Water today, water tomorrow

Consultation on changes to the regulatory accounting guidelines (RAGs)

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About this document

In this document, we make proposals to amend our requirements for the regulatory accounts, which are required under licence condition F and detailed in our regulatory accounting guidelines (RAGs).

Our proposals follow a review of our current requirements that we committed to in October 2011. They aim to make sure that the information we ask for is proportionate and targeted, and include adding the accounting separation requirements to the RAGs. We have developed the proposals in consultation with water companies and representatives from the audit firms.

The changes proposed in this paper would apply from the 2012-13 reporting year. We will confirm formally any changes to the RAGs by the end of 2012.

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Key messages

- In ‘Regulatory compliance – a proportionate and targeted approach’, we committed to review the content of the regulatory accounts. This is to make sure our information requirements remain fit for purpose and represent proportionate and targeted regulation.

- Our proposals reduce overall data requirements by 50% and eliminate much of the narrative requirements. These changes are part of an adaptable framework of information gathering, which may have more or fewer requirements in the future, or may include measures such as horizontal auditing.

- We have incorporated requirements for existing activity-based accounting separation within the RAGs, which will be subject to the regulatory accounts audit opinion.

- We are proposing to place a greater emphasis on a common set of principles that the companies should use when allocating their costs. This is in line with our risk-based approach and places accountability with the companies to choose the most appropriate approach.

- The UK Government’s draft Water Bill progresses the key recommendations from the independent review of competition and innovation in water markets (the ‘Cave review’), with the exception of any structural separation. So, we will consider whether we need to issue additional guidance to companies to minimise the risk of inappropriate allocation of costs.

- The draft Water Bill places greater importance on separate accounting information as a tool for providing transparency and revealing costs for all stakeholders. So, as well as activity-based information requirements, we propose to trial accounting separation at a services level from 2012-13. This would be an appendix to the regulatory accounts and we would not require this to be audited in 2012-13.

- We have worked with the water and sewerage sectors to develop these proposals and have amended our initial ideas in some areas.

- We are seeking views on our proposed changes to the RAGs and will publish final RAGs at the end of the year.

Questions for consultation

Regulatory accounts format and requirements

Q1 Are there areas where we could reduce disclosure requirements further? Have we reduced the requirements too far in other areas? Are there any additional requirements we need?

Q2 A statement on the links between directors' pay and standards of performance is required by the Water Act 2003. RAG3 currently specifies including the statement in the regulatory accounts. If we removed the requirement from RAG3, this would enable companies to decide where best to publish this statement to make sure it is easily accessible for their stakeholders. Should we remove the disclosure requirement from RAG3?

Q3 Although RAG3 requires annual provision of debt information, in practice we have only collected detailed information on debt at the base year for price setting. We propose to keep the annual provision requirement in RAG3, but then use the annual update letter[1] to exempt the requirement for years that it is not needed. Is this an acceptable approach?

Q4 We suggest that companies may wish to use a common format to publish the regulatory accounts electronically. This would mean that stakeholders could use the data more easily. What is the most appropriate common electronic format for regulatory accounts?

Accounting separation

Q5 We propose to provide companies with the principles and business unit summaries in appendix 4 to use when allocating their costs, rather than publishing prescriptive guidance. Do you agree with this approach? If not, please provide details of an alternative approach you think we should adopt.

Q6 Do you think there are areas of expenditure that are at high risk of companies classifying inappropriately? If yes, please provide evidence and advise how we could mitigate this risk in a proportionate way.

Q7 We are proposing to merge the sludge treatment and sludge disposal business units into one called sludge treatment, recycling and disposal. Do you agree with this approach?

Q8 We are proposing that all fixed assets should be recorded in the business unit of principal use. Do you agree with this approach? For some asset categories such as general and support expenditure (G&S) that have no natural business unit should we allow them to be allocated or should we require the approach described above for fixed assets?

Q9 We are proposing to trial the allocation of operating costs to services as detailed in appendix 6. As well as the service definitions in appendix 6, what information would companies need in order to report costs by these services? What incremental costs do you expect companies would incur in order to report operating costs by the proposed services to the same level of assurance as the regulatory accounts? What are the implementation options available to companies to report operating costs by these services?

[1] Each year, we publish an information notice that gives an update to the RAGs on current accounting issues. The most recent information notice is IN 12/01, which we published in January 2012.

Responding to this consultation

We would welcome any comments on this document. Please email them to Regulatory.AccountsT@ofwat.gsi.gov.uk

or post them to:

Changes to the regulatory accounting guidelines (RAGs) consultation response
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Ofwat
Centre City Tower
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The closing date for this consultation is **31 October 2012**.

We will publish responses to this consultation on our website at www.ofwat.gov.uk, unless you indicate that you would like your response to remain unpublished.

Information provided in response to this consultation, including personal information, may be published or disclosed in accordance with access to information legislation – primarily the Freedom of Information Act 2000 (FoIA), the Data Protection Act 1998 and the Environmental Information Regulations 2004.

If you would like the information that you provide to be treated as confidential, please be aware that, under the FoIA, there is a statutory 'Code of Practice' which deals, among other things, with obligations of confidence.

In view of this, it would be helpful if you could explain to us why you regard the information you have provided as confidential. If we receive a request for disclosure of the information we will take full account of your explanation, but we cannot give an assurance that we can maintain confidentiality in all circumstances. An automatic confidentiality disclaimer generated by your IT system will not, of itself, be regarded as binding on Ofwat.

1. Introduction

The information that companies provide in their regulatory accounts is essential for them to demonstrate their financial performance to stakeholders. They are the only source of regular, consistent and audited financial information on the regulated business. We will continue to require regulatory accounts alongside the new regulatory reporting tools.

The guidelines for the regulatory accounts are known as the regulatory accounting guidelines (RAGs). We have reviewed and challenged the existing content of the regulatory accounts to make sure that it is fit for purpose. We have also reviewed and included the accounting separation requirements in our proposed RAGs.

We committed to this review in 'Regulatory compliance – a proportionate and targeted approach: A consultation', which we published in October 2011, where we said:

> **"The companies will continue to have an obligation to produce regulatory accounts. But we are committed to reviewing the content of these and consulting on proposed changes. This includes incorporating accounting separation data into the regulatory accounts, to enable proportionate and targeted regulation. We will expect the companies to submit accounting separation information for 2011-12, although we recognise that it will be too early to incorporate them into the regulatory accounts."**

In IN 12/07, 'Regulatory reporting for 2011-12 – process', which we published in June 2012, we confirmed that the regulatory accounts are still required alongside our new regulatory reporting tools of the risk and compliance statement and key performance indicators.

We challenged our existing requirements internally so that we could then consult with the companies before this consultation. In February 2012, we held a workshop with representatives from all the companies and from auditor firms. We presented a preliminary set of tables for the regulatory accounts, together with our views on reducing commentary requirements. We also presented our plan to include accounting separation requirements in the regulatory accounts and to move to a principles-based approach for accounting separation.

We have set up a regulatory accounts working group with companies, which has helped to develop the proposals in this consultation. The group builds on the work that the accounting separation pilot companies have carried out since 2008. It has been extended to include other companies that have shown an interest in attending.

This working group provides us with a forum to engage with companies on regulatory accounting issues, including the continuing development of accounting separation information.

1.1 Stakeholder feedback

At our workshop in February, most companies supported the proposals put forward.

In particular, they were content with integrating accounting separation data into the regulatory accounts. Overall, companies agreed that a principles-based approach was preferable when compared with the alternative approach of publishing prescriptive guidance.

Companies acknowledged that they are best placed to determine appropriate allocation methods, but also raised the issue of consistency – particularly in relation to price setting. Some asked specifically for more clarity on the boundaries between business units. We have addressed this in our proposals.

Most companies thought we could reduce our proposed disclosures further, particularly regarding current cost accounting statements. We now propose to remove the requirement for a current cost balance sheet and to change our disclosure requirements accordingly. Other than for fixed assets, which are disclosed separately, the disclosures in the balance sheet are duplicated in the historical cost accounts.

Some companies asked why we require detailed information on debt each year when this is used for price setting. We now propose to keep the requirement in RAG3, but to use the yearly update letter to exempt the requirement for those years when it is not needed.

Other companies criticised our decision to retain a current cost valuation of assets until at least the end of the current price control period (2010-15). But we think this information is important, because it allows stakeholders to consider actual company performance relative to our assumptions at the last price review.

Auditors suggested that we make a clear distinction between the financial data and non-financial data as a single audit report would not be able to cover both sets of accounting separation data. We have now separated into two clear sections the financial and non-financial tables.

1.2 Regulatory accounts

For each table and every data point, we considered the rationale for including them in the regulatory accounts. We have reduced data requirements by more than 50%, which is a significant reduction in the data burden imposed on companies. We have included additional data requirements necessary for the revenue correction mechanism and the capital expenditure – capex – incentive scheme (CIS).

We also considered our existing narrative requirements and identified key risk areas.

We have removed the requirement for a narrative 'operating and financial review' as this can take a lot of time to produce and much of the information is duplicated in the statutory accounts. We have focused the remaining narrative requirements on the areas of:

- revenue recognition;
- capitalisation policy; and
- customer debt.

These have been areas of concern for both Ofwat and stakeholders in previous years.

This information builds greater confidence in the regulatory framework. It could prevent bills being higher than they would otherwise have been, as we will be able to identify inconsistent approaches between companies. This is in line with our risk-based approach. In future, we will continue to assess if this scrutiny is still in line with our risk-based approach and also if we require more explanation for other areas in the accounts.

Overall, we have reduced the level of narrative by about 50%.

1.3 Accounting separation data

Companies reported separate cost data as part of their June return for two years up to June 2011. They published their 2011-12 data with their regulatory accounts in July 2012. The auditors reviewed the June return data, performing agreed upon procedures and reporting the results to us.

We consider that the requirements for accounting separation information and companies' systems to produce such data are now sufficiently developed to be included within the regulatory accounts. So, we propose to include this information as part of the regulatory accounts from 2012-13 with the correspondingly higher level

of assurance. We are also proposing to place a greater emphasis on a common set of principles that companies should use when allocating their costs.

We consider that companies are generally best placed to decide on the methods they use in accordance with these overarching principles. But some respondents to 'Future price limits – a consultation on the framework', which we published in November 2011, raised concerns that companies currently allocate their costs differently between business units and this may mean the data is not sufficiently reliable for the purposes of setting price controls.

We acknowledge that certain methods of allocation will be more appropriate than others. Forcing consistent allocation through prescriptive guidance can, without specific consideration, increase the risk of companies producing separated accounts that are not robust. It could also diminish the incentives for companies to better understand their costs.

We recognise that the draft Water Bill places greater importance on separate accounting information as a tool for providing transparency and revealing costs for all stakeholders. So, we will consider whether we need to issue additional guidance to companies to minimise the risk of inappropriate allocation of costs. We consider this further in section 2.4.1.

As part of the next phase of our accounting separation work, we have defined a list of services for companies to report against in the future. This is so that costs can be better revealed for all stakeholders. This will, in turn, feed into our current work – for example, on charging and market reform. It will also inform price controls. We propose to collect this service-based information alongside activity-based information on a trial basis in 2012-13. The trial information will not be subject to an audit opinion. We discuss this further in section 3.1.

2. Overview of the proposed changes to the RAGs

Our review of the regulatory accounts follows on from our work on regulatory compliance. We have challenged the existing content of the regulatory accounts to make sure that it is fit for purpose in the context of the outcome of our consultation on regulatory compliance. This will ensure proportionate and targeted regulation. As a result of this, we have removed the requirement for an ‘operating and financial review’ and reduced other narrative reporting requirements. We now focus narrative solely on areas that we consider present the greatest risk to maintaining comparable information across the sectors to support our regulatory functions.

We have challenged the level of financial data that we collect and simplified our pro forma accounts. We have included new data requirements necessary for the revenue correction mechanism and the CIS. We have also replaced the previous activity cost and fixed asset tables with new tables for accounting separation.

The overall impact of all of the changes is a net reduction in data collection of about 50%. This will, in turn, reduce the work required by audit firms.

This chapter outlines our main proposals and changes to each RAG. The detailed changes are included in appendices 1 to 5.

2.1 RAG1

RAG1 would stay largely unchanged. This is because we propose to keep current cost accounting at least until 2014-15. We propose including some extra paragraphs on revenue recognition. These requirements are similar to those required for 2011-12 and set out in IN 12/01.

But we are also proposing to delete some redundant requirements. In the table below, we summarise what we are proposing to delete from RAG1 and why it is no longer required.

Table 1 Proposed deletions from RAG1

Deletion reference	What	Why
Paragraph 1.1.4	Details content of appendices	Not required as appendices are marked for deletion
Paragraph 1.12.7	Publication of RCV note	RCV note no longer required – we publish the RCV breakdown for all companies on our website in April, following the release of the March RPI information
Paragraph 1.12.11 – final sentence only	Reference to RCV note	
Paragraph 1.13.3 – final sentence only	Reference to RCV note	
Paragraph 1.13.4 – final sentence only	Reference to RCV note	
Part 3	Accounting guidelines – current cost	Duplication and refers to requirements that have now been removed
Appendix 1	Worked examples of pro formas	Only relevant worked examples have been included in the new appendix 1. Pro formas have now been updated and revised in RAG3
Appendix 2	Assumptions made in RAG1	No longer needed for regulatory accounts production as they largely relate to the position as at privatisation
Appendix 3	Current cost accounting policies	Removing duplicated guidance
Appendix 4	Acronyms	Largely irrelevant or are explained in the main body of the text
Appendix 5	Bibliography	No longer needed for regulatory accounts production

2.2 RAG2

We propose to revise RAG2 so that it reflects only the categories of capital expenditure that remain in the regulatory accounts. Some of the guidance referred to June return data, which we do not now collect. See appendix 2 for the proposed revised RAG.

2.3 RAG3

Our proposal for RAG3 (see appendix 3) now focuses on what should be included in the regulatory accounts in terms of pro forma tables and narrative disclosures. Specifically, we have proposed to:

- move all definitions of terms (that is, HCA profit and loss account, HCA balance sheet, CCA profit and loss account, CCA balance sheet and CCA cash flow statement) that remain in the new proposed pro formas to RAG4. This is to add clarity as all definitions would now be in one place;
- move the existing 'Transfer prices' and 'Disposal of land' section to RAG5 as it is not a disclosure in the regulatory accounts. As it relates to use of assets for non-appointed activities, it is more appropriate for it to be included in RAG5;
- delete associated company definitions because a cross-reference to the definition in RAG5 is sufficient; and
- delete the profit analysis and turnover analysis sections, which simply duplicate the headings in the pro formas and related definitions.

We have reviewed the existing information requirements to target them appropriately. We propose to delete the:

- existing activity cost analysis and fixed asset tables (which have been replaced with the accounting separation tables); and
- notes on the RCV, the current cost balance sheet and the movement on the current cost reserve.

We propose adding two new tables – a properties analysis and an analysis of capital expenditure, grants and land sales – to make sure we have the data necessary to operate the CIS and revenue correction mechanism.

Overall this would reduce the number of pro forma tables from 18 to 14.

Where possible, our proposals seek to reduce the number of data lines in the tables by removing duplication. We also reviewed the most recent sets of accounts to identify lines where disaggregation added little value to our comparative analysis.

This review identified several opportunities to merge lines and reduce the overall level of disclosure. But we have aimed to keep unnecessary changes to a minimum. This is because it is likely that in two years' time we will have to review the accounts again to take UK alignment with international financial reporting standards into account.

We propose to separate clearly the financial and non-financial tables into two sections. This is because auditors told us that they may only be able to provide an audit opinion on the financial data.

We have looked again at our requirements for the accounting separation tables. We propose merging several lines and deleting others completely. For the wholesale business unit, we propose to insert a new line to separate 'income treated as negative opex' (for example, income from power generation).

We propose to remove the requirement to include an 'operating and financial review' (OFR) in the regulatory accounts. Instead, we propose to focus the narrative on the three key areas of:

- revenue recognition;
- capitalisation policy; and
- customer debt.

These are areas where concerns about inconsistency of reporting have been raised in recent years. So, we propose to continue to require disclosure.

We also propose removing the exemption to prepare regulatory accounts for the total business only if non-appointed activities are less than:

- 1% of turnover;
- 1% of historical cost operating profit; and
- 1% of net operating assets.

A review of the 2010-11 regulatory accounts revealed that no company is currently using the exemption. Also, including a small amount of non-appointed activity could impact significantly on the accounting separation tables. This is because costs are now being split over smaller business units.

We are asking for views on whether we should continue to require companies to disclose directors' pay in the regulatory accounts or allow them to decide where best to publish this statement.

We require detailed information on debt. We propose to keep the requirement in RAG3, but then use the yearly update letter to exempt the requirement for years that it is not needed.

We have not specified any particular electronic format for publication in our proposals. But we may consider recommending a specific format in the future depending on companies' views and how the process works for the 2011-12 regulatory accounts submission.

Consultation questions

Q2 A statement on the links between directors' pay and standards of performance is required by the Water Act 2003. RAG3 currently specifies including the statement in the regulatory accounts. If we removed the requirement from RAG3, this would enable companies to decide where best to publish this statement to make sure it is easily accessible for their stakeholders. Should we remove the disclosure requirement from RAG3?

Q3 Although RAG3 requires annual provision of debt information, in practice we have only collected detailed information on debt at the base year for price setting. We propose to keep the annual provision requirement in RAG3, but then use the yearly update letter[2] to exempt the requirement for years that it is not needed. Is this an acceptable approach?

Q4 We suggest that companies may wish to use a common format to publish the regulatory accounts electronically. This would mean that stakeholders could use the data more easily. What is the most appropriate common electronic format for regulatory accounts?

2.4 RAG4

We propose to update RAG4 (see appendix 4) to incorporate the accounting separation requirements, and have taken this opportunity to merge several lines of data. As proposed, RAG4 now also contains line definitions for all disclosures previously included in RAG3.

2.4.1 Cost allocation principles

RAG4 now includes a set of proposed principles that companies should apply when allocating their costs. This approach will allow them to use the appropriate method given their circumstances in accordance with these principles.

At our workshop, several companies highlighted concerns that a principles-based approach could lead to the separated accounts not being robust because of inconsistent allocation methods across companies. But concerns have been raised

[2] Each year, we publish an information notice that gives an update to the RAGs on current accounting issues. The most recent information notice is IN 12/01, which we published in January 2012.

in the past and in response to our consultation on the future price limits framework that inconsistencies also exist under the current, more prescriptive, guidance.

We do not think it is desirable for us to publish highly prescriptive guidance. Even if every company is forced to use the same cost drivers, this would not necessarily translate into higher-quality returns. Prescriptive guidance could also reduce the incentives for companies to understand their costs.

We accept that under a principles-based approach companies could use different bases for allocating categories of cost. But we do not think that this automatically leads to the separated accounts not being robust. Rather, we acknowledge that there is not always one right way of allocating costs, because of differences in circumstances, systems and company structures. We recognise that certain methods of allocation will be more appropriate than others. But we consider that, in general, companies are best placed to decide on the methods they use in accordance with the overarching principles.

We realise that there is a risk of some inconsistency across companies in the recognition of costs that need to be allocated – for example, between retail and wholesale. When we review companies' 2011-12 accounting separation data and methodologies, we will assess the robustness of those data and the extent of any allocation issues. We will then decide the appropriate tool to use to address any issues identified.

Depending on the issue, there are a number of tools at our disposal. For example, we could:

- carry out a targeted review of some or all companies' data;
- publish additional guidance; or
- make adjustments to companies' costs when setting price controls.

Consultation questions

Q5 We propose to provide companies with the principles and business unit summaries in appendix 4 to use when allocating their costs, rather than publishing prescriptive guidance. Do you agree with this approach? If not, please provide details of an alternative approach you think we should adopt.

Q6 Do you think there are areas of expenditure that are at high risk of companies classifying inappropriately? If yes, please provide evidence and advise how we could mitigate this risk in a proportionate way.

2.4.2 Sludge business units

We are proposing to merge the sludge treatment and sludge disposal business units.

Sludge disposal assets and activities are a very small part of the sewerage service asset base. Most of the sludge disposal costs are operating costs, which are relatively low and are typically associated with recycling sludge to agricultural land. So, we do not think it is proportionate for us to require separate information on sludge disposal costs.

Sludge treatment and disposal are interdependent activities. The different quality of sludge products from sludge treatment will allow or inhibit different disposal opportunities.

For these reasons, we propose to combine the two distinct business units, calling the combined business unit 'sludge treatment, recycling and disposal'. So, although we will have less granular cost information between the two areas of activity (sludge treatment and sludge disposal), we propose to distinguish between these as separate services for the purposes of the services trial.

We have also clarified the boundary between the sewage treatment business unit and the sludge treatment, recycling and disposal business unit.

Assets for storing raw sludge are currently included in the sludge treatment business unit as sludge holding tanks. But we are looking to refine this allocation as part of our response to the OFT market study on organic waste. There are two different points of the value chain where sewage sludge can be stored.

- The first is at the sewage treatment works where sludge goes into holding tanks to:
  - enable gravity thickening of the sludge to minimise amounts for transport; and
  - store it until it can be transported (for example, at satellite sewage treatment works sewage sludge is stored until it is transferred to a remote sludge treatment centre).
- The second is at the sludge treatment centre. Here, the sludge is stored often with the aim of controlling and blending flows of sewage sludge into the treatment process.

If a third party provided sludge treatment, appointed water and sewerage companies would need to incur the costs of the first type of sludge storage but not the second. So, to improve the allocation it is appropriate to allocate the first type of service to

the sewage treatment unit while the second would belong to the sludge treatment, recycling and disposal business unit.

We appreciate that in some cases where sewage and sludge treatment is co-located it could be difficult to do a precise allocation. It would be appropriate to allocate such assets to the sludge business unit by preference.

Consultation question

Q7 We are proposing to merge the sludge treatment and sludge disposal business units into one called sludge treatment, recycling and disposal. Do you agree with this approach?

2.4.3 Fixed assets

Existing guidance requires companies to apportion fixed assets and associated operating costs across business units. But we are aware that they are inconsistent in how they do this. Some allocate the operating costs, but only report the full asset value in one unit. Others have also told us that they would prefer to record assets by principal use as this is how they are put into their fixed asset registers.

We have considered reinforcing the existing guidance that companies should allocate asset costs between business units. But given the feedback we received from companies, we are proposing that all fixed assets should be recorded in the business unit of principal use with reallocations to other business units covering depreciation and directly associated operating costs. Companies should record these reallocations in the lines provided in pro formas 7 and 8 in appendix 3.

This will provide additional transparency and better reflects the costs that would be incurred in each business unit if they were operated as a separate business. We think this approach will be straightforward to implement because companies should have this information readily available. This change in approach will not affect the total operating costs when compared with allocating assets because the reallocation lines will sum to zero.

But this change in approach will affect the recharges for the assets between business units. A breakdown of the recharges paid to each business unit will be required as part of the accounting separation methodology statement. Where assets have no natural business unit of principal use – such as IT infrastructure or corporate assets – companies will need to decide which business unit to record them in as they see fit and make the relevant recharges. At this time, recharges are outside of the scope of the transfer pricing guidance. We will review this after the 2012-13 regulatory accounts have been published and our methodology for the next price review in 2014 is better developed.

Assets that are used for both household and non-household customers in the retail business unit should continue to be allocated between them.

Consultation question

Q8 We are proposing that all fixed assets should be recorded in the business unit of principal use. Do you agree with this approach? For some asset categories such as general and support expenditure (G&S) that have no natural business unit should we allow them to be allocated or should we require the approach described above for fixed assets?

2.4.4 Retail definition

We will align the boundary between retail and wholesale with the outcome of our consultation on the definition of retail once this is concluded.

2.5 RAG5

We propose minimal changes to RAG5. We have proposed to delete part 2 ('Reporting requirements for the June return') because we no longer collect the June return.

We also propose to delete section 1.9 on partnering, which we consider unnecessary. This is because the same principles apply to all arrangements with associates. We propose to add a section on 'Use of assets for non-appointed activities', which was previously included in RAG3.

3. Next steps and future developments

We will consider the responses to this consultation, alongside our consultations on retail and wholesale price controls, and issue a revised set of RAGs in late 2012. During this period, we will continue to engage with companies through the regulatory accounts working group and through individual discussions at companies' request.

We will require companies to publish their regulatory accounts for 2012-13 by **15 July 2013**.

3.1 Trial of cost allocation to upstream services

The main focus of our accounting separation work so far has been on the allocation of costs between nine business units. As part of the next phase of this work, we have attempted to define a high level set of services, against which accounting data can be reported in the future.

There are three main benefits from the development of cost allocation to wholesale and retail services.

- **Future charging.** Separate accounting data provides a useful cross-check on the cost reflectivity of charges. Where it is not used for charging, the information will enable us to make sure companies can recover their overall costs from their overall revenues (over a reasonable period of time). The information can also bring about the development of more cost-reflective tariffs.

- **To inform price controls.** If we are to use accounting separation data to inform future price control setting, we will need associated data to reflect the services that our price limits regulate. A more granular approach will allow us to put in place more flexible reporting requirements and to step back from regulating services where price controls are no longer needed.

- **To facilitate market reform.** One of the main benefits of accounting separation is the greater transparency of costs and revenues – and, as a result, profits – it provides in general for all stakeholders. Moving towards accounting separation for services could help inform contestability analysis of services within the water and sewerage sectors. Separate accounting for each service will also provide new entrants with additional transparency, allowing them to assess if they are charged a fair amount for the services they require.

In 2011, we published an independent report by Deloitte that identified a set of wholesale services for the water and sewerage sectors that could be used to introduce accounting separation.

In determining a list of candidate wholesale services Deloitte considered the following criteria.

- **Contestability.** Contestable services may be identified separately and their costs and prices monitored to promote competitive supply.
- **'Bottlenecks'.** These are services that are required by a new entrant in order to provide competing products, but which cannot be sourced other than from the incumbent monopoly supplier. These services may be identified separately to promote competitive supply.
- **Transparency of costs over the value chain.** Transparency of costs is required to support a range of regulatory objectives, including contestability analysis, and to provide new entrants with the required information to inform negotiations over service tariffs.

We propose to continue to develop cost reporting on services data, but to trial this cost allocation as an unaudited appendix to the regulatory accounts from 2012-13. This will allow us to build on the work companies have already started on accounting separation. It will also give companies time to develop robust data before it is incorporated in the regulatory accounts with full audit at a future stage.

We have held a working group with companies to develop a set of services that they will pilot using their 2011-12 accounting data. Appendix 6 sets out the services, definitions and pro formas.

We will use the finding from this pilot scheme and the responses to this consultation to inform our final requirements for the trial of reporting upstream services data in 2012-13.

Consultation question

Q9 We are proposing to trial the allocation of operating costs to services as detailed in appendix 6. As well as the service definitions in appendix 6, what information would companies need in order to report costs by these services? What incremental costs do you expect companies would incur in order to report operating costs by the proposed services to the same level of assurance as the regulatory accounts? What are the implementation options available to companies to report operating costs by these services?

3.2 Future revisions to the RAGs

These proposals represent our view of reporting requirements for the immediate future. But we will continue to keep the content of the regulatory accounts under review to make sure they remain appropriate and reflect future developments, including those resulting from the UK Government's draft Water Bill.

We will have to revisit our accounting guidelines when International Financial Reporting Standards (IFRS) become mandatory for UK companies. This is expected to be effective from the 2015-16 reporting year. A review at this time will align with the first year for which prices will be set under our new approach to price setting (we will set prices for 2015-20 in 2014). This will ensure consistency between the regulatory accounts and our new price setting mechanisms.

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