South East Water's Response to changes to the regulatory accounting guidelines (RAGS)

31 October 2012

This paper sets out South East Water's views in response to Ofwat's recent consultation on changes to the regulatory accounting guidelines (RAGS).

INTRODUCTION

South East Water welcomes the opportunity to comment on the proposed changes to the Regulated Accounting Guidelines set out in Ofwat's consultation document. Our response to the consultation is structured as follows:

1. General comments on the consultation, the process and the timing of the proposed changes;
2. Comments with respect to the proposed changes to the Regulated Accounting Guidelines, where key points are not raised within the questions posed under Section 3; and
3. Answers to specific questions raised in the consultation document.

1 GENERAL COMMENTS ON THE CONSULTATION:

We would like to highlight a concern that at the current time, the water industry is considering the impending move from UK GAAP to IFRS and this move could have important implications on the AMP 6 business planning process, which if not considered could have negative consequences for water companies and the industry. Changes in accounting treatment expected as a result of transition from UK GAAP to IFRS mean that the base accounting records for the production of the regulated accounts are shifting. The Regulated Accounting Guidelines stipulate the adjustments necessary to adapt UK GAAP Accounts to produce Regulated Accounts. These adjustments and therefore the RAGS, should be considered with IFRSs as the accounting baseline. In our view, these considerations should be undertaken before the AMP 6 business planning process so that the underlying accounting adjustments required to produce Regulated Accounts, price setting mechanisms and financial modelling are all consistent.

The Regulated Accounts are the main source of audited financial information on the appointed business for potential investors and shareholders and, as such, should be closely aligned with the business plan. As such, any changes to the regulated accounts should be considered with this as a guiding principle. The proposed changes to the Regulated Accounting Guidelines do not make reference to or issue any guidance on Total Expenditure reporting, which is an area of great interest to shareholders.

It would be useful in future Consultation documents to set out proposed changes in a more easily identifiable manner. A single schedule listing the changes proposed with a cross reference to further detail would have been particularly useful (The Proposed deletions from RAG 1 are set out on page 11. This format was useful, however it was not repeated for other RAGs).

The consultation includes proposed requirements to include non- financial data, one example of this would be the inclusion of property data. Whilst this data is necessary as a component of the revenue correction mechanism, the Regulated Accounts audit opinion signed by our external auditors should be carefully considered and appropriately updated with regards to non-financial data.

Similarly, the accounting separation tables have historically been reviewed by the external audit team on a "agreed upon procedures basis". Inclusion of these tables within the body of the Regulated Accounts, will mean that the scope of the audit work will need to be clearly defined and an update to the Audit opinion will be required. Again, this needs consideration and agreement prior to the Financial year end.

We appreciate the desire to reduce the burden of regulation in the Water Industry and reducing the requirements set out in the Regulated Accounting Guidelines clearly achieves this objective. However, in our view there are some proposed changes which we do not believe should be reduced and these are set out in Section 2 below.

2 PROPOSED CHANGES TO REGULATED ACCOUNTS:

We have the following comments on the proposed changes to the Regulated Accounting Guidelines.

2.1 Regulated Accounting Guideline 1 - *Guideline for accounting for capital maintenance charges and current costs*

Table 1 on page 11 sets out the proposed deletions from RAG 1, which is a helpful summary. South East Water agrees with deletions listed with the exception to the proposed deletion of the RCV note. In our view, the RCV note is an extremely useful reference point for investors to the capital value of the business. Whilst it is accepted that this information is held on the OFWAT website, many potential investors refer to water and waste water company websites for this information. Deleting this note from the Regulated accounts would be a detrimental step.

2.2 Regulated Accounting Guideline 2 - *Guideline for classification of expenditure*

We have no comment

2.3 Regulated Accounting Guideline 3 - *Guideline for the format and disclosures for the regulatory accounts*

We have the following comments with respect to the proposed changes to RAG 3.

- We do not agree with the deletion of the current cost balance sheet and movement on the current cost reserve. The current cost balance sheet is calculated as part of the current cost financial statements. Eliminating the balance sheet would mean not presenting a full set of financial statements and should be retained for "completeness" purposes.

- We agree with the proposed elimination of the Operating and Financial Review and agree that this is a duplication of information produced elsewhere. We appreciate that this will be replaced by information requirements on Revenue recognition, capitalisation policy and customer debt and recognise that this is a key risk area for the industry

2.4 Regulated Accounting Guideline 4 - *Guideline for the definitions for the regulatory accounts tables*

We have no comment

2.5 Regulated Accounting Guideline 5 - *Guideline for transfer pricing in the water and sewerage sectors.*

We have no comment

3 ANSWERS TO SPECIFIC 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? Are there any additional requirements we need?

None to be specified

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?

We believe that the disclosure requirement should remain in RAG3, as this would benefit the stakeholders and potential investors by providing a consistent source of information for directors' pay and standards of performance.

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?

We agree that this is an acceptable 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?

Regulatory accounts work well provided as a PDF file format as they are a full set of accounts and cannot be changed as with word documents. To provide data via a capture system would only increase burden on companies and possibly lead to discrepancies.

The accounting separation tables could be published again in PDF format alongside the regulatory accounts to increase the ease of benchmarking between companies, without increasing burden.

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 proposed principles and business unit summaries appear to be sufficiently clear for submission – nevertheless the principles inevitably remain susceptible to differing interpretation from different companies and therefore success is reliant on reporter/audit verification being consistently applied.

We refer to our retail consultation response where we expressed concern regarding variations in cost apportionments between companies. Given the importance regarding the use of these costs (i.e. average cost to serve) it is our belief that these current differences are fully understood given prescriptive guidance was provided. In switching to principles and business unit summaries Ofwat should ensure this approach does not lead to further variation and loss of confidence in subsequent outcomes of using the data.

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 main burden of effort for accounting separation remains in allocating cost between the various business functions – the proposed reduction in line detail within each business function will not significantly reduce our burden since this is mostly achievable through simple cost centre analysis. Subsequently our preference would be to retain the current level of line detail, since we believe the consolidation of lines will be at the detriment of useful industry benchmarking analysis that can lead to best practice. Furthermore, the consolidation of a number of existing lines also increases the unaccountable nature of cost within the new proposed line (A7.5 and A8.8) "Other operating expenditure".

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 to South East Water .

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?

We agree fixed assets should be recorded in their natural business units as far as practicable; however we consider that some fixed assets do not have a natural business unit and, therefore, allocation would be a more accurate way of reporting(examples would be computer systems and vehicles, assets which are used across the business units.

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?

Proposed reporting at treated water distribution service levels (i.e. trunk or local) presents the only notable step change in reporting for SEW. Given our understanding of the proposed reporting we believe that current work-management systems within SEW can be adapted to report distribution activity between trunk and local. To realise this level of reporting, it is envisage that £110k of development work would be required, with approximately £20k onward annual costs to complete the reporting process. Remaining proposed service level cost requirements for other business units should be achievable via cost centre analysis.

It is unlikely that the required development of our systems, plus implementation training, would be completed in time for the 2012/13 period, and therefore a hybrid of analysis (described above) and rudimentary explanatory factors (i.e. length of main, expert opinion) would be employed to drive cost between the service activities.