SOUTH WEST WATER

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Dear Rob

REGULATORY ACCOUNTING GUIDELINES (RAGs) CONSULTATION

Response from South West Water

We are pleased to have the opportunity to respond to Ofwat's formal consultation on Regulatory Accounting Guidelines (RAGs).

The consultation includes a number of both significant and minor changes to the Regulatory Accounting Guidelines but we feel there are two key areas for consideration:

- The purpose of the regulatory accounts both currently and in the future
- The proposals for accounting separation and the services pilot.

This consultation is launched during a period of considerable change within the industry. Regulatory reform and the implications for 2014 price setting are already being considered and 2012/13 will be the first year where the revised approach to risk reporting will be embedded.

In responding to this consultation we have addressed the specific questions raised, but have also assessed the proposals against the background of 'delivering proportional and targeted regulation', regulatory reform proposals and future accounting developments.

Purpose of the Regulatory Accounts

The primary purpose of the Regulatory Accounts should be to publish a set of accounts for the regulated business in line with established guidelines which demonstrates financial performance against a determination. The accounts should not be used for additional information requests which are more appropriately dealt with outside of a formal set of accounts and assurance process.

The Regulatory Accounts in the current format incorporate an overview and put into context the company's annual performance and include information for the user of the accounts to understand the key definitions based on the current 'Frozen GAAP' guidelines for regulatory purposes. In addition they are intrinsically linked with the statutory accounts.

The consultation recognises that the introduction of International Financial Accounting Standards (IFRS) from 2015 will have an impact on companies, and that a further review of the RAGs is likely to be required to take UK GAAP alignment to IFRS reporting into account.

While this will impact on reporting, there is a more significant need to consider these changes in relation to price setting for the 2015-2020 period. We believe the industry would benefit from Ofwat publishing one set of revised RAGs which takes account of the changes required for UK GAAP/IFRS alignment, at the same time as it publishes its PR14 requirements. This would allow new price setting mechanisms and financial models for PR14 to be aligned with the updated accounting convention.

If IFRS is not considered for price setting, comparisons of future actual performance reported outside of the regulatory accounts will be further from any determination received.

Accounting Separation

Water companies are vertically and operationally integrated; as such any accounting separation is naturally based on the most appropriate splits, allocations and cost drivers for a specific company. Bearing this in mind, we have the following points to make.

While accounting separation information was included within South West Water’s 2011/12 regulatory accounts, this requirement remained optional. We welcome a consistent approach to this, but also note the difference between regulatory accounts and other required information noted previously.

Despite the current guidance for accounting separation it is inevitable that differences exist across companies which result in regulatory accounts not always being comparable.

A principles based approach for accounting separation, rather than detailed guidance, is consistent with the established framework for regulatory accounts which are prepared under accounting guidelines rather than a set of rules. This requires an element of management judgement and estimates which can again lead to differences across companies.

If accounting separation is to inform price setting or market pricing (both of which have yet to be determined) or inform a debate on comparative efficiency or access pricing, then specific Ofwat guidance may be required to ensure this is done on a comparable basis.

Whilst we support the combining of some activity drivers, within the retail business there are specific areas such as the costs associated with vulnerable customer schemes and charitable trusts that have merit in being separately identified. These costs are not associated with general customer service activities, and companies that spend higher amounts on assisting their vulnerable customers may be viewed as having an overall higher cost for customer services – a key area if cost comparisons are to be made on this data.

The inclusion of the accounting separation methodology statements into the regulatory accounts will not necessarily increase the detail on cost allocations which Ofwat desire. Methodology and additional commentary requirements are likely to be more appropriate if requested as a separate submission with guidance on the specific areas to be included. In addition consideration should be given to the information which will be publicly available as this may influence the detail on cost allocations that is included in any methodology.

Services Pilot

The pilot work for accounting separation took time before the information was included in the Regulatory Accounts. An appropriate approach would be to complete this analysis on a step by step basis as a separate return until the pilot outcomes are understood and processes are better developed. In addition including the information within the regulatory accounts would not necessarily result in additional assurance over the results as this would be reviewed separately.

Within this pilot we would support companies working with Ofwat to seek to define the allocations for services and understand both the operational and financial impacts of such a change.

We set out in an appendix to this letter, additional points on our analysis for the consultation together with our detailed responses to the specific consultation questions. We look forward to discussing our response with you.

Yours sincerely

Susan Davy

Finance & Regulatory Director

Appendix

Disclosure Requirements

While the consultation removes the requirement for an ‘operational and financial review’ and removes some other disclosures and reporting tables it does include some additional requirements including:

- Narrative on three key areas
  - revenue recognition;
  - capitalisation policy; and
  - consumer debt

These narrative requirements appear to mix accounting policy statements with reporting of performance and variances, for instance to turnover. We believe that, as a set of accounts, it is only appropriate for accounting policies to be reported and performance commentary should be left for the appropriate documents, in particular company annual performance reports.

- Additional disclosures for CIS and RCM

Regulatory reporting requirements (e.g. accounting separation, CIS and RCM) that were previously included in the June Return were audited under “agreed upon procedures” and focussed on checking data against specific Ofwat requirements. Audits of regulatory accounts are on a financial audit basis, and mixing these different requirements within the regulatory accounts is very difficult and expensive for companies as a result. Specific reporting guidance and procedures are required for audits on the regulatory information, and it may be better for this information to be subject to a separate submission rather than through the regulatory accounts.

- Non-financial information

The proposal to include non-financial information, such as property analysis, within the regulatory accounts may be difficult and costly to complete if these are to be covered by the external audit opinion.

Regulatory Accounts Format & Requirements

Q1 - Are there areas where we could reduce disclosures requirements further? Have we reduced the requirements too far in other areas? Are there any additional requirements we need?

While the consultation removes the need to prepare an ‘operating and financial review’ with some specific disclosures, companies will still need to ensure the performance of the company is reported to put the regulatory accounting results into context. In addition reporting of Ofwat KPIs is still required, and again a summary of performance will be expected to explain and context these results.

There are a number of new disclosures and tables required which have previously been reported as part of the June Return either in data tables or the corresponding commentary. With these changes aiming to reduce the disclosure requirements, it does not seem appropriate to bring back June Return aspects via the Regulatory accounts, it would be better to separate between a set of accounts and information requests – which can be satisfied outside of this process.

In some instances the commentary items previously provided in the June Return have been mixed with the accounting policy requirements which do not necessarily fit with the structure of the regulatory accounts – again better to include these within the performance reporting (if companies identify these as significant areas) or a separate information request from Ofwat.

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 requirements from RAG3.

The disclosures required for the links between the directors' pay and standards of performance are in many cases greater than the requirements for the statutory accounts. As a result South West Water would continue to disclose this within the Regulatory rather than Statutory 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?

The use of the debt information is solely for price setting purposes and therefore an improved approach would be to request this as part of each business plan or separate information request, rather than in the regulatory accounts. Showing detailed information one year and not the next may cause confusion to the users of the accounts.

In addition such information on debt and interest rates are price sensitive and companies may not want such information to be made public – in JR09 when similar data was last collected this specific information was considered 'commercial in confidence' and not appropriate for the public domain.

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?**

For 2011/12 SWW published its regulatory accounts on its website via PDF and an interactive HTML site.

<u>Accounting Separation</u>

Q5 – We propose to provide companies with the principles and business unit summaries in appendix 4 to use when allocating 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.

Despite the current guidance for accounting separation it is inevitable that differences exist across companies that result in regulatory accounts not always being comparable.

A principles-based approach for accounting separation, rather than detailed guidance, is consistent with the established framework for regulatory accounts which are prepared under accounting guidelines rather than a set of rules. This requires an element of management judgement and estimates which can again lead to differences across companies.

If accounting separation is to inform price setting or market pricing (both of which have yet to be determined) or inform a debate on comparative efficiency or access pricing, then specific Ofwat guidance may be required to ensure this is done on a comparable basis.

Whilst we support the combining of some activity drivers, within the retail business there are specific areas such as the costs associated with vulnerable customer schemes and charitable trusts that have merit in being separately identified. These costs are not associated with general customer service activities, and companies that spend higher amounts on assisting their vulnerable customers may be viewed as having an overall higher cost for customer services – a key area if cost comparisons are to be made on this data.

The inclusion of the accounting separation methodology statements into the regulatory accounts will not necessarily increase the detail on cost allocations which Ofwat desire. Methodology and additional commentary requirements are likely to be more appropriate if requested as a separate submission with guidance on the specific areas to be included. In addition consideration should be given to the information which will be publicly available as this may influence the detail on cost allocations that is included in any methodology.

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 on how we could mitigate this risk in a proportionate way.

As noted above the use of principles for accounting separation may result in differences between companies. As functions are not physically separated, necessarily accounting separation is based on decisions about cost drivers and allocations.

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?

The merging of sludge treatment and sludge disposal for business units is welcomed; however the benefit of this is greatly reduced with the requirement for companies to split costs into separate services for the proposed pilot.

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 required the approach above for fixed assets?

The allocation of fixed assets between business units is well established for accounting separation. While this approach may be appropriate for specific operational assets, where a site is predominantly one activity, this is not as noted above appropriate for general and support costs.

Therefore allocation of these costs across all of the business units should remain where no natural primary unit exists.

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 these 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?

The introduction of accounting separation into the regulatory accounts was only completed in 2011/12 (although this remained optional) following the pilot schemes completed in 2008/09 and 2009/10. 2010/11 was the first year information was included within the June Return for all companies.

The data and information to achieve this has been developed over these years culminating in the 2011/12 reporting but this remains for companies a detailed allocation of costs from the core information available.

If services are to be reported further information will be needed particularly in the areas of:

- sewerage collection with the issue of combined sewers
- sludge treatment which is to be split into 4 categories but where costs are not necessarily directly allocated to these services.

In the early stages the initial pilot is likely to be a 'desk-top' exercise to allocate costs appropriately from the core accounting separation information.

The speculative pilot of the services can be time consuming and the incremental costs of such an exercise are likely to be costly if independent assurance was required. An appropriate approach would be to complete this analysis outside of the regulatory accounts – as was the case for accounting separation – until the pilot outcomes are understood and processes are better developed.