Rob Lee
Finance and Networks
Ofwat

Wednesday 31 October 2012

Dear Rob,

Consultation on changes to the regulatory accounting guidelines

Please find below our responses to the questions set out in the consultation.

Questions for consultation

Regulatory accounts format and requirements

Q1 Are there areas where we could reduce disclosure requirements further?

The regulatory accounts are audited financial information. This gives a level of assurance of correctness and accuracy which should reduce the need for detailed disclosures, methodologies and narratives. Ofwat appear to be using them to supply data/information requirements which would be more appropriately directed to Ofwat themselves. Such information would be better put in the Annual Return as a supplementary information pack.

The additional narrative requirements being introduced are very detailed, and not always appropriate for an annual report:

- **Inclusion of the accounting separation methodologies in the regulatory accounts is a strange concept. It would be appropriate to give a high level definition of the Ofwat business units in the current cost accounting policies, and an overview of the principles of cost allocations. The methodologies as required for the June Return are far too detailed for inclusion in the Regulatory Accounts, yet still will not satisfy the level of detail Ofwat expects new entrants into the sector and competitors to be looking for. If Ofwat requires this information, it can be submitted separately, directly to Ofwat.**
- **The revenue recognition note is far too detailed, particularly the variance analysis of actual income against the FD, and the review of the measured income accrual. The income received is subject to audit, and this incorporates the accruals. There are no other comparisons to FD in the regulatory accounts, these can be provided in the Annual Return to Ofwat (KPIs). The disclosures read as random detailed information.**

- **A bad debt note is only necessary to identify material changes in the bad debt charge, which is audited information. The information requested again is very detailed, and superfluous to most stakeholders' requirements.**
- **Debt written off affects the provision and reduces debtors. It does not affect the bad debt charge. This questions the relevance of the information required in pro-forma A8 (Line A8.22 Debt written off).**

Have we reduced the requirements too far in other areas?

Taking out the Operating and Financial Review is a welcome change. Most of this information was copied from the Annual Report & Accounts so was duplication.

Are there any additional requirements we need?

A historic cost cash flow statement would be more appropriate than the current cost one being requested, especially as there is no current cost balance sheet, and the current cost adjustments have no cash effect.

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?

Yes. We would probably continue to publish it in our Regulatory Accounts.

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 to exempt the requirement for years that it is not needed. Is this an acceptable approach?

Currently 3 out of 5 years we are told it is not needed by an annual update letter. In the years it has been requested it has never been published in the Regulatory Accounts, only in the June Return. We suggest the information requirement is taken out of RAG3, and asked for as required, as supplementary information.

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?

BW's regulatory accounts are prepared in word, and then saved in pdf. The published accounts are in pdf.

A common format suggests a return to June Return type data, with tables and commentaries. Companies produce statutory accounts in their own preferred format, and stakeholders are able to use that data. We have no preference either way, but it detracts from the move for less prescriptive guidance.

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.

The less prescriptive the guidance, the more flexible is its interpretation. We agree with the approach as long as this inevitable flexibility in interpretation is recognised and accepted.

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.

There is a risk of different interpretations of business units, and different methods of allocations, both of which are heightened by the less prescriptive guidance. Whether these are considered inappropriate is a difficult question to answer, as inappropriate suggests some wrongdoing, inconsistent would be a better description.

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?

Not applicable

Q8 We are proposing that all fixed assets should be recorded in the business unit of principal use. Do you agree with this approach?

We do not agree as it is contrary to the move away from prescriptive guidance. Companies should be able to decide themselves which approach they adopt following the preference of less prescriptive guidance.

In addition this will require a change to the methodology of preparing the accounting separation tables as the current guidance was for assets to be allocated across business units. Investment has been made in systems to produce information under the current guidance, this change in guidance would therefore require changes to those systems.

The fixed asset accounting separation tables for previous years will not be comparable with data provided under this changed specification. The resultant operating costs will be the same.

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?

General and support assets should be allowed to be allocated.

Similar to general and support assets, there are retail assets, which are not specifically household or non-household, which are currently allocated over household or non-household categories, which also should be allowed to be allocated.

For asset categories with no natural business unit the only way of selecting the business unit of principal use will be the one to which the greater proportion is currently allocated.

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?

The service definitions, along with the business unit summaries, are useful.

More details of how to allocate assets and spend between trunk and local treated water distribution would be useful. In practice separating treated water distribution into trunk and local is very difficult, and the definitions as they stand do not work. DMAs are not simple, distinct entities; for example how should the following be allocated:

- A trunk main within a DMA
- A Service reservoir located within one DMA, which serves another DMA
- A Waste Water Metered District (WWMD) which is not in a DMA, but which serves customers
- District meters, within or outside a DMA
- Booster pumping stations which serve local customers, while pumping water to a service reservoir, or along a trunk main.

Service reservoirs are not mentioned at all in either local or trunk treated water distribution guidance, even though they are treated water distribution assets.

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?

One-off cost-Approximately £100k. This would be on the basis that this is a cost reallocation exercise, using information currently available from accounting separation and applying some additional analysis. It would cover time spent analysing assets and producing allocations.

Additional one-off cost of approximately £300k to implement system, rather than excel based, reallocations.

On-going costs-Approximately £30k, to cover maintenance and production of data, and auditor fees. This is because there will be an on-going input required from many departments to identify which accounting service costs and assets fall under.

Frequent revisions of reporting requirements will make this much more expensive.

What are the implementation options available to companies to report operating costs by these services?

Option used for pilot study:

Currently operating costs are held on our accounting system (SAP) under cost centres. Where cost centres do not fall under an accounting service they can be allocated across them as appropriate in excel spreadsheets.

Fixed assets (required to produce current cost depreciation charge) can be allocated to individual accounting services in the SAP CCA fixed asset register. There are over 16,000 fixed assets. The biggest challenge would be splitting mains between trunk and local, as there are very few mains asset which can be specifically identified as trunk, so a value will need to be determined, and assigned from current global mains assets, to new assets to be created.

There are facilities within SAP to perform reallocations. However, until requirements are certain, there is reluctance to invest time and money in such developments.

We have developed our business processes to operate efficiently. The business structure cuts across the accounting services. To align operations with the accounting services we will incur higher costs, duplication of activities and therefore inefficiencies. This means reallocations of costs is the only efficient option.

Other comments

Changes to Proforma A8

Some of the costs which are under discussion as to whether they should remain in retail have been amalgamated into either the new Customer Services line (A8.1) or the new Other Operating Expenditure line (A8.8). These should remain separate until the retail definition is finalised, specifically:

- **Meter maintenance/installation**
- **Network customer enquiries and complaints**
- **Disconnections**
- **Demand side water efficiency initiatives**
- **Customer side leaks**

Appendix 1. 3.Worked example of the financing adjustment

Provisions excluded from the financing adjustment

The deferred tax provision is specifically excluded in the worked example. It would be preferable to exclude all provisions (such as the pensions surplus/deficit and the deferred income balance).

Indexed linked debt

Index linked debt should not be excluded from the financing adjustment where the indexation is charged to the profit and loss accounts. This is an area where we have departed from the guidance in the past because it is not correct in this regard (see explanation below). We would prefer the guidance to be amended accordingly, so we can comply.

Explanation:

Excluding the index-linked debt from the financing adjustment treats the gain arising from the effect of inflation on the debt as a loss .

The historical accounting entries which recognise the indexation, increase the debt, with a correponding charge to P&L (a loss not a gain). These should not be confused with the Financing adjustment accounting entries under CCA to recognise the gains achieved by holding debt.

Using Ofwat's approach there is no reflection in the P&L of the gain accrued by holding the debt (see example 2 below).

We believe that the appropriate approach is as per example 3 below which is consistent with the rationale of the Current Cost Accounts (CCA):

			%	Opening £m	Closing £m	
Treatment of non indexed linked debt	1	Debt-not indexed linked		10.00	10.00	
		Financing adjustment	2.4		0.24	credit to p&l
Ofwats suggested treatment of indexed linked debt	2	Debt- indexed linked		10.00	10.24	
		Interest charge	2.4		-0.24	debit to p&l
		Financing adjustment			0.00	
BW view on treatment of index-linked debt	3	Debt- indexed linked		10.00	10.24	
		Interest charge	2.4		-0.24	debit to p&l
		Financing adjustment			0.24	credit to p&l

Example 3 is achieved by including the indexed linked debt (where indexation is charged to the P&L) in the calculation of the financing adjustment.

PR14

Forecasting data by business unit and accounting service will present challenges not yet addressed. There will definitely be more allocations and estimates, than with allocating historic data. While there is uncertainty as to the PR14 business plan requirements, this is an area it is difficult to predict the implications and suggest solutions.

We hope you find these helpful. I am happy to discuss any of the issues addressed in this response further.

Yours sincerely,

Beverley Lawton

Regulation Accountant