

United Utilities response to the Ofwat consultation: Further consultation on regulatory reporting for the 2016-17 reporting year



[Consultation on regulatory reporting for the 2016-17 reporting year](#)

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Introduction

United Utilities welcomes the opportunity to comment on Ofwat's consultation:
Further consultation on regulatory reporting for 2016-17 reporting year.

Consultation questions

Q1 What are your views on the content and format of the proposed tables in Appendix 1?

We recognise that a number of the points we raised in response to question 1 in the earlier consultation "Regulatory Reporting for the 2016-17 reporting year", submitted in June 2016, have been considered by Ofwat and the regulatory accounting guidelines subsequently amended.

Following review of the updated tables we have the following comments:

- **Table 4H - RORE**

In August 2016 Ofwat requested further information on the RORE figures presented in the Annual Performance Report. For our comments on the RORE calculation please refer to our reply to this request, sent by Mark Abbott from United Utilities to Elinor Mathieson and Aileen Armstrong at Ofwat on 22 August 2016, in which we highlighted a number of areas within this calculation where we consider additional clarification would be useful.

- **Table 4G - Wholesale current cost financial performance**

In RAG 4.06 page 33 it is not clear from the guidance to 4G.3 Capital maintenance charges whether the Wholesale Current Cost calculation per RAG 1.07 Appendix 1 is mandatory or optional. We consider it appropriate that where the current cost depreciation value can be calculated from a current cost asset register, companies can continue to use this approach as explained in RAG1 paragraph 2.1.5. We therefore propose that the guidance for row 4G.3 'Please see RAG1 paragraph 2.2 for more information on how to calculate this' be amended to 'Please see RAG1 section 2 for more information on how to calculate this'.

- **Table 2E - Capitalised grants and contributions**

In RAG 4.06 page 17 the guidance for row 2E.17 states 'Total value of capitalised grants and contributions carried forward as at 31 March. This should represent the wholesale element of 2C.26. The sum of lines 2E.12 to 2E.14.' We consider this should refer to '1C.26' rather than '2C.26', and '2E.14 to 2E.16' rather than '2E.12 to 2E.14'.

- **Intangible assets**

RAG 4.06 - We propose that all references to 'depreciation' in respect of intangible assets, across the Regulatory Accounting Guidelines, be replaced with 'amortisation' to be consistent with the requirements of IAS38 "Intangible Assets"

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To the extent that views we previously suggested have not been reflected in the latest version of the regulatory accounting guidelines, we continue to hold these views:

- **Table 2B Totex analysis - wholesale**

Infrastructure renewals expenditure (IRE) is included in line 5 “other operating expenditure” in table 2B. IRE is a significant expenditure item; with the infrastructure renewals charge (IRC) being separately disclosed in previous reporting periods. We recommend that IRE should be reported on a separate line in table 2B, given the level of expenditure.

- **Table 4H Financial Metrics**

- **Net Debt**

In the description for Line 1 “Net Debt” we assume the swapped GBP amount for the principal amount of foreign currency debt (which therefore include foreign exchange movement) can be used. It would help if this was clarified in the guidance to ensure consistency between companies.

- **Credit rating**

In respect of line 9 “Credit rating” we believe that the requirement should be to list all solicited long-term ratings for the appointed business along with the outlook / watch status. We would recommend that only solicited ratings are reported as only solicited rating agencies receive additional non-public information on which to make their assessments and so are likely to be more accurate than unsolicited ratings. We recommend that (as per existing guidance) the ratings reported are those for the appointed business as opposed to ratings applied to debt issuance as debt structuring impacts the rating applied to debt (either up or down) making cross sector comparisons difficult, in particular subordinated debt ratings should not be reported.

- **FFO**

We consider it would be more appropriate for line 12 “FFO” to be calculated in accordance with credit rating agencies’ methodology, where an underlying finance expense and current tax are deducted. The calculation in the 2015/16 tables does not deduct either interest or tax, and as a result this causes problems in the calculation of other ratios in the table.

- **Interest cover**

In line 13 “Interest cover” interest is added back to FFO, whereas in calculating FFO in line 12 interest was not deducted. In order for this ratio to be more useful, interest should have been deducted in the definition of FFO.

- **Adjusted interest cover**

The issue with line 13 is also relevant for line 14 “adjusted interest cover (cash)”.

- **FFO / Debt**

We expect line 15 “FFO / Debt” is likely to be interpreted by users as mirroring the rating agencies’ calculations. Whilst we recognise that Ofwat has stated that its approach will differ to the credit rating agencies, we still consider it would be more appropriate that this

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ratio is calculated based on Standard & Poor's methodology to ensure consistency in the calculation of this metric.

- **Free cash flow (RCF)**

Line 17 "Free cash flow (RCF)" should be calculated based on FFO defined to be after interest and tax. In addition we would advocate Moody's methodology, in particular by adding back IRE to FFO. IRE was previously reported as part of capital expenditure, but for 2015-16 reporting onwards it is now reported within operating costs; adding IRE back to FFO would improve comparability with previous years.

- **Table 4I Financial Derivatives**

We recommend that line 1 "Floating to / from fixed rate" is split into two lines, one for "floating to fixed rate" and the second for "floating from fixed rate". Whilst there may be instances where the principal amount may net to zero, the interest rates do not necessarily net down. Separating this into two lines will be more informative for the user.

If line 1 is to remain combined, it would be useful for Ofwat to clarify the signage to be used for pay and receive – we propose that "pay fixed" should be a positive figure and "receive fixed" a negative figure.

The current format of the table does not incorporate interest rate swaps where the rates are locked in but they start at a future date. It would be useful for clarification that forward dated swaps should not be included in table 4I.

Where cross currency swaps convert both the debt principal to sterling and also the interest rate from currency to sterling it would be misleading to split up the swaps into sections B and C. We recommend guidance that where swaps convert both debt principal and interest rate that these should not be separated and reported only in section C.

Q2 Do you have any comments on our proposal to elevate the reporting for water resources and bioresources from section 4 of the APR to section 2?

We support this proposal.

Q3 Do the definitions for the water resources activities in RAG4 provide sufficient detail for you to complete pro forma tables 2A, 2B, 2D, 4D and 4E? (Note that the decision over the location of the boundary is outside the scope of this consultation as set out above).

We consider the definitions for the water resources activities in RAG 4.06 do provide sufficient detail to complete the required tables within the Annual Performance Review, and we welcome the additional clarification provided.

However, we consider that further clarification in RAG 4.06 would be beneficial in respect of the following areas:

- **Raw water abstraction – boundary point**

In relation to the two new paragraphs now included after the bullet points on page 40 of RAG 4.06, when describing the raw water abstraction boundary points, we consider that assets upstream of the pumps / outlet should be included in the raw water abstraction

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service and recommend that the wording should be made clearer on this point to ensure consistent reporting across the industry. In addition, we also consider that the guidance should be amended to make it clear that an abstraction meter would count as part of the “structure controlling abstraction”, as the information from a meter reading would lead to control of the abstraction but there may not be a direct or physical control mechanism in place.

- **Raw water abstraction – Unit cost description**

On page 40 of RAG 4.06 we consider that some further clarity is needed in respect of the unit cost description for raw water abstraction as the definitions in the 1995 Demand Forecasting Methodology and June Return 2011 do not fully articulate the complexity of raw water systems. The total volume abstracted at the “point of chargeable abstraction” will include some water which is abstracted multiple times. For example a company may abstract water under licence from a river and then discharges it into a second river in order to support abstraction lower downstream from the second river. For demand forecasting purposes only the final abstraction is relevant, but as a cost driver for the Raw Water Abstraction Service it is the total abstraction which is relevant. We believe that the wording should therefore make clear that it is the total abstraction that is to be reported.

- **Unit cost description for treated water distribution**

On page 43 of RAG 4.06 in the unit cost description for treated water distribution we recommend removing the sentence “It is expected to be equal to metered distribution input.” The 1995 Demand Forecasting Methodology (page 43) and June Return 2011 definition requires MLE adjustment of the initial estimate of distribution input, so therefore the reported distribution input would not be expected to be equal to the metered distribution input.

- **Water resources boundary**

We consider the inclusion of the diagram in appendix 2 of RAG 4.06 to be helpful in clarifying the boundary, however we consider a change is required to further improve the guidance. Point D in the diagram refers to a reservoir with some natural catchment, but no abstraction licence, which supplies a water treatment works. The most likely situation for a reservoir without an abstraction licence would be for it to have no (or negligible) natural inflow, and consider that the example could be improved with the words “again with some natural catchment” omitted. We also recommend a further addition to the diagram to give an example of a compensation only reservoir, i.e. a reservoir with a legal requirement to provide water to a watercourse but no associated abstraction. Our understanding from RAG 4.06 is that this would be within the raw water abstraction service, but making this clear in the diagram would ensure consistency.

Q4 Do the definitions for the bioresources activities in RAG4 provide sufficient detail for you to complete pro forma tables 2A, 2B, 2D, 4D and 4E? (Note that the decision over the location of the boundary is outside the scope of this consultation as set out above).

We consider the definitions for bioresources activities in RAG 4.06 do provide sufficient detail to complete the required tables within the Annual Performance Review, and we welcome the additional clarification provided.

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However, we consider that further clarification in RAG 4.06 would be beneficial in respect of the following areas:

- **Imported Tankered Waste –RAG 2.06 Section 2.8**

In our response in June 2016, we suggested the following wording for section 2.8 of RAG 2.06 in respect of the treatment of the recharge to the non-appointed business for treating the imported tankered waste:

“Where a recharge is required in respect of imported tankered waste, which is calculated based on market rate, the presumption is that the full value of the two sides of the transaction - (i.e. the costs to the non-appointed business and the recharge from the appointed business, would represent opex and negative opex.)”.

We consider that the proposed wording in section 2.8 is still not clear enough and there could be misinterpretation of how the recharge should be reported and therefore we recommend including our proposed wording stated above.

- **Water sludges – RAG 2.06**

In appendix 2 of the consultation it stated that proposal 10 on water sludges has been accepted. The proposal was:

“The presumption is that the full value of the two sides of the transaction, i.e. the costs to the water price control and the recharge from the wastewater price control, would represent opex and negative opex in tables 2A and 2B. We would support clarification of this through a clear statement in RAG2.06.”

However, we have identified that RAG 2.06 has not been updated to refer to water sludges. To ensure consistency across the industry we recommend that this wording is included and explicitly stated in RAG2.06.

- **Income treated as negative expenditure – RAG 4.06 table 4E.2**

In addition to the items listed in definition 4E.2 of RAG 4.06, we propose the inclusion of “Electricity sales from National Grid ‘frequency response’” as a further example.

- **Sludge liquor treatment – RAG 4.06 Section 2**

In RAG 4.06 the boundary point for Network+ sewage treatment and disposal has been updated and now states “sewage treatment activities include those that thicken indigenous sludge to no more than 10% dry solids”. For further clarification, and to avoid any confusion, we request that the description is further extended to state where the costs of treating the liquors generated during this process are reported (we assume these would be within sewage treatment).

Q5 Please could you provide an estimate of the impact, for the changes that we have proposed to the boundary definitions for both water resources and bioresources at RAG4? (See questions 3 and 4 above).

The impact should include an estimate of the change in Net MEAV resulting from the assets that have moved under the change in boundary definitions for both water resources and bioresources separately.

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Water Resources

We consider that our 2015/16 regulatory accounts reasonably reflect the proposed boundary definition. Therefore, our preliminary view of the impact of the amended boundary definitions for water resources in RAG 4.06 is that we do not anticipate there will be any material changes to the allocation of costs or on the Net MEAV.

Bioresources

Based on the amended definitions in RAG 4.06, processes at a number of our sites would be reclassified from sludge treatment to network+ as they thicken indigenous sludge to no more than 10% dry solids and do not receive imported sludge.

We recognise that this change would result in additional direct costs reported within network+, and reduced direct costs within bioresources, and subsequently impact on the allocation of indirect costs across these services, but further work (including site inspections) would be required to obtain a reasonable estimate of the value of this change.

In respect of the impact on the Net MEAV, initial high level workings indicate that the estimated impact may be in the order of 2% to 5% of non-infrastructure sludge assets that would be reallocated from bioresources to the Wastewater network+ business. These assets are primarily at facilities which only treat indigenous sludge to less than 10% dry solids, and therefore under RAG 4.06 would be classified as Network+ facilities.

Q6 In the responses to our March consultation, some companies suggested that to avoid recognising numerous discrete connections as a raw water transport activity, a de minimis value (for example, length of pipe) should be added to the RAGs. This would clarify the allocation of raw water transport between water resources and water treatment. Under this approach if the length of pipe were below the threshold, the asset would be classified as water resources, and raw water transport if above. We propose an amendment to RAG4 to address this concern by making a specific reference to sites in the definition of raw water transport but have not added a de minimis value.

Do you consider that a de minimis threshold should be introduced? If yes, what should value of that threshold be?

We do not consider that there is any value in introducing a de minimis limit. We consider it to be appropriate to allocate relevant costs based on the location of the asset and the function that it performs in accordance with RAG 4.06. The length of a pipe has no bearing on its function and therefore we do not support the use of this as a method for allocating costs between upstream services.