Water today, water tomorrow

# Consultation on changes to the regulatory accounting guidelines (RAGs) – draft impact assessment

www.ofwat.gov.uk

OFWAT

# Contents

# 1. Summary – intervention and options

### What is the problem under consideration? Why is intervention necessary?

As part of its regulatory compliance project, Ofwat is reviewing the information it collects from companies in order to fulfil its duties. In our consultation 'Regulatory compliance – a proportionate and targeted approach', we made a commitment to review our requirements for the regulatory accounts – the 'regulatory accounting guidelines' (RAGs).

As part of our review of the RAGs, we are also reviewing options for the collection of accounting separation data. We have collected disaggregated accounting information from companies since 2010 through the annual June return. The regulatory compliance consultation proposed that we would no longer collect the June return data. So, we need to review our method for collecting this information.

The focus of accounting separation so far has been on the allocation of costs between nine business units. But further disaggregation may be necessary to inform and facilitate market reform and future price limits, including applying the future price limits framework in the 2014 price review, on which we have to consult further.

So, we need to review the extent to which we require companies to disaggregate assets and liabilities, and costs and revenues, to support the 2014 price review and beyond. Informing companies of our intentions now will enable them to do two things.

- It gives them sufficient notice to align their regulatory financial reporting with the process for setting ex ante controls before we decide on those controls.
- It also gives them sufficient flexibility to future-proof any systems they need to put into place.

And it will provide an appropriate level of clarity for the industry, investors and other stakeholders, and allow time for debate and challenge before the new requirements are implemented.

### What are the policy objectives and the intended effects? Please state which of Ofwat's strategic objectives is the key driver of the policy option and outline any other that the policy option will deliver or contribute to

The objective of this policy is to make sure that the information Ofwat requires through the regulatory accounts is targeted to discharging its duties effectively, and proportionate to the specific purposes for which the information will be used. This means removing information requirements that are of lower value than the costs of providing the information, but continuing to collect the information where the regulatory value justifies the costs involved. This will enable us to deliver better regulation, including promoting effective competition where appropriate.

## What policy options have been considered? Please justify any preferred option

In reaching our preferred option, we have considered policy options under the following three elements.

- The information we require in the regulatory accounts.
- The extent to which Ofwat requires companies to disaggregate information on operating costs and fixed assets.
- The mechanism through which Ofwat collects accounting separation data.

Our preferred options in each of the these three elements are to:

- revise the existing requirements for the regulatory accounts where appropriate. This is in line with our risk-based approach. We can make sure that regulatory scrutiny and burden are targeted appropriately and proportionately to the risks identified;
- replace the existing activity cost analysis and fixed asset tables with the accounting separation data, and trial the separation of operating costs to a set of upstream services. This is our preferred option because it reduces the burden on companies of producing two sets of tables when one is sufficient and allows the next stage of accounting separation to progress gradually; and
- collect the accounting separation data as part of the regulatory accounts, governed by the RAGs, with upstream services data included as an appendix to the regulatory accounts, initially on a pilot basis for at least 2012-13, with no audit assurance. This is our preferred option because it minimises the costs and burden on companies while allowing them to develop processes for service level accounting separation data.

## The information we require in the regulatory accounts

In our regulatory compliance consultation, we committed to review the content of the regulatory accounts and to consult on proposed changes.

We have now reviewed the information we ask for in the regulatory accounts alongside the accounting separation data previously collected in the June return.

Based on this review, we have developed new proposals for regulatory financial reporting which, if implemented, would reduce the overall volume of data required by about 50%. Our proposals would also reduce significantly reduce the narrative requirements as we are no longer asking companies to include an ‘operating and financial review’ in the regulatory accounts.

The result is that our preferred option would allow companies to reduce the costs of meeting regulatory financial reporting requirements. Because we consider that these revised requirements would focus financial reporting on the information that is of highest value to stakeholders and us in fulfilling our statutory duties, there should be no significant reduction in the benefits derived from the regulatory accounts as a result of our proposals.

## The extent to which Ofwat requires companies to disaggregate information on operating costs and fixed assets

Companies currently allocate their activity costs between nine business units for regulatory financial reporting purposes.

As part of the audited regulatory accounting requirements set out in the RAGs for 2012-13, we propose to continue with a slightly reduced level of disaggregation, by merging the sludge treatment and sludge disposal business units into one called ‘sludge treatment, recycling and disposal’. We also propose to trial, on an unaudited basis, the disaggregation of separated cost information at a services level from 2012-13. This phased approach will enable the evolutionary development of accounting separation at a services level, building on the activity-based separation that has already been implemented, while minimising the additional costs and burden on companies.

Continuing the current activity cost disaggregation, and further disaggregation of accounting information to services, will allow more effective regulation in a number of areas.

1. **To act as a key enabler for other projects, including future charging** – information on the historic costs of different services in the value chain will help to inform access pricing and contribute to more cost reflective charges.
2. **To inform price controls** – in ‘Future price limits – statement of principles’, which we published in May 2012, we confirmed our intention to set separate price controls for the retail and wholesale parts of the business from April 2015. To inform this, Ofwat needs reliable information on the costs incurred within retail and wholesale, both in setting controls in advance, but also to help monitor the effectiveness of the controls which are put in place and inform the longer term evolution of the regulatory framework on a phased basis, as set out in our statement of principles.
3. **To facilitate market reform** – separate accounting information is necessary to implement ex ante remedies (such as default tariffs, which protect contestable customers as the market develops) and wholesale price caps. This information will guide bulk supply and network access prices. It will allow sufficient margin for new entrants in contestable parts of the value chain. It will also be needed to set a retail price control based on average cost to serve to protect non-contestable customers. Separate accounting information will enable existing water companies and potential new entrants make more informed commercial decisions and help Ofwat to resolve disputes that may arise.

## The mechanism through which Ofwat collects accounting separation data

We have collected the accounting separation data in the June return for two years. During this time, Ofwat has developed the guidelines for accounting separation with companies so that they are fit for purpose under the existing price control framework and consistent with our other regulatory reforms. The companies have also had time to develop their reporting systems to make sure that their systems and processes are robust.

We consider that companies' systems should now be sufficiently developed to include the activity costs underpinning existing accounting separation data within the audited regulatory accounts with a correspondingly higher level of assurance from 2012-13.

### When will the policy be reviewed to establish its impact and the extent to which it has achieved the desired effects?

The RAGs proposed for 2012-13 will be reviewed continuously. This is to make sure that we keep the data burden of regulatory financial reporting requirements to a minimum while allowing us to regulate effectively and to adapt requirements over time. We will need to consider future developments in accounting standards and regulatory developments that may impact on information needs, including reviewing the results of the trial of services-based cost reporting in 2012-13.

# 2. Summary – analysis and evidence

### Base case

Under the base case, we are assuming no reforms to regulatory accounting guidelines. This means that the current requirements associated with the RAGs are maintained. Accordingly, we would continue to require companies to publish:

- regulatory accounts, including the operating financial review; and
- accounting separation data and methodology statement on the nine business units on their website.

### Option 1 – reform the regulatory accounting guidelines

Under this option, we would introduce a number of reforms to the regulatory accounting guidelines. These reforms can be summarised as follows.

- Regulatory accounts.
    - Eliminate the requirement for companies to submit the operating financial review.
    - Reduce the frequency and quantity of information that companies are required to publish in some areas – for example, debt.
    - Incorporate the accounting separation requirements (based on activity costing) into the regulatory accounts.
    - Eliminate the requirement to publish existing tables that are replicated by the accounting separation tables.
    - Reduce the number of business units that activity costs are allocated to from nine to eight.
- Trial the separation of expenditure to 15 upstream services.

We consider the costs and benefits below.

### Costs

The primary cost associated with this option is the requirement for companies to trial the collection of expenditure categorised by 15 upstream services.

In 2011, we asked companies for their views on how much introducing accounting separation by services would cost to implement. The companies submitted costs in the range described below.

- **One-off costs** – £23,000 to £400,000. (One company estimated £6.6 million, but this included an upgrade to SAP system, which would probably be required under the base case. So, we have discounted this estimate.)
- **On-going costs** – £5,000 to £105,000 a year.

It should be recognised that these views were based on the assumption that companies would be required to allocate costs to 17 services. This reflects the upstream services defined in Deloitte's report 'Accounting separation: definition of services in the water and sewerage industry' (May 2011). But our proposal is based on the allocation of expenditure to 15 services.

### Benefits

The principal benefits associated with these reforms include:

- reducing the regulatory burden associated with the regulatory accounts; and
- enabling the benefits of the Water White Paper reforms.

Before discussing these benefits, it should be noted that where possible we have tried to quantify the impact of the proposed reforms. To support this analysis, and following a workshop in February, we requested that companies should try to estimate the impact of a number of the proposed reforms. Unfortunately, none of the companies provided evidence that would enable a reasonable assessment of the savings arising from a lower regulatory burden. So, we have only been able to carry out a qualitative analysis.

### Regulatory burden

We are proposing to reduce a number of requirements associated with the regulatory accounts. Eliminating these requirements will reduce the overall volume of data that is required by about 50%. Other changes, such as abolishing the requirement to submit an 'operating and financial review' will generate cost savings in terms of reducing the :

(i) volume of information that is required; and
(ii) man-hours required to prepare the associated commentary.

We also expect to generate some savings by reforming the requirements associated with activity cost accounting separation data. In particular, we propose to reduce the number of business units from nine to eight. We also propose to eliminate from the regulatory accounts those tables that replicate the accounting separation data. Although we are changing the means by which we will publish the accounting separation data, we do not consider that this should have a material impact on costs.

## Regulatory reforms

Finally, we consider that the proposed accounting separation data on services will help enable the benefits of the reforms proposed by the UK Government in its Water White Paper and draft Water Bill. In particular, submitting costs by reference to the 15 wholesale services will help to promote more effective retail and upstream competition. This will increase transparency about the costs that incumbent companies will incur in providing different services.

It will also help to prevent discriminatory behaviour by incumbents, which the UK Government noted in its impact assessment was a major risk to realising the benefits of competition. And it will inform access pricing and the development of more cost-reflective tariffs. Overall, the UK Government estimated that the market reforms would generate net benefits of £2 billion (30 years net present value – NPV). We consider that these reforms will help to deliver these benefits and potentially provide further uplift by enhancing the effectiveness of the market.[1]

In the context of the Water White Paper reforms, the services data will provide us with information to inform our decisions on how we will regulate in the future. In particular, it could allow a more flexible regulatory framework where we can step back from regulating services where price controls are no longer needed.

## Key non-monetary costs and benefits incurred by each of the main affected groups

### Companies

- Better information will allow companies to identify and implement efficiency improvements.
- More certainty of future reporting direction.
- The companies are able to use the additional information to react to challenges to the water and sewerage sectors.
- Incentives to improve information capture and reliability.

### Consumers

- Helps promote more cost-reflective charges.
- Potentially lower charges as a result of increased transparency in different service areas and resulting efficiencies.
- Development of competition and promotion of efficient entry where appropriate for the benefit (direct and indirect) of consumers.

### Regulators

- Opportunity to develop more effective, targeted and proportionate regulation.
- Data requirements for financial regulatory reporting remain consistent with those in other regulatory initiatives including ex ante price controls.
- A further step in the promotion of effective competition.

## Key assumptions, sensitivities and risks

Current data are insufficient to inform the implementation of the new regulatory framework set out in our statement of principles, particularly in the longer term, and to support the reform proposals set out by the UK Government in its draft Water Bill.

Data on the costs of upstream services will facilitate market reform and future price limits.

[1] For example, the UK Government assumed in its retail impact assessment that its proposed reforms would achieve only 25% of the benefits of competition. This is because there is a risk that incumbents would discriminate against entrants in the absence of reforms that reduced the risk of discriminatory behaviour.

## 2. Summary – analysis and evidence (cont'd)

| Policy option: | Description: |
|---|---|
| What is the geographic coverage of the policy/option? | England and Wales |
| When will the policy be implemented? | 2012-13 regulatory accounts – to be published July 2013 |
| How will the policy be delivered? | Once the consultation has closed, we will review responses and publish a response to it with final RAGs. The companies have statutory and licence requirements to provide their data in accordance with our reporting requirements. We have powers to fine companies that misreport. |
| How is the proposal consistent with best regulatory practice? | This proposal is consistent with the better regulation principles.<br>**Transparency** – it has been developed with companies and other stakeholders, through individual company meetings, an industry workshop and an industry working group. The proposed reporting requirements will provide more transparent financial data to inform Ofwat's key regulatory reforms and the commercial decisions of new entrants and incumbents.<br>**Accountable** – it will make the companies accountable to stakeholders for providing more accurate financial data.<br>**Proportionate** – the data and narrative requirements are more clearly focused on key areas and are proportionate to the risk.<br>**Consistent** – our proposals remain consistent with our section 2 duties under the Water Industry Act 1991 (WIA91), in particular the consumer objective, the duty to contribute to the achievement of sustainable development, and with our strategic objectives set out in 'Delivering sustainable water – Ofwat's strategy', which we published in March 2010. |

| | |
|---|---|
| Which stakeholders will feel the impact? Indicate whether the stakeholders will feel a positive or negative impact or both. | Incumbent water companies expect to see an increase in costs as a result of reporting at a services level, offset by reduced requirements and costs in other areas. Ofwat, incumbents, new entrants, and ultimately customers will benefit from increased transparency of financial information, targeted where it is needed to support the future evolution of the wider regulatory framework. |
| How will the proposal further and comply with our primary duties as set out in section 2 of the Water Industry Act 1991 (WIA91)? | The information in the regulatory accounts will allow us to set price controls and take other actions as required that protect customers and enable companies to finance their functions. Disaggregated accounting information will allow us to promote competition where it is beneficial to customers. |
| How does the proposal further our duty to contribute to the achievement of sustainable development? | The revised RAGs including separate accounting data will allow Ofwat to use the best available information to support decision making for future price limits and market reform.<br><br>This information will facilitate market reforms that will increase pressure on companies to make sure consumers get a fair deal and receive a level of service that consistently meets their needs, with the particular emphasis in our statement of principles on longer-term outcomes which meet customers' wants and social needs. |
| Does the proposal contribute to or deliver our strategic objectives? | The revised RAGs, including the requirement for provision of accounting separation, will contribute to:<br>• **improving the effectiveness of market forces in complementing regulatory safeguards in more contestable markets** – the information will facilitate market reform and provide information to new entrants and incumbents for making commercial decisions; and<br>• **delivering better regulation** – the revised RAGs will focus on the provision of information which is of most value to effective regulation. |
| What is the impact on innovation? | Transparent financial information will highlight areas of inefficiency, encouraging companies to innovate to remain competitive and maximise profits, without recourse to undue exploitation of dominant market positions. |

| | |
|---|---|
| Impact on regulatory burdens | Net reduced impact. |
| Data requirement (increase/decrease/net change) | Reduction in data and narrative required in the regulatory accounts even after including the accounting separation data. |
| Cost of additional regulatory burden (£ – specify annual, one-off, etc) | Trial reporting of upstream services – one-off costs for companies to put reporting systems in place, and some on-going costs, as enabling measures to support targeted regulation. |

Ofwat
Centre City Tower
7 Hill Street
Birmingham B5 4UA

Phone: 0121 644 7500
Fax: 0121 644 7699
Website: www.ofwat.gov.uk
Email: mailbox@ofwat.gsi.gov.uk
July 2012



Any enquiries regarding this publication should be sent to us at mailbox@ofwat.gsi.gov.uk.

This document is also available from our website at www.ofwat.gov.uk.