

Regulatory accounts working group (RAWG)

Slides for workshop
28 February 2017

Timing	Description	Lead
10:00	Coffee and registration	
10:15	Introduction	Andrew Boardman
10:25	Cost assessment	David Young
11:30	Coffee break	
11:45	RCV allocation	Iain McGuffog
12:45	Lunch	
13:30	2016-17 Reporting - Tax disclosures - Audit opinion - Ignore changes in tables 2B/4D/4E - anything else?	Rob Lee
13:45	Data capture pilot exercise	Hanif Jetha
13:50	Cost of new connections	Mark Jones
14:05	Bioresources and Water resources - separate price controls; - Market information - Sludge measurement	Alison Ferguson
14:25	Refreshment break	
14:35	RAG5 - sludge trading and transfer prices	Andrew Boardman
14:50	2017-18 and future reporting 1. Review of the RAWG follow-up questions on 11 Nov 16 2. Retail market opening 3. Small company threshold 4. Consultation document	Rob Lee
15:30	End	

Introduction

Andrew Boardman

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- **Purpose of the day**
- **Housekeeping**

Cost assessment

David Young

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Welcome!!

The format of the session will be:

- **Introductions and Welcome**
- **Recap on Cost Assessment from November 2016**
- **Changes to the Annual Performance - Overview**
- **Information Request for 2016-17**
- **Discussion**
- **Closing Remarks**

Recap on Cost Assessment

- In every price review Ofwat sets an **efficient expenditure allowance** for the water companies for a period of five years.
- Cost assessment is an **extremely important and material** component of price reviews
- In PR14 our approach to cost assessment was based on top-down benchmarking of historical costs and special cost factors adjustments
- Specifically, we developed **benchmarking (econometric) models** on the basis of statistical relationships between historically incurred costs and 'cost drivers', as reported annually by companies. The models provided an initial cost baseline
- The initial cost baseline were then subjected to **“special cost factor”** adjustments, which are factors that impact company costs but are not captured in the model (e.g. a very large capital scheme such as building a new reservoir)
- The Cost Assessment Team issued information requests for Water and Waste Water in 2016. Following this data issues were identified and they have worked with the industry to rectify these.

Amendments to the APR for Cost Assessment

Amendments to the APR – Overview of changes

- We have incorporated Cost Assessment data needs into the **APR for 2017-18 reporting year.**
- We aim **to align the APR with the Information Requests.** Issues that were identified in 2016 should be corrected in this Consultation...work is ongoing!!
- We have further areas to consider for the consultation:
 - **Average Pumping Head**
 - **Retail**
 - **Pensions, 3rd Party Costs, Business Rates and Market opening costs**
 - **Alignment with new connections definitions**
- The expansion of the APR to include more cost assessment allows for the collection of data into a **controlled process**

Amendments to the APR – Overview of changes

	Table	Description
1	Table 4A	Non financial Info
2	Table 4B	Totex Analysis
3	Table 4C	RCV
4	Table 4D	HC WW Totex Analysis
5	Table 4E	HC WWW Totex Analysis
6	Table 4F	HH Opex Analysis
7	Table 4G	CC Income Statement
8	Table 4H	Fin Metrics
9	Table 4I	Fin Derivatives
10	Table 4J	Exp by BU WW
11	Table 4K	Exp by BU WWW
12	Table 4L	Enhancement Capex WW
13	Table 4M	Enhancement Capex WWW
14	Table 4N	ST Opex
15	Table 4O	STW data
16	Table 4P	Non Fin WW
17	Table 4Q	Properties, Population WW
18	Table 4R	Non Fin WWW
19	Table 4S	Sewage Treatment WWW
20	Table 4T	Sludge Treatment WWW
21	Table 4U	Properties, Population WWW
22	Table 4V	HC Water Opex Analysis
23	Table 4W	HC Sludge Opex Analysis

Information Request for 2016-17

- We aim **to align the APR with the Information Requests**.
- The 2016-17 Information Request has been **amended to clarify definitions** and improve data quality

We would like to discuss :

- **The span of data** – we would like the information request to cover **2016-17** reporting year and historic reporting years **2013-14, 2014-15 and 2015-16**. We may need to **extend this for WWT to include earlier years 2011-12**.
- It will capture both **Wholesale Water** and **Wholesale Waste Water**.
- It may also cover **Retail, Pensions, 3rd Party costs, Business Rates and Market Opening Costs**
- The extent of the Assurance requirements – ideally we would like the information request to be covered by the **assurance arrangements given in Section 4 of the APR**

2016/17 Information Request - Timetable

Date	Deliverable
Mid-March 2017	Ofwat to issue draft tables, guidance and Information Request
By no later than 15th April 2017	Ofwat to formally issue Information Request with tables and Guidance
By no later than 15th July 2017	Companies to return completed information requests

Discussion

Questions for Discussion



Are there any issues for your accounting and reporting systems with the additional information?

Do you consider the Section 4 Assurance for the Information request to be issued for 2016-17 appropriate?

Do you have any specific comments about the latest draft tables or draft guidance?

For the Information Request are there any issues with the historic reporting years

For the Information request are there any issues with the timetable



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RCV allocation

28th February 2017

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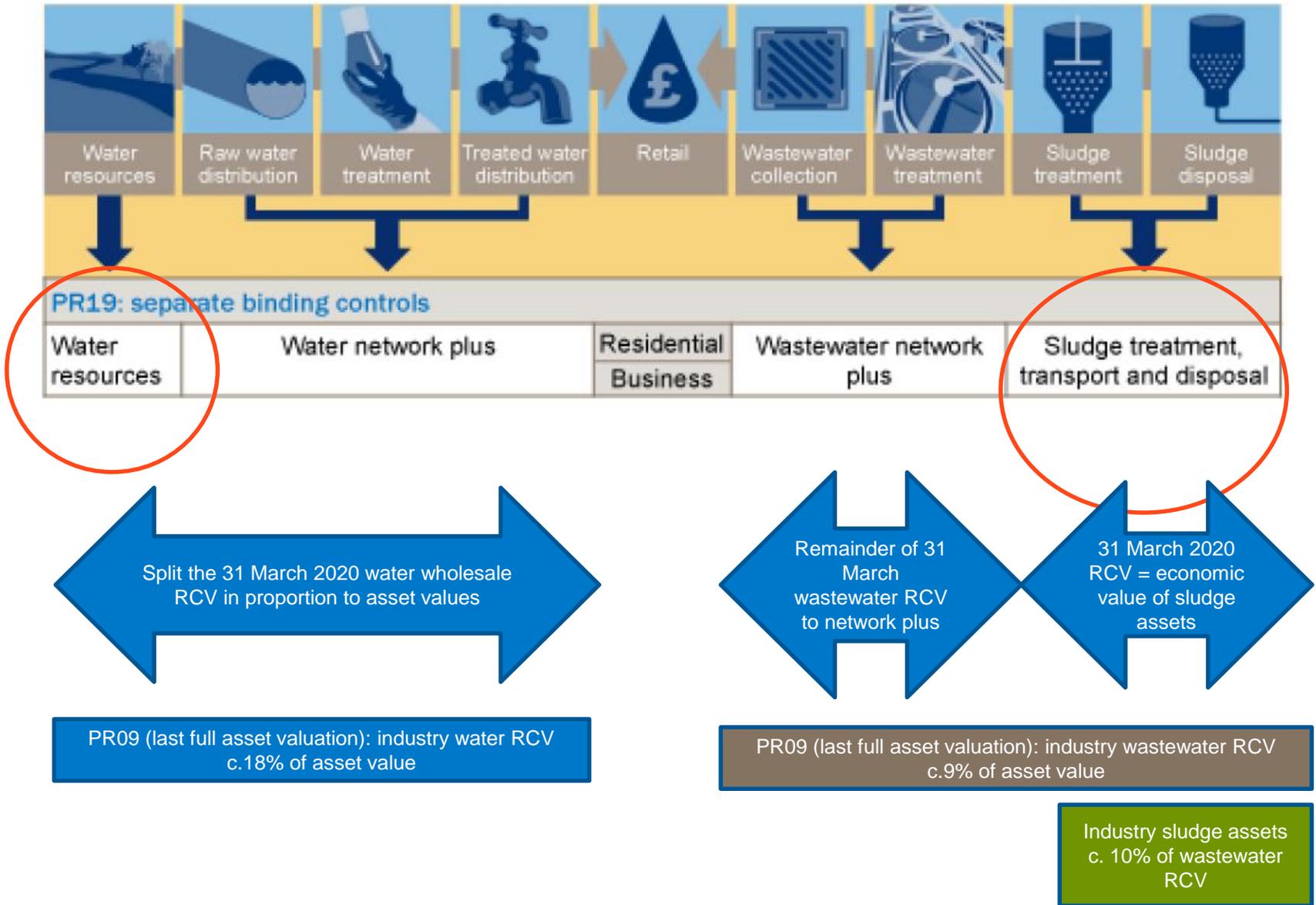
Welcome!!

The format of the session will be:

- **Introductions and Welcome**
- **Overview** – Water Resources and Bioresources
- **Water Resources**
- **Bioresources**
- **Discussion Group**
- **Closing Remarks**

Overview of RCV allocation

Background RCV Allocation



Differences between bioresources and water resources

	Bioresources	Water resources
Approach to RCV allocation	Focused – consulting on specific valuation of economic value of assets	Unfocused – proportion of assets relative to total water wholesale
Asset lives	Relatively short – non-infrastructure pumps, mechanical equipment, vehicles	Long infrastructure, particularly for reservoirs
Form of control assumed	Average revenue control	Total revenue control
Type of market	Specific trades with other WASCs and new entrants.	Bidding for incremental water resource schemes (not impacted). Bilateral market
Impact on Wholesale tariffs	Potential impact on relative cost of sludge processing versus sewage collection and treatment and so potential to impact on price of trade effluent versus wastewater service	Potential impact, if change to balance of water resource versus water distribution and treatment cost.
Impact on Bulk supplies	Not relevant	Indirect link. Potential impact where water resource surplus and/or average water resource above incremental cost
Relevance of MEAVs	Divergence between context of past valuations and economic value of trades. Valuation should vary with location and market value or bioresources, rather than just sludge technology	Not proportionate to do a full revaluation. Consider roll forward of PR09

Water resources RCV allocation

Water Resources: Recap on our decision on water resources RCV allocation in May



In our [May 2016 decision document](#) (see section 5.8) we set out:

- an **unfocused approach** would be the most appropriate methodology
- the **problems and costs of a MEAV revaluation** and the **potential impact on wholesale tariff structures**
- given this context it would be preferable for **each company to have greater ownership and responsibility for how its historical RCV is allocated** between water resources and network plus
- **companies will develop and justify proposals for the allocation** and these will be subject to a proportionate and risk-based review by us
- these proposals will be shaped by **Ofwat guidance** with the allocations to be finalised as part of PR19
- **companies will be able to revisit the allocation in PR24** if there are compelling reasons to change e.g. to meet the RCV protection guarantee or evidence of misallocation at PR19, this is expected to be by exception

The benefits of our approach are:

- it helps to avoid unnecessary impacts on wholesale tariffs and strengthens companies' ownership of their wholesale tariff structures;
- it avoids the regulatory burden of a full MEAV exercise;
- It does not place reliance on existing MEAV data that may be out-dated or otherwise unsuitable; and
- it enhances regulatory protection for the pre-2020 legacy RCV.

Overview of Water Resources RCV Allocation – Timetable

Date	Deliverable
April 2017 – May 2017	Meetings with companies to understand approach in response to our guidance
July 2017	Ofwat sets out the information we intend to collect alongside the Water 2020 methodology consultation
End of January 2018	Companies submit water resource RCV allocation information.
End of April 2018	Ofwat provide feedback on water resource RCV allocation to companies approach to inform their PR19 business plans
December 2019	Ofwat decision on RCV allocations as part of PR19 final determinations

We do not intend to collect information on company proposals for their water resource RCV allocations until after the draft Water Resource Management Plans have been developed. This will allow companies to consider fully the relationship between current and incremental water resource costs and the relationship with other services within network plus such as water treatment

Overview of water resource guidance

- A range of potential approaches described – what best reflects the broad principle of an unfocussed approach (e.g. roll forward of previous net MEAV, economic value share, totex analysis)
- Data used should reflect RAG 4.06
- Analyse how the proposals affect the calculation of wholesale charges for different services and customer groups (e.g. Testing the sensitivity of the legacy RCV allocation through charging models under a range of different allocation and competition scenarios)
- Companies should consider their RCV allocation approach alongside their Water Resource Management Plans (WRMPs). This will allow companies to consider the impact of their legacy RCV allocation on water resource markets and wholesale tariffs.
- Where bulk supply prices are related to average costs for components of water resource or network plus services, then the RCV allocation between water resources and network plus could have an impact on the cost associated with providing bulk supplies.

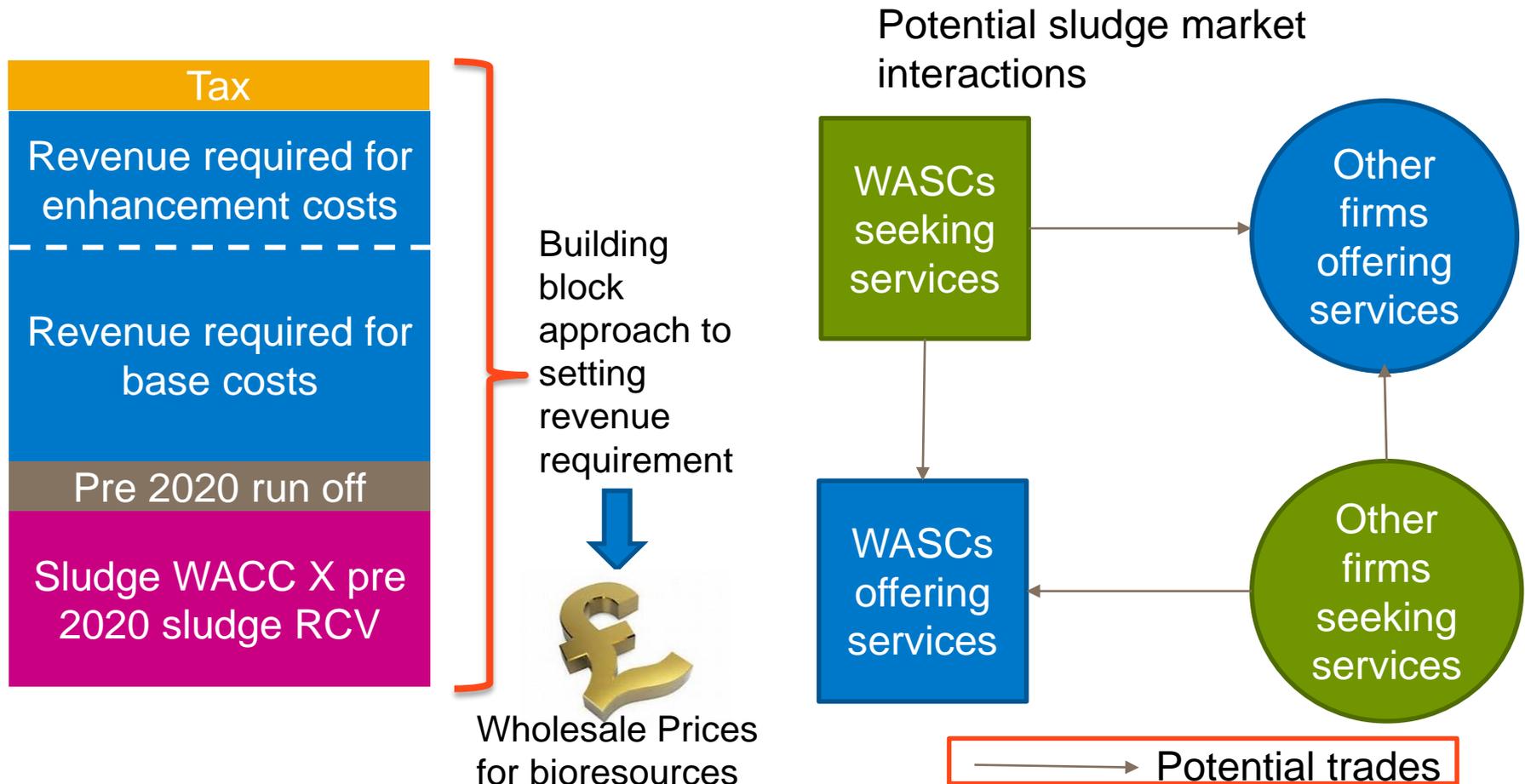
Topics for company meetings:

- Approaches being considered to allocating the pre-2020 RCV
- Approach to analysing impact on wholesale tariffs
- Relevance of Water Resource Management Plans to the approach
- Discussion on information requirements and timetable

Bioresources RCV allocation

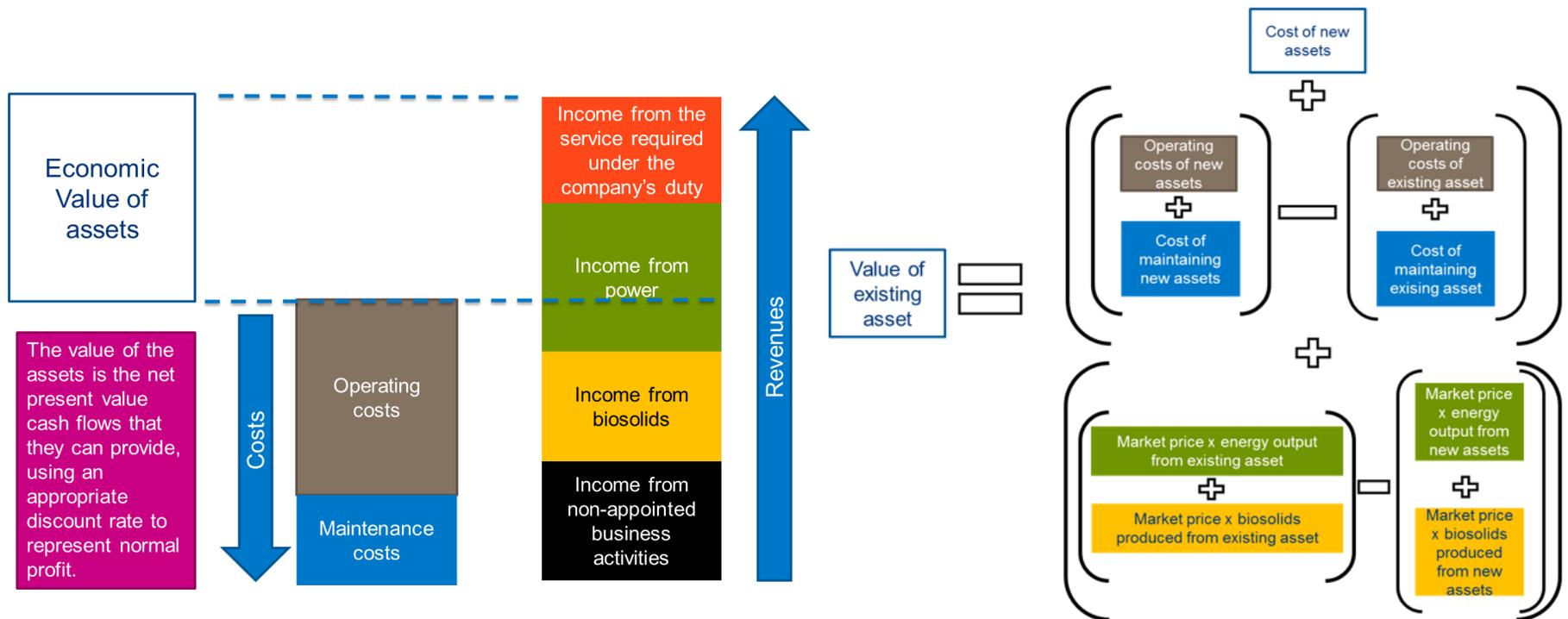
Bioresources: Why do we need a valuation?

- Valuation and RCV allocation needed for PR19 bioresources building block approach for price control
- Need to consider impact it may have on both narrow sludge market and wider bioresources market
- Focus on consistent approach to allocation.



Background: Economic value

- Present value of revenue stream net of costs
- Assume in a competitive market cost of hypothetical asset = PV of revenue stream – short cut in absence of market prices is for companies to cost new asset and then adjust for difference in asset life and economic value to actual assets



Bioresources : Summary of approach – valuation consultation

Processes you would build as if you were a hypothetical new entrant

Cost of hypothetical new asset:

Adjust hypothetical new assets to reflect differences in economic value of actual assets

Arrive at a net economic value of the current assets = focused valuation of RCV at 1 April 2020

Modern equivalent asset for:

Operating and maintenance costs
Income from treating third party waste
Income from energy generation
Income from biosolids product

Economic value:

Cross check against:

Current capacity
Locations
Product quality
Outsourcing arrangements

Discounted difference of cost and income

PR09 valuation roll forward?

Cost and condition of current assets?

Backwards look – historic expenditure / statutory accounts

Time period over which current assets deliver value

Forward looking concept:

Valuation includes:

If valuing current assets as at 31 March 2017, roll forward to 31 March 2020 with expenditure net of depreciation

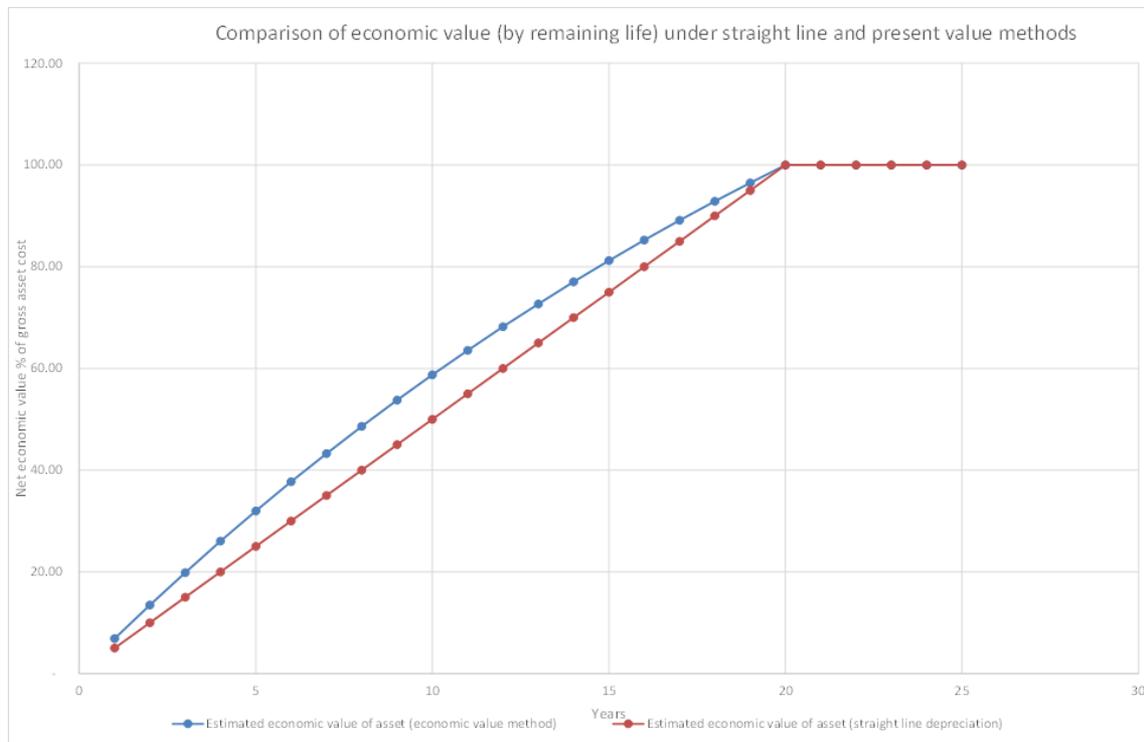
Consistency between charges and cost recovery

Consistent with sludge strategy (e.g approved plans, recent build choices)

Land
On costs
Infrastructure
Non site costs such as vehicles
Common costs e.g. IT, offices
M&G

Sufficient revenue implied for maintaining actual assets

- Considering hypothetical asset at sludge treatment centres at process level
 - Areas of common assumptions and approaches e.g. land
 - Use of accounting records (within valuation and as part of cross checks)
 - Publication of valuation submissions
-
- Use of present value discount rates to reflect economic life of actual asset



Bioresources - Timetable

Date	Deliverable
31 March 2017	Consultation closes on draft guidance
Late April 2017	Final guidance. We will provide companies with information in advance of this date should significant issues arise as a result of the consultation
29th September 2017	Companies to submit bioresources MEAV valuation and RCV allocation and assurance information to Ofwat.
January 2018	Ofwat provide companies with feedback on their valuation and proposed RCV allocation.
September 2018	Companies consider feedback from Ofwat and revise information as appropriate in their business plans. We will set out the requirements for companies alongside our methodology statement in July/December 2017 together with the other requirements for business plans.
By December 2019	We will confirm the allocation of the RCV to the bioresource control as part of our final determination

Discussion groups

Break out group questions



All Groups: Views on the high level approach for both water resources and bioresources?

Group 1 (Water resources and Bioresources) – How can we get best value out of existing accounting data? Have we captured the relevant cross checks? How can we test the impact on charging structures?

Group 2 (Bioresources) views on level of data collection for the tables - for each sludge treatment site including costs and revenues for cross checks, separate data for satellite sites, vehicles and common costs.

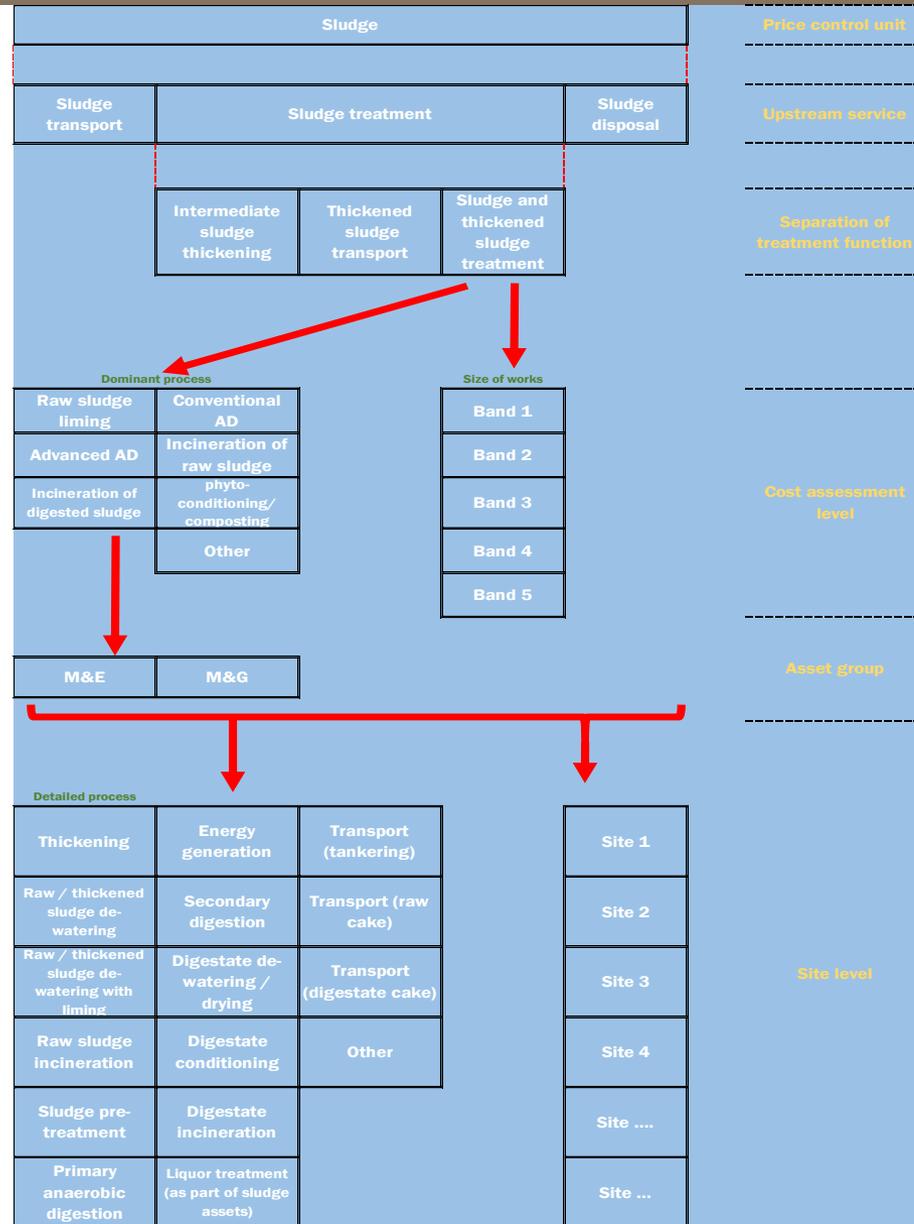
Group 3 (Bioresources): Views on the economic value approach? Have we highlighted the right areas for consistency in valuation approach (e.g. land)?

Group 4 (Water resources): How can we use information in Water Resource Management Plans to test the impact of proposed RCV allocations



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Group 2: Bioresources – Data Tables: Hierarchy of Data Flows



Group 3: Economic value calculation steps – illustration for company with 1 sludge treatment centre

Step	Value
a. New construction cost of process A of hypothetical new asset with a life of 11 years.	£10m
b. New construction cost of process B of hypothetical new asset with a life of 23 years.	£30m
c. = a. + b. Total hypothetical cost of sludge treatment centre	£40m
d. Asset life of hypothetical asset (weighted according to construction cost)	20 years
e. Sum of present value factors over 20 years for hypothetical asset at 3.6%.	14.33 (where year 1 is $1/(1+3.6\%)$) and subsequent years are previous year / $(1+3.6\%)$)
f. Sum of present value factors over 10 years remaining life for actual asset at 3.6%	8.42
g. = f / e. Adjustment factor to reflect remaining life of actual asset	58.8%
h. Annual additional operating and maintenance costs and lower revenues from actual asset compared to hypothetical	£0.1m
i. Discounted present value of h. over 10 years of remaining life of actual asset	-£0.84m
j. = i. / c. Adjustment factor for differences in operating and revenue costs	-2.1%
k. = g. + j. Net economic value of actual sludge treatment centre assets as proportion of hypothetical new build cost	56.7%
l. = k. * c. Economic value of sludge treatment centre	£22.7m (implied RCV run off of £2.27m over 10 years remaining life from 2020)
m. net asset valuation of intermediate sites, management and general and transport assets	£3m
n. Total sludge asset economic value proposed for historic RCV allocation	£25.7m

Group 4: Water resources: Relevance of WRMP to unfocussed RCV allocation. – consistency of cost allocation and cost recovery

Cost/price element with 10% historic RCV allocation to water resources	Existing resource	New Resource	Total
Cubic meters per year (m3)	900	100	1000
Water resources cost (£ per year)	195	40	235
Water resources unit cost (£/m3)	0.22	0.40	0.23
Compensation payment (£/m3)			-0.17
Network plus costs (£)			1783
Network plus unit costs (£/m3)			1.78
Network plus unit costs minus compensation payment – access price paid by third party water resource provider (£/m3)			1.62
Large user unit costs (£/m3)			1.49
Large user unit costs as a proportion of standard unit costs (£2.00/m3)			75%

Informed by Water resource management plan

RCV allocation would affect average water resource costs and network plus average cost (which could be relevant to bulk supplies). Particularly relevant if no incremental resource schemes.

RCV allocation should have no impact if incremental cost of new resources derived from WRMP for the revenue control

May be impacted by WRMP and RCV allocation (unlikely to be material)

2016-17 reporting

Rob Lee

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Some reminders and clarifications for this year's reporting.

- 1** Tax disclosures
- 2** Audit opinion
- 3** Cross references between tables 2B, 4D and 4E, error in RAG 4.06
- 4** Anything else?

Annual performance report to be published by 15 July 2017

Changes for 2016-17 reporting – A REMINDER!

Tax disclosures

3.11 Tax Strategy for appointed business

The Finance Bill 2016 will introduce the requirement for large companies to publish their tax strategy annually. We are also requiring all companies to publish details of their tax strategy (relating to the appointed business) within the Annual Performance Report. The tax strategy should cover the following key areas.

- The approach to risk management and governance arrangements;
- The attitude of the company towards tax planning;
- The level of tax risk that the group is prepared to accept; and
- The approach of the company towards its dealings with HMRC.

References and links may be made to tax strategies published in the statutory or group accounts as appropriate.

4.5 Current tax reconciliation

4.5.1 A reconciliation is required of the appointed current tax charge or credit reported in line 1A.12 to that resulting from applying the standard corporation tax rate to the profit or loss on ordinary activities for the appointed business before tax and any fair value movements as shown in table 1A. There should be no netting off of material positive or negative amounts.

4.5.2 A reconciliation is also required to explain any significant variations between the appointed current tax charge or credit reported in line 1A.12 for the appointed business to the total current tax charge allowed in price limits. **The reconciliation should quantify the £m difference relating to each particular area and narrative should be provided to explain at a high level the circumstances which led to the difference arising. E.g. If the value of capital allowances claimed is significantly different to that assumed at price limits, has this arisen due to changes in the level or type of expenditure, uncertainty/change around what expenditure would qualify for a particular allowance etc.?**

4.5.3 **The reconciliation should make reference to the following areas (this is not an exhaustive list):**

- **Prior year adjustments**
- **Payments for group relief – these transactions should also be disclosed in the transfer pricing table template (see sections 6.2 and 6.3)**
- **Effect of corporation tax rate changes**

4.5.4 Details of factors affecting future tax charges should be given.

Group relief arrangements

Tax losses are considered to be assets. The typical situation is where a loss arises in one period and can be carried forward to future periods – this accords with the normal accounting concept of an asset, which is a present right to future economic benefits (i.e. a company has the right to carry the loss forward for offset against future taxable profits).

It would be difficult to conceive of a situation where a tax loss is an asset when its use is only prospective, but ceases to be an asset in the period in which it is used (until the actual moment of use, when the loss is effectively extinguished through its use). Hence the surrender of tax losses from one company to another (for use in that period) must be considered as the transfer of an asset between companies.

Group relief surrenders should fall within the provisions of Paragraph 3 of the Appendix to Condition F.

Companies should note the requirement to fully disclose any group relief arrangements.

Audit opinion

New wording needed in order to align with **ICAEW Technical Release 'TECH 02/16AAF Reporting to regulators on regulatory accounts'** which updates **ICAEW Technical Release Audit 05/03 Reporting to regulators of regulated entities** (originally issued in 2003). We are currently discussing this with the 5 audit firms.

Ignore changes in tables 2B/4D/4E – apologies!

As identified at the last RAWG meeting, the RAGs for 2016-17 incorrectly reference the opex total for line 9 in tables 2B/4D/4E through to line 7 in table 2A. This is pre-recharges and so is incorrect. The reference should be to line 10 of 2A so that recharges have been taken into account.

Anything else?



Data capture system pilot

Hanif Jetha, Senior Associate
February 2017



The overall aim is to replace current spreadsheet tables with an online portal for Ofwat data collections.

Ofwat

- Faster data capture – integration with our database
- More automation/ less reliance on manual input
- Easier to create data collections
- Automatic query logging
- Better data validation

Companies

- Easier to complete data submissions than Excel templates
- Better communication of queries
- Permissions control to give companies control over users and sign off
- What else would be useful to companies?



March 2017 - First release of DCS

March 2017 – User feedback

March to June 2017 – work with two trial companies to work with to test the system (we are looking for one WOC and one WASC)

July 2017 – submission of the APR 2016-17 (or part of the APR)

August 2017 to December 2017 – Further development of DCS with a wider group of volunteer companies.

December 2017 – Final release of DCS

Early 2017 – roll out to companies ahead of APR 2017-18 and PR19 business plans

New Connection Cost Reporting

Mark Jones

28th February 2017



Objectives

- Provide greater visibility of the Network Infrastructure Reinforcement costs associated with new connection provision for both wholesale water and wastewater services

Requirements

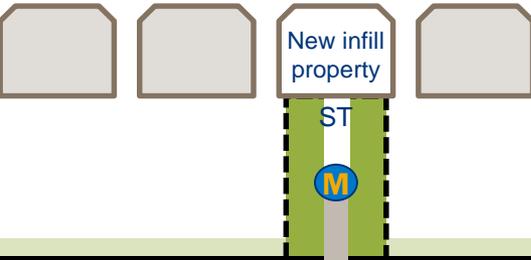
- Split of costs between wholesale water and wastewater
- Data to be clear, informative, understandable and reliable
- Not too simplified or detailed
- No needless additional burden on the companies in providing the data
- Clear understanding as to the classification of costs

Draft post TFG: Proposed boundaries for new WATER connection charging

Key

- M Meter
- ST Stop tap
- C Contestable
- NC Non-contestable
- Existing strategic assets
- Existing network
- On site / site-specific charging
- Site boundary

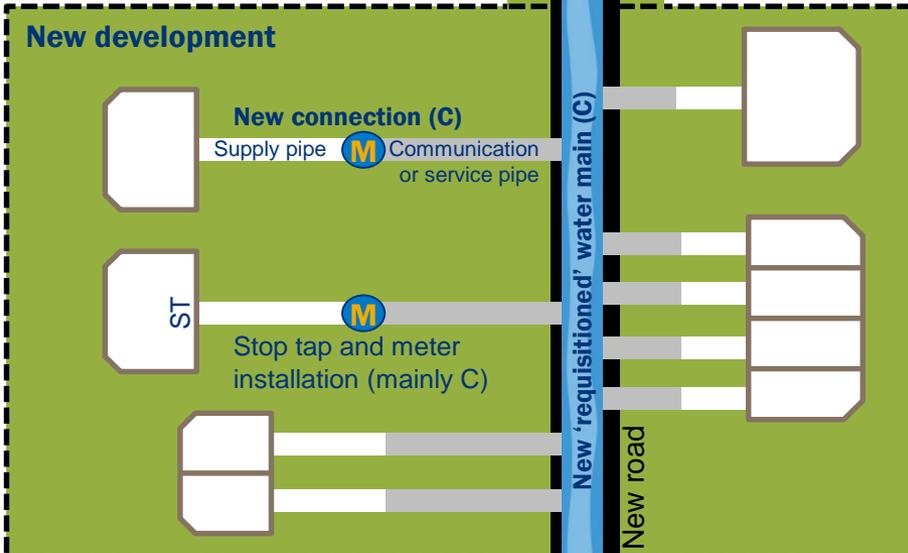
Existing properties



Existing 'live' water distribution main (non Trunk Main)

Connection to live main (mainly NC)
Piece-ups to the live main (C)

New development



Point of connection – the nearest practical location where the live main is the same size or larger than the new connecting main

The costs of necessary reinforcement work required to these existing strategic assets or the provision of new water resources or treatment assets (including the transmission between them), **are to be borne by the water company** and not the developer

Raw water aqueducts, balancing tanks, other raw water distribution structures and booster pumping stations

Dams and impounding reservoirs

Intake and source pumping stations

Water treatment works and forwarding pumping stations

Is the provision of further assets or additional capacity required to serve this and other new developments?

Service reservoirs

Booster pumping stations

Pressure management (including zonal metering)

Water towers

The **apportioned** costs of necessary reinforcement work required to the water company's existing network assets 'in consequence' of the new connections and as evidenced in water companies' business plans, **will need to be borne by the developer** through the water company's redefined infrastructure charge

Financial Year 2016-2017

- No changes

Financial Year 2017-18

- Include the new infrastructure reinforcement costs table (slide 6), in section 2
- No other changes to the APR

Financial Year 2018-19

- New rules implemented
- In addition to the new table for 2017-18, inclusion of the reconciliation table (slide 7), in section 2
- Addition of the narrative breakdown within the overall document, individual companies to decide the location

Table 2B – Totex Analysis: Wholesale Water and Wastewater

- Inclusion of new line 'Infrastructure network reinforcement'

Table 2E – Analysis of Capital contributions and land sales – wholesale

- No Change to the current table

Table 2J – Analysis of Infrastructure network reinforcement costs

- New additional table

Table 2K – Network Infrastructure reinforcements reconciliation

- New additional table

Tables 4D – Totex analysis – wholesale water

- Inclusion of new line 'Infrastructure network reinforcement'

Tables 4E – Totex analysis – wholesale wastewater

- Inclusion of new line 'Infrastructure network reinforcement'

Pro forma 2xx

Infrastructure reinforcement costs for the 12 months ended 31 March

XXXX

	Network reinforcement activity	On site / site specific activity (memo only)
Wholesale - water		
Distribution and trunk mains	I	I
Pumping and storage facilities	I	I
Other	I	I
Total	C	C
Wholesale - wastewater		
Sewers	I	I
Pumping and storage facilities	I	I
Other	I	I
Total	C	C

Pro forma 2xx

**Infrastructure reinforcement reconciliation for the 12 months ended
31 March xxxx**

	Water Services	Waste water Services	Total
Variance B/Fwd			I
Revenue	I	I	C
Costs	I	I	C
Variance C/Fwd	C	C	C

The narrative breakdown of the total variance carried forward can be found in section xxxxx

Proposed Changes to the APR – cont.

Pro forma 4D

Totex analysis for the 12 months ended 31 March 20xx - wholesale water							
	Water resources		Network+				Total
	Abstraction licences	Raw water abstraction	Raw water transport	Raw water storage	Water treatment	Treated water distribution	
Operating expenditure							
Power	I	I	I	I	I	I	C
Income treated as negative expenditure	I	I	I	I	I	I	C
Abstraction charges	I	I	I	I	I	I	C
Bulk supply	I	I	I	I	I	I	C
Other operating expenditure	I	I	I	I	I	I	C
Local authority rates	I	I	I	I	I	I	C
Total operating expenditure excluding third party services	C	C	C	C	C	C	C
Third party services	I	I	I	I	I	I	C
Total operating expenditure	C	C	C	C	C	C	C
Capital expenditure							
Maintaining the long term capability of the assets - infra	I	I	I	I	I	I	C
Maintaining the long term capability of the assets - non-infra	I	I	I	I	I	I	C
Other capital expenditure - infra	I	I	I	I	I	I	C
Other capital expenditure - non-infra	I	I	I	I	I	I	C
Infrastructure network reinforcement	I	I	I	I	I	I	C
Total gross capital expenditure (excluding third party)	C	C	C	C	C	C	C
Third party services	I	I	I	I	I	I	C
Total gross capital expenditure	C	C	C	C	C	C	C
Grants and contributions	I	I	I	I	I	I	C
Totex	C	C	C	C	C	C	C

Bioresources and water resources separate price controls
Market information and sludge measurement

Alison Fergusson

February 2017

- There is a change in company licences coming in April that will mean we can ask companies to provide to us or publish market information for water resources and bioresources (sewage sludge)
- We are proposing to consult on the market information we need companies to publish/provide in April 2017. Company responses will be due in July. The final decision will be published in October.
- The structure of the material will be a joint consultation document, with separate “Direction” documents with the contents of for bioresources and water resources.
- The Direction documents will have the look and feel of RAGs.

What type of bioresources information?

Physical market information

- We have discussed the potential scope of the information requirements with the sludge working group (SWG) [11 April 2016; 8 Sept 2016, 20 Oct 2016];
- We worked with United Utilities to develop an information template (WwTW; STC, Dewatering sites);
- The template was circulated to the SWG for feedback.
- We will ask companies to publish this information on their websites

Contract information

- We have been developing a template for “successful contract” data template with a potential entrant in to the market for bioresources services, with help from Wessex Water and Thames Water.
- We discussed the successful contract information with the SWG on 30 January 2017.
- We will ask companies to publish this information on their websites

Market activity information

- We are developing metrics to collect on market volumes, tender activity, trading volumes and contract values.
- We will ask companies to provide this to Ofwat using the same data capture processes as the APR data.

Guidance document

- We are drafting succinct guidance to accompany the data templates

What type of water resources information?

Physical market information

- We outlined our intentions for the water resources information platform in the May 2016 decision document
- We have consulted with buyers and sellers at a number of working groups
- We are preparing a formal consultation on our requirements for information that shall be published. The data is predominately drawn from WRMP tables
- Information will be presented in a consistent template
- We will ask the companies to publish this information on their websites

Cost information

- As set out in the May decision document we will require publication of cost information, again we expect this to be drawn from WRMP tables
- We are developing a template for the required information
- The aim of the information is to stimulate the market and encourage new entrants to recognise the value of their resources and services

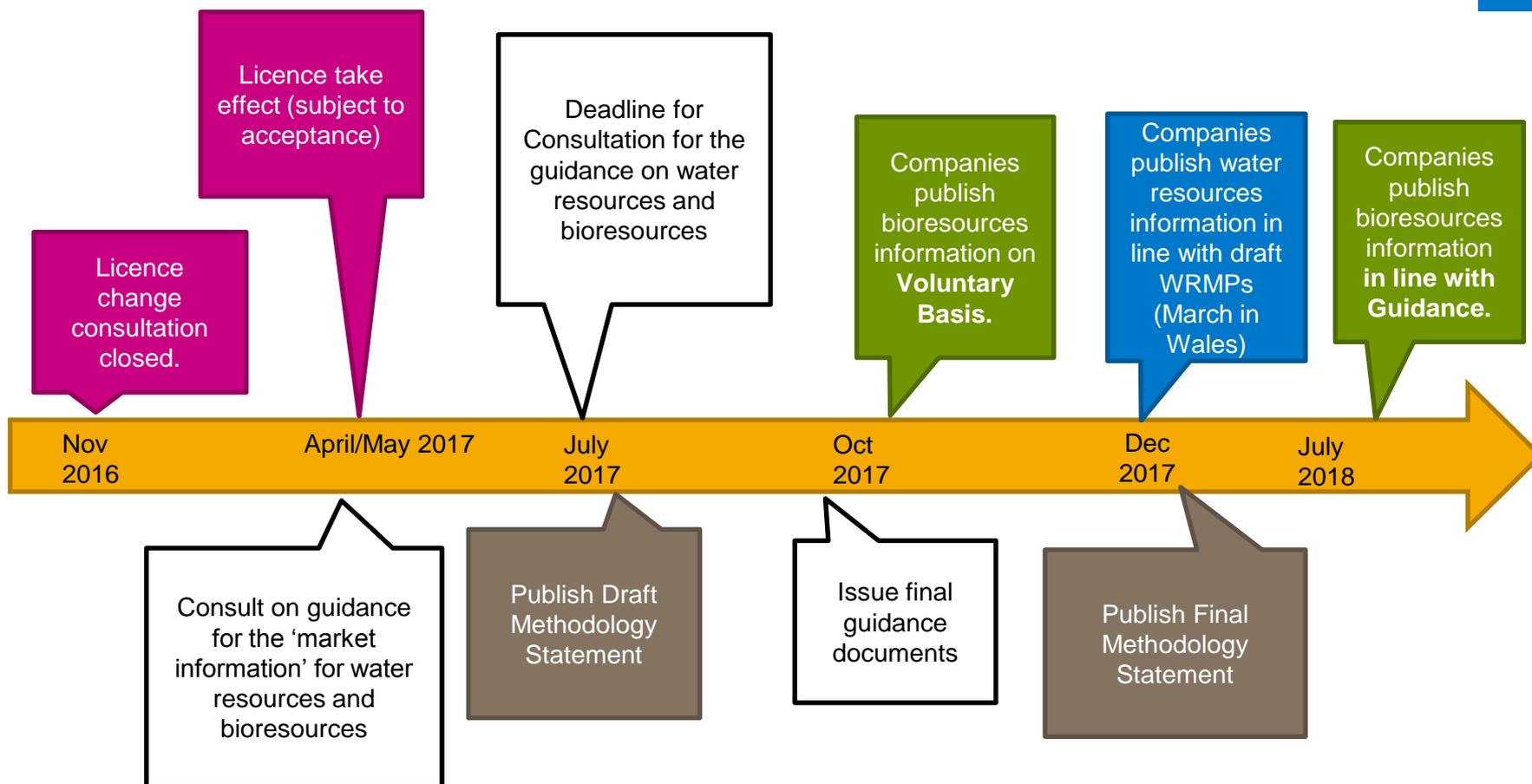
Market activity information

- New entrants can either 'bid in' to the WRMPs (England and Wales) or enter into bilateral agreement to supply customers using incumbent suppliers infrastructure, subject to an access price charge (England only)
- In the July Methodology we will publish principles for company bid assessment frameworks. This will include our expectations for transparency

Guidance document

- We are drafting succinct guidance to accompany the data templates

Market information provision: timetable



Note: We propose that the first year of bioresources market information is provided on a voluntary, “best endeavours” basis.

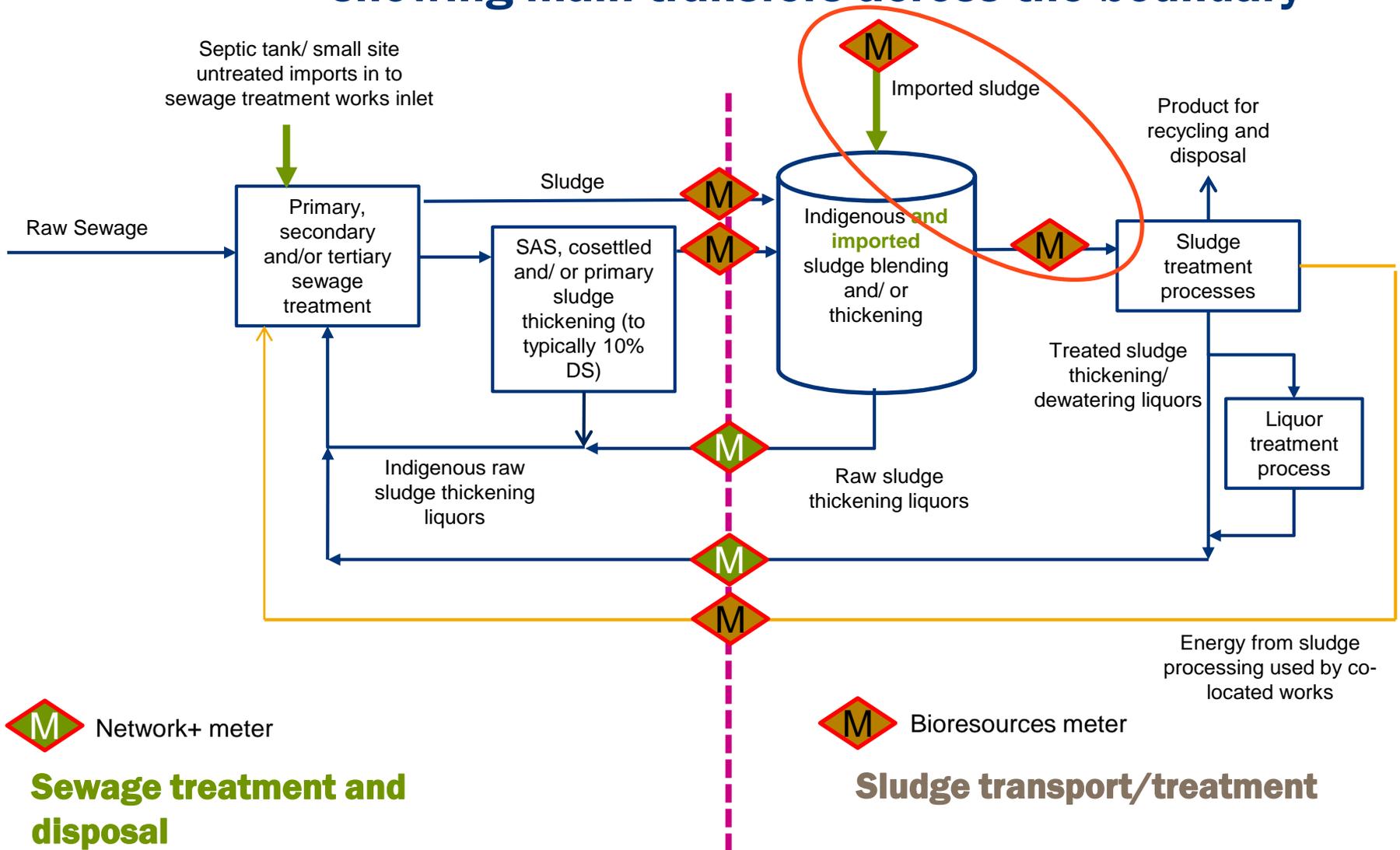


- We will expect companies to provide appropriate levels of data assurance for information designed to allow market participants to identify potential market opportunities. The published information will not be in such detail as would be required for a contract so may not need complex assurance processes.
- We will link this market information to the overall company information assurance process and company monitoring framework. This aligns with our strategy of building trust and confidence.
- This is why we plan to ask for the market information to be published or provided to Ofwat each July, so companies can cost-effectively use existing assurance processes as they see fit.

Bioresources measurement assets

- Separate price controls will require cost-reflective charges across the boundary between network plus and bioresources
- Working on the principle that those providing the service own and read the meter
- Bioresources are providing sludge treatment services
- Bioresources are providing energy to network plus
- Network plus is (usually) providing liquor treatment service, or polishing of pre-treated liquors
- Network plus may also be providing a service disposing of any rags or grit removed in sludge treatment processes (sludge import screens for example)

Appendix 5: Sludge boundary detail (co-located site detail) showing main transfers across the boundary





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RAG5

Andrew Boardman

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RAG5 concerns transfer pricing.

Much of the material flows from Condition F6 of the licence.

This means the internal charges, within a water company group, between different parts of the business:

- Between appointed business (AB) and non-appointed business (NB)
- Between appointed business and Associate (non-appointed usually)
- Within appointed business – between price control units (see Section 2 of APR and RAG2 on cost allocation)

Regulatory duty:

- Protect the interests of consumers (i.e. customers)

Objectives/ purpose:

- If NB uses assets from AB, it needs to recompense the AB via a cost re-charge or transfer price
- Reason: customers of the appointed business have effectively paid for these assets (via RCV and regulated price controls/ revenue).

Principle: cost re-charge or transfer price – as if trading at “arm's length”.

(Sometimes referred to as no “cross-subsidy”)

1. If external market exists for service (or use of assets), then use market price.
[Or a proxy for market price, by competitive tendering].
2. If no external market exists, use FAC (Fully allocated cost), where:
FAC = Opex + Capital costs
[Capital costs=Depreciation + a return on capital value of asset or “financing cost”]

We may review RAG5 over the next year or two and introduce some limited changes, where we see the need.

We are not carrying out a comprehensive review of the whole RAG and for all activities/ uses. Rather, we are looking at making specific changes, as required.

- **Bioresources:** this is the first area that we intend to look at (see slide below).
- **Tax:** following the recent targeted review into tax, we will consider providing further guidance around taxation, in particular the treatment of group loss relief.
 - We will publish our PR19 methodology consultation in July.
 - This will include our policy towards taxation in PR19.
 - Following this, we will consider whether we should revise RAG5 to provide further clarity around the treatment of tax and will consult on this.
 - The new RAG5 would be effective from the 2018-19 reporting year onwards.

Under Water 2020, we have considered:

- 1) Separate control for Bioresources
- 2) Facilitating trading in Bioresources (which can already happen)

Some WaSCs have raised concerns that:

- If they price trades at FAC in the external market, they believe that the transfer price would be too high and this would limit efficient trading opportunities.
- The transfer price under RAG5 may lead them to price at or above FAC.

Questions:

- 1) Do we need to change RAG5, to facilitate economically efficient trades happening?
- 2) If we change RAG5, how do we ensure that customers' interests are still protected?

One area to look at potentially:

Paragraph 9.8 may prohibit trades based on short run marginal cost (SRMC). What are the appropriate costing techniques for the Bioresources market? Consider: marginal costing, incremental costing, short-run and long-run.

(see RAG5, page 15: Marginal cost allocations)

Looking forward;
2017-18 and beyond

Rob Lee

ofwat

2017-18 and future reporting

- 1. Review of the RAWG follow-up questions on 11 Nov 16**
- 2. Retail market opening**
- 3. Small company threshold**
- 4. Consultation document**

Review of November RAWG follow up questions

Responses to questions

11 companies responded to the questions posed at the last RAWG meeting in November.

	Table	Question	Action for 2017-18 RAGs?
1	1C	IFRS categories – in line with RAGs?	Some differences are known and these are adjusted in table 1A. Will consider the ‘capex creditor’ issue in the consultation.
2	2B 2E	Should grants per 2B agree to 2E?	<ul style="list-style-type: none"> Align G&C definitions Non-infrastructure contributions
3	2D	How should companies deal with principal use assets that move between price control year on year?	Confirm that once established which price control initially in the principal user, stick with this throughout the AMP but document this approach in the methodology statement.
4	2D	Depreciation for third party services – what level of detail should be reported?	Only record depreciation for assets dedicated to Third Party Services in this line. Methodology to confirm use or not of dedicated assets.
5	2G 2H	Where do wholesale charges to a non-incumbent retailer should be included?	Suggestion of an additional line for wholesale supplies to other retailers?
6	2G 2H	What happens when an incumbent exits the non-household retail market with respect to these tables?	Not expectation to complete tables 2G and 2H after exiting the non-household market on 1st April 2017 - unable to produce the wholesale revenue on a tariff basis as would only have one customer (the retailer).
7	2G 2H	How should the retail revenue be split by <u>connection</u> where charges are determined at a <u>customer</u> level?	<ul style="list-style-type: none"> More meaningful to report on premises rather than connections? Charges determined at a customer level (special agreements) - split of charges between wholesale and retail for 2017-18 charges (not required for 2016-17); apply methodology for 2016-17 reporting? (UU)

	Table	Question	Action for 2017-18 RAGs?
8	4E	Combined sewers and apportioning costs/capex. A need for OFWAT guidance?	<ul style="list-style-type: none"> • For combined sewers, a reasonable first step would be to allocate costs between foul and the other sources (surface and highway) first. • Power and pump maintenance – allocation to foul based on consumption during dry periods • Blockages– based on cause of blockage recorded (typically fats, oil and grease and therefore foul). • OFWAT to review methodology statements.
9		High lift pumps; treatment or distribution?	<p>'High lift pumps' is maybe too restrictive a term? - suggestions include;</p> <ul style="list-style-type: none"> • "Pumping required for distribution" • "Pumping after the contact point" • Observation that pumping from one WTW to another point for blending would be 'treatment' – we agree with this.
10		Contracted out services and impact of FTE numbers as a driver – conflict?	RAG 2 could be updated to specifically exclude FTE for outsourced functions to ensure consistent treatment across the water companies.
11		M&G assets and PU – do we need more guidance?	<ul style="list-style-type: none"> • 2 responses noted that this could be inconsistent with totex assumptions in PR14 FD. • WaSCs more likely to allocate to wastewater under PU, so creates inconsistency with WoCs on cross industry comparison.

	Table	Question	Action for 2017-18 RAGs?
12	2I	'Other grants and contributions' - some items in this category may NOT be on the condition B list of excluded charges e.g. sewer adoption fees – and hence <u>should</u> be considered part of the price control?	Some support for additional line. Also apparent that there were inconsistencies as to how these were applied by companies in the business plan and hence in the final determination.
13	4D 4E	Could we derive a proxy for IRE as defined pre 2014-15?	<p>Suggested useful definitions;</p> <p>Repair – generally a reactive activity repairing a short length of pipe or fitting a collar to bring the asset back into service.</p> <p>Renewal – generally a planned activity to replace a significant length of old pipework. Targeted at improving network performance / solving ongoing problems. Restores an asset to full life.</p>
14		Would it be beneficial to collect more granular sludge treatment centre costs?	Adequately covered in the new cost assessment tables and RCV allocation data.

Impact of new financial reporting standards (IFRS 9,15,16) - we raised three questions with regard to the new financial reporting standards IFRS 15 (Revenue) and IFRS 16 (Leasing):

IFRS 16 - Leasing

Will not impact until final year of AMP6; perhaps a disclosure would be sufficient in the comparison to FD in order to explain incidence effects?.

IFRS 15 – infrastructure charges

At this stage, no clear view, but table 2E 'looks through' the accounting treatment and instead focuses on the cash received – so maybe not an issue?

IFRS 15 – ODI revenue

Possible some companies may interpret the new standard as a reason **to accrue for ODI rewards and penalties on an ongoing basis**. At this stage we're not expecting our accounting for ODIs to change, and we would continue to recognise rewards/penalties when received."

Potential for disclosure on a separate line any accrued ODI rewards/penalties in the income statement (table 1A) and the balance sheet (table 1C) to aid comparability.

Are companies planning to accrue for reward / penalties?

Retail market opening

At PR14, we said that the definition of households was as per the RAGs, or any future version of RAGs we issued (in the FD letter). This is actually still currently the form of the household control we set for 2015-20, and this is not affected by the PR16 controls. We did this because we knew that it was likely that some customers who were non-households at 1 April 2015 would become households at 1 April 2018 as the final eligibility criteria was settled: the ACTS control automatically adjusts according to the number of customers, so additional households should not cause a problem.

At PR16, we then said that the definition of households was as per Section 17c of the Water Industry Act (in the FD letter) and so is the official definition of eligibility and therefore 'non-household'. As of 1 April 2017, the non-household price controls apply to non-households under this definition. So – PR16 and market opening line up exactly.

PR16 doesn't change the definition for the purposes of household controls, and we will now need to do this through RAGs for 2017-18 (if we don't, companies will not be able to recover anything for customers who have moved from non-household to household since PR14).

The RAGs will need to reference to the legal definition i.e. **“household premises” has the same meaning as in section 17C of the Water Industry Act 1991.**

May need to reference the Act, rather than the guidance issued under it.

Small company threshold

Currently £6.5m for turnover, will propose to lift this to £10.2m in line with wider business deregulation – will only affect NAVs.

Consultation document

- Consultation to be launched in late March or early April.
- Revised RAGs to be issued in October 2017 at the latest.

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