United Utilities response to the Ofwat consultation:
Regulatory reporting for the 2016-17 reporting year

Introduction

United Utilities welcomes the opportunity to comment on the Ofwat consultation: Regulatory reporting for the 2016-17 reporting year.

We consider that the consultation raises the following key issues, which are set out in more detail in our response:

- In our response to Question 1 we have identified issues which have arisen when completing the tables for 2015-16 reporting.
- Question 3 asks about the balance of principles and guidance in respect of cost allocation. We would support further guidance in respect of costs which are allocated across a number of upstream services, particularly those which are allocated to water resources and sludge. Recognising that these will become separate price controls in 2020 it is most important that the allocation of costs to these services is performed consistently across the industry. RAG 2 currently only offers limited detailed guidance in respect of upstream reporting. We support further targeted reviews and the consolidation of Ofwat responses to company queries into the RAGs to facilitate the further development of guidance on cost allocation. Our recommendation is for annual updates to the guidance in the RAGs as a result of the consolidation of queries and findings from reviews, to improve the consistency of reporting across companies.
- Question 4 is concerned with the formula for calculating the cost of returned sludge liquors. We do not agree that the RAGs should impose a basis of charging for liquor returns. Companies already have standard wholesale charges for trade effluent supplies, which would (in practice) be equivalent to liquor returns. Therefore we consider that the RAGs should simply require that companies utilise their existing wholesale trade effluent charges as the basis for liquor returns, to ensure that there is no undue preference or discrimination between trade effluent charges and recharges for sludge liquors.

Questions relating to 2016-17 reporting

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

We have separated our views on the content and format of the proposed tables in Appendix 1 into two sections; those we consider to be of the most importance and other issues. Our comments include concerns identified during the 2015/16 reporting process.

<u>KEY ISSUES</u>

Table 4H Financial Metrics
Net Debt

In the description for Line 1 “Net Debt” we assume the swapped GBP amount for the principal amount of foreign currency debt (which therefore include foreign exchange movement) can be used. It would help if this was clarified in the guidance to ensure consistency between companies.

RORE

Line 5 RORE. The current definition of RORE in the APR appears to allow for a wide range of alternative interpretations. There are two primary differences in interpretation. The first being in respect of assessing real interest cost performance. The current methodology allows for either outturn RPI or the FD RPI value to be used when rebasing interest costs for assessing financing outperformance. To generate a better representation of company performance we recommend that outturn RPI is used; this will also ensure a consistent approach is taken across all companies. Secondly, the current definition allows a company to choose whether to smooth totex performance for annual profiling impacts. We recommend that totex is smoothed for annual profiling impacts to ensure that underlying company performance is revealed.

Credit rating

In respect of line 9 "Credit rating" we believe that the requirement should be to list all solicited long-term ratings for the appointed business along with the outlook / watch status. We would recommend that only solicited ratings are reported as only solicited rating agencies receive additional non-public information on which to make their assessments and so are likely to be more accurate than unsolicited ratings. We recommend that (as per existing guidance) the ratings reported are those for the appointed business as opposed to ratings applied to debt issuance as debt structuring impacts the rating applied to debt (either up or down) making cross sector comparisons difficult, in particular subordinated debt ratings should not be reported.

FFO

We consider it would be more appropriate for line 12 "FFO" to be calculated in accordance with credit rating agencies' methodology, where an underlying finance expense and current tax are deducted. The calculation in the 2015/16 tables does not deduct either interest or tax, and as a result this causes problems in the calculation of other ratios in the table.

Interest cover

In line 13 "Interest cover" interest is added back to FFO, whereas in calculating FFO in line 12 interest was not deducted. In order for this ratio to be more useful, interest should have been deducted in the definition of FFO.

Adjusted interest cover

The issue with line 13 is also relevant for line 14 "adjusted interest cover (cash)".

FFO / Debt

We expect line 15 "FFO / Debt" is likely to be interpreted by users as mirroring the rating agencies' calculations. Whilst we recognise that Ofwat has stated that its approach will differ to the credit rating agencies, we still consider it would be more appropriate that this ratio is calculated based on Standard & Poor's methodology to ensure consistency in the calculation of this metric.

Free cash flow (RCF)

Line 17 "Free cash flow (RCF)" should be calculated based on FFO defined to be after interest and tax. In addition we would advocate Moody's methodology, in particular by adding back IRE to FFO. IRE was previously reported as part of capital expenditure, but for 2015-16 reporting onwards it is now reported within operating costs; adding IRE back to FFO would improve comparability with previous years.

OTHER ISSUES

Table 2A Segmental income statement

Surface water drainage rebates

Table 2A requires the value of surface water drainage rebates paid or credited to customers' accounts in the year to be separately identified. The current guidance in RAG 4.06 leaves ambiguity about which rebates are to be included or excluded. We propose that this definition is expanded to "total value of surface water drainage rebates paid or credited to customers' accounts in the year where the customer has challenged the proportion of their site that is connected for surface water". Therefore any uncertainty surrounding rebates that may be due to properties made void for example would be excluded. The definition needs be made clearer to ensure all companies report on a consistent basis.

Water sludges

The water price control is recharged by the wastewater price control for treating water sludges, which is calculated based on market rate. The presumption is that the full value of the two sides of the transaction, i.e. the costs to the water price control and the recharge from the wastewater price control, would represent opex and negative opex in tables 2A and 2B. To ensure consistency across the industry we would support clarification of this through a clear statement in RAG2.06.

Table 2B Totex analysis - wholesale

Infrastructure renewals expenditure (IRE) is included in line 5 "other operating expenditure" in table 2B. IRE is a significant expenditure item; with the infrastructure renewals charge (IRC) being separately disclosed in previous reporting periods. We recommend that the IRE should be reported on a separate line in table 2B.

Table 2D Historical cost analysis of fixed assets

We think it would be helpful for users of table 2D if two additional rows were inserted into this table to provide additional information. The first addition would be to section A to disclose the value of transfers between price control units, so as to separate these from actual additions and disposals. Transfers between price control units would primarily arise where assets under construction are allocated across price control units on commissioning, or where Management and General assets are reassigned to a different price control unit as the principal use price control unit changes over time. For example, an IT system used by all price controls may be reported in table 2D in the wastewater price control as it has the largest number of licences (e.g. 41%), however the following year the principal use of this system may change to the water price control as the percentage of licences moves from 40% water to 41% water, and wastewater reduces from 41% to 40%. The second addition would be in section B for impairment losses, so as to separately distinguish these from the depreciation charge in the year.

Tables 2G and 2H Non-household water & wastewater – revenues by customer type

Tables 2G and 2H require column 4 to be populated with the number of customers to calculate the "average non-household retail revenue per customer". The description leaves ambiguity as to whether the number of customers referred to the number of connections, number of sites, or number of separate customers. For the avoidance of doubt, and to ensure consistency across the industry, we recommend that the description in RAG 4.06 is amended to state "The number of customers reported in column 4 should be consistent with the methodology used in the company's Price Control".

Table 2I Revenue analysis & wholesale control reconciliation

Table 2I currently requires section D "third party revenue – non price control", broken down between bulk supplies, other third party revenue, and other appointed revenue, to be presented in total. We think it would be useful to users of the table if the revenue included in section D of table 2I was split between water and wastewater. Table 2A currently asks for total non-price control revenue to be split between water and wastewater, therefore, the breakdown of these totals should be available.

Table 4A Non-financial information

Table 4A requires the breakdown of the number of households billed in columns 1 and 2, rows 1 to 3. This appears to be the same information as required in table 2F in column 4, rows 1 to 6.

The guidance for 2F states "the number of customers reported in column 4 should be the average number of customers in the year, calculated at least on a monthly basis", however, the guidance for 4A is less prescriptive. If the customer numbers reflected in these tables are expected to be the same, we recommend that the guidance for customer numbers in table 4A is the same as for table 2F. If the customer numbers reflected in the tables are meant to be different, then more prescriptive guidance for 4A is required.

Table 4B Wholesale totex analysis

Line 4 of this table "Other adjustments" requires an adjustment for legacy household depreciation. The line definition currently states "other adjustments to the menu for example transition costs or legacy household depreciation". For the avoidance of doubt, we think it would be useful for the guidance to explain when an adjustment for legacy household depreciation would be required. Our proposal would be to add the following to the line definition "Other adjustments in respect of legacy household depreciation are only required where the wholesale totex includes income from the retail business in respect of legacy household assets".

Tables 4D and 4E Wholesale totex analysis – water / wastewater

We suggest that there is further clarity in the descriptions for line 4D/E.4 bulk supply / bulk discharge "Total payments for bulk imports / exports" and for line 4D/E.8 third party services "Operating expenditure for providing third party services E.g. bulk supplies".

The existing descriptions have the potential to generate uncertainty, and therefore inconsistency, over the expenditure to be included in each of these lines. The use of "exports" in the description for 4D/E.4 could suggest bulk supplies being exported or bulk discharges.

We recommend that the descriptions be amended to remove this uncertainty. The descriptions that were provided in RAG 4.03 pages 7 - 9 contain a greater level of detail and we would support reflecting this in RAG 4.06.

Tables 4D and 4E Wholesale totex analysis – water / wastewater – unit cost information

To allow consistent comparison of performance across the sector, the company believes the unit cost table on Tables 4D and 4E should be based on the sum of operating expenditure, infrastructure renewals charge and depreciation rather than operating expenditure alone. One would expect companies to be implementing solutions that result in different levels of operating expenditure relative to capital expenditure, and the utilisation of operating expenditure alone in comparing unit costs may therefore distort comparisons.

Table 4D Line 27 – Distribution input treated water - The units in the table are m3 and the units in RAG 4.05 are Ml. We presume the correct unit is Ml and recommend the unit in table 4D should be amended to Ml.

Table 4I Financial Derivatives

We recommend that line 1 "Floating to / from fixed rate" is split into two lines, one for "floating to fixed rate" and the second for "floating from fixed rate". Whilst there may be instances where the principal amount may net to zero, the interest rates do not necessarily net down. Separating this into two lines will be more informative for the user.

If line 1 is to remain combined, it would be useful for Ofwat to clarify the signage to be used for pay and receive – we propose that "pay fixed" should be a positive figure and "receive fixed" a negative figure.

The current format of the table does not incorporate interest rate swaps where the rates are locked in but they start at a future date. It would be useful for clarification that forward dated swaps should not be included in table 4I.

Where cross currency swaps convert both the debt principal to sterling and also the interest rate from currency to sterling it would be misleading to split up the swaps into sections B and C. We recommend guidance that where swaps convert both debt principal and interest rate that these should not be separated and reported only in section C.

Table 3A

We agree with the content of table 3A, however reporting the £m absolute value of reward or penalty to 6 decimal places is inconsistent with both table 4C RCV (which states the ODI penalty/reward allowance to 3 decimal places) and also the Ofwat ODI calculator (which shows inputs to incentive calculation and the ODI penalty and reward to 4 decimal places.) We recommend that the reporting in table 3A should be to 3 decimal places.

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 approach that any difference between the infrastructure renewals expenditure and the infrastructure renewals charge should be shown as the capital maintenance charge, along with the current cost depreciation.

We support the simplified approach to assume that all of the appointee debt is attributable to the wholesale business, and the split between water and wastewater to be made on the basis of the split of the RCV between water and wastewater.

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?

Balance of principles and rules

We recognise there are advantages and disadvantages to offering detailed guidance versus high level principles. We believe detailed guidance improves the consistency of reporting across the industry and thus improve the comparability of reporting. In particular we would welcome additional guidance in respect for allocating costs between upstream services in part 4 of the APR.

We recognise the data collection requirements to use cost drivers that may be required in detailed guidance could be onerous, require additional expenditure to collect the necessary data and ultimately may not provide a materially different allocation than an allocation which is based on principles. Alternatively, due to difficulties in collecting data, some companies may use estimates for the cost drivers, reducing the comparability of data. Therefore caution needs to be taken in setting detailed guidance to ensure that the requirements will not potentially result in reducing the comparability of reporting or create potential unnecessary additional expenditure.

We would welcome further guidance in respect of costs which are allocated across a number of upstream services, particularly those which are allocated to water resources and sludge. Recognising that these will become separate price controls in 2020 it is most important that the allocation of costs to these services is performed consistently across the industry. For example, the allocation of costs to sludge services will impact the allowed average revenue per unit of sludge for each company. **It is imperative that the industry is aligned in its allocations to ensure a transparent market and give confidence of a level playing field with no cross subsidy between the monopoly WASC activities and sludge services.**

Companies may submit queries to Ofwat to request further guidance when producing the regulatory accounts and receive direct responses back to them. We think it would be useful if all the queries submitted and the responses from Ofwat were shared across the industry (on an anonymised basis), and the RAGs updated accordingly, so that all companies could benefit from all clarifications. We believe it would also be beneficial for Ofwat to set up a central repository to allow companies to search for all relevant guidance or clarifications currently in place in respect of a specified table or line item. This would improve the consistency of reporting as it would provide additional guidance on allocations which are principle based. As a result, over a period of time the industry would naturally transition to a more rules based approach where necessary, but without the onerous requirements of producing a full rule book in advance.

We recognise the value of the targeted review on water resources and sludge conducted in early 2016 and the improvements that will be made in the consistency of cost information across companies as a result. We would support a series of horizontal audits being performed by or on behalf of Ofwat on an annual basis, following the publication of the APR each year, focussing on the areas where the perceived challenges lie, to assess the consistency of reporting between companies. This would allow Ofwat to issue more prescriptive guidance in areas where it is felt that a principle based approach is insufficient to ensure the comparability of reporting.

We support the additional guidance issued in RAG2, with the exception of paragraph 2.14 Allocation of operating costs for imported potable bulk supplies – see our response to question 6.

Imported tankered waste

Where a recharge is required in respect of imported tankered waste, which is calculated based on market rate, the presumption is that the full value of the two sides of the transaction - (i.e. the costs to the non-appointed business and the recharge from the appointed business, would represent opex and negative opex.) To ensure consistency across the industry we recommend that this is clarified and explicitly stated in RAG2.06.

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?

We do not agree that the RAGs should impose a basis of charging for liquor returns. Companies already have standard wholesale charges for trade effluent supplies, which would (in practice) be equivalent to liquor returns. Therefore we consider that the RAGs should simply require that companies utilise their existing wholesale trade effluent charges as the basis for liquor returns, to ensure that there is no undue preference or discrimination between trade effluent charges and recharges for sludge liquors. This would enable a common methodology, based on companies' trade effluent charges, to be applied across the industry when allocating sewage treatment works costs to the operation of dealing with sludge liquor.

This is not a matter of what the basis of the common formula should be, but more an issue of process – the company's main charges are established consistent with the company's obligations, and approved each year by its board. We do not think it appropriate that the RAGs (in effect) dictate charging structure outside of that process.

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 proposed guidance that where sludge assets are used for energy generation all of the energy cost savings and external income through energy "sales" should be recorded as part of sludge treatment.

However, we consider that the current RAG 2.06 guidance needs to be expanded further to ensure consistency of reporting.

Energy generation (self-supply) results in a hidden revenue/recharge that occurs between sludge (bioresources) treatment and sewage treatment as the sludge (bioresources) assets produce energy in excess of the electricity consumed by the sludge (bioresources) treatment processes at co-located sites. This can only be revealed by creating an appropriate recharge so that sewage treatment clearly pays for the energy being supplied, and the sludge (bioresources) business receives an income (or negative cost).

The recharge should arguably be set on a commercial basis, i.e. based on what sewage treatment would be willing to pay for the energy. Given that this would be difficult to market test, as they are not separate independent legal entities, then it would help if there was some standard approach to ensure pricing consistency for provision of sludge services, e.g. based on the company's average price for externally purchased energy within the year (i.e. excluding all volumes of internally produced energy).

As we do not currently separately meter how much energy generation is supplied to sewage treatment, for 2015/16 reporting we have taken the net import cost at co-located sites and added back the net energy generation (generation less export) to arrive at gross cost for sewage and sludge treatment. The gross cost is then split between sewage and sludge treatment based on a percentage split of consumption (This is calculated from metered data (where available) or engineering assessment). In effect, whether sewage treatment is receiving its electricity from its external supplier or from CHP generation as part of the Sludge Treatment process it is paying the average unit price for each site. The benefit of the energy generated through the bioresources treatment process is therefore fully allocated to sludge treatment.

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

We consider that the idea of splitting the cost of imported potable bulk supplies between water resources and water treatment is reasonable in principle. Paragraph 2.14 in RAG 2.06 states "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" - however, the guidance doesn't offer an alternative basis of cost allocation.

To split the costs between water resources and water treatment we consider that a more reasonable approach would be to use the receiving company's own treatment costs and, after subtracting those, treat the remaining costs as water resources. This is on the basis that it is the resource which is really driving the need for the import of the water.

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?

We do not have any comments on the clarifications made to section 6 of RAG 3.09.

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 support the inclusion of site data for the Abstraction Incentive Mechanism (AIM) in the Annual Performance Report. We suggest that in table 3B the units for normalised AIM scores should be a number rather than in Ml.

Questions relating to future reporting

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

If the APR is to include more transparency over metering assets and installation and maintenance costs from 2017, the guidance in RAGs would need to be specific in relation to classification and categorisation, as further disaggregation of the cost base would add further complexity to the data gathering process, and potentially require us to categorise costs in different ways requiring changes with our contract partners providing this service. We propose that information in relation to specific scenarios is requested to ensure comparability across the industry. For example, for a 50mm meter exchange the costs to be disclosed should refer to a non-AMR enabled meter, mechanical meter operation, made footpath, including on-costs, including capital overheads and assumed to be fitted on a normal business day.

In addition, the disclosure of meter asset capital costs could result in the breaching of agreements with suppliers and allow other Wholesalers (and, for that matter, suppliers) to access commercially sensitive supplier information. Dependent on the information required to be reported, one option would be for this information to be submitted to Ofwat and redacted to prevent breaching of agreements with suppliers.

We consider it is important to recognise that improving the transparency of the costs does not necessarily mean that like for like costs are being compared. For example, companies who install AMR enabled meters will have higher priced meters, or companies with larger metering programmes may have negotiated more favourable rates with suppliers.

The APR may also need to take account of the use of Accredited Entities (AE) and how the financing and cost transparency would relate in these instances. The use of 'meter leasing' from AE's as already seen within other markets, may add future complications to the capturing of such data, particularly given future changes driven by IFRS 16 and how this would apply to such an arrangement would be unclear, given at their lowest form a Wholesaler could take a view of *de minimis* level suggested within IFRS 16 and treat the asset as an Operating Lease.

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 support the work being undertaken by Ofwat in developing charging rules for new connections. There are advantages and disadvantages of reporting this type of information in the annual report.

Including this type of information is consistent with the principle of transparency (as required by the Defra guidance to Ofwat.) However it will be important that there is clear guidance on the definitions of the different types of charges and how the costs incurred by the water companies are recovered in those charges. This will help to ensure that there is a consistent approach across the industry and to assist the developers in making appropriate pricing decisions.

However, it should also be recognised that the charges set in anyone year may be based on an average of costs incurred in more than one year (i.e. they may be a five year average). This is likely to cause some confusion with developers as they try to compare costs incurred in any one year with charges based on average years. This raise the question of the usefulness of publishing this information.