Regulatory Reporting Consultation Response

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Strategy & Regulation

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Dear Sir/Madam,

Consultation on regulatory reporting

Thank you for the opportunity to respond to your consultation on regulatory reporting for the 2017/18 reporting year.

We highlight below our comments on the more significant points in the consultation and we include our detailed responses to the consultation questions in the attached appendix.

In respect of question 1 concerning the proposed changes to the content of the Annual Performance Report (APR); question 3 regarding residual activities in the retail non-household price control; and, question 8 which outlines shadow reporting requirements, we have the following comments:

- We agree in principle that cost assessment information should be made available to some stakeholders; however given that the APR is a customer facing document and information contained therein should be presented in a customer friendly way, we believe that the inclusion of cost assessment data within the APR may not be appropriate. We believe it may be more appropriate for Ofwat to publish the company datashare on their website, which collates all companies' cost assessment information. We are conscious of our commitment to producing an APR that best meets the needs of our customers and want to ensure we focus on maintaining the right balance for customers.

- We agree that companies which have exited the non-household retail market will continue to incur certain costs in running their appointed business. For the remainder of AMP6, we believe it will be necessary for Ofwat to consider a number of factors (as detailed in appendix 1), which will enable companies to continue to report accurately and on a comparable basis, in a way that is accessible and understandable for customers.

- We are committed to submit shadow reporting information for leakage and sewer flooding against Ofwat guidance on a best endeavours basis however, we are faced with certain challenges in preparation, as detailed in appendix 1.

Please do not hesitate to contact either myself or my team if you have any questions or comments on our response. We look forward to working closely with Ofwat in supporting the further development of our Annual Performance Report.

Yours sincerely,

Brandon Rennet

Chief Financial Officer

Appendix 1 – Detailed responses

Questions relating to 2017/18 reporting:

Q1	**New tables:** **a) Do you agree with expanding the APR with more tables to capture more granular cost data?** We agree in principle that some further information should be made available to certain customers (such as developers), however given that the APR is a customer facing document and information contained therein should be presented in a customer friendly way, we believe that the inclusion of cost assessment data would be too detailed and unnecessary for the for the vast majority of customers. We believe that it may be more appropriate for Ofwat to publish the company datashare on their website; this would provide accessibility and comparability of all companies for interested parties. Furthermore, we would appreciate some clarification as to the purpose and benefit of some of the information collected through the cost assessment process (e.g. 4R.40 Chemical P sludge as % of sludge produced at STWs). Please could you also confirm that there will be no requirement to present historic data in the APR for 17/18 i.e. only the current year as shown in the proforma tables. **b) Do you agree costs should be captured through a controlled process?** We agree that costs should be captured through a controlled process. **c) Do we have sufficient guidance and definitions for the additional line items provided?** In general, we believe that the guidance and definitions are sufficient. However, there are certain items for which we would seek further clarification. These are outlined in part (d) below. **d) What line items need further definition?** i. For table 4N – please can you confirm that the sludge column should show the resultant cost for treating the sludge arising from these STW bands? ii. For table 4U Lines 13 & 14(energy consumption – network plus and sludge respectively) – per RAG 4.07 the definition is as follows: *Measure of energy usage (electricity, gas, liquid fuels) by the network+ wholesale business unit (irrespective of the power source). Energy usage should be measured NET i.e. imported + self-generated. No account should be taken of self-generated energy that is exported. Fleet transport and standby generation should be included as should an allowance for administrative buildings and head office function.* Please can you confirm how the transfer of self-generated power is included? Furthermore, please can you clarify how the amount of self-generated power transferred between price controls should be treated?

	iii. For tables 4J and 4k, please could you clarify the definition for 'Atypical expenditure'? Should this only include 'Exceptional items' as reported in the statutory accounts or should it include certain one-off type expenditure? Furthermore is there a materiality level that should be applied when assessing atypical spend? We would appreciate some examples of atypical spend if available.
Q2	**What are your views on the proposed changes to the existing tables in Appendix 1:** **a) Tax and non-appointed revenue (table 1A)** We agree that the update to table 1A would add clarity for customers. **b) Totex analysis (table 2B, 4D and 4E)** We would appreciate further clarification on the definitions for lines 5 (renewals expensed in the year – infrastructure) and 6 (renewals expensed in the year – non-infrastructure). Under IFRS 16, there are several elements of expenditure on assets that are expensed to operating expenses e.g. study costs, maintenance, repairs etc. relating to both infrastructure and non-infrastructure assets. We are not clear exactly which of these types of expenditure should be reported in these line items, i.e. which would be deemed 'renewals'; Some examples of what would and would not be included would be useful for clarification. In addition, in the Q & A document accompanying the 2016/17 cost assessment tables, Ofwat state that both of these lines should mirror UK GAAP 'IRE' spend, however, IRE only related to Infra assets and therefore we are not clear how this would apply to non-infra spend. 4D – Line 26 (Unit volume) - We would like clarification on the definitions for 'Distribution input volume' for water treatment and treated water distribution in this table. In RAG 4.07, the definitions are identical for both columns, however the boundary points for these two accounting separation units are different and hence we believe that the two figures should not necessarily be the same e.g. Volume leaving water treatment would include an element of water put back into the process for own use, whereas volume leaving treated water distribution is purely for customers' usage. Please could you clarify whether own use volume should be included in water treatment? We would also like clarification on the unit cost measure for water treatment and treated water distribution (plus others) as the volume definitions specify for end customer usage; however, the calculation uses operating expenditure including third party costs. We believe that the calculation should use operating expenditure excluding third party or the volume should include third party usage. **c) Other minor changes** Regarding the changes to table 4C (Impact of AMP performance to date on RCV), please could you confirm which price base you require the figures in this table to be presented in, for all lines?

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?** We agree that companies which have exited the non-household retail market will continue to incur certain costs in running their appointed business which were determined by Ofwat at PR14 to be recovered through the non-household price control. Under the proposed RAGs for 2017/18 these would continue to be accounted for as retail non-household. Such costs principally relate to the following activities: • Developer services: setting up accounts and answering calls. At PR14 these costs were allocated to retail, and recovered wholly through the non-household price control; and • Operational contacts: taking and routing initial contacts, aborted calls and admin related to disconnections/reconnections which can relate to household or non-household premises. At PR14 such costs dealing with network calls were allocated to the Retail price controls, to be split between household and non-household as applicable. Following exit from the non-household retail market, we do not expect to incur any residual costs related to meter reading which would be accounted for as non-household. Wholesale will obtain relevant meter readings through the market operator. At PR14 non-household metering costs were fully allocated to, and recovered from, the non-household retail control, however, we understand the market codes allow a portion of these charges to be re-charged to wholesalers. Given that these activities will continue to be undertaken as part of the appointed business of all companies, whether the company has exited the non-household retail market or not, it would seem appropriate that these costs are, as soon as practicable, re-allocated to wholesale. It is particularly important that the accounting classification of these costs is reviewed for the purposes of setting prices at the next price review to avoid a situation where a company is prevented from recovering necessary and efficiently incurred costs in delivering its appointed business and associated obligations. In the case of the two categories of cost noted above, a continuation of the current treatment would result in those companies which have exited the non-household retail market being unable to recover such costs from its customers, in contrast to those companies which have remained in that market. It would therefore be helpful for clarification on the treatment of these activities to be provided within the methodology documents for PR19. The appointed business also bears the risk of bad debts for NHH receivables at 31 March 2017 so there may be some future NHH operating expenditure relating to provision or write off of any unrecoverable debts. We assume that, having exited the NHH market, from 2017/18 the regulation costs which were previously allocated 1/9th to each accounting separation unit will be allocated 1/8th to the remaining accounting separation units.

	For the remainder of AMP6 it will be necessary for Ofwat to consider a number of factors in deciding how and whether to change the RAGs: • Implications of accounting for costs in a different price control unit from that in which it was treated at PR14, noting the different regulatory treatments of over/underspends within the Retail and Wholesale price controls; • A need to ensure that cost assessment and related data collection activities for PR19 provides a complete and accurate dataset of the cost of appointed wholesale and retail activities incurred by each company, collated on a consistent and fully comparable basis; and • To ensure that the Annual Performance Report continues to provide financial performance information for companies in a clear and accessible format. Any need to continue to show non-household retail costs for companies which have exited the non-household market should be presented in such a way to avoid confusion. This may potentially require additional disclosures to assist readers. Further to this, we would appreciate further clarification on which tables/sections of tables will not be applicable for companies who have exited the NHH market; In particular, tables 2G, 2H 2I, 4Q and 4U.
Q4	**Do we have sufficient guidance around cost allocations between business units?** • RAG 2.07: Section 2.7 – we agree that there needs to be a consistent formula for allocation of operating costs and capital costs for sludge liquor transferred to a sewage treatment works for treatment. We believe that the Mogden formula would be the best option for this. • RAG 2.07: Section 2.8 (Allocation of operating costs and capital costs for imported tankered waste) – the majority of cess waste cost is associated with network+ activity. Please can you provide further guidance regarding how this activity may be split the costs across both price controls?
Q5	**Do we have sufficiently defined boundaries for water resources and Bio resources?** We believe that the boundaries for Bioresources and Water resources are clearly defined and workable.
Q6	**Have we provided sufficient guidance for Average Pumping Head in table 4P?** We are satisfied with the guidance regarding average pumping head reported in table 4P assuming that Ofwat make the change identified in the Cost Assessment query process; removing the word "weighted" and changing the definition to read "Average pumping head for the ** business unit as defined …". Note: this query was noted in the Cost Assessment Query Log as Issue number 13.02.
Q7	**Should companies accrue for future ODI revenue rewards / penalties?** We do not believe that future ODI revenue rewards or penalties should be accrued for in the statutory or regulatory accounts, in the period in which they are incurred or achieved, given that the financial impact of these rewards or penalties is taken in the following AMP period.

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 will look to report on a best endeavours basis against the guidance issued on 3 July 2017. However, please note that there are several components that will not be possible to implement. This is due to the data/ technology not existing for the reporting year 2016/17. Due to the time required to implement some of these changes, this will also impact reporting in future years. As an example we will need to install numerous meters at our sites across London and Thames valley including 74 at unmetered supplies to sewage and water treatment works. We are also going to require the install of pressure logging equipment in many Flow Monitoring Zone ('FMZ'). We will only be able to include these requirements as and when the data is available. Other components of the new requirements require software changes to our corporate systems which will cause a further delay in our ability to fully meet reporting requirements. Until now, we have not calculated operability of our FMZs as we have relied on manual inspection of the data to confirm its validity. In order to implement this change, we will be required to make significant investment in time and resource.
Q9	**Do you agree with the proposal to raise the small company turnover threshold to £10.2m?** We have no view on this proposal.
Q10	**Does RAG 5, in its current form, inhibit efficient bio resources trades from happening? If so please explain why and if possible, provide evidence.** We agree with the analysis in the consultation that outlines how RAG5 could inhibit efficient bioresources trades, due to the need for transfer prices to be based on fully allocated costs. The existing RAG5 effectively requires a fully allocated charge to be made for sludge imported from out of area, which encourages companies to build their own assets even while there is spare capacity in a neighbouring area. An incremental cost-plus-margin approach would enable this capacity to be accessed to the benefit of customers in both areas.
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?** Our preference would be for option B - incremental cost plus a margin of the fee charged. We believe that this will provide the most fair allocation of revenue and risk between shareholders and customers **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.** Our preference would be for option B, and the proposed approach to setting the margin, for the reasons set out in the consultation paper. We believe that the margin should be down to the company to decide based on the level of risk adopted by the trade. For example, if the trade was small and there was a relatively large underutilised headroom capacity the risk of the trade is low and the regulated business should gain the larger proportion of the margin, however if the trade is based on several

	unquantifiable assumptions (such as sludge quality and quantity) there may be a case for the non-appointed business to have to seek alternative treatment routes at certain times and therefore would take a higher proportion of the margin. We note, in passing, that the options are not mutually exclusive - option A may be equivalent to option B, if the transfer price is above (not equal to) the incremental cost incurred by the appointed business in supplying the bioresources processing service.
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 expect Ofwat's proposals to encourage trading in bioresources, to the extent that such trades are currently being inhibited. We do not have any concerns with Ofwat's proposals.
Q13	**Are there any other ideas that you propose, to improve our regulation of transfer pricing for bioresrouces? If so, please provide analysis and where possible, evidence, to support these?** We have no suggested additions to Ofwat's proposals.
Q14	**Are there any other matters which we should be taking into consideration regarding transfer pricing for bioresources?** We have no suggested additions to Ofwat's proposals.
Q15	**Do our changes have any implications for the rest of RAG 5 or for activities other than bioresources?** We do not consider Ofwat's proposals to have material further implications.