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Our ref

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Rob Lee,
Finance & Networks,
Ofwat,
Centre City Tower,
7 Hill Street,
Birmingham,
B5 4UA.

30th October 2012.

Dear Rob,

Consultation on changes to the regulatory accounting guidelines

I am writing in response to the consultation on changes to the regulatory guidelines.

Our views on the individual questions that have been posed and additional comments are presented in the attached appendix. However, we wanted to highlight our key comments on the proposals below:

1. We fully support Ofwat in its efforts reduce the regulatory burden and ensure information provision is fit for purpose and targeted. We believe that there is an opportunity to reduce disclosure requirements further. All current cost accounting statements could be removed from annual reports with the relevant elements retained for price setting purposes only.

2. We are surprised Ofwat are proposing to remove the RCV statement in the regulatory accounts. This is one of the most useful pieces of information used by investors and stakeholder in assessing the financial value and viability of a company.

3. Ofwat is proposing that the RAGs will be reviewed for International Financial Reporting Standards (IFRS) after 31st December 2015. We believe this is too late and that it is in everyone's interests to publish alongside PR14 requirements, one set of revised RAGs which take account of modifications required for UK GAAP/IFRS changes. This would enable companies to ensure that new price setting mechanisms and financial modelling for PR14 are consistent with the approach to regulatory accounts under an IFRS based UK GAAP.

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4. We are supportive of a less prescriptive approach to cost allocation. However, a mechanism would need to be in place to allow for inconsistencies arising between companies that would inevitably result from this approach. The tools employed in addressing allocation issues would need to be entirely transparent to companies.

5. The greater the degree of accounting separation, the greater the need to apportion shared costs rather than cost directly. This will inevitably lead to inconsistencies in approach.

6. The split of additional accounting separation services set out under Treated Water Distribution and Sewage Collection are problematic in that they do not align with how we currently report costs or run our business. We would need a significant amount of time and resource to amend our reporting processes to adequately reflect these splits in regulatory accounts.

Please feel free to contact me if you wish to discuss our response in greater detail.

Yours sincerely

Jean Spencer

Jean Spencer
Regulation Director
Enc.
cc Keith Mason (Ofwat), Simon Evans (PWC)

Appendix - Responses to the consultation on changes to regulatory accounting guidelines

Regulatory accounts format and requirements

Q1 Are there areas where we could reduce disclosure requirements further? Have we reduced the requirements too far in other areas? Are there any additional requirements we need?

A: We believe that there is an opportunity to reduce disclosure requirements further. Specifically, we are unclear why the need for a current cost balance sheet has been removed but a current cost cashflow statement is still required. All current cost accounting in annual reports should be removed with the relevant elements retained for price setting purposes only, for example as suggested for debt under question 3, below.

We would like to understand who Ofwat considers are the users of current cost information. We are also unclear why Ofwat states that data requirements have reduced by 50% when new requirements have been added and where, although publication may no longer be necessary, companies will still need to maintain reporting internally (for example a CC balance sheet to generate CC cashflow).

Finally, we are unsure why Ofwat is considering changes to RAGs at this time when both the impact of IFRS in two years and the outcome of the PR14 pricing mechanism consultation will necessitate further changes. We therefore believe that the time would be better spent in understanding the impact of IFRS on companies' accounts and therefore RAGs and in particular the impact of IFRS changes on the next price review. We believe that it is in everyone's interests to publish alongside PR14 requirements, one set of revised RAGs which take account of modifications required for UK GAAP/IFRS changes. This would enable companies to ensure that new price setting mechanisms and financial modelling for PR14 are consistent with the approach to regulatory accounts under an IFRS based UK GAAP. This would also allow sufficient time to make the potentially significant changes that may be required to companies' accounting systems to take account of the revised RAGs.

Although RCV numbers are published on Ofwat's website, they are meaningless in isolation of other financial data. Investors and stakeholders should be able to see this data in the regulatory accounts.

Q2 A statement on the links between directors' pay and standards of performance is required by the Water Act 2003. RAG3 currently specifies including the statement in the regulatory accounts. If we removed the requirement from RAG3, this would enable companies to decide where best to publish this statement to make sure it is easily accessible for their stakeholders. Should we remove the disclosure requirement from RAG3?

A: Yes, we would rather have the discretion about where to publish this information.

Q3 Although RAG3 requires annual provision of debt information, in practice we have only collected detailed information on debt at the base year for price setting. We propose to keep the annual provision requirement in RAG3, but then use the annual update letter[1] to exempt the requirement for years that it is not needed. Is this an acceptable approach?

A: We agree with this approach.

Q4 We suggest that companies may wish to use a common format to publish the regulatory accounts electronically. This would mean that stakeholders could use the data more easily. What is the most appropriate common electronic format for regulatory accounts?

A: Our preference would be for regulatory accounts to be made available in excel format following the demise of Ofwat's financial performance report. Since the demise of Ofwat's financial performance report, we are having to compile excel spreadsheets from PDFs in order to do comparative analysis, as is every other company leading to inefficiencies.

Accounting separation

Q5 We propose to provide companies with the principles and business unit summaries in appendix 4 to use when allocating their costs, rather than publishing prescriptive guidance. Do you agree with this approach? If not, please provide details of an alternative approach you think we should adopt.

A: The answer to this question depends wholly on the way in which price limits will be set in future. In principle we would prefer a less prescriptive approach to cost allocation. However, the regulatory methodology for future modeling, cost comparison and price setting would have to ensure a mechanism was in place to allow for inconsistencies between companies. Page 15 of the consultation document acknowledges the potential for inconsistencies and sets out the tools that may be employed in addressing allocation issues. The use and subsequent outcomes of these, or any other tools, would need to be entirely transparent to companies.

Q6 Do you think there are areas of expenditure that are at high risk of companies classifying inappropriately? If yes, please provide evidence and advise how we could mitigate this risk in a proportionate way.

A: We assume by 'inappropriately' Ofwat means inconsistently? If so, there will be inconsistencies arising from the judgments made in relation to cost allocation, although we believe these are likely to be immaterial. However, any future price setting mechanism may drive perverse incentives to allocate costs incorrectly and in a way which is perceived to be favorable to a determination. In our view, the greater the reliance on accounting separation information for price setting, the more prescriptive the reporting requirements will need to be. As a general point, the greater the degree of separation, the greater the need to apportion shared costs rather than cost directly. This will inevitably lead to inconsistencies in approach.

Q7 We are proposing to merge the sludge treatment and sludge disposal business units into one called sludge treatment, recycling and disposal. Do you agree with this approach?

A: Yes, but this represents a very minor change.

Q8 We are proposing that all fixed assets should be recorded in the business unit of principal use. Do you agree with this approach? For some asset categories such as general and support expenditure (G&S) that have no natural business unit should we allow them to be allocated or should we require the approach described above for fixed assets?

A: We are not clear on the second part of this question because, as stated, some assets have no natural business unit.

Assets should be recorded in the business unit of principal use. However, where the asset is in use across more than one business unit, companies should be left to decide the most appropriate basis of allocation and describe the approach taken in the methodology statement. If we were to try and allocate all G&S assets to the business unit of principal use, this would require us to re-establish the PR09 asset inventory (asset values as at 31/3/08) and re-create the tables for each subsequent year to get to a current revised opening position for 2013.

Q9 We are proposing to trial the allocation of operating costs to services as detailed in appendix 6. As well as the service definitions in appendix 6, what information would companies need in order to report costs by these services? What incremental costs do you expect companies would incur in order to report operating costs by the proposed services to the same level of assurance as the regulatory accounts? What are the implementation options available to companies to report operating costs by these services?

A: Some of the services can already be reported with the same level of assurance as currently provided for regulatory accounts and some could, with further guidance on boundaries and relatively modest changes to internal processes and reporting, be brought up to the same level of integrity . However, the most problematic are the services set out under Treated Water Distribution and Sewage Collection in that they do not align, even at the most basic level, with how we currently report costs or run our business. We would need a significant amount of time to amend our reporting processes to adequately reflect these costs in regulatory accounts and the cost of achieving this would be significant.

Other comments outside the specific questions raised

1. The requirement to publish information on the costs of contestable retail service does not seem compatible with the operation of an effectively functioning competitive market. Whilst we accept that, in transition, different considerations might apply, we would urge Ofwat to consider carefully the publication requirement in the light of emerging competition.

2. Large projects (page 6 of appendices) – we are unclear why these require separate identification and question how this is in keeping with reducing the disclosure burden. It is also unclear what criteria are to be used to define a large project.

3. Revenue recognition rules (p15 of appendices) – we do not agree with the proposal to reinstate the June Return requirement to comment on variances from the price determination. We are also unclear where this would be reported if the OFR requirement has been removed?

4. Why is there a requirement to publish the capitalisation policy note if companies are complying with RAGs (p15 of appendices). Also, if companies are following a principles based approach to accounting separation, we question the need to publish a methodology statement (page 14 of appendices).

5. Bad debt note (p15 of appendices) – we believe that bad debt write offs and write off policies provide little insight into the relative performance of companies' debt collection activities and are not necessarily reflective of either a deteriorating or improving position. We would like to understand further how Ofwat intends to use debt write off information.