectiveness is not mandatory, however we expect all water companies to meet the requirements set out under the UK Corporate Governance Code, the Guidance on Board Effectiveness and this Information Notice.

UK Corporate Governance Code

The Financial Reporting Council issued a consultation on a revised UK Corporate Governance Code in December 2017. The consultation closed on 28 February 2018. The principles set out in this note are in line with the proposals set out in that consultation. In the event the consultation outcome is materially different from that proposed, if required, we will issue further guidance to address any concerns.

Section 4 of the revised Guidance on Board Effectiveness proposes that:

"companies should consider developing their viability statements in two stages, firstly by considering and reporting on their longer term prospects by taking into account the company's current position and principal risks, and then by stating whether they 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 of their viability assessment, drawing attention to any qualifications or assumptions as necessary."

The approach we expect companies to take in assessing their long term viability

As outlined by the UK Corporate Governance Code and the Guidance on Board Effectiveness, we expect companies to have a robust financial and operational plan that is stress tested, covers an appropriate forward looking period and that clearly states the most critical assumptions that underpin it.

As all the water companies are long term businesses and have twenty five year rolling licences with reasonably predictable revenue streams, the length of the forward looking period should not be constrained by the end of the current price review period. Companies are responsible for ensuring that they choose an appropriate period over which they make their assessment, and we expect them to provide an appropriate justification for their choice. We expect companies to look forward at least 5 years, and some companies have already chosen to use a longer period for their assessment.

Companies should stress test their forward looking plans by modelling appropriate scenarios and sensitivities which reflect the risks that the business faces.

It is for companies to determine the appropriate level of stress testing they consider necessary to determine that they are financially resilient over the longer term and to justify why they consider their approach to be appropriate.

The stress tests should cover severe, plausible and reasonable scenarios for key variables, covering the principal risks facing the business in the short and longer term. Companies' assessment of risks should take into account expected performance and reflect past ability to deliver for customers.

Companies should also consider the combined impact of multiple scenarios and should clearly state how the scenario combinations have been developed.

The variables which companies consider for stress testing should reflect the individual circumstances of each company and may include but are not limited to the following:

- inflation;
- revenue;
- totex;
- impact of ODIs;
- unfunded costs;
- debt service requirements;
- unfunded pension liabilities;
- exceptional items e.g. regulatory fines and legal claims;

The stress testing should also consider the impact (if any) on the financial viability of the regulated business as a result of the overall group structure, inter-group transactions and any other group activities outside the regulatory ring-fence.

Where it may be envisaged that further funding will be required for the continuation of efficient operation of the company, the long term viability assessment should consider dependency on the company's existing financing and/or equity buffer alongside the availability of new debt or equity.

The assumptions used in the stress testing should be consistent with the wider risk assessment undertaken by the company and reported in its statutory accounts.

Companies should consider any issues arising from the results of stress testing and detailed risk assessment. Where these issues impact the long term financial resilience (including but not limited to any credit rating) of the company, then management should set out the action plan to address those issues and mitigate the risks that the company faces.

What companies should publish

Ofwat expects companies to publish a clear, unambiguous and transparent statement which sets out the approach that they have adopted when determining the long term financial viability of the company.

Companies should clearly explain the underlying analysis that supports their long term viability statement, the period over which the assessment has been carried out and this should also include a clear explanation of how the company has carried out its analysis.

We do not expect companies to publish any commercially sensitive information, however, companies should set out details of the stress tests undertaken, including the reasons why they consider particular scenarios to be appropriate. Companies should outline the impact of the scenarios modelled on overall performance of the company, the ability of the company to service its debt and on its credit rating and set out the Board's action plan to address any concerns arising from the results of the stress tests.

Companies should clearly state what internal review processes they have followed and the extent to which they have used any third party assurance to ensure the quality and robustness of their long term viability statements.

The extent of third party assurance to be used is for companies to determine but should take into account the assurance requirements arising from the latest Company Monitoring Framework assessment.

Long term viability statements should be consistent with the overall company outlook reflected in the financial information and metrics published in companies' annual performance reports. For the financial years 2017-18 and 2018-19 they should be consistent with the business plans that are currently being prepared or have been submitted by each company in respect of the price review for 2020-25. Where an inconsistency arises, there should be an explanation for this.

Next steps for Ofwat

Ofwat has reviewed the long term viability statements published by the companies in their 2015-16 and 2016-17 annual performance reports. In the 2017 Monitoring Financial Resilience Report we highlighted concerns about the length of the time periods that companies had considered when making their long term viability assessments. The Financial Reporting Council has also set out an assessment of viability statements in its Lab Project Report on risk and viability reporting, issued in Nov 2017.

We have been further reviewing in detail the approaches that companies have adopted, analysis that they have undertaken when making their assessments and the way they have articulated their long term viability statements. We have identified that companies have been taking different approaches to the assessment and that statements that companies have made include differing levels of detail. We have discussed some of these differences in approach with companies individually.

The additional guidance set out in this Information Notice provides further clarity for companies on what we expect them to do in respect of long term financial viability statements and aims to ensure that all companies are applying an appropriate level of rigour in producing their statements and are providing sufficient information about their approach.

We will review the statements that are made in the annual performance reports for 2017-18 and in future years and will consider the quality of those statements (including the period that has been considered, methodology that the companies have followed and the stress tests undertaken) in line with the guidance set out in this information notice. We may take this into account in our assessment under the Company Monitoring Framework.

If, having reviewed the statements made by companies, we have concerns about the quality of procedures companies have undertaken or we do not consider that the procedures companies have followed are adequate, then we will consider taking the following steps:

- Challenging individual companies where they have not, in our opinion, followed a suitably robust procedure.
- Issuing further guidance to companies which sets out more prescriptive requirements in relation to the procedures undertaken, the period reviewed or the form and content of the statement included in the annual performance report;
- Mandating the use of third party assurance and directing the areas where additional assurance is required.

Failure to comply with the requirements of the UK Corporate Governance Code and the guidance set out in this information note could also lead us to review the company's categorisation within Ofwat's Company Monitoring Framework.

In years where price controls are being set, we may also take into account the approach that companies have used in determining their long term viability in our wider assessment of business plans.

Enquiries

If you have any questions about this information notice, please send them to FinanceAndGovernance@ofwat.gsi.gov.uk

More information

Information Notice (March 2016)

FRC consultation on a revised UK Corporate Governance Code (December 2017)

Company Monitoring Framework: 2017 assessment (November 2017)

Monitoring Financial Resilience (November 2016)

Monitoring Financial Resilience (November 2017)

FRC Lab Report on Risk and Viability reporting (November 2017)

Ofwat (The Water Services Regulation Authority) is a non-ministerial government department. We regulate the water sector in England and Wales. Our vision is to be a trusted and respected regulator, working at the leading edge, challenging ourselves and others to build trust and confidence in water.

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