Dear Rob,

Consultation on changes to the regulatory accounting guidelines

A response from Yorkshire Water

We are pleased to offer our response to the above consultation.

We agree with and support Ofwat’s intention to review the regulatory accounts and ensure they are fit for purpose and reflect changes in the regulatory and accounting environment. In order to answer the question of whether the regulatory accounts are fit for purpose it is important to understand how the current cost accounts will be used in AMP6 and beyond.

Two areas in particular which we would like to draw your attention to are raised below as we do not feel they are addressed by any of the specific questions you raised.

Trial of cost allocation to upstream services

As part of the Regulatory Accounts Working Group, we have been working with Ofwat in a pilot over the summer of 2012 to recut the accounting separation return at 31 March 2012 into 15 new service areas.

As a result of the significant difficulty ourselves and other companies have met identifying suitable cost drivers for some service areas (namely the split of water distribution into trunk main and local and the split of sewage collection into foul, surface water and highway drainage), we do not feel it is appropriate to include this cost allocation as an unaudited appendix to the 2012/13 regulatory accounts or elsewhere in the public domain for the following reasons:

- The industry has yet to establish a bottom up methodology for allocating costs into the sub-splits mentioned above. Any potential methodologies would take a minimum of two years before meaningful allocation data could be obtained. I.e. if a decision was made to capture flow data, or the work management system was redesigned to capture data in a different way there would be a period of time to set up a new system followed by a year of capturing data before a split of costs could be provided.
- The new sewerage categorisations do not reflect the type of assets held and therefore agreement would be needed throughout the industry on how to treat these
assets. E.g. a proportion of our sewerage assets are categorised as “combined” and
do not relate to one sewage collection category more than another.
- Any data provided over the next two years in these more complex areas of allocation
will not provide robust information but reflect a top down allocation only. If this data
was publicly available, in particular as part of the regulatory accounts, we do not
believe users of the accounts would fully understand the differing levels of certainty
and may place undue reliance on them.
- When accounting separation was initially introduced it was not included within the
regulatory accounts until processes to capture the data were well enough
established. We believe the same approach should be taken now.

Transition to International Financial Reporting Standards (IFRS)
As you state in the consultation document, it is likely that in two years' time the regulatory
accounting guidelines (RAGs) will need to be reviewed again to take account of alignment of
current UK accounting standards with IFRS. Completing two consultations in two years on
this subject of RAGs may, for Ofwat, be a diversion at a key time in the Price Review
process.

The transition to IFRS will change the accounting treatment of certain items, reclassifying
costs between operating costs, interest and capital. In addition, it is expected that there will
be greater inconsistency in accounting treatment throughout the industry as a result of
conversion. Ofwat has an opportunity at this point to review how it uses the regulatory
accounts and what it would like to see in them. RAGs can then be written to reconcile
between statutory accounts and regulatory accounts.

One other matter to consider is that as we move towards totex, in whatever form that takes,
the industry must become accustomed to the regulatory accounts diverging from statutory
reporting. We would suggest this is considered when reviewing the RAGs.

If the regulatory accounts are required to compare actual company performance with that
anticipated at the time of price setting, the RAGs must take account of the accounting
standards under which the statutory accounts are produced.

In addition to the above comments, please find attached to this letter our position on the
specific questions raised in the consultation document.

In conclusion, Yorkshire Water agrees that the regulatory accounts should be reviewed to
ensure they are fit for purpose. Our concerns are around the speed at which Ofwat wishes
to include the proposed new accounting separation categories into publicly available data
and we would urge Ofwat to take account of the timing of IFRS.

Yours sincerely,

Liz Barber
Director of Finance and Regulation
Responses to specific 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 additional requirements we need?

Overall disclosure requirements have increased compared to the existing requirements. Companies will still produce the information required for the current cost balance sheet in order to report the current cost cashflow, fixed asset note and working capital note.

In addition, the proposed removal of the OFR is replaced by the additional information proposed on revenue performance, debt write off performance and the accounting separation commentary covering year on year cost movements.

We consider that disclosure requirements could be reduced by removing the requirement to include the accounting separation methodology statement. The purpose of the regulatory accounts is to report financial performance in accordance with a consistent set of regulatory accounting guidelines. If companies are following the prescribed principles of cost allocation there should be no need for lengthy procedural information in a set of publicly available accounts.

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?

As the requirement to publish this information has not changed, we are happy to continue including it within 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 to exempt the requirement for years that it is not needed. Is this an acceptable approach?

We believe Ofwat should request this information as and when 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?

Yorkshire Water’s regulatory accounts are currently published as a pdf document. However, we would be happy to consider other formats if required. We would not support moving to an iXBRL format at this point in time due to the expectation that the regulatory accounting requirements will continue to change over the next couple
of years with the introduction of international financial reporting standards and iXBRL tagging could be time consuming and expensive.

**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 support adopting a principles based approach and believe there would be no significant impact from adopting this approach compared to the current more prescriptive guidance that is followed.

**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.

Following a principles based approach, we are not aware of any allocations that would be inappropriately applied.

However, with the proposed increase in accounting separation services to 15 from 9, the split of water distribution between trunk and local and the split of sewerage services into foul, surface water and highway presents a higher risk of inconsistency between companies and less robust cost allocation. Data is not currently captured in a way to allow these allocations to be made, especially in the area of sewerage, where one sewer can transport different sources of waste water.

**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?

Yes, we are happy to support this approach.

**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 have no concerns with recording water and waste assets in the business unit of principal use, however this does present difficulties with G&S assets such as IT systems which do not have one principal use. To allocate these assets would introduce inconsistency into the methodology. We do not feel that one answer is significantly preferential to another.
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?

Cost allocation into the additional service areas would currently be dependent upon management estimates and spread sheet allocations. This method may produce a suitably material cost allocation for historic data but we would not be able to produce business plan or forecast data in this way.

In order to collect the data at the correct level of detail in the financial ledger for a longer term solution, cost centre structures would need to be rebuilt, with the addition of an estimated 900 additional cost centres. There would also be the challenge of ensuring there were suitable processes in place to help colleagues select the correct cost centre from a significantly increased selection for any job. We have provided further detail on our ability to allocate costs into these additional categories as part of the Regulatory Accounts Working Group trial.

The forecast of what incremental costs would be incurred would be dependent on the final service areas to be included. For example if we were required to split sewerage into foul, surface water and highway incremental costs could be significant and could cover the following:

- New assets to collect flow data throughout the region;
- Re-design of financial hierarchies;
- Re-design of work management systems to ensure costs are captured appropriately into new categories;
- Significant staff training to ensure new work management system and cost hierarchies are understood and used appropriately.

The actual costs incurred would depend on the final data capture solution selected.