

April 2017

Trust in water

Consultation on regulatory reporting for the 2017-18 reporting year

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About this document

This consultation concerns proposed changes to the reporting requirements for the Annual Performance Report (APR) which are effective for the 2017-18 reporting year.

We intend to finalise the regulatory accounting guidelines (RAGs) in October 2017.

This document covers the following areas:

1. Proposed new information requirements for cost assessment purposes,
2. Proposed new information requirements for the cost of new connections,
3. Proposed updates to RAG 5 and some specific changes which will only apply to bioresources,
4. Proposed limited new disclosure requirements for non-appointed transactions,
5. Proposed changes to outcomes reporting,
6. Proposed changes recognising the new eligibility criteria for participants in retail market opening on 1 April 2017; and,
7. Proposal to raise the small company threshold.

We invite comments from all stakeholders and users of the APR.

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Responding to this consultation

We would welcome any comments on this document. Please email them to FinanceAndGovernance@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 **19 July 2017**. 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this consultation on our website at www.ofwat.gov.uk, unless you indicate that you would like your response to remain unpublished.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.

Consultation questions

We welcome responses from stakeholders to these specific questions and on any of the issues and matters we raise in this document.

Questions relating to 2017-18 reporting

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

<p>Q1</p>	<p>Appendix 1 contains new tables for;</p> <ul style="list-style-type: none"> • Information on new connections (table 2J) • Information on cost assessment (tables 4J to 4W) <p>a. Do you agree with expanding the APR with more tables to capture more granular cost data?</p> <p>b. Do you agree costs should be captured through a controlled process?</p> <p>c. Do we have sufficient guidance and definitions for the additional line items provided?</p> <p>d. What line items need further definition?</p>
<p>Q2</p>	<p>What are your views on the proposed changes to the existing tables in Appendix 1?</p> <p>a. Tax and non-appointed revenue (table 1A)</p> <p>b. Totex analysis (table 2B, 4D and 4E)</p> <p>c. Other minor changes</p>
<p>Q3</p>	<p>Do you agree that there will be some residual non-household retail activities (for example, developer services and meter reading) for an incumbent that exits the non-household retail market?</p>
<p>Q4</p>	<p>Do we have sufficient guidance around cost allocations between business units?</p>
<p>Q5</p>	<p>Do we have sufficiently defined boundaries for water resources and Bioresources?</p>
<p>Q6</p>	<p>Have we provided sufficient guidance for Average Pumping Head in table 4P (wholesale water non-financial data)?</p>

Questions relating Outcomes reporting

Q7	Should companies accrue for future ODI revenue rewards/ penalties?
Q8	Do you have any comments on our proposed shadow reporting of leakage, supply interruptions and sewer flooding according to the new consistent reporting guidance?

Question relating to small companies (RAG3)

Q9	Do you agree with the proposal to raise the small company turnover threshold to £10.2m?
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Questions relating to transfer pricing guidance (RAG5)

Q10	Does RAG5, in its current form, inhibit efficient bioresources trades from happening? If so, please explain why and if possible, provide evidence.
Q11	<p>a. Which of our proposed two options (Option A: incremental cost or above and Option B: incremental cost or above plus a margin) do you prefer and why?</p> <p>b. In the case of Option B, do you agree with our proposed approach to specifying an appropriate margin? Please explain your reasoning and provide evidence where possible.</p>
Q12	What implications or concerns (if any) do you foresee for new entry to the bioresources market, as a result of our proposals on transfer pricing for bioresources?
Q13	Are there any other ideas that you propose, to improve our regulation of transfer pricing for bioresources? If so, please provide analysis and where possible, evidence, to support these.
Q14	Are there any other matters which we should be taking into consideration regarding transfer pricing for bioresources?

Q15	Do our changes have any implications for the rest of RAG 5 or for activities other than bioresources?
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Executive summary

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 companies¹ 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 APR – 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.

This regulatory reporting consultation covers the following areas:

1. Proposed new information requirements for **cost assessment** purposes (section 2),
2. Proposed new information requirements for the **cost of new connections** (section 3),
3. Proposed updates to **RAG 5** and some specific changes which will only apply to bioresources (section 4),
4. Proposed limited new disclosure requirements for **non-appointed transactions** (section 6.3),
5. Proposed changes to **outcomes reporting** (section 5.1),

¹ By “companies” we mean, in this document, companies that hold appointments as water and/or sewerage undertakers under the Water Industry Act 1991.

6. Proposed changes recognising the **new eligibility criteria for participants in retail market opening on 1 April 2017** (section 5.2); and,
7. Proposal to raise the **small company threshold** (section 5.3).

Timeline

This consultation will run for 12 weeks closing on 19 July 2017.

After the conclusion of this consultation we will consider the responses and in October 2017 we plan to publish a finalised version of the RAGs.

Timeline	
27 April 2017	Launch RAG consultation
19 July 2017	RAG consultation closes
31 October 2017	Publish: <ul style="list-style-type: none">• Information notice;• summary of changes made to proposed RAGs; and• finalised RAGs

1. Introduction

In our document [Consultation on regulatory reporting](#) (September 2014) we stated that the APR 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.

In August 2016, we consulted on changes to the APR reporting to reflect the new business units as proposed in [Water 2020: our regulatory approach for water and wastewater services in England and Wales](#) (May Water 2020 document). We are now consulting on proposals to include further information to allow us to build high quality econometric cost models for the next price review, having developed these with the sector over the last twelve months.

In parallel with the APR consultations, we also published in July 2015 our [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.

On 22 November 2016, we published [Monitoring financial resilience report 2015-16](#). Our financial monitoring report is based on information that companies published in their 2015-16 APR and their responses to additional questions that we asked them about their published data.

Each company is responsible for implementing assurance procedures to make sure they meet all of their legal and regulatory obligations. We use our [Company Monitoring Framework](#) to provoke and challenge all water and wastewater companies to publish information that can be trusted. The company monitoring framework describes three categories of assurance which we [assign annually](#).

This consultation will run for 12 weeks from 27 April to 19 July 2017.

2. Cost assessment

2.1 Overview

In [Water 2020: our regulatory approach for water and wastewater services in England and Wales](#) (May Water 2020 document) we set out that we were progressing work on cost assessment and accounting separation. We had established the Cost Assessment Working Group (CAWG), where we work with the industry to develop and refine data requirements and our approach to cost assessment and modelling.

Cost assessment is an extremely important and material component of price reviews. We are proposing to expand the APR to incorporate more granular cost tables to assist our work on PR19.

In general the cost assessment process is supported by econometric benchmarking models which help assess the efficiency of companies' costs. The use of econometric benchmarking is consistent with other regulated sectors.

Developing high quality econometric models is crucially dependent on the quality of information that companies provide. Our view is that by collecting cost information through a controlled process we can improve the data quality and provide greater support to the cost modelling.

2.2 Background

In 2015 we discussed our initial thoughts on cost assessment data requirements with the Regulatory Accounts Working Group (RAWG).

In January 2016 we established the CAWG to work with water companies and other interested stakeholders as we develop a cost assessment approach for PR19. Furthermore within the CAWG, specialist sub-groups have been established to focus on particular workstreams. This approach aids transparency and allows for continued dialogue with stakeholders.

One of the first tasks the CAWG embarked on was to establish reporting requirements for the purpose of cost (efficiency) assessment. Such information is needed to allow us to develop cost assessment tools that will help us set robust price controls in PR19.

In 2016, following discussions with the companies in the CAWG we developed an Information Request to capture accurate cost data. We issued Information Requests for wholesale water in August 2016 and wholesale wastewater in October 2016. The provision of this information supported the development of cost models.

2.3 Our proposal

We are seeking to align the APR with the cost tables in the 2016 Information Requests. However, this has been an iterative process. The tables have evolved in certain areas to reflect comments raised by the industry with the aim of improving data quality and improving the cost models.

We signalled our intentions to expand the APR for cost assessment data at the February RAWG 2017. In advance of the meeting we provided draft cost assessment tables for discussion based on tables in the 2016 Information Request. These new tables are set out in Section 4 - tables 4J to 4W.

2.4 Assurance

Incorporating cost assessment data into APR will benefit both companies and customers – by allowing us to make better judgements on costs and provide greater transparency.

High quality data is critical to the development of robust cost models. Integrating cost tables into the APR means it is part of a controlled and understood process with clear guidelines set out in the RAGs.

To support this we would expect the additional tables to form part of the assurance and governance arrangements already in place for Section 4 of the APR. Furthermore we expect to include the new tables within our Company Monitoring Framework assessment. If companies provide poor quality data this will be reflected in our overall assessment of assurance.

2.5 Overview of the Tables

We have added 14 new tables. The basis of these tables was the 2016-17 Information Requests for wholesale water and whole wastewater.

For wholesale water, information on non-financial and physical characteristics of water resources, water treatment and distribution networks for each company is collected in Tables 4P and 4Q.

For wholesale wastewater, information on the non-financial and physical characteristics about sewage collection (network plus), sewage treatment (network plus) and bioresources activities is captured in Tables 4N, 4O, 4R, 4S, 4T and 4U.

Atypical expenditure by business unit is provided in Tables 4J (wholesale water) and 4K (wholesale wastewater). These tables identify atypical costs and splits them between network plus and other activities in the value chain.

Expenditure by purpose is provided in Tables 4L (wholesale water) and 4M (wholesale wastewater) identifies enhancement expenditure and again splits them between network plus and other activities.

Tables 4V and 4W provide further analysis of operating costs.

3. New connections - Infrastructure

In December 2016, we published [charging rules for new connection services](#) and updated our [charges scheme rules](#) for companies whose areas are wholly or mainly in England. The charging rules were issued using new legal powers that were inserted into the Water Industry Act 1991 by the Water Act 2014. These new rules (including the changes to our charges scheme rules) will be implemented from 1st April 2018. We intend to publish charging rules for companies wholly or mainly in Wales by the end of this year, subject to timely enablers from the Welsh Government.

Our new rules will redefine and clarify the services and costs infrastructure charges² will pay for in the future. This is to ensure they are fair and address developers' concerns that they are being overcharged. We consulted companies and stakeholders in our [Update on new connections charging rules](#) in October 2016 to allow the new charges to be fully reflective of network reinforcement costs when these are excluded from other charges. This included a licence modification to remove the cap on the level of infrastructure charges which is set out in Licence Condition C

Our charging rules require water companies to balance their revenues from infrastructure charges with the costs they are intended to cover over a rolling 5-year cumulative period (starting on 1 April 2018), as far as is reasonably possible. This rule applies at a company-wide basis (rather than a project-by-project basis).

Developers want to see that this rule is being adhered to and to understand how their money is being spent. If there a difference between expenditure and receipts in one year, customers will want to understand the reasons behind it and want assurance the imbalance will be corrected in future years. We need to monitor companies' compliance with the new rules as a regulator, so we can step in if needed.

In the past, some stakeholders have attempted to use data in companies' APRs to understand whether companies' charges are appropriate and make comparisons

² As well as recovering any costs incurred in making connections to a water supply or a public sewer, water companies can also make a charge for the connection to a water supply or a public sewer of premises which have never at any previous time been so connected for domestic purposes (see section 146(2) of the Water Industry Act 1991). These charges are known as "infrastructure charges".

between companies. However, the information companies currently publish is not appropriate for this kind of analysis and has only increased confusion.

We said in our [charging rules for new connection services](#) that we would consider how best to address these issues through the APR. We set out our starting point for how this might work and said we would develop our proposals through a dedicated working group.

Our working group comprises a number of water companies and representatives of the Home Builders Association, Home Builders Federation and Fair Water Connections. The group confirmed that transparency through the APR is key to building trust and confidence. Through this collaborative process, we have established the proposals below. These proposals meet the objectives and issues discussed above and enable comparisons between companies by establishing common definitions whilst avoiding undue regulatory burden.

The proposed changes have also been presented and discussed at the RAWG attended by representatives of the water companies.

3.1 Our proposals

Revenues from Infrastructure charges are already reported in table 4E: Analysis of Grants and Contributions and Land Sales. We propose a new table (2J – Infrastructure Network Reinforcement Costs) which details expenditure on network reinforcement. This expenditure is split between water and wastewater as there are separate infrastructure charges for each.

The expenditure is then further analysed into distribution mains, pumping stations, and storage facilities etc, in response to customers' requests to understand how their money is being spent by the companies. We believe that this provides additional transparency whilst at the same time not imposing an undue additional reporting burden on companies.

We are also proposing that companies provide similar cost information, as above, for on-site costs. Although not part of the new rules, this request was made at the working group and it was considered that it would be beneficial to record this information, as it provides a view on the total expenditure incurred by the company, it is on a memorandum basis only, and will not form part of the formal monitoring and reporting requirement.

The proposed format of monitoring and reporting of infrastructure charges can be summarised in table 1.

Reporting year	Cumulative variances between costs and revenues							APR review	Cumulative period
	2018-19	2019-20	2020-21	2021-22	2022-23	2023-24	2024-25		
2019	X							High level	1 year only
2020	X	X							2 years
2021	X	X	X						3 years
2022	X	X	X	X					4 years
2023	X	X	X	X	X			Detailed	5 years
2024		X	X	X	X	X			Rolling 5 years thereafter
2025			X	X	X	X	X		

Table 1 Proposed format of monitoring and reporting of infrastructure charges

Companies are asked to provide a commentary in their APR on the balance of costs and revenue each year from 2018-19 onwards. This will be proportionate to the scale of variance each year and will be based on a single year in 2018-19 and then cumulative thereafter.

However, we fully accept there are likely to be greater variances in the earlier years as the new charging rules are implemented and transitional arrangements are made.

We propose that these changes will be effective for the reporting year 2017-18 as this will provide a pilot year prior to full implementation. An additional reporting requirement will be introduced for 2018-19 - the reconciliation table and supporting narrative as shown in Table 2.

Table 2 Proposed pro forma table 2K ‘Network Infrastructure reinforcements reconciliation’³

Revenue / Costs Reconciliation	Water	Wastewater	Total
Variance brought forward			
Revenue			
Costs			

³ We propose to consult on this table for the reporting year 2018-19.

Variance carried forward	£m	£m	£m
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The narrative breakdown of the variance carried forward can be found in section xxx.

The proposals are being implemented over a two-year period due to the fact that the new rules for the calculation of the Infrastructure Charges do not come into effect until the 1st April 2018. Therefore the reporting year 2018-19 will be the first year for which both revenue and expenditure will reported on a consistent basis.

4. Bioresources Transfer Pricing and RAG5

4.1 Overview

We want to facilitate the development of a market in bioresources⁴. A well-functioning market should deliver benefits such as: efficiency in production, innovation in both technology and the range of services offered, and efficient allocation of resources such as capacity. Over time, we believe these benefits should ultimately flow through to customers as lower prices.

However, some companies have expressed concerns that our current Regulatory Accounting Guidelines⁵ (RAGs) may be inhibiting trades thus preventing the market from developing. We have discussed these issues with the bioresources working group and individual WaSCs to better understand their views on the scope for trading and potential barriers.

As a result, we are proposing changes to the Regulatory Accounting Guideline 5 (RAG 5) guidelines to clarify our approach to transfer pricing for bioresources trades. We propose that incremental costs plus a margin are an appropriate way of setting transfer prices for such trades, ie such trades should make a contribution to common costs.

The time horizon for the definition of incremental cost should be appropriate for the nature of the transaction eg for short term trading arrangements, a short run incremental cost may be justifiable, while for longer term arrangements, a long run incremental cost measure will be justifiable.

We have proposed guidance on the contribution to common costs that bioresource trades should make. Specifically, we believe a share of the margin made on the sale of bioresources processing should be contributed to the appointed business (over and above incremental costs). This share should reflect the risks incurred by the appointed and non-appointed business respectively.

Our proposed amended guidelines are set out in Appendix 1.

⁴ See [Water 2020: our regulatory approach for water and wastewater services in England and Wales – Appendix 2, May 2016](#)

⁵ See RAG5: Section 5 Guideline principles, paragraph 5.1, final bullet and Section 9 Cost allocation, paragraph 9.4 and 9.8. See also RAG2, which sets out our cost allocation principles.

4.2 Background

Trade in bioresources between water companies

Bioresources are the solid organic waste matter that settles out during the sewage collection and treatment process.

Water and Sewage Companies (WaSCs) have a duty to collect and dispose of bioresources generated from dealing with the contents of their sewers. These duties are carried out by the **appointed business**. The appointed business is subject to the regulatory framework and in particular, price controls.

WaSCs may also process materials from outside their region. Typically this would be bioresources from other WaSCs but it could include organic waste from other sources, such as food waste. This business is open to competition and falls outside our economic regulation. We call the business which carries out such activities the **non-appointed business**, since there is no duty on water companies to engage in such trades.⁶ The external market price charged by the non-appointed business for bioresources treatment is not subject to sectoral regulation and only governed by general competition law. Companies are responsible for their competition law compliance. This responsibility is not changed by the proposals being consulted on in this chapter.

At the moment, there are few trades in bioresources. Most of those that do take place relate to emergency situations (i.e. a company⁷ importing bioresources from another company that is unable to process it owing to an operational emergency).

Some companies have told us that they believe the market is being inhibited by Ofwat's RAGs which, amongst other things, sets out guidelines for the transfer pricing⁸ between the appointed and non-appointed business.

⁶ Companies may also carry out their non-appointed business within separate legal entities, which we term Associates. Throughout this document, where we refer to the non-appointed business this also includes Associates.

⁷ Throughout this document, where we use the term company or companies, we are referring to undertakers.

⁸ A transfer price is the price set internally by a business, for trading between its divisions or other entities in the same group.

The transfer price and RAG 5

RAG 5 establishes a framework for transfer prices for regulatory accounting purposes. The guideline describes the key principles with which companies should comply. One of the principles behind RAG 5 and the setting of transfer prices is that trades should be carried out at arm's length and should not give rise to any cross-subsidy.

Where possible, the transfer price should be benchmarked by reference to a market price through market testing. At present, there is not an active market for processing bioresources, so such benchmarking is not possible.

The guidance suggests that in situations where no market exists, transfer prices should reflect cost. Where costs are also common to other activities, the transfer price should include a fair allocation of these costs.⁹ The guidance states that short run marginal cost techniques should not be used, although in some cases long-run marginal costs may be admissible¹⁰. If marginal cost techniques are used at all by companies in determining transfer prices at present, then this requires justification.

The interpretation of RAG 5 in the case of bioresources trades

Some WaSCs have told us that efficient bioresources trades, which would be in the interests of both potential sellers and potential buyers, are not currently happening.

This is because some potential sellers of bioresources processing believe the current RAGs compel them to charge a transfer price calculated as fully allocated costs (or FAC). This may raise the external price that must be charged in order for the trade to be profitable for the non-appointed business. They argue that this is unattractive to some WaSCs looking to purchase services from them, as the would-be seller's FAC may be higher than the would-be buyer's incremental costs if the potential buyer has already incurred capital costs in its own bioresources processing. However, if the would-be seller's incremental costs is lower than the buyer's incremental cost, an opportunity for an efficient trade is lost: the would-be buyer's

⁹ Paragraph 9.7 of RAG 5.06 states that "In some cases, it may not be possible to charge for services on an activity basis; eg, for shareholder management costs (Register, Company Secretary, AGM etc). Costs of this type should be distributed fairly between each subsidiary of the parent and in a way that reflects the activities the parent on behalf of the individual subsidiaries."

¹⁰ See paragraph 9.8 of RAG 5.06

costs are higher than they otherwise would be, and the would-be seller has lost a revenue opportunity.

As set out above, our guidelines suggest that transfer prices should generally be set to include an allocation of common costs. We consider below whether or not there may be a justification for specific arrangements for transfer pricing involved in bioresources trades.

4.3 Analysis

Impact on consumers of transfer pricing arrangements for bioresource trades

We have a primary duty to further the consumer objective to protect the interests of consumers, wherever appropriate by promoting effective competition¹¹.

If it is true that efficient bioresources trades are not taking place, due to some companies' interpretation of the RAGs, then customers of the would-be buyer's and seller's appointed business are likely to be worse off as a result of the trades not taking place. If the trade had taken place, the would-be buyer's costs would have fallen, and its customers may have benefited from a price reduction.¹² The customers of the would-be seller's appointed business will not be worse off if the transfer price covers incremental costs. They will benefit if the trade also makes some contribution to the fixed costs of assets owned by the appointed business, and that contribution reflects an appropriate timeframe.

A transfer price below the incremental cost of using the appointed business means that customers of the seller's appointed business will unambiguously be worse off as they will be subsidising the non-appointed business.¹³

¹¹ See section 2 of the [Water Industry Act 1991](#). Where we refer to the Act in this document, we are referring to this.

¹² From now until 2020, any additional margin made by the appointed business as a result of a reduction in the cost of processing bioresources would be shared via the "totex sharing" mechanism set out in the 2014 Price Review reconciliation at the end of this Asset Management Period (AMP6). After 2020, the approach to sharing (if there is any) will depend on the form of the bioresources price control set in our 2019 Price Review.

¹³ Transfer prices below incremental costs would also be inconsistent with our secondary duty to ensure that consumers are protected regarding any non-appointed activities, in particular that any

There is potential for participation by other organic waste (OOW) operators in the bioresource market and for WaSCs to use appointed assets to participate in processing OOW. We have engaged with OOWs via the sludge working group, as part of the Water 2020 programme. We would welcome further views on this matter.

Timeframe for considering incremental costs

What is classified as an incremental cost depends on the time frame specified. In the short run, where there is spare capacity available, it may be justifiable to use short run incremental costs. In the long run, we would expect the would-be sellers to take full account of their planned trading and therefore make a contribution to the fixed costs of the assets of the appointed business. This would involve transfer pricing set at the level of long run incremental costs or above.

The relevant timeframe for assessing incremental costs is unlikely to be shorter than the length of an individual contract. However, if contracts for trades are conducted regularly over an extended period, the relevant timeframe is likely to be longer. This is because, when planning capacity, a company may build in an expectation of the use of bioresources trades. For instance, whilst ad hoc trades do not necessarily take account of fixed costs, taking advantage instead of existing spare capacity, repeated or planned trades that take place over a longer period of time need to.

4.4 Proposal

We have considered two options for the transfer price of bioresources:

Option A: The transfer price should be equal to or above the incremental cost incurred by the appointed business in supplying the bioresource processing service.

Option B: The transfer price should cover the incremental cost incurred by the appointed business in supplying the bioresource processing service and also

transactions are carried out at arm's length. Companies' licences also require that all such transactions are at arm's length, so that neither the non-appointed business nor the appointed business, gives to or receives from the other, any cross-subsidy.

include a proportion of the margin made by the non-appointed business on the trade.

Our preferred option is Option B.

Option A would ensure that no economically inefficient trades are deterred by the transfer price, benefiting customers of the buyer's appointed business. In addition, as long as the full incremental costs relating to the relevant time-period are recovered, the customers of the appointed business do not cross-subsidise non-appointed transactions.

We believe Option B would provide greater protection for consumers because it ensures that customers of the seller's appointed business also benefit from the trade. Moreover, since the margin on the transfer price above incremental cost is derived from the margin realised in the actual trade (i.e. the external market price), it does not limit efficient trades from taking place.

We propose the principle that the share of the margin realised in the external market price that is passed back to the appointed company (via the transfer price) should be linked to the relative risk taken by the appointed and non-appointed company. If the non-appointed company invested heavily in assets specifically for use in the bioresources market, it may be entitled to a greater share of the margin. For example, it may have invested in its own treatment plant, exposing itself to the risk that there was limited demand for its bioresources services. If in fact, demand exceeded its capacity, to the extent that it also used spare capacity in the appointed business, it may be entitled to a share of the higher margin.

We believe it is appropriate to allow companies to decide an appropriate share consistent with this principle, depending on the circumstances of the trade (though we would have ability to require companies to justify this). However, companies may prefer a simpler rule to apply which would not require an in-depth assessment of the appropriate share. We suggest an even split of the margin may be appropriate in those cases.

Changes to the RAG 5

We propose changes to the RAG 5 guidelines to clarify the use of incremental costs to set transfer prices for bioresources. We highlight the scope to use incremental cost prices and to align the time horizon for defining incremental costs with time period of trading arrangements.

For the purposes of this consultation, we have provided a marked-up version of the proposed RAG 5.07.

Monitoring compliance

The following changes to disclosure requirements in this area are proposed;

- Revenue – to change the reporting of non-appointed revenue as contained in RAG 3 table 1A; and,
- Transfer pricing disclosures as contained in RAG 3.

Review

We propose to review the effectiveness of the arrangements for bioresources transfer pricing, in the light of market developments, before the end of the next price review period, i.e. before 2025. We believe that this would be good practice and gives the right balance of certainty and responsiveness, for companies to invest and to prepare business plans for PR19 (the 2019 Price Review).

5. Other changes for 2017-18

5.1 Outcomes, performance commitments and outcome delivery incentive data

Changes to outcomes reporting

We collated each company's [2014 price review](#) (PR14) outcome, performance commitment and outcome delivery incentive 'base data' into a single [Excel spreadsheet](#). We collected this data from published 2014 price review documents for each of the largest 17 companies and checked it with those companies. The latest version of the spreadsheet (published 16 December 2016) includes 2015-16 actual performance levels as published by each company in its APR.

In [IN 17/03 Expectations for monopoly company annual performance reporting 2016-17](#) (published 23 February 2017) we set out the changes to annual reporting from 2016-17 for outcomes:

- Pro forma 3B - a new table for reporting sub-measure performance.
- Pro forma 3C - a new table for data relating to the Abstraction Incentive Mechanism (AIM), which started for most companies in 2016-17. The table captures information for the 13 companies to which the AIM applies.
- Pro forma 3D - a new table for reporting Service Incentive Mechanism (SIM) performance. The table needs to be completed with the qualitative (survey) scores, quantitative (complaints) data, and the resulting overall score.

We propose minor presentational changes to RAG 3 pro forma tables 3C and 3D and to RAG 4 for the reporting year 2017-18 and onwards.

Shadow reporting against new reporting guidance

Companies have been working together, co-ordinated by Water UK and supported by Ofwat, to develop consistent reporting guidance for three metrics (leakage, supply interruptions and sewer flooding) to help inform the setting of the outcome performance commitments from 2020 onwards. UKWIR commissioned an independent review of the draft reporting guidance to provide assurance of the definitions and finalise the consistent reporting guidance, which we expect to be published in April 2017.

Companies are calculating data for the first time against this consistent reporting guidance for 2016-17 and will report the data this year.

We propose to collect this data alongside the APR through “shadow” (i.e. unpublished) reporting. We expect the data to go through the same assurance process as other data collected as part of the APR. The reason for shadow reporting of the data is to avoid confusion with other published information on the same issues based on the previously existing definitions.

We recognise that 2016-17 is the first year companies will be reporting under the new consistent reporting guidance and so we are allowing companies until 31 August to provide the data. For 2017-18 data onwards we will expect companies to shadow report the data alongside the APR.

More precisely we want to collect data on the following:

1. Leakage
2. Supply interruptions
3. Internal sewer flooding
 - a. All internal sewer flooding
 - b. Internal sewer flooding excluding sewer flooding due to severe weather events
4. External sewer flooding
 - a. All external sewer flooding within the curtilage of a household or non-household premises
 - b. External sewer flooding within the curtilage of a household or non-household premises excluding sewer flooding due to severe weather events.

From 2021 onwards the data on leakage, supply interruptions and sewer flooding reported in accordance with the consistent reporting guidance will be reported as normal through the APR, i.e. shadow reporting will cease for the 2020-21 data onwards.

5.2 New eligibility criteria for participants in retail market opening

In December 2016 we reviewed the non-household retail price controls and set new controls for the period from 1 April 2017 to 31 March 2020 (PR16). This was in anticipation of retail market opening which occurred earlier this month. Our [PR16](#)

final decisions were published in [Business retail price review 2016: final determinations](#). We set price controls for business retail activities for English water companies in relation to **premises other than household premises (as defined in Section 17C of the Water Industry Act 1991)**.

This is different to our position at PR14. Our PR14 final determinations said that “households” had, for the purposes of the price controls for retail activities, “the same meaning as:

- (i) the regulatory reporting definition of that term set out in section A5.4 of Appendix 5 (Guidance on business plan tables) to ‘Setting price controls for 2015-20 – final methodology and expectations for companies’ business plans’ (July 2013); or (if different)
- (ii) such definition as may be included in Regulatory Accounting Guidelines issued under paragraph 5 of Condition F (Accounts and accounting information) of the Appointment”.

We included the reference to the RAGs because we knew that it was likely that the final eligibility criteria for the business retail market would be different. This meant that some customers who were non-households at 1 April 2015 for the purpose of the price controls set at PR14 were not eligible to switch supplier from 1 April 2017 because they fell outside the criteria.

By changing the definition of “households” in the RAGs for 2017-18 we can ensure that these customers continue to be protected by a retail price control. Therefore, we propose to update the RAGs so that the definition of “households” is the same as the legal definition of “household premises” in section 17C of the Water Industry Act 1991. Premises falling within that definition are not eligible to switch supplier. We have updated RAG 4 to include this new definition.

The 2015-20 **average cost to serve (ACTS)** control for household retail activities automatically adjusts according to the number of customers, so the newly classified households (who were previously non-households) will be assimilated under the household control without the need for further changes.

We intend to retain the original definition of “households” in the RAGs for water companies whose areas are wholly or mainly in Wales (Welsh water companies). No change in the definition is needed to protect customers of Welsh water companies. At PR16 our final determinations for Welsh water companies set price controls for business retail activities in relation to premises other than households using the same definition as at PR14. This is because, reflecting the policy position of the Welsh Government, the new business retail market has not been extended to customers of Welsh water companies. Customers of Welsh water companies

continue to be only able to switch their water supplier if they are supplied with at least 50MI of water per year.

5.3 Small company threshold

We currently define a company with an annual turnover of less than £6.5m as small in terms of regulatory accounting information requirements. To ease regulatory burdens on small companies and to align our definition to those used by government we propose to lift this to £10.2m. This is in line with government changes to the small companies' regime which were approved in March 2015. We have updated RAG 3 to reflect this proposal.

6. Summary of changes to RAGs 1 to 5

6.1 Background

This chapter summarises the changes made to RAGs 1 - 5 as modified by this consultation.

Most of the changes are as a result of additional data for cost assessment and new connections work. Other changes have been as a result of resolving technical observations made by companies and requests for clarification.

6.2 Proposed changes to text

RAG	Issue	Description	Paragraph affected
RAG 1 RAG 3	Revenue reporting	Expand application note to include a reference to the new accounting standard IFRS 15	RAG 1 para 1.5.3 RAG 3 para 1.22 RAG 3 para 3.6.1
RAG 2	Contracting out	Use of appropriate cost drivers other than FTEs when contracting out activities	RAG 2 chapter 5 definitions
RAG 2	Cross subsidy guidance	Overlapping guidance with RAG 5 deleted to allow RAG 5 changes to take precedent.	RAG 2 paras 2.1 and 2.3.1
RAG 2	New rules for imported sludge	Overlapping guidance with RAG 5 deleted to allow RAG 5 changes to take precedent.	RAG 2 paras 2.8 and 2.14
RAG 2	Definitions	Updated definitions to reflect recent changes	RAG 2 para 5.1
RAG 3	Non-appointed activities	Sludge and tankered waste are shown in a breakdown of revenue. Opex and capital costs shown separately or in narrative.	RAG 3 paras 4.5.3, 6.2.3, and 6.3.1
RAG 3	Tax and group relief	Disclosure of group relief transactions	RAG 3 para 6.3
RAG 3	RORE definition	Clarification of calculation period.	RAG 3 para 3.14

RAG	Issue	Description	Paragraph affected
RAG 3	Small company turnover threshold	Increase from £6.5m to £10.2m	RAG 3 para 5.1.2
RAG 4	High lift pumps	Clarification that 'high lift pumps' are part of Treated Water distribution	RAG 4 chapter 2
RAG 4	Eligibility for retail switching	The retail household definition has been amended to include any non-eligible non-households that are non-eligible for market participation.	RAG 4 chapter 3
RAG 4	Sludge liquors treatment plants	RAG 4 clarification that stand-alone liquor treatment plants are part of sludge treatment.	RAG 4 chapter 2
RAG 5	Sludge	Revised transfer pricing rules for imported sludge activities.	RAG 5 para 9.8, new paras 9.9 to 9.13 and new section 12

6.3 Proposed changes to tables (RAG3) and definitions (RAG4)

Table	Issue	Description of change	Table changes	Line definition changes
1A	Non-appointed revenue	Split between imported sludge, tankered waste and other.	Y	Y
1A	Effective tax rate	Calculation needs to exclude PY tax impact, maybe note to 1A to breakdown the tax charge between PY and other?	Y	Y
1D 2B 2E 4D 4E 2I - line definitions	Grants and contributions	Consistent wording needed; including table titles. Clarify that 1D is for <u>capital</u> grants (as defined by GAAP treatment) but section 2 and 4 refers to all grants.	Y	Y
2A	Recharges	Add heading in table and change line definitions to ensure this is for principal use recharges only.	Y	Y
2B, 4D and 4E – split of renewals	Ability to create proxy for pre-2015 infrastructure renewals expenditure	Insert 2 new lines.	Y	Y

Table	Issue	Description of change	Table changes	Line definition changes
2B (amendments) , 4D and 4E - rename	For clarity Local authority rates includes cumulo rates	Change to 'Local authority and cumulo' rates.	Y	Y
2B, 4D, 4E	New connections - network reinforcement	Add new line, redefine 'other capex' lines (12 and 13) in 2B, 4D, 4E to exclude network reinforcement.	Y	Y
2C	'Household' definition	Reference to definition of household updated to reflect changes now captured in RAG 4.	n/a	Y
2D	Depreciation; third party services	Depreciation for third party services should only be recorded for dedicated assets.	n/a	Y
2E	Other contributions	Split between price control and non-price control.	Y	Y
2G, 2H	Retail exit - no need to populate	Text added on line definitions.	n/a	Y
2I	Grants & Contributions	Updated to take into account new lines in table 2E.	n/a	Y
2J	New connections - network reinforcement	Insert new table.	Y	Y
3C, 3D	Outcome, performance commitment and outcome delivery incentive data - Presentational issues	Pro forma 3C; year references removed from headers Pro forma 3D; line 6 description: changed from 'Quantitative composite score' to 'Total contact score'	Y	Y
4B, 4C (1E, 4H)	Cross references to FD / rule book	Cross references to be simplified to make a general reference to the rule book model and FD documents, this was previously causing confusion. Dependent references on other tables updated.	n/a	Y
4C	New lines	New lines to give increased transparency in calculating changes to the RCV.	Y	Y

Table	Issue	Description of change	Table changes	Line definition changes
4F	Cost assessment for retail	<p>Table 4F changes - description updated from 'Operating cost analysis' to 'Cost analysis'</p> <p>Line 4F.9 'Depreciation- tangible fixed assets' further split into pre and post 1 April 2015 assets.</p> <p>New line added for capital expenditure</p> <p>Reference to definition of household updated to reflect changes now captured in RAG 4.</p>	Y	Y
4J to 4W	Cost assessment - new tables	Add new tables 4J to 4W	Y	Y

7. Future changes to accounting standards

7.1 IFRS 16 Leasing

There is no impact from this standard until the 2019-20 reporting year. We will monitor the expected impact of this standard with companies and it is likely that business plans for PR19 will require these changes to be taken into account when forecasting performance for 2020-25.

7.2 IFRS 15 and Infrastructure charges

We do not anticipate any direct impact from this standard since table 2E 'looks through' the accounting treatment and instead focuses on the cash received in the year.

7.3 IFRS 15 and ODI revenue

We asked companies for their views on the impact of this standard. Some companies believe that it is possible some companies could accrue for ODI rewards and penalties on an ongoing basis. However some companies thought that they would not need to recognise this in the accounts. We will continue to have dialogue with companies and auditors to monitor developments in this area.

Companies recognising such accruals may have to make a narrative statement to explain this treatment to aid comparability.

8. Next steps

We are seeking comments on the proposals in this document by **19 July 2017**.

After the conclusion of this consultation we will consider the responses and in October 2017 we plan to publish a finalised version of the RAGs.

Timeline	
27 April 2017	Launch RAG consultation
19 July 2017	RAG consultation closes
31 October 2017	Publish: <ul style="list-style-type: none">• Information notice,• summary of changes made to proposed RAGs; and,• finalised RAGs

Appendix 1 Proposed regulatory accounting guidelines

The links below are for the proposed RAGs:

[RAG 1.08 Principles and guidelines for regulatory reporting under the 'new UK GAAP' regime \[Draft\]](#)

[RAG 2.07 Guideline for classification of costs across the price controls \[Draft\]](#)

[RAG 3.10 Guideline for the format and disclosures for the annual performance report \(excludes tables – see link to pdf document below\) \[Draft\]](#)

[RAG 4.07 Guideline for the table definitions in the annual performance report \[Draft\]](#)

[RAG 5.07 Guideline for transfer pricing in the water and sewerage sectors \[Draft\]](#)

[Pro forma tables 2017-18 \[Draft\]](#)

Appendix 2: Bioresources Transfer Pricing and RAG5

1. Background

Transfer pricing

A transfer price is the price set internally by a business, for trading between its divisions or other entities in the same group. There are little or no constraints under UK or International Generally Accepted Accounting Practice (GAAP) as to how transfer prices should be set. The two main criteria are: (a) tax legislation and (b) to incentivise good decision making behaviour by business units, so that they act in the interests of the group as a whole.

Therefore our main considerations in designing a transfer pricing scheme are our regulatory strategy and objectives, as guided by our section 2 duties in the Act, as well as the ring fence in the licence.

The distinction between appointed and non-appointed business

Bioresources is the solid organic waste matter that settles out during the sewage collection and treatment process. Companies have a duty to collect and dispose of the sludge generated from dealing with the contents of their sewers and we term this the **appointed business**. This business is considered a geographic monopoly and is therefore subject to certain regulation and in particular, price controls. Companies may also process materials from outside their region. Typically this would be sludge from other WaSCs but could include organic waste from other sources, such as food waste. This business is open to competition and falls outside our economic regulation. We call this the **non-appointed business**, since there is no duty on companies to carry this out.

In this case, the transfer price is the price at which trading occurs between the appointed and the non-appointed business.

Companies may also carry out their non-appointed business within separate legal entities, which we term Associates. As explained above, throughout this document, where we refer to the non-appointed business this also includes Associates.

The main purpose of transfer pricing and RAG5

The principle behind RAG5 and the setting of transfer prices is that trades should be carried out at arm's length. This is so that customers of the appointed business are protected.

The protection acts in two ways:

- For goods and services, the appointed business will receive a fair price (as if in the open market) for what it sells and will pay a fair price for what it buys from the non-appointed business, so that customers are protected.
- For transfers of assets (or use of them), similarly, the price received or paid needs to be fair and reflective of an open market, so that customers are protected.

Sectoral regulation and competition policy

We believe that the current drafting of RAG5 may limit competition, to the detriment of consumers. It may also be potentially detrimental to the efficiency of undertakers, given the limited state of competition in the market for bioresources treatment, at this time.

Accordingly, in line with our primary duty to further the consumer objective to protect consumers, wherever appropriate by promoting effective competition, and our secondary duty to promote economy and efficiency of undertakers, we are considering amending RAG5 to address these concerns.

However, we also want to ensure that undertakers use their assets for the benefit of customers, as well as for their shareholders. We will therefore seek to ensure that any gains from increased trading are shared appropriately between customers and shareholders.

Costs should include an appropriate return on capital, and capital and associated depreciation costs should be apportioned between the appointed and non-appointed businesses depending on the usage of the assets in question. A cross-subsidy is an amount which does not reflect the value of the service received or is an under-recovery of costs by the appointee.

RAG 5.06 states that transfer prices should normally be calculated on a fully allocated costs basis. It states that short run marginal cost techniques should not be

used¹⁴. It also states in general that if marginal cost techniques are used at all by undertakers in determining transfer prices at present, then this requires justification.

In contrast to our sectoral regulation described above, which we in general exercise in advance or **ex ante**, we usually carry out our competition functions afterwards or **ex post**, for example by investigating a complaint. Competition law tends to be developed flexibly, by case precedent, rather than being set out in detail, in advance, in legislation. Ofwat's aim is to be de-regulatory or non-interventionist, leaving competition and the market to function and only intervening when there is a need. In this case, the external market price charged by the non-appointed business for bioresources treatment is not subject to sectoral regulation and only governed by general competition law.

The nature of bioresources and its associated costs

There are three main activities involved in dealing with sludge. These are:

- transport (both from the sewage works to the sludge treatment centre (STC) and of the end product from the STC to disposal or recycling to land);
- sludge treatment; and
- disposal (or recycling).

Each of these three elements is a significant portion of the total cost. The location/ geography of each company's region impacts upon these factors in different ways. For example, location of sewage works and STCs, both for the exporter and importer of sludge, will influence transport costs and geography will influence the availability of agricultural land for recycling or spreading the end product (e.g. typically the west of the UK has more rainfall and livestock farming, whereas the east has more arable land suitable for receiving the product). Finally, significant energy (in the form of gas or electricity) and income (including incentive schemes) can be generated from sludge treatment. This may overall reduce or possibly exceed the total costs of processing sludge.

¹⁴ See paragraph 9.8.

Evidence gathering

In addition to our ongoing work around bioresources under the Water 2020 programme (including a separate control under Price Review 2019 (PR19) and developing a market) and in particular, our discussions with the bioresources working group, we have engaged with eight of the WaSCs over the last two months to better understand their views on the scope for trading and potential barriers.

2. Further discussion of sharing of the gain/ margin

Firstly, third parties will buy from the WaSC if the external price is below their next best alternative. Therefore, provided the WaSC prices to reflect underlying costs, it should incentivise economically efficient trades.

In this situation, if the purchaser is another WaSC exporting sludge, then their costs of dealing with sludge will be reduced, as the trade is more efficient than processing it themselves. This efficiency benefit will be realised within their appointed business and shared with customers via the cost sharing mechanism in the price control.

Secondly, companies importing sludge and investors will want to undertake a trade, provided they receive some share of the benefit. This share may be realised directly or explicitly within the non-appointed business. Or it may arise in the appointed business, due to cost sharing on price control outperformance.

Companies would implement the sharing of margins or gains by setting a transfer price at the appropriate level. The overall margin for the group (the difference between the external price and the incremental costs of the group for the activity) generated by the trade may be split when the company sets a transfer price. Some of the margin may be left in the non-appointed business, while the remainder will inherently be contained within the transfer price and thus transferred to the appointed business.

Currently, during AMP6, the income from transfer pricing is set against operating expenditure in the appointed business, as a negative cost.

The margin that remains in the non-appointed business could be distributed to shareholders.

The margin that is transferred to the appointed business may subsequently be shared between customers and shareholders, depending upon the nature of our wider economic regulation at the time. From now until 2020, this margin would be

shared via totex sharing, through the PR14 reconciliation at the end of this AMP (AMP6). After 2020, any sharing or not will depend on the approach taken under PR19.

3. Marginal costing

The current RAG5 does allow some limited flexibility (at paragraph 9.8) to depart from FAC and use marginal costing, where companies can justify it. However, given the limited number of trades happening currently, we do not believe that this provides sufficient flexibility.

For bioresources only, we propose an incremental cost approach, as discussed elsewhere and we propose to replace paragraph 9.8 with the new approach.

Marginal cost differs from incremental cost, in that marginal cost refers to the cost of producing one extra unit of output whereas incremental cost refers to the cost of producing the increment. An increment usually refers to carrying out a specific activity.

Marginal cost can be very small whereas incremental cost would normally be more than marginal cost.

We provide further definitions below and in RAG5 and RAG2.

4. Glossary of terms

For ease of reference, we repeat here the definitions that we have added to RAG5.

Marginal costing – see definition at Section 5 of RAG2.

Incremental cost – is the cost caused by the provision of an identified increment of output, given that some level of output (which may be zero) is already being produced. Equivalently, incremental cost can be defined as that cost that is avoided (i.e. saved) by not providing the increment of output. The incremental cost should reflect forward-looking increases (or decreases) in operating costs and the forward-looking capital costs associated with provision (or non-provision) of the increment. The costs associated with the provision (or non-provision) of an increment are related to the period of time over which the increment is provided.

Increment - is the output over which the costs are measured, and theoretically there is no restriction on what products, services or outputs could collectively or

individually form an increment. *In extremis*, the cost of providing an extra unit of output of a service will equal the marginal cost, whilst the incremental cost of providing the entire output of an undertaker will equal the total cost of the undertaker. More commonly, increments are related to the output of a discrete activity and could relate to, for example, a contract, a group of contracts, a customer, a group of customers or a division.