Annual Performance Report Consultation 2018–19

Southern Water's Response

Southern Water’s response to the Annual Performance Report consultation.

We welcome the opportunity to respond to the consultation on the Annual Performance Report and set out our response to the specific questions below:

Q1 Transparency of financial flows - Appendix 1 contains our new table 1F;

a. **Do you agree with the scope of the proposed information items in the new table?**
b. **Is there any information missing from this table which you think should be included in order to achieve transparency and consistency for financial flows reporting?**

Do any of the line item definitions require further explanation?

In general we agree with the overall scope of the proposed information items. We note that the proposal is to include this within section 1 of the APR as table 1F. As this section is reporting primary financial statement information for the year in question, we believe that the financial flows information, which is presented in 2012–13 prices, sits more naturally within section 4 alongside the other financial metrics which are already reported in table 4H.

We have reviewed the proposed table and guidance and have detailed, in the table below our views regarding the information included and improvements to line item definitions.

Line	Issue
1	The RORE published in the PR14 Risk Assessment Tools (RAT) included a return relating to the non-household retail business. Companies which exited the retail market no longer receive this return. We believe that a reduction to the base return reported in the RAT should therefore be included either within this line item or, for increased transparency, within an additional adjusting line item (similar to the 'Actual performance adjustment 2010–15'), feeding the 'Adjusted return on regulatory equity'. While this adjustment is small (0.06% in 2017–18) it fell within the specified accuracy (2 decimal places) for the table.
1 and 2	Actual returns and notional regulatory equity The guidance note states 'the impact…of departing from the notional structure. Calculated as…return on the **actual** regulatory equity base'. This column reports on **notional** regulatory equity, and therefore we believe that no gearing adjustment is required in this column.

4	The regulatory equity in the Financial Flows table originally published in our 2017–18 APR, and in the supporting workbook submitted to Ofwat, was reflected in 2012–13 year-average prices, having converted from March year-end price base. This approach appears consistent with that reported for other WaSCs in the Financial Flows worksheets published alongside the 'Monitoring Financial Resilience, January 2019' report. We believe, however, that the current guidance note on indexation of the RCV could be open to misinterpretation. It would be useful if the guidance notes relating to RCV price base conversion are expanded to avoid potential for further misinterpretation. This could include an explanation of the requirement to use the specified March indices to convert from March year-end price base to 2012–13 year-average price base. An illustrative worked example could also be useful. Further, we note that in the workbooks published by Ofwat the regulatory equity reported for two WaSCs in 2015-16 implies an RCV which appears to differ from the index-adjusted RCV reported in the published RCV workbooks. We would be grateful for additional guidance to ensure that any adjustments, possibly relating to transition between AMPs are captured and reported correctly.
5	<u>Actual returns and notional regulatory equity</u> We do not believe that a gearing adjustment should be applied in this column (**notional** regulatory equity). If the entry in this column for line 1F.3 continues to be adjusted, then the entry in line 1F.5 should be a direct contra to reverse out the impact under the notional structure. This could be confusing to users, and unintentionally mask the impact of companies adopting capital structures which vary from the notional model, which is reported in the next column of the table. <u>Actual returns and actual regulatory equity</u> To remove the risk of misinterpretation, the guidance could be updated to make specific reference to using the '**adjusted** return on regulatory equity (1F.3)'.
6	The line guidance is prescriptive, and does not allow companies to include many of the material adjusting items which contribute to the taxable profit, against which the main rate of corporation tax is applied. This skews the reported impact on equity return. Companies are already required to include in their APR a reconciliation of their current tax charge to that provided in the FD. We propose that companies should link this element of the financial flows calculation directly to this tax reconciliation deflated to 2013–13 prices. This would avoid inconsistency in the APR and promote transparency and accuracy.
7	In our feedback, below, against line 1F.21 (Block D, lines 1F.20 - 1F.22 exist to adjust for round-trip entries) we highlight our round-trip arrangement comprising the payment of dividends and also payments for group relief received on interest losses on an intercompany loan. We would welcome an amendment to the guidance for line 1F.7 'Group relief' to allow exclusion of the payment for group relief received on this round-trip arrangement, allowing accurate reporting of the returns impact for remaining payments.

	Further, as highlighted above for line 1F.6 'Variance in corporation tax', we believe that a link to the FD tax reconciliation (in which we clearly identify the impact of the round-trip group relief payment) would promote consistency, transparency and accuracy.
8	Guidance note (c) states: 'less; movement in RPI for the reporting period…'. Drawing on the guidance for the RORE metric (Table 4H, Line 5), this states explicitly that this adjustment to a real rate should be made using the Fisher Method. To remove the risk of error, it would be useful if this Financial Flows guidance note was made more explicit, stating whether 'less' means a simple arithmetic subtraction or a deflation using the Fisher Method. Note that the second of these approaches would ensure consistency with the RORE metric, reported elsewhere in the APR. Guidance note (f) states: 'adjusted for Corporation Tax (at the standard rate)'. This appears counter to the tax treatment of other adjusting items in the columns for actual returns, and we believe that a consistent approach across all adjusting items would be more transparent to users. Alternatively, an explanatory note in this guidance would promote understanding of the requirement to adjust for corporation tax on the cost of debt and be useful to preparers of the table. Specific guidance on treatment of the interest receivable on inter-company loans (part of a round-trip arrangement within the regulatory ring-fence, as described below for line 1F.21) would be welcomed. We believe that excluding this item from the cost of debt calculation ensures a like-for-like comparison with the allowed cost of debt in the published Final Determination. We draw your attention to the fact that the guidance note should state: "LESS Line 1F.9" not "LESS Line 1F.7"
19	We draw your attention to the fact that the guidance note should state: "Line 1F.17 minus line 1F.18" not "Line 1F.17 minus line 1F.17"
21 (and rows 7,8 and 18)	We understand that some companies pay dividends to a parent company in order to allow the payment of interest on an intercompany loan from the operating company to the parent company - a so-called 'round-trip' arrangement. The deduction in this line is intended to recognise that the gross dividend should be reduced by this amount in order to accurately reflect the net dividend paid. We have a similar round-trip arrangement (documented in our Annual Report), although we make both dividends and payments for the group relief received for the interest loss at the parent company. These 'distributions' are made in order to fund the payment of the interest on the intercompany loan. We would welcome an amendment to the description and guidance note for this line item, to allow us to capture this round-trip (returns neutral) arrangement, while remaining compliant with the specified guidance.

The items below relate to more general observations, rather than specific existing line items.

Potential omission	Issue
Disposal of the non-household retail business	We request above, in our comment on line 1, incorporation of a reduction to the base return (as reported in the PR14 RAT) to reflect disposal of the non-household retail business. In addition, we would welcome guidance on how to incorporate the additional returns relating to the proceeds on disposal of the non-household business. We highlighted the impact on returns in our detailed 2017–18 narrative, but did not include it in the table as it did not meet the guidance note definitions.
Ex-ante revenue penalties (excl. 'actual performance adjustment 2010-15')	In our PR14 FD we received an ex-ante revenue penalty under the Totex Incentive Mechanism (approx. £2m p.a.). While any ex-post true-up for actual delivery will be incorporated into our AMP7 Financial Flows, in the AMP6 periods the adjusted return on regulatory equity does not reflect this returns deduction. While small (in 2017–18 this was equivalent to 0.25% on actual regulatory equity), it falls within the specified accuracy (2 decimal places) of the table.
Revenue recovery	In our 2017–18 Financial Flows commentary, we highlighted that the additional returns reported in Line 1a 'Actual Performance adjustment 2010-2015' related mainly to the revenue recovery shortfall in AMP5. Had the Financial Flows been reported in AMP5 in its current format, then this reduction to returns would not have been captured - but the increase in the following AMP would have been. This would present an upside-only view of this issue. The transition to the WRFIM mechanism, with in-AMP recovery correction, should to a large extent mitigate the impact. However, with a two-year recovery lag, the impact on returns could theoretically be material. A revenue recovery variance of +/-2% (i.e. the limit of the accepted no-penalty forecasting tolerance) in both 2018–19 and 2019–20, would be equivalent to c.0.8% on our notional equity in each of those years. Note that this does not reflect a forecast for the company, and is used for illustrative purposes only. We would welcome confirmation that the approach to Financial Flows is designed so that a situation such as this would be reported in a balanced manner, with both the downside and subsequent upside (or vice-versa), captured in reporting.

Divergence from RORE (Table 4H, Line 5)	The prototype versions of the Financial Flows table showed a clear correlation to the existing RORE metric, but with additional granularity for financing, and an extension to make clearer the impact on returns of having a capital structure which varied from the assumed notional structure. It appeared to be an improved version of RORE, and natural replacement. The two approaches appear to have diverged, with differing treatments in a number of areas. We believe that having 2 measures of the 'return on regulated equity' with similar, yet different, results could be confusing to users.

Q2 New connections - Appendix 1 contains our new table 2K;

a. **Do you agree with the scope of the proposed information items in the new table?**
b. **Is there any information missing from this table which you think should be included in order to achieve transparency and consistency for new connections reporting?**

Do any of the line item definitions require further explanation?

We agree with the scope of the proposed information items in this table.

Q3 What are your views on the proposed changes to the existing tables in Appendix 1?

Table	Line	Issue
2E	Various	While the relevant sections of the Water Industry Act have been removed from the face of the table, we feel that these remain useful in helping define the contents of each row and should be added to the supporting table guidance.
2E	Various	Note, following the adoption of IFRS 15 ‘Revenue from Contracts with Customers’, the accounting for some of our grants and contributions will change for 2018–19. We will be recognising the income associated with requisitions, diversions and adoptions in the income statement. The rows for asset adoptions, rows 8 and 15, will therefore need amending to allow data to be entered into column 1 of the table.
4H	5	The guidance states “Where a regulated business ceases to undertake a particular activity (e.g. exiting the non-household retail market) then a note should be included setting out how this has impacted on the RORE compared to the base RORE set at FD.” The implication, given the prescribed calculation as a series of steps from the FD base RORE, is that this impact should not be included in the RORE metric reported in this line. This gives

		primacy to a metric which does not reflect potentially material items, with the reported impact on returns potentially over-looked in supporting narrative. Additional guidance, specifying whether and how this impact should be included in the calculation of the RORE metric, or simply excluded and commented on, would help to ensure industry consistency. Of particular interest is the industry-wide issue of exit from the non-household retail market, including the treatment of the margin included in FD base returns and proceeds on disposal (which do not fit naturally with the definition of retail cost performance). We believe this to be of increased importance given the development of RORE reporting disclosures through inclusion of new lines 4.H21 – 4H.26 and the proforma table, which could restrict the presentation of this information by companies.
4H	21-26	We note that line 4H.25 includes a specific instruction to calculate the impact of tax using the headline tax rate. For consistency, and the avoidance of doubt, it would be useful if lines 22 – 24 contained a similar instruction – albeit this can be inferred from the requirement for line 4H.26 to equal line 4H.5.
4M	29	*Transferred private sewers and pumping stations.* Under IFRS rules we do not capitalise expenditure incurred for the replacement of formerly private lateral drains as they do not constitute a 'significant' refurbishment. We expect most of our expenditure replacing small parts of the network to continue to be expensed. Will there be a reconciliation table required to cover the potential of the total costs on table 4M being different from the total of 'Enhancement' expenditure on table 4E?
4N/4O	All financial	We note that tables 4N and 4O have been amended to be in £'000. Can you please ensure there is consistency in the number of decimal places required for the two tables, as one feeds the other?
4W	Various	We welcome the addition to 4W of sludge transport so that there is now a full breakdown of the Bioresources price control. However, in line with Appendix 4 in RAG4 we would not expect there to be any trucks involved in Sludge Transport. As the sludge itself is less than 10% dry solids it would only be tankers employed, due to the level of liquid in the sludge. Trucks would only be used once Sludge Treatment has begun, and therefore their cost will be within Sludge Treatment.

Q4 What are your views on the issues highlighted in section 3 'Future developments in performance reporting'?

Are there any other issues which we should consider?

We are particularly interested in your views on the impact of additional price control units (section 3.2).

IFRS 16
Adoption of IFRS 16 will result in the creation of fixed assets and associated finance lease liabilities as well as the removal of the annual leasing charges from operating costs.

We support keeping the statutory and regulatory presentation of the accounts aligned however the impact of the adoption of the standard on totex, RCV, net debt and gearing will need to be considered for regulatory purposes.

2A
We support the proposal to report revenues for each price control in table 2A from 2020–21. Whether these revenues are directly available from our billing system, and the structure of future tariffs, remains uncertain so it should be noted that they may need to be derived from an allocation approach.

The recharges we make between business units, currently shown in table 2A, represent the recharge of depreciation from the business unit of principal use to other business units for the use of shared/corporate assets.

These recharges do not form part of the operating expenditure reported in row 3 of table 2A, which is linked to total operating expenditure reported in tables 2B, 4D and 4E. As a result, recharges are not reported in the totex analysis shown in tables 4D and 4E, which is used compare to the Final Determination in table 4B. This comparison only reflects the initial capital investment to the business unit of principal use.

We would propose that separate rows for recharges be added to tables 2B, 4D and 4E, within operating expenditure, to allow them to be included as part of the comparison to the Final Determination in table 4B. As this operating cost then feeds table 2A, the rows for recharges on that table could then be removed.

Retail non-household exit
We agree that the costs of certain activities, detailed in RAG 2.07, for example investigatory visits, should be treated as wholesale where companies have exited the non-household market.

Diversions
The implications on the APR tables, of treating diversion income as part of the price control, will need to be considered.

Q5 What are your views on our preference to require all costs associated with the 'Traffic management act' to be reported (section 6)?

We feel that only the direct costs of the permits should be included, and that is what we have done with all the data provided to date.

The administration costs, such as applying for permits, varying permits and planning to avoid lane rental etc. are incurred by our contractors. These costs are therefore embedded within the cost of the job paid to the contractor and are not provided separately to us.

Q6 What are your views on our additional asset type descriptions for Water resources which recognise 'desalination' and 'effluent reuse' abstraction assets (section 7)?

We currently have no desalination or effluent reuse assets, though are happy to recognise them separately in the future should we construct any.