Consultation on regulatory reporting for the 2017-18 reporting year

Southern Water's response

19 July 2017

Southern Water

Regulatory reporting consultation for the 2017-18 reporting year - Southern Water's response

We welcome the opportunity to respond to the consultation on regulatory reporting and set out our response to the specific questions below:

Q1. Appendix 1 contains new tables for:

- **Information on new connections**
- **information on cost assessment**
  - **a. Do you agree with expanding the APR with more tables to capture more granular cost data?**
  - **b. Do you agree costs should be captured through a controlled process?**
  - **c. Do we have sufficient guidance and definitions for the additional line items provided?**
  - **d. What line items need further definition?**

a. We acknowledge Ofwat's requirement to capture additional cost assessment data for use in the price control setting process for PR19 however we do not believe that expanding the APR is necessarily the best way of capturing this data.

The APR is intended to be an accessible document that we publish in a easy to read format to provide stakeholders with relevant regulatory performance information. Including these additional tables in the APR would add clutter to the report, make it unwieldy and muddle up the publication of performance information with data capture for modelling purposes. For example, tables 4J and 4K are a repeat of tables 4D and 4E in a year when there are no atypical items, a memorandum to 4D and 4E would be a better way of presenting this.

We believe that the majority of the data included in tables 4J onwards is at too granular and technical for publication in an external report. Furthermore it does not in our view meet the criteria set out in the executive summary to the consultation of being easy to understand and navigate for users of the report, with the exception of the econometric modelling team at Ofwat.

b. We agree that the costs should be captured through a controlled process. This was achieved historically in the June Return through a data capture tool provided by Ofwat with a subset of the tables forming the Regulatory Accounts. We understand from the recent Regulatory Accounts Working Group (RAWG) meeting that Ofwat is intending to implement a web based data capture tool for these tables. We feel this should be sufficient to provide control over the capture of the additional data without the need for it to be published within the APR.

c. We have the following comments regarding the additional line items:
   - Further to our responses to questions a. and b. we believe the tables from 4J onwards should not form part of the APR. For example tables 4J and 4K are a repeat of tables 4D and 4E down to row 24 and just add clutter to the APR.
   - We have submitted additional queries for clarification from the cost assessment data exercise. These were submitted those as part of our cost assessment submission.

d. We believe that the classification for APH needs further clarification. See our response to question 6 below

Q2. What are your views on the proposed changes to the existing tables in Appendix 1?

a. Tax and non-appointed revenue (table 1A)
b. Totex analysis (table 2D, 4D and 4E)
c. Other minor changes

a. From a presentation perspective, both of these items look incongruous on the face of the income statement. The tax information is already provided in the APR as part of the tax note and reconciliation. Analysing our non-appointed revenue, which represents 1.2% of total statutory revenue, in further detail here feels immaterial to the rest of the content of the table.

b. We presume you mean table 2B not 2D.
   - Tables 2B.5, 4D.5, 4E.5 – we are still not clear what the intention of this row is. Under old UKGAAP we capitalised "repairs/renewals" to the network under renewals accounting. Under IFRS we expense repairs but capitalise the planned renewals as given by this definition. As a result we would report no cost in this line using the definition given. Are you trying to capture a proxy for the costs historically included in IRE, if so this would need to cover repairs in our case (note other companies will have different approaches).
   - Table 2B.6, 4D.6, 4E.6 – we are not sure what non-infrastructure renewals are and what the purpose of this row is, is it trying to capture non-infrastructure repairs? The definition provided relates to infrastructure assets as it relates to pipes.

c. Following completion of the APR for 2016–17 we would suggest that the following may need consideration:
   - Reconciliation between table 1C and 2E – the removal of the value of adopted assets from the grants and contributions balances in rows 16 to 19 of table 2E means that carried forward balance does not agree with row 26 of table 1C. It may be worth adding an additional row to table 1C for to separate out the value of adopted assets held within liabilities or include guidance that they should be included in row 21.

Q3. 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?

Yes

Q4. Do we have sufficient guidance around cost allocation between business units?

Ofwat's clarification between the different cost units has been useful.

We welcomed the opportunity to discuss the schematics of our water resources system with Ofwat. This was very insightful. We would recommend that Ofwat works with the industry to produce a compendium of these examples to provide further clarification to the industry.

Q5. Do we have sufficiently defined boundaries for water resources and Bioresources?

Further clarity would be helpful on the sludge boundary in particular in relation to treatment works where thickening is undertaken to in excess of 10% dried solids. Including some specific wording for this scenario in RAG 4 would be beneficial.

Q6. Have we provided sufficient guidance for Average Pumping Head in table 4P (wholesale water non-financial data)?

The additional guidance that Ofwat has provided has been very useful and has helped to clarify the boundaries between the various business units.

However, there will inevitably be a large degree of uncertainty involved when apportioning this head across several business units. Due to a particular configuration of the network, whereby a single pump provides the driving head for a number of different parts of the supply system, the calculation to apportion the head across business units is based on a series of assumptions.

We believe accuracy could be improved through the installation of monitors at various points in the system to provide a better breakdown of the driving head across the various business units. At this time we are unsure whether such investment is required in order to improve accuracy or not. We would welcome Ofwat's view on whether APH is likely to be sustained in the long term as a key indicator of costs.

Q7. Should companies accrue for future ODI revenues / penalties?

There is currently no applicable IFRS accounting standard that permits accounting for regulatory assets and liabilities.

In order to keep the differences between the statutory and regulatory reporting to a minimum we don't believe there is a benefit to including accruals for future rewards and penalties. Recognition and then subsequent unwinding of any accruals is likely to cause greater confusion in the accounts.

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?

We agree that a consistent method for calculating leakage across the sector is the best way forward.

The proposed changes to the methodology comes at a time where it is potentially too late to inform the draft water resource management plan. We will, of course, pick up the changes between the draft and final plans. The change in methodology will therefore mean that there will potentially be two sets of WRMP tables, and the tables for the WRMP will not be able to be used to set the final ODIs which relate to PCC and leakage until the revised WRMP has been published.

Q9. Do you agree with the proposal to raise the small company turnover threshold to £10.2m?

No comment

Q10. Does RAG5, in its current form, inhibit efficient bioresouces trades from happening? If so, please explain why and if possible, provide evidence.

Yes.

We believe that RAG5 in its current form is likely to inhibit the development of the bioresources market by limiting future trades between water and sewerage companies (WaSCs). This is principally driven by the level of sunk costs in sludge assets.

In order to compete, unless a capacity increment was necessary, a third party would need to offer a price that was below the incumbent's marginal cost. It is highly unlikely that any WaSC would be able to offer such a price based on fully allocated costs, as required by RAG5.

Q11.

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?

b. In the case of Option B, do you agree with our proposed approach to specifying an appropriate margin? Please explain our reasoning and provide evidence where possible.

We believe that Option B, which provides an explicit benefit for the seller's customers, is most appropriate and more likely to stimulate a market, by ensuring that the appointed business has a clear incentive to engage in that market.

We note that a 50:50 margin split is suggested as a 'fall-back'. We would go further and suggest a 50:50 margin split as a default, unless there were good reasons to depart from this, such as the non-appointed business explicitly taking more risk. A simple rule of this kind provides a degree of certainty for companies in evaluating potential trades and is, in our view, more likely to stimulate the market than a more principles-based rule, which could be subject to ex-post challenge.

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?

We believe the proposals are likely to provide a strong stimulus for WaSCs to engage in the market. In terms of entrants from outside the sector, we would expect them to adopt a similar pricing strategy, where spare capacity was available. Thus the transfer pricing proposals should serve to level the playing field between new entrants and WaSCs.

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.

The principal role of regulation should be to remove barriers to economic trading.

We believe the proposals in the consultation address the most obvious issue with the development of the bioresources market. Alongside the Water 2020 information sharing proposals these should stimulate the right commercial conversations between operators in the market.

Given that margins in the market are likely to be fairly small, minimising transaction costs may also help stimulate more trading. There may therefore be a future role for standardised contract terms or trading codes, but we would not advocate their introduction at this stage.

Q14. Are there any other matters which we should be taking into consideration regarding transfer pricing for bioresources?

None that we are aware of.

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

There may be other areas of water company operations, where a similar approach could be taken i.e. where utilisation of spare capacity may provide benefits for water customers through a contribution to fixed costs. This suggests that a more flexible approach to transfer pricing may be

necessary in future as companies seek to innovate and secure better value for customers from use of their assets.

However, at this stage we would suggest a case-by-case approach is taken, with explicit carve-outs from the general RAG5 requirements where companies can demonstrate that this is clearly in the interests of water and sewerage customers.

Q16. Should an additional line be added to table 1C in the non-current liabilities section; 'Deferred income – adopted assets'?

Please refer to our response to question . We propose either a separate line to be included in table 1C or that the creditor for adopted assets should be reported within 'non-current assets, trade and other payables'.

Q17. Should RAG 1 be amended to specifically require amortisation of grants & contributions and adopted assets to be recorded as 'other income' and adjusted in table 1A?

We currently record these items as other income and we think this should be required for consistency.

Q18. Should RAG 1 1.8.1 be amended to specifically include 'income recognised in the year which is recorded as negative operating expenditure' and require this to be adjusted and shown as 'other income'?

Income treated as negative expenditure, for example power from sales to the grid already has its own row in tables 2B, 4D and 4E. Grants and contributions received through the income statement should be treated as other income.

Q19. Should supervision fees be added to RAG 4 appendix 1 as price control income and the reference in the 2E.11 line definition be removed?

Agreed, although we presume that you mean to remove these from the line item definition of 2E.13.

Should you have any queries or regarding our response, or would like to discuss any aspect of it with us, please contact our Head of Economic Regulation, Nikki Deeley, on 01903 272336 or by email nikki.deeley@southernwater.co.uk.