Regulatory Reporting Consultation Response

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Dear Ofwat

Consultation on regulatory reporting

Thank you for the opportunity to respond to your consultation on regulatory reporting for the 2016/17 reporting year.

We highlight below our comments on the more significant points in the consultation and we include our detailed responses to the consultation questions in the attached appendix.

In respect of question 1, "what are your views on the content and format of the proposed tables in Appendix 1?" and question 3, "RAG2 consists of a mixture of high level principles and detailed guidance for cost reporting – discussion of principles and rules", we have the following comments:

- It would be helpful to have more clearly defined boundaries around the Upstream Services, and specifically those which will become stand-alone price controls from the next price review period. Some progress was made in this area as a result of the targeted CEPA review conducted in early 2016. We would like to see the findings and recommendations of this exercise more clearly defined within the RAGs.

- We would appreciate further guidance over the definition of 'bulk supply' and 'third party services'. Specifically, what should be included in each category and where the costs should be recognised both in 2C and by Upstream Service in the more detailed Section 4 tables. This clarification would be aided by some practical examples and diagrams that show the nature and type of bulk supply and third party services costs and how they should be allocated.

- For Table 2E, grants and contributions we note that RAG4 requires a specific value for grants and contributions be used in determining totex and that this number excludes contributions relating to 'diversions' and 'other'. We feel that, where cash has been received by the business it should be reflected in the totex number. This would result in the inclusion for totex reporting of all grants and contributions including those relating to 'diversions' and 'other' (though excluding fair value of adopted assets for which no cash is received).

- We would value further clarification over the purpose and anticipated benefit of the principal use accounting methodology. The current requirement to capitalise 100% of shared assets to the price control of principal use with a corresponding recharge being apportioned to the other price controls based on their respective use is not in line with how we currently manage our business.

We are conscious of our commitment to producing an Annual Performance Report ("APR") that best meets the needs of our customers and want to ensure we focus on maintaining the right balance for customers. This is particularly relevant where additional and more detailed disclosures are being considered.

Please do not hesitate to contact either myself or my team if you have any questions or comments on our response. We look forward to working closely with Ofwat in supporting the further development of our Annual Performance Report.

Yours sincerely

Nick Fincham,

Nick Fincham
Director of Strategy & Regulation

Appendix 1 – Detailed responses

Questions relating to 2016/17 reporting:

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

Our view on the content and format of the proposed tables in Appendix 1 are reflected in the comments below:

1) Content

With respect to the content of the proposed tables in Appendix 1 of the consultation paper, overall we are happy that the nature and extent of content being reported is reasonable, useful and that it is right to continue to produce the information specified. We have only a few minor suggestions with respect to content:

- Table 1E: Additional disclosure around company's adjusted gearing will enhance comparability across the industry and also improve usefulness to the end stakeholder;
- Table 2A: We would value further clarification over the purpose and anticipated benefit of the principal use accounting methodology. The current requirement to capitalise 100% of shared assets to the price control of principal use with a corresponding recharge being apportioned to the other price controls based on their respective use is not in line with how we currently manage our business.
    - Principal use requires a focus on 'earnings before interest and tax' (EBIT) in order to be of greatest benefit to the reader, where we are currently more focused on totex. We feel that the principal use methodology is not currently in line with how we manage our business, which from a capital nature is managed discreetly with the acquisition cost and subsequent depreciation of 'shared' assets being allocated directly to each price control who also hold in their budgets a share of these capex costs.
    - It would feel more logical for us, therefore, to apportion shared assets at source in line with our management accounting. The end result is the same as that which would be achieved under the principal use guidance from an EBIT perspective;
    - the disclosure of recharges to and from the price control segments in Table 2A. We believe that assets are best and most accurately reflected if apportioned to the price controls upon inception/acquisition, which is in line with how our business is currently being managed; and
- Table 4E: we believe we have a reasonable and practical methodology for calculating surface water and highway drainage though wish to note this did not form part of the historical June Return process and is potentially an area of inconsistency within the industry.

2) Format:

With respect to format, we have the following recommendations and areas requiring additional guidance/clarification:

- Section 1 (All): Where possible we would like to see regulatory categories disclosed in the Section 1 tables more closely aligned with IFRS categories. Such closer alignment would save time and reduce the level of complexity and manual intervention involved in populating the regulatory tables. This is particularly relevant to the Statement of Financial Position and Cash Flow;
- For Table 2E, grants and contributions, we note that RAG4 requires a specific value for grants and contributions be used in determining totex and that this number excludes contributions relating to 'diversions' and 'other'. We feel that, where cash has been received by the business it should be reflected in the totex number. This would result in the inclusion for totex reporting of all grants and contributions including those relating to 'diversions' and 'other' (though excluding fair value of adopted assets for which no cash is received); and
- 2C Bulk supply and Third Party Services'. We would appreciate further guidance over the definition of 'bulk supply' and 'third party services'. Specifically, what should be included and where these costs should be recognised both in 2C and in the more detailed Section 4 tables (4D and 4E)? This clarification would be aided by some worked examples and diagrams that show the nature and type of bulk supply and third party services costs and how they should be allocated.

3) In addition to the clarification requested in our comments concerning content and format above, we would also appreciate further clarification on the following:
   - 2D: additional information concerning the definitions of the elements within the new depreciation disclosure as well as clarification as to the purpose of this additional disclosure; and
   - Water abstracted: we would welcome further information on the definition of water abstracted to clarify whether it's appropriate to exclude raw water imports and exports.

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

We agree with the revised guidance in RAG1, Section 2, and recognise that current cost accounts (CCA) is an ongoing topic of discussion. It is currently being considered as part of the Sludge working group. As such, we anticipate further refinement of the guidance in this area throughout the remainder of this AMP6.

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?

We feel the balance between principles and rules is appropriate.

Q3b Are there areas where more principles should be provided?

We do not feel there are any areas for which more principles are required.

Q3c Are there areas where more guidance should be provided?

We would appreciate further guidance around the following areas:

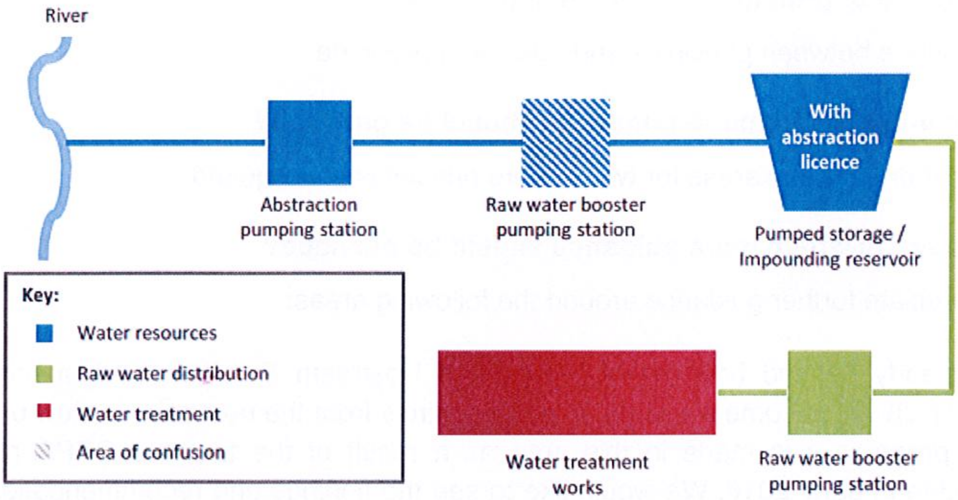
- More clearly defined boundaries around the Upstream Services, and specifically those which will become stand-alone price controls from the next price review period. Some progress was made in this area as a result of the targeted CEPA review conducted in early 2016. We would like to see the findings and recommendations of this exercise more clearly defined within the RAGs.
- Diagrams and decision trees in the appendices of the guidance showing the upstream services boundaries and how to decide on where the costs should be included, would help to ensure the separation is consistent between companies.
- Further guidance is required for allocation of central/ overhead costs to ensure consistent approach taken across the industry.

We have interpreted the current guidance such that none of the reservoirs in Thames Water's region are considered to be storage reservoirs. This is due to the fact that all reservoirs are associated with an abstraction site which holds an abstraction licence.

It should be noted that abstraction licences are issued for the point at which water is abstracted and do not include reference to the reservoir they feed, therefore it is possible for the abstraction point name to be a different name to the reservoir. As an example, our most downstream abstraction point from the River Lee in North London is a site called Chingford Supply Channel which is also the name stated on the abstraction licence. This abstraction site feeds Low Maynard reservoir.

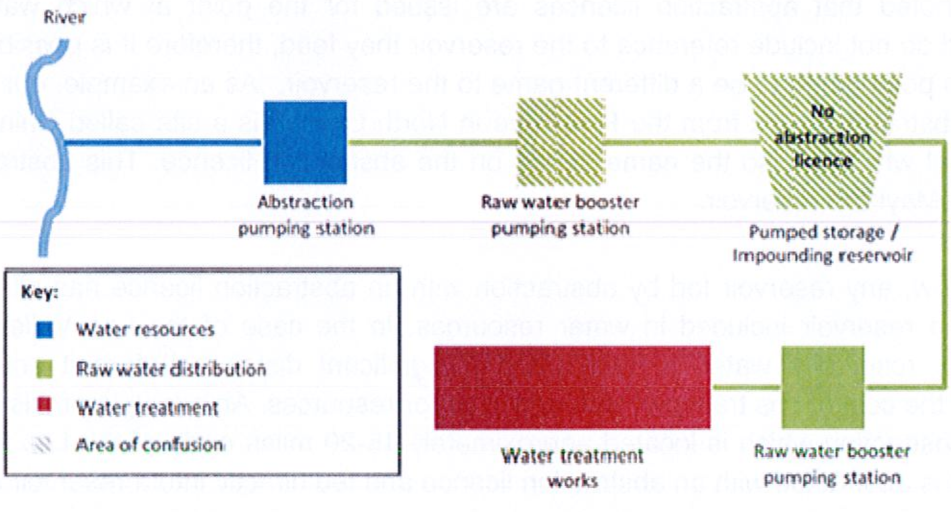
In figure 1 below, any reservoir fed by abstraction with an abstraction licence has all water transport to the reservoir included in water resources. In the case of the Lee Valley and Thames Valley reservoirs water is transported a significant distance before it enters a reservoir, with the cost of this transport included in water resources. An example of this is the New Gauge abstraction which is located approximately 15-20 miles north of the Lee Valley reservoirs, but is abstracted with an abstraction licence and fed directly into a reservoir in the Lee Valley.

Figure 1: Water resources boundaries as per RAG 4.05 and current boundary issues (reservoir with an abstraction licence)



We would also like clarification relating to scenarios with a reservoir that is not associated with an abstraction licence shown in figure 2 below, as we understand that all abstraction over 20m^3 per day requires an abstraction licence.

Figure 2: Water resources boundaries as per RAG 4.05 and current boundary issues (reservoir without an abstraction licence)



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 method for calculating returned sludge liquors suggested in RAG2 appears reasonable.

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?

We agree with the approach.

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

We agree with the approach in RAG 2; 2.14 which states that 'Companies should either use the costs of the exporting company as a guide to a split of the costs where possible and this should be described in the accounting separation methodology statement.'

The wording suggests that there is an alternative approach to allocating operating costs for imported potable bulk supplies but no alternative is provided. Please confirm if there is another approach that should be considered.

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?

With respect to RAG 3.09, clause 6.2.3 states "transactions in the last four categories may be aggregated with any other similar transaction in the same category with the same associated company", whilst clause 6.2.1 states that "transactions should not be aggregated". We would welcome clarity, therefore, as to the extent to which aggregation is permitted.

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 have accepted (with some initial reservations) the need to report metrics related the financial monitoring framework within the APR, and the need to report AIM data, as this question was covered more broadly as part of the AIM consultation in early 2016. Given this, we agree that the most appropriate place to disclose this information is within the APR.

Questions relating to future reporting:

Q9 Should the Annual Performance Report contain more transparency over metering assets and installation and maintenance costs from 2017?

Where the inclusion of additional information relating to metering asset installation and maintenance costs is beneficial for our customers and stakeholders we support the move toward greater transparency. As with any other information against which a reader of the APR may form a comparison to other companies in the water and sewerage sector, it is important that any relevant context and distinguishing factors are also presented (e.g. streetwork costs which are materially higher in London compared with elsewhere, which impact on our installation and maintenance costs).

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?

We are conscious of our commitment to producing an Annual Performance Report that best meets the needs of our customers and want to ensure we focus on maintaining the right balance where we consider additional and more detailed disclosures.

We are happy, in principle, to support the inclusion of additional cost information within the Annual Performance Report. We note, however, that where additional cost information relates to new connections/developer services, this may require collaboration between Wholesale and Retail which could be at odds with the functional separation the industry aspires to for the purposes of facilitating the competitive retail market.