

June 2021

Overhead cost reporting – revising RAG2 (consultation)

About this document

This consultation concerns proposed changes to the cost allocation guidance for the Annual Performance Report (APR). The current guidance on cost allocation for the APR is contained in our [regulatory accounting guideline 2.08](#) (RAG 2.08). It sets out how companies should allocate costs across price controls and so ensures that data is published consistently across the sector. This promotes transparency and allows all stakeholders to understand and challenge companies.

We intend to publish the revised RAG2 in late 2021.

We invite comments from all stakeholders.

Responding to this consultation

We would welcome comments on this document. Please email your response to OfwatPandO@ofwat.gov.uk.

The closing date for this consultation is 5pm Monday 2 August 2021. If you wish to discuss any aspect of this consultation, please contact Rob Lee on 0121 644 7776 or by email at OfwatPandO@ofwat.gov.uk.

We will publish responses to this consultation on our website at www.ofwat.gov.uk, unless you indicate that you would like your response to remain unpublished. Information provided in response to this consultation, including personal information, may be published or disclosed in accordance with access to information legislation – primarily the Freedom of Information Act 2000 (FoIA), the General Data Protection Regulation 2016, the Data Protection Act 2018, and the Environmental Information Regulations 2004. For further information on how we process personal data please see our [privacy policy](#).

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Consultation questions

Question 1	Do you agree with the guidance that we propose adding to RAG2?
Question 2	Are the ‘general and support’ categories carried over from RAG 2.08 still appropriate? If not then what should we use instead?
Question 3	Are there any areas that we have not covered by these proposals that we should?
Question 4	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?

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1. Overhead cost reporting

- 1.1 The 2024 price review (PR24) will set the price service and incentive package for incumbent water companies for the 2025-30 period. In May 2021, we shared our ideas and ambitions for PR24 in [PR24 and beyond: Creating tomorrow, together](#). We identify that, where appropriate, there is more that we could do to improve the effectiveness of markets. This includes improving guidance on the allocation of costs to different parts of the value chain, in particular to bioresources, developer services and water resources.
- 1.2 This document consults on improved guidance on the allocation of overhead costs in relation to:
- developer services;
 - bioresources; and
 - general costs spanning wholesale controls.
- 1.3 Our current guidance on cost allocation for company Annual Performance Reports (APRs) is contained in RAG 2.08. Much of the current guidance in that document is aimed at the split of costs between retail and wholesale. And within retail there is guidance on further disaggregation between different retail customer types.
- 1.4 We propose to use RAG2 as the basis for providing improved guidance on the allocation of overhead costs, where necessary, so that companies are able to consistently allocate costs between wholesale price controls. We therefore propose to issue new version of the regulatory accounting guidance, RAG 2.09, to reflect the improved guidance. We propose that this guidance will apply to company annual performance reports for 2021-22 onwards.

Question 1	Do you agree with the guidance that we propose adding to RAG2?
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- 1.5 While there is not a separate developer services price control at present, we consider that the developer services market would benefit from improved consistency in cost allocation and so our proposals incorporate similar guidance for these services.¹ We are also continuing to consider whether a separate price control for developer services would be appropriate.²
- 1.6 Overhead cost allocation was noted as an issue for bioresources in Jacobs' review [Bioresources Market Review – 10 May 2021](#). The review suggests that we consider **more prescriptive accounting rules** in relation to how **overhead, shared asset and**

¹ See Ofwat, [PR24 and beyond: Creating tomorrow, together](#), May 2021, p. 80.

² See Ofwat, [PR24 and beyond: Creating tomorrow, together](#), May 2021, p. 80.

labour costs should be allocated to Bioresources³. Jacobs have subsequently [undertaken further work examining](#) how companies allocate overheads to bioresources. Jacobs makes the following observations:

- companies vary in how they allocate General and Support expenditure, and this is causing material variation in bioresources overhead allocation;
- guidance in relation to the allocation of regulation costs has become unclear and may no longer be relevant to the current price control structure; and
- Overhead burden rates on capital expenditure are a potentially material source of variation between companies.

- 1.7 Our proposed changes address these points by applying further guidance to the allocation of General and Support expenditure and providing new guidance for the allocation of regulation costs. Overhead burden rates vary between companies depending on the size of capital programmes. We therefore consider that there is a legitimate reason for cost variation here and so have not included additional guidance.
- 1.8 Our suggested changes for overhead cost reporting include all wholesale price controls, including bioresources and water resources and also covers developer services. We do not propose to change the principal use rules that currently govern reporting of shared asset costs between price controls.
- 1.9 When the current guidance was established our understanding from companies was that the **general and support** categories that we identified in RAG 2.08 (such as ‘IT costs’ or ‘motor vehicles’) were likely to be appropriate and that these gave disaggregated data at the most detailed level that companies identified with. Our proposed revisions therefore retain these overhead categories although our question 2 in this consultation invites comments on this point.

Question 2

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

³ Recommendation R15

1.10 To better reflect the scale of activity we are also proposing to amend the guidance for allocating regulation costs across price controls. Our guidance proposes that the regulation cost allocated should be changed as set out in table 1 below.

Table 1 Allocation of regulation costs

Price control	RAG 2.08 Water and sewerage company	RAG 2.09 Water and sewerage company	RAG 2.08 Water only company	RAG 2.09 Water only company
Retail	1/9	1/10	1/5	1/6
Water resources	1/9	1/10	1/5	1/6
Water network +	3/9	3/10	3/5	3/6
Wastewater network +	2/9	3/10	-	-
Bioresources	2/9	1/10	-	-
Developer services	-	1/10	-	1/6

1.11 In the proposed RAG 2.09 we have split the guidance more logically into chapters with minor drafting and tidying up applied. However chapter 6 is almost entirely new and is focused on the allocations within wholesale. In this chapter we have included a new table 4 which closely mirrors the categories used for retail.

1.12 We have additionally incorporated all of the relevant wholesale guidance previously included in RAG 2.08 into this table. Some guidance has moved to separate chapters. The revised locations are set out in table 2 below.

1.13 We propose removing the allocation of developer services activities to retail as this will now be included in the proposed developer services category.

Question 3	Are there any areas that we have not covered by these proposals that we should?
Question 4	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?

Table 2 Wholesale cost guidance

	RAG 2.08 location	RAG 2.09 location
Borehole pumping	Paragraph 2.26	Chapter 6 table 4
Imported potable bulk water	Paragraph 2.28-2.29	Chapter 6 table 4
Sludge liquor transferred to a sewage treatment works for treatment	Paragraph 2.15-2.19	Chapter 6 table 4
Bioresources energy generation	Paragraph 2.27	Chapter 6 table 4
Developer services	Paragraph 2.22-2.23	Chapter 6 table 4
Rates	Paragraph 2.24-2.25	Chapter 6 table 4
Services provided by one price control to another	Paragraph 2.31	Chapter 6 table 4
Imported tankered waste	Paragraph 2.20-2.21	Paragraph 7.1-7.3
Imported sludge	Paragraph 2.30	Paragraph 7.4

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