

March 2016

Trust in water

Consultation on regulatory reporting

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About this document

This consultation concerns proposed changes to the reporting requirements for the Annual Performance Report which are effective for the 2016-17 reporting year.

The proposed changes draw upon feedback and learning from the initial implementation of 2015-16 reporting by companies, a targeted review of costs and revenue allocation for sludge and water resources activities and feedback from wider stakeholders.

Information in the regulatory accounts inevitably has strong links to our forward looking work areas - notably our Water 2020 project. We discuss the longer term outlook for reporting and the potential impacts of such policy developments. However we are only consulting on the specific changes proposed for 2016-17 in this document. We invite comments from all stakeholders and users of the Annual Performance Report.

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Responding to this consultation

We would welcome any comments on this document. Please email them to regulatory.accounts@ofwat.gsi.gov.uk or post them to:

Regulatory reporting consultation response
Ofwat, Centre City Tower
7 Hill Street
Birmingham
B5 4UA.

The closing date for this consultation is **22 June 2016**. We will publish responses to this consultation on our website at www.ofwat.gov.uk, unless you indicate that you would like your response to remain unpublished.

Information provided in response to this consultation, including personal information, may be published or disclosed in accordance with access to information legislation – primarily the Freedom of Information Act 2000 (FoIA), the Data Protection Act 1998 and the Environmental Information Regulations 2004. If you would like the information that you provide to be treated as confidential, please be aware that, under the FoIA, there is a statutory ‘Code of Practice’ which deals, among other things, with obligations of confidence.

In view of this, it would be helpful if you could explain to us why you regard the information you have provided as confidential. If we receive a request for disclosure of the information we will take full account of your explanation, but we cannot give an assurance that we can maintain confidentiality in all circumstances. An automatic confidentiality disclaimer generated by your IT system will not, of itself, be regarded as binding on Ofwat.

Executive summary

Background

Our shared vision for the water sector in England and Wales is one where customers, the environment and wider society have trust and confidence in water and wastewater services, reflecting the vital nature of these public services. We want the companies that provide these services to be accountable to their customers for delivering the services they need and want at a price they can afford.

We expect companies to report on their performance directly to customers and other stakeholders (including Ofwat) and engage effectively with their customers to find out what they want to see. Having information that is easy to understand and navigate provides transparency and helps everyone build trust and confidence in the sector. Information forms the basis for conversations so that water companies can listen to their customers and other stakeholders and deliver the outcomes they, the environment and wider society want.

We want companies to explain their performance and their leading indicators of risk. Companies should decide how they report on their performance each year. But we also expect companies to publish some common content in an annual performance report – this is important as it allows customers and stakeholders to compare the performance of individual companies to the rest of the sector, and sets out a minimum we would expect companies to report on.

The changes proposed in this consultation document clarify the common content necessary to compare performance. They also help improve the clarity and increase the consistency of reporting in relation to sludge and water resources. These are the areas which we identified in [Water 2020: Regulatory framework for wholesale markets and the 2019 price review](#) as being ones where there is most scope to make a greater use of markets to help us deliver more for less.

Key messages

- Our proposals are intended to apply to reporting for the 2016-17 year. We also discuss and invite views on future developments in reporting, related to policy development.
- Our recent targeted review of sludge and water resources has also resulted in some further clarification and additional guidance.
- The core of this consultation is about making minor corrections and clarifications to the existing requirements. These have developed as companies have learnt from implementing 2015-16 reporting and are as a result of dialogue with us.
- Other policy developments, such as the Financial Monitoring Framework (FMF) and the Abstraction Incentive Mechanism (AIM), now have associated data requests which have been included in the proposed tables.
- In other areas we have invited views on proposals made by wider stakeholders for more data to aid transparency.

In terms of the regulatory accounts and the Regulatory Accounting Guidelines (RAGs), there are two types of changes that we discuss in this document:

- Proposals to refine/ improve the existing RAGs (based on the existing definitions of the sludge and water resources boundaries).
- Policy dependent changes to reporting that could potentially arise following our Water 2020 decision document in May.

Regarding the first, we have focused on the existing reporting requirements for sludge and water resources – looking to improve clarity and increase the consistency of reporting across companies. We recognise that the development of reporting requirements is closely linked to our approach to the next price review in 2019 (PR19). In particular, given that we have proposed separate price controls for sludge and water resources, we have focused on these areas. Between December and February, we carried out a targeted review (with the help of Cambridge Economic Policy Associates (CEPA)) on reporting in these areas. Many of our proposed changes come out of this. However, we also recognise that our proposals are based on existing arrangements and that following publication of the Water 2020 decision document we may potentially need to revisit and revise some of our proposals.

Regarding the second, we have outlined and discuss some of the potential changes in reporting that we may require, as a result of policy development around Water 2020. We welcome stakeholder views on these. Following the May decision document, we will consider whether we need to make further proposals about the

Annual Performance Report and reporting for 2016-17. Should we need to propose further changes we will consult on these in the summer for a 4 week consultation period. This is shorter than normal. However, we believe that this is proportionate, given that we are communicating changes to the RAGs well in advance and carrying out wider engagement on Water 2020.

This consultation will run for 12 weeks from 30 March 2016. It is focused on specific changes to RAGs 1-4 rather than any proposals for PR19. But the timing means that respondents will have the opportunity to consider the forward looking policy proposals from the Water 2020 decision document, at the same time as the reporting proposals in this consultation. We plan to publish the finalised RAGs in September 2016.

Timeline	
30 March	Launch RAG consultation
May	Publish Water 2020 decision document
22 June	RAG consultation closes
15 July	Deadline for 2015-16 Annual Performance Report
August/September	Consult on any further changes to RAGs (4 weeks)
September	Publish: <ul style="list-style-type: none"> • Information notice; • summary of responses; and • finalised RAGs

Questions for consultation

Throughout this consultation, we raise a number of specific questions, which we have summarised here. As well as responses to these specific questions, we welcome views from stakeholders on any of the issues and matters we raise in this document.

Questions relating to 2016-17 reporting

The RAGs and Tables referred to below are contained in Appendix 1.

Q1	What are your views on the content and format of the proposed tables in Appendix 1?
Q2	Do you have any views on the revised guidance in RAG1 which is intended to assist completion of pro forma table 4G?
Q3	<p>RAG2 consists of a mixture of high level principles and detailed guidance for cost reporting;</p> <ul style="list-style-type: none"> • Q3a Is the balance of principles and rules appropriate? • Q3b Are there areas where more principles should be provided? • Q3c Are there areas where more guidance should be provided?
Q4	RAG2 suggests that a common method for calculating returned sludge liquors should be implemented. Do you have any observations on the approach suggested and any suggestions for a common formula?
Q5	In RAG2 we have set out how energy costs and savings from sludge processes should be treated – do you have any views on this approach?
Q6	In RAG2 we have set out how imported potable bulk supplies should be treated – do you have any views on this approach?
Q7	In RAG3 we have clarified our expectations for reporting transactions with associates and the non-appointed business. Do you have any comments on these?

Q8	Our intention is to include the metrics for the Financial monitoring framework and site data for the Abstraction Incentive Mechanism (AIM) in the Annual Performance Report. Do you agree with this approach?
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Questions relating to future reporting

Q9	Should the Annual Performance Report contain more transparency over metering assets and installation and maintenance costs from 2017?
Q10	Ofwat is working with the sector to develop new charging rules covering activities such as connection charges, infrastructure charges and other contributions from third parties. Should the Annual Performance Report contain more detailed cost information on new connections and other costs associated with these charges?

1. Introduction

In our document [Consultation on regulatory reporting](#) (September 2014) we stated that the Annual Performance Report would have to be flexible so that we could make updates as required. Updates would be driven by changes in policy objectives driven by Ofwat's wider strategy or from feedback from interested stakeholders.

Since that consultation we also consulted in July 2015 in [Consultation on financial monitoring framework](#) which set out how we will monitor the financial stability of the sector. The purpose of this is to enhance visibility and transparency of company financing to ensure stakeholders can maintain trust and confidence in the sector.

In December 2015 we engaged CEPA to lead a targeted review focusing on sludge and water resources cost reporting. The scope of work has covered the water and sewerage companies (WaSCs) because they are involved in both of the activities that CEPA have studied. The water only companies (WoCs) may face similar issues in respect of water resources, they will have an opportunity now to respond to the proposals in this consultation. In addition we will be meeting them all individually in April-May 2016.

CEPA identified issues in the review and these have driven the proposed changes to the RAGs for this consultation, particularly in RAG2. These changes to the guidance and all of the changes to the Annual Performance Report reporting are effective for the 2016-17 reporting year. Final guidance will be issued in September 2016.

We have continued to engage through our Regulatory Accounts Working Group (RAWG) in 2015 and earlier this month. We have shared most of the changes proposed with the group in advance and have taken into account some of the comments from that group. This has included views on our prospective changes for additional data arising from our Water 2020 project.

This consultation will run for 12 weeks from 30 March 2016 to 22 June 2016. It is focused on the specific changes to RAGs 1-4 rather than any proposals for price setting. But the timing means that respondents will have the opportunity to consider the forward looking proposals from the Water 2020 decision document at the same time as the proposals in this consultation.

We will consult further in the summer on any changes needed to the RAGs which arise as a result of our Water 2020 policy work. We will do this over a shorter, 4 week period before publishing the finalised RAGs in September 2016. This is a

shorter period than we would normally consult on. However the wider engagement on Water 2020 both before and after the May decision document means that the background to any of the changes to the RAGs will have been communicated well in advance.

2. Annual updates to reporting requirements

Since we last revised the RAGs we have received some queries from companies as to how the RAGs should be interpreted. This has in particular meant that minor clarifications and corrections have been needed to the line definitions in RAG4 – Guideline for the table definitions in the annual performance report (RAG4). Following these changes companies will be able to follow the guidance consistently. We are grateful to companies for raising these issues with us as they are in many ways best placed to understand the practical applications of any financial reporting requirements.

Our only change proposed to RAG1 – Principles and guidelines for regulatory reporting under the new 'UKGAAP' regime (RAG1) is as a result of queries to the current cost table (pro forma 4G). Our intention is that this table should show current cost results at a high level only. We acknowledge that companies will no longer be following renewals accounting as a result of changes in UKGAAP. Our guidance will allow a simplified approach to completing this table to make it as straight forward as possible.

Finally we have been asked to clarify our expectations for reporting transactions with associates. This followed concerns that some companies were providing insufficiently granular information compared with that intended by the RAGs. Our clarifications should now make this clear.

3. Proposed updates from the targeted review

3.1 Background to accounting separation

Accounting separation was a first step towards developing a better understanding of company activities and costs across the value chain. Two of the business units we identified as part of accounting separation were the water resources and sludge business units.

As we further evolve our approach to regulation we are moving towards a more market based approach. Our proposals for PR19 include separate price controls for sludge and water resources. If we were to model costs and revenues and set prices for separate controls, we would need good quality data in 2016-17 and 2017-18. Consistency of cost information across companies and alignment with our policy proposals is key to us being able to set prices. Although companies have been reporting their accounting separation data, including costs for water resources and sludge, in their regulatory accounts for several years we need to now further refine this area.

3.2 The scope of the targeted review

We identified a number of areas to look at in more detail in order to address the issues introduced above. These were:

- Sludge revenues and non-appointed income
- Sludge related activities outside the price control
- Reporting of costs – sludge and water resources
- Interaction with non-appointed businesses
- The challenges in calculating MEAV valuations (and the 2009 revaluation)

We engaged CEPA to lead a targeted review of these areas. CEPA issued a standard questionnaire to all 10 WaSCs and followed this up with a one day visit to each WaSC. Following these meetings, the questionnaire responses were initially revised by CEPA to reflect its understanding of the discussions and then by each WaSC to confirm the responses and make further additions.

The scope of work has covered the WaSCs because they are involved in both sludge and water resources. The Water only Companies (WoCs) may face similar issues in respect of water resources.

3.3 CEPA high-level findings

CEPA identified a high-level summary¹ of the issues identified by the review which we have reproduced in Appendix 4. We summarise below some of the findings identified by topic area specified in our instructions to them:

Area investigated	Examples of findings
Sludge revenues and non-appointed income	A minority of companies share the external revenues from power sales with the sewage treatment business unit rather than recognising this in sludge treatment.
Sludge related activities outside the price control	Some companies were treating income from treatment of tankered waste as appointed rather than non-appointed.
Reporting of costs – sludge and water resources	Some companies choice of cost drivers do not seem to be the most appropriate available, for instance regarding allocation of local authority rates.
Interaction with non-appointed businesses	Not all companies were fully recharging costs relating to the non-appointed businesses use of appointed assets.
The challenges in calculating MEAV valuations (and the 2009 revaluation)	Companies had adopted different approaches to the calculation in 2009. This could be whether there is an assumption that the modern equivalent asset is built on an existing or greenfield site, whether the latest technology is always considered (e.g. advanced anaerobic digestion for sludge) or how economies of scale should be incorporated into the costs. There was also recognition that some large assets, such as reservoirs, are difficult to value as no recent comparator information exists.

3.4 CEPA detailed changes - overview

CEPA made 44 observations and proposed 32 changes in all, 13 relating to water resources and 19 for sludge.

¹ See Executive Summary of the CEPA report in our website under “Findings”.

	CEPA	OFWAT	
Water resources		Change accepted	Change rejected
RAG2 change required	8	6	2
RAG4 change required	5	5	0
Total changes required	13	11	2
Observations (no change)	6		
Total	19		
Sludge		Change accepted	Change rejected
RAG2 change required	14	10	4
RAG4 change required	5	4	1
Total changes required	19	14	5
Observations (no change)	6		
Total	25		

We propose to accept the vast majority of CEPA’s proposed changes to the RAGs. Our response to each is set out in appendix 3. CEPA observed and commented on 12 further areas but did not recommend any changes be made to the RAGs in respect of these.

3.5 CEPA detailed changes – RAG2

CEPA proposed 22 changes to RAG2 – Guideline for classification of costs across the price controls (RAG2), we have accepted 16 of these. Appendix 3 shows the analysis of the changes required for each RAG. For RAG2 this has meant that we have, for the first time in some areas, provided guidance on cost drivers to be used. This is because CEPA identified inconsistencies in the way companies were approaching the existing reporting requirements. There were some areas, particularly in the sludge business, where some quite wide variations in accounting for costs and revenues were identified. There were also differences in the classification of assets around the boundary point with sewage treatment.

Prescription versus innovation in reporting

Inevitably there is a potential trade-off between innovations that companies may have in terms of their own methods of allocating costs and prescriptive techniques in the RAGs. After all the companies legitimately have different circumstances which may mean that one cost driver may be more cost reflective for one particular company but less for another.

However by proposing more prescriptive cost drivers in some areas we can encourage more consistency in reporting across all companies. This brings benefits as it allows stakeholders to be confident that information is being reported across the industry on a consistent basis. This is critical where a comparative regime is used for price control purposes. It also facilitates more consistent assurance processes, further building confidence in the reported information.

We are proposing to mandate cost drivers in particular areas and these are set out in RAG2. We think that the benefit of prescription in the reporting rules outweighs the loss of innovation that may be demonstrated by some companies.

Our current release of RAG2 is restrictive in terms of the price control units which it describes. We propose to rationalise the text so that RAG2 describes more generally how separate price control units should be identified and reported, rather than referring to the existing four controls. This makes it more adaptable to changes in the number of price control units which may follow as our PR19 policy develops. So if the number of price controls changes, we can more easily modify tables in section 2 of the Annual Performance Report to accommodate these units and have the high level cost recognition rules in place in RAG2 to deal with them.

The importance of the accounting separation methodology statement

The accounting separation methodology statement should provide relatively detailed information on the methodology that companies have applied to the attribution and allocation of revenues and costs between business segments. This includes providing basic details on cost drivers and the implications of any changes in the current methodology for consistency of reporting with earlier periods. Companies are required to publish this statement and keep it up to date. We expect that as a result of our proposals on the RAGs most companies will need to revisit their methodology statements to ensure that they are compliant with the more prescriptive cost allocation rules in RAG2.

The level of detail included in companies' methodology statements is left to individual companies to determine but is based on a general requirement for there to be enough detail to enable users to understand how the companies have prepared the separated accounts. This will include:

- cost allocation bases (cost drivers) and any changes year on year,
- a breakdown of the recharges paid to and received from other business units for the use of fixed assets;
- significant changes in cost types in the year; and
- details of processes and systems and any changes year on year.

3.6 CEPA detailed changes: RAG4 – Guidelines for the table definitions in the annual performance report

The CEPA report suggested 10 changes to the definitions in RAG4, five each for water and wastewater. In general, these changes were needed as the current RAGs did not address certain processes within the companies' water resources or sludge operations. The changes to the wording of the RAGs are small, but even so the impact of them could be significant in monetary terms. For example CEPA estimates that misallocated reservoirs represented around 16% of the total water resources 'gross modern equivalent asset value' (GMEAV).

The areas where changes were proposed are, for water:

- Reservoirs and abstraction licences
- Wholly compensating reservoirs
- Aquifer recharge schemes
- Recognition of blending processes
- Bulk supply definitions

For wastewater:

- Power generation – treatment of external revenues
- Power generation - cost sharing
- Costs of liquors returned to sewage treatment works from sludge treatment centres
- Treating waste from other WaSCs
- Boundary issues, particularly regarding sludge holding tanks

We hope that the changes proposed will reduce ambiguity in the future, in areas where it appears costs are currently being treated differently by different companies. This should ensure consistency in reporting which means cost information will be more comparable across companies and better understood.

As for the RAG2 changes explained above, the benefit of these clarifications will be that they allow stakeholders to be confident that information is being reported across the industry on a consistent basis.

3.7 CEPA – MEAV discussion

For completeness, we refer briefly to the preliminary work that CEPA carried out regarding modern equivalent asset valuations (MEAVs). This work was merely preparatory and therefore has not led to any proposals here to change or require additional reporting for the 2016-17 year.

Any requirement to perform a MEA valuation would follow policy development in the Water 2020 project. The May decision document will provide a further update.

4. Additional information required resulting from recent policy decisions

4.1 Financial Monitoring Framework

In July 2015 we consulted on our proposals for a financial monitoring framework and following that consultation we set out a set of financial metrics which measure financial stability. These metrics have already been incorporated into the Annual Performance Report for 2015-16 and guidance has been issued for this.

The July 2015 consultation contained proposals that set out how companies should demonstrate that they are financially resilient over the longer term. Some objections to this were raised in the responses to the consultation. Following a review of the issues raised by respondents to that consultation and after discussions with companies and others we revised our proposals and issued a further consultation on how companies should demonstrate long term financial resilience in January 2016.

The revised proposals set out how we would like all water companies to use the requirements of the 2014 Corporate Governance code. This requires premium listed companies² to include a statement about their long term financial viability in their statutory accounts. In addition to this, we proposed that companies provide us with assurance that their Boards have made an appropriate assessment of the company's financial viability and the basis on which they have made their assessment.

We have reviewed [the responses to the January 2016 consultation](#) and have published [IN 16/03 'Expectations for companies demonstrating long term financial resilience'](#), which sets out how we expect companies to demonstrate that they are financially viable over the longer term. The first year that this requirement will apply is 2015-16.

² Defined as follows in the UK listing rules; "A Premium Listing is only available to equity shares issued by trading companies and closed and open-ended investment entities. Issuers with a Premium Listing are required to meet the UK's super-equivalent rules which are higher than the EU minimum requirements. A Premium Listing means the company is expected to meet the UK's highest standards of regulation and corporate governance – and as a consequence may enjoy a lower cost of capital through greater transparency and through building investor confidence."

4.2 Abstraction Incentive Mechanism

The abstraction incentive mechanism (AIM) has the objective of encouraging water companies to reduce the environmental impact of abstracting water at environmentally sensitive sites when water is scarce. The AIM will start in reputational form from 1 April 2016. A sector taskforce developed a proposal for the AIM in July 2015. We consulted on the taskforce's proposal from November 2015 to January 2016 alongside our additional proposal for reporting on the AIM. We issued guidelines for the AIM on 29 February 2016. The guidelines set out the process by which companies should agree their AIM sites, trigger points and baselines with their local stakeholders. The guidelines have proposed that companies will report their AIM performance in the Annual Performance Report (pro forma 3B). We are not requiring five companies to report on the AIM: South West Water, Dŵr Cymru, Bristol Water, Dee Valley Water and Bournemouth Water because the environmental information we currently have does not suggest there is a need for them to do so.

5. Potential future changes to reflect future policy development

5.1 PR19 disaggregated price controls

- We will publish our Water 2020 decision document for PR19 in May 2016.
- Our work on Water 2020 has a clear overlap with the regulatory reporting requirements we are current consulting on in this document. Therefore it is possible that we may need to make further changes to the data we collect. If we make further changes to the Annual Performance Report requirements for 2016-17 in this respect we will consult further over August and September.
- Within the Water 2020 project we are considering the possibility of further separation of the price controls;

Sludge	In our December Water 2020 consultation our preferred approach was a separate binding price control for sludge activities, which would include treatment and recycling/disposal activities and may also include transport. We are considering carefully where the boundary between sewage treatment and sludge should be, which may mean a future change to the current accounting separation definitions for some assets or activities. We are also considering whether the Annual Performance Report can be used to collect more detailed information about sludge activities to help us with price setting for a separate sludge price control in PR19
Water resources	In our December Water 2020 consultation our preferred approach was for a separate binding control for water resources. We proposed to base this control on the existing accounting separation definition. We are considering carefully whether the existing water resources boundary is appropriate, which may mean a future change to the current accounting separation definitions for some assets or activities. We are also considering whether the Annual Performance Report can be used to collect more detailed information about water resources activities to help us with price setting for a separate water resources price control in PR19.

5.2 Boundaries

Our clarifications on the boundary points in RAG4 have arisen solely from the CEPA work, which was focused on the existing reporting and boundary definitions. Whilst this clarifies the current regulatory accounting boundary, the precise scope of any new price control areas will form part of the discussion, as well as decisions leading up to the final PR19 methodology. Therefore the definitions currently in the RAGs may need to be changed in the future.

5.3 Water resources - Access pricing

The Water Act 2014 envisaged that further extension of upstream markets would require effective access prices. We have proposed in our Water 2020 consultation documents to implement access pricing for water resources. Access pricing may, in turn require companies to hold and possibly report more location specific cost information in order to calculate and demonstrate cost reflective prices. So for water resources, we may, for instance, require companies to break down costs into water resource zones³.

5.4 Sludge – information platform

Our proposal for an information platform in our December Water 2020 consultation may mean that we require data on volumes of sludge produced at sewage treatment works and on costs for individual sludge treatment centre sites in the future.

5.5 Data for cost assessment

Cost assessment is an extremely important and material component of price reviews. We have said that we will continue to apply benchmarking to assess the efficient level of costs and to help protect the interests of customers.

In 2015 we discussed our initial thoughts on cost assessment data requirements with the RAWG. Since then we have established a cost assessment data working group. A data set has been proposed and the group is currently discussing the proposed data set.

The reporting requirements for the 2015-16 Annual Performance Report did not include any specific cost assessment data requirements. However one of the aims

³ Water Resource Zones are defined in companies' Water Resource Management Plans (WRMPs). Typically, water resource costs may vary significantly between different zones for a company.

of the Annual Performance Report was that it would provide flexibility in reporting, especially with respect to Section 4.

We are currently planning to collect historic data for 2015-16 outside of the Annual Performance Report process. We will be collecting this data in August 2016.

Feedback from the group suggests that there is broad support for inclusion of future cost assessment data in the APR. Therefore we propose to collect future data (from 2016-17 onwards) in Section 4 of the Annual Performance Report. We have included examples of the information we may collect in Appendix 2.

5.6 MEAVs and any potential revaluation

Our targeted review and CEPA's work included considering MEAVs. We have also discussed this briefly above at Section 3.7.

Further policy development in this area may potentially lead to changes to reporting in future. We will consider this further after the Water 2020 decision document in May.

5.7 Other topics

5.7.1 Information to support the retail market for Business, Charities and Public Sector Organisations in England

From 3 April 2017, all business, charities and public sector organisation (referred to here as 'business') customers in England will be able to switch their retail supplier. Open Water is a programme of work that brings together all of the key organisations to design and deliver the new market by April 2017. Part of the enabling market architecture is a draft Code that governs interactions in the market between wholesalers and retailers, including those in relation to metering arrangements. This draft Wholesale-Retail Code (WRC) can be found on the [Open Water website](#).

Following the opening of the non-household retail market in Scotland in 2008, the Water Industry Commission of Scotland (WICS) initiated some changes to the Scottish market framework and codes to support greater innovation and efficiency in the provision of metering and other services; by allowing certain accredited third parties to provide these wholesale services on behalf of Scottish Water. Information on these changes can be found on WICS' [website](#).

The Business Terms (part 2) of the WRC for the business retail market in England set out the proposed framework for governing these interactions between wholesalers and retailers and the detailed 'Code Subsidiary Documents' (CSDs) provide more detailed process steps. The Operational Terms (part 3) of the WRC allow an 'accredited entity' to provide certain wholesale activities on behalf of the appointee, including for example new connections, trade effluent sampling and analytical services and metering activities. Various processes further define how the new arrangements could work. Schedule 1A and B of the Business Terms in the WRC also includes some information about how these arrangements could operate. The arrangements in the codes largely mirror the revised arrangements in the Scottish market.

'To support the implementation of the codes on accredited entities, we are seeking your views on whether we should collect more disaggregated information on some of these activities, including the installation cost and capital cost of metering assets as well as the associated maintenance costs. This could improve the transparency of the costs of these activities and, alongside other information, help us to understand how well these arrangements were working.

We are keen to hear views about whether Ofwat should be collecting this information. At this stage we are simply seeking early views and do not expect to introduce further reporting requirements for 2016-17. This is because any new arrangements will not be in place before the retail market opens in April 2017 and so data collection would only commence at that point.

5.7.2 New connections

Ofwat is working with the sector on developing new charging rules covering a range of activities undertaken by regulated water companies. They include rules covering charges for connections, infrastructure charges and associated contributions from developers and other customers.

We included changes in the Annual Performance Report for 2015-16 which gave greater transparency over the income generated in this area. This is key to understanding the actual receipts compared with that assumed in the PR14 final determination. In particular it allows interested parties to reconcile the statutory treatment to the cash receipts.

We have received some feedback from some stakeholders requesting additional transparency of the costs and the basis of the charges which companies make when providing new connections.

Splitting charges for such specific services into their key components could improve customer understanding and help to strengthen levels of companies' service commitments. More granular cost information might reveal differences between companies and promote the effective operation of relevant competitive markets.

We are interested in understanding stakeholders' views on such increased transparency and reporting.

6. Next steps

We are seeking comments on the proposals in this document by **22 June 2016**.

Before and after this date, we intend to continue to engage and consult with companies and other stakeholders.

After the conclusion of this consultation we will consider the responses. We will also consider feedback from our Water 2020 decision document which will be published in May.

Following on from these developments, if we need to propose further changes we will issue a short consultation during the summer and consider the responses. In September we plan to publish a technical information notice along with a finalised version of the RAGs.

Timeline	
May	Publish Water 2020 decision document
22 June	RAG consultation closes
15 July	Deadline for 2015-16 Annual Performance Report
August/September	Consult (if needed) on any further changes to RAGs (4 weeks)
September	Publish: <ul style="list-style-type: none"> • Information notice; • summary of responses; and • finalised RAGs.

Appendix 1: Proposed regulatory accounting guidelines

The links below are for the proposed RAGs:

[RAG 1.07 Principles and guidelines for regulatory reporting under the 'new UK GAAP' regime](#)

[RAG 2.06 Guideline for classification of costs across the price controls](#)

[RAG 3.09 Guideline for the format and disclosures for the annual performance report \(excludes tables – see link to excel document below\)](#)

[RAG 4.06 Guideline for the table definitions in the annual performance report](#)

[Pro forma tables \(Excel format\)](#)

Appendix 2: Cost assessment data (examples of the information that we may collect)

We provide below some examples of the type of information that we may require to be reported in the Annual Performance Report. This list is not exhaustive.

Ofwat is working with companies via the cost assessment working group to develop a full set of data. If we do have a further consultation on the RAGs in the summer, we will include more specific proposals.

Water examples

Data description	Existing line definitions
Capital expenditure by purpose - Water total	
Making ecological improvements at abstractions (habitats directive, SSSI, BAPs)	Capital expenditure to deliver environmental investigations, carry out options appraisals and implementation of projects required to deal with the environmental impact of water abstraction during the report year. [Refers to expenditure to deliver the outputs included in the water quality enhancement schedule (annex 4 of the company supplementary report 2009) or amendments confirmed at an interim determination of prices for environmental investigations, options appraisals and the implementation of projects (PR09 driver codes Hw 1-3, lw1-3, BAPw1, Wfw1-3, Lw1-3).]
Addressing low pressure	Capital expenditure to reduce the number of properties with low pressure. [Refers to expenditure to deliver outputs with PR09 driver code ESL01 Step change in service to consumers - infrastructure].
Improving taste / odour / colour	Capital expenditure to deliver improvements to consumer acceptability of the drinking water (relating to colour, taste and odour) [Refers to expenditure to deliver outputs related to reducing customer contacts in relation to discolouration (PR09 driver code 5WA11) under quality enhancement and taste and odour (PR09 driver code ESL01) under enhanced service levels.]
Meeting lead standards	Capital expenditure to meet lead standards. This includes expenditure to deal with the conditioning of water before entering distribution to reduce plumbosolvency, expenditure on replacing lead communication pipes owned by the company and any other lead related work including investigations. [Refers to expenditure to deliver the outputs included in the water quality enhancement schedule (annex 4 of the company supplementary report 2009) covered by PR09 driver codes 5WA2 and 5WA10].

<p>Enhancements to the supply / demand balance (dry year critical / peak conditions)</p>	<p>Capital expenditure to enhance the supply / demand balance. Includes expenditure associated with schemes to deliver supply side (resource and production options) and demand side (distribution and customer options) enhancements to supply demand capacity in dry year critical / peak conditions. [Refers to expenditure to maintain or enhance the supply demand balance as covered by PR09 driver codes SDB1 through to SDB19 with the exception of SDB7 and SDB8 for new development]</p>
<p>Enhancements to the supply / demand balance (dry year annual average conditions)</p>	<p>Capital expenditure to enhance the supply / demand balance. Includes expenditure associated with schemes to deliver supply side (resource and production options) and demand side (distribution and customer options) enhancements to supply demand capacity in dry year annual average conditions. [Refers to expenditure to maintain or enhance the supply demand balance as covered by PR09 driver codes SDB1 through to SDB19 with the exception of SDB7 and SDB8 for new development]</p>
<p>New developments</p>	<p>Capital expenditure associated with the provision of local distribution infrastructure and non-infrastructure assets for water service to provide for new customers with no net deterioration of existing levels of service. The capital cost of connecting a new property (including the cost of a meter, communication pipe and boundary stop tap valve etc) should be recovered through the connection charge and should not be included in this line. [Refers to expenditure to maintain the supply demand balance as covered by PR09 driver codes SDB07 and SDB08]</p>
<p>Investment to address raw water deterioration (THM, nitrates, Crypto, pesticides, others)</p>	<p>Capital expenditure to address raw water deterioration. [Refers to expenditure to deliver the outputs included in the water quality enhancement schedule (annex 4 of the company supplementary report 2009) to treat/remove nitrate (PR09 driver code 5WA1), THM (5WA3), pesticides (5WA6), cryptosporidium (5WA5), and other parameters (5WA7)].</p>
<p>Resilience</p>	<p>Capital expenditure to improve resilience. This relates to expenditure to manage the risk of giving consumers an appropriate level of service protection in the face of extreme events caused by hazards that are beyond their control. [Refers to expenditure to deliver the outputs included in the supplementary report for improving resilience (e.g. PR09 driver code ESL04).]</p>
<p>SEMD</p>	<p>Capital expenditure to comply with the requirements of Security and Emergency Measures Direction (SEMD). [Refers to expenditure to deliver the outputs included in the water quality enhancement schedule (annex 4 of the company supplementary report) or amendments confirmed at an interim determination of prices for work to improve security and provide emergency supplies of water (PR09 driver code 5WA13)].</p>
<p>NEP - Flow monitoring at water treatment works</p>	<p>Capital expenditure to introduce flow monitoring at water treatment works. [Note we are not expecting any investment to be allocated to this driver during 2010-15 as it is a new requirement for 2015-20 as set out in Environment Agency's Operational Instruction 403_12.]</p>

NEP - Drinking water protected areas	Capital expenditure on investigations listed in the NEP for AMP5 or AMP6 which is associated with Drinking Water Protected Areas under Article 7 of the Water Framework Directive. [For AMP5 this is the capital expenditure to deliver the outputs (including investigations) included in the water service quality enhancement schedule (Annex 4 – S) to meet the requirements of driver code WFD5.]
Supply / demand - Metering	Capital expenditure associated with the total number of free meter options installed at household properties during the year. Include meters installed at household properties fitted in any location (e.g. internal, external in garden, external at boundary, etc.). Include only those meters which have been installed free of charge to the customer and which are used to determine a customer's bill. Include meters which have had capital expenditure allowed for explicitly (in full or in part) in price limits. Please also include capex for selective metering in this line.
Additional proposed variables	
Additional operating expenditure supply/demand balance	The additional operating expenditure in relation to the base year, which results from supply/demand balance capital investment to maintain basic services; including new development and free meter optants.

Wastewater examples

Data description	Existing line definitions (using most recent available source)
Capital expenditure by purpose - Wastewater total	
First time sewerage	Capital expenditure for new and additional sewage treatment and sewerage assets for first time sewerage schemes to meet the duty under s101A of the Water Industry Act 1991. [For AMP5 this is the capital expenditure to deliver the outputs (including investigations) included in the sewerage service quality enhancement schedule (Annex 4 – S) to deliver first time sewerage schemes (driver code A14)].
Sludge (enhancement and base)	Capital expenditure on all sludge treatment and disposal assets and associated biogas treatment for all purposes i.e. meeting new environmental obligations, providing new capacity and maintaining existing assets. This is for both infrastructure and non-infrastructure assets.
Sludge treatment & disposal - enhancement	Capital expenditure on sludge treatment and disposal assets and associated biogas treatment for meeting new environmental obligations listed in the NEP and providing additional capacity. This is for both infrastructure and non-infrastructure assets.
Sludge treatment & disposal - base	Capital expenditure to maintain long term capability of sludge treatment and disposal assets and associated biogas treatment. This is for both infrastructure and non-infrastructure assets.

Maintaining the serviceability of sewage treatment works	Capital expenditure to maintain the serviceability of sewage treatment works including any non-infrastructure investment associated with sea outfalls and headworks. Expenditure on sludge assets should be excluded as base investment in sludge should be reported in line 2. Grants and capital contributions should be included.
Maintaining the serviceability of sewage pumping stations	Capital expenditure to maintain the serviceability of sewage pumping stations (including in-line and terminal pumping stations). Expenditure on private sewers should be excluded as this is to be treated as enhancement and reported in line 29. Expenditure on sludge assets should be excluded and reported in line 2. Grants and contributions should be included.
Maintaining the serviceability of management and general assets	Capital expenditure on non-infrastructure management and general assets required to maintain base service.
NEP - Conservation drivers	Capital expenditure on the primary cost driver at quality enhancement schemes listed in the NEP for AMP5 or AMP6 where the objective of the primary driver is to meet the requirements of conservation drivers (the Habitats and Birds Directives, the CRoW Act and the UK Biodiversity Action Plan) over and above that on schemes and investigations for which expenditure is required to be reported elsewhere in this table (principally lines 15 to 19).
NEP - Event Duration Monitoring at intermittent discharges	Capital expenditure on quality enhancement schemes listed in the NEP for AMP5 or AMP6 to provide event and duration monitoring of intermittent discharges. [For AMP5 this is the capital expenditure to deliver the outputs included in the sewerage service quality enhancement schedule (Annex 4 – S) driven by the revised EU Bathing Water or Shellfish Waters Directives (driver codes rB5 and S8 respectively).]
NEP - Flow monitoring at sewage treatment works	Capital expenditure on quality enhancement schemes listed in the NEP for AMP6 to provide flow monitoring at sewage treatment works (driver code Flow3).
NEP - Monitoring of pass forward flows at CSOs	Capital expenditure on quality enhancement schemes listed in the NEP for AMP6 to provide monitoring of pass forward flows at CSOs (driver code Flow4).
NEP - Storage schemes to reduce spill frequency at CSOs, storm tanks, etc	Capital expenditure on the primary cost driver of quality enhancement schemes listed in the NEP for AMP5 or AMP6 where the objective of the primary cost driver is to reduce spill frequency of CSOs, storm tank overflows etc by the provision of new or additional storage volume.
NEP - Chemicals removal pilot/full-scale demonstration plants	Capital expenditure on monitoring, investigations, feasibility studies and improvements listed in the NEP as part of the national Chemicals Investigation Programme (driver codes C1 - C3 in AMP5 and C4 - C7 in AMP6) or the AMP6 Phosphorus removal technology investigations programme (driver codes P1 - Px).
NEP - Groundwater schemes	Capital expenditure on the primary cost driver of quality enhancement schemes listed in the NEP for AMP5 or AMP6 where the objective of the primary cost driver is to meet one or more requirements of the EU Groundwater Directive. [For AMP5 this is the capital expenditure to deliver the outputs included in the sewerage service quality enhancement schedule (Annex 4 – S) associated with driver codes G1, G2, G3 and G4.]

NEP - Investigations	Capital expenditure on investigations listed in the NEP for AMP5 or AMP6 over and above that on investigations for which expenditure is required to be reported elsewhere in this table (principally line 13 and for AMP5 years only, line 14).
NEP - Nutrients (N removal)	Capital expenditure on the primary cost driver of quality enhancement schemes listed in the NEP for AMP5 or AMP6 where the objective of the primary cost driver is to meet new or tightened consent conditions for nitrogen.
NEP - Nutrients (P removal at activated sludge STWs)	Capital expenditure on the primary cost driver of quality enhancement schemes listed in the NEP for AMP5 or AMP6 where the objective of the primary cost driver is to meet new or tightened consent conditions for phosphorus at an activated sludge STW.
NEP - Nutrients (P removal at filter bed STWs)	Capital expenditure on the primary cost driver of quality enhancement schemes listed in the NEP for AMP5 or AMP6 where the objective of the primary cost driver is to meet new or tightened consent conditions for phosphorus at a biological filter STW.
NEP - Reduction of sanitary parameters	Capital expenditure on the primary cost driver of quality enhancement schemes listed in the NEP for AMP5 or AMP6 where the objective of the primary cost driver is to meet new or tightened consent conditions for one or more of the sanitary parameters.
NEP - UV disinfection (or similar)	Capital expenditure on the primary cost driver at quality enhancement schemes listed in the NEP for AMP5 or AMP6 where the objective of the primary cost driver is to meet new or tightened consent conditions for microbiological parameters to meet the requirements of the EU Shellfish Waters or revised Bathing Water Directives. Such schemes will typically involve UV disinfection but may involve alternative technologies eg membrane filtration.
NEP - Discharge relocation	Capital expenditure on the primary cost driver at quality enhancement schemes listed in the NEP for AMP5 where the objective of the primary cost driver is to meet the requirements of the Habitats Directive or the CROW Act (2000) by relocating the discharge to controlled waters
NEP - Flow 1 schemes	Capital expenditure on the primary cost driver of quality enhancement schemes listed in the NEP for AMP5 where the objective of the primary driver is to ensure no deterioration in the current classification of the receiving waters as a result of increased volumes of discharge (historic) - (driver code: Flow1)
Odour	Capital expenditure on schemes where the primary objective is to effect a step change improvement in odour control above base standards.
New development and growth	Capital expenditure associated with the provision of new development and growth in sewerage services. Includes capital expenditure associated with the provision of local distribution assets for sewerage services to provide for new customers with no net deterioration of existing levels of service (new development) and capital expenditure associated with changes in sewage collected from new and existing customers whilst maintaining existing levels of service (growth). This should exclude capital expenditure for the purpose of reducing the risk to properties and external areas of flooding from sewers that should be reported in line 28, unless an increase of risk is clearly the result of new development.

<p>Growth at sewage treatment works (excluding sludge treatment)</p>	<p>Capital expenditure associated with meeting or offsetting changes in demand from new and existing customers at sewage treatment works but excluding sludge treatment centres. Expenditure at sludge treatment centres should be reported under line 2.</p>
<p>Resilience</p>	<p>Capital expenditure to improve resilience. This relates to expenditure to manage the risk of giving consumers an appropriate level of service protection in the face of extreme events caused by hazards that are beyond their control. [Refers to expenditure to deliver the outputs included in the supplementary report for improving resilience (e.g. PR09 driver code ESL04).]</p>
<p>SEMD</p>	<p>Capital expenditure on schemes to protect assets and assessments of potential further improvements to comply with the Security and Emergency Measures Direction 1998 including associated Advice Notes. [This is the capital expenditure to deliver the outputs included in the sewerage service quality enhancement schedule (Annex 4) to comply with the SEMD (driver code SEMD).]</p>
<p>Reduce flooding risk for properties</p>	<p>Capital expenditure for the purpose of enhancing the public sewerage system to reduce the risk to properties and external areas of flooding from sewers. Exclude infrastructure renewals expenditure that should be reported in line 3 and expenditure associated with the provision of new sewers for new development and such other expenditure required in consequence of the new development that should be reported in line 25.</p>

Appendix 3: CEPA proposed changes

CEPA made 44 observations – the topics for each are set out below. For a detailed explanation of each of these please see the CEPA report.

Where changes have been suggested by CEPA we show below whether or not these were accepted by us and incorporated into the proposed RAGs.

Water resources

		CEPA			OFWAT	
		RAG2 change required	RAG4 change required	No change required	Change accepted	Change rejected
1	Impounding reservoirs and abstraction licences		Y		Y	
2	Wholly compensating reservoirs		Y		Y	
3	Redundant reservoirs			Y		
4	Pumping – upstream of impounding reservoirs			Y		
5	Pumping – borehole cost disaggregation	Y			Y	
6	Pumping – borehole pumping head and management estimate	Y			Y	
7	Borehole to WTW pipes			Y		
8	Aquifer recharge schemes		Y		Y	
9	Other “flow reversal” schemes			Y		
10	Blending		Y		Y	
11	Labour and maintenance costs	Y				Y

12	Cumulo rates	Y			Y	
13	M&G asset allocation – principal user	Y			Wider RAG2 changes	
14	M&G asset allocation – choice of driver	Y				Y - Further work with RAWG
15	Third party services – activities	Y			Y	
16	Third party services – cost transfers	Y			Y	
17	Bulk supply definition		Y		Y	
18	Other cost allocation			Y		
19	Direct vs allocated costs			Y		

Sludge

		CEPA			OFWAT	
		RAG2 change required	RAG4 change required	No change required	Change accepted	Change rejected
1	Power – CHP assets			Y		
2	Power – external revenue sharing		Y		Y	
3	Power – cost savings		Y		Y	
4	Sludge product sales			Y		
5	Treating waste from other WaSCs		Y			Y - Compliance issue
6	Tankered domestic and commercial waste – appointed vs non-appointed	Y			Y	

7	Tankered domestic and commercial waste – business unit treatment	Y			Y	
8	Tankered domestic and commercial waste – costs included in cost transfer	Y			Y	
9	Sludge and sewage treatment boundaries – high level			Y		
10	Sludge and sewage treatment boundaries – tankering to STWs		Y		Y	
11	Co-located sites power costs allocation	Y				Y - Further work with RAWG
12	Labour and maintenance costs	Y				Y - Further work with RAWG
13	Liquor treatment – cost transfers	Y			Y	
14	Liquor treatment – extent of cost transfers	Y			Y	
15	Liquor treatment – calculation of cost transfers	Y			Y	
16	Liquor treatment – costs included in cost transfers	Y			Y	
17	Water treatment works sludge – cost transfers	Y			Y	
18	Water treatment works sludge – costs included in cost transfers	Y			Y	
19	Local authority rates	Y			Y	

20	Management & General allocation – principal user	Y				Y - Compliance issue
21	Management & General allocation – choice of driver	Y				Y - Further work with RAWG
22	Third party services			Y		
23	Charging for appointed assets			Y		
24	Sludge treatment / disposal boundary		Y		Y	
25	Direct vs allocated costs			Y		

Key

Wider RAG2 changes	CEPA change has not been adopted as suggested, but the concern has been met by making wider changes to RAG2 which make it more flexible to the potential changes to the number of price control units.
Compliance issue	No changes to the RAGs are thought necessary as a result of this observation but we will take particular interest in how companies approach these areas. The Methodology statement in particular will be used to check companies' approaches to classifying costs in these areas.
Further work with RAWG	CEPA have suggested more guidance be given in certain areas. Some of these areas are technical and require engineering or operational input in order for such guidance to be workable. For these highlighted areas we have not yet finalised any changes in the RAGs to address these issues as we need to work with companies during the summer to develop appropriate guidance.

Appendix 4: CEPA high-level findings

- Water resource boundary issues. Although the RAGs are broadly clear on the start and end-points of each water business unit, they do not give completely clear direction on some specific cases. As a result the most suitable treatment is currently unclear to companies (e.g. wholly compensating reservoirs without abstraction licences; aquifer recharge schemes; blending). There are also been some instances where we consider the RAGs to be clear, but companies have not allocated costs or assets in a way which is consistent with them (i.e. pumping upstream of impounding reservoirs; pumps which serve multiple business units).
- Sludge boundary issues. Companies currently put the boundary between sludge and sewage activities in different places - especially with respect to thickening at standalone sewage treatment works. According to our approximate calculations, the different approaches are likely to be material. The boundary between appointed and non-appointed activities is also interpreted differently (i.e. CHP assets; gas to grid; treating waste from other WaSCs; tankered waste). Given the possibility of a separate sludge price control, companies have emphasised the need for consistency among WaSCs and new entrants in the sludge business.
- Principal user allocation methodology. Allocation by principal use is currently recommended for splitting values across separate price controls, but some companies also use it to allocate M&G assets between business units. Given that M&G asset values are up to 8% of water resource and sludge business unit totals, the difference between the two approaches seems likely to be material and worthy of further consideration.
- Recharges. Where one business unit provides a service for another, companies are not always consistent as to whether or not they apply recharges (i.e. water sludge, power savings, sludge liquor treatment). In addition, the content of these recharges and charges from the appointee to associated businesses also vary - often only including elements of direct opex rather than being “fully loaded” to include elements to account for overheads and capital costs (e.g. bulk supplies; 3rd party services; tankered waste).
- Choice of cost drivers. Some companies currently use drivers which do not seem to be the most appropriate available (e.g. allocating rates costs based on estimates of employee time spent on activities). There are also opportunities to achieve greater consistency by issuing guidance on preferred cost drivers where, for instance, nine out of ten WaSCs already follow the same approach.

Ofwat (The Water Services Regulation Authority) is a non-ministerial government department. We regulate the water sector in England and Wales. Our vision is to be a trusted and respected regulator, working at the leading edge, challenging ourselves and others to build trust and confidence in water.

Ofwat
Centre City Tower
7 Hill Street
Birmingham B5 4UA

Phone: 0121 644 7500
Fax: 0121 644 7533
Website: www.ofwat.gov.uk
Email: mailbox@ofwat.gsi.gov.uk

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