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Ofwat Performance & Outcomes
Ofwat

By email: OfwatPandO@ofwat.gov.uk

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Dear Ofwat P&O team

Overhead cost reporting – revising RAG2

We set out our response against the specific consultation questions that are relevant to Bristol Water. Our main concern is whether we have fully understood the proposals from the consultation document, as to us it appeared to be that the consultation was looking ahead to how RAG2 may be in the future, rather than being changes that were all appropriate to 2021/22 reporting. However, we may have misunderstood the intention from the consultation.

Q1: Do you agree with the guidance that we are proposing to add to RAG2?

Having reviewed RAG 2.09, this appears to largely be a restructuring of the allocation guidance, rather than new guidance in 2.08. There were elements of 2.08 which were deleted with reference to developer services and retail/wholesale, which we support removal as it is out of date. Section 6 included only a new table 4, with no cross-references elsewhere in the document. The RAG as drafted does not state what these are to be used for. We would suggest some introductory text.

We disagree that the RAG should assume a separate price control for developer services – this seems to us to be presumptive of the outcome of the PR24 high level discussion document where this is only one option, rather than a firm proposal, and is an early consultation at this stage in any case. We caution against imposing additional regulatory burden until a decision has been reached on this point. The table on page 24 refers to separate binding price controls, which as the footnote clarifies is not the case at the moment. RAG 2 is likely to be clearer if developer services were removed from the list with the footnote being retained, as that appears from the 2021/22 APR consultation to be the basis of reporting for this year.

It is not clear to us that Ofwat would require the reporting of additional disaggregation at this point in order to support any decision on separation of the price control. However, this is

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one point on which further clarification would be helpful, as we would be more supportive of this proposal if it were clearly required as part of PR24 preparations.

The cost allocation guidance would similarly then not include developer services at this stage, which is not currently a separate price control, or subject to cost allocation drivers as the draft RAG 2.09 appears to suggest in the other RAGs.

As it stands Table 3 of RAG 2.09 includes possible cost drivers to developer services (e.g. for billing and bad debt), which would not apply to developer services, or describe a split between measured and unmeasured customer types which is also not relevant. We do not think just adding in developer services as a column to table 3 works for the proposed RAG 2.09, as it reduces clarity and does not provide meaningful guidance. The consultation does not consider or ask what drivers might be needed for developer services – in our view these are currently directly identified or allocated costs for charges, such as for billing etc.

It may be that there are allocation issues that will arise from Ofwat's developer services information request in January 2021, but as the results have not yet been published we do not have sufficient visibility in order to respond. In addition, we cannot see the link between this consultation and the separate developer services information consultation which looked at a project cost level. It may be better to revisit this guidance when there is clarity on the approach, as currently it is not clear, other than the allocation of regulatory costs, that there are any changes to developer services for 2021/22 arising from RAG 2.09 that are necessary.

Q2. Are the 'general and support' categories carried over from RAG 2.08 still appropriate? If not then what should we use instead?

These carried over general and support categories remain relevant and appropriate for the guidance. We do not have any alternatives to suggest.

Q3. Are there any areas that we have not covered by these proposals that we should?

We agree with the principle that an element of regulatory costs should be allocated to developer services. We are not convinced that it needs to be applied in practice for the purposes of developer services markets as the cost exists as part of network plus activities and is not something that should be recovered through charges to developers, reflecting the mix of contestable and non-contestable with network reinforcement costs.

In addition, if we were to apply for market purposes, it is not clear, given that developer services applies to both water and wastewater, why 1/6th of regulation costs would be allocated to developer services for a water only company, and 1/10th for a water and



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sewerage company – this appears to assume little or no incremental developer service costs for the wastewater element which we consider is unlikely to be the case.

We would expect the proportional allocation to more closely reflect the relative level of cost and revenue of developer services compared to the overall business, which would suggest an allocation nearer to 5% in our case. Whilst the recent level of consultations and information requirements has caused a higher proportion of regulatory time to be spent on developer services issues, we would not expect this to be the case in future once the regulatory approach is finalised. At this level, the cost may be too low to require allocation to this level of granularity.

Whilst this change could be made now, given the uncertainty we identify with the rest of the proposed RAG 2.09, we would suggest revisiting why this change is needed and the level of regulation costs that should apply. It may be better to consider the form of regulation (as per the PR24 consultation options, which are not definitive at this stage) before making this change.

Q4. For 2021-22 we are considering asking companies to report costs on both their existing approach and the new approach so that we can understand the impact that this has on the allocation of costs across controls. Would you agree with this approach? If not then how could we assess the impact of this in advance of the PR24 business plan submissions?

We disagree with the burden of reporting on the basis of both the existing approach and the new approach, on the grounds that it is not clear from the draft RAG 2.09 what the proposed approach is. It would be reasonable for the published accounting separation methodology to set out the approach used, and provide commentary to changes from previous years. There could be a materiality to understand the changes. However, as we set out in the answer to Q1, as currently drafted the RAG is not clear as there is only a table 4 in RAG 2.09, and no guidance as to what these are to be used for.

The same challenge also applies to table 4 as table 3 with respect to the addition of developer services. For instance, it is not possible to allocate cumulo rates by gross MEA values – presumably this means this is N/A in practice, although there may be other approaches that could be taken. In our view, no allocation is required for developer services / new connections functions, but might be for activity delivery functions. As it stands, there is no consideration of what drivers are appropriate for the different elements of developer services to make the guidance workable.

Our suggestion is that this topic is revisited once the PR24 consultation responses have been considered and the developer services future market, including conclusions following the request for information are published. At the moment, we do not have sufficient information to respond with what developer services allocation guidance may be useful. As this is not

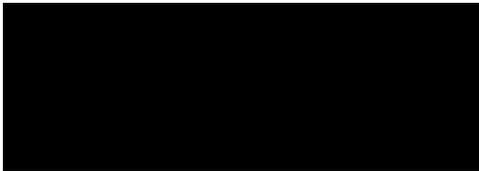


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currently in the PR19 business units (where developer services activities are directly allocated within treated water distribution), this would appear to require a different approach to that proposed in the RAG 2.09 consultation in any case.

The recent 2021/22 RAG consultation also does not appear to require a split of developer services, and therefore for 2021/22 report the costs would remain principally within water network plus on table 2B. This adds to our uncertainty as to what RAG 2.09 is proposing as it currently stands.

Yours faithfully



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Director of Strategy & Regulation