

Consultation on changes to the regulatory accounting guidelines

This is Sembcorp Bournemouth Water's response to Ofwat's consultation on proposed changes to the regulatory accounting guidelines (RAGs).

In the following section we provide responses to the specific consultation questions, and make observations on issues we note in Appendix 4. We make general comments below.

- The value and benefit of the data companies will be asked for is currently unclear to us, but it is certain that there will be a cost to provide it. This will place an additional administration burden on companies which needs to be paid for.
- In particular the changes proposed in Appendix 6 will incur a significant cost to companies. Ofwat must ensure that the benefit to customers clearly outweighs the cost and complexity of implementation. A move away from the current regime will only be appropriate if there is a clear benefit for customers and a positive cost benefit balance.
- Service allocation proposals suppose that there is discrete infrastructure which will enable the requested splits. In reality, due to the nature of the infrastructure, it will not be possible to identify these distinct service areas. This will result in allocations, which could then be reallocated elsewhere. This is not logical and will result in highly subjective and arbitrary reporting. We estimate that in some areas this could be as much as +/- 50%. We do not see any benefit for Ofwat, companies or new entrants of data that will not provide a true cost. As we cannot see a realistic alternative to the current approach we question whether this particular proposal should be pursued.
- Ofwat intends to issue guidance in January 2013 for March 2013 reporting. However lead times will be needed to enable companies to design, test and implement changes to systems to comply with new reporting structures. We estimate this could be as long as 6-9 months. Ofwat must therefore accept that, in particular, data reported by 'service' for 2012-13 could be of little value since it is likely to be based on a high level of assumptions and allocations. Data for 2013/14 will also be subject to the same issues as it is unlikely that system changes will be in place at 1 April 2013.

Consultation questions

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?*

- The purpose of the RAGs is to provide Ofwat with the information it needs to regulate the industry. Ofwat is therefore best placed to decide what can be struck from the disclosure requirements.
- We welcome any reduction in the regulatory burden but find it difficult to comment on what Ofwat will need to effectively regulate in the changing regulatory landscape.
- As the data requirements for the 2014 periodic review have not yet been finalised we caution against removing any further requirements until PR14 needs have been clarified.
- We are pleased to note the reduction in capex reporting but are concerned that this, or similar, information will be needed the future. Dropping and then reinstating the same or similar data requirements is expensive.

Are there any additional requirements we need?

- Data will be needed to set accurate PR14 baselines to support a cost performance menu incentive. To set these there is very little option other than to collect data from companies. We have suggested in our response to the wholesale consultation that this could be by way of specified ex-JR lines. Anticipating such a request, we have continued collecting the data and we would welcome an early indication of what data Ofwat will require.
- Data will also be required for other forthcoming wholesale incentives. This should be proportionate and no more than the minimum needed to regulate effectively. Further discussion of what will be required would be helpful once more details of the new incentives are known, and in time to set up systems to collect data before events occur.
- Looking forward, delivering ongoing changes to the regulatory regime will require a flexible approach by both companies and Ofwat as it is difficult to foresee exactly what will be required. Realistic implementation timescales will be key to facilitating this flexibility.

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?*

- This decision is entirely Ofwat's and we therefore do not have any comment.

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?*

- We agree that the proposal to use the annual update letter to exempt the RAG3 debt information requirement for years that it is not needed is an acceptable approach which will reduce the regulatory burden for Ofwat and companies.
- To ensure consistency between years, requests for debt data should be kept outside the regulatory accounts and submitted as an appendix. The data should still be subject to audit.

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?*

- We do not agree with prescribing a common format for publication.
- Prescribing formats will remove the empowerment of companies that Ofwat is moving towards in other areas of regulation. Therefore it should be for companies to decide on their approach.
- Common formats may also not be feasible where company-specific needs to publish data or narratives exist.

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.*

- We agree with the proposed approach of providing companies with principles and business unit summaries. A principles-based approach is preferable to a prescriptive approach.
- A prescriptive approach is not practical as it will constrain effective reporting in that it will be difficult to create rules that recognise all possible permutations of individual companies' structures.

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.*

- The more complex and detailed a regime becomes the greater the risk of inappropriate classification. The forthcoming changes to the RAGs and data requirements will therefore increase the risk.
- Ofwat needs to be mindful of this increased risk when creating new requirements and allow at least one reporting year, or where possible two, for reporting to stabilise. During this time, as initially with accounting separation, it is preferable for the data not to be published. The challenge process during the equivalent period for the introduction of accounting separation was useful in revealing issues which helped the comparability of numbers prior to them being placed in the public domain.
- Horizontal audit could assist in revealing issues but the ultimate cost and burden of an audit should not outweigh the benefit.
- Overhead costs are difficult to split in a complex regime therefore complexity should be kept to a minimum.
- The discrete service areas assumed in Appendix 6 are not a useful split as they do not exist in reality. Therefore the allocation of distribution costs to these hypothetical areas will create the need for arbitrary and subjective allocations, which may themselves then be reallocated. This will result in high levels of uncertainty around the robustness of the data.

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?*

- We do not have a view on this question as we are not involved in these activities.

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 with the proposed approach to record all fixed assets in the business unit of principal use. This will increase complexity and therefore the associated risk.
- The current approach permits transparency and consistency of the allocation of all costs within business units and should be retained. To avoid complex and arbitrary recharges it is better and simpler to pro rata the assets across business units.

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?

- We do not agree with the approach above suggested for fixed assets.
- It is appropriate to allocate G&S on a pro rata basis in line with opex allocations.
- For consistency the same approach on a pro rata basis should also be used for all fixed assets.

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?*

- Ofwat acknowledge that different companies will allocate costs differently due to their circumstances. In our case reporting ‘Trunk Treated Water Transport’ will be particularly difficult. Our mains network is not structured this way therefore any reporting will be of an artificial scenario and therefore not representative of SBW. We question the benefit for Ofwat, companies or new entrants of data that depends heavily on the high level pro rata of costs. Therefore guidance on how Ofwat foresees companies will split mains network costs in to the proposed categories when one main serves both functions would be of use.

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?

- The proposals will require considerable work to deliver the required output since existing data will need to be allocated to a more granular level.
- As previously discussed the risk of reduced accuracy and misallocation will also increase with a larger number of small cost ‘buckets’.
- It is important that Ofwat provides companies with its rules and guidance in time for them to change their systems and procedures in both finance and operational areas. This will allow them to allocate costs on an activity basis and so reduce the need to pro rata as far as possible.
- The work can be achieved but we estimate the costs could be around:

One-off cost	£000
SAP system changes	75

<i>Ongoing cost</i>	£000
Additional manpower costs	45
Additional audit/assurance cost	75

- A further example of the potential to increase cost (which is not included in the above estimates) is the inclusion of Trunk Treated Water Transport. To make power allocation robust additional flow meters could be required and this would increase the workload and cost significantly. However it is also unlikely to be cost-justifiable therefore a trade-off will be required between cost and data-robustness.

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

- There are two feasible options:
 - a) some activity-based costing plus some pro rata
 - b) pro rata all costs.
- Whichever option is used pro rata will feature heavily due to the difficulty in reporting some of the requirements due to the configuration of the mains network.

General comments on appendices

- The boundary points between business units in **Appendix 4** are currently unclear and subject to interpretation. To illustrate:

The boundary point for Water Resources (3.1.1 page 24) states that the end is:

'Supply of raw and partially treated (non-potable) water through a pump or gravity fed through a valve into the raw water distribution system.'

The start point for the next business unit (Raw Water Distribution, 3.1.2, page 25) is:

'Raw water and partially treated (non-potable) water that has been pumped or gravity fed through an outlet valve.'

It is unclear from these definitions where the costs associated with the pump sitting between the two business units should be allocated; in Water Resources or Raw Water Distribution. Discussion within the company has revealed a number of different interpretations of the definition which underlines the need for Ofwat to ensure that no grey areas that could lead to mis or alternative interpretation by companies exist.

- We cannot find reference to costs associated with new meters in the business unit summaries (**Appendix 4**, pages 24 – 37). We appreciate that where this cost will sit is still subject to confirmation following the retail consultation but Ofwat will need to make this clear once the decision making process has been concluded.

Sembcorp Bournemouth Water
October 2012