August 2016

Trust in water

Targeted review of revenue and cost information – water only companies

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1. Introduction

Cambridge Economic Policy Associates (CEPA) undertook a targeted review in early 2016 with the aim of helping Ofwat consider the extent to which sludge and water resource cost and revenue data is robust and comparable across the ten water and sewerage companies (WaSCs). Whilst we gained a good insight into the water activities of the WaSCs from the CEPA targeted review, it was recognised that it would be useful to additionally engage with the seven water only companies (WoCs) to ensure that all potential issues were covered, particularly those which are company specific.

We subsequently undertook a review of the seven WoCs over April-June 2016, the findings of which are discussed in this document. The objective of this review of the WoCs, in line with the CEPA review, was to gain a better understanding of the robustness and comparability of water resources reporting data of the companies and to identify any additional issues.

A standard questionnaire, similar to that issued to the WaSCs, was used as the basis of the review to ensure consistency and comparability of the data collected from the companies. A template of this questionnaire is provided in appendix 1. The questionnaire was pre-populated where possible before being sent to the companies for completion. We then met each of the WoCs at their offices and received a presentation of their water resource operations before discussing the questionnaire responses. Following the meetings, we revised the responses to reflect our understanding of the discussion and returned a final summary document to each WoC, including actions and next steps.

Many of the findings mirrored those from the CEPA targeted review of the WaSCs, although several new company specific issues were also identified. The aim of this document is to summarise the findings and make recommendations for each whilst highlighting the link to the revised regulatory accounting guidelines (RAGs).

The RAGs consulted on in August 2016 therefore take into consideration the findings of both the CEPA review of the WaSCs as well as the findings of our review of the WoCs. In some instances issues have been identified that require further discussion and these will be addressed in Regulatory Accounting Working Groups (RAWGs).

2. Findings

In this section we provide the RAG and cost allocation issues identified for water resources from the questionnaire responses and discussions with the seven WoCs. The key findings are provided in a table along with a brief summary and action/recommendation for each. Some of the actions have been addressed in revisions to the RAGs as consulted on 17 August 2016. Each finding is then discussed in more detail in the following subsection.

2.1 Summary of findings

Issue	Summary	Action/Recommendation
Impounding reservoirs and abstraction licences	Impounding reservoirs without abstraction licences are allocated into water resources, rather than raw water distribution.	Topic to be addressed in the water resources working group. A useful exercise would be to work through an example to better understand the split.
Co-located boreholes and water treatment works (WTW)	Different assumptions used by WoCs for cost allocation when boreholes are in close proximity to WTW.	The revised RAG 4.06 contains more guidance for co-located boreholes and WTWs.
Splitting costs between borehole, transport and WTW	One company incorrectly allocated costs relating to a co-located borehole and WTW, into water treatment only.	The company has agreed to reallocate these costs into water resources and raw water distribution.

Pre-treatment and Blending	One WoC pre-treats water before it gets to the WTW as a drought contingency. The company also has an emergency bulk import option of treated water in a raw water reservoir.	Guidance has been provided on this area in RAG 4.06.
Aquifer recharges	Aquifer recharge schemes allocated to either raw water distribution or water treatment rather than water resources.	Companies have been asked to review their treatment of aquifer recharge costs to ensure compliance with the RAGs.
Allocation of power costs	Several WoCs used different approaches for allocation of power costs into water resources. One WoC does not allocate any power costs to water resources.	The revised RAG 2.06 has been clarified in this area.

Allocation of labour costs	WoCs use a variety of approaches in allocating employment costs to water resources.	Companies employ a variety of different methods for capturing labour costs, some are more sophisticated than others. However where allocations are used, RAG 2.06 is clear that the methodology for power costs should not be used to allocate labour costs between water resources and water treatment.
Potable bulk supply imports	Majority of WoCs with bulk supply imports did not correctly split the costs between water resources, raw water distribution and water treatment.	RAG 2.06 has been updated to improve clarity in this area.
Rates	Several WoCs highlighted confusion about the correct treatment of cumulo and local authority rates in the previous RAGs.	Clarity has been provided in RAG 2.06.
PR09 MEAV revaluation	Differences in the assumptions made for asset valuation affecting GMEAV and NMEAV in PR09.	This area is to be addressed as part of the Water 2020 workstream for the 2019 price review.

Assets: Land and Roads	One WoC had allocated 50% of land and roads cost in the PR09 GMEAV allocation into water resources and 50% into water treatment without any clear explanation. The company doesn't keep a CCA register so all allocations are based on the GMEAV proportion which presents the issue of potential misallocation into water resources.	The company stated that they would look into this further and reconsider the company split between these business units. As above, this area is to be addressed with the aim of introducing a standardised set of assumptions for future valuations.

2.2 Discussion of findings

Impounding reservoirs and abstraction licences

Several companies have allocated impounding reservoirs without abstraction licences into water resources, rather than raw water distribution. This is in line with the findings in the CEPA report.

One WoC highlighted an example where they have an abstraction licence out of a river but no licence to abstract from the reservoir and requested clearer guidance as to where these costs should sit. A suggestion of a distance based approach was made by this company, i.e. if reservoirs are within a mile of an abstraction point then this could be classified as water resources. Another company also requested a working example in order to better understand the split in this area. The companies were informed that this topic would be addressed in detail in the water resources working group. We have provided worked examples in RAG 4.06 to provide clarity.

Co-located boreholes and water treatment works

It was noted that the several companies make different assumptions for cost allocation when water resource sites (boreholes) are in close proximity to water treatment works. One WoC mentioned the situation where they have pumps that operate boreholes which are located in the same building as the WTW (estimated 10% of building). These are currently allocated into water treatment. We have clarified the cost allocation guidance in RAG 4.06.

Splitting costs between borehole, transport and WTW

One company incorrectly allocated costs for a relatively short length of pipe that transports water from a borehole to a WTW into water treatment only, without any allocation to water resources or raw water distribution. The company agreed to split these costs for 2016-17 based on some reasonable basis.

Pre-treatment and blending

One WoC pre-treats water before it gets to the WTW as a drought contingency, but considers this process immaterial. The company also has an emergency bulk import option of treated water in a raw water reservoir and is currently investigating the materiality of this process. As proposed by CEPA, guidance has been provided on this topic in RAG 4.06.

Aquifer recharges

As per the CEPA report, the 2016-17 RAGs are clear that aquifer recharge activities should be allocated to water resources. Several WoCs had small aquifer recharge schemes allocated to either raw water distribution or water treatment, instead of water resources. In cases where this is immaterial, specific companies have not been asked to reallocate these costs into water resources.

We found that one WoC in particular had allocated all pipework relating to aquifer recharges into raw water distribution. This company has been asked to review how it accounts for these costs and assets.

Allocation of power costs

The WoCs adopt a wide variety of approaches to the allocation of power costs into water resources. One WoC directly coded power by site and business unit. Two WoCs allocate power per business unit based on pumping head, another uses meter readings to allocate costs and a fourth splits allocates power costs based on GMEAV. Finally, it was found that another WoC does not allocate any power costs to water resources. It is clear from these findings that the companies are not applying a uniform approach to allocating these costs. Our additional guidance in the proposed RAG 2.06 specifically addresses cost allocation for co-located boreholes and treatment works.

Allocation of labour costs

It was also found that the WOCs use a variety of approaches in allocating employment costs into water resources. For the majority of companies, costs are coded directly or allocated based on management estimates.

Companies employ a variety of different methods for capturing labour costs, some are more sophisticated than others. More accurate systems log employee time to activities based on the asset that they are working on (this may be identified by a bar code reader which is integrated with the time recording system). One company allocated costs based on pumping head – this is considered a weak driver for these costs. The company acknowledged that this should be reviewed.

The CEPA report proposed that, RAG 2 should include clearer guidance in this area, suggesting that unless a better driver can be found, management estimate should be used to allocate site labour. RAG 2.06 is now clear that the methodology for power costs should not be used to allocate labour costs between water resources and water treatment. This means that companies that do need to allocate employee time will have to consider this separately from power.

Bulk supply imports

It was identified that the majority of WoCs with bulk supply imports did not allocate these costs in line with RAG guidance.

One company recognises all of its imports in water treatment when an element of this should be allocated to water resources. The company explained that the imported water comes from several different sources and is blended, making it complicated to estimate the portion to attribute to water resources. It has been suggested that the WoC estimate this based on the companywide average water resources split of the company from which they import the supply.

Another example of inconsistencies is where one WoC allocated 100% of a treated water import to water resources while a different WoC allocated 100% of a treated water import to water treatment.

The RAGs for 2016-17 have been clarified to reflect that import costs should be split between water resources and water treatment.

Rates

Several WOCs highlighted confusion around the guidelines for the treatment of cumulo and local authority rates in the previous RAGs. While the allocation method prescribed in RAG 2.05 had been changed to align it with PR14, the guidance assumed that cumulo rates was applied to operational [wholesale] assets and business rates was applied to office buildings (where retail operations are located). This assumption applied to WaSCs but was not the case for all WoCs, some of which only receive a cumulo rates bill.

We accept that the billing of rates is not as straightforward as was previously assumed. To ensure more comparability, clarity has been provided in the cumulo and local authority rates section of RAG2. Essentially, for companies with only a cumulo rates bill, they will need to firstly calculate a notional rates bill for the offices where there are both wholesale and retail activities. At that point the existing allocation rules can then be applied.

PR09 MEAV revaluation

As was noted in the CEPA report, it was also found that the WoCs had made different revaluation assumptions affecting GMEAV and NMEAV in PR09. These differences have been covered in detail in the CEPA report and are not discussed at length in this summary.

In order to improve consistency and comparability, we will propose a standardised set of assumptions across all WaSCs and WOCs to be used at PR19. This will be addressed in future working groups.

Assets: Lands and roads allocation

One WoC is in the unusual situation in that they do not hold a CCA fixed asset register. The company's allocations are made pro-rata based on GMEAV and rolled forward at the aggregate level, while other WoCs' allocations are based on their disaggregated registers.

An issue was identified with this particular WoCs PR09 GMEAV revaluation with regard to their allocation of land and roads cost under water resources. 50% of this cost was allocated to water resources and 50% to treatment. This is a significant item for the company at over a third of total GMEAV. The company were unclear as to why it was separated this way for the PR09 valuation, however they were clear in their methodology statement that this was the approach being taken. The company stated that they would look into this further and reconsider the allocation method.

Appendix 1

WoC questionnaire

1. Reporting of costs – Water resources

(1a) For impounding reservoirs and raw water booster pumping stations, describe the rules applied for treating the assets and associated costs as part of the water resource business unit or the raw water distribution business unit, and quantify the impact in 2014-15.

(1b) For each of single boreholes, grouped boreholes with a raw water pipeline, and conjunctive use boreholes, describe the rules applied for treating the assets and associated costs as part of the water resource, raw water distribution, and water treatment business units, and quantify the impact for 2014-15.

(1c) For those sources which require more than one treatment process (eg blending, re-chlorination), describe the rules applied for treating the assets and their costs as part of the water resource, raw water distribution and water treatment business units, and quantify the impact for 2014-15.

(1d) Where the expected flow of activities can be reversed, e.g. where raw or partially treated water is returned to aquifers, rivers or coastal areas for subsequent use, describe the rules applied for treating the assets and their costs as part of the water resource, raw water distribution and water treatment business units, and quantify the impact for 2014-15.

(1e) For any of the activities in 1a to 1d, are you aware of any other companies which adopt a different accounting treatment?

(1f) Including General & Support costs, quantify the extent to which the costs (opex and depreciation) reported under water resource in the regulatory accounts for 2014-15, are directly coded or resulting from allocation.

(1g) For those costs in 1f above which arise from a process of allocation, please:

- State what drivers are used to allocate which (quantified) costs
- Explain why direct coding is not used, the rationale for adopting the allocation drivers used, and quantify these drivers
- State if there are any plans either to adopt improved methods of allocation or direct coding

2. Non-appointed activities

(2a) Where appointed business assets are used for either the non-appointed business of the appointee, or by an associated company, please quantify for 2014-15 and describe how the appointed business charges for their use.

3. Regulatory accounts – recognising 'other income'

(3a) Do you include any amounts under 'other operating income' or 'other income'? What do you include in these categories?

(3b) Do you receive any bulk supply imports from other companies (treated or untreated)? Which business unit do you use to recognise these costs?

(3c) Do you make bulk supply exports to other companies (treated or untreated)? How do you use to recognise the associated:

- Income
- Costs?

(3d) Customer side supply pipe repairs – do you charge customers for repairing leaks? If so how do you account for the income?

4. Geographic cost disaggregation

(4a) Does your company area cover more than one Water resource management zone (WRMZ)? If so describe them below.

(4b) Do you have different tariffs for different geographical areas? If so, what is the basis for these different charges? Do you have any plans to change these?

5. MEAV revaluation in 2009

(5a) At the last full MEAV revaluation at PR09, for the water resources business unit assets, describe the approach to calculating:

- the gross replacement cost
- the total life and remaining life
- the valuation of "out-of-life" and mothballed assets

(5b) Quantify and explain the effect of the PR09 revaluation on water resource business unit asset values and also on the level of CCD for these activities over the period from 2010-11 to 2014-15.

(5c) Quantify and explain those areas of the PR09 revaluation for the water resource business unit activities where it was assumed that the Modern Equivalent Asset was substantially different to the existing asset, and also where asset lives were assumed to be significantly different to engineering lives.

(5d) Since the PR09 revaluation up to 2014-15, describe the approach to rolling forward the net MEAVs reported in the regulatory accounts.

(5e) For the net MEAV of the water resource business unit activities reported at 31 March 2015, specify the value associated with assets which belong wholly to the water resource activities, and that which is the result of allocation.

For that which results from an allocation, explain how the assets have been allocated, and provide net MEAV values for each method of allocation.

(5f) Appendix 1 shows the net MEAVs by company for each of the water business units. Appendix 2-4 show this data alongside the asset inventory information from PR09.

- Do you have any comments on your relative position in the graphs in appendix 2-4 compared with other companies?
- If there are any reasons why you believe that the appointee's PR09 MEAV revaluation for water resource business unit assets rolled forward is not comparable with that of other appointees, please explain.

6. CEPA recommendations

(6a) What are your views on the proposed cost allocation guidance which has been added to our proposed RAG2?

(6b) In our consultation we noted that the CEPA recommendation regarding Management & General (M&G) cost allocation would need more work with the industry. Do you have any suggestions as to what the most appropriate cost driver should be? Are there any issues in applying the principal user policy when allocating M&G assets?

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.

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