Matt Lewis
Regulatory Director
South Staffordshire Water
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8 May 2013

Dear Matt

Accounting separation targeted review feedback

As you will be aware, in January we engaged Ernst and Young (EY) to carry out a targeted review of the 2011-12 accounting separation data and methodologies. The purpose of this review was to provide us with confidence that accounting separation data reported by companies is robust for the purposes of retail price controls and to ensure our future reporting requirements are fit for purpose.

The review focused on the boundaries between the retail and wholesale business units and between household and non-household. It examined the appropriateness of individual companies' cost allocations, consistency of cost allocations across the industry, the potential impact of inconsistencies on the average cost to serve and the appropriateness and consistent application of accounting policies.

As part of the review EY and Ofwat visited every company and asked a range of questions before, during and after the meetings. Following evaluation of the information provided by companies, EY has produced a final report with its findings and recommendations that we have subsequently reviewed and accepted. The Executive Summary of the report is enclosed with this letter.

Following finalisation of the report, we are writing to all companies to highlight the key recommendations and provide company-specific feedback on the accounting separation data and methodologies. The purpose of this letter is to highlight any specific issues and areas for improvement identified through the review.

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Key findings of the review

The report has concluded that the costs incurred by companies in delivering core customer service activities are ‘in the main robust and comparable’.

Areas identified as being potentially less robust included retail activities that are not part of core customer services and general and support (G&S) costs which require manual disaggregation and allocation from wholesale costs to retail. Current cost depreciation was also identified as an area of concern, as companies had little understanding of how it related to the underlying assets.

The review identified several inconsistencies in the way companies treat different types of cost. Most of these inconsistencies affect line by line comparability of the accounting separation data, but not the total retail costs used in the average cost to serve. Most of these varying treatments were found to be reasonable given differences in companies’ structures and underlying cost drivers. However, this lack of comparability can lead to a perception that the data is not robust.

The level of detail provided in methodology statements varies, but generally there is a lack of transparency in the disclosure of how companies are treating their costs and the reasons for differences across companies. This makes it difficult for users of the data to determine its robustness and to make comparisons across companies. It also raises concerns in the industry regarding the reliability of the data and companies’ methodologies.

The review made extensive enquiries into all companies’ revenue recognition policies to determine whether there were any inconsistencies which may be material to Ofwat’s average cost to serve calculations. EY concluded that whilst there were some minor inconsistencies, the policies applied by companies were reasonable and the effect on the average cost to serve was negligible. Concerns in this area appeared to be caused by a lack of transparency in the policies applied by companies.

Key recommendations of the review

EY has recommended that retail data reported within the regulatory accounts should be subject to additional external assurance on the retail data in the form of ‘agreed upon procedures’ to be performed by external auditors. We agree that the additional focus by auditors should improve users’ perception of robustness of the data. We

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accept the recommendation and intend to work with auditors to develop and implement these requirements for the 2013-14 regulatory accounts.

To improve comparability of the retail data lines, we will provide clarification of the retail activity definitions for network calls, scientific services and other business activities. These areas of inconsistency impact on overall retail costs.

To improve transparency and comparability for users of the data, EY recommends several disclosures of additional information through the methodology statement. Some of these disclosures we have already specified in our information notice for the 2012-13 regulatory accounts. We accept this recommendation and will work to finalise the additional disclosures and confirm these in the regulatory accounts information notice for 2013-14.

To improve consistency and comparability of the retail data for the purposes of price controls, EY has recommended that we require companies to restate retail costs in their business plans using specified drivers for General and Support expenditure and allocations between household and non-household. We intend to implement this recommendation for business plan reporting but this would not apply to the annual regulatory accounts.

Feedback specific to South Staffs Water

We were satisfied in your review meeting that your accounting separation allocations followed the definitions set out in IN 12/01 for 2011-12.

Feedback specific to Cambridge Water

We noted during your review meeting a number of areas where your accounting separation allocations did not follow the definitions set out in IN 12/01 for 2011-12. These included:

- All retail employment costs (amount not quantified) included in direct costs, we would expect some ie: legal, HR, senior management to be included line 18 General and Support expenditure.
- Network calls – no allocation of costs of schedulers and investigatory to retail.
- G&S – insurance costs, premises/facilities costs and management/professional fees not allocated to retail.

While the first point does not affect overall retail costs, it affects the comparability of data across companies. The last two observations do affect overall retail costs.

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Since the impact of these on retail costs is likely to be small, in line with EY's recommendation, we will not require you to restate your 2011-12 retail costs. Although the RAGs line definitions 2012-13 are less prescriptive than the 2011-12 guidance, under the accounting separation principles set out in the RAGs, we would expect some allocation of these costs to the retail business.

In addition, no costs of sampling at the customer tap were allocated to retail scientific services. While our 2011-12 definitions did not specify this, we consider this to be a retail activity, as indicated in our earlier guidance. We will clarify this in our business plan reporting requirements and in the regulatory accounts information notice for 2013-14.

In your February meeting you also mentioned a few instances where you could use better allocation or cost drivers for example in considering allocating a percentage of your Water Quality Team and Waterbeach premises to retail and reviewing the amount of Managing Director's time currently allocated to retail (10%) and the method of apportioning electricity to retail. We will also expect you to take account of these in your 2012-13 accounting separation data.

Where feasible, and particularly where these points were highlighted at the meeting in February, we will expect you to have taken account of them in your 2012-13 accounting separation data. Your methodology statement should detail changes you make for 2012-13.

Next steps

We are currently consulting on, and will conclude in the summer, our requirements for business plan reporting. We will take this opportunity to clarify activity definitions as identified by the targeted review and the basis upon which general and support and household/non-household allocations should be restated.

If you have any comments on the implications of the recommendations for business plan reporting, please provide feedback with your response to the business plan reporting consultation. The consultation closes on 23 May.

Over the coming months, we will work with companies and auditors to develop agreed upon procedures for the 2013-14 regulatory accounts. We will also finalise disclosure requirements and clarification of definitions ahead of the regulatory accounts information notice for 2013-14.

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Given that the review has highlighted the importance of increased transparency, we intend to publish EY's full report in the next few weeks. This will provide additional detail to all companies to understand the issues and where improvements need to be made. If you have strong concerns about the publication of any of the information provided by your company, please contact Liz Harvey (liz.harvey@ofwat.gsi.gov.uk, 0121 625 7811) or Cheryl Steventon (cheryl.steventon@ofwat.gsi.gov.uk, 0121 644 7589) **by 17 May**.

Yours sincerely

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