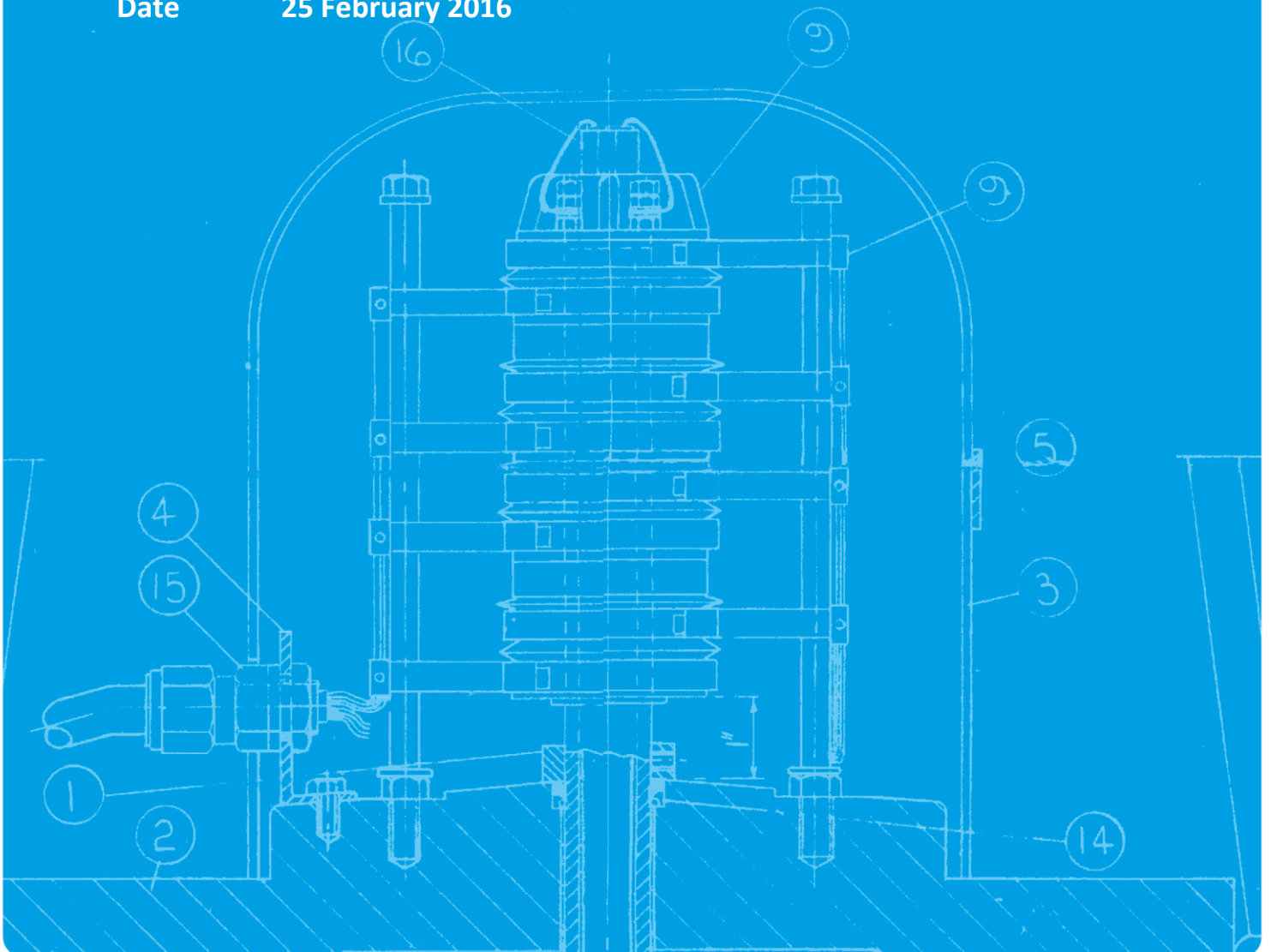


Consultation on how companies should demonstrate long-term financial resilience

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We welcome the opportunity to share our views on how companies should demonstrate long-term financial resilience. We are pleased to note the revisions that Ofwat has made to its initial proposals following its previous consultation on this matter. We continue to believe that the requirements on companies to demonstrate long-term financial resilience should take into account, and take advantage of the UK Corporate Governance Code requirements in respect of long term viability that already exist for listed companies in the sector, and not seek to duplicate or extend them.

We have concerns about disclosure of mitigating actions that management would need to take in severe circumstances as we believe that management will normally have a number of options available and so there would not be a single action, or set of actions that it would need to take. Selection of the most appropriate action would be a matter of management judgment based on the prevailing circumstances.

In our view there is an opportunity for Ofwat to provide more detail by setting out its specific expectations in relation to the assurance requirements for these statements. We think detailed proposals for the assurance requirements in this area should be published at the earliest opportunity to allow all companies to best prepare and should follow the requirements for auditors of listed companies reporting under the Corporate Governance Code.

We have provided a more detailed response to the consultation questions in the following Annex.

Annex – detailed response to questions

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?

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

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

We agree with the proposal that the requirements for regulated companies to demonstrate their financial resilience should be aligned with the requirements of the UK Corporate Governance Code and its related Guidance.

However, we do not agree that companies should be required to outline actions that management would need to take in the event that the situations used for stress testing were to result in an unacceptable level of deterioration in the company’s financial metrics. Stress tests evaluate the impacts of a number of hypothetical outcomes to specific risk factors. Companies might have a number of options available to them in response to the crystallisation of such risks and the most appropriate response would be dependent on the circumstances at that time. For example actions available to management might include reduction/suspension of dividend payments, renegotiation of credit lines, re-phasing of capital expenditure plans etc. The most appropriate action would be determined by management based on the prevailing circumstances, however, where there are suitable alternatives available, management may not need to take such action. It would be misleading to list all of the available options.

In our view it is sufficient for companies to make an explicit statement that they have assessed their viability over a specified period; to confirm that they have considered the impact of the principle risks to the company’s viability, in severe but plausible scenarios, and to describe those risks; and to state any qualifications or assumptions that have been made. This should provide stakeholders with sufficient information to determine whether a robust assessment of viability has been performed.

The proposal states that Ofwat expects the assessments of financial resilience to be “appropriately assured”. However, the nature of what would be considered to be appropriate assurance is not discussed. Appendix 1 indicates that third party assurance is expected but there is no indication of the form that such assurance might take. In our view it is important that the assurance arrangements for such statements are discussed and agreed at the earliest possible opportunity in order to provide clarity for all concerned and should follow the requirements for auditors of listed companies reporting under the Corporate Governance Code.

We do not consider that there is anything else that Ofwat should be recommending that companies explicitly include in their statement on long-term financial viability.

We believe that alignment with the Corporate Governance Code is the most appropriate approach for Ofwat to take in requiring companies to demonstrate their long term viability and we do not consider that there are alternative approaches that Ofwat should be considering.

However, we note that in the consultation Ofwat uses the terms “financial viability” and “financial resilience” interchangeably. These terms could be interpreted differently and we would recommend that a single term should be used in this area. Our preference would be for “financial viability” as this would align with the Corporate Governance Code.