SOUTH WEST WATER

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Dear Sir / Madam

We are pleased to have this opportunity to respond to Ofwat's formal consultation on regulatory reporting.

This consultation reflects the recommendations of the recent CEPA review into consistency in regulatory reporting, and proposes some amendments to RAGs to help improve comparability between companies.

We agree that this is important, particularly in light of proposed changes at the next price review, however we acknowledge that there will likely be further changes as PR19 methodology is finalised.

We note that a number of the suggested changes require a more prescriptive approach to the RAG guidance to ensure consistency and comparability. We agree with that there is an inevitable trade off between innovations in cost allocations developed when companies develop their own methods, and a more prescriptive approach. We agree that there is a need for refinement in some areas to ensure consistency and where necessary we have suggested that these approaches are worked through as part of industry workshops, to ensure that different companies' situations are covered.

With regard to the specific questions being asked in the consultation, we have provided our responses in Appendix A.

Yours sincerely

Iain Vosper
Regulatory Director

Q1 - What are your views on the content and format of the proposed tables in Appendix 1?

We have reviewed the proposed changes and do not have any specific comments on the new content and format of the proposed tables.

Q2 - Do you have any views on the revised guidance in RAG1 which is intended to assist completion of pro forma table 4G?

We do not have any comments on the revised RAG 1.07 Principles and guidelines for regulatory reporting under the 'new UK GAAP' regime.

We note that SWW prepares its Financial Statements and Regulatory reporting in IFRS rather than UKGAAP. SWW already reports details of transactions with associates in its Annual Report and Financial Statements.

Q3 - RAG2 consists of a mixture of high level principles and detailed guidance for cost reporting;

- **Q3a Is the balance of principles and rules appropriate?**
- **Q3b Are there areas where more principles should be provided?**
- **Q3c Are there areas where more guidance should be provided?**

We consider that the CEPA review is the most relevant assessment of whether changes are needed in the guidance in order to ensure consistency across the industry.

We understand that the CEPA review identified inconsistencies in the way that companies were approaching some of the existing reporting requirements. Over recent years reporting has become more innovative with companies developing the most appropriate allocation for their specific business or circumstance. We agree with Ofwat's view that there is a trade off between innovative reporting, and comparability brought by more prescriptive RAG guidance.

On balance we are supportive of the requirement for the RAG guidance to be more prescriptive in some areas to ensure comparability, particularly ahead of future price limit changes.

We have included specific comments on the areas of proposed change below:

- *Water resource boundary definitions* – we understand that there were a variety of interpretations of the existing guidance on water resource boundaries and welcome the proposed amendments to ensure consistency prior to PR19
- *Water cost drivers* – we understand that there was some inconsistency in the approach to cost allocation between companies and agree that amendments are required to help ensure comparability
- *Energy generation from sludge* – we have given a detailed response on some of the potential issues with this change under question 5
- *Tankered Waste* – We agree with the clarification here to ensure consistency in the reporting of tankered waste activities
- *Wastewater cost allocations* – we agree with the amendments which are designed to improve consistency of approach across the companies. However we note that the ongoing sludge workshops and preparation for PR19 are likely to result in further changes here.

Q4 RAG2 suggests that a common method for calculating returned sludge liquors should be implemented. Do you have any observations on the approach suggested and any suggestions for a common formula?

The challenge with prescribing a specific formula for applying a cost to the value of treating return liquors is that different companies will measure different things in different levels of granularity. Whilst we agree that consistency is important, a prescribed approach to the calculation should not result in some companies having to make additional investment in measuring equipment (for example at the recent RAWG workshop there was a discussion around sub-metering different parts of the sewerage and sludge process).

We consider that industry workshops would be an appropriate method for defining the calculation as there are a number of different scenarios in different companies. We would welcome involvement in these workshops and we suggest that this could be incorporated in to the existing sludge working group.

Q5 - In RAG2 we have set out how energy costs and savings from sludge processes should be treated – do you have any views on this approach?

The guidance states (under "Allocation of operating costs for Sludge energy generation") *"Where sludge assets are used for energy generation then all of the cost savings and all of the negative opex from external sales should be recorded as part of sludge treatment. Cost savings or income should not be shared with the sewage treatment operations".*

This change increases the granularity of reporting in the RAGs by allocating a benefit associated with avoided cost to the sludge business unit, however there are a number of factors which we consider should be included within the guidance:

- In self supply situations this adjustment requires a charge from the sludge business to the sewerage business. Where energy generated is used by both sludge and sewerage processes, but companies do not have sub metering in place, companies will need to determine how much (in terms of consumption) to charge
- Where the energy generated is part of a self supply arrangement (i.e. not exported to grid), the benefit / avoided cost will need to be valued. Energy prices are complex and subject to frequent change so the valuation method needs to carefully considered in order that the calculation itself is not unnecessarily complex
- There are different elements of the energy tariff that could be considered when valuing this benefit. Energy costs comprise the following elements (in terms of energy tariffs), combination of which could be used to derive a unit price:
    - Wholesale price
    - Environmental taxation / levies
    - Distribution charges
    - Transmission charges
    - System charges.

We also note that in making this change there is no provision for allocating costs between sludge and sewerage to reflect the transfer of sewerage between the business units as a raw material.

Q6 - In RAG2 we have set out how imported potable bulk supplies should be treated – do you have any views on this approach?

We do not currently have any imported potable bulk supplies therefore have no comments on this change.

Q7 - In RAG3 we have clarified our expectations for reporting transactions with associates and the non-appointed business. Do you have any comments on these?

SWW already complies with RAG5 principles with group companies and non appointed activities and transactions with group companies are disclosed in detail within the annual performance report.

Q8 – Our intention is to include the metrics for the Financial Monitoring Framework and site data for the Abstraction Incentive Mechanism (AIM) in the Annual Performance Report. Do you agree with this approach?

We included comments on the proposed metrics in our response to the consultation on the proposed Financial Monitoring Framework. We do not believe that the financial monitoring framework metrics should be used for comparative purposes as the financial structures, and thus financial performance and resilience of companies, differs across the industry. In addition we do not support the monitoring of other financial measures, outside of those for regulatory or price setting purposes, which may contradict statutory reporting and which again are not comparable across companies.

The UK Corporate Governance Code is increasing reporting relating to sensitivities but does not prescribe the sensitivities as these will inevitably differ from company to company. We would therefore not support a proposal to introduce reporting against a standard set of metrics.

We support the principle of using AIM to provide targeted environmental benefits however SWW currently does not have any sites where the AIM would apply.

Q9 – Should the Annual Performance Report contain more transparency over metering assets and installation and maintenance costs from 2017?
We do not support the inclusion of additional information on metering assets and maintenance costs in the Annual Performance Report post market opening for Non Household Customers. The market mechanisms and codes are in place to facilitate the operation of the market and we do not believe there is a need for additional regulatory reporting as a result of market opening.

Q10 – Ofwat is working with the sector to develop new charging rules covering activities such as connection charges, infrastructure charges and other contributions from third parties. Should the Annual Performance Report contain more detailed cost information on new connections and other costs associated with these charges?

Details of standard charges are included within companies' charges schemes and non standard charges are quoted on a case by case basis. We do not therefore consider that inclusion of further information in the Annual Performance Report is necessary.