

Glossary of terms and definitions

Abstraction: The removal of water from any source, either permanently or temporarily.

Building Cost Information Service (Ltd) BCIS: A company of the Royal Institution of Chartered Surveyors that provides statistical analyses of current prices and cost samples from the UK building and construction industry.

Capital asset pricing model (CAPM): An economic model used to provide an estimate of the expected rate of return on a financial investment. One of the cornerstones of modern finance theory.

Charging year: The period for which companies bill customers which commences on 1 April each year.

Competition Commission: The body to whom companies can appeal if they disagree with Ofwat's determinations of their price limits, licence amendments or accounting guidelines.

Covenants: Conditions attached to debt, which aim to protect lenders' capital and interest payments. Covenants set out the action lenders may require, for example restricting dividend payments or preventing new lending, if certain triggers are met. Such triggers might include financial ratios falling below certain levels, indicating a weakening of the company's financial position.

Credit quality: The probability that an issuer of debt will make the promised payments to lenders. Credit rating agencies such as Standard and Poor's, Moody's and Fitch Ratings issue credit quality ratings as a service to investors. They take into account investors' demand for a higher return on bonds from issuers with lower credit quality as compensation for the greater risk of default.

Cryptosporidium: A micro-organism, chiefly originating from livestock, commonly found in lakes and rivers which is highly resistant to disinfection in the water treatment process.

Data envelopment analysis (DEA): A method based on linear programming used to assess the relative efficiency of operating units with the same goals and objectives. DEA allows us to measure the comparative efficiency with which operating units (eg water companies) transform resources and/or environmental factors to useful outcomes.

Depreciation: Depreciation is a measure of the consumption, use or wearing out of an asset over the period of its useful economic life.

Diffuse pollution: Pollution from widespread activities with no one discrete source, eg nitrate, pesticides, urban run-off, etc.

Distribution mains: The pipework by which water is delivered to customers. Water companies are responsible for the water mains.

Dividend cover: The number of times a company's dividends to ordinary shareholders could be paid out of net profits after tax in the same period.

Dividend growth model (DGM): A financial model used to provide an estimate of equity returns by reference to the expected growth in dividends.

Embedded debt: Debt, due in more than one year, in company balance sheets as at 31 March 2004, which attracts a fixed rate of interest rather than a floating rate.

Engineering judgement grades (EJGs): Used to assign both a reliability and accuracy grade to each individual cost in the cost base. For example, for the cost base an EJG of A1 would define a standard cost where the company has considerable experience in its own region and can call on data from a series of similar completed projects (Reliability grade A), and the standard cost represents works where reliable company-specific data is available and site-specific factors have been made accurately (Accuracy band 1). An EJG of D4 (the lowest) might be assigned to a standard cost based on national estimates for work not usually carried out by the company.

Enhanced service levels: Permanent, identifiable and measurable improvements in service levels that are above the most recent established company-wide base levels of service and which are additional to improvements resulting from expenditure in other purpose categories.

Equity beta: A coefficient (ie a number) that measures the riskiness of equity capital. Individual equity shares may be more or less risky than the overall equity market. The riskiness of a share, as measured by beta, is the volatility of its price in relation to that of a market portfolio. The beta factor is a component of the capital asset pricing model, which we use as the framework for estimating the cost of equity capital. A beta of 1 implies that the company's share price changes at the same rate as prices in the market as a whole. A lower beta implies that the company's share price is less susceptible to changes in the return than the market as a whole, while a higher beta indicates that the price is more volatile than that of the market.

Equity market risk premium (ERP): The difference between the expected return on the equity market portfolio and the risk free return. The additional return is required by investors to reflect the extra risk of the equity instruments compared with Government issued securities.

Financial Reporting Standards (FRS): Authoritative statements of how particular types of transaction and other events should be reflected in financial statements and accordingly compliance with accounting standards will normally be necessary for financial statements to give a true and fair view. FRSs are issued or adopted by the Accounting Standards Board (ASB).

Gearing: A company's net debt expressed as a percentage of its total capital. We use net debt as a percentage of the regulatory capital value as our measure of gearing. Other common measures include the ratio of net debt to net debt plus equity expressed as a percentage.

Geometric average: A compounded average that is time weighted for a specified time period.

Incentive allowance: The operating expenditure incentive allowance allows companies to retain the benefit of their past incremental outperformance against the operating expenditure assumptions in price limits for five years. After five years customers will benefit from the lower costs. The allowance is added to companies' revenue requirement and hence included in price limits. There is a similar mechanism for outperformance of capital expenditure assumptions.

Infrastructure charges: Paid by developers and customers in properties (in addition to connection charges) for a first time connection of premises for domestic purposes to a public water supply or public sewer.

Infrastructure renewals charge: An annual accounting provision for the cost of renewing infrastructure assets (ie mainly underground pipes) charged to the profit and loss account.

Interim determinations: Condition B of the licence allows Ofwat to make adjustments to the price limit in any year for certain relevant changes of circumstances or in response to a notified item, provided these are material. Key variations are: for changes in legal obligations placed on companies; failure to achieve legal requirements allowed for when price limits were set; and to allow for differences between the actual proceeds of surplus land and the proceeds assumed when price limits were last set.

Investment grade credit quality: A company with investment grade credit quality has a credit rating of BBB- or above (Standard and Poor's/Fitch Ratings), or Baa3 or above (Moody's). A company with a credit rating below investment grade will find it expensive to raise new finance, as investors will perceive it as high risk (see 'Credit quality').

K factors: The annual increase in charges that companies can make. The amount by which a company can increase (or must decrease) its charges is controlled by the price limit formula $RPI \pm K + U$. K is a number determined by Ofwat for each company, usually at a price review, for each year to reflect what it needs above inflation in order to finance the provision of services to customers. RPI is expressed as the percentage increase in the Retail Price Index in the year to the November before the charging year and U is the amount of K not taken up in previous years.

Large users: In general terms, large users are industrial and commercial customers using significant amounts of water each year. Under the Competition and Service (Utilities) Act 1992, amended by the Water and Sewerage Undertakers (Inset appointments) Regulations 2000 [SI2000/1842], inset appointments can be granted to sites using 100 megalitres or more a year in England and 250 megalitres or more a year in Wales.

Lending triggers: See 'Covenants'.

Logging down/logging up: The process between price reviews enabling companies to set aside variations in costs, which are then taken into account when next setting price limits.

Market to asset ratio (MAR): A measure of the relationship between the market value of a company's invested capital (equity and debt) and the value of its assets – in the case of a water company, its regulatory capital value. As the market value of equity varies with a company's share price, the MAR can give an insight into how equity investors perceive quoted water companies. For example, it may reflect a company's performance against our efficiency assumptions and investors' views on whether the rate of return we allow the company to earn on its regulatory capital value is equal to their view of the required return.

Policy codes: Cost driver or alphanumeric codes defined by Ofwat, the Environment Agency and Defra, and used by companies to assign projects and expenditure to specific quality policies and obligations. A detailed list explaining these codes can be found in the 'Business plan 2004: Information requirements – Final definitions' which is on our website, with cross-references to the relevant Environment Agency documents.

Quality regulators: A collective term for the Drinking Water Inspectorate, the Environment Agency, English Nature and the Countryside Council for Wales.

Regulatory capital value: The capital base used in setting price limits. The value of the appointed business which earns a return on investment. It represents the initial market value (200-day average), including debt at privatisation, plus subsequent net new capital expenditure including new obligations imposed since 1989. The capital value is calculated

using our methodology (ie after current cost depreciation and infrastructure renewals accrual).

Retail Price Index (RPI): Charges are controlled by the formula $RPI \pm K$. RPI is expressed as the percentage increase in the Retail Price Index in the year to the November before the charging year.

Risk-free rate: The risk-free rate is normally measured on the real return on a government security.

Small company premium: A premium on the basic cost of capital that we allow for the water only companies to ensure that they can maintain access to the capital markets.

Security of supply index: Assesses each company's ability to supply customers in dry years without imposing demand restrictions such as hosepipe bans. Companies with higher index score bands have better security of supply.

Serviceability: A long-run approach, which considers the ability of the water and sewerage networks to maintain a standard of service to customers.

Stable credit quality: A company with stable credit quality maintains a fairly constant credit rating over time (see 'Credit quality').

Stochastic frontier analysis: A method of regression analysis where the difference between the predicted cost (from the regression) and the actual costs are assumed to measure both inefficiency as well as stochastic or random error.

Target headroom: The minimum buffer a water company should allow between supply and demand to cater for specified uncertainties.

Tariff basket: The basket of charges to which the annual regulatory price limits apply comprising: charges for unmeasured water supply; charges for measured water supply; charges for unmeasured sewerage services; charges for measured sewerage services; and charges for reception, treatment and disposal of trade effluent.

Tariff basket headroom effect: The increase in a company's unmeasured charges is calculated using the average charge per supply. When this reduces, for example when a company introduces a new charge that is below the average, the company has scope ('headroom') to increase its charges to all of its customers. This is known as the tariff basket headroom effect.

WaSC: Water and sewerage company.

Water resource zone level: The largest possible zone in which all water resources, excluding external transfers, can be shared. Hence, it is the zone in which all customers experience the same risk of supply failure from a resource shortfall.

Weighted average cost of capital (WACC): For a company, the average of its cost of debt and cost of equity capital, weighted according to the balance of debt and equity which finances the company's assets.

WoC: Water only company. Provides water but not sewerage services.



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