Water today, water tomorrow

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

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Section 1: Summary – intervention and options

This impact assessment updates the draft impact assessment published with our 'Consultation on changes to the regulatory accounting guidelines' in August 2012.

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

As part of its regulatory compliance project, Ofwat reviewed 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 also reviewed options for the collection of accounting separation data. In 2010 and 2011, companies provided disaggregated accounting information through the yearly June return. The regulatory compliance consultation concluded that we would no longer collect the June return data. So, we reviewed our method for collecting the accounting separation information.

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

So, we have reviewed the extent to which we require companies to disaggregate assets and liabilities, and costs and revenues, in their accounting separation reports to support the 2014 price review and beyond. We have now decided on the changes to be put in place for regulatory financial reporting in relation to the 2012-13 financial year. Informing companies of our intentions in this respect now will enable them to do two things.

- It gives them sufficient notice to align their regulatory financial reporting with the process for setting controls, including our review during 2013-14 of companies' business plans for the price review, before we decide on those controls later in 2014.
- It also gives them sufficient flexibility to help 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 of possible new reporting requirements after 2012-13 before any such 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 require 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

We considered policy options in the following three areas.

- Reducing the existing information we require in the regulatory accounts where this is of insufficient value in relation to our regulatory duties and functions.
- The extent to which Ofwat requires companies to disaggregate accounting separation information on operating costs and fixed assets.
- The mechanism through which companies provide accounting separation data.

Following consideration of the responses to our consultation we have decided on the following options in each of the three elements for 2012-13:

- revise the existing requirements for the regulatory accounts where appropriate. This is in line with our risk-based approach. We can ensure that regulatory requirements and scrutiny are targeted appropriately and proportionately to the risks identified with less information in a number of areas, but additional information in some key risk areas;
- replace the existing activity cost analysis and fixed asset tables with a single set of accounting separation data as part of the regulatory financial reporting requirements, and trial the further separation of operating costs into a set of upstream services. This 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. Potential implementation and interpretation issues can then be identified before decisions on including the relevant requirements in the audited reports are made;
- include the accounting separation data as part of the published regulatory accounts, governed by the RAGs, reflecting the results of the earlier trials; and

- require companies to publish upstream services data on their websites, on a trial basis for 2012-13, with no audit assurance. This approach minimises the additional audit costs for companies during the trial of further disaggregation, while providing transparent information to all stakeholders. It will also maintain momentum for the development of processes for service level accounting separation data ahead of decisions on the new proposed regulatory framework.

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 to the RAGs.

We reviewed the information we previously asked for in the regulatory accounts via the RAGs alongside the accounting separation data previously collected in the June return.

The changes we are making will reduce the overall volume of data required by about 50%. We also expect the changes will reduce significantly the supporting narrative requirements, as we are no longer asking companies to include an 'operating and financial review' in the regulatory accounts.

This will enable companies to reduce the costs of meeting regulatory financial reporting requirements. Because we consider that our revised requirements focus financial reporting on the information that is of highest value to stakeholders and us in fulfilling our statutory duties, we do not expect a material 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.

We proposed to reduce the level of disaggregation required by merging the sludge treatment and sludge disposal business units into one. However, respondents to the consultation said that this would result in only a minimal reduction to the regulatory burden.

As set out in our consultation on the 2014 price review, sludge is an area where we are proposing to seek greater transparency of information in a number of areas in the next control period. This is because of the potential benefits associated with the prospects for greater competition identified by the Office of Fair Trading and others.

We will therefore keep these business units separate and retain the nine existing business units for audited accounting separation purposes for 2012-13 regulatory financial reporting.

We will trial, on an unaudited basis, the disaggregation of separated cost information at a services level in 2012-13. This phased approach will enable the continued evolutionary development of accounting separation at a services level, building on the activity-based separation into nine business units that has already been implemented following the earlier trial, while minimising the additional costs and burden on companies.

Continuing the current activity cost disaggregation, and the trial of further disaggregation of cost 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 our decisions in relation to charges 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. We published our proposals for doing so in the next control period in 'Setting price controls for 2015-20 – framework and approach: a consultation'. To inform this, Ofwat needs reliable information on the costs incurred within the retail and wholesale parts of the integrated businesses. This is both in setting controls in advance and 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. Some of the information will need to be complemented by additional specific information (for example, to support our proposals for separate forms of control for household and non-household retail customers) when we finalise the details of the methodology concerned.

3. **To facilitate market reform** – separate accounting information is necessary to implement before the event remedies (such as default tariffs, which protect contestable customers as the market develops) and wholesale controls. This information will potentially help to guide other decisions subject to regulatory oversight (such as the setting of bulk supply and network access prices). It will also be needed to help 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 which may arise.

The mechanism through which Ofwat collects accounting separation data

We collected the accounting separation data via the June return for two years (2010 and 2011). During this time, we developed the guidelines for accounting separation with companies, so that they are now fit for purpose under the existing price control framework and consistent with our other regulatory reforms. Companies have also had time to develop their reporting systems to make sure that their systems and processes are robust for the existing extent of accounting separation. We consider that companies' systems and methodologies should therefore 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.

As the further service level separations will still be in the trial phase, we will not require these to be audited as part of the regulatory accounts in 2012-13, and the level of reliance that can be placed on these data will be correspondingly lower.

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

We will review the RAGs continuously 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. We will also need to consider the impact of the harmonisation of UK accounting standards with international financial reporting standards.

Section 2: Summary – analysis and evidence

Base case

Under the base case, we are assuming no reforms to the existing 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, but on a continued unaudited basis.

Option 1 – reform the regulatory accounting guidelines

We are introducing a number of reforms to the regulatory accounting guidelines. The reforms to the regulatory accounts, which we still require companies to publish on their websites, can be summarised as follows.

- Eliminate the requirement for companies to submit the operating and 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 audited regulatory accounts.
- Eliminate the requirement to publish existing tables that are replicated by the accounting separation tables.

We will also trial the separation of operating costs to 15 upstream services outside of the regulatory accounts for 2012-13, which companies will publish.

We consider the costs and benefits below.

Costs

The primary additional cost associated with this option is the new requirement for companies to trial the further separation of operating costs to 15 upstream services.

In 2011, we asked companies for their views on how much such a disaggregation by services would cost to implement. Some companies also provided estimations of cost with their responses to the consultation. The companies' cost estimations were in the ranges described below. They relate to the long term capital and operating costs of implementing an audited reporting framework, rather than the lower costs of our proposed unaudited trial for 2012-13 in order to understand the full potential impacts of the proposal.

One-off costs

One company estimated £1 million of capex would be necessary to implement a new accounting system, while another estimated £300,000 to implement a new system. We consider that these costs relate to expenditure which would be needed regardless of the move to service level reporting.

Companies estimated costs of £75,000 to £110,000 for system changes and reallocation of costs to the service definitions. One company estimated 60 working days for a one-off audit of sites and mapping of assets to services.

Ongoing yearly costs

Companies estimated additional annual costs of £20,000 to £45,000. These included additional sampling costs, flow meters, surveys and assessments and investments in the IT system. One company estimated additional manpower of 34 days, rather than a monetary cost estimation.

Some companies already maintain data upon which a number of the cost drivers for accounting separation services reporting can be based, so thought that incremental costs should be relatively small.

Additional assurance costs

One company estimated an increase in assurance costs of £75,000 a year in addition to one-off and incremental costs above. However, for 2012-13, no audit is required.

Our view is that if companies incur high one-off costs then we would expect low ongoing costs or vice versa. This is because companies face a trade-off between implementation costs and ongoing costs. For example, a company could incur high implementation costs to set up streamlined automated reporting arrangements and then incur minimal ongoing costs. We therefore do not think that the cost of complying with the reforms would be at the high end for both one-off and ongoing costs.

Based on these cost estimates from companies, we have calculated the whole-life efficient implementation cost of £35,000 to £50,000 a year excluding audit costs and £110,000 to £125,000 per company a year including audit costs. Taking the mid-point of these ranges, we have calculated the present value of the costs to the industry over 30 years to be £40 million[1] including audit costs.

[1] Based on 18 companies over 30 years, including audit costs and using a discount rate of 3.5%.

	Costs £
Per company (including audit)	£117,000
Industry (per year)	£2,106,000
PV 30 years	£40 million

Separating costs by services is an important input for promoting effective retail and upstream markets. As discussed below, the UK Government valued the benefits of these markets in its impact assessments that accompanied the Water White Paper at £190 million for retail[2] and £1.9 billion for upstream[3]. Accordingly the cost associated with implementing services (£40 million PV) is small when compared against the benefits of effective retail and upstream markets (£2 billion + NPV).

Benefits

The principal benefits associated with these reforms include:

- data and narrative requirements that are better targeted and focused on key areas; and
- enabling the benefits of the draft Water Bill to be realised.

Before discussing these benefits, it should be noted that where possible we sought to quantify the benefit of the proposed reforms in reducing regulatory burden. 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.

Targeted data and narrative requirements

We are focusing data and narrative requirements on areas which are most important for us to carry out our functions and of most benefit to other stakeholders. This reduces 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.

[2] http://archive.defra.gov.uk/environment/quality/water/documents/wwp-ia-retail-1346.pdf
[3] http://archive.defra.gov.uk/environment/quality/water/documents/wwp-ia-upstream-1347.pdf

We will also eliminate from the regulatory accounts those tables that replicate the accounting separation data. Although we are changing the means by which companies provide the accounting separation data, we do not consider that this should have a material impact on costs.

Regulatory reforms

As indicated our proposed reforms to regulatory financial reporting will enable us to begin the implementation of the regulatory reforms set out in our future price limits statement of principles. The supporting impact assessment for that decision identified additional benefits of £3.2 billion (net present value over 30 years, over and above any benefits from the Government's future legislative proposals), including a reduction in regulatory burden of £60 million over the 30 year evaluation period. While the package of changes to the 2012-13 regulatory financial reporting requirements is only a first enabling step to realising these longer term benefits, it is a necessary step, given the timing of the next price control review and companies' preparation of consistent information to support it.

In addition, we consider that the proposed accounting separation data on services will also help enable the benefits of the reforms proposed by the UK Government in its Water White Paper and draft Water Bill, and to prepare the reporting framework for timely evolution in future. Overall, the UK Government estimated that the market reforms would generate net benefits of £2 billion (30 years net present value). We consider that these reforms will help to deliver these benefits and potentially provide further uplift by enhancing the effectiveness of the market.

In particular, submitting costs by reference to the 15 wholesale services will help to promote more effective retail and upstream competition, and support the flexible adaptation and targeting of regulation as new industry arrangements evolve. In the context of the draft Water Bill 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, by improving the transparency about the costs that incumbent companies will incur in providing different services. We have set out in our price review consultation proposals for how this increased cost transparency can then be evolved into a better understanding of associated revenues for some of the services during the next control period.

It will also help to safeguard against the risks of discriminatory behaviour by incumbents, which the 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. We will ask companies to publish the trial services data from 2012-13. This is so that stakeholders will have early access to the information and companies maintain momentum in the development of their service level data.

Publication of 2012-13 trial services data

We recognise and have considered carefully the risks and benefits of requiring publication of the trial services data for 2012-13.

Benefits of publication

Existing integrated companies can use published information on other companies' cost splits to understand how better the relevant value chain is being managed by other companies. Companies and their investors can use the information to benchmark themselves and identify opportunities for improved performance.

Information on relative costs of services within the value chain can assist informed entrants in assessing where they can operate profitably, given their own costs. It can also provide less informed entrants with initial indications of broad entry opportunities. The information provides entrants with greater means and evidence on which to challenge any defensive strategies by incumbents.

Publication can act as a powerful reputational incentive on companies to improve data quality where they can, and to justify why judgements on allocation have been made and identify the potential impacts. Publication can hence improve companies' accountability to their investors and other companies.

Disadvantages

One issue with publishing the data in July 2013 will be the expected quality of it at that time, and hence the extent to which market participants can understand and place reliance on it for decisions. The degree of estimation and subjectivity used in preparing the data may not be clear. Therefore, conclusions that can be drawn from it may not be as robust as when the data splits are more mature and subject to audit.

We have already acknowledged concerns over the quality of the existing accounting separation data and have initiated a targeted review of the 2011-12 data and methodologies. New entrants and other users have not been party to the development of this work and the current definitions. Accordingly there is a risk that some market participants will not make appropriate judgements over their materiality, while market development is at a relatively early stage. This gives rise to risks of information asymmetry.

We recognise that the specific costs and benefits of disclosure are important, and need to be balanced. We consider that on balance the benefits of early publication outweigh the costs. We will expect companies to publish full and transparent methodologies alongside their 2012-13 trial data to mitigate the concerns about the quality of the data.

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

	Non-monetary costs and benefits
Companies	• Better information will enable companies to identify and implement efficiency improvements – including by improving the quality of comparative information available. • More certainty of future reporting direction by including existing accounting separation in framework of audited reports in the RAG. • The companies are able to use the additional information to react to emerging challenges to the water and sewerage sectors in different parts of the value chain. • Incentives to improve information capture and reliability, with higher assurance standards for accounting separation data. • Limited costs of implementing new processes to capture service level cost information offset by significant savings in previous reporting requirements.
Market entrants	• Information to provide indications of potential entry opportunities. • Greater means and evidence on which to challenge incumbent water companies' strategies (such as wholesale service pricing).
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 before the event price controls. • A further step in the promotion of effective competition.

Key assumptions, sensitivities and risks

Without change, the RAG is not sufficient to generate the regular historic financial data required to inform the implementation of the new regulatory framework set out in our statement of principles and our price review methodology framework proposals, 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.

Users of the published 2012-13 services information will recognise its limitations while it is being reported on a trial basis outside of the regulatory accounts.

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?	We are publishing a consultation responses document and an information notice that will set out the requirements for regulatory accounts from 2012-13. 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. **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. **Accountable –** it will make the companies accountable to stakeholders for providing more accurate financial data. **Proportionate –** the data and narrative requirements are more clearly focused on key areas and are proportionate to the risk. **Consistent –** our proposals remain consistent with our section 2 duties under the Water Industry Act 1991 (WIA91) – in particular, the consumer objective and 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. This will be 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 enable us to set price controls and take other actions as required which protect customers and enable companies to finance their functions. Disaggregated accounting information will enable 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 enable Ofwat to use the best available information to support decision making for future price limits and market reform. This information will facilitate market reforms which 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 that 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: • **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 • **delivering better regulation** – the revised RAGs will focus on the provision of information that 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: Data requirement (increase/decrease/net change): Cost of additional regulatory burden (£– specify annual, one-off, etc):	Potential net reduced impact. Reduction in data and narrative required in the regulatory accounts even after including the accounting separation data. Trial reporting of upstream services – one-off costs for companies to put reporting systems in place, and some ongoing costs, as enabling measures to support targeted regulation.

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