
GUIDELINE FOR
TRANSFER PRICING
IN THE
WATER INDUSTRY

**REGULATORY
ACCOUNTING
GUIDELINE 5.04**

Operative:
Financial Year
2005-06



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The Water Act 2003 states that from 1 April 2006 the functions of the Director General of Water Services will be carried out by a corporate body, the Water Services Regulation Authority (the Authority). References to Ofwat in this document include both the Director General and from 1 April 2006, the Authority.

Part One – Accounting guideline and explanatory note

1.1 Introduction

- 1.1.1 Appointees are under a duty to trade at arm's length and to ensure that there is no cross-subsidy with respect to transactions between the Appointed Business and Associated Companies and the non-Appointed Business.
- 1.1.2 The onus is on individual Appointees to ensure that their activities comply with this duty and this guideline is in place to assist Appointees. Appointees should be able to demonstrate transparently to Ofwat, and to the public and other audiences, that they are meeting their duty to trade at arm's length from associates and that cross-subsidy does not exist. (A definition of terms is included in the Appendix.)
- 1.1.3 Abuse of monopoly power, for example through the exclusive use of an associate at above market rates, may lead to unfair competition in local and national markets. It may lead to greater costs for the regulated business, and ultimately to higher bills for customers. It may also breach the Competition Act 1998. To guard against this Appointees should let contracts competitively.
- 1.1.4 Ofwat monitors the performance of individual Appointees both through annual reports prepared by company Auditors, assisted where appropriate by Reporters, and through independent studies into company performance commissioned by Ofwat. Ofwat publishes its findings in the annual report *Financial Performance and Expenditure of the water companies in England and Wales*.
- 1.1.5 At Periodic Reviews Ofwat sets price limits on the basis of the costs involved in providing water and sewerage services. Where cross-subsidy is found, downward adjustments will be made to base costs in order that customers do not pay more as a result of cross-subsidy.
- 1.1.6 Breach of Licence Condition F (or any licence condition) could also warrant a financial penalty from 1 April 2005, under revisions to the Water Industry Act 1991, made by S.48, Water Act 2003.
- 1.1.7 The aim of the guideline is to establish a framework with which Appointees must comply. The guideline describes the key principles with which companies should comply and also reflects key areas of non-compliance highlighted by investigations into company activities.

1.2 Licence Authority

- 1.2.1 Section 50 of the Competition and Service (Utilities) Act 1992 places a duty on Ofwat to ensure that transactions between Appointees and their associated companies are at arm's length and that the Regulatory Accounts are presented in such a way as to make this transparent. Revisions to Condition F of the Licence came into force on 4 March 1993 to reflect this duty, by prohibiting any cross subsidy between the Appointed and non-Appointed Businesses, and from the Appointee to any associate company, including the parent, within the group. It also extends the disclosure of information on transactions.

1.3 The Water Act 2003

- 1.3.1 The Water Act 2003 will enable enforcement authorities (the Secretary of State, the National Assembly for Wales and Ofwat) with powers to impose financial penalties of up to 10% of turnover on statutory undertakers and licensed water suppliers. Penalties may be imposed for contraventions or contributing to contraventions of appointment conditions, licence conditions, and other requirements as noted in the *Statement of policy with respect to financial penalties* published by Defra, Ofwat and the National Assembly for Wales, dated 17 March 2005.
- 1.3.2 Ofwat will comply with the statement of policy.
- 1.3.3 Ofwat's primary objective on transfer pricing is to ensure that cross-subsidy does not occur so that customers are not disadvantaged. The conduct of Appointees will be a major determinant in whether it is appropriate to levy a fine, in addition to agreeing prompt remedial action to end the breach, and a possible adjustment at future periodic reviews.
- 1.3.4 Section 3 of the statement of policy sets out our approach.

1.4 The Competition Act 1998

- 1.4.1 The Competition Act 1998 (the Act) grants Ofwat concurrent jurisdiction with the Director General of Fair Trading in relation to the regulated water sector in England and Wales. The application of the Act to the water sector has been published jointly by Ofwat and the Office of Fair Trading in: *Competition Act 1998: Guidance on application in the water and sewerage sectors*.
- 1.4.2 When trading with associates, Appointees should pay particular regard to the specific application of the Act as outlined in the following sections of the report.

- Issues in pricing of water and sewerage services: Sections 4.9 – 4.24;
- Competition in providing Contestable Services, Sections 4.25-4.29;
- Conduct relating to non-price terms, Sections 4.30-4.33;
- Agreements that may restrict, distort or prevent competition, Sections 4.53-4.54.

1.4.3 Where Ofwat is satisfied that the relationship between an Appointee and an associate company is, has or is likely to contravene the prohibitions of the Water Industry Act 1991, it may choose to use its powers under either the Water Industry Act 1991 to enforce Licence Condition F and/or to use its powers under the Competition Act. When using its powers under the Competition Act, such as imposing financial penalties, Ofwat is not required to have regard to the Water Industry Act 1991 requirement to secure that undertakers are able to finance the proper carrying out of their functions.

1.5 Guideline Principles

1.5.1 The principles of this guideline are that:-

- the Appointed Business pays a fair price for services and products received;
- transfer prices for transactions between the Appointed Business and associate companies are based on market price or less. Where no market exists, transfer prices are based on cost;
- market-testing¹ is used to establish market prices for supplies, works and services provided to the Appointee.
- costs are allocated in relation to the way resources are consumed;

1.5.2 Appointees are required to demonstrate, through the application of these principles, the basis of arm's length trading and that cross subsidy does not exist.

1.5.3 Within the framework of these guidelines, Appointees must develop processes and procedures to ensure compliance; these processes and procedures should meet their own specific circumstances, and ensure that transactions are supported and documented. A full account of the processes should be retained to allow monitoring by Ofwat and the Appointee's Auditors. These records should record all stages in the decision-making process and demonstrate that the processes and procedures have been operated in an open and transparent manner.

¹ The principles of market-testing are set out in Section 1.8.

1.5.4 These guidelines and principles will apply to all water only and water and sewerage companies. Within each Appointee the policies and methods adopted for cost allocation, transfer pricing, market-testing and reporting should be consistent. Where it is anticipated that a re-appraisal will result in system and/or policy changes, Appointees should ensure that proposed modifications comply with this guideline and inform Ofwat of the modifications. Appointees should seek advice from Ofwat where they consider their proposals may differ from the spirit of the guideline.

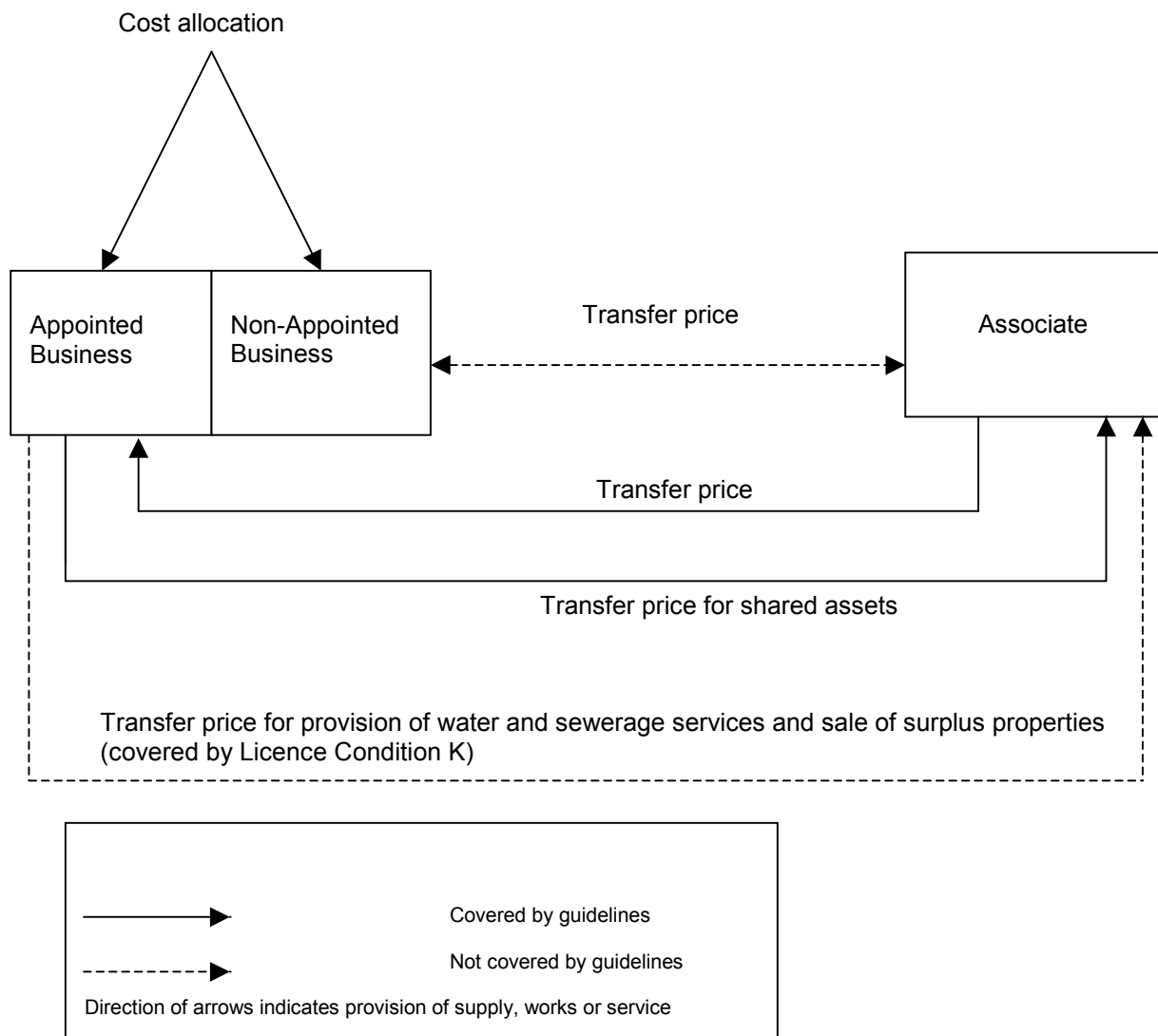
1.6 Applicability

1.6.1 These principles apply to:

- cost allocation within the Appointee between the Appointed and non-Appointed activities;
- transfer prices for the provision of supplies, works or services between the Appointed Business and an associate company;
- transfer prices for rechargeable works and services where the Appointee is a monopoly supplier to the associate company, eg for use of accommodation and other shared assets; or where the parent is monopoly supplier, eg shareholder costs to the Appointee and associates.

This is shown in diagram 1.

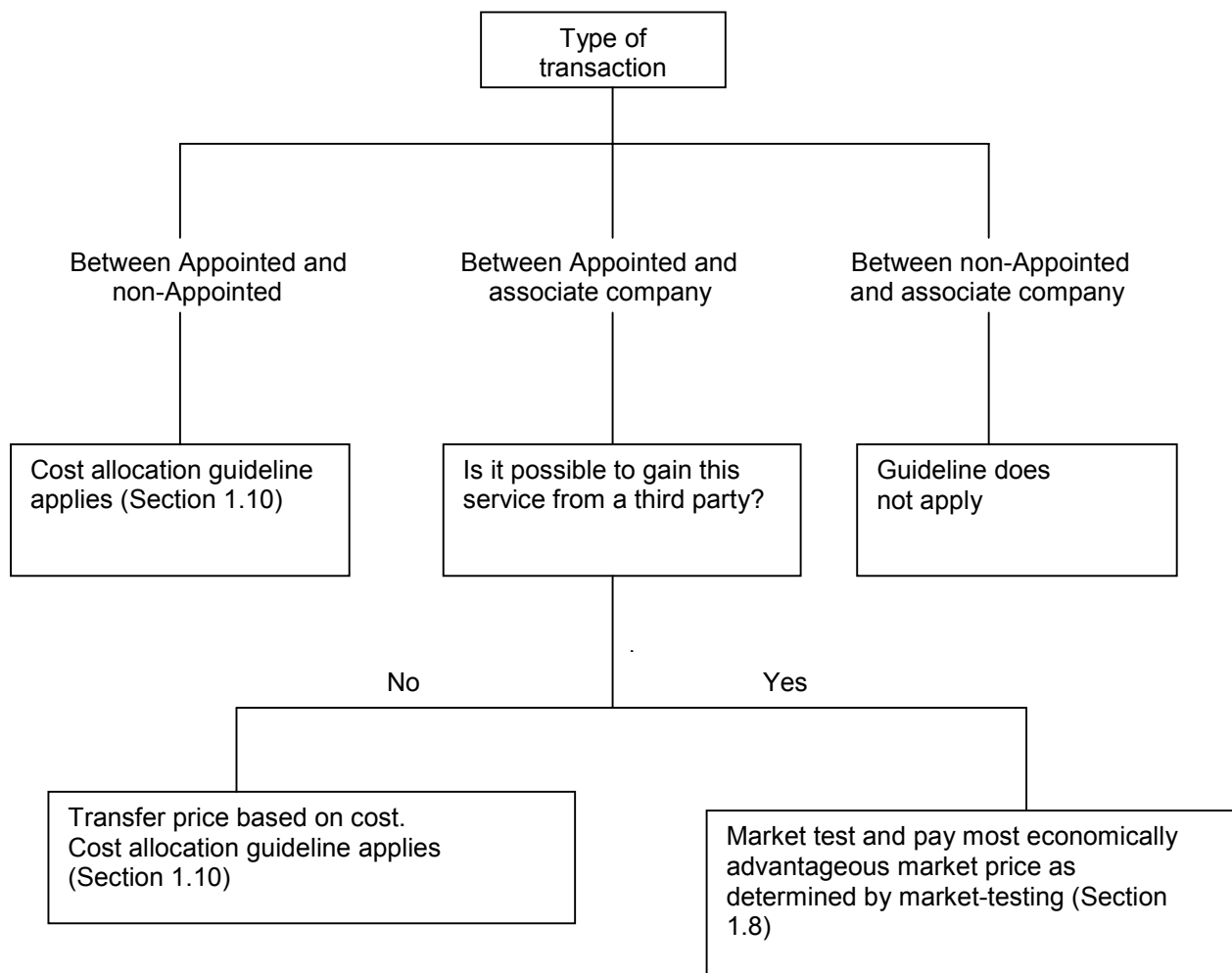
Diagram 1. Cost allocation and transfer pricing



- 1.6.2 This guideline will apply to transactions with all associate companies. For the purposes of this guideline, and to ensure complete transparency, an associate company should be determined in accordance with *Financial Reporting Standard 8 (FRS 8)*, *Related party disclosures* as modified in *Ofwat Dear Regulatory Director* letter RD 29/97. When FRS 8 is superseded by a standard consistent with International Accounting Standard 24 (IAS 24), as proposed in Financial Reporting Exposure Draft 25 (FRED 25), Ofwat will take a consistent approach to determining related parties and necessary disclosures. Ofwat's view is that the existence of any common shareholding, regardless of the level which may distinguish between control and the ability to exert influence, defines a related party. Any exceptions to this must be agreed with Ofwat.

1.6.3 The onus will be on Appointees to determine whether or not any company with whom they trade is an associate company. In reporting transactions with associate companies Appointees should report all transactions regardless of how remote or otherwise the connection with that associate company. Appointees will need formalised procedures to check whether a company with whom they trade is an associate. Appointees should establish with Ofwat any departures from this reporting requirement. Diagram 2 provides an overview of the guidelines and the key decision points relating to cost allocation and transfer pricing.

Diagram 2. Overview of guidelines



1.7 Principles of Transfer Pricing

- 1.7.1 The primary principle is that transfer prices should be based on market price or less and that market price should be determined by market-testing. The principles of market-testing are described in Section 1.8. Market price should be the most economically advantageous price taking into account objective criteria such as completion date, quality, running cost, after sales service, technical merit, security of supply, effectiveness, whole life cost, capability, capacity, etc.
- 1.7.2 The market-testing process must be applied in a fair, open and transparent manner with no guarantee of success for associate companies. This will facilitate fairness of treatment between potential contractors and ensure that a competitive edge is maintained within the process. This provides the greatest assurance that cross-subsidy of associates is not taking place. Where a service is market tested, the process should be fair, effective and proportionate to the value and complexity of goods, works or services being procured. The work should be awarded to the tender² that is the most economically advantageous. This should be determined by reference to the objective criteria set out above.
- 1.7.3 Where an associate company gains a substantial proportion of its turnover from the Appointed Business, ie more than half, the price the associate company charges should incorporate a discount from the external market price to reflect the following:
- inherent long-term guarantee of work;
 - volume of work;
 - lower marketing and sales costs;
 - lower bad debt risk;
 - lower commercial risk;
 - reduced credit period.
- 1.7.4 Where no market exists for particular supplies, works or a service, the transfer price should be based on cost, and the cost allocation guidelines in Section 1.10 followed.
- 1.7.5 On occasion, the Appointee may choose to use the services of an associate for strategic reasons. For example, it may wish to retain intellectual properties within the group or it may require a particular product or service which can only be provided by an associate. Under these circumstances, the transfer price should also be based on cost.

² All references to tender include related terms, such as bid or proposal to supply.

- 1.7.6 If there is a market for a service/good and the Appointed Business does not choose to test the market for that service/good then transfer prices should be at cost. In the medium term, Appointees should consider bringing the activity within the Appointed Business. An Appointee that uses an associate company for a service, for which there is a market, without market-testing the prices paid cannot demonstrate arm's length trading. For price setting purposes, Ofwat will assume that such supplies, works or services under these circumstances are provided at cost to the Appointed Business, as if the services have been delivered within the Appointee. Under these circumstances cost will be deemed as the actual cost to the supplier of the goods, works or services plus a rate of return on capital as defined in the Appendix; unless there is a compelling case to convince Ofwat, for using an alternative measure.
- 1.7.7 The Appointed Business may be indirectly supplied with goods, services and supplies by an associate company via a third party. This may occur where an associate is sub-contracted to a third party, perhaps as a nominated sub-contractor. Appointees are required to report on the value of transactions undertaken by associate companies via a third party. Reporting should record the value of such transactions and the associates involved including the nominated sub-contractor.

Other transfer prices

- 1.7.8 Not only do transfer prices apply to goods, services and supplies, they can also apply to staff where they provide services or are seconded to associate companies and vice versa. Where Appointee staff undertake work for associates, the Appointee should be reimbursed to reflect the individual's salary and overheads associated with that individual's employment, ie accommodation, pension, car.
- 1.7.9 Appointees should have systems to record details of staff and time spent on non-appointed activities. Where the Appointee employs or trains associate staff, it should document the requirements for that individual and the basis of remuneration.
- 1.7.10 In some circumstances companies may choose to transfer assets into and/or out of the Appointee. Where assets are transferred out of the Appointee to an associate, the associate should pay a fair price, as determined by net book value or a fair market price, for those assets. Associates should not receive assets from the Appointee at a price below that which would be charged by a third party.

1.8 Principles of Market-Testing

1.8.1 Market-testing is the process of determining a market price for particular supplies, works or services. Transfer prices for transactions between the Appointed Business and associate companies can only be at a market rate if they are a result of market-testing. This is essential to ensure that the price paid for a product or service does not exceed a fair market price. Appointees that let contracts in a competitive manner to associates and third parties alike are able to demonstrate that trade with associates is conducted at arm's length.

Methods of market-testing

1.8.2 There are a number of methods of market-testing:

- competitive letting;
- comparison to published list prices;
- third party evaluation;
- benchmarking.

1.8.3 The industry to date has used all of these methods to determine transfer prices, with varying degrees of success. A number of companies have been unable to demonstrate arm's length trading due to weaknesses in their market-testing processes. As a result Ofwat made downward adjustments to declared costs at the 1999 and 2004 Periodic Reviews. Ofwat assumed that some supplies, works and services were provided at cost to the Appointee and future price limits were set on this basis.

1.8.4 The majority of adjustments made by Ofwat were as a result of poor or no market-testing. In the main, companies had used comparison to published list prices, third party evaluation and benchmarking. Following investigations Ofwat concluded that market-testing by these means did not demonstrate arm's length trading because a large element of subjectivity was involved. Comparisons were not always made on the basis of the same type and volume of supplies, works or services. These methods of market-testing tended to involve a judgement of a fair market price and/or interference in the market. Ofwat was not satisfied that this form of market-testing produced a fair market price.

1.8.5 The most robust means of determining a fair market price is to invite independent contractors to tender a price for given supplies, works or services, ie competitive letting of a contract. Competitive letting is the only means of market-testing which objectively tests and preserves the competitive market. All other methods tend to compare a predetermined price with the market, as a means of justifying the original price. In these circumstances the Appointee has to make a judgement as to what a fair market price should be. Competitive letting avoids this problem as it inherently discovers the market price without interference in or judgement of the market.

- 1.8.6 Though competitive letting produces the most robust transfer price, there are circumstances where the competitive letting process is demonstrably impractical. For example, where a contract of small value is not suitable for inclusion in a framework agreement, or where, for example, group services may not be provided at cost. In these rare circumstances market-testing by comparison to published list prices, third party evaluation and benchmarking could be used to demonstrate arm's length trading.
- 1.8.7 In exceptional circumstances the Appointee may need to engage the services of a third party at short notice to deal with operational needs. This would include dealing with emergency situations where the prompt action required would not enable a full procurement exercise to be undertaken. To alleviate concerns, the Appointee should fully document the operational emergency and the reasons for selecting the associate. This process should accord with the Appointee's stated emergency procedures.
- 1.8.8 The Appointee will be expected to make a strong case for using methods other than competitive letting and will need to demonstrate the robustness of the methods used. Only well-documented and cogent exercises will satisfy Ofwat that transfer prices are at market rates. However, Ofwat does not expect to receive many such proposals as competitive markets exist for almost all goods, works or services that Appointees procure.

Market-testing procedures

- 1.8.9 Appointees should establish and apply clear policies and procedures for market-testing. The reasons for the methods, thresholds and criteria adopted should be transparent and should be capable of withstanding scrutiny by Ofwat, customers and competing contractors. Ofwat will examine the policies and procedures of individual Appointees and challenge the approach where necessary.
- 1.8.10 At the 1999 and 2004 Periodic Reviews Ofwat also adjusted companies' costs where arm's length trading could not be demonstrated because the competitive letting process was not set down in advance.
- 1.8.11 Policies and procedures should be documented and include the following as a minimum:
- market-testing methods to be used;
 - procedures to be adopted with respect to each method;
 - frequency of market testing;
 - review procedures;
 - responsibilities for conducting market-testing; and
 - documentation of procedures.

- 1.8.12 Transparent, well-documented market-testing processes that record the steps and decisions in the procurement process are necessary to demonstrate compliance with these guidelines. Where Appointees are unable to provide sufficient evidence to demonstrate this, Ofwat may require access to the costs of associate companies who provide services to the Appointee. Ofwat needs to be content that the price paid for the goods or services provided does not exceed a fair market price.
- 1.8.13 Prior to commencing the competitive letting process the Appointee should ensure the following decisions are taken:
- contractual arrangement to be used and the circumstances in which they will be used eg fixed price, schedule of rates, partnering, term, negotiated and call-off contracts;
 - the minimum number of bids to be obtained dependent on materiality of the contract;
 - qualification processes for potential contractors;
 - an evaluation process;
 - policy on informing tenderers of results.
- 1.8.14 When inviting companies to tender Appointees should ensure that the qualification requirements do not give any undue advantage to associates. Appointees should ensure that they do not abuse a dominant position or enter into agreements or concerted practices which might breach the prohibitions in the Competition Act 1998.
- 1.8.15 The tender evaluation process and respective weightings for each criterion should be set out and documented by the Appointee in advance of any tenders being opened. This will help demonstrate that associate companies and external companies undergo the same tender process, without any preferential treatment or guarantee of success for the associate.
- 1.8.16 Appointees should be able to demonstrate that the assessment criteria are relevant to goods, works or services in the procurement exercise. It will be difficult for the Appointee to demonstrate that trading has been at arm's length if cost is given a weighting of less than 50% compared to qualitative factors. If Appointees consider that a lower weighting should be used then they should document the reasons for this and this will be subject to RAG 5 audits.

Frequency of market-testing

- 1.8.17 To demonstrate a fair market price the Appointee will need to undertake frequent market-testing that produces valid results. There is a balance between the advantages of frequent market-testing of short-run contracts and the benefit of stability, continuity and possibly lower costs for longer term work. As a general guide, contracts should normally be market tested every one to three years. Contract periods longer than three years could lead to the Appointee paying prices that are very different from prevailing market rates. Where Appointees choose to let a contract for longer than three years they should refer to the market on an annual basis thereafter.
- 1.8.18 Repeat market-testing is likely to be necessary when there is any material alteration to an existing contract, for example where an increased volume of work is conducted than had been envisaged when the contract was let. Market-testing that does not match the current profile of work will not remain valid.
- 1.8.19 In general, the greater the likelihood of fresh competition and new technology emerging, then the shorter the period between market-testing. Appointees should have regard to these issues in determining their strategy.

Unacceptable practices

- 1.8.20 Market-testing procedures should comply with EU and prevailing standards. Appointees should not split contracts or use artificial methods to calculate the value of contracts in order to circumvent applicable thresholds or the aggregation rules of the EU.
- 1.8.21 Market-testing should be used to award contracts to the most economically advantageous tender, not as a device to justify prices paid to associate companies. Where examples of this practice are found, Ofwat will assume these works, supplies and services are provided at cost, as arm's length trading cannot be demonstrated. This could also constitute grounds for an investigation under the Competition Act 1998.
- 1.8.22 Third parties will not continue to offer competitive bids to the Appointed Business if they perceive that the company is not seeking the most economically advantageous bid or that third-party bids are mostly used to establish market prices to be paid to associate companies.

1.9 Partnering

- 1.9.1 Where Appointees pursue partnering arrangements with associate companies they should take account of the following principles:
- selection of partners should be made following a competitive letting process;

- the partnering arrangement should run for a stated period of time (this should be made clear in the competitive letting documents);
- any partnering agreement should include reasonable targets for improving performance and reducing costs; and
- contract awards should be on the same terms and conditions to all partners and these should be appropriate to the type of work being awarded.

1.9.2 Partnering arrangements which involve an associate company run the risk of appearing 'cosy'. Appointees will therefore need to take steps to enable them to demonstrate that such arrangements operate at arm's length and are producing tangible benefits in terms of improved performance and reduced costs. This can best be achieved by:

- proper documentation of the competitive letting and selection exercise;
- clearly defined targets for reducing costs and improving performance including incentives;
- ensuring performance is measured and the rules for rewards and penalties where targets are surpassed or underachieved are appropriate and reflect the risk borne by each party to the contract;
- an open book policy providing details of the costs involved in providing the service and the level of profit achieved on the contract; and
- setting criteria for awarding additional parcels of work within the agreement period, particularly when a number of partners are engaged.

1.10 Principles of Cost Allocation

1.10.1 Cost allocation is the means by which costs are divided between the Appointed and non-Appointed activities within the Appointee, and to specific products and services. Cost allocation rules apply to transfer prices from associate companies where no external market exists, including services received from the parent company, or where costs are incurred commonly by Appointed and non-Appointed activities.

1.10.2 The key principle is that costs should be allocated in relation to the way resources are consumed. Allocations based entirely on turnover, volume or direct labour rates should not be used as they are unlikely to reflect the activities involved. Allocation must also be consistent with other Regulatory Accounting Guidelines, in particular RAG 4.

1.10.3 Costs can be considered as:

- direct costs of activities (eg materials and wages);
- indirect costs which are directly consumed or allocated to activities (eg space occupied, IT resource used by an activity) and those not related to activities (eg management fees).

- 1.10.4 Allocating costs in relation to the way resources are consumed provides a means of building up service and product costs. This approach views a business as a series of activities, each of which consumes resources and, therefore, generates costs. An activity based approach should result in the majority of the total costs being allocated on a meaningful basis. It is expected that at least 80 per cent of costs will be allocated by activity. All costs must ultimately be allocated, including, where appropriate, depreciation charges (CCD charges in CC Reports and HC costs in HC Reports) on assets and financing charges.
- 1.10.5 Cost allocation must be fair and reasonable and there must be consistent treatment of costs for Appointed and non-Appointed activities. These principles should prevent Appointed activities cross subsidising non-Appointed activities.
- 1.10.6 Where cost is used the Appointee should have access to the costs of that associate and should conduct validation exercises to ensure that transfer prices are at cost. This should be incorporated within the contract monitoring process agreed by the parties.
- 1.10.7 Each Appointee should have policies and procedures for a clear cost allocation methodology. These should specify:
- activities;
 - cost drivers for allocating costs to activities;
 - cost drivers for allocating activity costs to products and services;
 - departures from guideline/implementation process;
 - review procedures;
 - documentation of procedures.
- 1.10.8 The onus is on companies to ensure that all costs are ultimately allocated in accordance with this guideline.
- 1.10.9 The allocation of indirect costs should be achieved by:
- identifying the activities that comprise a particular service or product and what drives the level of activity;
 - determining the relationships between activities and resources consumed;
 - costing the activities by costing the resources consumed;
 - pooling costs that cannot be related to activities and allocating them on a subjective basis, eg turnover or proportion of direct costs.

- 1.10.10 Although a significant proportion of costs can be allocated in relation to the way resources are consumed, it is recognised that a point of diminishing returns will be reached where the cost of further allocation outweighs the benefit. Where companies apply a de minimis level below which they will not seek to allocate costs, this should be declared in the commentary to Tables 30 & 31 of the June Return.
- 1.10.11 In addition, it is recognised that some costs will not be driven by activities and that some subjective allocation will be necessary to arrive at the full cost. Where a subjective allocation is applied the principles governing this allocation should be set out in the commentary to Tables 30 & 31 of the June Return.

1.10.12 The differences between traditional cost allocation approaches and an activity based approach are illustrated in Diagrams 3 and 4.

Diagram 3. Traditional Costing

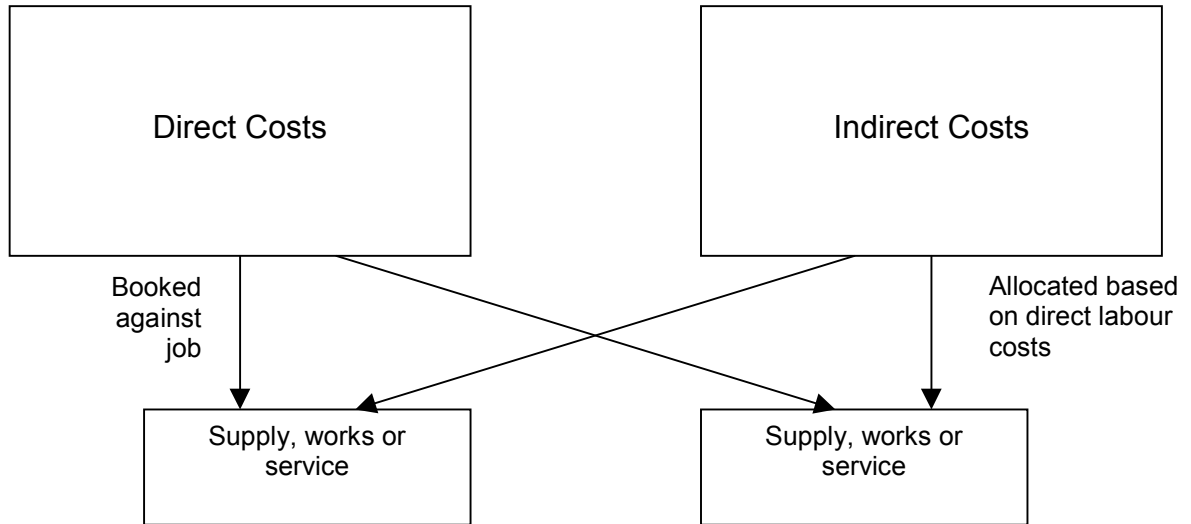
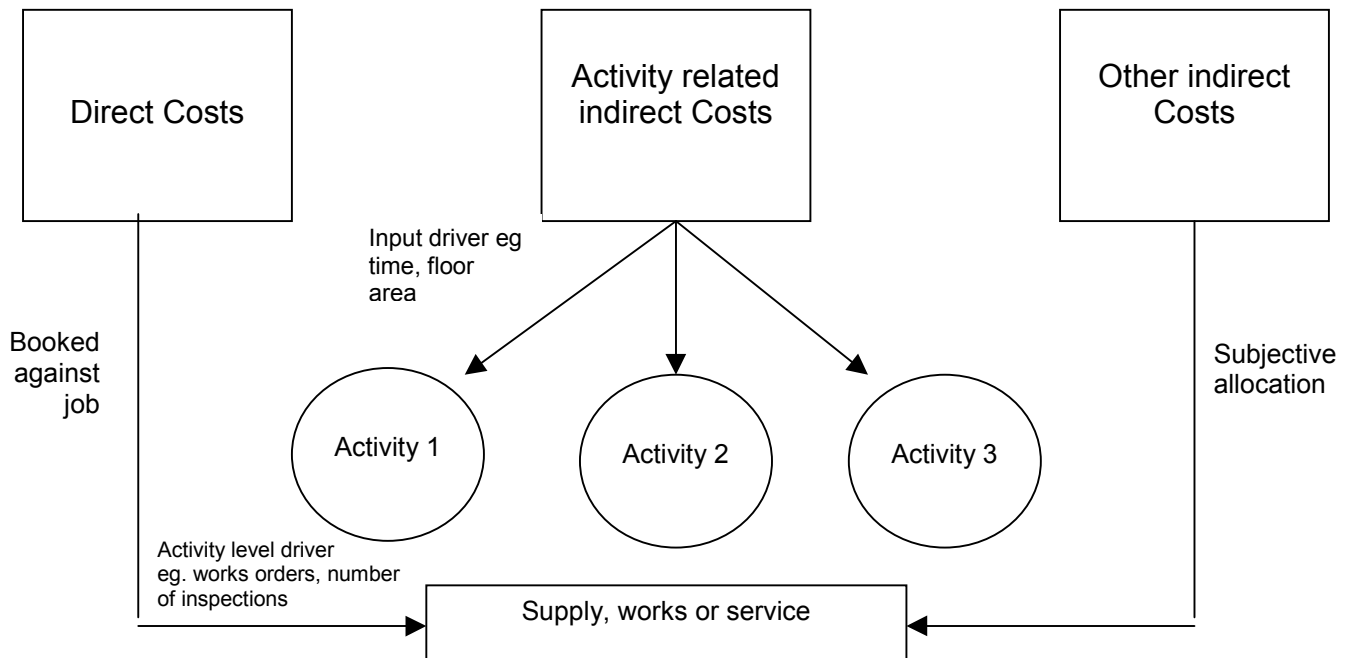


Diagram 4. Activity Based Costing



Services provided by the parent company

- 1.10.13 All Appointees pay a charge to the parent company for services provided. The services provided to individual Appointees vary. It is important that the basis of charging used by the parent company reflects the group structure at the time charges are being levied and actual services provided. The charges paid to the parent must be related to the services provided and should be charged at cost, eg legal services and treasury services. The onus is on the Appointee to demonstrate charges reflect the costs incurred by the provider of the service. Management fees should not be inflated by additional costs beyond those actually incurred, eg where the parent treasury function provides a guarantee to the Appointee, a charge should not be made for the provision of that guarantee beyond that paid by the parent.
- 1.10.14 Where it is not possible to charge for services on an activity basis; eg for shareholder management cost (Register, Company Secretary, AGM etc). Costs of this type should be distributed fairly between each subsidiary of the parent and in a way that reflects the activities the parent undertakes on behalf of the individual subsidiaries. Distributing charges to associates on the basis of profitability or turnover of individual associates will not provide a proxy for activity, and apportionment on this basis should be avoided. Discrepancies between treatment in the regulatory and statutory accounts should be avoided

Marginal cost allocations

- 1.10.15 Allocations based on short run marginal costing techniques should not be used. In some instances it may be admissible to use long-run marginal costing techniques, for instance where a water only company bills and collects payments for sewerage services on behalf of a water and sewerage company. In cases where a company considers that a marginal costing technique is the most suitable means of charging for a particular service, it will be expected to justify its reasons for using this technique and should explicitly report this (see Part 2).

1.11 Appointee Structure

- 1.11.1 Systems should be in place to ensure that directors or senior managers who have responsibilities in both the Appointee and associate companies, or companies with whom the Appointee trades, do not face a conflict of interest.
- 1.11.2 No individual, in such a position, should be able to influence either the purchase or supply of goods, services and supplies. Where cross-directorships exist these should be described in the commentary to Tables 30 and 31 in the June Return and in the Regulatory Accounts. Appointees should set out the steps taken to ensure that probity in relation to decisions taken by these individuals is maintained at all times. Transparency with regard to the existence of such cross-directorships will help mitigate Ofwat's and the public's concerns.

Part Two – Reporting requirements

2.1 Introduction

- 2.1.1 Appointees must demonstrate that they comply with Condition F of their Licence and that trade with associates is at arm's length and cross subsidy is not occurring.
- 2.1.2 Policies and procedures should satisfy this guideline. Appointees should advise Ofwat, in their June Returns, of any areas where policies and procedures may not comply with the revised guideline and the time frame for ensuring that they will.

2.2 Appointees' June Return Reporting Requirements

- 2.2.1 Licence Condition F requires Appointees to trade at arm's length from associate companies, to ensure that no cross-subsidy occurs. To demonstrate that this condition has been met, Appointees have a duty to provide Ofwat with information on transactions that have taken place between the Appointed Business and associate companies.
- 2.2.2 Appointees should have policies and procedures governing the procurement of supplies, works and services which comply with the principles of RAG 5.04. Appointees should put in place systems enabling all transactions with associate companies to be recorded and reported in line with the requirements set out below, which are issued annually, as part of the June Return reporting requirements.
- 2.2.3 Appointees will be expected to provide the following information with the June Return each financial year:
 - 1. A statement of compliance that the Appointee has complied with Condition F of its Licence;
 - 2. a declaration by the Directors and Senior Managers of the Appointee of interests in associates with whom the Appointee trades;
 - 3. details on procedures used to award the contracts to associates which are declared in Tables 30 and 31;
 - 4. details on transactions with associates other than for the direct provision of supplies, works or services to the Appointee.

2.2.4 Details of these four key requirements are set out below:

1. The Directors of the Appointed Business should state that the Appointee complies with the objectives and principles of RAG 5.04, namely that transactions with associate companies are at arm's length and that cross subsidy is not occurring.
2. The Directors of the Appointed Business should accompany their declaration of interests with a statement that no Director has acted as both purchaser and supplier in any transaction with an associate company. The Appointee should give a description of procedures that it has put in place to ensure that conflicts of interest do not occur.
3. For transactions with associate companies, the Appointee should set out the following information in the relevant chapters of the June Return: Chapter 30 should be used to record capital expenditure and Chapter 31 should include profit and loss expenditure.

2.2.5 For each contract in excess of 1% of the Appointed Business turnover the following details should be provided in the commentary to Table 30 & 31. Also where the aggregate value of trade with an associate represents more than 50% of the associate's turnover, but individual contracts are less than 1% of the Appointed Business turnover, the following details should be provided for a sample number of contracts.

- The value of supplies, works or services supplied in the current year.

2.2.6 The total value of the contract. Any significant variations between the anticipated contract value and actual expenditure should be explained.

2.2.7 The date when the contract began and the date when it is due to expire. Any options to extend or terminate that were included in the original contract should be recorded.

- Details of the advertisement of the contract;
- The method of selection that was used to award the contract;
- Where other market-testing was used state who conducted the evaluation or benchmarking. The method and the number of comparators used;
- When the contract was advertised and the number of parties which expressed an interest;
- The number of companies that were invited to submit a tender and the basis for their selection;

- The number of tenders³ that were submitted and the number and basis for those tenders which were excluded or withdrawn;
- The number of tenders that were evaluated and the method used, including details where applicable of the tender evaluation score sheet or other similar matrices. This should demonstrate that all tenders were evaluated on a consistent basis;
- The outcome of negotiations undertaken with interested parties; and
- The reason for the award of the contract.

2.2.8 For those contracts not covered above, the following details should be provided. Please provide this commentary by reference to line numbers in Table 30 & 31.

- The value of supplies, works or services supplied in the current year.
- The procurement policy used and the number of tenders received and rejected. Where other market-testing was used state the method and number of comparators used.
- The rationale for the selection of the successful party, including the basis of the tender evaluation.

2.2.9 The commentary should also include the overall value of transactions with each individual associate and that associate's turnover as required by Licence Condition F6.5.

2.2.10 The commentary to the June Return should provide details on the following transactions with associate companies. None of the information described below should be included in the tables:

- Income received from associates or recharges made by the Appointee where it supplies goods, services or supplies to associates, eg accommodation, IT services, personnel services, etc. This should also be recorded as non-appointed income in the Regulatory Accounts where it is in excess of the thresholds for reporting.
- Indirect transactions with associates via a third party should be reported in the commentary to Tables 30 & 31. The commentary should record the value of such transactions, the associates involved and whether or not the associate was nominated as a sub-contractor. All transactions involving a nominated associate should be recorded. Where it is not possible to include details of associates sub-contracted to the Appointee, an explanation should be provided. Appointees should provide proposals to Ofwat of any materiality levels that they consider to be appropriate to the recording of this information.

³ All references to tender include related terms, such as bid or proposal to supply.

- All transfers of assets, land or property that took place within the financial year should be recorded in the commentary. Any significant difference between 'fair market price' or net book value, and the price at which assets are transferred should be recorded.
- Details of loans, capital, issues or redemptions and dividends should be recorded, in the commentary to Table 31 where they relate to trade between the Appointee and associate companies.
- A statement of turnover for associates with whom the Appointee has traded. A summary of the total transactions, by associate, between the Appointee and associates and details of the percentage of the associate's turnover that this represents.
- The commentary should describe the terms of any partnering arrangements that exist between the Appointee and associate companies. This should set out the method used to select the Partner; the period of time for which it will run; mutually agreed and reasonable targets for improving performance and reducing costs.

2.2.11 If the Appointed Business is unable to provide any of the information above, it should make this, and the reasons for not providing the information, clear in the commentary. For each of the requirements that does not apply to the company, a 'nil return' should be included.

2.3 Auditors' Reporting Requirements

2.3.1 Auditors should prepare a long form report with the Appointee's June Return. The format will be of an 'agreed upon procedures' engagement. This should identify material areas of judgement and any other material circumstances which appear to the Auditor to be relevant having regard to the guidelines and to the scope of work agreed with Ofwat including relevant levels of materiality.

2.3.2 Ofwat may require Auditors to adopt a particular focus in examining compliance with this guideline. Auditors will be required to provide for Ofwat's agreement, prior to each financial year-end, proposals in a draft audit plan which they have discussed with the Appointee, detailing the areas they propose to cover in relation to this guideline in the course of the audit. The audit plan will need to be prepared in accordance with 'Terms of Reference' issued by Ofwat. These will provide the framework of the Auditors' reporting requirements each financial year.

- 2.3.3 The scope of the work to be conducted should enable the Auditor to provide a long form report that covers the areas;
- set out in the agreed terms of reference;
 - matters which may be relevant to the Appointee and its compliance with the guideline, as informed by Ofwat to the Auditors;
 - sample transactions should be performed as identified in the agreed terms of reference.
- 2.3.4 The purpose of the long form report is to provide Ofwat with information to allow it to form a judgement on the compliance or otherwise of the Appointee with the guideline in respect of those matters reported and having regard to the scope of work performed. Ofwat will provide feedback to the Auditors in writing on the compliance of the Appointee with the guidelines.
- 2.3.5 In addition, this report should identify any findings that were drawn to the attention of the Appointee and what steps have, or will be, taken to remedy any departures from this guideline.
- 2.3.6 Reporting compliance with this guideline falls to the Auditors. Reporters do not currently have an obligation or duty to report to the Appointee's Auditors. However it may be appropriate for Reporters to report on specific transactions. In these instances, Appointees and their Auditors should establish clear responsibilities for Reporters. For example, use can be made of a Reporter for examination of market-testing of engineering services, where the Auditors may not have the appropriate skills. Ofwat may, on occasion, also require the Reporters to examine such transactions.

Appendix – Definition of terms

A number of terms have been used throughout the guidelines. To avoid confusion, they are defined as follows:

Accounting terms

The definitions to be used are as set out in Regulatory Accounting Guideline 3 (RAG 3).

Activity

A logical grouping of tasks.

Appointee

The company appointed to be the water undertaker or sewerage undertaker for any area of England and Wales, as set out in the Water Industry Act 1991.

Appointed Business

The Appointed Business comprises the regulated activities of the Appointee which are activities necessary in order for an appointee to fulfil the function and duties of a water or sewerage undertaker under the Water Industry Act 1991.

Arm's length trading

Arm's length trading is where the Appointee treats the associate on the same basis as external third parties.

Associate company

For the purposes of compliance with these guidelines and to ensure complete transparency, an associate company should be determined in accordance with *Financial Reporting Standard 8 (FRS 8), Related party disclosures* as modified in *Ofwat Dear Regulatory Director* letter RD 29/97. When FRS 8 is superseded by a standard consistent with International Accounting Standard 24 (IAS 24), as proposed in *Financial Reporting Exposure Draft 25 (FRED 25)*, Ofwat will take a consistent approach to determining related parties and necessary disclosures. Ofwat's view is that the existence of any common shareholding, regardless of the level which may distinguish between control and the ability to exert influence, defines a related party. Any exceptions to this must be agreed with Ofwat.

Competitive letting

Letting contracts as a result of a tendering process.

Cost

The actual cost to the supplier, in a transaction with the Appointee, of the goods, works or services, plus a reasonable rate of return on capital employed. Unless the circumstances of the transaction provide a convincing case for the use of an alternative measure, the return on capital will be the weighted average cost of capital for the individual Appointee as set out in Ofwat's final determination of 2 December 2004 (or any other determination applicable in the 2005-10 period).

Cost allocation

Cost allocation is the means by which all costs are allocated to Appointed and non-Appointed Businesses or specific supplies, works and services, ensuring a fair share of overheads.

Cost driver

A cost driver is the factor or factors which cause cost to occur. This can be further divided between the driver that causes an activity to occur, and a driver that determines how often it occurs.

Cross-subsidy

Cross-subsidy in this context is monetary aid or contributions from the Appointee to the associate which is not merited by services received. It also relates to services provided by the Appointee to associate companies where there has been an under-recovery of costs incurred by the Appointee.

Economically advantageous price

The economically advantageous price is the net cost to the Appointee after taking account of all factors including the contract price, contractor management time, cash flow impact of the payment schedule, completion date, quality, after sales service, technical merit, aesthetics, security of supply, effectiveness, whole life cost, capability, etc.

Framework agreement

Framework agreements are as defined by the EU Utilities Directives. Broadly these are agreements covering terms, prices and, where appropriate, envisaged quantities for contracts to be awarded over a specified time period.

Indirect transaction

A transaction where the Appointee has a contract with a third party and that third party has made use of an associate company of the Appointee to provide that service. In this instance the Appointee does not have a contract with the associate company, but part of the turnover of the associate company is indirectly provided by the Appointee.

Marginal costing

Marginal costing is the additional variable cost of the production of the next unit. Short-run marginal costing merely includes the short-term costs involved in producing the additional unit, whereas long-run marginal costs include the additional costs, including a capital element, involved in producing the next unit.

Market price

The price of a good, service, supply as determined by market-testing.

Market-testing

Market-testing is the process of determining a market price for a particular supply, works or service.

Materiality for disclosure

A contract whose total expected value is the greater of either 0.1% of the Appointee's turnover for the reporting year immediately preceding the date it is awarded, or a contract value of over £100,000.

Transaction

For the purposes of RAG 5.04, a transaction occurs where the Appointee and its associates supply goods, works or services to each other, directly or indirectly via a third party.

Transfer pricing

A transfer price is the price paid by one group company to another for transactions between the two companies.