Consultation on changes to the regulatory accounting guidelines (RAGs)

Southern Water's Response

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Southern Water's response to Ofwat's consultation on changes to the regulatory accounting guidelines (RAGs)

Introduction and summary of our response

We are pleased to be able to provide you with our response to the consultation on changes to the regulatory accounting guidelines (RAGs).

We fully support the objective of ensuring that the content of the regulatory accounts is fit for purpose and represents proportionate and targeted regulation.

In summary our response makes the following key points:

- Ofwat should consider carefully the rationale for making changes to the regulatory accounts at this time and it may be sensible to defer the amendments to coincide with the other changes that are likely to be required in 2015-16.

- Whilst there are some disclosure reductions proposed, these do not materially reduce the regulatory burden placed upon companies and we do not see a reduction in the level of information required.

- The extension of the accounting separation information requirement to the additional service levels will increase the regulatory burden and is almost certain to add additional costs to the reporting process.

- To enable the effective provision of costs by the proposed services we do have some significant concerns in a number of areas, principally with respect to sewage collection and liquor treatment. Further issues may arise as we progress through the current exercise to allocate costs to these proposed services.

- There is a significant risk of inconsistency in approaches for accounting separation due to the levels of judgement required, particularly with the further disaggregation to service level. This is particularly important if such information is to be used as the basis of future access prices.

- In 2015/16, UKGAAP is due to be replaced by IFRS of FRS102 and Ofwat are also proposing changes to the overall regulatory regime. As a result of these imminent further changes, consideration should be given, to whether to make these changes now or whether a better approach would be to make one set of changes to coincide with the IFRS conversion timetable and further revisions to the regulatory accounting requirements resulting from changes to the regulatory regime.

Responses to the specific questions raised are set out below:

Response to the 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?

The reduced disclosure requirements seem to place much the same burden upon companies as before. For example, we already produce the Operating and Financial Review as part of our statutory accounts to satisfy the requirement for a Business Review and this requirement will remain. Similarly, where tables have been combined, for example in the case of the current cost profit and loss account and turnover table, there is little overall reduction in the level of detail required, since in this case the analysis of turnover has simply been incorporated in the profit and loss account.

We note that Ofwat have proposed that an accounting separation methodology statement and related commentary should be included within the regulatory accounts. Whilst we are prepared to provide this information to Ofwat, we consider it would be disproportionate to the information it relates to within the regulatory accounts and we propose that it is more appropriate to include a high level statement on policy / approach to accounting separation within the regulatory accounts instead.

In terms of additional requirements, Ofwat should ensure that it gathers sufficient analysis on Retail service costs to ensure they are comparable between companies for future price setting.

Given that the Accounting Standards Board are proposing that UKGAAP is replaced by IFRS or FRS102 by 2015-16 and also that Ofwat are consulting on wholesale incentives for the 2014 price review, in which a totex approach to cost assessment is proposed, Ofwat should consider carefully the rationale for making changes to the regulatory accounts at this time. It may instead be sensible to defer the amendments to coincide with the other changes that are likely to be required in 2015-16, which could also include removal of the requirement for current cost accounts and historic UK GAAP items such as renewals accounting.

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 agree that it would be best to allow companies to decide where it would be best to publish this statement. Therefore we agree with the proposal to remove the disclosure requirement from RAG3.

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 support the approach to not supplying this information every year. However, we suggest that Ofwat should make it clear in RAG3 that the information will not form part of the annual information requirement and will be requested using the annual update letter in the years that it is required.

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?

This should be considered once the final form and content of the regulatory accounts is known, although we would support the submission of a common format, for example spread-sheets for the data tables, which should allow stakeholders to compare data more easily.

We would expect to continue to produce the regulatory accounts as part of our combined annual report, along with the statutory accounts, in pdf format.

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 that the principles based approach should allow companies to select the most appropriate method of allocating costs for their underlying business. It should be noted however that this may also lead to some difficulty in the comparison between companies.

In instances where Ofwat intends to rely more heavily on the comparative analysis of costs, for example for the setting of retail price caps, a more prescriptive approach should be considered as we know differences in allocation and accounting practices are widespread within the industry. Ofwat needs to minimise the extent to which differences between companies are due to how things are 'measured' as opposed to how things are 'managed'.

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.

Given the principles based approach, costs should not be classified inappropriately on an individual company basis since each company will have a good understanding of their costs; however, they are likely to be allocated inconsistently across the industry.

Inconsistent reporting is likely to be most sensitive where it impacts allocation between wholesale and retail business units given the separation of price limits in the future. A targeted scrutiny of these allocations would be consistent with a risk based approach.

We also consider that the introduction of a further disaggregation of costs to a service level below business unit is more problematic and will increase the level of subjectivity inherent in the cost allocation methods and judgements being used and therefore significantly increase the inconsistency between companies' reported data. We would need to understand in more detail how Ofwat intends to use this data in order to assess how best to control this in future.

Generally we support the proposal by Ofwat to address areas open to a greater risk of potential allocation issues through targeted reviews on a timely basis, additional guidance and, in exceptional circumstances with full transparency, the application of price setting adjustments. The choice will be dependent on the specific matter.

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?

Though it seems sensible to combine business units where there is no reason for separating them, the current split of sludge disposal is relatively simple to undertake and we see little benefit in combining this with sludge treatment. This also appears to be at odds with the drive for a greater level of disaggregation to service level which re-introduces these as separate services. Combining them for inclusion within the regulatory accounts makes no difference to the regulatory burden.

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?

In principle we agree with this approach, but would welcome additional guidance regarding the level to which assets are expected to be allocated to the unit of principal use.

Costs for our current capital schemes are split between business units based on an analysis of the assets that are to be delivered by that scheme. We would propose to continue to follow this approach.

Where it is not possible to determine a specific business unit for an asset, e.g. liquor treatment, then we would agree with the recharge approach.

For general and support corporate assets, for example the finance accounting system, a separate general and support business unit may be more appropriate with recharges to the underlying business units. Alternatively, Ofwat could either leave them to be allocated as currently or provide guidance on which business unit to select as the principal business unit for these assets.

Either way the important factor is that the cost is allocated in a reasonable manner to ensure it reflects appropriately the economic benefit that the relevant business units derive from the particular asset. The principles approach seems the most effective manner in which to achieve this, where a company understands the cost drivers and benefits derived.

Q9 We are proposing to trial the allocation of operating costs to services as detailed in appendix 6.

9.1 As well as the service definitions in appendix 6, what information would companies need in order to report costs by these services?

Service definitions and principles should be enough in general to enable us to be able to report costs by these services. However we do have a number of concerns over certain areas of the information being requested, as follows:

Sewage collection

The requirement to allocate costs over foul, surface water drainage and highway drainage is extremely difficult and therefore open to a huge amount of subjectivity and inconsistency in approach and may well lead to misleading information.

Significant lengths of our sewers are combined and as such will need to have costs proportionally allocated. In this particular case there is a conflict between the options available to apportion cost. For example, the construction cost is heavily dependent upon pipe size which is predominantly affected by the potential volume of surface water and highway drainage from storm events. This could heavily bias the asset cost towards surface water and highway drainage even though these storm events are infrequent and the foul flows occur every day.

In addition, given the variety of different maintenance activities, there is significant difficulty in easily identifying a suitable driver for maintenance work that allows compliance with the second principle set out by Ofwat which states that costs should be allocated to the service that causes the cost to be incurred. Maintenance costs can result from a number of external factors and are not necessarily proportionate to, or driven by, the volumes or the source or nature of the flow.

Furthermore to analyse costs between surface water and highway drainage a significant number of assumptions, particularly in relation to relative catchment areas, will need to be made in order to make an assessment of the contributing volumes of each. This approach will result in a level of inaccuracy, as, for example, we do not hold details of highway drainage systems and therefore some significant judgement would need to be made for these. This is reflected in companies' current charges, where the majority simply assume an equal split between the two services.

The acquisition of private drains and sewers by the industry further complicates the disaggregation on the sewage collection costs due to the limited information currently available about these assets.

Liquor treatment

Additional clarity is required regarding liquor treatment.

Liquors arising from the majority of our wastewater treatment works are the product from quiescent settlement of sludge prior to transportation to sludge treatment centres. These liquors are generally small in volume in comparison to incoming sewage flows, and as such we would propose that the costs associated with these liquors should be included as an element of sewage treatment.

However, we recognise that for a small number of sites, less than ten per cent, where either dewatering is undertaken prior to transportation of raw sludge cake, or sludge treatment centres are co-located on wastewater treatment works, larger volumes of liquors are produced and a suitable allocation method for costs may be required.

In addition, clarification regarding the treatment of de-watering costs as either part of the sewage treatment business unit or the sludge treatment business unit would be helpful.

9.2 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?

Based on our current approach to produce the accounting separation information in spread-sheets we expect the initial incremental cost for reporting in 2012/13 will not be significant. However, a piece of work is underway, using internal resources, to identify how to report costs by these services so at the moment we are not clear on the full costs of this exercise.

We do however anticipate that there may be additional costs associated with independent assurance provision, depending on the guidance provided by Ofwat to the auditors.

It should be noted that the costs associated with the additional services proposed will be calculated using further allocations of costs reported in the business units, as we do not capture direct costs at these service levels.

In future, we expect that additional data will be required in order to ensure the most appropriate allocation is used, which inevitably will lead to additional costs being incurred. It is difficult to estimate how much these may be at this stage, but examples would be:

- Additional sampling costs and laboratory analysis to assess the incoming sewage and the return liquor loads as well as additional flow meters to enable the apportionment of costs for liquor treatment.

- Detailed surveys and assessments to estimate the contributing areas and enable the allocation of costs between surface water and highway drainage. It

should be noted that even with these surveys the accuracy of this data is still likely to be subject to a significant level of judgement.

As mentioned above, in the longer term, once clarity is provided on the proposed way forward we expect we will very likely have to invest in amendments to existing systems or the introduction of new systems to collect data in different ways or to aid automation of allocations and assurance. This may give rise to significant IT costs, that to date have not been assessed.

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

The implementation options available to each company will differ depending on the level of data available and systems that are in place. In the short term we intend to create an extension to our existing accounting separation process which uses a spread-sheet based model to map costs directly from our general ledger into business units and also perform the allocations required, based on cost drivers and allocation rules with control totals, to produce the final accounting separation data.

We do not believe that it would be practical or cost-effective at this stage to collect costs directly at these lower service levels, until definitive decisions are made around the service levels.

Depending on the level of complexity and cost involved we expect we will have to adapt our source system or, more likely, implement an additional IT solution to undertake the allocations and production of this information in the future.