
**GUIDELINE FOR THE
CONTENTS OF
REGULATORY ACCOUNTS**

**REGULATORY
ACCOUNTING
GUIDELINE 3.06**

**Operative:
Financial Year 2006-07**



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Part One – Explanation Note

1.1 Introduction

- 1.1.1 This regulatory accounting guideline (RAG) covers the Condition F requirements for accounting information, with the exception of the current cost accounting methodology which is covered by regulatory accounting guideline 1 (RAG 1), the classification of expenditure (RAG2) and the activity cost analysis and methodology which is addressed in RAG4.
- 1.1.2 Regulatory accounts should be prepared in accordance with these guidelines for each financial year. Additionally under the information requirements of Condition B of the Licence, companies are required to provide in electronic format audited accounting information for the appointed business as part of the June return reporting requirements each year. Separate guidance is provided for these returns.

1.2 Licence authority

- 1.2.1 Paragraph five of Condition F of the Licence provides for the Director General (replaced by the Water Services Regulation Authority or WSRA from 1 April 2006) to issue guidelines on the segmental analysis of costs and assets. This regulatory accounting guideline contains guidance on paragraph five and on various issues relating to paragraphs four, six and nine of Condition F, where it has been considered helpful to clarify the interpretation of the Licence, or in some instances, to make minor modifications to the requirements arising from the Licence, as listed in Appendix 1.
- 1.2.2 This guideline therefore addresses the following requirements of Condition F:
- the accounting statements of the Appointee (paragraph 4);
 - the activity cost analysis of the Appointed Business (paragraph 5); RAG4 also provides additional details;
 - transactions with associated companies (paragraph 6); and
 - audit and publication of accounting statements (paragraph 9)

1.3 Role of Regulatory Accounting Guidelines

- 1.3.1 Regulatory accounts are the primary source of regular audited financial information about the business regulated by Ofwat. It is intended that the RAGs should take precedence over the accounting standards issued by the Accounting Standards Board in the preparation of regulatory accounts. Where the RAGs do not specifically address an accounting issue, then UK Generally Accepted Accounting Practice (UK GAAP) should be followed.
- 1.3.2 Currently, figures in the historic cost regulatory accounts differ from those in the statutory accounts following, inter alia the adoption of FRS12 (Provisions,

contingent liabilities and contingent assets) and FRS15 (Tangible fixed assets). For the purposes of regulatory accounts, infrastructure renewals accounting will continue and the relevant sections of FRS12 and in FRS15 should be dis-applied.

- 1.3.3 For statutory purposes FRS17 – Retirement benefits and FRS19 – Deferred tax require certain disclosures by way of a note to the accounts. Where a company produces statutory accounts to a 31 March year end, and these are bound within the regulatory accounts in the document, the additional disclosures specified in FRS17 and 19 are not required in the regulatory accounts. Where a company does not produce statutory accounts at 31 March or where it produces them in a separate document, full disclosures under FRS17 and 19 must be made in the regulatory accounts.
- 1.3.4 A full reconciliation between the statutory accounts (whether these are produced using UK GAAP or International Financial Reporting Standards) and the historic cost regulatory accounts should be provided, in the prescribed format, within the regulatory accounts (see appendix 2, pro forma 3).
- 1.3.5 Merger accounting will be retained for regulatory purposes, so as to ensure comparability, and the relevant sections of FRS6 should be dis-applied. Again a full reconciliation between the statutory accounts and the historic cost regulatory accounts should be provided.
- 1.3.6 The RAGs also require certain information, not normally provided under UK GAAP to be prescribed in the notes to the regulatory accounts. This includes, for example, details of the regulatory capital value and disaggregated cost information. Appendix 2 sets out proformas for both the primary financial statements and the supporting notes to the accounts.

1.4 Annual regulatory accounts letter to Regulatory directors

- 1.4.1 A letter to regulatory directors will be issued annually, in March or April. This will detail any amendments to the current version RAG3. New accounting standards issued by the ASB may mean that Ofwat considers a departure from UK GAAP is necessary. When such changes are required these will be detailed in this letter. It will also set out the required format for the auditor's opinion which is required for the regulatory accounts.

Part Two – Definition of terms

Historic cost accounts – profit and loss account

2.1.1	Turnover	All revenue derived from standard charges as defined in Condition B for inclusion in the tariff basket calculation, together with revenue from non-tariff basket charges, revenue grants and other sources as defined below. These definitions also apply, where relevant, to the notes to the accounts.
2.1.2	Measured water supply	All revenue derived from the sale of water at standard rates that are included in the Principal Statement, where all or some of the charges are based on measured quantities of volume. It excludes revenue from large users.
2.1.3	Unmeasured water supply	All revenue derived from the sale of water other than on a measured basis and including optional unmeasured water charges at standard rates for example, for hosepipes and swimming pools.
2.1.4	Measured sewerage services	All revenue derived from the provision of sewerage services at standard rates, (which includes revenue raised by any rateable value element of measured sewerage tariff), where all or some of the charges are based on measured quantities of volume. It excludes revenue from large users. Sewerage services includes sewage treatment and disposal and excludes reception, treatment and disposal of trade effluent.
2.1.5	Unmeasured sewerage services	All revenue derived from the provision of sewerage services at standard rates, (which excludes revenue raised by any rateable value element of measured sewerage tariff), other than on a measured basis.
2.1.6	Trade effluent	All revenue derived from the reception, treatment and disposal of trade effluent at standard rates.
2.1.7	Large user and special agreement	All revenue derived from the sale of water and sewerage services to: <ul style="list-style-type: none"> premises where the premises were supplied in the reporting year with not less than such quantity of water as was specified at the time under section 7(5)(a) of the Water Industry Act 1991. This is specified in the June return reporting requirements for table 23. Include revenue from new licensees; or where the charges are fixed in accordance with agreements with the persons to be charged as is referred to in section 142 (2)(b) of the Water Industry Act 1991, instead of being fixed in accordance with a charges scheme. Revenue from the sale of non-potable water should be included.
2.1.8	Revenue grants	All revenue grants received for the provision of water and sewerage services, split between services.
2.1.9	Rechargeable works	All income received for services (carried out by the appointed business) where the appointee is the monopoly supplier, the cost of which is recovered from any person and recorded as revenue.
2.1.10	Bulk supplies/inter company payments	<ul style="list-style-type: none"> All income received from providing a bulk supply to another water undertaker. Do not include income received from new licensees. All income received from sewerage connection agreements with

		another sewerage undertaker or any other inter-company payments for sewerage services.
2.1.11	Other appointed business (third party)	All other sources of income that are not reported in 2.1.9 and 2.1.10 but are derived from third parties for the provision of water services for which costs are separately disclosed in the activity cost table. Exclude revenue derived from the sale of non-potable water (reported under 2.1.7).
2.1.12	Third party services	Revenue derived from third parties for the provision of water and sewerage services to third parties for which costs are separately disclosed in the activity cost analysis table, split by service.
2.1.13	Other sources	All other sources of turnover including non-tariff basket charges, special agreements (excluding those with large users). Sections 40 and 71 annual deficits, compensation, contributions from developers (of a revenue nature), excluding third parties.
2.1.14	HCA operating costs	HCA operating costs including exceptional items, depreciation and infrastructure renewals charge but excluding extraordinary items. (Both exceptional and extraordinary items are defined below). RAG4 provides a segmental analysis. HCA operating costs should include those items detailed in 2.1.15 – 2.1.28 :
2.1.15	Employment costs	The sum of the total costs of "non-manual and manual manpower" which are directly attributable to each of the individually identified service activities: water resources and treatment, water distribution and water service total. To be included are the gross salaries and wages of all employees within the relevant activity, including payments resulting from bonus and profit-related payment schemes, employer's National Insurance contributions, pension costs, unfunded pension liabilities, sick pay, sickness benefits, private health insurance, retirement awards, death in service benefits, paid leave, subsistence, travel, entertaining and conference expenses.
2.1.16	Power	All energy costs other than energy used for transport.
2.1.17	Agencies	All Section 73 costs of subcontracting sewerage services to local authorities, which are directly attributable to each of the individually identified service activities: water resources and treatment, water distribution and water service total. All other subcontracted water services are included in hired and contracted services.
2.1.18	Hired and contracted services	All hired and contracted services, not capitalised or included in the infrastructure renewals charge. Hired services include the hire of plant, machinery, office and general equipment and transport excluding leased company cars. Contracted services includes all contracted labour, professional advice (such as lawyers, accountants and consultants), purchased (non capitalised) computer software and local authority contracts for the collection of water or sewerage charges. Contracted services do not include services provided by associated companies.
2.1.19	Materials and consumables	All materials and consumables that are not capitalised, included in the infrastructure renewals charge or included in hired and contracted services which are directly attributable to each of the individually identified service activities: Water resources, water treatment, bulk transport, local distribution, customer services and water service total, Sewage reception and conveyance, sewage treatment and Sludge treatment and disposal, customer services and sewerage service total. This category of cost includes equipment (such as small tools and clothing), provisions, tarmac

		and backfill materials, but excludes all items capitalised or included within infrastructure renewals expenditure. Most, if not all stock items fall into this category. This category of cost includes tools, equipment, provisions, clothing, chemicals, petrol, stationery, office equipment, tarmac and backfill materials.
2.1.20	Service charges	Total cost of service charges by the Environment Agency or BWB (British Waterways Board) for water abstraction which are directly attributable to individually identified service activities: water resources and treatment, water distribution and water service total.
2.1.21	Bulk supply imports	Total payments for imported bulk supplies that are directly attributable to individually identified service activities: Water resources and treatment, Water distribution and Water service total.
2.1.22	Other direct costs	Any other operating costs, but excluding interest and taxation, on an aggregated basis, including costs associated with the provision of depots and offices, and insurance premiums, (where such costs exceed 5% of total operating costs, an analysis should be provided), also include fines and penalties, which can be directly attributable to individually identified service activities: water resources and treatment, water distribution and water service total.
2.1.23	General and support expenditure	<p>General and support activities include all centrally provided services, except for any items specifically covered under the individually identified activities. The following services should be included:</p> <ul style="list-style-type: none"> • administrative; • personnel; • financial; • legal and property management; • research and development; • policy determination, implementation and monitoring; • audit; • public and employee relations; • data processing; • planning liaison; • vehicles and plant (including hired vehicles and plant, and leased company cars); • electrical and mechanical maintenance; • land and property maintenance; • materials storage; • operational and technical support; and • general and support buildings. <p>Where an associated company provides such services, the relevant charge should be included.</p>
2.1.24	Rates	General and business rates including cumulo rates for water supply.
2.1.25	Bad and doubtful debts	The charge/credit to the profit and loss account for bad and doubtful debts.
2.1.26	Depreciation	The depreciation charge on tangible fixed assets. The depreciation charge on non-redundant infrastructure assets is taken to be zero when infrastructure renewals accounting is in use.
2.1.27	Intangible assets amortisation	Any amortisation or other reduction in the balance sheet valuation of intangible assets, such as goodwill.

2.1.28	Infrastructure renewals charge	The infrastructure renewals charge is the forecast cost based on an operational assessment of activity needed to maintain the serviceability of the underground infrastructure over a medium to long-term period (typically in excess of 15 years).
2.1.29	Amortisation of grants	The amortisation of deferred credits arising from third party contributions on non-infrastructure assets. These are amortised over the life of the related asset.
2.1.30	Other operating costs	All other operating costs on an aggregated basis including leased company cars and telephone costs but excluding interest and taxation.
2.1.31	Operating income	Profit on sale of fixed assets, other operating income and exceptional items as detailed in 2.1.32 – 2.1.34 :
2.1.32	Profit on sale of fixed assets	Proceeds from the disposal of fixed assets less book value and offsetting costs.
2.1.33	Exceptional items	Exceptional items are defined in FRS 3 (Reporting Financial Performance) as material items derived from events or transactions that fall within the ordinary activities of the company and which need to be disclosed separately by virtue of their size or incidence and which need to be disclosed if the financial statements are to give a true and fair view.
2.1.34	Other operating income	Any operating income that is not profit on sale of fixed assets or exceptional items.
2.1.35	Other income	Includes rental income and income from investments (e.g. share income) but excludes net interest received and profit on disposals on fixed assets.
2.1.36	Net interest	Interest payable including interest paid on loans, leases, debenture, floating rate debt, overdrafts, preference shares and all other borrowings less interest receivable including interest received on cash deposits, loans etc.
2.1.37	Taxation - current	Taxation on ordinary activities for the charging year including any shadow advance corporation tax recoverable, mainstream corporation tax, income and other taxes. FRS16 (Current tax) should be adhered to.
2.1.38	Taxation - deferred	The movement in the deferred tax provision. FRS19 should be adhered to.

2.1.39	Extraordinary items	Extraordinary items are defined in accordance with paragraph 6 of FRS3 as material items possessing a high degree of abnormality which arise from events or transactions that fall outside the ordinary activities-of the reporting entity and which are not expected to recur.
2.1.40	Dividends	Dividends on ordinary shares only. Dividends on preference shares are to be included in net interest.

Historic cost accounts – balance sheet

2.2.1	Tangible fixed assets	Net book value of tangible fixed assets at the end of the charging year less any grants and contributions received relating to capital expenditure on infrastructure assets.
2.2.2	Investments – loan to group company	Loans made to other group companies repayable in more than one year.
2.2.3	Investments – other	Fixed asset investments which are intended to be held for the long term eg shares in other group companies.
2.2.4	Stocks	Consumable stores and work in progress including chemicals, stationery, petrol, backfill materials etc.
2.2.5	Debtors	All amounts owing to the company at the end of the charging year including trade debtors, prepayments, accrued income, amounts owed by group undertakings and amounts falling due after more than one year. This definition <u>excludes</u> any infrastructure renewals prepayments.
2.2.6	Cash	Cash in hand and at bank at the year-end. It does not include overdrafts.
2.2.7	Short term deposits	Investments which are readily convertible into known amounts of cash. This may include deposits made with group companies.
2.2.8	Infrastructure renewals prepayment	Any cumulative excess of IRE over IRC.
2.2.9	Creditors, amounts falling due within one year	All creditors due to be paid within one year. This will comprise trade creditors, overdrafts, infrastructure renewals accrual, borrowings, tax and dividends payable and other creditors. The separate elements to be disclosed are in 2.2.10 – 2.2.16 .
2.2.10	Overdrafts	Bank overdrafts as defined by FRS1.
2.2.11	Infrastructure renewals accrual	Any cumulative excess of IRC over IRE.
2.2.12	Creditors	Trade creditors and any other accruals or creditors due with one year that are <u>not</u> overdrafts, borrowings, IRA, tax creditors or dividend creditors.

2.2.13	Borrowings	Balances due <u>within one year</u> which comprise; <ul style="list-style-type: none"> • obligations under finance leases, • loans due to other group companies, • redeemable debentures, • bonds, • commercial paper, • bills of exchange, • bank loans, • any other borrowings. <p>Accrued interest on borrowings should not be included.</p>
2.2.14	Corporation tax payable	Amounts owed to HMRC in respect of corporation tax. This should exclude deferred tax balances.
2.2.15	Ordinary share dividends payable	Amounts owed in respect of dividends declared on ordinary shares at the year-end. The figure should exclude amounts due on preference shares.
2.2.16	Preference share dividends payable	Amounts owed in respect of dividends due on preference shares at the year-end. The figure should exclude amounts due on ordinary shares.
2.2.17	Creditors, amounts falling due after one year	All creditors due to be paid at dates over one year from the end of the charging year. The separate elements to be disclosed are in 2.2.18 – 2.2.19 .
2.2.18	Borrowing	Balances due <u>after more than one year</u> for debt types listed in 2.2.13 .
2.2.19	Other creditors	Other amounts due after more than one year which are <u>not</u> borrowings or provisions for liabilities and charges. This will include accrued interest and mains deposits.
2.2.20	Provisions for liabilities and charges	All provisions including the deferred taxation provisions and restructuring or reorganisation provisions.
2.2.21	Deferred tax provision	A provision for tax liabilities arising from timing differences between the recognition of gains and losses in the financial statements and their recognition in a tax computation.
2.2.22	Post employment asset/(liabilities)	The net of the fair value of the scheme assets and the present value of the scheme liabilities as defined by FRS17.
2.2.23	Deferred income - grants and contributions	Deferred income in respect of grants and contributions on capital expenditure relating to non-infrastructure assets.
2.2.24	Other provisions	All provisions including restructuring or reorganisation provisions but excluding the deferred tax provisions.
2.2.25	Preference share capital	Nominal value of the preference share capital.
2.2.26	Called up shares	Nominal value of the ordinary shares of the company which are issued and fully paid.

2.2.27	Share premium	Excess of proceeds from share issues over the nominal value of the shares issued, less amounts written off for approved purposes under the Companies Act 1985.
2.2.28	Profit and loss account	Cumulative balance of historical cost profits retained.
2.2.29	Other reserves	All non-distributable reserves, other than called up share capital and share premium including capital redemption reserves, contingency reserves and other capital reserves.

Current cost accounts definitions

Current cost accounts – profit and loss account

Definitions are provided where different from the HCA profit and loss account

2.3.1	Current cost operating costs	Total cost current operating costs including current cost depreciation, infrastructure renewals charges and exceptional charges but excluding extraordinary items.
2.3.2	Current cost operating income	Current cost operating income including current cost profit or loss on disposal of fixed assets and income from exceptional items. Exceptional items are as defined in paragraph 5 of FRS3.
2.3.3	Working capital adjustment	The adjustment for the impact of general inflation on the real value of working capital to the business. See RAG1 sections 1.11.6 and 7 for more details.
2.3.4	Financing adjustment	The real gain or loss arising for the providers of funds from the impact of general inflation on monetary assets and liabilities. See RAG1 sections 1.11.8 and 1.11.12 for detailed calculation guidance.

Current cost accounts – balance sheet

Definitions are provided where different from the HCA balance sheet

2.4.1	Tangible fixed assets	The current cost net book value of tangible fixed assets before third party contributions. This value reflects the asset valuation principles set out in RAG1 Sections 1.7 to 1.10. Assets are included at Modern Equivalent Asset (MEA) values.
2.4.2	Third party contributions	Grants and third party contributions received (since 1990) in respect of infrastructure assets and the balance of deferred income relating to grants and third party contributions for non-infrastructure assets.
2.4.3	Working capital	<p>All current assets and liabilities that relate exclusively to income or expenditure items brought into the calculation of operating profit. This is disaggregated in the regulatory accounts as a notes (see Appendix 2, pro forma 11).;</p> <ul style="list-style-type: none"> • Stocks, • trade debtors, • measured income accrual, • prepayments and other debtors, • trade creditors, • deferred income – customer advance receipts, • capital creditors, • accruals and other creditors. <p>‘Other debtors’ and ‘other creditors’ will include intra-group trading balances.</p> <p>A breakdown of working capital items are to be shown as a note to the accounts. (See Appendix 2, pro forma 11).</p>
2.4.5	Non-trade debtors	Debtors other than those included in working capital and also excluding any infrastructure renewals prepayment .
2.4.6	Non-trade creditors due within one year	<p>Creditor balances due to paid in less than one year from the end of the charging year, excluding;</p> <ul style="list-style-type: none"> • amounts included as working capital, • dividends payable, • tax payable, • borrowings due within one year, • any infrastructure renewals accrual.
2.4.7	Profit and loss account	Cumulative balance of profits retained under current cost accounting.
2.4.8	Current cost reserve	Current cost reserve balance. This will be the opening balance on the current cost reserve at the start of the year adjusted for any AMP and RPI adjustments in respect of fixed assets, working capital, financing, grants and third party contributions.

2.4.9	Other reserves	Non-distributable reserves (other than share capital, current cost reserves and share premium) under current cost accounting rules. It will include capital redemption reserves, contingency reserves and other capital reserves. Amounts attributable to minority interests (if applicable) should also be included in this category.
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Cash flow statements

2.5.1	Net cash flow from operating activities	The net increase or decrease in cash resulting from the operations shown in the profit and loss account in arriving at operating profit.
2.5.2	Returns on investments and servicing of finance	This includes receipts resulting from the ownership of an investment excluding those items classified under operating, investing or financing activities. Cash inflows include interest received, dividends received net of any tax credits and other income received. Cash outflows include interest paid including any associated tax and the interest element of finance lease rentals. The detailed elements are defined below.
2.5.3	Interest received	The amount of interest received by the company in the year. This includes interest on cash balances, loans to other group companies or third parties, and other investments.
2.5.4	Interest paid	The amount of interest paid by the company in the year. This includes interest on any overdrafts, loans (from all sources) and debenture stock.
2.5.5	Interest in finance lease rentals	The interest element on finance leases paid by the company in the year.
2.5.6	Non equity dividends paid	Dividends relating to non-equity shares as defined in paragraph 12 of FRS4 "Capital Investments" (defined as 'financial instruments' classified as liabilities per FRS25).
2.5.7	Taxation paid	All cash flows to or from taxation authorities in respect of the company's revenue and capital profits.
2.5.8	Gross cost of purchase of fixed assets	The gross purchase price of fixed assets paid for by the company before any deduction of grants and contributions.
2.5.9	Receipts of grants and contributions	The total amount of capital grants and other contributions received in respect of fixed assets during the year.
2.5.10	Infrastructure renewals expenditure	Expenditure incurred in maintaining the existing operating capability of infrastructure assets.
2.5.11	Disposal of fixed assets	Cash proceeds from the sale of fixed assets.
2.5.12	Movements on long term group loans	Cash flows relating to the movement in long term loans to group companies.
2.5.13	Net cash flow from investing activities	The sum of the cash flows classified under 2.5.8 – 2.5.12 .
2.5.14	Acquisitions and disposals	The cash flows related to acquisition or disposal of any trade, business or any investment, which becomes or ceases to be either an associate, joint venture or subsidiary undertaking. It is envisaged that

		this heading will be rarely used.
2.5.15	Equity dividends paid	Dividends (ordinary and special) paid relating to equity shares as defined in paragraph 7 of FRS 4 "Capital Instruments" (defined as financial instruments classified as equity for FRS25). This will include any special dividends paid in the year.
2.5.16	Net cash flow from Management of Liquid resources	This is the movement in current asset investments such as short-term deposits or other liquid resources. These are defined as a readily disposable investment is one that is disposable without curtailing or disrupting its business and is either readily convertible into known amounts of cash at or near its carrying amount or traded on an active market.
2.5.17	Net cash flow from financing	Financing cash flows comprise receipts from or repayments to external providers of finance including receipts from the issue of shares, debentures and borrowings and the capital element of finance lease rentals. The detailed elements are defined below.
2.5.18	Capital element in finance lease rentals	The net movement due to; <ul style="list-style-type: none"> • the capital elements in finance lease repayments made in the year, • cash flows arising from the drawing down of finance lease facilities.
2.5.19	New bank loans	The receipts from any loans taken out in the year. These include the proceeds of any loans taken out from other group companies.
2.5.20	Repayment of bank loans	The repayments of any loans repaid in the year. These include any loan repaid to other group companies.
2.5.21	Proceeds from share issues	The net proceeds of any share issues received in the year, less cost of any share buy backs.
2.5.22	Increase / (decrease) in cash and cash equivalents	This comprises of total net cash flows from all sources.

Part Three – Accounting Guideline

3.1 Accounting statements

Condition F requirements

3.1.1 Paragraph 4 of Condition F states that all Appointees shall prepare a profit and loss account, a statement of assets and liabilities and a statement of source and application of funds in respect of each of:

- the appointed business;
- the non - appointed business; and
- the total business of the appointee.

Companies should provide a cashflow statement (Appendix 2 pro-forma 6) to fulfil the requirement for a statement of source and application of funds.

3.1.2 Since the introduction of this condition, statutory accounting requirements have evolved. The primary financial statements, currently required by the Accounting Standards Board (ASB), include a cash flow statement instead of a statement of source and application of funds along with a statement of total recognised gains and losses (STRGL) and a reconciliation of movements in shareholders' funds. For regulatory accounting purposes, the cash flow statement is considered to be an important primary statement, which should be included in the regulatory accounts along with the profit and loss and the balance sheet. A statement of total recognised gains and losses (STRGL) has not previously formed part of the regulatory accounts. However the introduction of FRS 17 – Retirement benefits, means that for most companies, balance sheet movements in a pension scheme liability will not be fully reflected in the profit and loss account. The movement that is not reflected will form part of the STRGL. Pro-forma 18 gives the layout required.

Reconciliation of statutory and regulatory accounts

3.1.3 Companies who are part of groups where the holding company produces IFRS accounts may themselves wish to adopt IFRS at the appointee level. The first column of Pro forma 3 should therefore be annotated to show whether the statutory accounts are prepared under UK GAAP or IFRS. Water companies now include in their regulatory accounts a cash flow statement in place of the source and application of funds statement formally required by Condition F. The cash flow statement is accompanied by reconciliations between operating profit and net cash flow from operating activities and also the movement in cash in the period and the movement in net debt. The cash flow statement should be prepared using the proformas set out in Appendix 2, which have been prepared in accordance with the required structure and minimum level of disclosure set out in FRS 1 (Cashflow statements, revised 1996).

Pro formas

- 3.1.4 The Licence requires that regulatory accounting statements should, as far as is practicably possible, have the same content as the statutory annual accounts of the Appointee prepared under the Companies Act 1985. They should be prepared in accordance with the formats and the accounting policies and principles which apply to those annual accounts.
- 3.1.5 The information in the regulatory accounts should be provided in a common format for all companies. The proformas for the submission of data are included in Appendix 2; they comprise:

	Statement
1	historic cost profit and loss account
2	historic cost balance sheet
3	reconciliation between statutory accounts and regulatory accounts
4	current cost profit and loss account
5	current cost balance sheet
6	cash flow statement
7	analysis of turnover and operating income
8-10	current cost analysis of fixed assets by asset type and service
11	current cost working capital
12	movement on current cost reserve
13	reconciliation of current cost operating profit to net cash flow from operating activities
14	analysis of net debt
15	regulatory capital value
16-17	disaggregated activities
18	STRGL

It is intended that these proformas are consistent with those submitted as part of the June return. However the following proformas do **not** form part of the June returns;

- The reconciliation between statutory accounts and regulatory accounts (pro forma 3),
- The analysis of net debt (pro forma 14), and;
- The regulatory capital values (pro forma 15) are those determined by Ofwat at periodic reviews (which may be subsequently modified due to interim determinations).

The pro forma for the statements of disaggregated activities are included for completeness but are fully described in RAG4. These differ slightly from the equivalent tables in the June return. The June return includes lines for analysis of 'reactive and planned maintenance' – these are not included in the proforma. The proforma includes an analysis of CCA asset values by service activity – these are not included in the June return tables.

- 3.1.6 Ofwat's primary concern is with the current cost accounts. Therefore the analysis of operating profit (incorporating the analysis of operating costs and turnover) and of fixed asset values by asset type and by service should only be prepared on a current cost basis. The regulatory requirement for the analysis of historical cost operating profits and fixed assets will be largely met by the statutory requirements.

Dividend policy

- 3.1.7 Paragraph 6 and Appendix 1A to Condition F requires companies to report on the value of any dividend paid to an associate and provide a comprehensive explanation of the basis of the dividend.

Comparability – accounting treatment of acquisitions

- 3.1.8 Regulatory accounts are used for assessing comparative performance between appointed businesses. So when appointed businesses combine their operations it is necessary for merger accounting to be used for regulatory reporting. This may conflict with the requirements of FRS6 (Acquisitions and mergers) for the preparation of Statutory Accounts. The regulatory accounts should include a note reconciling in full the amounts reported in the Statutory accounts with those reported in the historic cost part of the regulatory accounts.

Transparency

- 3.1.9 Regulatory accounts should aim to be transparent and readily understood by their readers. Accounting policies should be fully and clearly set out. Changes to such policies should be clearly identified.
- 3.1.10 The objectives and constraints considered by Directors when selecting and changing accounting policies are to be stated. The disclosures required under FRS18 (Accounting Policies) for the statutory accounts are also to be made in the regulatory accounts.

Disclosures required in the regulatory accounts

3.1.11 Companies should :

- Include an 'Operating and Financial Review' (OFR),
- Include a note which describes the link between Directors' pay and Standards of Performance (as required by section 50 of the Water Industry Act 2003),
- Provide a statement as to disclosure of information to auditors,
- Include a statement on dividend policy for the appointed business in the notes to the regulatory accounts,
- Include a statement describing the accounting treatment of amounts given to charitable trusts assisting customers or similar funds, in the notes to the regulatory accounts,
- Describe any material changes in the accounting policies and assumptions underpinning the calculation of IRC and CCD, and;
- Include a comprehensive statement on the principles of the cost allocations for the disaggregated activity tables.

Regulatory capital values

3.1.12 Companies are also specifically required to provide additional commentary and explanation of the Regulatory Capital Values as set out in the footnote to the pro forma (see Appendix 2 – proforma 15).

Operating and Financial Review (OFR)

3.1.13 Companies should include an OFR in their regulatory accounts. This replaces the previous commentary requirements for the current year results.

3.1.14 'Reporting Statement: Operating and Financial Review' (ASB January 2006) describes best practice for companies preparing an OFR. This should be followed for regulatory accounting purposes.

3.1.15 The OFR should **additionally** cover the following specific areas;

- Movements in turnover should be described with reference to the allowed price limit and to customer demand,
- Atypical operating expenditure items,
- Significant movements in IRC and CCD,
- Donations to charitable trusts assisting customers or similar funds,
- Dividend payments.

Statement of Director's remuneration and standards of performance

- 3.1.16 The Water Act 2003 introduces a requirement for companies to make a statement to the Water Services Regulation Authority (WSRA) at the end of each financial year, regarding links between director's pay and standards of performance.
- 3.1.17 A statement linking Directors' pay and standards of performance should be disclosed in a separate note to the regulatory accounts.
- 3.1.18 The statement should be provided in conjunction with a note on Directors' Remuneration, which the company must produce even if it is not required to under the Directors Remuneration Report Regulations 2002.
- 3.1.19 The statement should detail any arrangements linking the remuneration of the directors of the company to standards of performance in connection with the carrying out of functions of a relevant undertaker. Any person who has been a director of the company at any time and received remuneration during the financial year should be covered in this statement.
- 3.1.20 The statement should disclose whether or not remuneration has been paid under such an arrangement and if so should comprehensively explain the arrangements, including all information relevant to the users of the regulatory accounts.
- 3.1.21 Remuneration means any form of payment, consideration or other benefit (including pension benefit).
- 3.1.22 Standards of performance include any standards, which are set by condition of the company's appointment, any applicable regulations or any that are set or agreed to by the company. Any new standards coming into force or any that change during the year also need to be covered by the statement.
- 3.1.23 The statement must include in particular;
- a) The date the arrangements were made.
 - b) A description of all the standards of performance in question,
 - c) An explanation of the purpose of linking each particular standard of performance to remuneration,
 - d) A description of the targets set for each standard,
 - e) An explanation of how all the standards of performance are assessed and the source of the data.
 - f) An explanation of;
 - whether targets were achieved or not,
 - how the remuneration was calculated for each standard, and
 - details of the amounts paid to individual directors.

- 3.1.24 Even if no remuneration has been paid under any arrangements in the financial year, the regulatory accounts must still disclose the details of any arrangements in force or any arrangements intended to be in force during the financial year.
- 3.1.25 If only part of a Directors' remuneration is linked to standards of performance, detail must be provided on what the rest of the remuneration is based on.
- 3.1.26 Commentary on future targets should also be provided as well as detail on any changes to previous arrangements such as targets, source of data and calculation method.
- 3.1.27 If no such arrangements are in place an explanatory paragraph should be provided detailing the reasons why it has been decided not to put into place any such arrangement.
- 3.1.28 Ofwat publishes several reports annually, which covers the performance of companies against key measures of customer service, leakage and financial performance. The statement must confirm how the remuneration committee (or Non-Executive directors if appropriate) have considered these reports when assessing the achievement of standards of performance.

Statement as to disclosure of information to auditors

- 3.1.29 The Companies (Audit, Investigations and Community Enterprise) Act 2004 (s234ZA) now includes clauses dealing with the auditor's rights to information.
- 3.1.30 Previous legislation in this area (s389A of the Companies Act 1985) meant that auditors were entitled to require information and explanations for their duties from 'officers' of the company. Whilst it was a criminal offence to provide misleading, false or deceptive information it was not an offence if officers failed to provide any such required information. The revised legislation means it is now a criminal offence to fail to provide this information.
- 3.1.31 The new legislation requires each director to make a statement in the accounts that:
- a) so far as the director is aware, there is no relevant audit information of which the company's auditors are unaware; and
 - b) he has taken all the steps that he ought to have taken as a director in order to make himself aware of any relevant audit information and to establish that the company's auditors are aware of the information.
- 3.1.32 Typically this is included in the Directors report for statutory purposes. Ofwat requires this statement to be made in companies' regulatory accounts.

3.2 Appointed Business

Definitions

- 3.2.1 The Licence separates the activities of an Appointee into:
- the appointed business which is defined to be the regulated activities of the Appointee; and
 - the non-appointed business which is defined to be the non-regulated activities of the Appointee.
- 3.2.2 Regulated activities are defined in Condition A of the Licence to be the “functions of” and the “duties imposed on” a water and sewerage undertaker by the Water Industry Act 1991. Regulated activities are consequently those activities that are **necessary** in order for an Appointee to fulfil the functions and duties of a water and sewerage undertaker.
- 3.2.3 In general, non - regulated activities are activities for which either the water and sewerage undertaker is not a monopoly supplier (for example, the sale of laboratory services to external organisations) or the activity involves the optional use of an asset owned by the Appointed Business (for example, the use of underground assets for cable television).
- 3.2.4 Appendix 3 contains further guidance on the division between appointed and non - appointed activities based on these criteria.
- 3.2.5 Despite these definitions, exceptions will arise to the general rules. (For example, trade effluent treatment is regulated under the Licence but undertakers are not monopoly suppliers of this service.) The consistency and accuracy of the definitions applied will become increasingly important as appointed companies continue to diversify. Appointees are therefore required to detail in the notes to the regulatory accounting information their definition of appointed and non - appointed businesses adopted for the purposes of those accounts. This note should be, as far as is practicably possible, in line with the guidance provided above. Companies should discuss areas of difficulty, in advance of preparing the accounts, with Ofwat.

Materiality considerations

- 3.2.6 Companies may if they wish, only publish financial statements for the Total Business, provided all material non - appointed activities take place in associated companies and consequently the appointed business is effectively the same as the total business. This reflects the use primarily of the current cost accounts of the appointed business when undertaking periodic reviews.

3.2.7 Following this decision therefore, if:

- (a) the total annual income generated (calculated as 'turnover plus 'other operating income' plus 'other income') by all non – appointed activities of an Appointee is less than 1% of the turnover of the appointed business; and
- (b) the historical cost operating profit generated by all non –appointed activities of an Appointee is less than 1% of the historical cost operating profit of the appointed business; and
- (c) the net operating assets, carried in the historical cost balance sheet wholly or principally for non - appointed activities are less than 1% of the net operating assets of the appointed business;

then companies may, if they wish, regard the non – appointed activities as immaterial and the total business of the Appointee as the appointed business.

3.2.8 A low materiality threshold of 1% has been chosen for this purpose since the implicit threshold in the Licence is 0% and because companies should only disregard non – appointed activities if they are genuinely immaterial in the context of the total business of the Appointee. However to reduce the burden in small water only companies, up to £100,000 of non – appointed turnover may also be treated as appointed. This limit will therefore only exceed the 1% threshold for Appointees with a turnover of less than £10m.

3.2.9 Furthermore, if the non–appointed activities of a water only company are material using these criteria but would be immaterial if billing commission were treated as appointed, then such companies may also regard non – appointed activities as immaterial and the total business of the Appointee as the appointed business.

Transfer prices and disposals of land

3.2.10 When a non–appointed activity includes the optional use of an asset owned for an appointed activity, then it is appropriate that both shareholders and customers should benefit. This objective can be achieved in one of two ways.

3.2.11 If the use of an asset for a non-appointed activity involves a disposal of protected land then the requirements of Condition K apply, as described in 'MD' letters. For this purpose, land includes buildings and other structures, land covered by water and any estate, interest, easement, servitude or right in or over land, and the disposal of protected land includes the creation of any interest or right in or over land. Examples of disposals of protected land include permission for cable TV in sewers, the erection of aerials and the granting of fishing rights.

3.2.12 If the use of an asset for a non – appointed activity does not involve a disposal of protected land then an arms length transfer price should be negotiated. This transfer price will appear in the turnover of the appointed business and the costs of the non – appointed business.

3.2.13 RAG 5.04 –Transfer pricing in the Water Industry (Revised March 2000) incorporates the disclosures required in respect of the apportionment and allocation of revenues, costs, assets and liabilities between the appointed business and any other business of the Appointee or between the Appointee and an associated company, as required by paragraph 7 of Condition F. Transactions to be disclosed in the regulatory accounts are set out in Section 3.4 on this guideline.

3.3 Profit Analysis

Analysis of total current cost operating costs

3.3.1 Paragraph 5 of Condition F and the detailed requirements given in RAG4 (The analysis of operating costs and assets) require a segmental analysis of the total current cost operating costs of the appointed business for each of the following:

- water supply:
 - resources and treatment
 - distribution
- sewerage service:
 - sewerage reception and conveyance
 - sewage treatment
 - sludge treatment and disposal

3.3.2 The regulatory requirements in respect of the subjective analysis of operating costs have been incorporated into the proformas in Appendix 2. Condition F sets out the minimum required disclosures. Section 1.2.1 explains that there are differences between the licence requirements and the guidelines in these RAGs. For the corresponding regulatory accounts tables in the June return there have been modifications since the licences were first issued. In order to maintain consistency between the June return tables and the regulatory accounts, the additional items have been listed. The headings of this analysis are as follows:

- Employment costs;
- power;
- rates;
- service charges;
- agencies;
- materials and consumables;
- hired and contracted services;
- bulk supply imports;
- other direct costs;
- general and support expenditure;
- customer services;
- scientific services;
- other business activities;
- doubtful debts;
- current cost depreciation;
- intangible assets depreciation;

- infrastructure renewals charge;
- exceptional items;
- third party services; and
- other operating costs.

Definitions of these headings are included in Part 2 to these guidelines.

Services sub – contracted to Associated Companies

- 3.3.3 If the total cost of all hired and contracted services from associated companies (excluding services that are capitalised or included in the infrastructure renewals charge) exceeds 20% of the total operating costs of the appointed business, before interest and tax, then such costs should be analysed across the headings of the segmental analysis as if the sub-contracted activities were carried out by the Appointee.
- 3.3.4 If the total cost of sub-contracted services falls below this limit then companies may, instead of the above analysis, identify their total cost as a separate and additional line in the segmental analysis of costs described above.
- 3.3.5 Such transactions with associated companies are also subject to the general requirements of paragraph 6 of Condition F and RAG5.04.

Turnover analysis

- 3.3.6 Paragraph 5 of Condition F and the June Return Reporting Requirements also requires an analysis of the turnover of the Appointed Business under the following headings:

tariff basket

- measured water supply;
- unmeasured water supply;
- measured sewerage services;
- unmeasured sewerage services;
- trade effluent;

non-tariff basket

- large user revenues;
- bulk supplies;
- other appointed business;
- third party services;
- revenue grants; and
- all other sources (excluding large users and third parties).

- 3.3.7 This analysis of turnover should only include income from standard charges (as defined in Condition B of the Licence) under each of the five headings corresponding to the tariff basket elements. Non-tariff income should be included in the remaining four categories as appropriate.

- 3.3.8 When 'all other sources' exceeds 5% of turnover this figure should be disaggregated into its major components.
- 3.3.9 All items of income should be stated gross and should not be netted off against items of expenditure.
- 3.3.10 This analysis should not include:

- rental income;
- interest received;
- income from investments; and
- profit from the sale of fixed assets.

However, profit from the sale of fixed assets and exceptional items should be disclosed separately. Rental income and income from investments should be shown, net of any associated expenses as other income after operating profit in the profit and loss account. Interest received should be included in the interest line. The analysis should be by service and include:

- current cost profit/(loss) on disposals of fixed assets;
- exceptional items;
- other operating income; and
- the working capital adjustment.

This analysis should be submitted in the format recommended in Appendix 2 (pro forma 7).

Reconciliation with the Profit and Loss Account

- 3.3.11 The subjective analysis of total operating costs should be combined with the analysis of turnover in order to disclose an analysis of operating profit, split between water and sewerage which can be readily reconciled with the profit and loss account of the appointed business.

This analysis should be submitted in the format recommended in Appendix 2 and RAG4.

3.4 Associated companies

Definitions

- 3.4.1 Condition A of the Licence defines an associated company to be any group company or related company. RAG5.04 updates this definition in accordance with FRS8 (Related party disclosures) and as modified by RD29/97 (Identification of related companies).
- 3.4.2 Paragraph 14 of FRS8 seeks to distinguish between the control and influence of entities. Where Appointees consider that paragraphs 14(a) and 14(b) of FRS8 are applicable they should demonstrate that this is the case. Where entities have

Directors in common and transactions have taken place between these entities as covered in FRS8 paragraph 14(c); Appointees are to be required to have procedures in place to ensure such Directors are unable to influence such transactions.

Transactions to be disclosed

- 3.4.3 Paragraph 6 of Condition F also requires that all transactions between the Appointee and its associated companies must be disclosed, subject to the materiality considerations discussed below. In particular, the Appendix to Condition F specifies that the following transactions, with related data, must be disclosed:
- loans by or to the Appointee;
 - dividends paid to any associated company;
 - guarantees or other forms of security by the Appointee;
 - transfer of any asset or liability by or to the Appointee;
 - supply of any service by or to the Appointee;
 - omission by the Appointee or any associated company to exercise a right as a result of which the value of the net assets of the Appointee is decreased, and
 - waiver of any consideration, remuneration or other payment by the Appointee.
- 3.4.3 The Appendix to Condition F also specifies the information to be disclosed for each of these categories of transactions. Where appropriate, formulae may be disclosed in place of figures, for example for interest rates.
- 3.4.4 Any transactions in the last four categories may be aggregated with any other similar transaction in the same category with the same associated company. This aggregation does not include netting off transactions to the Appointee against transactions by the Appointee or vice versa.
- 3.4.5 If a company is an associated company of an Appointee for only part of a financial year then transactions with that associated company throughout the financial year should be disclosed, unless the Appointee has agreed with the Director that partial disclosure is sufficient.
- 3.4.6 To increase the transparency of inter-company trading RD25/98 was issued on 17 August 1998 (Regulatory Accounting Reporting). All companies should include details in their Regulatory Accounts of services supplied by associate companies to the regulated business and services supplied by the regulated business to other group companies. If a materiality level below which transactions are not disclosed is applied this should be declared.
- 3.4.7 In addition to the transactions identified in Section 3.4.3 above, the following details of inter-company transactions should be provided:
- Where costs have been allocated between regulated and non-regulated businesses the methodology for allocating costs should be described.

- Where dividends have been paid to an associated company the policy underlying the dividend should be commented on.

3.4.8 The following details should be included in the published regulatory accounts:

Service	Company	Turnover Of Associate	Terms Of Supply	Value
Service received by regulated business or service provided by regulated business.	Associate providing the service or associate to whom the service is provided.		A statement of the means by which the price to associates has been established eg competitive tendering.	Of service received by regulated business or service supplied by regulated business.

Directors' statement

3.4.9 The disclosure of transactions with associated companies should include a statement that to the best of the directors' knowledge, all appropriate transactions with associated companies have been disclosed. Nil returns are also required.

Transfer prices

3.4.10 All transactions between the Appointee and associated companies should be considered on an arm's length basis and follow the guidance provided in RAG5.04.

Diversification and protection of core business

3.4.11 Condition F6A requires companies to submit at the same time as the regulatory accounting information, a certificate from the directors stating that the company will have available to it sufficient financial resources and facilities to enable it to carry out, for at least twelve months, its regulated activities and sufficient management resources to enable it to carry out its functions.

For some companies, Condition F6A has been extended. In addition to the requirements outlined above, these companies are required to:

- Confirm that in the opinion of the directors all contracts entered into with any associated company include all necessary provisions and requirements concerning the standard of service to the company, to ensure that it is able to meet all its obligations as a water and sewerage undertaker.

- Submit with each certificate a statement of the main factors which the directors have taken into account in giving that certificate.
- Provide a report prepared by the companies' auditors and addressed to the WSRA, stating whether they are aware of any inconsistencies between the certificate and the financial statements or any information obtained in the course of their work.

3.4.12 If the period to which the statement relates straddles the period when the WSRA is entitled to issue an interim determination notice, the opinion of the directors should in no way be compromised.

3.4.13 This certificate should be submitted to the WSRA as part of the published regulatory accounting information.

3.5 Publication of accounting statements

Reports to be delivered

3.5.1 Accounting information can be sub-divided as follows:

- statutory information which is not required by Condition F (for example, emoluments of directors);
- statutory information which is also required by Condition F (for example, profit and loss account of the Appointee);
- non-statutory information which is required to be published by Condition F (for example, segmental analysis of operating costs), together with an auditors report on this information.
- non-statutory information which is required by Condition F but is not required to be published, together with a report from the auditors on this information. This generally covered by the requirements of RAG5.04.

3.5.2 Appointees with a UK holding company (whether this is an ultimate holding company or an intermediate holding company as part of an overseas group of companies) should submit the following documents to the Director:

- Ultimate UK holding company accounts;
- Appointee accounts which should also be circulated on request, to customers of the Appointee and shareholders of the ultimate holding company; and
- A supplementary report containing the unpublished information which will be treated as commercial in confidence.

- 3.5.3 Appointees without a holding company should submit the following documents to the Director:
- Appointee accounts which should also be circulated on request to customers; and
 - A supplementary report containing the unpublished information which will be treated as commercial in confidence.
- 3.5.4 It should be noted that where a company has a statutory year end of 31 March the regulatory accounts of the Appointee should always include the full statutory accounts of the Appointee.
- 3.5.5 It is recommended that water bill notifications, and where appropriate holding company accounts, make reference to the availability, upon request, of the Appointee accounts.
- 3.5.6 A checklist of the statements and reports required under Condition F is contained in Appendix 4.
- 3.5.7 Paragraph 9.3 of Condition F requires that the Appointee shall deliver to the WSRA a copy of the accounting statements and auditors reports prepared under Condition F as soon as reasonably practicable and in any event not later than 15 July following the end of the financial year to which they relate. Appointees should deliver five copies of each of these statements and reports.
- 3.5.8 Where a company has a 31 March statutory year end and publishes its statutory and regulatory accounts in one document, then it may refer in the regulatory accounts to any relevant information provided as part of the statutory accounts. If however, the company has a different statutory year end or produces separate regulatory accounts then it must include all commentary in the regulatory accounts.

Reports to be published on websites

- 3.5.9 Companies are required to publish their regulatory accounts on their websites at the same time as they are submitted to the WSRA.

Reports to be published

- 3.5.10 Paragraph 9.4 of Condition F requires that all of the accounting statements and reports delivered to the Director shall also be published, with the exception of:
- details of transactions (other than the summary outline in section 3.4.8 above) with associated companies referred to in paragraph 6; and
 - details of the allocation and apportionment of assets and costs.
- 3.5.11 The published accounts should also contain a statement as to whether the Appointee was in compliance with paragraph 3.1 of Condition K at the end of the financial year.

3.5.12 All material required to be published by Condition F will be placed in the Ofwat library. Other material will be held within the office on a commercial-in-confidence basis.

3.6 Audit

Auditors reports

3.6.1 Paragraph 9 of Condition F requires auditors to address reports to WSRA concerning:

accounting records;
accounting statements;
historical cost accounts;
current cost accounts; and
trading with associates (see RAG 5.04)

3.6.2 Regulatory accounting information falls into two categories – that which is required to be published and that which is not required to be published – as discussed above. It is therefore convenient for auditors to prepare two reports to WSRA – one relating to the published accounts and the other to the information that is not required to be published.

3.6.3 These reports are in addition to the statutory report of the auditors to the shareholders.

Report on published accounts

3.6.4 The required wording of the auditors opinion to the WSRA on the published accounts will be set out in our annual letter to Regulatory Directors on 'Regulatory Accounting Guideline 3' which we will issue in March or April.

Report on unpublished information

3.6.5 The arrangements for the provision of the report from the auditors to the WSRA on the accounting information which is not required to be published is covered in RAG5.04.

Auditors details

3.6.6 The WSRA should be informed by the company of any change in the company's auditors and the following details provided:

- the name and address of the new auditors;
- the name of the partner responsible for the audit;
- the name, address, telephone number and e-mail address of the principal contact; and
- the date on which the auditors were appointed.

Further information required from auditors

- 3.6.7 The WSRA also requires a statement confirming that the contract of appointment with the auditors satisfies the requirements of paragraph 9.2 of Condition F namely "that the auditors will provide such further explanation or clarification of their reports, and such further information in respect of the matters which are the subject of their reports, as the Director [WSRA] may reasonably require."

APPENDIX 1 Clarification of licence condition F

Section Condition	Issue	Licence
3.1	Accounting statements	F4.1
3.1.2/3	Cash flow statement	F4.1
3.1.4	Pro formas	F4.2
3.3.2	- Analysis of total operating costs - payment to EA for discharge consents - intangible assets written down - infrastructure renewals expenditure and - infrastructure renewals accrual - segmental analysis for associated companies	F5.1(1)
3.3.8	Disaggregation of "all other sources" of turnover	F5.1(2)
3.4.1 to 5	Definition of associated companies.	A3
3.4.11	Licence amendment regarding diversification and protection of the core business	F6A.2

APPENDIX 2 Pro-forma regulatory accounts

Notes used in this appendix;

I: Input

C: Calculation

(a): note required; see separate table for further analysis

(b): note required only if regulatory accounts are not bound with statutory accounts or if the amount reported is different to the statutory accounts

Pro forma 1

**Historic Cost Profit and Loss Account
for the Twelve Months ended 31 March 20XX**

	Note	Current Year			Prior Year		
		Appointed	Non Appointed	Total	Appointed	Non Appointed	Total
Turnover	(a)	I	I	C	I	I	C
Operating costs		I	I	C	I	I	C
Historical cost depreciation		I	I	C	I	I	C
Operating income		I	I	C	I	I	C
Operating profit		C	C	C	C	C	C
Other income		I	I	C	I	I	C
Net Interest		I	I	C	I	I	C
Profit on ordinary activities before taxation		C	C	C	C	C	C
Taxation - current	(b)	I	I	C	I	I	C
- deferred		I	I	C	I	I	C
Profit on ordinary activities after taxation		C	C	C	C	C	C
Extraordinary items	(b)	I	I	C	I	I	C
Profit for the year		C	C	C	C	C	C
Dividends		I	I	C	I	I	C
Retained profit for year		C	C	C	C	C	C

Pro forma 2

Historic Cost Balance Sheet as at 31 March 20XX

	Current Year			Prior Year			
	Note	Appointed	Non Appointed	Total	Appointed	Non Appointed	Total
Fixed Assets							
Tangible Assets	(b)	I	I	C	I	I	C
Investments							
- loan to group company		I		C	I		C
- other		I		C	I		C
Total fixed assets		C	C	C	C	C	C
Current Assets							
Stocks		I	I	C	I	I	C
Debtors	(b)	I	I	C	I	I	C
Cash		I	I	C	I	I	C
Short term deposits		I	I	C	I	I	C
Infrastructure renewals prepayment		I		C	I		C
Total current assets		C	C	C	C	C	C
Creditors: amounts falling due within one year							
Overdrafts		I	I	C	I	I	C
Infrastructure renewals accrual		I		C	I		C
Creditors		I	I	C	I	I	C
Borrowings		I	I	C	I	I	C
Corporation tax payable		I	I	C	I	I	C
Ordinary share dividends payable		I	I	C	I	I	C
Preference share dividends payable		I	I	C	I	I	C
Total creditors		C	C	C	C	C	C
Net current assets		C	C	C	C	C	C
Total assets less current liabilities		C	C	C	C	C	C
Creditors: amounts falling due after one year							
Borrowing		I	I	C	I	I	C
Other creditors		I	I	C	I	I	C
Total creditors		C	C	C	C	C	C
Provisions for liabilities and charges							
Deferred tax provision	(b)	I	I	C	I	I	C
Deferred income – grants and contributions		I		C	I		C
Post employment asset/(liabilities)		I		C	I		C
Other provisions		I		C	I		C
Preference share capital		I	I	C	I	I	C
Net Assets employed		C	C	C	C	C	C
Capital and reserves							
Called up share capital		I		C	I		C
Share premium		I		C	I		C
Profit & loss account		I	I	C	I	I	C
Other reserves	(b)	I	I	C	I	I	C
Capital & reserves		C	C	C	C	C	C

Pro forma 3

Reconciliation between statutory accounts and regulatory accounts

£m	Statutory UK GAAP / IFRS*		Regulatory	
<u>Profit and loss account</u>				
Operating profit				<explanation of difference>
Profit before tax				
<u>Balance sheet</u>				
Tangible fixed assets (net book value)				<explanation of difference>
Debtors				<explanation of difference>
Deferred income – grants and contributions	n/a			<explanation of difference>

* delete as applicable

Pro forma 4

**Current Cost Profit and Loss Account
for Appointed Business year ended 31 March 20XX**

		Current Year	Prior Year
Turnover	Note (a)		
Current cost operating costs	(a)		
Operating income	(a)		
Working capital adjustment	(a)		
Current cost operating profit		C	C
Other income			
Net Interest			
Financing adjustment			
Current cost profit before taxation		C	C
Taxation - Deferred	(b)		
- Current	(b)		
Current cost profit on ordinary activities		C	C
Extraordinary items	(b)		
Current cost profit attributable to shareholders		C	C
Dividends	(b)		
Current cost profit retained		C	C

Pro forma 5**Current Cost Balance Sheet for Appointed Business as at 31 March 20XX**

	Note	Current Year	Prior Year
Fixed Assets			
Tangible assets	(a)	I	I
Third party contributions since 1989-90		I	I
		C	C
Working capital	(a)	I	I
Cash		I	I
Short term deposits		I	I
Overdrafts		I	I
Infrastructure renewals prepayment / (accrual)		I	I
Net operating assets		C	C
Non operating assets and liabilities			
Borrowings		I	I
Non-trade debtors		I	I
Non-trade creditors due within one year		I	I
Investment - loan to group company		I	I
Investments – other		I	I
Corporation tax payable		I	I
Ordinary share dividends payable		I	I
Preference share dividends payable		I	I
Total non operating assets and liabilities		C	C
Creditors: amounts falling due after more than one year			
Borrowings		I	I
Other creditors		I	I
Total creditors falling due after more than one year		C	C
Provisions for liabilities and charges			
Deferred tax provision		I	I
Post employment asset/(liabilities)		I	I
Other provisions		I	I
Total provisions		C	C
Preference share capital		I	I
Net assets		C	C
Capital and reserves			
Called up share capital		I	I
Share premium		I	I
Profit and loss account		I	I
Current cost reserve	(a)	I	I
Other reserves		I	I
Total capital & reserves		C	C

Pro forma 6**Current Cost Cash Flow Statement for Twelve Months Ended 31 March 20XX**

	Current Year			Prior Year		
	Appointed	Non Appointed	Total	Appointed	Non Appointed	Total
Net cash flow from operating activities	(a)		C			C
Returns on investments & servicing of finance						
Interest received			C			C
Interest paid			C			C
Interest in finance lease rentals			C			C
Non-equity dividends paid			C			C
Net cashflow from returns on investment & servicing of finance	C	C	C	C	C	C
Taxation paid			C			C
Capital expenditure and financial investment						
Gross cost of purchase of fixed assets			C			C
Receipt of grants and contributions			C			C
Infrastructure renewals expenditure			C			C
Disposal of fixed assets			C			C
Movements on long term group loans to group companies			C			C
Net cash outflow from investing activities	C	C	C	C	C	C
Acquisitions and disposals			C			C
Equity dividends paid			C			C
Management of liquid resources						
Net cash flow from management of liquid resources			C			C
Net Cash flow before financing	C	C	C	C	C	C
Financing						
Capital element in finance lease rentals			C			C
New bank loans			C			C
Repayment of bank loans			C			C
Proceeds from share issues			C			C
Net cash inflow from financing	C	C	C	C	C	C
Increase/(decrease) in cash	C	C	C	C	C	C

Pro forma 7**Analysis of Turnover and Operating Income for the Appointed Business**

	Current Year			Prior Year		
	Water Services	Sewerage Services	Appointed Business	Water Services	Sewerage Services	Appointed Business
Turnover						
Unmeasured	I	I	C	I	I	C
Measured	I	I	C	I	I	C
Trade effluent	I	I	C	I	I	C
Large user and special agreement	I	I	C	I	I	C
Revenue grants	I	I	C	I	I	C
Non-potable large user and special agreement	I	I	C	I	I	C
Rechargeable works	I	I	C	I	I	C
Bulk supplies/inter company payments	I	I	C	I	I	C
Other appointed business (third party)	I	I	C	I	I	C
Third party services (excl non-potable water)	C	C	C	C	C	C
Other sources	I	I	C	I	I	C
Total turnover	C	C	C	C	C	C
Operating income						
Current cost profit or loss on disposal of fixed assets	I	I	C	I	I	C
Exceptional items	I	I	C	I	I	C
Other operating income	I	I	C	I	I	C
Total operating income	C	C	C	C	C	C
Working capital adjustment	I	I	C	I	I	C

Pro forma 8

Current Cost Analysis of Fixed Assets by Asset Type

Water Services

	Specialised Operational Assets	Non-Specialised Operational Properties	Infrastructure Assets	Other Tangible Assets	Total
Gross replacement cost					
At 1 April 20XX					C
AMP adjustment					C
RPI adjustment					C
Disposal					C
Additions					C
At 31 March 20XX	C	C	C	C	C
Depreciation					
At 1 April 20XX					C
AMP adjustment					C
RPI adjustment					C
Disposals					C
Charge for year					C
At 31 March 20XX	C	C	C	C	C
Net book amount at 31 March 20XX	C	C	C	C	C
Net book amount at 1 April 20XX	C	C	C	C	C

Pro forma 9

Current Cost Analysis of Fixed Assets by Asset Type

Sewerage Services

	Specialised Operational Assets	Non-Specialised Operational Properties	Infrastructure Assets	Other Tangible Assets	Total
Gross replacement cost					
At 1 April 20XX					C
AMP adjustment					C
RPI adjustment					C
Disposal					C
Additions					C
At 31 March 20XX	C	C	C	C	C
Depreciation					
At 1 April 20XX					C
AMP adjustment					C
RPI adjustment					C
Disposals					C
Charge for year					C
At 31 March 20XX	C	C	C	C	C
Net book amount at 31 March 20XX	C	C	C	C	C
Net book amount at 1 April 20XX	C	C	C	C	C

Pro forma 10

Current Cost Analysis of Fixed Assets by Asset Type

Total Services	Specialised Operational Assets	Non-Specialised Operational Properties	Infrastructure Assets	Other Tangible Assets	Total
Gross replacement cost					
At 1 April 20XX					C
AMP adjustment					C
RPI adjustment					C
Disposal					C
Additions					C
At 31 March 20XX	C	C	C	C	C
Depreciation					
At 1 April 20XX					C
AMP adjustment					C
RPI adjustment					C
Disposals					C
Charge for year					C
At 31 March 20XX	C	C	C	C	C
Net book amount at 31 March 20XX	C	C	C	C	C
Net book amount at 1 April 20XX	C	C	C	C	C

Pro forma 11

Working Capital (Current cost)

	Current Year	Prior Year
Stocks		
Trade debtors - measured household		
- unmeasured household		
- measured non-household		
- unmeasured non-household		
- other		
Measured income accrual		
Prepayments and other debtors		
Trade creditors		
Deferred income – customer advance receipts		
Capital creditors		
Accruals and other creditors		
Total working capital	C	C

Pro forma 12

Movement on Current Cost Reserve

	Current Year	Prior Year
Balance at 1 April 20XX		
AMP adjustment		
RPI adjustments:		
Fixed assets		
Working capital		
Financing		
Grants and third party contributions		
Balance at 31 March 20XX	C	C

Pro forma 13

**Reconciliation of Current cost operating profit
to net cash flow from operating activities**

	Current Year	Prior Year
Current cost operating profit		
Working capital adjustment		
Increase in working capital		
Receipts from other income		
Current cost depreciation		
Current cost profit on sale of fixed assets		
Infrastructure renewals charge		
Movement in provisions		
Net cash flow from operating activities	C	C

Pro forma 14

Net Debt Analysis

Interest rate risk profile

	Fixed rate	Floating rate	Index linked	Total
--	------------	---------------	--------------	-------

Maturity profile

Less than one year	I	I	I	C
Between one and two years	I	I	I	C
Between two and five years	I	I	I	C
Between five and twenty years	I	I	I	C
In more than twenty years	I	I	I	C

Borrowings (excluding preference shares)	C	C	C	C
--	---	---	---	---

Preference share capital				I
--------------------------	--	--	--	---

Total Borrowings				C
------------------	--	--	--	---

Cash				I
------	--	--	--	---

Short term deposits				I
---------------------	--	--	--	---

Net Debt				C
----------	--	--	--	---

Pro forma 15

Regulatory Capital Value (RCV)

	Current Year
Opening RCV	I
Capital expenditure (excluding IRE)	I
Infrastructure renewals expenditure	I
Infrastructure renewals charge	I
Grants and contributions	I
Depreciation	I
Outperformance of regulatory assumptions	I
Other adjustments	I
Closing RCV	C
Average year RCV	I

A note is required for this table to explain that;

- it shows the RCV used in setting the price limits for the period [2005-10],
- the differences from the actual capital expenditure and depreciation etc will not affect price limits in the current period,
- Capital efficiencies will be taken into account in the calculation for the next periodic review in 2009.

Companies may also explain items which may be logged up and items of discretionary expenditure for possible inclusion in the RCV in future. The commentary should note that these items will required agreement with Ofwat prior to the next price setting period.

Where 'other adjustments' has been populated (usually arising as a result of an interim determination), then a comment should be included stating when the determination took place and that the net effect on the RCV is represented by this amount.

Proforma 16

Published activity cost table – water and sewerage companies

	Water Supply			Sewerage Services			
	Resource & treatment	Distribution	Water Supply Subtotal	Sewerage	Sewage Treatment	Sludge Treatment & Disposal	Sewerage service total
Direct Costs							
Employment costs			C				C
Power			C				C
Agencies			C				C
Hired and contracted services			C				C
Associated companies			C				C
Materials and consumables			C				C
Service charges			C				C
Bulk supply imports			C				C
Other direct costs			C				C
Total Direct Costs	C	C	C	C	C	C	C
General & support expenditure			C				C
Total Functional Expenditure	C	C	C	C	C	C	C
Business activities							
Customer services							
Scientific services							
Other business activities							
Business activities sub-total			C				C
Local authority rates							
Doubtful debts							
Exceptional items							
Total opex less third party services			C				C
Third party services – opex							
Total operating expenditure			C				C
Capital maintenance							
Infrastructure renewals charge			C				C
Current cost depreciation							
- service activities			C				C
- business activities							
Amortisation of grants							
Amortisation of intangible assets							
Capital maintenance (excluding third party services) sub-total			C				C
Third party services							
- current cost depreciation							
- infrastructure renewals charge							
Total Capital maintenance			C				C
Total Operating Costs			C				C
CCA (MEA) Values							
Service Activities			C				C
Business Activities							
Service Totals			C				C
Services for the Third Parties							
Total			C				C

Proforma 17

Published activity cost table – water only companies

	Water Supply		
	Resource & treatment	Distribution	Water Supply Subtotal
Direct Costs			
Employment costs			
Power			C
Agencies			C
Hired and contracted services			C
Associated companies			C
Materials and consumables			C
Service charges			C
Bulk supply imports			C
Other direct costs			C
Total Direct Costs	C	C	C
General & support expenditure			C
Total Functional Expenditure	C	C	C
Business activities			
Customer services			
Scientific services			
Other business activities			
Business activities sub-total			C
Local authority rates			
Doubtful debts			
Exceptional items			
Total opex less third party services			C
Third party services – opex			
Total operating expenditure			C
Capital maintenance			
Infrastructure renewals charge			C
Current cost depreciation			
- service activities			C
- business activities			
Amortisation of grants			
Amortisation of intangible assets			
Capital maintenance (excluding third party services) sub-total			C
Third party services			
- current cost depreciation			
- infrastructure renewals charge			
Total Capital maintenance			C
Total Operating Costs			C
CCA (MEA) Values			
Service Activities			C
Business Activities			
Service Totals			C
Services for the Third Parties			
Total			C

Pro forma 18

Statement of total recognised gains and losses (historical cost accounting) for Appointed Business year ended 31 March 20XX

		Current Year	Prior Year
Profit for the year	Note (a)	I	I
Actuarial gains/(losses) on post employment plans	(a)	I	I
Other gains and losses	(a)	I	I
Total recognised gains and losses for the year	(a)	C	C

APPENDIX 3 Appointed versus non appointed activities

The lists of appointed and non - appointed activities in this Appendix are based on the criteria discussed in paragraph 3.2. **These lists are for guidance and are not intended to be exhaustive.** Companies are encouraged to discuss borderline cases with Ofwat.

Appointed activities

- water supply (potable and non-potable*, including bulk supplies and secondary supplies, large user customers and Water Supply Licensing licensees)
- sewerage
- sewage treatment and disposal (including imported sewerage and sludge)
- management and holding of protected land
- conservation
- rechargeable work for which Appointee **is a monopoly supplier***, this may include, but is not restricted to, the following;
 - fluoridation
 - fire hydrant maintenance
 - mains diversions
 - recharges for repairs to contractors
- recreation and amenity uses of those waters and lands which the Appointee employs for the purposes of water supply, in order to comply with the Water Act 1989, this may include, but is not restricted to, the following;
 - rambling
 - forestry

Non-appointed activities

Activities where the appointee's resources or assets are used to provide services to external parties which are not part of their normal duties to provide water and sewerage services to customers.

- sale of non water and sewerage services, e.g.
 - billing commission
 - meter reading commission
 - insurance commission
 - electricity generation
 - stores sales
 - laboratory services
 - consultancy
 - IT
 - transport and garage services

- property searches
- rental income from non-appointed land and buildings
- rechargeable work for which Appointee **is not monopoly supplier***
- the haulage of tankered waste (domestic and non-domestic)
- recreation and amenity uses of non appointed assets which the Appointee employs for the purpose of water supply (typically land and waters), beyond the duties imposed by the Water Act 1989, e.g.
 - water skiing
 - restaurants.

* These activities are defined as “Third party services” for the purposes of disaggregating revenue and operating costs in the Regulatory accounts.

Rental income

Note that the receipt of rental income from protected land will generally involve the disposal of an interest of right over the land and will therefore be subject to the requirements of Condition K as described in MD letters.

Classifying non-appointed activities

When determining whether activities should be classified as appointed or non-appointed business we would consider the following factors;

1. Whether the assets used in providing the activity sit within the appointed or non-appointed business.
2. How has the activity has been traditionally been classified?
3. Would reclassifying an activity add to the costs of the appointed business, e.g. need for enhanced cost allocation procedures, monitoring costs etc?
4. What classification will ensure the most efficient delivery, consistent with other duties?
5. How do the majority of companies classify the activity?
6. The reasons for reclassification.

Where companies classify activities as non-appointed and these workstreams make use of appointed assets, then either;

- a) these assets need to be removed from the RCV, if possible, or
- b) if not, there needs to be an appropriate charge from the appointed business to the non-appointed business for the use of these assets.

APPENDIX 4 checklist of condition F requirements

This appendix summarises the reports and statements to be included in the regulatory accounts, by reference to paragraph numbers in Condition F and including any subsequent modifications to the Licence requirements.

Paragraph 4: Accounting statements

Reports:

- HC Profit and Loss Account
- HC Balance Sheet
- CCA Profit and Loss Account
- CCA Balance Sheet and
- CCA Cash Flow Statement,
for each of the Appointed Business, the Non appointed Business and the total business of the Appointee subject to the materiality criteria.
- Notes to these accounts

Paragraph 5: Segmental information

Analysis of:

- turnover, operating income and working capital adjustment of the Appointed Business;- current cost operating costs of the Appointed Business split between water resources and treatment and distribution for water supply, sewage, sewage treatment, sludge treatment and disposal for sewerage services.

Paragraphs 6 & 6A: Transactions with Associated Companies & Ring Fencing (note RAG 5.04 – part 2 provides more details)

- statement of compliance with condition F and RAG 5.04
- details of transactions between the appointee and associated companies and between the Appointed and Non appointed Businesses of the Appointee
- statement that to the best of the directors' knowledge, all appropriate transactions with associated companies have been disclosed.
- details of procedures used to award contracts to associates.
- directors' certificate regarding diversification and protection of the core business.
- declaration by Directors and Senior Managers of interests in associates.

Paragraph 7: Basis of allocations and apportionment

- description of the basis of allocation and apportionment of costs and assets between the Appointee and its associated companies and between the Appointed and the Non appointed Businesses of the Appointee.
- Further details are also given in RAG4.

Paragraph 8: Current cost accounts

- CC Profit and Loss Account,
- CC Balance Sheet,
- CC Cash Flow Statement,
- analysis of fixed assets by asset type within service,
- calculation of AMP adjustment where appropriate,
- statement of accounting policies,
- working capital note and
- movement on current cost reserves note,
- infrastructure renewals account reconciliation,
- analysis of net debt.

Paragraph 9: Audit reports

- report on published accounts
- report on non - published information

APPENDIX 5 Regulatory accounts – pro forma 3 example disclosure

Reconciliation between Statutory Accounts and Regulatory accounts

£m	Statutory UK GAAP	Regulatory	
<u>Profit and loss account</u>			
Operating profit	258.3	256.3	In the statutory accounts the company classifies rental income of £2.0m as operating income. Ofwat accounting guidelines state that this should be classified as 'other income' ie below the operating profit line. Profit before tax is unaffected by this re-classification.
Profit before tax	150.2	150.2	
<u>Balance sheet</u>			
Tangible fixed assets (net book value)	3,562.9	3,565.8	In the statutory accounts the company adopts infrastructure accounting as set out in FRS 15. Ofwat requests that , for regulatory accounting purposes, FRS15 is <u>not</u> applied for infrastructure renewals accounting. The infrastructure renewals accrual of £2.9m is therefore excluded from the fixed asset net book value.
Infrastructure renewals accrual	n/a	(2.9)	
Debtors	362.1	262.1	In the statutory accounts a long term group debtor of £100.0m is disclosed within debtors due after more than one year. Ofwat accounting guidelines state that this should be classified as an investment.
Investments – loan to group company	n/a	100.0	
Deferred income - grants and contributions	n/a	(39.3)	In the statutory accounts deferred income relating to grants and contributions of £39.3m is classified as; - Creditors due within one year £10.8m - Creditors due after more than one year £28.5m

APPENDIX 6 RD 07/93 - The long range normative charge for infrastructure renewals

RD7/93

9 June 1993

**TO REGULATORY DIRECTORS OF ALL
WATER AND SEWERAGE COMPANIES
AND WATER ONLY COMPANIES**

Dear Regulatory Director

THE LONG RANGE NORMATIVE CHARGE FOR INFRASTRUCTURE RENEWALS

- 1** The Accounting for AMP 2 Technical Group has been working over the past eighteen months on several accounting issues emerging from the AMP 2 process. These have included, inter alia, a detailed review of the infrastructure renewals charges currently being charged by companies in their current cost regulatory accounts and the identification of factors causing the significant variations which have been observed across the industry. This letter deals with one of these issues, the charge to the profit and loss account for the maintenance of infrastructure assets.
- 2** When the infrastructure renewals charge - or more appropriately, the 'long range normative charge' ('LRNC') for infrastructure renewals - was initially derived, there was a lack of consolidated guidance on the most appropriate basis of calculation. This was the case both for the derivation of the charge from the underlying information on maintenance costs in companies' underground asset management plans, and for the subsequent adjustment to the annual charge.
- 3** Attached to this letter is draft guidance on the LRNC, which revisits the theory of infrastructure renewals accounting and its applicability to the water industry. The paper also addresses the practical implications for measuring the LRNC and identifies factors for companies to take into account in the AMP 2 calculations.

- 4** The paper covers a number of issues which are central to the determination of the provision for asset maintenance in the Strategic Business Plan, and the reflection of these costs in price limits and in accounts. These issues include:
- the presumption that the infrastructure renewals charge should be broadly constant in real terms between reviews;
 - the distinction between the provision for backlog - required to bring assets up to steady state - and the long range normative charge;
 - the coverage of the charge, and its relationship to other items in the AMP;
 - the period over which the long range normative charge should be assessed;
 - the basis of indexing the charge to reflect changes in prices; and
 - the importance for establishing consistency in approach between companies.
- 5** The issues discussed in the paper will need to be addressed by all companies in the preparation of their Strategic Business Plans. It is important that the basis of the figures in the AMP 2 is consistent, and that there is a clear link between the expenditure profiles for asset maintenance included in the AMP 2 and the subsequent charge to the profit and loss account. Because of the importance of this link, there is a role for both engineering certifiers and auditors in reviewing the figures included in the Strategic Business Plan. We propose to discuss the paper with certifiers and auditors at a seminar to be organised later in the summer, and I should be grateful if you would send a copy of this letter and attachment to your certifier and auditor.
- 6** One issue which remains to be considered is the coverage of the infrastructure renewals charge in the accounts, in particular the treatment of reactive maintenance costs. Clearly AMP2 will need to include an estimate of these costs, and it is conceptually part of the long range normative charge. But it is currently not included in the infrastructure renewals charge in the accounts. RD2/93 sought comments from companies on whether, in future, reactive maintenance should be included within the infrastructure renewals charge. These comments are being considered further in the Accounting for AMP 2 Technical Group and in the Working Group on Accounting Issues for Regulation ('WGAR'). Companies will have an opportunity to comment separately on any proposals to modify Regulatory Accounting Guideline ('RAG')2.
- 7** Subject to any comments which you may have on the current paper, we intend that it should be issued formally as an Appendix to the Strategic Business Plan Manual, and also incorporated into a revised RAG 2.
- 8** Comments on the paper should be sent to me by 30 July 1993. If you have any specific queries on the content of this letter, please contact Liz Hamilton on 021 625 1353.

9 I am copying this letter to Janet Langdon (WSA), Michael Swallow (WCA), Neil Summerton (DOE) and Alwyn Jones (Welsh Office).

Yours sincerely

C W Bolt
Head of Economic Regulation

**OFFICE OF WATER SERVICES
THE LONG RANGE NORMATIVE CHARGE FOR INFRASTRUCTURE RENEWALS**

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1. What is the long range normative charge?

The Long Range Normative Charge ('LRNC') is generally referred to throughout the industry, and in the Regulatory Accounting Guidelines, as the Infrastructure Renewals Charge. Describing it as the LRNC has two advantages - it avoids the common confusion with Infrastructure Charges, and also contains a reminder of the need to look some way ahead when determining it.

Put simply, the LRNC is the amount that must be charged to the Profit & Loss Account, each year that is sufficient to keep the entire system of infrastructure assets operating at the required level of effectiveness and therefore at the same level of value to the business as previously.

One consequence is that, to achieve this result, the annual charge to the Profit and Loss Account will also remain unchanged (in principle) in real terms, i.e. ignoring price inflation, when the size of the system remains basically unchanged and the standards of operating effectiveness also remain unchanged.

Similarly, when the size of the infrastructure system changes, or the standards of performance required of it increase, the new size or level of the system will be maintained by a new constant level of renewals expenditure. Why this should be so is not immediately obvious, and this paper sets out to explain it.

2. The principles underlying renewals accounting

The concept of the LRNC arises from the renewals accounting approach. Renewals accounting has been adopted in the context of the infrastructure assets of the water industry, and what follows is a description of the theoretical basis for it.

Any individual asset, with the exception of freehold land, has a finite physical life and so loses value over time. Accounting tries to chart that loss of value and ascribe its progress to the accounting periods in which it occurs. This loss is generally described as depreciation.

Determining the amount of depreciation to allocate to each particular period is always a process of estimation, and the estimate becomes more and more a broad approximation the longer the estimated life of the asset. The quality of accounting for industries with very long-lived assets is heavily dependent upon the quality of the process for making these estimates.

The LRNC is one way of making this estimate, but not the commonest way. However, it is intended to give the same answer in principle as the more usual methods of estimating. Let us look at the ordinary method first.

Route 1 Ordinary depreciation

The standard method for assessing depreciation involves first forecasting the life of the asset. Although actual physical life is important, the asset's useful economic life may be shorter than that and that is the life over which the fall in the value of the asset, from cost to any scrap value, must be charged against profits.

In economic terms, that loss in value (expressed in real terms) must be recovered out of income before the entity has made a profit. Recovery should be made period by period, according to how much of the value is lost in each period, and a second estimate is necessary to decide that.

Mostly, for all practical purposes it can be assumed that the loss occurs evenly over the life and so the expected loss of value is divided up evenly over the life and each period charged with a similar amount of the cost, i.e. depreciation for each period equals cost less residual value divided by total years of life.

What happens if the life is likely to be very long and there is great uncertainty about how long? Is there a better way of arriving at this estimate of the annual charge to the Profit and Loss Account in such circumstances?

The use of infrastructure renewals accounting and the LRNC is an attempt to formulate a better way. It is important to understand that it is not an attempt to avoid charging depreciation. It is a different method of determining an appropriate annual charge for the phenomenon known as depreciation.

Route 2 Infrastructure renewals accounting

A simple example serves to illustrate the principle.

Imagine a fleet of taxis. The owner runs five identical vehicles, one purchased in each succeeding year, each of which has a useful economic life of five years and (for simplicity only) a nil residual value.

In real terms, i.e. doing our calculations in £s of current value, not £s of the varying values at the time each vehicle was purchased, each year the owner will provide in his accounts for one-fifth of the cost of each vehicle. Each year, one vehicle will reach the end of its useful life and will be retired, to be replaced by a new successor.

So each year the cost of replacing the retired vehicle, one component of the fleet, will be precisely the same as the depreciation charged to the Profit & Loss Account, i.e. five cars times one-fifth of the current (new) cost of each. And the result in the Balance Sheet is that the depreciated carrying value of the fleet at the beginning of the year has been reduced by the depreciation charge, increased by the cost of the new vehicle and unaffected by the retiral of the old vehicle which by then stands at nil.

Since the cost of the new vehicle equals the total annual depreciation charge, the fleet carrying value remains the same. The size and economic effectiveness of the fleet also remains unchanged, with five vehicles ranging from a new one to one four years old. The fleet remains, as the term is, in 'steady state'^{*}, in spite of the fact that its component parts are undoubtedly depreciating.

This very simple example serves to show that a system of assets in 'steady state' will suffer depreciation of exactly the same amount as the cost of the new components necessary to replace the loss of effectiveness of the system as a result of the period's usage.

^{*} Steady State is where a body of assets remains in indefinite equilibrium because its component parts are wearing out and being replaced at a constant rate such that the operational effectiveness and hence value of that body of assets remains a constant in real terms.

Consequently, you have a practical accounting choice. You may continue to charge the depreciation and capitalise the cost of the new components; but you will achieve exactly the same effect, in both the Profit & Loss Account for the period and the Balance Sheet, if instead you charge the cost of the new components to the Profit & Loss Account and leave the carrying value in the Balance Sheet unchanged. In case there is any doubt, this is illustrated in the following Examples 1 and 2.

EXAMPLE 1 – STEADY STATE – assuming unchanged prices

A taxi fleet consists of five vehicles, each lasting five years, one purchased each year. Cost each time = 100.

Year of Purchase	Cost @ Year 5	Cum Dep'n @ Year 5	Net @ Year 5	Annual Dep'n @ Year 6	Cum Dep'n @ Year 6	Net @ Year 6
Year 1	100	80	20	20	100	-
Year 2	100	60	40	20	80	20
Year 3	100	40	60	20	60	40
Year 4	100	20	80	20	40	60
Year 5	100	-	100	20	20	80
	500	200	300	100*	300	200
Year 6	100*					100
						300

EXAMPLE 2 – STEADY STATE – assuming rising prices

Fleet of vehicles as in Example 1, but costs over 5 years of (say) 100, 120, 130, 160 and 170 respectively. Cost in Year 6 has risen to 180. Shown in current cost terms for Year 6.

Year of Purchase	Cost @ Year 5	Cum Dep'n @ Year 5	Net @ Year 5	Annual Dep'n @ Year 6	Cum Dep'n @ Year 6	Net @ Year 6
Year 1	180	144	36	36	180	-
Year 2	180	108	72	36	144	36
Year 3	180	72	108	36	108	72
Year 4	180	36	144	36	72	108
Year 5	180	-	180	36	36	144
	900	360	540	180*	540	360
Year 6	180*					180
						540

In both examples, the steady state of the system or fleet is maintained because the total depreciation charged each year precisely equals the cost of the replacement capitalised.

One conclusion that may be drawn from this is that, if you are operating a system of assets with an unchanging operating capability (i.e. one which behaves as though it is in a steady state), one way of measuring the extent of depreciation of that whole system in any one period is to look at how much it is necessary to spend in that period to maintain that system. That amount constitutes prime facie evidence of the depreciation figure.

However, that prima facie evidence can be rebutted. As we have seen, if the amount which needs spending in each succeeding period is not (in real terms) identical, then one of two things has happened. Either you have not measured the amount you need to spend correctly, or the system you are dealing with is not in steady state. The first conclusion would send you back to do your calculations more carefully. The second would invalidate justification for using this method and force you to return to more conventional ways of measuring the depreciation, which must be occurring.

3. Application to the water industry

How does this apply to the water industry? This is an industry whose underground assets can last so long that even some of those built in the nineteenth century are still in use and there is a shortage of empirical evidence about the length of useful economic lives, especially of underground assets. Some components of the system have moving parts and their rates of wear and tear may be predictable to within normal levels of estimating accuracy, but they only account for a very small proportion of the total value of the system.

Some years ago a new proposal was developed. It was observed that entire systems for each entity continued to operate effectively and achieve the standards required of them, as a result of the expenditure of modest and reasonably predictable amounts for maintenance and renewals each year. This provided prima facie evidence that the systems were in a steady state and therefore renewals accounting could reasonably be adopted -which is what happened.

There were a number of reasons for developing and adopting this proposal but one element in particular seems to have played a part. The process of ascribing lives to infrastructure assets, necessarily delegated to engineers in each entity, had been a source of concern to the industry and seen, by the engineers in particular, as excessively arbitrary. On the other hand, engineers also had the task of assessing the probable course of renewals and repair work, a more tangible and less arbitrary task than assessing lives.

With the development of the regulatory regime and the Asset Management Plan, it was necessary to develop a more far-sighted view of future renewals expenditure anyway. While clearly that process is subject to all the uncertainties of any process of estimation, it is a process that takes full account of current knowledge and experience and one with which engineers are familiar and in which they have some confidence. The attractions of satisfying both reporting requirements and the industry's concerns over estimates with no grounding in real experience proved sufficient reason to encourage the adoption of the alternative of renewals accounting.

What remained was the need to codify and systematise the measurement of the necessary charge to the Profit & Loss Account, i.e. the depreciation substitute. Although some work has been done on this, the wide diversity of the charges that have emerged suggests that not everyone understands the basis on which the charge needs to be determined, or perhaps the criteria which it needs to meet, in order to be credible and satisfy the requirements of a renewals accounting system (assuming that there is no strong wish to return to trying to estimate depreciation by the adoption of arbitrary asset lives).

The charge for each period is not intended to be precisely what is actually spent. The actual timing of spend can be unpredictable, not least because the point at which any individual part of the segment fails and requires replacing is generally reckoned to be random. Over an entire system, the number of such random incidences of breakdown in any period is a more predictable figure, but still subject to external vagaries, for example extreme weather conditions. Any difference between actual spend and the long range charge, over or under, is included in the balance sheet as either a prepayment or an accrual.

4. Backlog

Some confusion tends to arise because of similarities between the LRNC and what is known throughout the industry as Initial Backlog.

The process of regulating the industry has been complicated by certain of the mechanisms inherited as a result of the privatisation process. One of these was the determination of an amount entitled Initial Backlog as at the start of the first period of regulation. It has proved a source of confusion, complicating the understanding of the

LRNC - with good reason, because the expenditure involved in reducing Initial Backlog may be identical in kind to that involved in the LRNC. It is worth spending a moment on explaining the difference and how it works.

To enable companies to start using renewals accounting, it was necessary to make an assumption about whether systems were or were not in steady state. Few companies could sign up to the proposition that their infrastructure systems were already demonstrably in a steady state, if only because the standards of operating required of the industry had been rising.

Consequently, there was a backlog of expenditure necessary to bring systems up to a level of operating effectiveness required by existing standards and incorporated in the initial Asset Management Plan. Estimates were made at the time of the original flotation of the water authorities, and those estimates of backlog figures were subsequently accommodated in regulatory current cost accounts under RAG 1, as a reduction in the carrying value of the assets.

All that the Initial Backlog represents is an accrual of renewals expenditure, made necessary because that work was not carried out to the new standards in earlier periods. It may appear to be no different from the accrual that has to be made when expenditure in the period falls short of the pre-determined LRNC. The crucial practical differences are as follows:

- i) the Initial Backlog is, in certain companies, a particularly large number which will not be eliminated, i.e. the expenditure will not be fully incurred, for many years - up to twenty, or more in some cases;
- ii) expenditure each year to catch up on the identified backlog is additional to the need for a constant (real) annual renewals charge;
- iii) Initial Backlog and any LRNC accrual are treated differently in the balance sheet - the backlog provision carried forward (the balance of Initial Backlog still remaining) is deducted from the carrying amount of the infrastructure assets (with the same net effect as if it were depreciation) while the LRNC accrual appears as an accrual in working capital; and
- iv) consequently, expenditure to reduce Initial Backlog is capitalised, while LRNC expenditure is charged to the Profit & Loss Account.

The principal practical consequence is that it is important, in respect of every element of renewals and maintenance expenditure, to distinguish between that which was undertaken to rectify the shortfall identified as a part of Initial Backlog and that which forms part of the period's LRNC.

There are two reasons why this is important: first, because the continuing size of Initial Backlog remains an uncomfortable reminder of the original heroic assumption and a potential political stick with which to beat members of the industry for demonstrably not having their infrastructure assets up to new standards; and secondly, because any confusion between the two will distort the size of any LRNC accrual (or prepayment) and risk creating confusion when attempting to review forecasts of the necessary level of the LRNC at each Periodic Review.

5 Practical implications for measuring LRNC

We have looked at the underlying theory of renewals accounting and the focal role played by the LRNC in that theory. This section looks at what this means for the industry in practical terms when accounting for the LRNC, based both on the requirements of the theory and on the experience of the industry to date in operating renewals accounting.

5.1 Practical requirements for a credible LRNC

The basic requirements for a credible renewals charge, the LRNC, may at this point be summarised as follows:

- i) it must be at broadly the same level of cost each successive year, in real terms; or, if there has been any material change in the size of the system from year to year, the renewals charge for subsequent years should continue to be broadly the same proportion of the carrying value of the system (in current cost terms).

Other possible reasons for variation would include technological change and the imposition of new standards of service. The former may presently be discounted, because technological change is not predicted to have any noticeable impact on the infrastructure assets of this industry in the foreseeable future. The latter, new standards of service, will impose new levels of maintenance from time to time, and the charge for maintaining them will need to be forecast separately as a discrete element of the renewals charge and, like the basic charge, might be expected to remain a constant in real terms, for the same reasons.

- ii) it must be practicable. While a company may expect to spend more or less than the LRNC in any given year, a planned continuously cumulating difference between LRNC and actual spend which is not expected to reverse and start unwinding at some point in the future tends to call the calculated steady state of the system into question.

Similarly an LRNC of a size demonstrably well beyond the company's capacity to plan, manage and carry out the work would tend to raise doubts as to credibility. If the company accrues for work it clearly has not intention of carrying out at some definable point in the future, then the assets are unlikely to be in steady state and any provisions would more properly be described as depreciation.

5.2 What expenditure should be included?

What therefore will be include in the long range normative charge? In principle, it should include all expenditure of every kind involved in sustaining the system in its present state and protecting it from falling in value. This would cover:

- the cost* of renewing any components that fail, for whatever reason, during the period;
- the cost* of planned maintenance of any elements of the system;

* Conceptually, there might also be an expectation that proportions would be broadly similar across the industry, but it is possible that differences of approach to planning renewals might be capable of accounting for consistent differences between companies.

- the cost* of emergency repairs to any part of the system;**
- the cost* of that part of any planned improvement or expansion of the system which relates to the otherwise unplanned renewal or maintenance of an existing part of the system;
- overheads directly associated with the planning and carrying out of renewals and maintenance.

Critical to the determination of the LRNC is the categorisation of renewals and maintenance expenditure described in RAG 2, which focuses particularly on the REVENGE classification, distinguishing between the REV (Revenue) element and the ENGE (enhancement, growth and efficiency, i.e. capitalisable) elements. Some points which impact upon the measurement of the LRNC include:

- operating costs - described in RAG 2 as 'routine maintenance expenditure which is not in the AMP and which arises in a reactive way on a day to day basis'. It has tended to be assumed that, because this does not form a part of REV, it does not form part of the LRNC. This is not logical as it is bound to constitute expenditure intended to restore infrastructure assets to full operational condition. To the extent that provision is made in the Asset Management Plan, and hence in price limits, for a certain quantity of repair work of random incidence (e.g. bursts), it is planned. To the extent that more of such work has to be undertaken in a period than had been budgeted for, it is unplanned i.e. has occurred sooner than expected.

By definition, it will therefore have been anticipated in principle as a part of a future year's LRNC. Occurring now, it reflects only a timing difference in the LRNC, a prepayment. In the event that such expenditure happened to vary widely from year to year, failing to include it in the LRNC could either account for the LRNC varying in size or, where the LRNC is correctly provided for as a constant, distorting the accrual or prepayment by effectively double-counting this expenditure.

- proportional allocation. Some expenditure designed to enhance the system necessarily involves the early replacement of parts of the existing system, and guidance is given in RAG 2 on how to allocate the overall cost between REV and ENGE, i.e. LRNC and capital cost.

Where this occurs, the REV element is again merely a bringing forward of replacement expenditure anticipated at some future point in the LRNC. This will be a recurring feature every year, and will therefore be a normal element of the LRNC for as far into the future as we can see. Unless this element of REV cost is expected to be quite abnormally large in any year or over several years, it should not distort the constant nature of the LRNC.

There may be practical distortions occurring if there is any doubt over consistent application of proportional allocation between the planning stage and accounting for the actual expenditure. Unless there are safeguards in place in each company's system to

* All costs should be net of third party contributions.

**In practice, emergency repairs are currently included as an operating cost, not as part of the infrastructure renewals charge.

check that planned schemes involving proportional allocation are in fact accounted for in the event in the same way as they were included in the LRNC, it is possible that an accumulation of nonreversing differences could build up, which would be a source of concern.

Revisions are being considered to RAG 2 which could include the redefinition of REV expenditure to embrace additionally all repair and maintenance costs* associated with infrastructure assets which have previously been included as part of Operating Costs. Including such costs within REV expenditure in AMP 2 could eliminate confusion.

5.3 Over what period should expenditure be averaged?

Over what timescale should the renewals charge be reviewed in order to determine (generally by taking a simple arithmetic average) the appropriate annual level of LRNC? As we have seen, the number we are attempting to predict is the number which will be broadly consistent as a percentage of the systems' carrying value.

Evidence for the appropriate level of charge should be sought partly from evidence of past costs, where appropriate, but particularly from future expenditure plans. Engineers, who are best placed to advise on foreseeable expenditure needs, will indicate what they regard as likely in the short, medium and perhaps long term, in order to keep the system operating properly to specified levels. They will probably indicate figures that vary from year to year for operational reasons. The need therefore is to look far enough ahead to have reasonable confidence that the average of those forecast annual charges, in real terms, will continue to be a broadly appropriate level of expenditure when extrapolated further into the future - hence the term 'long range'.

Some companies originally limited themselves to the five-year planning period to the next likely AMP. Others looked ahead twenty years. A number of companies fell between these two. No period is necessarily right, because it depends upon circumstances. However, a twenty-year period would be sensible because that coincides with the AMP planning horizon, and the choice of a shorter period could imply failure of correlation with the AMP. Whatever period is settled on, it has to be in the confident belief that no significant peak or trough of such expenditure can be foreseen beyond the time horizon chosen. If such a peak or trough can be foreseen, then the time horizon chosen should be extended to include that peak/trough and its consequences.

There is no guarantee that twenty years is necessarily long enough for a wholly confident prediction of an LRNC. If engineers' experience of their system leaves them concerned that a twenty-year forecast of renewals and maintenance expenditure is inadequate, particularly if they confidently anticipate a heavy peak of expenditure in subsequent years, then it is necessary to improve the quality of the forecast. This would be achieved by extending the time-frame of forecasting the LRNC.

In extremis, theory would be satisfied by reverting to the more primitive method of predicting a physical life for the system and calculating the size of the arithmetic depreciation charge that would result - but this would be adopted if, but only if, that was

* The kind of expenditure which might become a part of REV instead of Operating Costs includes that on repairing, maintaining and renewing infrastructure assets on a routine reactive basis, including both direct costs and the standing charges associated with employing maintenance teams for both emergency repairs and regular maintenance.

the only method in which the engineers felt they could have confidence, the opposite of the view which led to the adoption of renewals accounting in the first place. (Physical life would be the critical determinant because nobody questions the idea that the economic useful life of the water and sewerage systems is indefinite. The physical life that one would be seeking would be the length of the life-cycle over which the major part of the system will need to be replaced.)

5.4 How is indexation for price change handled?

As we have seen, the LRNC should in principle be the same in real terms every period, for an unchanged system and unchanged service standards. In money terms of course it will vary as prices change. In the current cost accounts, opening balances expressed at last year's prices must be reexpressed in terms of this year's prices to be meaningful, hence the indexing forward, using the Retail Price Index (RPI), of all fixed asset gross values and, for non-infrastructure assets, aggregate depreciation brought forward.

Any LRNC accrual (the provision for renewals expenditure not yet spent) or prepayment is similarly re-expressed into £'s of that year's spending power as it is brought forward each year as part of working capital.

The re-expression of all these items (gross asset values, accumulated depreciation and accrued provisions for both LRNC and Initial Backlog) into £'s reflecting the current year's price levels using the RPI produces a total increase in net assets which is taken to reserves in the current cost regulatory accounts. No part of it is credited or debited to the Profit & Loss Account because it does not represent any gain or loss to either members or customers. (It is similar to the translation of items from one currency to another, but without any commission on the transaction!).

The only element which would find its way into the Profit & Loss Account for the period is where a material difference develops between the specific price of REV activity and the cost anticipated in the AMP re-expressed by using the RPI. As indicated in RAG 1.02 (para 1.10.13), that difference is in principle expensed/recovered in the period in which it arises.

6. Conclusion - consistency cross check

This paper has stressed that renewals accounting and depreciation accounting are simply two alternative ways of arriving at what in principle will be the same answer. The reason for adopting renewals accounting rather than the more conventional depreciation approach is simply because it offers, in the context of the water industry, a way of making the estimations necessary under either method with more confidence than the bald estimation of asset lives produced in the past. One further point emerges from this analysis, which can be useful.

All users of accounts are aware that, because (straight-line) depreciation is determined by dividing the gross asset by the life, so average life may be estimated by dividing the gross assets by the total depreciation charge. Because the LRNC is in principle the same figure as depreciation would have been if arrived at on a consistent basis, it may be used as a depreciation surrogate to determine an average asset life. Divide gross infrastructure assets by the annual LRNC and the result is an estimation of the weighted average life of the whole asset system.

Companies can make use of this fact, as well as Ofwat. These weighted average lives are easily calculated and compared for every company. Where significant variations arise, they may be explained by known differences between the companies, their systems and their approaches to maintenance and renewals. If material differences arise which are inexplicable, they need to be explored further and an explanation sought. A Company that finds its results are out of line with other similar companies in this respect, with no obvious reason available may wish to initiate a collaborative exploration and comparison with another company to establish where, how and why differences on such a scale arise. It may be that, in such a case, the two parties have interpreted the guidelines on either the valuation of assets or the estimation of the LRNC very differently.

Discovering the source of such differences will provide guidance on whose numbers should change and why. The result would be to greatly enhance the credibility of both the figures and the approach to renewals accounting in that company.