United Utilities response to the Ofwat consultation:

Regulatory reporting for the 2017-18 reporting year

Introduction

United Utilities welcomes the opportunity to comment on Ofwat's consultation on Regulatory Reporting for the 2017/18 financial year.

Q1. Appendix 1 contains new tables for;

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

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

We agree with expanding the APR to capture more granular cost data and consider that the proposed new tables, which provide more detailed breakdowns of costs should enhance consistency of future reporting and evidence of trends.

More granular cost or engineering data should enable better alignment of costs with drivers and greater clarity on the underlying logic, and therefore better prediction of responses. In addition to granularity, quality and consistency of data is also important, as it enables identification of trends where appropriate.

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

We agree that costs should be captured through a controlled process. This will be critical in improving the industry's ability to understand costs, identify cost drivers and make meaningful comparisons across companies.

c) Do we have sufficient guidance and definitions for the additional line items provided? /and
d) What line items need further definition?

Table 2J

We are supportive of the inclusion of this table capturing infrastructure network reinforcement costs. It is our assumption that, to ensure all developer costs are captured, this table should also include Renewal expensed in the year (infrastructure), reported within operating costs, as well as capital expenditure. Assuming this is the intention, we would recommend changing the column heading 'Network reinforcement capex' to 'Network reinforcement costs' for clarity. We would also assume that this column should capture off-site costs only and not the combined on-site and off-site total. However, it may be worth clarifying this to ensure all companies report this on a consistent basis.

For the line definitions 2J.1, 2J.5 and 2J.6 we would expect renewals expensed in the year (infrastructure) to be captured on these line. The current definition only refers to capital expenditure and to ensure this operating expenditure can be captured, we would recommend amending the start of each line definition to include the underlined section below "Capital expenditure <u>or renewals expensed in the year (infrastructure)</u> on new or upsized……..".

For the two 'Other' lines 2J.3 and 2J.8, we would expect capex from lines 4D/4E.14/15 to be included in here. However, the current definitions specifically say '….other than defined in 4D.14, 4D.15…' which prevents these costs being included. We would recommend amending these line definitions as follows: "Any other capital expenditure other than defined in ~~4D.14, 4D15,~~ 2J.1 and 2J.2"

Finally it would be helpful to provide categorisation bands to support the definition or thresholds for 'small reservoirs and towers' in RAG4.07 definition 2J.2.

Table 4J/4K
Table 4J appears to be the equivalent of Table 4D and Table 4K the equivalent of 4E, except that 4D/4E contains unit costing information and 4J/4K strip out atypical costs. We would question whether the new tables are necessary and whether it would be more efficient to simply extend the existing Tables 4D & 4E to add in extra lines showing atypical costs.

In RAG4.07, Table 4J/4K the guidance on atypical expenditure within lines 25-29 suggest that atypical expenditure is included within the above lines within in this table. However, the titles for Operating expenditure (covering lines 1-11), Capital expenditure (lines 12-21) and Cash expenditure (lines 22-23) all state that atypical expenditure should be excluded. The total (line 31) adds the atypical costs to the line 23 sub-total totex to derive the total totex, again suggesting atypical costs should be excluded from lines 1-24. We recommend amending the line description for lines 25-29 to make it clear that these atypical costs are not included within the above lines in this table i.e. 'Specify any atypical expenditure ~~included in~~ excluded from the lines above (to be defined by the company in item description)'

Given the nature of capital expenditure, it could be easy to interpret a large number of capital expenditure items as atypical (in lines 25-29). Our current assumption is that only operating expenditure items are singled out as atypical, but it would be useful to clarify this in the definition.

Also see our response in relation to table 2B/4D/4E within question 2b) below with regards to 'Renewals Expensed in the year (Non-Infrastructure)' (line 6) and 'Infrastructure network reinforcement' (line 16), which is also relevant for both tables 4J and 4K.

Table 4N/4O
The Ofwat clarification points (2.05 & 15.04) issued on 27/6/17 states that rates should be excluded from direct costs within Table 10 of the July data submission tables. The RAG4.07 definition of direct costs in Table 4O.11 states this is the cost directly attributable to each works and then below the table states that this is the costs directly attributable to each identified service. However, rates is a directly attributable cost and therefore, if the intention is to exclude rates, then the definition needs to be clear that this is excluded.

The Ofwat clarification points (2.05 & 15.04) issued on 27/6/17 states that scientific services etc. should be excluded from G&S whereas the definition on page 58 of RAG4.07 lists "operational & technical support" as an included cost. For simplicity, we would recommend including all costs associated with the works so that table 4N reconciles back to the total cost of sewage treatment within Table 4E.

Table 4N analyses the operating expenditure of sewage treatment by size band of works. However, the table also includes a column for the capture of sludge costs. We would query why sludge costs are required in the analysis of sewage treatment operating expenditure. Furthermore, there is no guidance on how to allocate the sludge costs by size band of works. We would recommend the deletion of the sludge and the total columns, leaving just the sewage treatment column.

Table 4P / 4Q / 4R / 4S / 4T / 4Q Non-financial data
We have been involved in the development of these tables and have found the process of capturing information through a structured data process and then collaboratively reviewing this data, to try to ensure the information is a sensible cost driver and is being consistently reported, has been very effective.

We are keen to ensure that this process is maintained and that companies continue to be actively involved in both clarifying any inconsistencies or anomalies that emerge in the reported data and in supporting the development of the PR19 cost models. With any revisions or further clarifications identified through this process being reflected in the final guidance for the 2017/18 tables.

Table 4R
The only specific addition to this table that we would suggest at this stage, is adding 'total volume of storage' by company to enable comparison of work associated with drainage by company, including management of spills.

Table 4V
We agree in principle with providing more granular cost information in Table 4V. As a number of the lines may well rely on allocations to get down to an asset level it may be worth asking companies to provide supporting commentary to explain how they do these allocations in order to enhance visibility.

Line 9-12 – Point for noting. In line with the approach taken to complete table 18.2 for the July submission of Regulatory Reporting 2017, it would be our intention to utilise our organisation structure to define what was Direct and Indirect; however as not all companies are structured within the same way it may create differences between the allocations for direct and indirect costs. For example, some organisations may have Network Scheduling team within their Water Delivery Business Unit, however UUW have this element within Other Wholesale and as a result treat it as indirect. UUW also treat most resource involved with the delivery of the Capital Programme as indirect including expertise resource such as Engineering. We will include commentary on this (including an explanation of our method) within next year's APR.

Lines 14-16 – These line definitions all include reference to discharge consents which seem to relate to wastewater rather than water. It should also be noted that under the current definition the total of these lines will not match line 3 on table 4D. For example at UUW we pay an abstraction fee to Natural Resources Wales for the abstraction of water from the River Dee, we also pay the Canals and Rivers Trust a Service Charge for the passage of the same water along a canal. To avoid double counting and in line with the definition of 4D.3 only the fee paid to Natural Resources Wales is included within this line, however in line with the definition on Table 4V we would include both the abstraction fee on line 15 and the service charge paid to the Canals and Rivers Trust on line 14.

Table 4W
In proforma Table 4W, an additional column is required for 'Advanced digestion' in line with the revised table 18.3 issued for the July data submission.

Also, following completion of the July data Table 18.3, there is a query over whether the sludge treatment block should include sludge transport costs. The Ofwat clarification point (17.08) issued on 27/6/17 states that sludge transport costs should be included in Other Direct. However, as this is a separate upstream service, we would recommend instead including a separate line or section to capture sludge transport costs. This would clearly separate the three upstream services within sludge and ensure it can be agreed back to Table 4E.

Lines 4W.23 to 4W.25 – It should be noted that under the current definition the total of these lines will not match line 3 on table 4E. The definition of line 4E.3 only includes the cost of discharge consents by the environment agency or canal & river trust and does not include the cost of other discharge charges / permits captured in line 4W.25. We would recommend the line definition for 4E.3 is expanded to include other discharge charges and permits so the total of 4W.23 to 4W.25 reconcile to 4E.3.

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 2B, 4D and 4E)**
- **c. Other minor changes**

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

We are supportive of the increased tax and non-appointed revenue disclosures in Table 1A

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

Line 5 – Renewals expensed in the year (infrastructure)
We support the proposal to show infrastructure renewals as a separate line. Our IRE was previously embedded within 'other operating expenditure' making cross-industry cost comparison more difficult, particularly with the different accounting treatment of IRE across the water industry.

Line 6 – Renewals expensed in the year (non-infrastructure)
It is unclear what is meant by the cost capture of 'Renewals Expensed in the year (Non-Infrastructure)' and we are not sure what is intended to go into this line. The definition is exactly the same as 'Renewals Expensed in the year (Infrastructure)' which provides no clarity. If it is aiming to capture repair expenditure on non-infrastructure assets, the definition would need to be enhanced. We do not currently capture expenditure in this way and any calculation would likely be based upon a sample based assessment of specific cost types and therefore not have a high confidence grading. We do not currently see the benefit in trying to separate out this cost line and believe this line should be removed from Tables 2B, 4D, 4E as well as 4J and 4K.

Lines 12/13 – Maintaining the long term capability of the assets
In RAG 4.07, Table 4D lines 12 and 13 a new sentence has been added 'Where objects have drivers both of enhancement and capital maintenance, companies should apply a method of proportional allocation to allocate costs between enhancement and capital maintenance.'

We believe this should apply across all of wholesale, as the same principle should apply to both water and wastewater. As such, we would propose this same definition also is appended to lines 12 and 13 of Table 2B and 4E as well.

Line 16 – Infrastructure network reinforcement
The expenditure which would fit into this capital expenditure category is already captured in the above lines of each table (e.g. within Other capital expenditure – infra or non-infra). Since line 17 capital expenditure total also includes this new line, it would result in all capex within this line being double-counted in totex. Importantly, there is also an element of Infrastructure reinforcement costs within operating costs, renewals expensed in the year (infrastructure). If all network reinforcement costs were stripped out of the above lines it would result in operating expenditure being reported incorrectly, since there is an element of opex within this network reinforcement total. Therefore, we would recommend that this line is shown for information only, but split by operating and capital expenditure.

c) Other changes to the existing regulatory tables in RAG 4.07

Table 4C
The proposed changes to Table 4C and the calculation of the Shadow RCV require companies to apply customer sharing to the totex over/underspend using the PR14 reconciliation rulebook. The totex reconciliation model does not use customer sharing and if it is applied to the totex over/underspend in table 4C it will result in a reduced adjustment to the RCV. This would mean that the Shadow RCV is no longer reflective of the actual impact on RCV that we would expect to see during the current AMP period.

Customer sharing of over/under performance is applied as a revenue adjustment, and not as an adjustment to RCV. If it is applied to the RCV value as well then the customer sharing element changes from the assumed ratio in the menu. The examples below show the effects of including the customer sharing under three scenarios, introducing the customer sharing into the RCV calculation and the menu results (example C) the value recovered from customers is reduced to zero.
If this is not what is intended then further guidance would be appreciated to clarify what is meant by applying customer sharing to the over/underspend. Our recommendation would be to remove line 4C.2 completely and amend the definition of the existing line 4C.3 to replace the reference to '4C.2' with '4C.1'.

	A) As per totex reconciliation model	B) RCV adjusted for company/customer share	C) RCV & Revenue adjusted for company/customer share
Company overspend by:	**£20m**	**£20m**	**£20m**
PAYG	60%	60%	60%
Menu choice	100.00	100.00	100.00
Customer share	50%	50%	50%
Menu reward/(penalty)			
Revenue	(£10m)	(£10m)	(£10m)
RCV	£0m	£0m	£0m
Totex reconciliation			
Revenue	£12m	£12m	£6m
RCV	£8m	£4m	£4m
Total company			
Overspend	£20m	£20m	£20m
Total Revenue adjustment	£2m	£2m	(£4m)
Total RCV adjustment	£8m	£4m	£4m
Total adjustment	**£10m**	**£6m**	**£0m**
Share of overspend recovered from customers	**50%**	**30%**	**0%**

Table 4F Cost analysis – household retail

We support the splitting out of the depreciation and amortisation charge into pre and post 31 March 2015 assets. Assets under construction do not incur depreciation until they are commissioned and we believe it should be from the point of commissioning that the depreciation and amortisation should be split. Pragmatically it would difficult to report on assets existing at 1 April 2015 since any depreciation charge relating to assets existing but not yet commissioned at this date would contain an element of depreciation which related to pre 1 April 2015 expenditure and an element post 1 April 2015.

As such, our recommendation would be to clarify the line definitions to refer to the commissioning date of the assets as per below:

- Line 9: "Total depreciation charge on legacy assets ~~that existed~~ commissioned before 1 April 2015……."
- Line 10: "Total depreciation on assets ~~acquired~~ commissioned since 1 April 2015……"
- Line 11: "Amortisation of intangible assets ~~existing~~ commissioned at 31 March 2015…."
- Line 12: "Amortisation of intangible assets ~~acquired~~ commissioned since 1 April 2015….."

Table 4H Financial metrics - Return of Regulatory Equity (RORE)

In Table 4H, within the updated line 5 RORE definition, section 4 states:
'When calculating the actual real interest rate paid from the actual nominal interest rate paid (nominal interest paid/average net debt) the average year interest rate should be used to deflate the nominal rate to a real rate'.

We think the underlined section should refer to the '"Actual year average inflation" rather than "average year interest rate". If amended to refer to the actual year average inflation rate then we again would agree with the extra clarity this would bring to ensure companies are able to calculate RORE on a consistent basis.

It may also be worth clarifying in the above quoted sentence "….actual nominal interest paid (nominal interest paid/average net debt)….." as to which specific net debt figure companies should use~~.~~ We believe it should be based on actual net debt because this part of the calculation is using this net debt number to calculate an actual interest rate paid. We have used actual statutory net debt in our reported RORE calculation, as stated in our 2016/17 APR, as we currently have issues with the net debt defined in Table 1E (see separate points raised in the additional comments section at the end of this response document).

Finally, it may be worth reiterating your guidance to use the Fisher equation to translate from nominal to real interest rates (as per email from Elinor Mathieson to James Bullock on 18 May 2017).

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, there are certain activities which, under the existing RAGs, we will continue to report as part of our non-household retail activities despite having exited the non-household retail market. The main area is 'providing developer information and administration for new connections' (under RAG2.07 table 2.4.1) which did not migrate to our Water Plus joint venture. Our other additional residual non-household activities include customer side leaks and investigatory visits.

However, this therefore denotes a few possible issues:

- Those companies who have not separated Non-Household retail activities are at a disadvantage to new entrants as they will be carrying costs within that price control which new entrants would not, reducing their margin; or
- Those companies who have separated their retail activities are unable to pass costs across to the appropriate retailer via the market code that is in operation

This indicates that the current RAG cost categorisations are not in line with the competitive market in following an approach where customer contact drives whether the cost is the retailers. Given that those companies who have separated have effectively derived their own cost base by the activities they undertake, the RAGs should be amended to follow the precedent set by the real-life situation rather than having stranded costs. Our recommendation is therefore to reclassify the activity ''providing developer information and administration for new connection" in RAG2.07 table 2.4.1 to sit entirely within wholesale. We would also suggest in the same table that "Investigatory visits" and "Customer side leaks" in relation to non-household customers should also be reclassified as a wholesale activity.

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

Generally we believe that there is sufficient guidance, albeit it should be recognised that there will be differences between companies reported costs depending on the accuracy of their underlying cost allocations and driver information, as well as different interpretations e.g. where a management estimate is used.

We suggest the addition of a further principle that: where consistent with the other principles, drivers used in cost allocation should be consistent with those used in assessing baseline expenditure requirements for each price control for AMP7. Companies have recently provided information to allow Ofwat to develop econometric models for the PR19 process. Within this information, expenditure and cost drivers, have been allocated to price controls based upon current understanding and definitions, therefore any subsequent changes in methodology may cause discrepancies between price controls, particularly when reconciling performance. This is most relevant to items 2.7 (on costs of treating sludge liquor) and 2.11 (on the costs of borehole pumping) of RAG2.07.

There is a question on sludge liquor treatment that does not take place at a stand-alone liquor treatment plant. These costs are currently included in the Network+ upstream service. Our view is that, with the introduction of Bioresources as a separate price control, these costs are actually an operating cost of Bioresources and therefore the cost allocation guidance should be amended to require that a market rate charge should be made from Network+ to Bioresources to cover the cost of this activity. The costs of this activity should be recovered in the Bioresources average revenue price control from 2020.

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

Yes.

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

We believe it would be useful to provide more detailed guidance in the RAGs. Other than the guidance in RAG2 appendix 1, in relation to allocating borehole power costs, there does not appear to be any other specific guidance on Average Pumping Heads.

Summary of measure

Average Pumping Head is calculated by taking total pumping head (i.e. the sum of the products of the total flow and mean lift at each pumping station) divided by the distribution input to give the average pumped head. The reporting requirements are detailed in Chapter 12 (Non-financial measures - Water explanatory factors) of the June return reporting requirements and definitions manual 2011. As part of our performance reporting, assets are split out into 4 categories (Resources, Raw Water, Treatment and Distribution) and the same methodology is used for average pumping head in each category.

Accurate reporting of Water Company pumping head requires year-long measured data. There is no industry best practise and companies could be using different assumptions which may impact the comparability of this data. We would welcome further discussion with Ofwat on reporting requirements and would support further cross industry discussion to improve transparency and consistency of reporting methodology.

Potential issues with reporting methodology

Total Flow
The most reliable way to determine total flow for each pumping station is to measure the flow over the course of the reporting year. If measured data is not available then an estimate of total flow will need to be made. The following errors/assumptions could lead to the over estimation of pumped flow:

• Using maximum duty flow instead of actual flow – would give a large error particularly if applied to variable speed pumps or rarely used/emergency pumps.

• Extrapolation of low resolution/ incomplete flow data leading to reporting of longer pump durations (higher flows).

• Simplification of sites could lead to reporting that all site flow is pumped when not necessarily the case. (e.g. assume that all water supplied from Franklaw was pumped from boreholes when in reality it can also treat water from gravity sources).

Mean Lift
The most reliable way to determine mean lift for each pumping station is to measure the suction and delivery pressure over the course of the year and then subtract average suction pressure from average delivery pressure. If measured data is not available then an estimate of mean lift will need to be made. The following errors/assumptions could lead to the over estimation of mean lift:

• The suction head could be understated or ignored if not known.

• The head lost caused by friction in the pipeline could be overstated.

• Using maximum duty pressure instead of actual flow – would give a large error particularly if applied to variable speed pumps.

• Simplification of sites could lead to reporting that all pumped flow is to the highest head when this might not necessarily be the case (e.g. at Franklaw there are 2 different routes that water could be pumped each with different heads. Using the highest head value for all distribution flow from Franklaw, instead of splitting into two, would increase UU's Average Pumping Head by 0.48m).

The potential issues above could have a significant impact on the comparability of the pumping head reported by companies.

Questions relating to Outcomes reporting

Q7. Should companies accrue for future ODI revenue rewards/ penalties?

From a Statutory reporting perspective, the recognition of regulatory mechanisms such as ODI revenue rewards/ penalties, WRFIM adjustments and the Totex incentive mechanism are not currently permissible under International Financial Reporting Standards (IFRS). This is an area currently being researched by the International Accounting Standards Board (IASB) as part of their Rate Regulated Activities project.

As this is the case, we would not recommend accruing for these in the regulatory accounts since this would create an additional statutory to regulatory adjustment which we do not believe is necessary.

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 recognise that substantial work has been undertaken to develop new and consistent reporting guidance for these metrics. Like any new methodology it is important that time is taken to trial the new measures and to implement any new systems and processes that may be required to accurately report against these new definitions.

As such we support the proposal to collect this data alongside the APR through shadow (i.e. unpublished) reporting. However, we do not believe this data should be published more widely.

We also think that any comparative targets that may be set on these or other common measures, should take into account the potential for differences in approach and measurement.

For these measures to provide the intended comparisons between companies, we believe that it is important that all companies can demonstrate that they are applying these methodologies consistently. Therefore, we support the proposal that this information should go through the same assurance process as other data collected as part of the APR. This data should not be subject to the audit opinion. The focus of the assurance of this data, should be to validate the effectiveness of the application of the new methodologies by the company, and to confirm a RAG status or confidence grade applied to the data.

Furthermore, we consider that it is greatly in customers' interests that a horizontal audit is undertaken by Ofwat to satisfy itself on the consistency of approach that companies are taking to reporting these new measures.

In the case of sewer flooding, we have very significant concerns about the comparability of this measure across companies because of the different operational processes that companies evidently adopt in identifying sewer flooding incidents. We set out more information about this below.

The recent UKWIR report on reporting consistency included guidelines on reporting sewer flooding. We support the general objective of ensuring that companies are reporting on a comparable basis but we are concerned that this may not be achieved in this case. It is important that all sewer flooding incidents are recorded, to achieve consistency when making performance comparisons based on reported data, and to ensure that decisions on addressing flooding are based on full information. We take considerable care to ensure that all incidents are recorded, even if not reported by customers.

Our current procedure for establishing the extent of sewer flooding involves a thorough check of neighbouring properties, whereas there is anecdotal evidence that other companies do not take similar steps to identify affected properties.

We suggested to Atkins, who were carrying out the UKWIR study, that the number of incidents self-reported by companies should be separately recorded. This would mirror the approach taken with pollution incidents and encourage companies to investigate the extent of flooding more thoroughly. The suggestion was not supported by any other company, and it was suggested that "pollution incidents were quite different from flooding incidents in that they rarely had a direct effect on individual customers". This implies that customers would almost always report flooding incidents, whereas in 2016/17 9,928 incidents were reported by customers and 2,300 were identified by investigation.

In view of the potential impact on comparisons, we suggest that all companies should report the number of incidents which they identify themselves. This information should be readily available, so it should not involve any additional costs. If this shows significant differences between companies, then we consider that these differences should be taken into account when making comparisons and (in turn) when setting any targets based on comparative performance.

Question relating to small companies (RAG3)

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

Yes, we do not have any issues with the proposed change.

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.

Yes. The current guidelines can be interpreted in different ways in that:

- The guidelines state that: "The guiding principle for transfer prices is that transactions between the appointed business and non-appointed business should be based on market price".
- The guidelines set out the basis for charges for the non-appointed business using appointed assets, that the appointed business should recharge the non-appointed business fully for the use of assets. This includes all the operating costs, capital costs and depreciation charges as it states: "All costs must ultimately be attributed or allocated, including, where appropriate, depreciation charges on assets and financing charges."

In our view, the cost allocation rules only apply when there is no market price available. However, the ambiguity leads to companies interpreting the guidelines differently.

Short-term trades within the Bioresources market will ensure the market is more dynamic and more trades happen this will lead to a lower cost to serve and thus lower bills for customers. Full allocation of costs inhibits short-term trades, as it is clear that the market price is less than full average cost – the potential buyer will not pay that price. We have observed this when discussing potential trades. Even if it involves transporting for long distances then the potential buyer's costs will normally be less than paying average total cost to another provider.

Q11a. 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?

Option B is our preferred option, as sharing the margin with the appointed business ensures the appointed business's customers benefit proportionately to the amount of risk the appointed business takes.

Therefore, including a margin means a fair market for regulated customers, as it will bring down the total cost to serve, thus meaning customers' bills will be lower.

Q11b. 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.

Yes, we agree with the proposed approach of including a proportion of the non-appointed margin in the transfer price. The proposal that the margin should vary with the costs and risks borne by the non-appointed business is consistent with the cost plus method of pricing, set out in OECD guidelines[1]. This method identifies the direct and indirect costs incurred by the vendor of the goods or services in a controlled transaction and then adds a mark-up to that cost base. We agree that the appropriate share is difficult to determine and that an even split of the margin is a reasonable default value.

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?

The guidance requires companies to align the period over which incremental costs are considered and the trading arrangements. Therefore, where new capacity is needed, potential new entrants will be able to compete on an equal basis. Thus, we do not consider that the approach will discourage competitive entry.

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.

No, we support the ideas proposed in this consultation.

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

No.

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

Providing competition law is still complied with, it is in customers' interests that companies have a flexible approach to pricing for the non-appointed business to use appointed business assets, if this enables spare capacity to be used. As having a flexible approach to pricing will entice companies to be more proactive in trading this will lower the cost to serve to the appointed business thus bringing down bills for our customers. Therefore, there may be other areas where some clarification is needed on RAG5 guidance on pricing. However, this is probably best addressed on a case-by-case basis rather than by making the guidance more general.

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

We agree with this proposal. This should ensure line 26 'Deferred income – G&Cs' of table 1C can be agreed to the 'carried forward' balance sheet line within table 2E (which does not include adopted assets).

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?

Yes, we support the reclassification of the amortisation of grants & contributions (G&Cs) to 'other income'. Under our statutory IFRS accounting treatment, we recognise the amortisation of capitalised G&Cs as a credit to operating expenditure. Under the existing RAGs this will flow through as a credit to totex.

[1] OECD (2010), *OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations 2010*, OECD Publishing, Paris. DOI: http://dx.doi.org/10.1787/tpg-2010-en

However, the original developer contribution is also recognised in totex (as a deduction to capex) which means both the original contribution and the annual amortisation for G&Cs would be reported within totex. Reclassifying the amortisation of G&Cs to 'other income', as proposed, would remove this charge from totex so only the G&C received would be corrected included within totex.

As well as amending RAG1.08, we would also recommend that in RAG4.07 the definition for Table 1A.5 'other income' should be amended to also reflect the reclassification of the amortisation of G&Cs.

Under statutory IFRS accounting treatment, the amortisation of adopted assets should go through depreciation. As it is already outside of totex there is no need to reclassify this to 'other income'.

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'?

The current definition of RAG1 1.8.1 refers to companies recognising grant income directly to the income statement and proposes this is reclassified to 'other income'. This definition therefore already encapsulates income recognised within operating expenditure. However, the definition could be amended to clarify this e.g. adding to the existing 2nd sentence "Some companies may recognise grant income directly to the income statement (either through revenue or a deduction to operating costs)"

However, in RAG4.07 the definition for Table 1A.5 'other income' only refers to revenue, so we believe this should be amended to also include amounts recognised to operating costs (as well as amending for the amortisation for G&Cs as per question 17 above).

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?

Inspection and supervision fees referred to in RAG 4.06 in the line definition for 2E.11 relate to the adoption of sewers. In our PR14 business plan submission, income from inspection fees for Section 104 adoptions was considered to be outside of the wholesale wastewater price control, and therefore not part of the wholesale wastewater revenue cap.

As set out in the current national guidance "Sewers for Adoption - 6th Edition", the inspection charge (of 2.5% of the estimated asset value) allows undertakers to recover costs incurred in carrying out the various activities in the course of the adoption procedure, which includes technical vetting, processing the submission and inspection or survey. These costs are recovered through the inspection fees. We therefore consider that this activity falls under "rechargeable works".

Therefore, we do not support the change to show this income as price control income in appendix 4, as we do not consider this income to be the same as the developer contributions reported as income governed by the price control. We recommend that the list of rechargeable works included in appendix 1 of RAG 4.06 is amended to include s104 sewer adoption inspection fees. We do not consider any changes are necessary to the line definition for 2E.11 "Other contributions (non-price control)".

Additional comments re: RAGs not covered in above consultation responses

We have separated our additional comments re: RAGs not covered in above consultation responses into two sections; those we consider to be of most importance and other issues. Our comments include concerns identified during the 2016/17 reporting process that we feel have not been reflected in the latest version of the regulatory accounting guidelines and of which we continue to hold these views:

Key issues

Pro forma Tables

Table 1E Net debt analysis
Table 1E line 2 Preference share capital is defined as "The nominal value of the preference share capital. This should equal 'Preference share capital' as reported in column 'Total appointed activities' of table 1C (i.e. line 1C.27)". We report preference share capital as current borrowings in the company's statutory accounts due to the nature of the preference shares in issue and therefore the total reported for table 1C line 27 is nil. This results in Table 1E omitting our preference share capital and therefore understating net debt by £130m. This understated net debt value also flows through to Table 4H financial metrics.

We propose that that table 1E line 2 should not be explicitly linked to table 1C line 27 to allow flexibility in how preference share capital is reported for statutory purposes.

Alternative solutions could be a requirement to reclassify all preference share capital in table 1C, regardless of statutory accounting treatment, to line 27 or, to include a 'Preference share capital' line within the 'Current liabilities' section of table 1C reflecting the statutory accounting classification.

Also see additional comments raised on 1E within other issues later in this document.

Table 4B: Wholesale totex analysis
The guidance for Totex menu PR14 reconciliation within the rulebook states that expenditure should be entered in accordance with the figures used within this table. Table 4B compares the performance of the Wholesale price controls against the cost assumptions within the final determinations. Given that costs were allocated on a proportionate basis for PR14, the resulting comparison between actual and 'allowed' totex is therefore skewed by the impact of changing capex allocations to a principal use basis. For companies that have different menu choices (and resulting customer/company sharing rates) for each of the wholesale price controls, there is the potential that customers (or companies) could be burdened with additional costs simply as a result of a change in regulatory accounting practice rather than any actual variances in expenditure. The table below summarises the impact of moving to principal use, Scenario A is the base case where actual and allowed expenditure are both on a proportionate allocation basis. Scenario B involves £25m expenditure being reallocated between water and wastewater (net nil on a Wholesale level), whereas scenario C involves Retail Household being the principal user for £25m of Wholesale expenditure.

	A) Proportionate		B) Principal use (net nil)		C) Principal use (adjusted total)	
	Water	Wastewater	Water	Wastewater	Water	Wastewater
Menu choice	100.48	106.24	100.48	106.24	100.48	106.24
Efficiency incentive	49.90%	48.75%	49.90%	48.75%	49.90%	48.75%
Allowed expenditure	£500.60m	£507.80m	£500.60m	£507.80m	£500.60m	£507.80m
Actual expenditure	£500.60m	£507.80m	£475.60m	£532.80m	£488.10m	£495.30m
Total revenue adjustment	£0.00m	£0.00m	(£4.33m)	£0.33m	(£4.33m)	£0.00m
Total RCV adjustment	£0.00m	£0.00m	(£9.12m)	£13.44m	(£9.12m)	£0.00m
Over/(under) recovery	**£0.00m**		**£0.31m**		**(£13.46m)**	

We propose that totex performance, and therefore table 4B, should be calculated on a like-for-like (proportionate allocation) rather than on a principal use basis. We are not proposing an adjustment to the RAGs as we believe that this could be achieved by the addition of an adjustment line which reverses the impact of principal use on actual totex. This would then enable the totex reconciliation to be calculated on a comparable basis and removes the risk that customers/companies incorrectly bare additional costs.

Other issues

RAG2.07

2.8 Imported Tankered Waste
In our consultation response in June 2016, we suggested the following wording for section 2.8 of RAG 2.06 in regards to the treatment of the recharge to the non-appointed business for treating imported tankered waste: "Where a recharge is required in respect of imported tankered waste, which is calculated based on market rate, the presumption is that the full value of the two sides of the transaction – (i.e. the costs to the non-appointed business and the recharge from the appointed business) would represent opex and negative opex."

We consider that the proposed wording in section 2.8 of RAG 2.07 is still not clear enough which could lead to a misinterpretation of how the recharge should be reported. We therefore continue to recommend including our proposed wording stated above.

5.1 Price control units
The 'price control units' definition refers to 2014 price review splits i.e. wholesale water, wholesale waste water, retail household and retail non household. But elsewhere in the RAGs, price control units appears to be written in the context of the PR19 splits as per section 2 of the APR e.g. when referring to principal use in section 2.1 or the allocation of capital costs between price control units in section 2.3.2. It may be clearer to change this definition to the new reporting units but ensuring the new definition not used incorrectly e.g. within 2.1 'No cross subsidy between price controls' which should still refer to the PR14 price controls.

Water sludges
In appendix 2 of the Ofwat Consultation: Regulatory reporting for the 2016-17 reporting year it is stated that proposal 10 on water sludges had been accepted. The proposal was: "The presumption is that the full value of the two sides of the transaction, i.e. the costs to the water price control and the recharge from the wastewater price control, would represent opex and negative opex in tables 2A and 2B. We would support clarification of this through a clear statement in RAG 2.06."

However, we have identified that neither RAG 2.06 nor RAG 2.07 have been updated to refer to water sludges. To ensure consistency across the industry we recommend that this wording is included and explicitly stated in RAG 2.07.

RAG 4.07

Table 4E Income treated as negative expenditure
In addition to the items listed in line definition 4E.2, we propose the inclusion of "Electricity sales from National Grid 'frequency response'" and "dynamic demand income" as a further example.

Pro forma Tables

Table 1E Net debt analysis (in addition to point raised within key issues above)
There is an inconsistency within this table at present in the way borrowings in line 1 are categorised between Fixed rate and Floating rate and the way interest costs, interest rates and average years to maturity are categorised on lines 9-14. The borrowings in line 1 are currently categorised based upon the terms of the debt instrument only and do not reflect the synthetic (post-hedge) position created as a result of our financial derivatives, whereas lines 9-14 reflect the synthetic (post-hedge) position. We would recommend that the guidance be amended to state that the borrowings in line 1 be categorised based on the synthetic (post-hedge) position which would result in all the information in the table then being on a consistent basis.

In addition, the borrowing valuations used in line 1 represent a 'notional value' basis which we believe is more appropriate than book value and is in line with the guidance. In our opinion, the guidance could be more explicit in stating that 'notional values' should be used (as has been done in the guidance for 'preference share capital' in line 2) rather than book values and recognising that this could create a reconciling difference to borrowings in Table 1C. We are currently inferring the use of notional values from the guidance which states: 'The following should not be included: fair value accounting adjustments which do not impact on the principal sum outstanding on the debt or the total interest paid. For example when financial instruments, such as interest rate swap agreements are presented at fair value.'

Table 2D Historic cost analysis of tangible fixed assets – wholesale & retail
We think it would be helpful for users of table 2D if two additional rows were inserted into this table to provide additional information. The first addition would be to section A to disclose the value of transfers between price control units, so as to separate these from actual additions and disposals. Transfers between price control units would primarily arise where assets under construction are allocated across price control units on commissioning, or due to changes in the RAG definitions e.g. the reclassification of treatment facilities that do not receive imports nor treat sludge to greater than 10% (DS), from sludge to wastewater network+ price control units. The second addition would be in section B for impairment losses, so as to separately distinguish these from the depreciation charge in the year.

Table 4G Wholesale current cost financial performance
We continue to support the simplified assumption that all interest costs are allocated to wholesale. However, there are additional items within other income that should not be attributed to the wholesale business as they are genuine retail costs or income. An example of this is other income derived from the use of central systems by other group entities. This includes shared central systems that span all price controls not just the wholesale business for which income is received.

Our proposed approach would be to append the current line 4G.6 definition with the underlined section as shown here: "Equal to 1A.5<u>, less any other income attributable to the retail business</u>".

Table 4H Financial metrics

Credit rating
In respect of line 9 "Credit rating" we believe that the requirement should be to list all solicited long-term ratings for the appointed business along with the outlook / watch status. We would recommend that only solicited ratings are reported as only solicited rating agencies receive additional non-public information on which to make their assessments and so are likely to be more accurate then unsolicited ratings.

FFO / Debt
We expect line 15 "FFO / Debt" is likely to be interpreted by users as mirroring the ratings agencies' calculations. Whilst we recognise that Ofwat has stated that its approach will differ to the credit rating agencies, we still consider it would be more appropriate that this ratio is calculated based on Standard & Poor's methodology to ensure consistency in the calculation of this metric. The key difference is that FFO should be calculated after deducting all underlying interest, not just cash interest as per the line 12 FFO definition. Net debt should also include any reported pension deficit. An additional sentence could be added to the existing line definition so it reads:

"Ratio of FFO to net debt. <u>FFO as per line 12 less interest charge for the accretion of index-linked debt. Net debt as per line 1 plus any reported pension deficit (as per Table 1C, line 24).</u> We acknowledge that our approach to calculating this differs from some of the methodologies applied by the credit rating agencies."

Table 4I Financial derivatives
We faced a couple of limitations with the table for 2016/17 reporting. Firstly, line 23 requires 'Other financial derivatives' to be included as one line to reconcile the total (line 24) mark-to-market value through to table 1C. We have two types of derivatives which feed into this line, being electricity swaps and forward dated floating to fixed interest rate swaps. In relation to the electricity swaps the nominal value by maturity would have been GWh rather than a financial amount and there is no weighted average interest rate to disclose only a fixed price per GWh. In relation to the forward dated floating to fixed interest rate swaps, the nominal value by maturity assumes the swaps have reached their value date which they have not due to them being forward starting. As such we only disclosed a combined Mark to Market value for the two types of swaps in line 23 and left the other fields blank, providing additional analysis instead within the narrative. One potential solution to this issue might be to specifically exclude commodity swaps from the table and require a reconciliation instead to table 1C. Line 23 could then be used purely for forward starting swaps, we could provide a weighted average interest rate, but with these swaps we would remain unable to provide a maturity analysis due to them not having reached their value dates.

The second issue we faced was the inclusion of two different currencies in line 16, 'Currency interest rate swaps Other'. One of our swaps was HKD/ GBP and the other was reverse dual currency, swapping USD principal and JPY interest into GBP. As a result, the interest receivable disclosed in the table was a blend of HKD and JPY interest rates. One solution to this issue might be to allow for more currency lines within the table.