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Regulatory reporting consultation response
Ofwat
Centre City Tower
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13 September 2016

Dear Sir or Madam,

Further consultation on regulatory reporting for the 2016-17 reporting year

Thank you for the opportunity to comment on the further consultation on regulatory reporting for the 2016-17 reporting year. We welcome the additional clarity provided and believe that this represents an important step as we move towards the introduction of separate price controls as set out in the Water 2020 document.

We are supportive of the changes proposed relating to water resources as currently set out. The changes for bioresources represent a larger modification that may require more significant changes to implement. This potential impact is discussed in our answers to questions four and five of this consultation.

Whilst we have endeavoured to provide accurate information, specifically regarding the impacts of the boundary definitions for water resources and bioresources, the assessment should be considered as an initial high level assessment. We have based our response on the assumption that we are wholly compliant with the current guidance (RAG 4.05). Therefore impacts are limited to those changes from 4.05 to 4.06.

We regularly review our reporting processes to ensure compliance with the latest RAGs and we will continue to do this as we gain further understanding of the changes. We hope that you find our response helpful, our detailed response to the questions is provided in the appendix attached to this letter. If you would like any more information or details regarding our response please contact me using the following e-mail address, wendy.kimpton@yorkshirewater.co.uk.

Kind Regards,

Wendy Kimpton
Head of Regulation

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Appendix 1: Response to six consultation questions

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

The changes should not have a significant impact on our existing processes on the whole. We have no specific comments regarding the content and format of the pro-forma tables in appendix 1,

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 agree that this is the right action to place increased emphasis on the information provided in this area. We have no comments or objections to the movement of water resources and bioresources from section 4 to section 2 of the APR.

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).

The definitions in RAG 4.06 have sufficient clarity to allow us to complete table 4D, which should in turn allow the completion of the other pro-forma tables.

Currently our asset inventory (AI) system is used to account for grouping of assets under a single cost centre. This is based upon the data available in our AI system which may incorporate various different assets. An initial review suggests that our cost centres do already point to the relevant accounting separation categories under these definitions. However, we will deliver a more detailed review in due course and update our processes and data to reflect the changes in this area as they become more fixed.

Some proposal, such as for boreholes may have a greater impact in terms of accounting. We currently have an individual cost centre that capture energy and maintenance costs for boreholes (single or grouped). We can make the accounting split as required, but this will require a review of the technical setup of each borehole to satisfy the complex formula in the example provided. This is a level of granularity seems excessive when considered that the borehole cost centres (for Yorkshire Water) accumulates £1.1M a year in total, which currently sits 100% in raw water abstraction. We would welcome an alternative approach that is proportional for companies where the scale of value is low in this area.

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).

Whilst we can confirm that sufficient detail is provided in relation to the requirements to complete the tables we can foresee some potential difficulties in allocating these costs accurately.

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Currently we do not keep detailed records of how sludge imports are thickened with or without indigenous thickening occurring, or whether the same assets are utilised. This is complicated by the fact that on some of sites it is possible to receive imports as follows:

- Un-thickened imports, never thickened, treated without thickening.
- Un-thickened imports dropped into the STW inlet and co-settled.
- Un-thickened imports, thickened on their own designated thickener (this could be occasionally used for indigenous sludges, with temporary pipework but we don't keep records for this).
- Un-thickened imports that are then thickened with indigenous sludges. the proportions of indigenous sludges to imports could change, as for example the indigenous sludge increases and decreases, or are occasionally co-settled (we currently do not record this level of detail).
- Thickened imports, that are not re-thickened but are blended.
- Thickened imports that are then put over a thickener with indigenous sludge.

Whilst this happens, indigenous sludge may or may not require thickening or be co-settled etc. The amount each asset does of an activity varies from site to site, and additionally over time. Currently, our main point of sludge measurement is downstream of this point in the process. Therefore we do not have data collected that can be used to determine the proportion of the asset that is used to thicken different sources of sludge.

Whilst we understand the new wholesale wastewater service activity definitions – noting we consider that "*liquor treatment which is done at a self-contained sludge processing centre*" should be explicitly included as a sludge treatment asset – given the above issues we are not yet sure how we will apportion our sludge thickening operating/capital costs between network+ (sewage treatment/disposal and sludge liquor treatment) and sludge 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.

We have separated our response into negative and positive strategic impacts of the bioresource boundary change and a consideration of detailed impacts on Net MEAV.

Negative Impacts

We are concerned that this change will complicate the allocation of costs as sludge thickening assets (and associated capital and operating costs) will have to be apportioned according to thickener performance (> or < 10%) and typical use (whether imported sludge is co-thickened with indigenous sludge, or not); as opposed to their simple fundamental engineering design (active or passive thickening).

We also consider that active sludge thickening is a fundamental unit operation for the sludge management service, the cost and performance of all downstream unit operations depends

on active sludge thickener performance. It is not immediately clear to us why this strategic sludge management activity should not be always located in the sludge revenue control.

A company may wish to manage some of the more remote active thickening assets differently, for example by the network+ business. In our view, that does not mean they should be automatically excluded from the sludge revenue control. We think the claim that the market would not be interested in this particular sludge thickening activity is to prejudge the market and where true economic value could be added. Our general preference would be to include all of the key sludge unit operations within the sludge revenue control. This will then provide the maximum potential for markets to perform and innovate. Removing them provides for an immediate negative impact, by reducing the scope of the market to reduce our cost base. This will depend on the scale of the costs that have been moved between the controls as a result of the new boundary change.

Positive Impacts

The impact of moving these raw sludge thickening and associated liquor treatment activities will be to transfer material sludge related processing costs – especially operating costs such as polymers/power for sludge thickening and associated liquor treatment - into the network plus business. The consequence of this accounting treatment may mean that the thickened sludge (<10%) passing across the new sludge boundary is closer to having some intrinsic economic value. Given the policy position outlined in Water2020 this shift in accounting treatment may be considered to be a positive impact of the boundary change.

A second positive impact of the boundary change relates to the position of current TDS measurement. Most companies measure TDS load after the sludge thickening activity, prior to the sludge treatment unit operation. Hence the measurement of TDS/yr load, the potential basis of the average sludge revenue control at PR19, will correlate better with the new post (<10%) sludge thickening boundary.

A third positive impact is that the accounting complication of recharging for the treatment of large raw sludge liquor flows is materially reduced. The risk of incorrectly scaling the accounting recharge is therefore also reduced. It is not avoided completely; as smaller treated sludge liquors and some raw sludge liquors will still cross the revenue control boundary. But the transfer pricing complications - associated with raw sludge liquor treatment - are reduced as these costs are mostly retained within the network plus business.

We know these impacts are hypothetical and difficult to quantify. But we think they deserve further regulatory consideration. On balance we think the three negative impacts identified outweighs the three positive impacts.

MEAV Considerations - Water resources

Using the same classification of impounding reservoirs used at year-end, the total net MEAV value of reservoirs to be transferred from water resources to raw water storage (as per the new RAG 4.06) is estimated at up to **£44m**. This can be compared to a net MEAV for water resources of £4,392.4 m in March 2015. The approach taken was to use the reservoir classification in our asset inventory system, and this is consistent with the allocation of capital expenditure in the APR for 2015/16.

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The change represents the movement of one reservoir (Loftsome bridge ESR) which has an aquifer recharge scheme. It has previously been classed as an ESR (storage reservoir) where the volume is from an upstream river abstraction. We have for the purposes of this initial review assumed that potentially all of the Net MEAV for Loftsome bridge could be reallocated. A detailed review on an asset by asset basis has not been undertaken, although we will undertake a detailed review in due course over an appropriate timeframe to ensure full compliance with the final RAG definitions.

Additionally, after evaluating our asset inventory we have not found any evidence of pre-treatment assets at boreholes. Only two boreholes appear to have had pre-treatment in the past and they have both been decommissioned.

MEAV Considerations – Bioresources

Noting the issues identified in question 4, to estimate the impact of the changes we have assumed that;

- In the new approach, thickening of sludges for export is sewage treatment.
- We have also assumed that thickening for indigenous SAS on self-contained sites is also sewage treatment (as this is usually done separately from imported sludge).
- We have then reviewed whether primary sludge is thickened and, if so, whether this is done in normal operating conditions in some form of combination with imported sludge. For these sites identified, 50%, 25% or 10% of thickening has been allocated to sludge activity based on it being usual practice to co-thicken imports and primary sludge on the site identified.

Therefore we have estimated that the impact of the changes is circa **£33m** Net MEAV will be reallocated from sludge treatment to sewage treatment. This can be compared to a net MEAV for sludge treatment of £264.9 m in March 2015.

Summary

	Water storage to Water Resources	Sludge treatment to Sewage treatment
Net MEAV	Upto £44m	Circa £33m

There will also be operating cost impacts (eg maintenance, polymers and electricity associated with raw sludge thickening to below 10%) associated with the bioresource boundary change. We have not been able to scale these impacts in the time available. If you would like a provisional estimate of the other cost impacts then please do not hesitate to contact us.

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

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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?

Currently the changes from RAG 4.05 to 4.06 do not have a significant impact on discrete connections, as we have already included some pipework between raw water sites in raw water abstraction. As such we have not changed our allocations from 4.05 as we have assumed that for the purposes of this consultation response, noting the timescales, that we are wholly compliant with RAG 4.05.

The introduction of a de minimis value would require us to review all pipework individual against any criteria set (in terms of length). We would prefer that the boundaries are set as clearly as possible and where possible ambiguous specifications be avoided. This should limit any issues of divergence within the industry in respect of interpretation. We will do a fundamental review of our compliance with RAG 4.06 in due course in measured manner over an appropriate time period.