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Dear Mr Lee

Consultation on changes to the regulatory accounting guidelines (RAGs)

Thank you for the opportunity to respond to your document 'Consultation on changes to the regulatory accounting guidelines'. We have set out in the attached appendix 1 our views on the specific questions posed and would welcome the opportunity to discuss these further.

We believe that the proposals are consistent with Ofwat's 'Regulatory compliance – a proportionate and targeted approach: A consultation' published in October.

We support the aspiration in attributing costs to the appropriate upstream wholesale service level where it is practical to do so. Indeed we believe that it is essential for management information that costs are reported to a lower level of granularity both to enable efficiencies and as part of the market reform of the industry. Therefore, we have taken the opportunity of this consultation to inform Ofwat of the direction the Company is taking to report costs at a more granular level, which we have set out below.

Whilst we support the need to provide greater granularity of financial information for upstream wholesale services for the Wholesale accounting separation units, we question the requirement to separately disclose operating costs to some of the services proposed at this stage and whether it should be published as part of the regulatory accounts from 2013/14, given the inevitable level of allocation and management judgement that will be required.

The use of combined assets and processes in some of the upstream wholesale services proposed will have implications on the ability of companies to report, meaningfully, costs at this level, requiring assumptions and judgements in allocating costs accordingly. Ofwat should be aware of the difficulties associated with operating combined sewer and sludge assets and hence its guidance should recognise and address these issues to ensure a consistent approach across the sector.

The strategies that the Company is pursuing will support the inclusion of audited upstream wholesale services in the regulatory accounts in the longer term. Meanwhile, the reporting of this information as an appendix to our regulatory

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accounts will be in some instances based on management judgement where the degree of accuracy will be reduced. This is particularly true with regard to the requirement to report, for example, highway drainage within Sewage collection and Liquor treatment within Sludge treatment, recycling and disposal.

Thames Water's costing strategy

We note that Ofwat has formalised the inclusion of accounting separation within the regulatory accounts, as a number of WaSCs, including Thames Water, have already taken advantage of information notice IN 12/01 replacing existing operating cost and fixed asset information with the accounting separation equivalents in their regulatory accounts.

Thames Water, as part of its continuous improvement programme, will from April 2013 be able to internally report direct and indirect operating costs attributable to discrete areas of activity.

This will provide more detailed granularity in reporting accounting separation information for these types of costs. However, it should be noted that, for the purposes of accounting separation reporting we will still need to allocate general and support costs based on appropriate assumptions and management judgments.

Ofwat should also be aware that whilst we have a methodology that splits assets to accounting separation units, this relies on a level of management judgment. Therefore some historic depreciation will need to be apportioned.

We do have some other observations that may be helpful to Ofwat in developing the final RAGs to be adopted.

Principles rather than prescriptive guidance

We understand Ofwat's desire to encourage companies to take ownership of its plans and financial reporting, but we believe that more prescriptive guidance on the accounting principles to be used would be beneficial for comparison purposes. This is important to enable Ofwat to have the consistency of information for comparative efficiency purposes in setting opex/capex (or totex) allowances in a price review. Equally, a more specific guidance would better enable more effective development and operation of competition within relevant elements of the value chain.

In addition, we believe that it would be beneficial if Ofwat would provide one set of guidance for the upstream wholesale service, replacing the current set of accounting services guidance, but provide detail of any changes between the two. We note that the definitions set out in the consultation document for the reporting of these services in some instances conflict with the guidance already established for accounting separation reporting. For example, costs associated with impounding reservoirs are proposed to be reported within Raw water storage, a service of the accounting separation unit Raw water distribution. These costs are currently reported in line with Ofwat's guidance for accounting separation reporting within Water resources.

Replacing the definitions of the current accounting separation wholesale business with definitions for the upstream wholesale services will overcome any current conflicts between the two.

Fixed asset reporting in business unit of principal use

We have some concerns with the approach proposed as it appears to contradict the cost allocation proposals used in the allocation of operating costs to accounting separation units. We are not convinced that the proposal of all fixed assets being recorded in the business unit of principal use and recharged to the appropriate business unit will provide any further granularity than the current allocation process.

We currently record our assets by purpose code within our fixed asset register in line with the accounting separation guidelines, with any general and support assets not specifically identified by unit, recorded within central purpose codes. These assets and depreciation costs are then subsequently allocated to the accounting separation units by appropriate defined judgemental allocation rules.

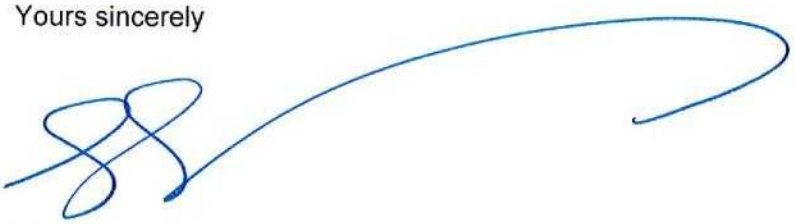
We would suggest that companies should have the option to either record assets in the unit of principal use and recharge (if they are unable to separately record data into source asset) or continue to use their current practice where it is already considered fit for purpose.

Reducing the overall data requirement

We believe that the changes proposed are broadly sensible and we support the proposals. However, we do not agree that the current proposals will reduce regulatory reporting to the extent claimed in the consultation. Companies will still be required to produce similar information to ensure data integrity and meet external audit requirements even though it may no longer need to be reported in the regulatory accounts.

In conclusion we support the requirement to provide further granularity in the upstream wholesale services both to enable the industry to continue to deliver efficiencies for customers and to support market reform. However, we have concerns as to whether the current detailed proposals will deliver these aspirations.

Yours sincerely



Stuart Siddall
Chief Financial Officer

Appendix 1 – 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?

Company response
We consider that the proposed changes are consistent with Ofwat's 'Regulatory compliance – a proportionate and targeted approach: A consultation' published in October 2011.

Thames Water Utilities Limited, in its regulatory accounts for the year ended 31 March 2012 and as it has done in previous years has not produced a separate OFR. This departure from producing a separate OFR is due to the items required to be disclosed as required by RAG 3.06 are covered within either the 'Chief Executive Business review' and 'Directors report' of the company's statutory accounts.

Additionally, the proposed changes to the regulatory financial statements do not in themselves reduce the regulatory burden as we will still need to produce a current cost balance sheet and current cost reserve statement to support the audit of the current cost statements that are disclosed. This provides audit assurance with the data integrity of the information disclosed.

We note the increased level of disclosure required regarding, revenue recognition, capitalisation policy and bad debt write offs and provisioning, which we support.

It is our view, therefore that there will be very little impact on companies regulatory accounting process and reporting.

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?

Company response
We support this proposal to remove this disclosure requirement from the RAG's as full disclosure of director's remuneration, as required by the Company's Act 2006, is provided within the statutory accounts. Thames Water did so in its Annual report and financial statements for the year ending 31 March 2012.

The removal of the need to separately disclose links between directors' pay and standards of performance, will remove any duplication between a detailed remuneration report and the regulatory requirement. Informing the reader of where information regarding the link between directors' pay and standards of performance can be found in the remuneration report is all that is required to be disclosed in the regulatory 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 1 to exempt the requirement for years that it is not needed. Is this an acceptable approach?

Company response
We believe that this is a sensible approach and support it.

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?

Company response
Our combined statutory and regulatory accounts within the Company's Annual report and financial statements are to be found on our website 'http://www.thameswater.co.uk/about-us/4229.htm'. We consider that this is the most appropriate way that this information should be reported. We do not believe that imposing a common format would add any real benefit to a process that has worked well in the past.

Accounting separation

Q5 We propose to provide companies with the principles and business unit summaries (see appendix 5 attached) 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.

Company response
We understand Ofwat's desire to encourage companies to take ownership of its plans and financial reporting, but we believe that more prescriptive guidance would be beneficial for comparison purposes. This is important to enable Ofwat to have the consistency of information for comparative efficiency purposes in setting opex/capex (or totex) allowances in a price review. Equally, a more specific guidance would better enable more effective development and operation of competition within relevant elements of the value chain.

Prescriptive guidance has been used in accounting separation reporting since companies were required to do so from 2010 and this guidance is well understood by the WaSCs. Whilst there is merit in leaving companies to determine how costs should be allocated in line with the proposed principals, comparability of data across companies may be compromised.

In addition, we believe that it would be beneficial if Ofwat would provide one set of guidance for the upstream Wholesale service, replacing the current set of accounting services guidance, but provide detail of any changes between the two. We noticed that the definitions set out in the consultation document for the reporting of these services in some instances conflict with the guidance already established for accounting separation reporting. For instance, within Raw water storage, a service of the accounting separation unit Raw water distribution, will report the costs associated with impounding reservoirs. These costs are currently reported in line with Ofwat's guidance for accounting separation reporting within Water resources.

Replacing the definitions of the current accounting separation wholesale business with definitions for the upstream wholesale services will over come any current conflicts between the two.

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.

Company response
As stated above Ofwat may wish to consider providing specific guidance where there are concerns where the choice is between contestable and non-contestable services. A good example would be allocation of general and support overheads (Human Resources, Information Systems, finance etc.) to household and non-household within Retail. Additional guidance from Ofwat would be helpful, e.g. an expected methodology of general and support cost allocation.

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?

Company response
We support this proposed treatment. However, we do have some reservations regarding service level reporting, which are discussed in answer to Q9.

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?

Company response
We have some concerns with this approach as it appears to contradict the cost allocation proposals used in the allocation of operating costs to accounting separation units. We are not convinced that the proposal of all fixed assets being recorded in the business unit of principal use and recharged to the appropriate business unit will provide any further granularity than the current allocation process.

We currently record our assets by purpose code within our fixed asset register in line with the accounting separation guidelines, with any general and support assets not specifically identified by unit, recorded within central purpose codes. These assets and depreciation are then subsequently allocated to the accounting separation units by appropriate defined allocation rules.

We would suggest that companies should have the option to either record assets in the unit of principal use and recharge (if they are unable to separately record data into source asset/depreciation data) or continue to use their current practice where it is already fit for purpose.

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

Company response
Whilst we support the need to provide greater granularity of financial information for upstream wholesale services for the Wholesale accounting separation units, we question the requirement to separately disclose operating costs to some of the services proposed.

The use of combined assets and processes in some of the upstream wholesale services proposed will have implications on the ability of companies to report costs at this level, requiring assumptions in attributing costs accordingly. Ofwat should be aware of the difficulties associated with operating combined sewer and sludge assets and hence its guidance should recognise and address these issues to ensure a consistent approach across the sector.

You will recall that we provided estimates of costs to support the reporting of accounting separation down to service level, providing you with high level estimates in November 2011 and expressing our concerns to the level of accuracy of service level reporting. Since then, we have been investigating various strategies that would support reporting to service level. These strategies will support the inclusion of audited service level reporting in the longer term. Meanwhile, the reporting of service level information as an appendix to our regulatory accounts will be in some instances based on management judgement where the degree of accuracy will be reduced. This is particularly true with regards to the requirement to report for example highway drainage within Sewage collection and Liquor treatment within Sludge treatment, recycling and disposal.