Information notice

IN 19/07 April 2019

Ofwat

Expectations for companies in issuing long term viability statements

We have seen a step change in the overall quality of the long term viability statements published by companies in 2018, when compared with those published in 2017. Clear evidence of the board having been actively involved in the development of, and having signed off, the company's long term viability statement was a particular area of improvement.

However, there were areas of inconsistency in the level of detail evidenced by companies and where further improvements can be made. This information notice is intended to build on the previous guidance issued (Information Notice IN18/04 March 2018 'Expectations for companies in issuing long term viability statements') in order to address these areas.

In order to alleviate the need for companies to consult multiple Information Notice's to enable them to retrieve the overall guidance, we have amalgamated the guidance from our Information Notice IN18/04 March 2018 'Expectations for companies in issuing long term viability statements' with further guidance in this information note.

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 transparent and robust. This guidance is applicable to the statements that companies need to include in their statutory accounts and annual performance report for the 2018-19 financial year and in subsequent years.

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

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.

Companies' future operational and expenditure plans need to reflect an accurate, up to date view. These plans should take account of companies' operational plans as well as anticipated changes in financing and gearing.

Companies are responsible for ensuring that they choose an appropriate period over which to make their assessment, and we expect them to provide clear justification as to why their chosen period is appropriate. We expect companies to look forward at least 5 years, and some companies have already chosen to use a longer period for their assessment.

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.

Risk assessment and forward looking stress testing

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

As part of companies' detailed risk assessments, we expect companies to identify clearly and describe the full range of principal and emerging risks faced by the company and also to set out and evidence appropriate mitigating actions in respect of those risks. They also need to describe clearly the process they have undertaken in relation to this.

Within this risk assessment, companies should.

- Ensure full consideration of the common external risks that affect the sector as a whole, as well as company specific risks.
- Ensure that they have considered the full range of categories of risk which could impact the company, such as financial risks, operational risks and regulatory risks.
- Ensure they consider their workforce policies and practices, and that these support the company's long term success.
- Ensure they consider all liabilities, including pensions.
- Ensure they consider any exposure to revenue variation.
- Ensure they consider risks which may result in downgrade of their credit rating, and mitigating actions they could take against these risks.

The risk assessment should reflect expected future performance and take account of past performance in respect of the ability to deliver for customers.

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. Companies should outline clearly the methodology used, and approach taken, for this testing and to justify why they consider their approach to be appropriate.

The scenarios and sensitivities included in this testing should cover severe, plausible and reasonable scenarios for key variables, covering the principal risks facing the business in the short and longer term as identified within the risk assessment.

Companies should explain how the scenarios were developed and justify why they deem the scenarios used to be appropriate.

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.

Companies should evidence clearly the severity of their stress testing. Where applicable, this should include details of the stresses applied (e.g. Opex increased by £Xm/X% to reflect all of the relevant issues. Relevant issues include expected price increase or other challenges. Where there are other challenges these need to be explained and the related costs quantified) and detail the assumptions underpinning each of the scenario tests.

Companies should justify why they deem the stresses applied, and resulting stretch levels assessed, to be appropriate.

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.

In assessing the long term viability of the regulated business, companies should also take account of the impact of the activities of any other group companies, any inter-group transactions and of the overall group structure on the financial viability of the regulated business.

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.

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 of the company (including but not limited to impact on the company's ability to service its debt and meet the requirements of its debt covenants, as well as the impact on the company's credit rating), then management should evidence their consideration of mitigating actions to offset these issues.

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.

Within their long term viability statements, we expect companies to evidence the detailed assessment they have undertaken to assess the robustness of their plan and evidence how they have concluded on the long term 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, outline clearly the methodology used, and approach taken, for this testing and provide reasoning as to why they deem the testing approach and particular scenarios used 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. Companies should evidence their consideration of any concerns arising from the results of the stress tests. They should provide detail, with supporting evidence, of either the mitigation actions proposed, or the justification why mitigation action is not deemed necessary.

Companies should also evidence that they have carried through the outcomes of the scenario testing and mitigation considerations into the Board's overall assessment of the company's viability over the assessment period.

Assurance

We expect companies to provide appropriate assurance over the long term viability assessment completed.

Companies should clearly detail the 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.

Financial years included within the long term viability assessment period which are also included in any ongoing price review should be consistent with the business plans submitted by each company in respect of that price review. Where an inconsistency arises, there should be an explanation for this.

Actions highlighted in the PR19 Initial Assessment of Plans

Following the PR19 Initial Assessment of Plans (IAP), we set out actions for companies. Where a company has received an action which has relevance to the long term viability statement, we expect them to also consider this point when completing their long term viability statement for 2018-19.

Examples of IAP actions which, if received, we would expect companies to consider when completing their long term viability statement include, but are not limited to.

- The need to consider the risks, and mitigation actions, they have identified in the context of debt refinancing requirements.
- The need to take account of any mechanism for sharing financial outperformance for companies with actual gearing levels of 70% and above.
- The need to take into account the potential outcomes of all regulatory investigations.

Where companies have been challenged within their IAP actions to look forward further than 2025, we expect companies to do so in their long term viability statements.

PR19 prescribed scenarios or ratios

As part of the PR19 documents 'Putting the sector back in balance – summary of Ofwat's decision on issues for PR19 business plans' document and 'Delivering Water 2020: Our final methodology for the 2019 price review' document we prescribed certain scenarios and financial ratios to be used by companies.

When completing their long term viability statement assessment, we expect companies to use appropriate and relevant scenarios and ratios for the assessment of their business. These do not need to include the PR19 prescribed scenarios or ratios. If companies do choose to use the PR19 prescribed scenarios or ratios, they must explain why the scenarios or ratios are specifically relevant for the assessment of their business.

The FRC

The requirements we have set out in relation to long term viability statements are broadly consistent with the UK Corporate Governance Code, which was revised in July 2018. Companies should take account of the requirements of the previous or updated code, as applicable depending on accounting period, when preparing their statements.

The FRC are currently including work on the effectiveness of longer-term viability reports in their review of the FRC's guide to risk management, internal controls and related reporting, and we will review any updates in relation to this as they become available.

Next steps for Ofwat in relation to long term viability statements

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

We will review the statements that are made in the annual performance reports for 2018-19 and future years and will consider the quality of those statements in line with the guidance set out in this information notice.

If, having reviewed the statements made by companies, we have concerns about the quality or adequacy of the procedures companies have undertaken, 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.
- Mandating the use of third party assurance and directing the areas where additional assurance is required.

Enquiries

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

More information

IN 18/04 - Expectations for companies in issuing long term viability statements (March 2018)

IN 16/03 - Expectations for companies demonstrating long term financial resilience (March 2016)

The UK Corporate Governance Code (July 2018)

RAG 3.11 – Guideline for the format and disclosures for the annual performance report, section 3.13 (March 2019)

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Printed on 75% minimum de-inked post-consumer waste paper
[April 2019]