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SEVERN TRENT WATER

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Dear Mr Lee,

Consultation on changes to the regulatory accounting guidelines (RAGs)

I am writing to give Severn Trent Water's response to the consultation on the changes to the regulatory accounting guidelines.

We welcome the opportunity to respond to your consultation on changes to the regulatory accounting guidelines. We strongly support the objective of ensuring that the content of the regulatory accounts is fit for purpose and represents proportionate and targeted regulation.

We think that the elimination of narrative that is now deemed unnecessary or better reported elsewhere will result in clearer, more focussed regulatory accounts and reduce duplication with other reports such as statutory accounts.

However, we do not think that it is in the interests of the industry to ignore the issue of the mandatory alignment of UK GAAP with IFRS. This will potentially require fundamental changes to the Regulatory Accounting Guidelines ('RAGs'). We believe that Ofwat needs to address this issue as a matter of urgency. We suggest that Ofwat publishes one set of revised RAGs which takes account of changes required for UK GAAP/IFRS alignment, at the same time it publishes its PR14 requirements. This will enable us to ensure that new price setting mechanisms and financial modelling for PR14 are consistent with the approach to regulatory accounts under IFRS-aligned UK GAAP. In addition, it will allow sufficient time to make the potentially significant changes that may be required to companies' accounting systems to take account of the revised RAGs, and avoid the inefficiencies of making two separate sets of changes.

This issue has been discussed within the industry in some detail, specifically by the UK Financial Controllers Group. We would be happy to provide assistance in the formulation of revised regulatory accounting guidelines which achieve the required outputs.

Continued ....

In relation to the new requirements to produce accounting separation at a 'services' level we would like to better understand the purpose of collecting this information and how it will be used. For example, we are unclear how the disaggregation of sewage collection could be representative of potentially contestable services, and therefore do not see the benefit in requesting this to be reported. Similarly, we do not see how treated water distribution could be contestable at a services level. We believe that disaggregation at this lower level will lead to costs being allocated on the basis of more subjective cost drivers which will increase the risk of inconsistency between companies' reported figures.

In the trial year we consider that the new information should not be published and should therefore be submitted to Ofwat separately rather than being included as an unaudited appendix to the regulatory accounts. This would enable companies to refine methodology following feedback on trial data before the information is made available in the public domain. This approach would be consistent with that used to trial previous reporting requirements such as the current accounting separation tables.

Our responses to the specific questions and proposals set out in the consultation are set out in the attached appendix.

Yours sincerely,

Dr Tony Ballance
Director of Strategy and Regulation
Severn Trent Water

Appendix

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?

We believe this consultation needs to address the issue of UK GAAP/IFRS alignment becoming mandatory in the near future.

We believe that there is an opportunity for Ofwat to revise its current cost requirements in the regulatory accounts. We think that Ofwat could establish a regulatory depreciation charge which does not refer to current cost accounts. This would remove the burden of MEAV revaluations and RPI uplift of assets.

The reduced disclosure requirements place much the same burden upon companies as before, as the same work has to be undertaken to produce the aggregated numbers to be submitted, and to provide appropriate assurance over them.

Q2: A statement on the links between directors' pay and standards of performance is required by the Water Act 2003. RAG3 currently specifies including this 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 agree. We believe that the most appropriate place for this statement is in the Annual Report and 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?

We have no objections, although perhaps would be simpler to ask for this information when you require it under licence condition M.

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 believe that companies should use the most appropriate format for publishing their regulatory accounts for their circumstances. Companies may already have developed reporting systems providing outputs in a specific format. We do not think that customers should bear the costs of developing additional systems for the benefit of other stakeholders.

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 then publishing prescriptive guidance. Do you agree with this approach? If not, please provide details of an alternative approach you think we should adopt.

Yes, we agree that prescriptive guidance could result in the inappropriate allocation of costs and lead to AS data that does not reflect the underlying business.

Our experience with June Return has also shown that prescriptive guidance brings significant increases in regulatory burden and a loss of focus on what is important, without achieving consistency.

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.

Regarding AS Services, we believe that the introduction of a greater level of disaggregation will increase the level of subjectivity inherent in the cost drivers being used and therefore the likelihood of inconsistency between companies' reported data. Our initial assessment of the level of subjectivity inherent in AS vs. AS services indicates that the level of costs being allocated on a highly subjective basis would increase from around 7% to 22%, and the proportion of costs being directly attributed would fall from around 60% to 35%. We would need to better understand what the data will be used for specifically in order to discuss how best to control the risks.

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 agree with the approach of merging the sludge business units. However, this has no real impact because we are required to disaggregate costs between sludge treatment and sludge disposal in the AS services reporting.

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 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 with this approach where assets have a business unit of principal use. Where this is not the case, we would suggest allocation as being appropriate. Alternatively, a separate category for general and support-type assets could be created.

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, although we do have some specific concerns regarding specific areas of the disaggregation being requested.

Sewage collection disaggregation
We do not believe that the services into which sewage collection is to be disaggregated could be contestable. We therefore do not see the benefit in the requirement to report this.
The majority of our sewers are combined. This means that very little of the cost of sewage collection is directly driven by the activities represented by the AS services categories. The drivers of the costs incurred in the sewage collection activity are far wider than the volume and/or nature of what is being conveyed through the sewerage system (for example, a large proportion of the maintenance required on sewers is driven by factors external to the pipe, such as the surrounding environment). The disaggregation proposed therefore introduces the necessity for significant levels of judgement in how these costs are allocated. This is likely to lead to arbitrary and inconsistent allocations being made, resulting in misleading outputs when comparisons are made between companies.

Additionally, Ofwat state that accounting separation systems need to comply with the set of general principles set out in RAG 4. The second of these is 'causality: cost causality requires that costs are allocated to those activities and services that cause the cost to be incurred'.
Whatever basis is used for the allocation of sewage collection costs across these three categories, Ofwat's principle of causality cannot hold true, as the much of the cost is driven by factors entirely outside of the categories being allocated across.

Liquor treatment
We think that some additional clarity is required regarding the liquor treatment service. We assume that the de-watering activity that takes place at sewage treatment works is intended to remain part of the sewage treatment business unit, given that related assets are now included there, and therefore should not be included in the liquor treatment service.

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?

The level of incremental costs will relate directly to what data companies currently have/ report. It will therefore be different for each company. We maintain data upon which most of the cost drivers for AS services reporting can be based, so incremental costs should be relatively small.

Any such costs of implementation will be absorbed. There would be increased costs relating to independent assurance provision, however.

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

Implementation options: The implementation options that are most appropriate will differ from company to company, depending on what data the company has at its disposal to underpin the necessary cost allocations, how robust that data is, and whether it can easily be reported. We would intend to create an extension of our existing accounting separation process, which maps cost directly from the ledger to business units, and where necessary, makes allocations based on cost drivers in an Excel matrix, which has the necessary checks and balances, such as reconciliations, built in.