South West Water

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19 July 2017

Finance and Governance Team
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By email: FinanceAndGovernance@ofwat.gsi.gov.uk

Dear Sir,

REGULATORY REPORTING FOR THE 2017-18 REPORTING YEAR

This is South West Water's response to Ofwat's consultation on regulatory reporting for the 2017-18 reporting year. We welcome the opportunity to respond.

We provide our responses to the questions raised in Appendix 1. In addition to these specific points we make the following observations:

- we note that confidence grades do not appear to be required for new Tables 4J - 4W which will replace the 2016/17 Information Request. It is our strong view that confidence grades enable a better understanding of data which in turn results in a superior overall process. We would support their continued inclusion in these tables

- we acknowledge that Information Request Tables 19 – 21 (Retail; Miscellaneous Wholesale Waste Water rates analysis and non-household costs) are not included in future data gathering. We are cautious that any decision to not collect this data alongside the remainder of the tables may be reversed at a later date. If this may occur our preference would be to reintroduce the tables for 2017/18 and continue to report on an annual basis.

If you have any questions on our views we will be pleased to provide further information.

Yours faithfully

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APPENDIX 1

Question 1

Appendix 1 contains new tables for;

- **Information on new connections (table 2J)**
- **Information on cost assessment (tables 4J to 4W)**

Do you agree with expanding the APR with more tables to capture more granular cost data?

Our views on this question are included in the response to the next question.

Do you agree costs should be captured through a controlled process?

New Connections

We agree that it is helpful and do not have any further comment in relation to infrastructure network reinforcement costs.

Cost Assessment

We agree that cost assessment is an important and material component of price reviews and are supportive of Ofwat's intention to expand the APR tables to also capture data currently provided by companies through the cost assessment process. Combining these tables is a logical next step following the alignment of the submission deadlines in 2016/17 and it also allows more time for effective Board engagement as well. From the consultation we understand that Ofwat's intention is to integrate all the cost assessment data collected into the published Company Annual Performance Report. This is a significant increase in the volume of detailed data included in this report and we note that this may make the document more difficult to understand from a customer perspective.

Currently SWW's Financial Statements and financial aspects of the regulatory accounts are audited by its financial auditors. The Corporate Governance Code restricts other work that can be undertaken by the financial auditors; consequently the financial aspects of cost assessment tables and price review submissions must be audited by a separate financial auditor. Under the new proposed expanded APR companies would need to consider whether it would be appropriate under the Corporate Governance Code for their financial auditors to undertake the assurance on the detailed tables. If companies considered that separate auditors were needed for the detailed tables, they may therefore need to include three separate audit reports within the APR (for example core financial, detailed financial and non-financial).

Do we have sufficient guidance and definitions for the additional line items provided?

New Connections

Further guidance is needed to ensure that reporting is consistent. We detail our comments in our response to the next question.

Cost Assessment

There is currently limited guidance for the information required in the cost assessment tables. While the query log maintained by Ofwat is a useful way of clarifying expectations, there are a number of areas where Ofwat has determined that it is for companies to decide the most appropriate approach. This creates a risk of inconsistencies between companies' approaches.

What line items need further definition?

New Connections

We make the following observations and requests for clarification:

- The term "third party capex" could be defined. It would appear to mean capex incurred by third parties at no immediate cost to the company where the assets either i) remain the assets of the third party or ii) are adopted by the company and are treated as assets for the purposes of IFRIC 18. It does not appear to mean capex relating to third party services but we would welcome clarification.

- Our interpretation of third party assets is that it appears to exclude assets wholly or partly financed by grants and contributions, and that where a project involves assets partly constructed by the company and partly by a third party only expenditure by the company, including asset payment expenditure, is to be reported. Again, we welcome further clarification.

- It should be made clear that infrastructure reinforcement assets exclude assets, whether infrastructure or not, relating to water resources, raw water distribution and storage, or to sludge transport. If an asset is replaced by a new asset of greater capacity than the original (upsizing) the whole of the expenditure is to be treated as infrastructure enhancement expenditure not just that proportion of the expenditure that relates to the increase in capacity.

- It should be made clear that infrastructure reinforcement expenditure including non-infrastructure expenditure included solely relates to increases in capacity including storage and pumping capacity e.g. the acquisition of new or upgraded assets.

- The treatment of storage assets located at treatment works could be clarified. Assets are frequently located at treatment works because of land acquisition, compensation and planning issues. Logically these assets, except for raw water storage assets, should be included.

- Where a project contains significant infrastructure reinforcement and other expenditure, a reasonable apportionment of expenditure should be acceptable unless the other expenditure is insignificant.

- The definitions at 4D.14, 4D.15, 4E.14 and 4E.15 should be amended to make it clear that the values at 4D.16 and 4E.16 are to be excluded.

- If any specific 'growth' projects such as new towns or first time sewerage are to be excluded this should be made clear.

Cost Assessment

There is limited guidance within the cost assessment tables as to the approach to take to including costs in some lines, which could lead to inconsistencies between companies.

Ofwat have run a query log for the 2016/17 cost assessment tables recording questions where companies have asked for guidance or more clarification. We suggest that Ofwat's responses to these questions be incorporated into formal guidance for the tables.

South West Water have raised a clarification query on the amended definition of average pumping head for 2017/18 reporting through the Water Resources Cost Assessment working group, but are still awaiting a response. It would be helpful if this too was included in finalised guidance. Please see question 6 where we have replicated the query.

It is important that Ofwat includes all clarifications in the finalised guidance, including those issued after the publication of this consultation.

Question 2

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

a. **Tax and non-appointed revenue (table 1A)**

   We do not have any specific comment on the changes proposed.

b. **Totex analysis (table 2B, 4D and 4E)**

   The changes proposed align with the cost assessment reporting requirements for 2016/17. We do not have any specific comments.

c. **Other minor changes**

   We do not have any specific comment on the changes proposed.

Question 3

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?

Currently some retail non-household developer services activity remains with the incumbent even after retail exit. When the market operator system is further developed, these activities will also become part of the market. We understand this is planned for 2018/19.

We would not expect there to be any residual meter reading activity after retail exit. We would expect any meter reading activity carried out for other retailers would be a non-appointed activity charged at a commercial rate.

Questions 4 and 5

Do we have sufficient guidance around cost allocations between business units?
Do we have sufficiently defined boundaries for water resources and Bioresources?

Ofwat, through CEPA, carried out a detailed targeted review of the interpretation of guidance on splitting costs between Water Resources, Bioresources and respective Network Plus business units. As a result, some revisions to guidance were made in 2015/16 and feedback was given to companies directly on any inconsistencies in their interpretation of the guidance. Other revenue control guidance at the water, waste and retail level is well established. We therefore consider that current guidance is sufficient.

We also note that consistency in guidance from year to year is important in the lead up to PR19, with significant focus on cost modelling through Ofwat's Cost Assessment Working Group. Amendment to boundary definitions at this stage would lead to challenges in obtaining consistent historic cost data for the econometric models.

Question 6

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

Some time ago we raised a clarification query through the Water Resources Cost Assessment Working Group on the amended definition of average pumping head for 2017/18 reporting; but have not yet received a response. Our query is included below for reference. It relates to a presentation circulated to the Water Resource Cost Assessment Working Group in March 2017 and subsequent conference call:

> 'Slides 6 and 7 show the formula for calculating the proportion of water resources costs with an example. We have the following comments and queries relating to these:
>
> - The figure and definition of 'Pump Level' implies this is the depth of the pump in the borehole. However, this does not seem relevant to the calculation – does this actually refer to "pumping water level in the borehole" rather than the depth of the pump?
> - The figure also shows a black dot in the treatment plant along the line of the rising main. Can you clarify whether this is a pump or just a junction in the pipework? If this is a pump then this would be important given the location of the treatment works. We need to know if the borehole pump is pumping to the surface or pumping all the way to the service reservoir. It links into the criticality of the treatment plant location.
> - The formula uses 'Ground Level' which is defined as the ground level at the borehole pumping site. The implication is the location of the treatment plant is not relevant to the calculation – can you confirm this?'

We raise the following comments on the definitions listed below.

- *Wholesale water non-financial data / Water Resources, Water Treatment / proportion of distribution input derived from different types of sources (lines 4P.1 – 4P.6 Page 59)*

  A note on page 67 of RAG 4.07 states:

  'The proportions entered in lines 4P.1 to 4P.6 should sum to unity. The proportion of water in each source category is a measure of how difficult a company's water is to treat. When classifying the water into one of the categories, ***please see the June Return reporting requirements and definitions manual (Chapter 12)*** for guidance on allocation.'

  We presume that this instruction refers to the June Return 2011 Chapter 12 guidance; this being the last guidance issued. However to avoid uncertainty clarification within the final APR guidance is important. Our preference would be for the APR guidance to clearly state what is required rather than referring the reader to a set of guidance that is a number of years old, but if this is not possible then for completeness full reference to the guidance should be made.

- Disaggregation of wholesale activities / upstream services / classification of high lift pumps

  In an email dated 18 October 2016, Ofwat stated that:

  'Some companies have assigned high lift pumps to 'treatment', other companies to 'distribution'. For consistency with RAGs, high lift pumps should be part of treatment and therefore their average pumping head reported under treatment.'

  However, in our view RAG 4.07 remains unclear as to whether pumps at WTWs that pump treated water into the treated water distribution network should be included in water treatment or treated water distribution.

To illustrate this we have extracted two definitions from RAG 4.07 and provided our comments.

Example 1 – 'Network+ - Water treatment / Boundary points / End: 'treated water which enters the water distribution network' (page 94)

This could be interpreted as meaning that pumps used at WTWs to pump water into the distribution system[1] should be included in water treatment, however we not completely clear that this is the intention.

Further, while RAG 4.07 states that 'pumps which support the treatment process' (Assets, page 95) are included in water treatment, it does not explicitly state that pumps at WTWs pumping water into the distribution system should be included water treatment.

Example 2 – 'Network+ - Treated water distribution / Boundary points / Start: 'treated water that has been pumped or gravity fed into the treated (potable) water distribution network' (Page 95)

This description implies to us that pumps used at WTWs to pump water into the distribution system should not be included in treated water distribution (and hence should be included in water treatment). However, this appears to be contradicted by reference to 'booster pumps and high lift pumps' under Treated Water Distribution / Assets RAG 4.07 (page 95). This reference implies that high lift pumps should be included in treated water distribution.

To avoid misinterpretation RAG 4.07 guidance needs to be far more explicit about whether pumps at WTWs that pump treated water into the distribution system (i.e. high lift pumps) should be included in water treatment or treated water distribution; and that this should be clearly and unambiguously stated in both the water treatment and treated water distribution sections of the RAG 4.07.

Questions Relating To Outcomes Reporting

Question 7

Should companies accrue for future ODI revenue rewards/ penalties?

We do not consider that changes to IFRS15 impact on the recognition of revenue or penalties from ODIs. We note that during discussion on IFRS 15 changes at the Water UK FC forum, ODI revenue recognition was not raised as an area that companies considered was impacted.

Question 8

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 are supportive of the consistency work being undertaken on supply interruptions and sewer flooding and our initial work on these demonstrates few issues with implementation.

However application of the leakage consistency measure requires significant changes to business processes, reporting systems and the data analysis methodology before a fully compliant leakage

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[1] What South West Water refer to as High Lift Pumps at WTWs

performance measure can be reported. The August 2017 submission will be re-analysed as accurately as possible; however, the retrospective application of the detailed approach will incorporate a number of assumptions in advance of reporting compliance.

Reporting under the new consistency methodology, and the purchase and deployment of a substantial number of additional specialist data loggers to achieve appropriate compliance, will take at least two years to implement and require an additional, significant, investment for data collection.

Compliance with the new methodology will affect companies to different extents and naturally involve varying timescales for each company. We are concerned that data may be placed in the public domain before it is sufficiently compliant and therefore before it is appropriate to compare company performance. We acknowledge that the consultation clearly states that shadow reporting will be unpublished until 2021, but it is our understanding that elements of the data may be used in other documentation, exposing companies that may not have reported on a comparable basis to commercial and reputational risk. We are strongly of the view that no data reported under the shadow regime should be placed in the public domain.

Question Relating To Small Companies (RAG3)

Question 9

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

We agree that in the interest of easing the regulatory burden on small companies raising the threshold is reasonable, and it is logical that the proposed level is in line with Financial Statement reporting requirements.

Questions Relating To Transfer Pricing Guidance (Rag5)

Question 10

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

South West Water does not have direct experience of the issue given its geography (and consequently its trading opportunities), however we understand the perception that other companies have.

Where current RAG guidance suggests that fully allocated costs must be considered when considering a transfer price, efficient trades (where incremental costs of company A are lower than incremental costs of company B) may be prevented.

An example is set out below:

- Company A has spare bioresources capacity in its appointed business and the cost it charges it non appointed business for processing non appointed bio-resources is fully allocated rather than incremental.
- Company A is selling bioresources services to third parties. It needs to recover the costs it incurs from its appointed business (fully allocated) plus any admin / margin.
- Company B is buying bioresources and has relatively inefficient bioresource assets. It has identified Company A as a potential trading partner. When considering whether a trade is

cost beneficial it considers the incremental costs it would save through not using its own assets, against the price charged by Company A's non-appointed business.

In this example it is likely that the fully allocated costs of Company A would be higher than the incremental (avoided) costs of company B therefore the trade would not be beneficial to both parties at this price.

It is possible however that the incremental costs of Company A plus any non appointed margin / admin costs would be lower than the incremental (avoided costs) of Company B. In this instance there is a price at which a trade would be beneficial for both parties, if an alternative approach to fully allocated cost is used.

If fully allocated costs are considered trades will only be beneficial to both parties where fully allocated costs of Company A (seller of bioresource processing through its non-appointed business) are lower than incremental costs of company B. Company A's appointed business charges Company A's non appointed business at fully allocated cost.

Question 11

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?

We agree with Ofwat's proposal to refine the guidance for transfer pricing for bioresources to encourage efficient future trades whilst protecting customers. We consider that the incremental cost plus margin approach is most considering the market as a whole, and would enable a cost to be applied to represent the transfer of risk.

We note however that the margin (representing transfer of risk) would be included as a negative cost for the seller and a cost for the buyer, whereas companies who do no trading would not recognise a cost associated with risk. This could influence the relative efficiency assessments for the regulated businesses as part of the price review, and therefore could discourage trades. Further consideration needs to be given to how this would be dealt with.

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.

The calculation of the appropriate margin component requires further thought and guidance. The margin is intended to pay the appointed business of the seller a fair contribution towards common costs, as informed by the relative risk faced by the appointed and non-appointed business. Ofwat notes an example whereby an appointed business (the seller) has invested heavily in bioresources processing - thereby exposing itself more to higher or lower demand, and potentially meaning a higher margin. This seems similar to the concept of 'operational gearing'. Companies who are in contractual relationships whereby demand shocks hit their revenues, but where costs remain relatively fixed, have higher operational gearing and, in turn, a higher cost of capital.

However, some provisos are required in the case of bioresources. The first is that, while a higher margin for risk from the appointed business may be seen as protecting the functions of the seller's appointed business in the face of underutilisation, this will ultimately increase the price paid by buyers to sellers (and hence the customers of the buyers' appointed business). In effect, buyers (and their customers) will pay a higher margin to sellers to cover the risk that investment in bioresources assets by sellers was not entirely prudent. This seems to go against the spirit of the average revenue control being proposed for bioresources (which exposes companies to demand risk). The second is that the contractual relationship between the buyer and seller will determine the extent to which the seller is exposed to demand risk, and hence the degree of operational gearing and the appropriate margin. Finally, there are likely to be disagreements between buyer and sellers on the appropriate margin. Ofwat's role could be clarified here.

Nonetheless, we agree that for higher-volume, longer-term contracts, a bespoke approach could be followed to determine the margin. For shorter-term, standard, lower-volume trades a higher-level approach could be adopted.

<u>Question 12</u>

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 note that new entry by other OOWs is currently inhibited by environmental legislation. If these regulations change in future, this will facilitate new entrants into the bioresources market.

Ofwat's proposals should encourage entry only where it is more efficient over and above trade in sludge between WASCS (or the incremental cost of trade by the incumbent), therefore helping to create a level playing field.

<u>Question 13</u>

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 guidance does not currently state who adjudicates in the event of disputes over calculating the impacts on capacity and costs of long-run and short-run trades.

<u>Question 14</u>

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

We do not have any specific comments on other matters at this time.

<u>Question15</u>

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

We note that the bio-resources guidance will be included as a new section to RAG 5. Currently the guidance does not say how it affects the applicability (or otherwise) of previous section. We suggest that the new section 11 explicitly states that it applies to bioresources only and the remainder of RAG 5 explicitly states that it does not apply to bioresources.