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Dear Rob

Consultation on Changes to the Regulatory Accounting Guidelines (RAGs)

We welcome Ofwat's consultation of proposed changes to the Regulatory Accounting Guidelines, which we agree need to evolve in step with changes to the regulatory regime as a whole. The touchstone for our response is therefore whether the changes suggested in this consultation are in step with the evolution of the regulatory regime at present.

<u>RAGs are Important</u>

We will make many observations on the scope and approach to Regulatory Accounting Guidelines in this response, some of which will be critical of the proposals in your consultation. None of these should, however, be taken as in any way critical of the importance of having such Guidelines. Their establishment in the early years of economic regulation of the water industry – and their subsequent development as the regulatory regime has evolved – have been critical to the consistency and transparency of the regime, and without such Guidelines the scope for regulatory error, inconsistency and perverse incentives would have been magnified. We all recognise that there are areas where consistency across water companies can be improved, but the level of consistency is far better than in other sectors (such as energy) where guidelines are far less well-developed. At a time when some familiar features of existing regulatory practice are being changed in quite radical ways, the stability and assurance provided by such Guidelines becomes even more important. We therefore remain strong advocates of their retention.

<u>RAGs need to evolve – in a timely manner</u>

One of the reasons that RAGs have been so important – and successful – in the water industry is that they have kept in step with developments in the regulatory regime as a whole and have therefore remained relevant. We support the intent to evolve the Guidelines in a direction consistent with a more proportionate and targeted approach to regulation, thereby reducing the burden of unproductive regulatory oversight for companies and Ofwat. We therefore welcome many of the proposals to eliminate analyses and disclosures which serve no generally applicable purpose (albeit that they may be required in specific, targeted instances where circumstances dictate). We consider that there is further scope for elimination of requirements that do not need to be included within the RAGs: in particular adoption of general principles that:

- matters already covered in other publically available material need not be repeated in regulatory accounts; and
- matters that may be helpful for the development of the regulatory regime – but are not yet enshrined within agreed regulatory practice – should not be crystallised within RAGs, with the attendant accuracy and verification requirements.

The latter principle is driven by the need to recognise that changes in reporting requirements are more onerous to establish and validate than continuation of existing practice, particularly for smaller companies where resources are limited (and tend to have been sized for efficient delivery of existing requirements).

Narrative Information

We welcome the removal of the requirement for a narrative "operating and financial review" as this information is already contained within statutory accounts. We also support the removal of the statement on the links between directors' pay and standards of performance from RAG3. Similar statements are required in statutory accounts and there is no point duplicating the statements. A compromise would be to enshrine within the RAGs a requirement to include the information within the regulatory accounts or explain where the information can be obtained (which should be in a publically available source).

The same approach should be adopted for the other disclosures required under RAG3. In particular, where a single report on company performance is produced for statutory and regulatory purposes, companies should be given discretion as to where the disclosures required are included. This will aid streamlining and accessibility of reports and avoid unnecessary duplication or disjointed narratives. For example, notes on revenue recognition, capitalisation policy and bad debt policy might be incorporated in the accounting policies notes for statutory accounts (where they are the same), and do not need repeating. Similarly, the statement on dividend policy for the appointed business might be adequately covered in statutory accounts disclosures.

We have serious concerns about the inclusion of an accounting separation methodology statement and commentary within the regulatory accounts. The minimum requirements suggested in the draft guidelines are a mixture of information that could be found elsewhere in published accounting information (for example, commentary on significant changes in costs in the year will be included in operating and financial reviews), static information (costs drivers, details of processes and systems, and how RAG4 principles have been applied), and detailed points at odds with the intent to reduce regulatory burdens (changes in cost drivers and breakdowns of recharges between business units). The overall approach to accounting separation requirements in the draft guideline appears at odds with the more proportionate approach adopted elsewhere aimed at reducing reporting requirements. A greater degree of consistency between accounting separation and all the other sections of regulatory accounting requirements needs to be achieved. At present, there is a danger than the abandonment of the June Return financial tables (most of which were simple copies of what was in the regulatory accounts) is offset by the creation of a new set of accounting separation tables (see below).

Cost Allocation Principles

We support the adoption of a set of principles for cost allocation in preference to more prescriptive, detailed guidance that still leaves inconsistencies between companies, largely because of different operating circumstances, organisational structures and financial control frameworks. These differences need to be taken into account by companies when deciding upon appropriate cost allocation techniques. We agree that more detailed guidance on the definitions of business units can be helpful and welcome the clarifications contained in the latest draft guidelines. We would favour discussions with companies (possibly on a rolling or risk-based programme) to understand better areas where there are evident inconsistencies or potentially high risk assumptions.

Where inconsistencies between companies are identified, we favour the issuing of short notes identifying the issues and clarifying the intent behind the RAGs. The most obvious areas for potential inconsistency at present (apart from the perennial debate over the appropriate boundary between opex and capex, particularly in relation to leakage activities) are in the scope of business units, and in particular the determination of which "contentious" activities fall within the scope of Retail units. There is a risk of RAGs being out of step with developments on price control frameworks, which are still subject to further consultations.

Cost Allocation Development

We support using pilot studies as a means of developing cost allocations in advance of their use for regulatory purposes (whether in price controls, charging development or market reform), and therefore support the proposed approach to the allocation of costs to services (as opposed to business units).

We do not however agree that these pilot allocations should be published as an appendix to regulatory accounts, which would imply a degree of reliability and acceptability of the analyses that will be premature at this stage. In particular, to be useful for the purposes stated in the consultation (future charging, informing price controls, and facilitating market reform), allocated average accounting costs are in themselves insufficient, and presuppose that other bases of approach have been discounted. For example, long run marginal costs (potentially including social and environmental impacts) may be more appropriate bases for charging for resources in a competitive market. Even if average accounting costs are to be used, they need to be supplemented by considerations of asset and working capital funding and appropriate returns – for which additional information will be required, or an agreed approach to its estimation will be required. To build an edifice of accounting separation information requirements in advance of more fundamental questions being addressed will potentially waste much effort across the industry. As a minimum, Ofwat should set out a roadmap of how the proposed information requirements fit into broader regulatory developments, so that the risk of wasted effort is clearly understood by all parties.

Other Matters

We support the proposal to collect the information included in regulatory accounts in a commonly accessible format to facilitate sharing and industry-wide comparisons. Effectively this re-instates many of the financial tables from former June Returns.

We agree that Guidelines will need to remain under review, not only to accommodate changes which may arise from the transition to IFRS for UK companies, but to reflect the changes arising from the finalisation of the methodology for the 2014 Price Review. We consider such updates essential to maintain the relevance and usefulness of the Guidelines. However, the introduction of changes into formal reporting requirements requires time and effort if reliable information is to be provided, and finalisation of reporting requirements should preferably be completed six months before the end of the reporting period in which the new requirements have to be applied. As a minimum, no changes should be required within three months of the year end to which they will apply.

As always, we remain willing to expand or clarify any of the observations made in this response in any manner that Ofwat find helpful.

Yours sincerely

John Chadwick
Finance Director