

Water today, water tomorrow

**Consultation on changes to the regulatory
accounting guidelines (RAGs)
– appendices**

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Appendix 1: Regulatory accounting guideline 1 – Guideline for accounting for capital maintenance charges and current costs (proposed changes to RAG1.04)

1. Deletions

The following will be deleted from RAG 1.04.

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 a requirement
Paragraph 1.12.11 – final sentence only	Reference to RCV note	RCV note no longer a requirement
Paragraph 1.13.3 – final sentence only	Reference to RCV note	RCV note no longer a requirement
Paragraph 1.13.4 – final sentence only	Reference to RCV note	RCV note no longer a requirement
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
Appendix 3	Current cost accounting policies	No longer needed for regulatory accounts production
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

Any reference to RAG3.06 will be changed to RAG3.07 or deleted where applicable.

2. Revenue recognition

The following paragraphs will be inserted after paragraph 1.13.6.

1.14 Revenue recognition

- 1.14.1 We first addressed the issue of turnover recognition in ‘[RD 05/08: Regulatory accounts for 2007-08: reporting requirements RAG 3.06](#)’. We investigated incidents where companies had not complied with this policy in the 2008 regulatory accounts. We made appropriate adjustments to companies’ opening positions and our assessments of relative efficiency at the 2009 price review.
- 1.14.2 Our requirement is that companies should bill all properties where a service is being received, and should fully recognise the bill in the reported turnover figures in the regulatory accounts.
- 1.14.3 Therefore companies should **not** use the guidance in FRS5 to de-recognise turnover for amounts billed which they deem to be uncollectable.
- 1.14.4 This approach ensures the desired outcome for price setting purposes. All bad debt costs are fully recorded in the activity cost data (for our cost assessment calculations) and turnover is recorded correctly for operating the revenue correction mechanism (RCM).
- 1.14.5 Under the RCM, we have said that properties that are billed must be recorded in turnover. For clarity, this ensures that properties **only** fall into the following **two** categories for regulatory accounts purposes:
- a) Billed **and** recorded in turnover; or
 - b) Void properties.
- 1.14.6 Some companies receive revenue from customers via an agent, eg a WaSC may receive sewerage income from a WoC where the WoC raises a combined water and sewerage bill. In such circumstances, the recipient company should record both the billed amount (in turnover) and the full amounts of bad debt cost.
- 1.14.7 Commentary requirements for this area are set out in RAG3.

3. Worked examples of the working capital and financing adjustments

A new appendix 1 will show example calculations as follows.

Appendix 1

Worked examples of the working capital and financing adjustments are shown below.

Working capital adjustment

	xx13
	£m
Opening working capital	(7.7)
RPI	3.1%
Adjustment: $-7.7 \times 3.1\% \times (-1)$	0.2

Financing adjustment

	xx13
	£m
Net assets employed	17,514.1
Less:	
Total fixed assets	19,619.5
Working capital	(7.7)
Indexed linked debt	(168.0)
Deferred tax provision	(157.2)
	(19,286.6)
Revised opening net finance	(1,772.5)
RPI	3.1%
Adjustment: $-1,772.5 \times 3.1\% \times (-1)$	54.9

Appendix 2: Regulatory accounting guideline 2.04 – Guideline for classification of capital expenditure

1. Infrastructure and non-infrastructure assets

Infrastructure assets generally comprise:

- underground systems of mains and sewers;
- impounding and pumped raw water storage reservoirs;
- dams;
- sludge pipelines;
- sea outfalls; and
- information about infrastructure assets eg zonal investigation records.

All other assets, typically above ground, are classified as non-infrastructure.

2. Purpose category

2.1 Expenditure is categorised as shown below.

Purpose category	
Base service provision	Expenditure required to maintain the current (most recently established base) level of serviceability to customers
Enhancement	Expenditure resulting in a permanent increase in the current level of serviceability to a new “base” level (for example where a network is extended or improved to enable flows to be transferred for efficiency or maintenance reasons)

2.2 Enhancement projects may serve several purposes and in most cases will involve an element of maintenance works being carried out earlier than otherwise necessary. This advanced maintenance element should be allocated to base service provision.

- 2.3 Proportional allocation of capital expenditure is required between purpose categories. Schemes and projects under each service area should be allocated by proportion to each of the relevant purpose categories to at least the nearest 5%. However, threshold limits have been set on scheme values above which expenditure must be proportionally allocated because of the effect that a large individual scheme may have on the allocation of expenditure to a particular purpose category.

Annual capex programme (2007-08 price base)	Threshold scheme/project size for which proportional allocation is required
<£10 million	£10,000
£10 million – £100 million	£50,000
>£100 million	£100,000

- 2.4 Total scheme expenditure should be proportioned across the purpose categories in relation to the relative magnitudes of each element of the scheme. A single physical measure should be identified that is appropriate to all the relevant investment categories in a service area for example, rate of flow, equivalent population or hydraulic capacity.
- 2.5 Companies should continue to apply the allocation rules that they adopted for the preparation of the relevant business plan relating to the reporting year. Any material changes in allocation methodology should be disclosed in the regulatory accounts – see RAG3. Routine maintenance which is not capitalised in the accounts is treated as an operating cost.

3. Large projects

Companies should identify separately capital expenditure associated with large projects.

The criteria for such a project are that it should be:

- large;
- discrete;
- long term (span more than one price review);
- present a different risk profile to the portfolio of projects that constitute the rest of the company's capital programme.

Appendix 3: Regulatory accounting guideline 3.07 – Guideline for the format and disclosures for the regulatory accounts

1. Explanatory note

1.1 Introduction

1.1.1 This regulatory accounting guideline (RAG) covers the Condition F requirements for accounting information. This regulatory accounting guideline contains guidance 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.

1.2 Role of regulatory accounting guidelines

1.2.1 Regulatory accounts are the primary source of regular audited financial information about the business regulated by the Water Services Regulation Authority (Ofwat). It is intended that the RAGs should take precedence over UK accounting standards. Where the RAGs do not specifically address an accounting issue, then UK Generally Accepted Accounting Practice (UK GAAP) should be followed.

1.2.2 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. Sections of FRS5 that allow turnover to be disregarded should also be dis-applied.

1.2.3 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 pro forma A4).

1.2.4 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 Annual information notice on the regulatory accounts

1.3.1 Ofwat will publish an information notice annually, between January and March. This will include any required amendments to RAG3. If any new accounting standards mean that a departure from UK GAAP is necessary it will be covered in this letter. It will also set out the required format for the auditor's opinion in the regulatory accounts.

2. Accounting statements

2.1 Accounting statements

Condition F requirements

2.1.1 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.

Reconciliation of statutory and regulatory accounts

2.1.2 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 A4 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 pro formas set out in Appendix 1.

Pro formas

2.1.3 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.

The information in the regulatory accounts should be provided in a common format for all companies. The pro formas for the submission of data are included in Appendix 1.

Comparability – accounting treatment of acquisitions

2.1.4 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.

2.2 Publication of accounting statements

Reports to be delivered

2.2.1 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 Ofwat:

- Ultimate UK holding company accounts;
- regulatory accounts;
- statutory accounts (if not bound with regulatory accounts).

2.2.2 It is recommended that water bill notifications make reference to the location of the regulatory accounts on the appointee's website.

2.2.3 Paragraph 9.3 of Condition F requires that the appointee shall deliver to the Water Services Regulation Authority (Ofwat) 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 can submit electronic copies by email to Ofwat.

2.2.4 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

2.2.5 Companies are required to publish their regulatory accounts on their websites at the same time as they are submitted to Ofwat.

2.3 Audit

Auditors' reports

2.3.1 Paragraph 9 of Condition F requires auditors to address reports to Ofwat concerning:

- accounting records;
- accounting statements;
- historical cost accounts;
- current cost accounts.

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

2.3.3 The required wording of the audit opinion will be set out in our annual information notice on the regulatory accounts.

Auditors' details

2.3.4 Ofwat 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

2.3.5 The licence requires that the contract of appointment with the auditors contains a statement “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 Ofwat may reasonably require.”

2.4 Appointed business

Definitions

2.4.1 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.

2.4.2 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.

2.4.3 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).

2.4.4 Appointees are 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.

3. Accounting disclosures

3.1 Disclosures required in the regulatory accounts

3.1.1 Companies should include:

- a note which describes the link between directors' pay and standards of performance (as required by section 50 of the Water Act 2003);
- a statement as to disclosure of information to auditors;
- a statement on dividend policy for the appointed business;
- an accounting separation methodology statement and commentary;
- a note on revenue recognition;
- a note on capitalisation policy;
- a note on bad debt policy;
- statement on Condition K compliance; and
- diversification and protection of core business.

3.2 Statement of director's remuneration and standards of performance

3.2.1 The Water Act 2003 introduces a requirement for companies to make a statement to Ofwat at the end of each financial year, regarding links between directors' pay and standards of performance.

3.2.2 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.

3.2.3 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. It should comprehensively explain the arrangements, including all information relevant to the users of the regulatory accounts.

3.2.4 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. Even if the directors are also directors of another group or holding company they still need to be covered by this statement.

3.2.5 Remuneration means any form of payment, consideration or other benefit (including pension benefit).

3.2.6 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.

3.2.7 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 all individual directors.

3.2.8 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.

3.2.9 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.

3.2.10 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.

3.2.11 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.

3.3 Statement as to disclosure of information to auditors

3.3.1 The Companies (Audit, Investigations and Community Enterprise) Act 2004 (s234ZA) now includes clauses dealing with the auditor's rights to information.

- 3.3.2 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.
- 3.3.3 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.
- 3.3.4 Typically this is included in the directors’ report for statutory purposes. Ofwat requires this statement to be made in companies’ regulatory accounts.

3.4 Dividend policy

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

3.5 Accounting separation methodology statement and commentary

- 3.5.1 Companies must include an accounting separation methodology statement and accompanying commentary. It is for companies to decide what level of detail to include to enable users to understand the basis against which the separated accounts have been prepared.

As a minimum we would expect companies to include:

- cost allocation bases (costs drivers) and any changes year on year;
- a breakdown of the recharges paid to and received from other business units in respect of the use of fixed assets;
- significant changes in costs in the year;
- details of processes and systems and any changes year on year; and
- how companies have applied the principles set out in RAG4.

3.6 Revenue recognition note

3.6.1 Your revenue recognition note should cover the following:

- A description of any adjustments between amounts billed (as adjusted by the opening and closing income accrual) and amounts recorded as turnover in the regulatory amounts.
- Whether or not you bill void properties speculatively, that is to ‘the occupier’. If so, you should confirm that this bill is then recorded in turnover.
- If you do not speculatively bill, how you check that the property is indeed unoccupied. You should also describe how you ascertain the identity of any occupier.
- A description of the variance between the amounts of revenue assumed at the previous price determination and those recognised in the year. This would typically include factors such as the number of connected properties, the number of void properties, volume of consumption and price limit.
- Any changes in methodology in calculating the measured income accrual.
- Any significant differences between a retrospective review of the previous year’s measured income accrual and the amounts actually billed in the year.
- A description of steps that you take to establish whether properties with no occupier information are void or occupied, eg visits to properties, searches using third party electronic data such as council tax/electoral role records.
- A description of any differences between statutory accounts revenue recognition policies and regulatory accounts policy.

3.7 Capitalisation policy note

3.7.1 Companies should explain the basis for allocation of costs between operating expenditure and capital expenditure. Companies should also clearly state any general allocation rules which have been used (e.g. a rule requiring the capitalisation of any expenditure greater than £100). Companies should also detail any changes in judgements, apportionments or adjustments since the prior year, including changes to their capitalisation policies.

3.8 Bad debt note

3.8.1 Companies should set out details of their write-off policy and explain any changes from the prior year in their policies, procedures or practices in relation to write-offs along with the reasons for any changes.

3.8.2 Where a change in write-off policy (including ‘house-keeping’ exercises) results in a material change in the level of reported write-off, companies should explain whether this level is likely to continue in future years or is being reported as an atypical cost in this report year only.

3.8.3 Companies should comment on their bad debt provisioning policy, particularly where this has changed from the prior year. The effect of any changes should be quantified.

3.8.4 Where there has been significant movement in the trade debtor balance companies should comment on the reasons for the movement. This should refer to outstanding customer debt and the bad debt provision.

3.9 Condition K requirements

3.9.1 The regulatory 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.

3.10 Diversification and protection of core business

3.10.1 The ring fencing provisions in the licence require 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.

3.10.2 For most companies, the provisions in the licence have 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 Ofwat, 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.

4. Associated companies

4.1 Associated companies

Definitions

4.1.1 An associated company is defined in RAG5.05. All transactions between the appointee and associated companies should be considered on an arm's length basis and follow the guidance provided in RAG5.05.

Transactions to be disclosed

4.1.2 The licence requires that all transactions between the appointee and its associated companies must be disclosed and if any single transaction exceeds 0.5% of the turnover of the appointed business (or £100,000 if greater) it should not be aggregated. In particular, 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.

4.1.3 The licence 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.

4.1.4 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.

4.1.5 If a company is an associated company of an appointee for only part of a financial year then transactions with that associated company will only need to be disclosed whilst they were an associated company.

Transfer prices

4.1.6 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.

Appendix 1: Pro forma regulatory accounts

Table	Description
Pro forma A1	Historic cost profit and loss account for the 12 months ended 31 March 20xx
Pro forma A2	Statement of total recognised gains and losses (historical cost accounting) for the 12 months ended 31 March 20xx (appointed business only)
Pro forma A3	Historic cost balance sheet as at 31 March 20xx
Pro forma A4	Reconciliation between statutory accounts and regulatory accounts
Pro forma A5	Current cost profit and loss account for the 12 months ended 31 March 20xx (appointed business only)
Pro forma A6	Current cost cash flow statement for the 12 months ended 31 March 20xx (appointed business only)
Pro forma A7	Operating cost analysis for the 12 months ended 31 March 20xx (wholesale business only)
Pro forma A8	Operating cost analysis for the 12 months ended 31 March 20xx (retail business only)
Pro forma A9	Current cost analysis of fixed assets (wholesale business only)
Pro forma A10	Current cost analysis of fixed assets (retail business only)
Pro forma A11	Analysis of capital expenditure, grants and land sales for the 12 months ended 31 March 20xx
Pro forma A12	Analysis of working capital
Pro forma A13	Analysis of net debt, gearing and interest costs
Pro forma B1	Properties analysis for the 12 months ended 31 March 20xx

[RAG3 pro forma tables – Excel files](#)

Appendix 2: Regulatory accounts – pro forma A4 example disclosure

Reconciliation between Statutory Accounts and Regulatory accounts

£m	Statutory UK GAAP	Regulatory	
Profit and loss account			
Turnover	750.4	753.7	The company has not recognised revenue in the statutory accounts where it does not consider it probable that it will receive payment. In the regulatory accounts revenue is recognised in respect of all recorded occupied properties regardless of any previous payment history or whether the company has the occupier's name. As there has been a corresponding adjustment to the bad debt charge there is no impact on profit.
Operating profit	258.3	256.3	In the statutory accounts the company classifies rental income of £2.0m as operating income.
Profit before tax	150.2	150.2	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.
Balance sheet			
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.
Infrastructure renewals accrual	n/a	(2.9)	Ofwat requests that, for regulatory accounting purposes, FRS15 is not applied for infrastructure renewals accounting. The infrastructure renewals accrual of £2.9m is therefore excluded from the fixed asset net book value.
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.
Investments – loan to group company	n/a	100.0	Ofwat accounting guidelines state that this should be classified as an investment.
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 4: Regulatory accounting guideline 4.04 – Guideline for the definitions for the regulatory accounts tables

1. Regulatory accounting principles

1.1 Introduction

This regulatory accounting guideline covers the form, content and principles of the analysis of operating costs and assets to be produced as part of the current cost accounts, and includes a list of definitions of terms.

1.2 Objectives

The analysis of operating costs and fixed assets detailed in this document is designed to facilitate:

- transparency and comparability of costs across the water and sewerage value chain;
- informed regulatory decisions; and
- demonstrate costs and assets employed in providing water and sewerage services.

1.3 Format

The analysis will form part of the current cost regulatory accounts submitted to Ofwat under Condition F of the licence. The basic format of the analysis is of a subjective disaggregation of the operating costs directly incurred under a range of activities, together with an associated analysis of fixed assets. The definitions of the cost components are different from those originally specified in the licence.

1.4 Licence authority

Condition F, paragraph 5, sets out the analysis of operating costs which appointees are required to provide. This guideline will replace those requirements.

2. Cost allocation

2.1 Cost allocation principles

Accounting separation systems need to comply with the following general principles. Principles should be applied in the order of priority as set out below:

- **Transparency:** the attribution methods applied within the accounting separation system need to be transparent. This requires that the costs and revenues apportioned to each service and business unit should be clearly identifiable. The cost and revenue drivers used within the system should also be clearly explained to enable a review of their appropriateness.
- **Causality:** cost causality requires that costs (and revenues) are allocated to those activities and services that cause the cost (or revenue) to be incurred. This requires that the attribution of costs and revenues to activities and services should be performed at as granular level as possible.
- **Non-discrimination:** the attribution of costs and revenues should not favour any business unit within the regulated company and it should be possible to demonstrate that internal transfer charges are consistent with the prices charged to external third parties.
- **Objectivity:** the cost and revenue attribution criteria need to be objective and should not intend to benefit any business unit or service.
- **Consistency:** the cost and revenue attribution criteria should be consistent from year to year to enable meaningful comparison of information over time. Changes to the attribution methodology from year to year should be clearly justified and documented.

2.2 Concepts

Ofwat's primary concern is with the current cost accounts. Therefore the analysis of operating costs and of fixed asset values by asset type and by business unit should only be prepared on a current cost basis. The regulatory requirement for the analysis of historical cost operating costs and fixed assets will be largely met by the statutory requirements. No analysis of operating costs is required as part of the historical cost accounts.

Each item of operating expenditure and capital charges should be either coded directly to a business unit or allocated across several business units.

Section 1.7 of RAG1.04 explains principles for asset valuation.

Fixed assets directly involved in the activities within each of the business units should be recorded in that business unit. In addition other assets used such as land,

office, depots and workshops and vehicles that solely relate to a business unit should be recorded directly in that unit.

Where an asset is utilised in more than one business unit, the asset should be recorded in the business unit of principal use with recharges made by the other business units that use that asset. Recharges should reflect the proportion used by each unit.

Companies should ensure that the fixed assets and operating expenditure relating to the same activity is recorded in the same business unit.

2.3 Business units

Companies should attribute all costs and assets across the following business units that represent different high-level activities that are fundamental in the provision of water and sewerage services to customers.

A summary of the activities, processes and assets included within each business unit is included in the next section.

2.3.1 Water service

- Water resources.
- Raw water distribution.
- Water treatment.
- Treated water distribution.

2.3.2 Sewerage service

- Sewage collection.
- Sewage treatment.
- Sludge treatment, recycling and disposal.

2.3.3 Retail service

- Retail household.
- Retail non-household.

3. Business unit summaries

3.1	Water service	
3.1.1	Water resources	
	Description	<p>Identify sources of raw water, obtain permission for their extraction or collection and input it to the raw water distribution system.</p> <p>Inputs: Raw water from aquifers, lakes, reservoirs, rivers and third parties.</p> <p>Outputs: Supply of quantities of raw and partially treated (non-potable) water into the distribution system for transport to treatment works.</p>
	Boundary points	<p>Start: None.</p> <p>End: Supply of raw and partially treated (non-potable) water through a pump or gravity fed through a valve into the raw water distribution system.</p>
	Processes	<ul style="list-style-type: none"> • Identify raw water abstraction sites, negotiate and agree licences. • Pay licence fees to abstract raw water. • Construct assets at sites – boreholes, dams, control rooms, pump assets, etc. • Inspect, operate, maintain, and repair assets on sites. • Pump water from abstraction sites. • Initial filtration or partial treatment of water on site (eg, to remove large impurities). • Pump water between resource sites (pumped storage). • Supply management. • Procuring raw water and sale of raw water from/to other water suppliers/customers. • Testing of water samples at sites. • Catchment management of water abstraction sites (eg, reservoirs and lakes). • Managing sustainability issues (eg, investigations into environmental impact and taking corrective action). • Power generation. • Emergency planning. • Monitoring and control of processes.

	Services	<ul style="list-style-type: none"> • Abstraction licence – annual licence including negotiating with third parties to obtain abstraction rights and agree charges. • Water abstraction – includes activities related to the identification of new sources, licence management, and the required abstraction infrastructure.
	Operating expenses	All costs associated with identifying sources of raw water, extraction, collection and input into the raw water distribution system. Include the cost of bulk raw water supplies purchased.
	Assets	<ul style="list-style-type: none"> • Reservoirs and lakes – dams, control rooms, valves, sluices. • Abstraction sites (rivers and boreholes) – pumping equipment, buildings and other sundry equipment at sites. • River abstraction infrastructure – screens, inlet works. • Pipework between raw water sites (pumped storage). • IT assets – abstraction sites control. • Vehicles. • Premises.
	Third party involvement	<ul style="list-style-type: none"> • Environment Agency. • British Waterways Board. • Drinking Water Inspectorate. • Suppliers/customers of raw or partially treated (non-potable) water. • Third parties involved in power generation/sale.
3.1.2	Raw water distribution	
	Description	<p>Transport raw water and partially treated (non-potable) water from abstraction site to treatment works (including where small numbers of customers are supplied direct from the pipe – with on-site treatment facilities) or to end user customer.</p> <p>Inputs: Receipt of raw water and partially treated (non-potable) water from abstraction sites that has either been pumped or gravity fed through an outlet valve.</p> <p>Outputs: Delivery of raw water and partially treated (non-potable) water to treatment works or to customers.</p>
	Boundary points	<p>Start: Raw water and partially treated (non-potable) water that has been pumped or gravity fed through an outlet valve.</p> <p>End: Raw water and partially treated (non-potable) water entering treatment works or being delivered to the end user customer.</p>
	Processes	<ul style="list-style-type: none"> • Construct pipelines between water abstraction sites and water

		<p>treatment works or end user customers including booster pumps.</p> <ul style="list-style-type: none"> • Inspect, operate, maintain, and repair pipelines and pump assets. • Waste/leakage detection within raw water distribution network. • Transport water along aqueducts and pipelines including pumping. • Storage of raw and partially treated (non-potable) water. • Testing of water at sample sites. • Management and operation of raw water distribution network including strategic planning of network. • Undertake diversions work (including highway diversions) at the instruction of local authorities and others. • Power generation. • Emergency planning. • Monitoring and control of processes.
	Services	<ul style="list-style-type: none"> • Raw water transport – transporting raw water from the boundary of the abstraction site to treatment plants, raw water storage facilities, other water companies or to industrial customers. • Raw water storage – raw water storage facilities, including impounding reservoirs without abstraction licence.
	Operating expenses	<p>All costs associated with the transport of raw and partially treated (non-potable) water from abstraction site to treatment works (including where small numbers of customers are supplied direct from the pipe – with on-site treatment facilities) or to end user customer. Include the cost of distributing bulk water supplies purchased.</p>
	Assets	<ul style="list-style-type: none"> • Pipework and aqueducts. • Pumping stations into treatment sites. • Booster pumps, valves and other equipment within the raw water distribution network. • Storage reservoirs for raw or partially treated (non-potable) water. • Leakage detection equipment. • IT assets – network control. • Vehicles. • Premises.

	Third party involvement	<ul style="list-style-type: none"> • Non-potable water customers. • Third parties involved in power generation/sale. • Local authorities, highways authorities, other utilities and others.
3.1.3 Water treatment		
	Description	<p>Receive raw or partially treated (non-potable) water from raw water distribution system and undertake treatment processes.</p> <p>Inputs: Raw water and partially treated (non-potable) water from raw water distribution network.</p> <p>Outputs: Treated water pumped into the treated water distribution network, non-potable treated water delivered to end user customer or waste discharged to sewer.</p>
	Boundary points	<p>Start: Input of raw water and partially treated (non-potable) water from the raw water distribution system or direct from abstraction sites.</p> <p>End: Discharge of treated water through a pump or gravity fed into the treated water distribution network, delivery of non-potable treated water to customers or discharge of waste by-products into the sewerage network.</p>
	Processes	<ul style="list-style-type: none"> • Receive water from raw water distribution network or abstraction sites. • Treat water through addition of chemicals or filtration etc. • Dispose of any waste products, surplus chemicals etc. • Pump water within treatment process. • Inspect, operate, maintain, and repair treatment assets. • Discharge water into treated water distribution system. • Construct treatment plants (including installing pumping assets). • Sample testing of water quality before, during and after treatment process. • Management of treatment activity, capacity planning, supply, etc. • Procuring bulk treated water and sale of treated water from/to other water suppliers/customers. • Technical water process advice and support. • Power generation. • Emergency planning. • Monitoring and control of processes.

		<ul style="list-style-type: none"> • Construct and upgrade pipeline between water treatment works and non-potable customer including booster pumps. • Discharge waste by-products (eg, nitrates) into sewerage network.
	Services	Water treatment – includes all the activities in the treatment of raw water, including both chemical and physical treatment.
	Operating expenses	All costs associated with the treatment of raw and partially treated (non-potable) water and discharge to the treated water distribution system or delivery of non-potable treated water to customer. Include the cost of treated water supplies purchased.
	Assets	<ul style="list-style-type: none"> • Treatment works including on site pipework and pumps. • IT assets – treatment works control. • Vehicles. • Other premises.
	Third party involvement	<ul style="list-style-type: none"> • Suppliers/customers of bulk treated water. • Non-potable treated water customers. • Drinking Water Inspectorate. • Third parties involved in power generation/sale.
3.1.4	Treated water distribution	
	Description	<p>Transport of treated (potable) water from treatment sites to customer properties and new appointees. This activity includes intermediate storage facilities (eg, reservoirs and storage towers) with possible further treatment taking place within the network.</p> <p>Inputs: Treated (potable) water from treatment sites and third parties.</p> <p>Outputs: Supply of treated (potable) water to customers and new appointees.</p>
	Boundary points	<p>Start: Treated (potable) water that has been pumped or gravity fed into the treated water distribution network.</p> <p>End: Supply of treated (potable) water to retail customer/new appointee boundary.</p>
	Processes	<ul style="list-style-type: none"> • Construct and upgrade pipelines between water treatment sites and customers including booster pumps (including upgrades required by legislation). • Inspect, operate, maintain, and repair pipelines, pump assets and ancillary assets (including fire hydrants). • Waste/leakage detection within treated water distribution network.

		<ul style="list-style-type: none"> • Transport water along pipelines. • Storage of treated water in reservoirs and booster sites. • Testing of water at sample sites. • Secondary treatment of water within system. • Cleaning of water mains and service reservoirs. • Investigation of operational issues (eg, low pressure, discolouration, water quality). • Adoption of new connections into the network. • Decommissioning redundant mains and involvement in the disconnection process. • Undertake diversions work (including highway diversions) at the instruction of local authorities and others. • Management and operation of treated water distribution network including strategic planning of network, modelling and demand management. • Management of planned and unplanned interruptions. • Power generation. • Emergency planning. • Monitoring and control of processes.
	Services	<ul style="list-style-type: none"> • Trunk treated water transport – transporting treated water across two or more District Metered Areas (DMAs). • Local treated water distribution – transporting treated water within a District Metered Area (DMA).
	Operating expenses	<p>All costs associated with the transport of treated water from treatment sites to customer properties and new appointees. This includes costs associated with intermediate storage facilities (eg reservoirs and storage towers) and further treatment taking place within the network. Exclude the costs of installation, removal and replacement of consumer meters and meter reading. Where distribution employees are employed to work partly or wholly on work related to tariff matters, and charging and billing enquiries, the appropriate proportion of their time should be charged to the retail accounting unit and recorded in the supplementary retail services table.</p>
	Assets	<ul style="list-style-type: none"> • Water mains and pipework up to meter point or curtilage in customer premises or new appointee boundary. • Booster pumps, valves and other equipment within the distribution system. • Storage reservoirs, service reservoirs and water towers within the distribution system.

		<ul style="list-style-type: none"> • Leakage detection equipment. • IT assets – network control. • Vehicles. • Premises. • Meter chambers.
	Third party involvement	<ul style="list-style-type: none"> • Customers. • Local authorities, highways authorities, other utilities and others. • New appointees. • Retailer. • Fire service. • Third parties involved in power generation/sale. • Drinking Water Inspectorate.
3.2	Sewerage service	
3.2.1	Sewage collection	
	Description	<p>Collection of sewage from customers and new appointees and transport to treatment works.</p> <p>Inputs: Sewage from customer’s premises and new appointees, highways drainage, surface water drainage and infiltration.</p> <p>Outputs: Sewage at treatment work sites or through CSOs.</p>
	Boundary points	<p>Start: Receipt of sewage from retail customer or new appointee.</p> <p>End: Sewage arriving at the inlet to sewage treatment works or discharging through CSOs in adverse weather conditions.</p>
	Processes	<ul style="list-style-type: none"> • Construct sewers between customer sites and sewage treatment works. • Inspect, operate, maintain, and repair sewers, pump assets, street furniture and emergency overflows and outfalls. • Surface water drainage • Transport sewage to sewage treatment works. • Testing of sewage at sample sites. • Unblocking and repairing sewers and manholes, clearing obstructions undertaking inspections. • Rodent control. • Cleaning up sewer flooding incidents. • Odour control. • Septicity control.

		<ul style="list-style-type: none"> • Investigation of complaints (eg, sewer flooding, odour complaints). • Adoption of new sewerage connections into the network. • Decommissioning redundant sewers and involvement in the disconnection process. • Undertake diversions work (including highway diversions) at the instruction of local authorities and others. • Management and operation of sewage collection network including strategic planning of network, modelling and demand management. • Planning to mitigate and prevent sewer flooding. • Power generation. • Emergency planning. • Monitoring and control of processes.
	Services	<ul style="list-style-type: none"> • Sewage collection – foul. • Sewage collection – surface water drainage. • Sewage collection – highways drainage.
	Operating expenses	All costs associated with sewage collection and transport to treatment works. Exclude pumping costs (ie, costs incurred in pumping into treatment works).
	Assets	<ul style="list-style-type: none"> • Sewers and pipework – from customer premises/new appointees to sewage treatment works. • Pumping stations and other assets within the sewerage system (eg manholes and inspection chambers). • Storm overflows and screens. • Street furniture and other ancillary assets. • Emergency outflows. • IT assets – network control. • Vehicles. • Premises.
	Third party involvement	<ul style="list-style-type: none"> • General customers. • New appointees. • Local authorities, highways authorities, other utilities and others – diversions. • Third parties involved in power generation/sale.

3.2.2 Sewage treatment	
Description	<p>Receive untreated sewage from the sewage collection system into treatment works, undertake treatment processes and discharge treated wastewater into rivers, etc and sewage sludge to treatment processes.</p> <p>Inputs: Untreated sewage from sewage collection system.</p> <p>Outputs: Treated wastewater into receiving watercourses, discharge of sewage sludge for transfer to sludge treatment processes.</p>
Boundary points	<p>Start: Sewage arriving at the inlet to sewage treatment works.</p> <p>End: Consented sampling point at point of discharge of treated wastewater to receiving watercourse; discharge of sewage sludge from sewage treatment process into pipework leading to sludge treatment processes; or to holding tanks for tankering to sludge treatment site.</p>
Processes	<ul style="list-style-type: none"> • Construct and upgrade sewage treatment sites including pumping stations and pipework. • Construct sewage outfalls including pipework for transfer of treated wastewater to watercourses. • Inspect, operate, maintain and repair assets on sewage treatment sites, including routine maintenance of pumps, valves, etc. • Inspect, operate, maintain, and repair terminal pumping assets. • Inspect, operate, maintain and repair pipework including leakage detection and repair. • Operate sewage treatment sites including preliminary treatment and primary, secondary and tertiary treatment processes and UV treatment. • Discharge treated wastewater to watercourses. • Disposal of other waste from treatment works (eg, screenings, grit, surplus chemicals, other residue). • Power generation. • Policing of trade effluent discharged into the system • Liaison with and provision of wastewater advice and support to retailers in relation to customers who discharge trade effluent into the network. • Sample testing of sewage during treatment process. • Management of sewage treatment sites – capacity planning, strategic planning, logistics, etc.

		<ul style="list-style-type: none"> • Storage of sewage sludge on site before transport to sludge treatment facilities/process. • Emergency planning. • Monitoring and control of processes.
	Services	<ul style="list-style-type: none"> • Sewage treatment and disposal – includes all the activities related to the treatment and disposal of sewage from customers.
	Operating expenses	All costs associated with sewage treatment including receiving untreated sewage pumping costs, discharge of sewage sludge to pipework to sludge treatment or holding tank and discharge of treated wastewater to receiving watercourses.
	Assets	<ul style="list-style-type: none"> • Sewage treatment plants – tanks, filters, strainers etc. • Pumps, valves and other ancillary assets. • Sludge holding tanks. • IT assets – treatment works control. • Vehicles. • Other premises.
	Third party involvement	<ul style="list-style-type: none"> • Trade effluent customers. • Septic tank and cesspool emptying companies and retailers. • Third parties involved in power generation/sale. • Environment Agency. • Other bodies involved in waste management compliance process.
3.2.3	Sludge treatment, recycling and disposal	
	Description	<p>Collect sewage sludge from sewage treatment processes, undertake treatment and dispose of treated sludge in various forms including ash disposal, disposal to landfill, disposal or recycling to land of composted sludge, sludge cake disposal or recycling to land, and export of treated sludge for disposal.</p> <p>Inputs: Sewage sludge from sewage treatment plant.</p> <p>Outputs: Sludge disposed or recycled.</p>
	Boundary points	<p>Start: Pumping through pipes or other transport of sewage sludge to sludge treatment sites.</p> <p>End: Sludge disposed or recycled to land.</p>
	Processes	<ul style="list-style-type: none"> • Construct and upgrade sludge treatment sites. • Inspect, operate, maintain, and repair assets on sludge treatment sites, including routine maintenance of pumps,

		<p>valves, etc.</p> <ul style="list-style-type: none"> • Transfer of sewage sludge from sewage treatment site to sludge treatment site. • Operate sludge treatment sites including digestion, dewatering, thickening, centrifuging, composting, incineration and other treatment processes. • Sample testing of sludge during treatment process. • Management of sludge treatment sites and sludge disposal processes – including capacity planning, strategic planning, logistics, etc. • Export of sewage sludge for treatment by other parties. • Gas collection for power generation. • Storage of sludge at sludge treatment site (eg, for controlling and blending flows). • Disposal or recycling of treated sludge through recycling to land, sludge cake disposal, disposal of composted sludge, disposal to landfill and other means. • Disposal of ash from incineration. • Exporting treated sludge for disposal/recycling by other companies. • Inspect, operate, maintain, and repair assets used for sludge transport, recycling and disposal, eg, vehicles. • Maintenance of landfill sites or sludge tips. • Monitor compliance with appropriate environmental regulations and undertake sample testing on treated sludge. • Construct and commission new sludge disposal sites. • Power generation. • Emergency planning. • Monitoring and control of processes.
	<p>Services</p>	<ul style="list-style-type: none"> • Sludge transport – includes all the activities related to transporting sludge from sewage to sludge treatment plant. All types of transport are included within this service. • Sludge treatment – includes all the activities related to sludge treatment. • Liquor treatment - includes all activities in transporting and treating liquors generated during the sludge treatment process. • Sludge disposal and recycling – includes all the activities related to the disposal/recycling of sludge including transport, regardless of the method of disposal.

	Operating expenses	All costs associated with sludge treatment, recycling and disposal, including pumping or transporting from sewage treatment process to sludge treatment, sludge liquor treatment and onward transport and disposal/recycling of treated sludge in various forms including ash disposal, disposal to landfill, disposal of composted sludge, sludge cake disposal and export of treated sludge for disposal.
	Assets	<ul style="list-style-type: none"> • Pipework from sewage treatment site to sludge treatment site. • Pre-treatment sludge blending tanks. • Sludge treatment plants – thickeners, digesters, centrifuges, vacuum presses, belt presses, other dewatering assets, sludge dryers, drying beds. • Liquor pipework from sludge treatment to sewage treatment site. • Liquor plants. • Composting vessels and facilities. • Incinerators. • Pumps, valves and other ancillary assets. • Treated sludge storage facilities. • Vehicles. • IT assets. • Premises. • Gas treatment and energy generation equipment (eg, CHP). • CHP electrical connection to the grid.
	Third party involvement	<ul style="list-style-type: none"> • Environment Agency and other bodies involved in waste management compliance process. • Haulage contractors. • Third parties involved in energy generation/sale. • Third parties supplying sewage sludge for treatment. • Farmers.
3.3	Retail service	
	Description	<p>Management and delivery of water and sewerage services to the final customer including customer sales, billing, payment handling and provision of customer services and liaison.</p> <p>Inputs: Requests for water and sewerage services from customers and third parties.</p> <p>Outputs: Provision of water and sewerage services, related customer facing activities and billing/debt collection services.</p>

	Processes	<ul style="list-style-type: none"> • Marketing, new product development and sales to final consumers. • Manage customer data, issue bills and manage billing exceptions. • Payment handling, remittance and cash handling. • Manage debt recovery. • Handle network related customer enquiries and complaints. • Handle non network related customer enquiries and complaints. • Manage meter reading. • Manage meter maintenance, repair and replacement. • Inspect, operate, maintain, and repair retail assets. • Manage and perform disconnections. • Provision of demand side water efficiency initiatives. • Manage developer queries and provide services to developers. • Provide support for trade effluence compliance. • Investigate and resolve customer side leaks. • Emergency planning. • Monitoring and control of processes.
	Services	<ul style="list-style-type: none"> • Retail – customer facing costs of water and sewerage services.
	Operating expenses	<ul style="list-style-type: none"> • Retail household – all direct costs associated with the provision of retail services to household customers. • Retail non-household – all direct costs associated with the provision of retail services to non-household customers.
	Assets	<ul style="list-style-type: none"> • Billing system. • Call centre telephone system. • Other IT telephony. • Customer meters. • Office premises, fixtures and fittings. • Vehicles. • Other premises.

	Third party involvement	<ul style="list-style-type: none"> • Customers • Non-potable water customers • Developers. • Network water companies. • Third parties involved in energy generation/sale.
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4. Definitions of terms

Pro forma A1

Historic cost profit and loss account for the 12 months ended 31 March 20xx

A1.1	Turnover	<p>Appointed – Total business revenue that is within the scope of price limits. 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. Equal to line A5.9.</p> <p>Revenue as defined in RAG1.05.</p> <p>Non-appointed – Total business revenue that is outside the scope of price limits.</p>
A1.2	Operating costs	Historical cost operating costs.
A1.3	Infrastructure renewals charge	The total infrastructure renewals charge.
A1.4	Historical cost depreciation	The depreciation charge on non-infrastructure assets in the historic cost accounts. This should include depreciation on intangible assets and should be net of grant amortisation. The depreciation charge on non-redundant infrastructure assets is taken to be zero when infrastructure renewals accounting is in use.
A1.5	Operating income	Historical cost operating income includes profits or loss on disposal of fixed assets; income arising from exceptional items should also be included. Normally a positive number, but a loss should be negative.
A1.6	Operating profit	Historical cost operating profit. Equal to the sum of lines A1.1 to A1.5.
A1.7	Other income	Includes rental income and income from investments (eg, share income); excludes net interest and profit on disposals on fixed assets.

A1.8	Net Interest	<p>Interest receivable less interest payable. A negative figure for net interest payable.</p> <p>Interest payable includes interest paid on loans, leases, debenture, floating rate debt, overdrafts, preference shares and all other borrowings. Interest receivable includes interest received on cash deposits, loans, etc.</p>
A1.9	Profit on ordinary activities before taxation	Historical cost profit on ordinary activities before taxation. Equal to the sum of lines A1.6 to A1.8.
A1.10	Current tax	The current tax charge on profits from ordinary activities. This will include mainstream corporation tax, income and other taxes. It should exclude any deferred tax charge which is to be reported separately. FRS16 or IAS 12 should be adhered to. A positive number for tax credit, negative number for tax charge.
A1.11	Deferred tax	The movement in the deferred tax provision. FRS19 or IAS 12 should be adhered to. A positive number for tax credit, negative number for tax charge.
A1.12	Profit on ordinary activities after taxation	Historical cost profit on ordinary activities after taxation. Equal to the sum of lines A1.9 to A1.11.
A1.13	Extraordinary items	Extraordinary items are defined in accordance with UK GAAP.
A1.14	Profit for the year	Historical cost profit for the year. To be shown after taxation and extraordinary items, but before deduction of dividends. Equal to the sum of lines A1.12 and A1.13.
A1.15	Dividends	Total dividends. Dividends on ordinary shares only. Dividends on preference shares are to be included in net interest.
A1.16	Retained profit for year	Total historical cost retained profit for the year. Equal to the sum of lines A1.14 and A1.15.

Pro forma A2

Statement of total recognised gains and losses (historical cost accounting) for the 12 months

A2.1	Profit for the year	Historical cost profit for the year. Equal to line A1.14.
A2.2	Actuarial gains/(losses) on post-employment plans	Actuarial gains/(losses) on post-employment plans as defined by UKGAAP.
A2.3	Other gains/(losses)	Other gains and losses.
A2.4	Total recognised gains/(losses) for the year	Total recognised gains and losses for the year. Equal to the sum of lines A2.1 to A2.3.

Pro forma A3

Historic cost balance sheet as at 31 March 20xx

Fixed assets		
A3.1	Tangible fixed assets	Historical cost net book value of tangible fixed assets at the end of the financial year. This is stated after deducting grants and contributions received relating to infrastructure assets.
A3.2	Investment – loan to a group company	Loans made to other group companies repayable in more than one year.
A3.3	Investment – other	All investments as defined by UKGAAP, excluding those in line A3.2, eg, shares in other group companies.
A3.4	Total fixed assets	Historical cost total fixed assets. Equal to the sum of lines A3.1 and A3.3.
A3.5	Infrastructure renewals prepayment/(accrual)	The cumulative difference between the IRE and IRC. Prepayment where the IRE has exceeded the IRC; accrual where the IRC has exceeded the IRE.

Current assets		
A3.6	Other current assets	<p>All other current assets. Includes stock, debtors, cash, and short term deposits.</p> <p>Stocks held at the year end. Stocks consist of consumable stores and work in progress, including chemicals, stationery, petrol, backfill materials, etc.</p> <p>Debtors consist of all amounts owing to the company at the financial year end including trade debtors, prepayments and accrued income. This includes amounts falling due after more than one year.</p> <p>Cash consists of cash in hand and at bank. Overdraft balances should not be netted off as it should be included separately in ‘Other creditors’.</p>
Creditors: amounts falling due within one year		
A3.7	Borrowings	<p>Balances due within one year which comprise:</p> <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; and • any other borrowings. <p>Accrued interest on borrowings should not be included.</p>
A3.8	Other creditors	<p>All other creditors falling due within one year. Includes overdrafts, creditors, corporation tax payable, ordinary share dividends payable, and preference share dividends payable.</p> <p>Corporation tax payable consists of any balances of corporation tax due to HMRC.</p> <p>Ordinary share dividends payable includes any unpaid dividends which have been recognised in accordance with FRS21.</p> <p>Preference share dividends payable includes any unpaid preference share dividends.</p>
A3.9	Total creditors: amounts falling due within one year	<p>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</p>

		creditors. Equal to the sum of lines A3.7 and A3.8.
A3.10	Net current assets	Historical cost net current assets. Equal to the sum of lines A3.5, A3.6 and A3.9.
A3.11	Total assets less current liabilities	Total assets less current liabilities. Equal to the sum of A3.4 and A3.10.
Creditors: amounts falling due after more than one year		
A3.12	Borrowings	Balances due after more than one year 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; and • any other borrowings. Accrued interest on borrowings should not be included.
A3.13	Other creditors	Other amounts due after more than one year which are not borrowings or provisions for liabilities and charges. This will include accrued interest and mains deposits.
A3.14	Total creditors: amounts falling due after one year	Total creditors due after one year. Equal to the sum of lines A3.12 and A3.13.
A3.15	Provisions for liabilities and charges	Total provisions for liabilities and charges due after one year. Includes deferred tax provision, deferred income – grants and contributions, post-employment asset/(liabilities), and all other provisions including restructuring or reorganisation provisions.
A3.16	Preference share capital	Nominal value of the preference share capital.
A3.17	Net assets employed	Total assets employed by the business under the historical cost accounting convention. Equal to the sum of lines A3.11, A3.14, A3.15 and A3.16.
A3.18	Capital and reserves	Total of shareholders' funds. The sum of called up share capital, share premium, profit and loss account, and other reserves. This equals line A3.17.

Pro forma A4

Reconciliation between statutory accounts and regulatory accounts

Statutory UK GAAP / IFRS*

The Statutory accounts produced under UK GAAP or IFRS.

Regulatory

Financial statements that the appointed water companies submit to us in respect of the regulated business. They are always produced to a 31 March year-end.

Profit and loss account		
A4.1	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. Same as line A1.1.
A4.2	Operating profit	Operating profit. Same as line A3.1.
Balance sheet		
A4.3	Tangible fixed assets (net book value)	Net book value of tangible fixed assets at the end of the financial year. This is stated after deducting grants and contributions received relating to infrastructure assets.

Pro forma A5

Current cost profit and loss account

A5.1	Unmeasured – household	All revenue derived from: <ul style="list-style-type: none"> the sale of water at tariff basket charges; optional unmeasured water charges at standard rates for example, for hosepipes and swimming pools; and the provision of sewerage services at tariff basket charges, to households other than on a measured basis.
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A5.2	Unmeasured – non-household	All revenue derived from: <ul style="list-style-type: none"> the sale of water at tariff basket charges; and the provision of sewerage services at tariff basket charges to non-households other than on a measured basis.
A5.3	Measured – household	All revenue accrued from the sale of water and from the provision of sewerage services at tariff basket charges to households where all or some of the charges for the supplies are based on measured quantities of volume.
A5.4	Measured – non-household	All revenue accrued from the sale of water and from the provision of sewage treatment and disposals at tariff basket charges to non-households where all or some of the charges for the supplies are based on measured quantities of volume. Exclude reception, treatment and disposal of trade effluent.
A5.5	Trade effluent	All revenue accrued from the reception, treatment and disposal of trade effluent at tariff basket rates.
A5.6	Bulk supplies/inter-company payments	All income received from providing a bulk supply to another water undertaker.
A5.7	Other third party services (incl. non-potable water)	All other sources of income that are not reported in lines A5.1 to A5.6 but are derived from third parties for the provision of water and sewerage services. Include revenue accrued from the sale of non-potable water in the water service column.
A5.8	Other sources	All other sources of turnover for water and sewerage services that are not reported in lines A5.1 to A5.7. Include revenues from large users, special agreements, revenue grants, rechargeable works, and other appointed business. The large user threshold is as specified under section 7(5)(a) of the Water Industry Act 1991 and it remains independent of the WSL threshold. The large user threshold remains at 50MI per annum, unless the undertaker’s area is wholly or mainly in Wales for which the quantity is 250MI per annum.
A5.9	Total turnover	Total appointed business revenue for water and sewerage services. The total of lines A5.1 to A5.8.
A5.10	Current cost operating costs – wholesale	Total cost current operating costs including capital maintenance charges, exceptional charges but excluding extraordinary items concerning the wholesale business. Equal to the water and sewerage sub-totals in line A7.19.

A5.11	Current cost operating costs – retail	Total cost current operating costs including current cost depreciation, infrastructure renewals charges, and exceptional charges but excluding extraordinary items concerning the retail business. Equal to the total of line A8.21 split between water and sewerage services.
A5.12	Operating income	Operating income including current cost profit or loss on disposal of fixed assets and income from exceptional items as defined by UK GAAP.
A5.13	Working capital adjustment	An adjustment for the impact of general inflation on the real value of working capital to the business. If both working capital and RPI are positive, then the adjustment will give a reduction in profit and so be negative.
A5.14	Current cost operating profit	The sum of lines A5.9 to A5.13.
A5.15	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.
A5.16	Net interest	Interest receivable less interest payable. Interest receivable includes interest on cash and other deposits. Interest payable includes interest on loans, leases, debentures, overdrafts, and all other borrowings, eg commercial paper or bills of exchange.
A5.17	Financing adjustment	The real gain or loss arising for shareholders from the impact of general inflation on monetary assets and liabilities.
A5.18	Current cost profit before taxation	The net of current cost operating profit and other income, net interest and financing adjustment. The total of lines A5.14 to A5.17.
A5.19	Net revenue movement out of tariff basket	Include the revenue from customers: <ul style="list-style-type: none"> • Criss-crossing the tariff basket threshold The revenue of customers reported as non-tariff basket revenue but were in the tariff basket in the previous year less the revenue of customers reported as tariff basket revenue but were in the non-tariff basket in the previous year. • Switching to another provider under the WSL regime The revenue of customers previously in the tariff basket who have switched to another service provider less the revenue of customers going into the tariff basket who have switched from another service provider.

A5.20	Back-billing amount identified	<p>For a company to be able to make a claim for the back-billing incentive it would have had to have back-billed the customer and have received all outstanding amounts due from the customer.</p> <p>Where a company wishes to claim for the back-billing incentive, it should provide us with the total amount for the back-billing adjustment that it wishes us to include in the revenue correction mechanism (RCM) calculation.</p> <p>It should follow the guidance as specified in information note IN 11/04, 'Simplifying the revenue correction mechanism (RCM)'.</p>
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Pro forma A6

Current cost cash flow statement

For lines A6.10 to A6.23, a cash outflow is shown as negative and a cash inflow is shown as positive.

A6.1	Current cost operating profit	Current cost operating profit before tax, interest and extraordinary items. This is equal to line A5.14.
A6.2	Working capital adjustment	<p>An adjustment for the impact of general inflation on the real value of working capital to the business.</p> <p>The negative value of line A5.13.</p>
A6.3	Movement in working capital	The movement in the total of the working capital items as presented in pro forma 12.
A6.4	Receipts from other income	Receipts in the year from other sources of income other than interest. These include rental income and any other income received from any other sources. It excludes receipts from the sale of fixed assets.
A6.5	Current cost depreciation	The negative value of current cost depreciation.
A6.6	Current cost profit on sale of fixed assets	The negative value of net current cost profit/loss on disposal of fixed assets.
A6.7	Infrastructure renewals charge	The negative value of total infrastructure renewals charge.
A6.8	Movement in provisions	The negative value of any other non-cash profit and loss items which affect operating profit. This will include, but is not restricted to:

		<ul style="list-style-type: none"> • movements in provisions; and • the difference between pension contributions and the FRS17 charge (to operating profit).
A6.9	Net cash flow from operating activities	Net cash flow movement from the operating activities of the company. The sum of lines A6.1 to A6.8.
A6.10	Returns on investment and servicing of finance	Net of interest received, interest paid, interest on finance lease rentals and non-equity dividends paid.
A6.11	Taxation paid	All cash flows to or from taxation authorities (or other group companies) in respect of the company's revenue and capital profits including total mainstream and advance corporation tax paid/received and group taxation payments/receipts by the company in the year.
Capital expenditure and financial investment		
A6.12	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.
A6.13	Receipt of grants and contributions	The total amount of grants and other contributions received for fixed asset purchases in the year.
A6.14	Infrastructure renewals expenditure	Expenditure incurred in maintaining the existing operating capability of infrastructure assets.
A6.15	Disposal of fixed assets	Cash proceeds received in the year on the sale of fixed assets
A6.16	Movements on long term group loans to group companies	The movement in the loans advanced to group companies.
A6.17	Net cash outflow from investing activities	The net cash flow of the company relating to the acquisition or disposal of any asset held as a fixed asset. The sum of lines A6.12 to A6.16.
A6.18	Acquisitions and disposals	The cash flows related to acquisition or disposal of any trade or business or any investment.
A6.19	Equity dividends paid	The total equity dividend paid by the company in the year. This includes any special dividends paid in the year.
A6.20	Net cash flow from management of liquid resources	The net cash flow from the withdrawal/redemption and purchase of short term deposits and other liquid resources.

A6.21	Net cash flow before financing	The net cash flow generated from operations, but after returns on investments and servicing of finance, taxation and investing activities. The sum of lines A6.9, A6.10, A6.11, A6.17, A6.18, A6.19 and A6.20.
A6.22	Net cash inflow from financing	The net effect on cash flow after repaying the capital element of finance leases, raising /repaying loans and share issues.
A6.23	Increase/(decrease) in cash	The net cash flow of the company in the year measured by the change in the level of cash. The sum of lines A6.21 and A6.22.

Pro forma A7

Operating cost analysis (wholesale business only)

Operating expenditure		
A7.1	Power	All energy costs, including the climate change levy.
A7.2	Income treated as negative expenditure	Income received from energy generation, input as a negative number.
A7.3	Service charges	Total cost of service charges by the Environment Agency or British Waterways for water abstraction and discharge consents.
A7.4	Bulk supply imports	Total payments for bulk imports. If a supply is a shared supply and is jointly owned, the costs associated with it should not be reported in the bulk supply imports line but in the appropriate cost lines or line A7.5.
A7.5	Other operating expenditure	Any other operating costs (ie excluding interest, taxation and LA rates).
A7.6	Local authority rates	The cost of local authority rates. This should include both the local authority rates, cumulo rates and sewerage site rates (where appropriate).
A7.7	Exceptional items	Exceptional items as defined by UK GAAP.
A7.8	Total operating expenditure excluding third party services	The sum of lines A7.1 to A7.7.

Capital maintenance		
A7.9	Infrastructure renewals charge	Infrastructure renewals charge, excluding any part which relates to infrastructure assets which are used for third party services (which are included in line A7.17).
A7.10	Current cost depreciation	The current cost depreciation charge on tangible fixed assets.
A7.11	Recharges to other business units	Total amount of recharges made to other business units for use of fixed assets, input as a positive number.
A7.12	Recharges from other business units	Total amount of recharges received from other business units for use of fixed assets, input as a negative number.
A7.13	Amortisation of deferred credits	The amortisation of deferred credits arising from third party contributions on non-infrastructure assets. These are amortised over the life of the related asset.
A7.14	Amortisation of intangible assets	Any amortisation or other reduction in the balance sheet valuation of intangible assets, such as goodwill.
A7.15	Total capital maintenance excluding third party services	Total capital maintenance costs less capital maintenance charges in respect of third party services.
Third party services		
A7.16	Operating expenditure	Operating expenditure for providing third party services.
A7.17	Infrastructure renewals charge	Infrastructure renewals charge on infrastructure assets used for providing third party services.
A7.18	Current cost depreciation	Current cost depreciation on non-infrastructure assets used only for third party services.
A7.19	Total operating costs	Total operating costs for the wholesale business only within each business category. The sum of lines A7.8, A7.15 and A7.16 to A7.18.

Pro forma A8

Operating cost analysis (retail business only)

Operating expenditure		
A8.1	Customer services	<p>The costs associated with the following activities.</p> <ul style="list-style-type: none"> • Billing. • Payment handling, remittance and cash handling. • Charitable trust donations. • Vulnerable customer schemes. • Non-network customer enquiries and complaints. • Network customer enquiries and complaints.
A8.2	Debt management	<p>All costs relating to the management of debt recovery – monitoring of outstanding debt, including issue of reminders and follow up telephone calls, managing and monitoring field recovery of debt, includes costs of customer visits, managing and monitoring external debt collection routes including debt collection agencies and legal, including notification of disconnections to non-household customers.</p>
A8.3	Doubtful debts	<p>The charge for bad and doubtful debts.</p>
A8.4	Meter reading	<p>Costs associated with meter reading – including ad hoc read requests, cyclical reading, scheduling, transport, physical reading, reading queries and read processing costs, managing meter data plus supervision and management of meter readers.</p>
A8.5	Meter maintenance/installation non-capex	<p>Costs associated with meter installations, maintenance, testing and removal – installation, repair and exchange of customer meters, including planning and scheduling of work, pre installation survey, design of work and costing.</p>
A8.6	Support for trade effluent compliance	<p>Costs of support for trade effluent compliance including managing trade effluent consents – setting consent conditions for discharges to sewer to ensure that treatment works operation, health</p>

		and safety or the environment is not compromised.
A8.7	Services to developers	<p>The operating costs of providing services to developers, to include:</p> <ul style="list-style-type: none"> • provide developer information – deal with questions from developers where physical aspects of infrastructure are required to change, investigate and advise on implications; • provide connections for developers – including project management, contracting with third parties; and • administration for new connections.
A8.8	Other operating expenditure	<p>Any other operating costs (ie, excluding interest and taxation), on an aggregated basis, including costs associated with the provision of depots and offices, and insurance premiums.</p> <p>Include the costs of (among other costs):</p> <ul style="list-style-type: none"> • disconnections; • demand-side water efficiency initiatives; • customer side leaks; • other direct costs; • general and support expenditure; • scientific services; and • other business activities.
A8.9	Local authority rates	The cost of local authority rates. This should include both the local authority rates, cumulo rates and sewerage site rates (where appropriate).
A8.10	Exceptional items	Exceptional items as defined by UKGAAP.
A8.11	Total operating expenditure excluding third party services	The sum of lines A8.1 to A8.10.
A8.12	Third party services operating expenditure	The operating costs of providing retail services to third parties.
A8.13	Total operating expenditure	<p>Total operating expenditure for households and non-households within the retail business only.</p> <p>The sum of lines A8.11 to A8.12.</p>

Capital maintenance		
A8.14	Infrastructure renewals charge	Infrastructure renewals charge in respect of the retail business.
A8.15	Current cost depreciation	Current cost depreciation on non-infrastructure assets used for the retail business only.
A8.16	Recharges to other business units	Total amount of recharges made to other business units for use of fixed assets, input as a positive number.
A8.17	Recharges from other business units	Total amount of recharges received from other business units for use of fixed assets, input as a negative number.
A8.18	Amortisation of deferred credits	The amortisation of deferred credits arising from third party contributions on non-infrastructure assets. These are amortised over the life of the related asset.
A8.19	Amortisation of intangible assets	Any amortisation or other reduction in the balance sheet valuation of intangible assets, such as goodwill.
A8.20	Total capital maintenance	The total capital maintenance costs for the retail business. The sum of lines A8.14 to A8.19.
A8.21	Total operating costs	Total operating expenditure in respect of the retail business. The sum of lines A8.13 and A8.20.
A8.22	Debt written off	Water and/ or sewerage outstanding debts that have been written off in the report year, net of collections of previously written off debt. Write-offs in relation to court or other debt recovery costs should not be included.

Pro forma A9

Current cost analysis of fixed assets (wholesale business only)

The classification of capital expenditure within headings is identified in RAG 2.04.

Non-Infrastructure assets		
Gross replacement cost		
A9.1	At 1 April 20xx	This is the gross MEA brought forward from the previous year. The gross MEA value of an asset is what it would cost to replace an old asset with a technically up to date new asset with the same service capability.
A9.2	AMP adjustment	The adjustment to GMEA as a result of an MEA revaluation. This aligns the gross asset value brought forward, with the value of the MEA revaluation.
A9.3	Reclassification adjustment	The adjustment to GMEA as a result of reclassifying assets between business units during the year.
A9.4	RPI adjustment	Adjustment for valuation from previous year to current year prices using year end RPI by asset type.
A9.5	Disposals	The reduction in gross value of assets caused by disposal of assets, by type.
A9.6	Additions	Increase in gross value of assets by type caused by purchase. These comprise non-infrastructure expenditure on the base service, plus all enhancement expenditure.
A9.7	At 31 March 20xx	This is the total gross MEA at the end of the year. The sum of lines A9.1 to A9.6.
Depreciation		
A9.8	At 1 April 20xx	Accumulated depreciation brought forward on assets by type at the beginning of the year.
A9.9	AMP adjustment	The adjustment to accumulated depreciation as a result of a MEA revaluation.

A9.10	Reclassification adjustment	The adjustment to accumulated depreciation as a result of reclassifying assets between business units during the year.
A9.11	RPI adjustment	The depreciation on the adjustment of valuation from previous year to current year (adjustment by year end RPI recorded in line 4) by asset type.
A9.12	Disposals	A negative number representing the reduction in depreciation caused by disposal of assets by type.
A9.13	Charge for the year	Depreciation charge on assets by type.
A9.14	At 31 March 20xx	Accumulated depreciation carried forward by asset type at the end of the charging year. The sum of lines A9.8 to A9.13.
A9.15	Net book amount at 31 March 20xx	Net book value by asset type at the year end. The sum of lines A9.7 and A9.14.
A9.16	Net book amount at 1 April 20xx	Net book value by asset type at the beginning of the year. The sum of lines A9.1 and A9.8.
Infrastructure assets		
	Gross replacement cost – line definitions as per non-infrastructure assets.	

Pro forma A10

Current cost analysis of fixed assets (retail business only)

Non-infrastructure assets – line definitions as per pro forma A9 – current costs analysis of fixed assets (wholesale business only).

Pro forma A11

Analysis of capital expenditure, grants and land sales

The classification of capital expenditure within each line item is detailed in RAG2.04.

Items not detailed in RAG2.04:

Grants and contributions		
A11.1	Developer contributions (ie, enhancement requisitions, grants and contributions)	Capital contributions excluding infrastructure charges.
A11.2	Infrastructure charge receipts – new connections	Infrastructure charges for new connections.
A11.3	Other contributions	Capital contributions which are not from developers or from the infrastructure charge.
A11.4	Total grants and contributions	The sum of lines A11.1 to A11.3.
A11.5	Land sales – proceeds from disposals of protected land	The net proceeds, after the deduction of all offsetting costs from disposals of protected land, including those already subject to regulation through Condition K of the licence.

Pro forma A12

Analysis of working capital

A12.1	Stocks	Stock held at the year end. Stocks comprise consumable stores and work in progress, including chemicals, stationary, petrol, backfill materials, etc.
Trade debtors		
A12.2	Measured household	Trade debtors relating to measured household billings.
A12.3	Unmeasured household	Trade debtors relating to unmeasured household billings.
A12.4	Measured non-household	Trade debtors relating to measured non-household billings.
A12.5	Unmeasured non-household	Trade debtors relating to unmeasured non-household billings.
A12.6	Other	Trade debtors relating to billings not covered by the other four line categories above. This may include amounts for services provided other than water and sewerage charges.

A12.7	Measured income accrual	The accrual for revenue from measured customers which relates to the reporting year but that has not yet been billed. Include trade effluent.
A12.8	Prepayments and other debtors	Prepayments and other debtors which relate to operating activities, excluding the measured income accrual and the infrastructure renewals prepayments.
A12.9	Trade creditors	Trade creditor balances at the year end falling due within one year.
A12.10	Deferred income – customer advance receipts	The liability relating to all monies received from customers where the turnover relating to this has not yet been recognised. This will include: <ul style="list-style-type: none"> • unmeasured customers' payments made in advance of the 1 April for the next charging year; and • measured customers who have credit balances arising from a direct debit payment plan.
A12.11	Capital creditors	Creditor balances at the year end for capital goods falling due within one year. This should include any accruals for capital goods.
A12.12	Accruals and other creditors	Accruals and non-trade creditors which relate to operating activities, excluding deferred income from customer receipts and also excluding the infrastructure renewals accrual.
A12.13	Total working capital	The total of all stock, debtors and creditors which relate to operating items, including short term capital creditors, but excluding any infrastructure renewals prepayment or accrual. The sum of the lines A12.1 to A12.12.
A12.14	Total revenue outstanding – households	The amount of revenue relating to water and/or sewerage charges (whether measured or unmeasured) at the end of the report year that has been billed to households but which has not been collected. Unmeasured revenue billed in the report year which relate to charges for services to be delivered in the following year should not be included. Written off debt should not be included.

		Debts relating to costs in connection with recovery actions should not be included.
A12.15	Total revenue outstanding – non-households	<p>The amount of revenue relating to water and/or sewerage charges (whether measured or unmeasured) at the end of the report year that has been billed to households but which has not been collected.</p> <p>Unmeasured revenue billed in the report year which relate to charges for services to be delivered in the following year should not be included.</p> <p>Written off debt should not be included.</p> <p>Debts relating to costs in connection with recovery actions should not be included.</p>

Pro forma A13

Analysis of net debt, gearing and interest costs

A13.1	Borrowings (excluding preference shares)	<p>Borrowings such as:</p> <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; and • any other borrowings. <p>The following should not be included:</p> <ul style="list-style-type: none"> • accrued interest on borrowings; • mains deposits; and • fair value of interest rate swap agreements.
A13.2	Preference share capital	Nominal value of the preference share capital.
A13.3	Total borrowings	The sum of lines A13.1 and A13.3.
A13.4	Cash	Cash in hand and at bank at the year-end. Overdraft balances should not be netted off the figure.
A13.5	Short term deposits	Investments which are readily convertible into

		known amounts of cash. This may include deposits made with group companies.
A13.6	Net Debt	The sum of lines A13.3 to A13.5.
A13.7	Regulatory capital value	<p>The regulatory capital value (RCV) used in setting price limits for the current AMP period.</p> <p>This is the year end RCV. It should be taken from the annual update which Ofwat publishes on its website in April. If a company has had an interim determination, then the RCV will have been updated for this by Ofwat.</p>
A13.8	Gearing	Line A13.6 divided by A13.7.
A13.9	Full year equivalent nominal interest cost	<p>Full year equivalent nominal interest cost as at 31 March. Calculated as the ‘Nominal interest rate’ multiplied by the ‘Principal sum as at 31 March’.</p> <p>Nominal interest rate is defined as the coupon associated with nominal debt or equivalent implied by the coupon of index linked debt.</p> <p>Rates entered for borrowings in hedging relationships should be stated at the post hedge interest rate.</p> <p>Processing rule:</p> <p>Fixed rate instruments</p> <p>The coupon rate as an input.</p> <p>Floating rate instruments</p> <p>The nominal coupon rate at the last pricing of the instrument.</p> <p>Index-linked instruments</p> <p>Nominal interest rate = $((1 + \text{real coupon}) \times (1 + \text{RPI})) - 1$.</p> <p>The principal sum outstanding should not be adjusted for accounting adjustments such as unamortised issuance costs.</p> <p>Processing rule:</p> <p>Fixed rate and floating rate instruments</p> <p>In most instances this will be the principal sum at initial recognition of the instrument. For instruments with stepped principal repayments, the principal sum is the sum outstanding as at 31 March.</p>

		<p>Index-linked instruments</p> <p>The principal sum outstanding at 31 March, ie the principal sum at initial recognition plus indexation of the principal.</p> <p>Foreign currency instruments</p> <p>The Sterling equivalent upon which interest is calculated.</p> <p>Swaps that are not in designated hedging arrangements</p> <p>The paid and received legs should be reported separately in the appropriate categories within the table. The notional value of the swap should be reported as the principal sum, with the received leg reported as a negative principal sum.</p>
A13.10	Full year equivalent cash interest payment	<p>Full year equivalent cash interest payment at 31 March.</p> <p>Processing rule:</p> <p>Fixed rate instruments and floating rate instruments</p> <p>Copied from ‘Full year equivalent nominal interest cost’.</p> <p>Index linked instruments</p> <p>Calculated as the ‘Real coupon’ multiplied by the ‘principal sum as at 31 March’.</p> <p>The real coupon is associated with index linked debt or the equivalent real coupon implied by the coupon of nominal debt.</p> <p>Processing rule:</p> <p>Fixed and floating rate instruments</p> <p>Calculated as $\text{real coupon} = (100 + \text{nominal rate}) / (100 + \text{RPI}) - 1$.</p> <p>Index-linked instruments</p> <p>The coupon rate as an input.</p> <p>Rates entered for borrowings in designated hedging arrangements should be stated at the post hedge interest rate.</p>

Indicative interest rates		
A13.11	Indicative weighted average nominal interest rate	Line A13.9 divided by the principal sum outstanding as at 31 March for fixed, floating and index linked instruments on which interest payments are calculated.
A13.12	Indicative weighted average cash interest rate	Line A13.10 divided by the principal sum outstanding as at 31 March for fixed, floating and index linked instruments on which interest payments are calculated.
A13.13	Weighted average years to maturity	<p>Calculated as the multiple of the principal sum and years to maturity divided by the principal sum outstanding as at 31 March for fixed, floating and index linked instruments on which interest payments are calculated.</p> <p>Definition of years to maturity:</p> <p>Full years to maturity of the instrument from 31 March 2009.</p> <p>Instruments with no fixed maturity should be reported as follows.</p> <ul style="list-style-type: none"> • Instruments that are instantly callable should be classified as loans due in less than one year. • Inter-company loans should be matched with the instrument at group level at the external borrowing rate. <p>Instruments with no fixed maturity that are not instantly callable should be reported with a maturity of 25 years.</p>

Pro forma B1

Properties analysis for the 12 months ended 31 March 20xx

Number of properties ('000s)		
B1.1	Households billed	Average number of households billed within the supply area. Exclude void properties.
B1.2	Non-households billed	Average number of non-households billed within the supply area. Exclude void properties.
B1.3	Household voids	Average number of household properties, within the supply area, which are connected to the distribution system but do not receive a charge, as there are no occupants. This should not include properties that do not receive a bill because it would be uneconomical to do so.
B1.4	Non-household voids	Average number of non-household properties, within the supply area, which are connected to the distribution system but do not receive a charge, as there are no occupants. This should not include properties that do not receive a bill because it would be uneconomical to do so.
B1.5	Properties served by new appointee in supply area as at 1 April 2009	Number of properties served by a new appointee in the existing appointee's supply area as it was on 1 April 2009.
Per capita consumption (excluding supply pipe leakage) l/h/d		
B1.6	Unmeasured household	Estimated per capita consumption of households that are supplied with unmeasured water. This figure applies to billed unmeasured households and excludes underground supply pipe leakage. Underground supply pipe leakage is any loss of water from the underground supply pipe.
B1.7	Measured household	Estimated per capita consumption of measured households. This figure applies to billed measured households and excludes underground supply pipe leakage.

Appendix 5: Regulatory accounting guideline 5.05 – Guideline for transfer pricing in the water and sewerage sectors

1. Introduction

- 1.1 Appointees are under a duty to trade at arm's length and to ensure that there is no cross-subsidy with respect to transactions between the appointed business and associated companies and the non-appointed business.
- 1.2 The onus is on individual appointees to ensure that their activities comply with this duty and this guideline is in place to assist appointees. If required, appointees should be able to demonstrate transparently to the Water Services Regulation Authority (Ofwat), and to the public and other audiences, that they are meeting their duty to trade at arm's length from associates and that cross-subsidy does not exist. (A definition of terms is included in the Appendix.)
- 1.3 Abuse of monopoly power, for example through the exclusive use of an associate at above market rates, may lead to unfair competition in local and national markets. It may lead to greater costs for the regulated business, and ultimately to higher bills for customers. It may also breach the Competition Act 1998. To guard against this, appointees should let contracts competitively.
- 1.4 Where cross-subsidy is found Ofwat will take account of this at price reviews to ensure that customers do not pay more as a result of this cross-subsidy.
- 1.5 Breach of Licence Condition F (or any licence condition) could also warrant a financial penalty, under section 22A of the Water Industry Act 1991.
- 1.6 The aim of the guideline is to establish a framework with which appointees should comply. The guideline describes the key principles with which companies should comply and also reflects key areas of non-compliance highlighted by investigations into company activities.

2. Licence authority

- 2.1 Section 2 of the Water Industry Act 1991 places a duty on Ofwat to ensure that transactions between appointees and their associated companies are at arm's length. Condition F of appointees' licences reflects this duty, by prohibiting any cross-subsidy between the appointed and non-appointed businesses, and from the appointee to any associate company, including the parent, within the group.

3. Financial penalties

- 3.1 The Water Industry Act 1991 provides enforcement authorities (the Secretary of State, Welsh Government and Ofwat) with powers to impose financial penalties of up to 10% of turnover on statutory undertakers and licensed water suppliers. Penalties may be imposed for contraventions or contributing to contraventions of appointment conditions, licence conditions, and other requirements as noted in the ‘Statement of policy with respect to financial penalties’ published by Defra, Ofwat and the Welsh Government, which had effect from 1 November 2010, and any subsequent revisions to this.
- 3.2 Ofwat’s primary objective on transfer pricing is to ensure that cross-subsidy does not occur so that customers are not disadvantaged. The conduct of appointees will be a major determinant in whether it is appropriate to levy a fine, in addition to agreeing prompt remedial action to end the breach, and a possible adjustment at future price reviews.

4. The Competition Act 1998

- 4.1 The Competition Act 1998 grants Ofwat concurrent jurisdiction with the Office of Fair Trading in relation to the regulated water and sewerage sectors in England and Wales. The application of the Competition Act 1998 to the water and sewerage sectors has been published jointly by Ofwat and the Office of Fair Trading in: ‘Guidance on the application of the Competition Act 1998 in the water and sewerage sectors’.
- 4.2 Where Ofwat is satisfied that the relationship between an appointee and an associate company is, has or is likely to contravene the prohibitions of the Water Industry Act 1991, it may choose to use its powers under either the Water Industry Act 1991 to enforce Licence Condition F and/or to use its powers under the Competition Act 1998. When using its powers under the Competition Act 1998, such as imposing financial penalties, Ofwat is not required to have regard to the Water Industry Act 1991 requirement to secure that undertakers are able to finance the proper carrying out of their functions.

5. Guideline principles

5.1 The principles of this guideline are that:

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

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

5.3 Within the framework of these guidelines, appointees should develop and maintain processes and procedures to ensure compliance; these processes and procedures should meet their own specific circumstances, and ensure that transactions are supported and documented.

5.4 These guidelines and principles will apply to all water only and water and sewerage companies. Within each appointee the policies and methods adopted for cost allocation, transfer pricing, market-testing and reporting should be consistent.

6. Applicability

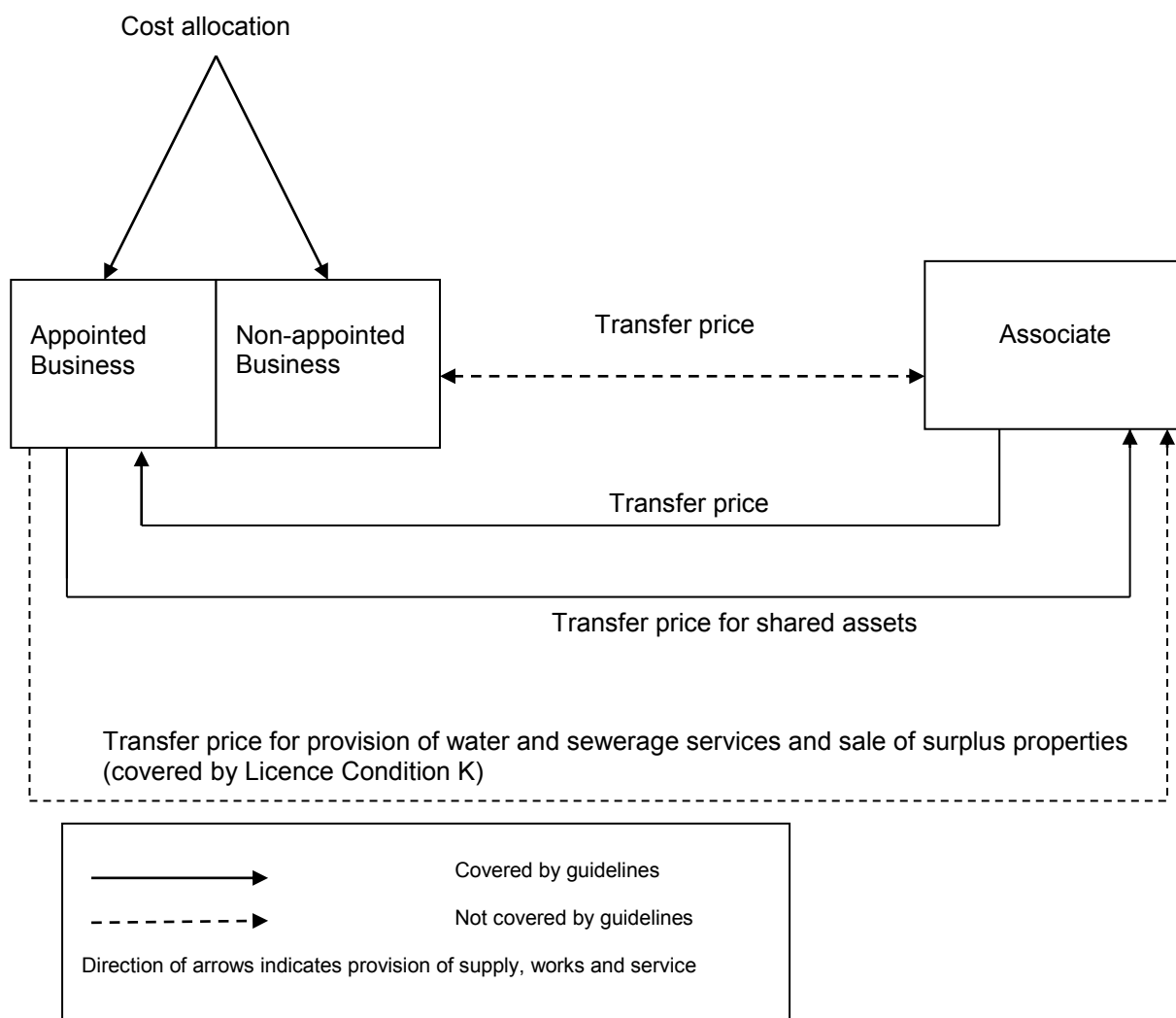
6.1 These principles apply to:

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

This is shown in figure 1.

¹ The principles of market-testing are set out in section 8.

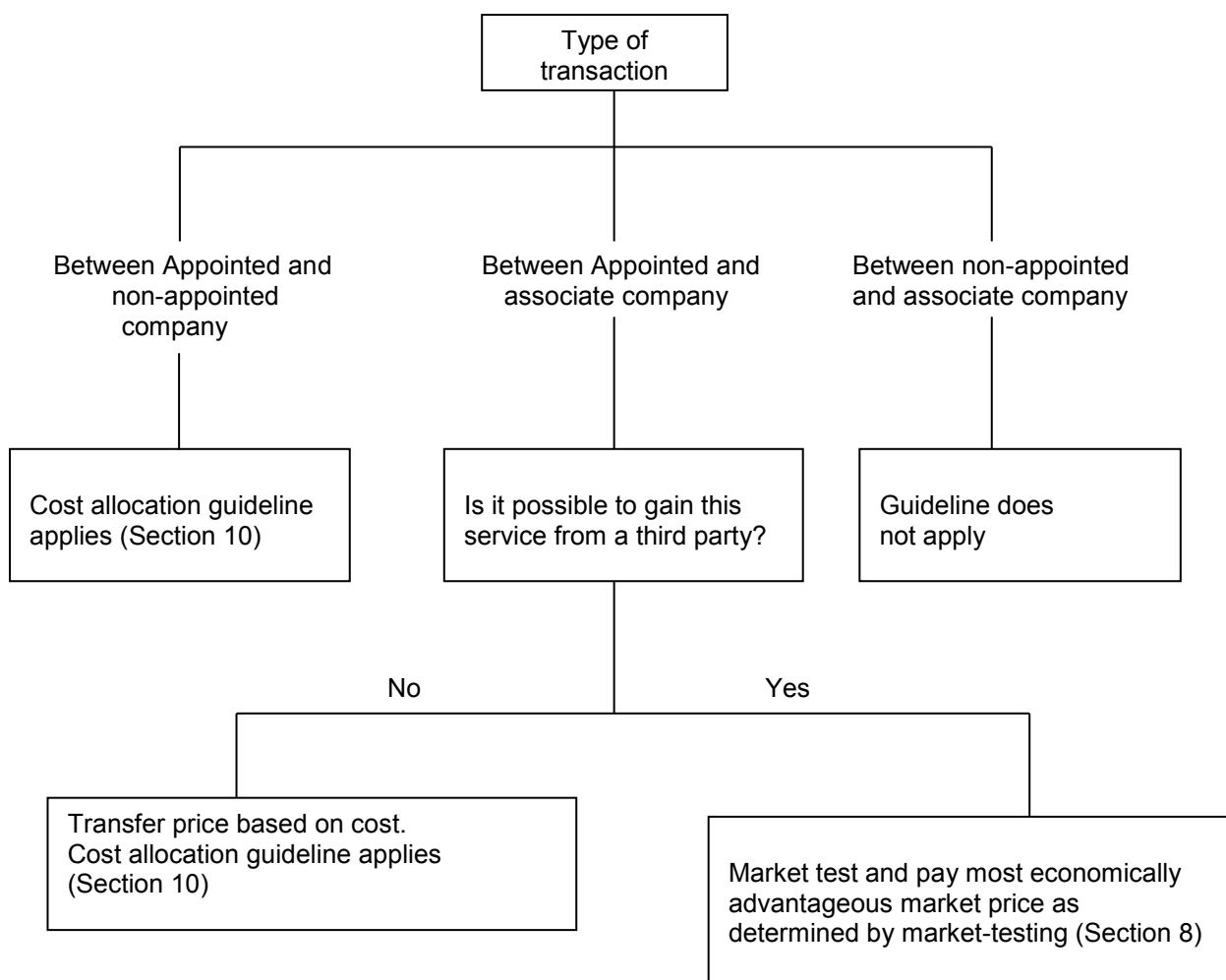
Figure 1 Cost allocation and transfer pricing



6.2 This guideline will apply to transactions with all associate companies. For the purposes of this guideline, and to ensure complete transparency, an associate company should be determined in accordance with ‘Financial Reporting Standard 8 (FRS 8), Related party disclosures’ as modified in Ofwat’s Dear Regulatory Director letter RD 29/97. Any exceptions to this must be agreed with Ofwat.

6.3 The onus will be on appointees to determine whether or not any company with whom they trade is an associate company. Appointees will need formalised procedures to check whether a company with whom they trade is an associate. Figure 2 provides an overview of the guidelines and the key decision points relating to cost allocation and transfer pricing.

Figure 2 Overview of guidelines



7. Determining transfer pricing

Principles of transfer pricing

- 7.1 The primary principle is that transfer prices should be based on market price or less and that market price should be determined by market-testing. The principles of market-testing are described in Section 8. Market price should be the most economically advantageous price taking into account objective criteria such as completion date, quality, running cost, after sales service, technical merit, security of supply, effectiveness, whole life cost, capability, capacity, etc.

- 7.2 The market-testing process must be applied in a fair, open and transparent manner with no guarantee of success for associate companies. This will facilitate fairness of treatment between potential contractors and ensure that a competitive edge is maintained within the process. This provides the greatest assurance that cross-subsidy of associates is not taking place. Where a service is market tested, the process should be fair, effective and proportionate to the value and complexity of goods, works or services being procured. The work should be awarded to the tender² that is the most economically advantageous. This should be determined by reference to the objective criteria set out above.
- 7.3 Where an associate company gains a substantial proportion of its turnover from the appointed business, ie more than half, the price the associate company charges should incorporate a discount from the external market price to reflect the following:
- inherent long-term guarantee of work;
 - volume of work;
 - lower marketing and sales costs;
 - lower bad debt risk;
 - lower commercial risk;
 - reduced credit period.
- 7.4 Where no market exists for particular supplies, works or a service, the transfer price should be based on cost, and the cost allocation guidelines in Section 9 followed.
- 7.5 On occasion, the appointee may choose to use the services of an associate for strategic reasons. For example, it may wish to retain intellectual properties within the group or it may require a particular product or service which can only be provided by an associate. Under these circumstances, the transfer price should also be based on cost.

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

- 7.6 If there is a market for a service/good and the appointed business does not choose to test the market for that service/good then transfer prices should be at cost. In the medium term, appointees should consider bringing the activity within the appointed business. An appointee that uses an associate company for a service, for which there is a market, without market-testing the prices paid cannot demonstrate arm's length trading. For price setting purposes, Ofwat will assume that such supplies, works or services under these circumstances are provided at cost to the appointed business, as if the services have been delivered within the appointee. Under these circumstances cost will be deemed as the actual cost to the supplier of the goods, works or services plus a rate of return on capital as defined in the Appendix; unless there is a compelling case to convince Ofwat, for using an alternative measure.

Other transfer prices

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

8. Principles of market testing

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

Methods of market-testing

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

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

8.3 The sectors to date have used all of these methods to determine transfer prices, with varying degrees of success. The most robust means of determining a fair market price is to invite independent contractors to tender a price for given supplies, works or services, ie competitive letting of a contract. Competitive letting is the only means of market-testing which objectively tests and preserves the competitive market.

8.4 Where companies use comparison to published list prices, third party evaluation and benchmarking there can be a large element of subjectivity involved. These methods of market-testing may involve a judgement of a fair market price and/or interference in the market and tend to compare a predetermined price with the market, as a means of justifying the original price. Competitive letting avoids this problem as it inherently discovers the market price without interference in or judgement of the market.

8.5 Though competitive letting produces the most robust transfer price, there are circumstances where the competitive letting process is demonstrably impractical. For example, where a contract of small value is not suitable for inclusion in a framework agreement, or where, for example, group services may not be provided at cost. In these rare circumstances market-testing by comparison to published list prices, third party evaluation and benchmarking could be used to demonstrate arm's length trading.

- 8.6 In exceptional circumstances the appointee may need to engage the services of a third party at short notice to deal with operational needs. This would include dealing with emergency situations where the prompt action required would not enable a full procurement exercise to be undertaken. To alleviate concerns, the appointee should fully document the operational emergency and the reasons for selecting the associate. This process should accord with the appointee's stated emergency procedures.
- 8.7 The appointee should be able to make a strong case for using methods other than competitive letting and demonstrate the robustness of the methods used. Only well-documented and cogent exercises will allow the appointee to demonstrate that transfer prices are at market rates. However, Ofwat does not expect there to be many such instances as competitive markets exist for almost all goods, works or services that appointees procure.
- 8.8 A number of companies have previously been unable to demonstrate arm's length trading due to weaknesses in their market-testing processes. Where this has been the case, Ofwat made downward adjustments to declared costs at price reviews. Ofwat assumed that some supplies, works and services were provided at cost to the appointee and future price limits were set on this basis.

Market-testing procedures

- 8.9 Appointees should establish and apply clear policies and procedures for market-testing. The reasons for the methods, thresholds and criteria adopted should be transparent and should be capable of withstanding scrutiny by Ofwat, customers and competing contractors.
- 8.10 At previous price reviews Ofwat also adjusted companies' costs where arm's length trading could not be demonstrated because the competitive letting process was not set down in advance.
- 8.11 Transparent, well-documented market-testing processes that record the steps and decisions in the procurement process will help appointees demonstrate compliance with these guidelines. Appointees should be able to demonstrate that the price paid for the goods or services provided does not exceed a fair market price.

- 8.12 Prior to commencing the competitive letting process the appointee should ensure the following decisions are taken:
- contractual arrangement to be used and the circumstances in which they will be used eg fixed price, schedule of rates, partnering, term, negotiated and call-off contracts;
 - the minimum number of bids to be obtained dependent on materiality of the contract;
 - qualification processes for potential contractors;
 - an evaluation process;
 - policy on informing tenderers of results.
- 8.13 When inviting companies to tender, appointees should ensure that the qualification requirements do not give any undue advantage to associates. Appointees should ensure that they do not abuse a dominant position or enter into agreements or concerted practices which might breach the prohibitions in the Competition Act 1998.
- 8.14 The tender evaluation process and respective weightings for each criterion should be set out and documented by the appointee in advance of any tenders being opened. This will help demonstrate that associate companies and external companies undergo the same tender process, without any preferential treatment or guarantee of success for the associate.
- 8.15 Appointees should be able to demonstrate that the assessment criteria are relevant to goods, works or services in the procurement exercise. It will be difficult for the appointee to demonstrate that trading has been at arm's length if cost is given a weighting of less than 50% compared to qualitative factors. There should be clear reasons where, exceptionally, a lower weighting is used.

Frequency of market-testing

- 8.16 To demonstrate a fair market price the appointee will need to undertake frequent market-testing that produces valid results. There is a balance between the advantages of frequent market-testing of short-run contracts and the benefit of stability, continuity and possibly lower costs for longer term work.

- 8.17 Repeat market-testing is likely to be necessary when there is any material alteration to an existing contract, for example where an increased volume of work is conducted than had been envisaged when the contract was let. Market-testing that does not match the current profile of work will not remain valid.
- 8.18 In general, the greater the likelihood of fresh competition and new technology emerging, then the shorter the period between market-testing. Appointees should have regard to these issues in determining their strategy.

Unacceptable practices

- 8.19 Market-testing procedures should comply with EU and prevailing standards. Appointees should not split contracts or use artificial methods to calculate the value of contracts in order to circumvent applicable thresholds or the aggregation rules of the EU.
- 8.20 Market-testing should be used to award contracts to the most economically advantageous tender, not as a device to justify prices paid to associate companies. Where examples of this practice are found, Ofwat will assume these works, supplies and services are provided at cost, as arm's length trading cannot be demonstrated. This could also constitute grounds for an investigation under the Competition Act 1998.

9. Cost allocation

Principles of cost allocation

- 9.1 Cost allocation is the means by which costs are divided between the appointed and non-appointed activities within the appointee, and to specific products and services. Cost allocation rules apply to transfer prices from associate companies where no external market exists, including services received from the parent company, or where costs are incurred commonly by appointed and non-appointed activities.
- 9.2 The key principle is that costs should be allocated in relation to the way resources are consumed. Allocations based entirely on turnover, volume or direct labour rates should not be used as they are unlikely to reflect the activities involved. Allocation must also be consistent with other regulatory accounting guidelines.

- 9.3 Costs can be considered as:
- direct costs of activities (eg materials and wages); and
 - indirect costs which are directly consumed or allocated to activities (eg space occupied, IT resource used by an activity) and those not related to activities (eg management fees).
- 9.4 Allocating costs in relation to the way resources are consumed provides a means of building up service and product costs. This approach views a business as a series of activities, each of which consumes resources and, therefore, generates costs. An activity based approach should result in the majority of the total costs being allocated on a meaningful basis. All costs must ultimately be allocated, including, where appropriate, depreciation charges (CCD charges in CC Reports and HC costs in HC Reports) on assets and financing charges.
- 9.5 Cost allocation must be fair and reasonable and there must be consistent treatment of costs for appointed and non-appointed activities. These principles should prevent appointed activities cross subsidising non-appointed activities.
- 9.6 Where cost is used the appointee should have access to the costs of that associate and should conduct validation exercises to ensure that transfer prices are at cost. This should be incorporated within the contract monitoring process agreed by the parties.
- 9.7 The onus is on companies to ensure that all costs are ultimately allocated in accordance with this guideline.
- 9.8 The allocation of indirect costs should be achieved by:
- identifying the activities that comprise a particular service or product and what drives the level of activity;
 - determining the relationships between activities and resources consumed;
 - costing the activities by costing the resources consumed; and
 - pooling costs that cannot be related to activities and allocating them on a subjective basis, eg turnover or proportion of direct costs.
- 9.9 Although a significant proportion of costs can be allocated in relation to the way resources are consumed, it is recognised that a point of diminishing returns will be reached where the cost of further allocation outweighs the benefit.

- 9.10 In addition, it is recognised that some costs will not be driven by activities and that some subjective allocation will be necessary to arrive at the full cost.
- 9.11 The differences between traditional cost allocation approaches and an activity based approach are illustrated in figures 3 and 4.

Figure 3 Traditional costing

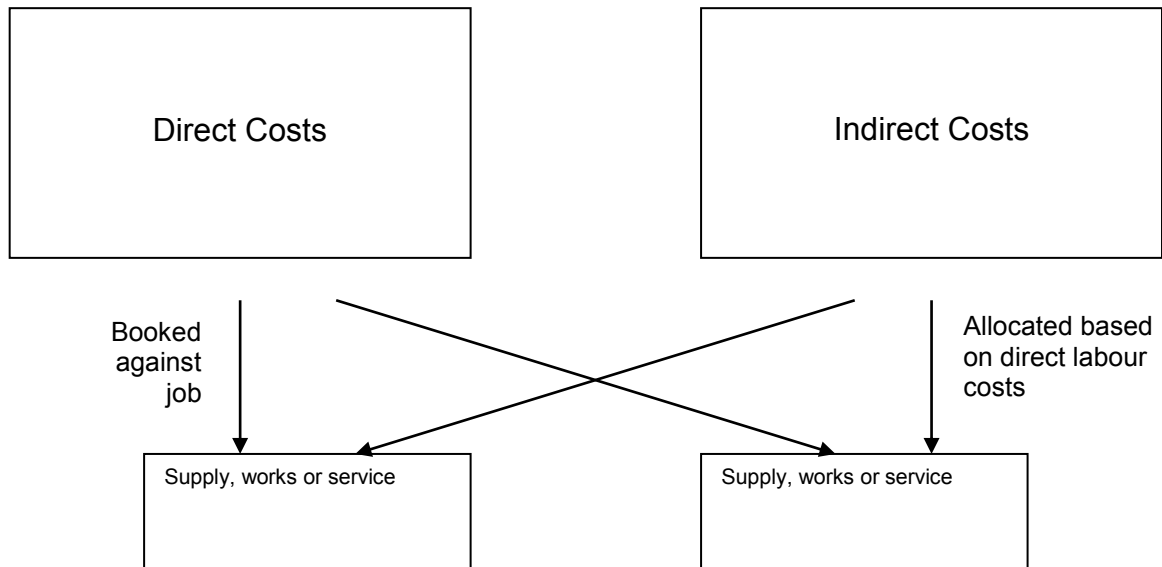
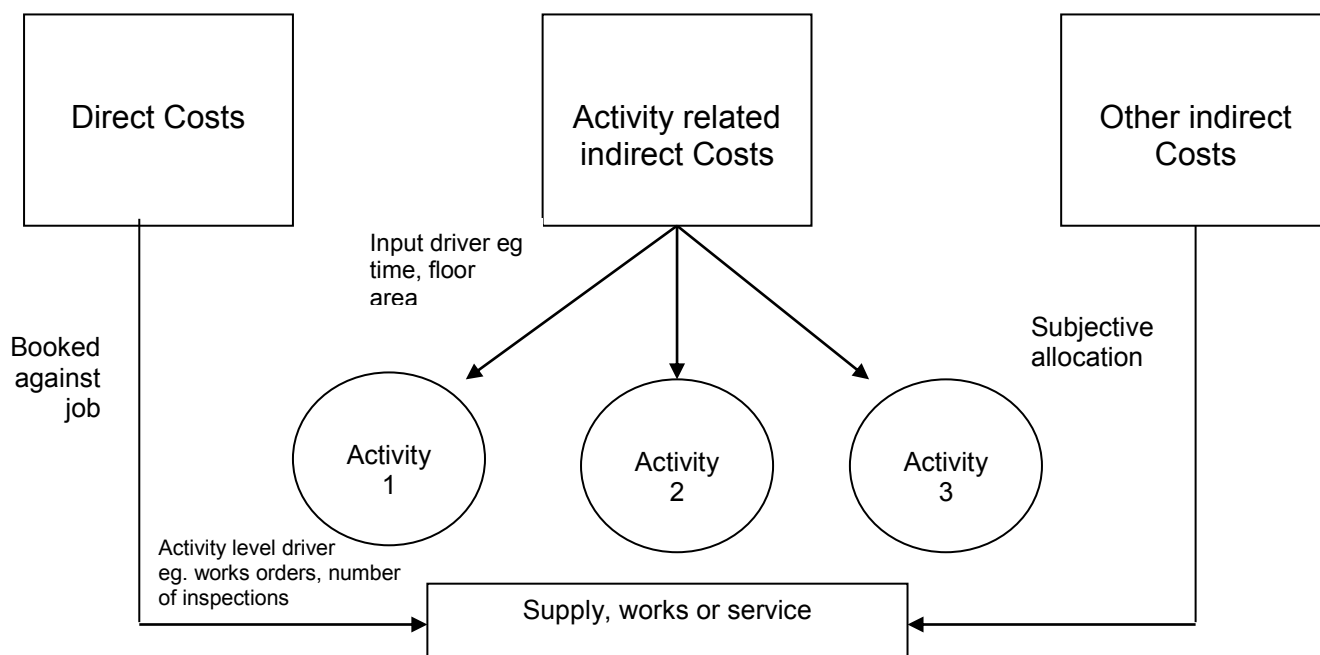


Figure 4 Activity-based costing



Services provided by the parent company

9.12 There may be instances where appointees pay a charge to the parent company for services provided. It is important that the basis of charging used by the parent company reflects the group structure at the time charges are being levied and actual services provided. The charges paid to the parent must be related to the services provided and should be charged at cost, eg legal services and treasury services. The onus is on the appointee to demonstrate charges reflect the costs incurred by the provider of the service. Management fees should not be inflated by additional costs beyond those actually incurred, eg where the parent treasury function provides a guarantee to the appointee, a charge should not be made for the provision of that guarantee beyond that paid by the parent.

9.13 In some cases it may not be possible to charge for services on an activity basis; eg for shareholder management costs (Register, Company Secretary, AGM etc). Costs of this type should be distributed fairly between each subsidiary of the parent and in a way that reflects the activities the parent undertakes on behalf of the individual subsidiaries. Distributing charges to associates on the basis of profitability or turnover of individual associates will not provide a proxy for activity, and apportionment on this basis should be avoided. Discrepancies between treatment in the regulatory and statutory accounts should be avoided.

Marginal cost allocations

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

10. Use of assets for non-appointed activities

- 10.1 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.
- 10.2 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 the installation of fibre optic cables in sewers, the erection of aerials and the granting of fishing rights.
- 10.3 If the use of an asset for a non-appointed activity does not involve a disposal of protected land then costs for use of the asset should be allocated between the appointed and non-appointed business. Section 9 sets out the principles companies should use when allocating costs.
- 10.4 Appointees should consider if it is appropriate to move assets from the appointed to non-appointed business, eg if an asset is being used primarily for non-appointed activities.

11. Appointee structure

- 11.1 Systems should be in place to ensure that directors or senior managers who have responsibilities in both the appointee and associate companies, or companies with whom the appointee trades, do not face a conflict of interest.
- 11.2 No individual, in such a position, should be able to influence either the purchase or supply of goods, services and supplies.

12. Definitions of terms

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

Activity: A logical grouping of tasks.

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

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

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

Associate company: For the purposes of compliance with these guidelines and to ensure complete transparency, an associate company should be determined in accordance with 'Financial Reporting Standard 8 (FRS 8), Related party disclosures' as modified in Ofwat's Dear Regulatory Director letter RD 29/97. Ofwat's view is that the existence of any common shareholding, regardless of the level which may distinguish between control and the ability to exert influence, defines a related party. Any exceptions to this must be agreed with Ofwat.

Competitive letting: Letting contracts as a result of a tendering process.

Cost: The actual cost to the supplier, in a transaction with the appointee, of the goods, works or services, plus a reasonable rate of return on capital employed. Unless the circumstances of the transaction provide a convincing case for the use of an alternative measure, the return on capital will be the weighted average cost of capital for the individual appointee as set out in Ofwat's final determination of 26 November 2009 (or any other determination applicable in the 2010-15 period).

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

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

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

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

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

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

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

Transaction: For the purposes of RAG5, a transaction occurs where the appointee and its associates supply goods, works or services to each other, directly or indirectly via a third party.

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

Appendix 6: Upstream services

Abstraction licence

This service has been identified separately from the raw water abstraction service because of the potential for a market to emerge in the future, which would enable abstraction licences to generate a separate income stream.

This service includes activities related to negotiating with third parties to obtain abstraction rights and to agree charges, as well as the annual cost of the licence itself. This service should not include activities that are incurred in choosing abstraction sites, optimising abstraction or ensuring compliance with licence conditions. All such abstraction planning activities and licence administration activities should be included in the “raw water abstraction” service.

Raw water abstraction

Start: none.

End: supply of raw and partially treated (non-potable) water through a pump or gravity fed through a valve into the raw water distribution system.

The water abstraction service includes activities related to the identification of new sources, including catchment management, licence management, and the abstraction infrastructure.

Pre-treatment processes can vary, from a relatively simple physical separation of the largest impurities, to more complex chemical treatments, depending on the source of abstraction and on the type of treatment plant to which the raw water is transferred. Therefore, it seems appropriate to combine activities related to abstraction and pre-treatment within the same service. Moreover, any transport from the water abstraction site is included within the abstraction service, although these costs are expected to be very small. For example, transport between reservoirs where both reservoirs have an abstraction licence is considered to be part of the raw water abstraction service. However, transport which occurs between a reservoir with an abstraction licence and a reservoir/storage tank without an abstraction licence would be considered to be part of the raw water transport service.

All activities related to planning are to be included in “water abstraction” and it is only the administrative costs involved in obtaining the licence and the cost of the licence itself that should be included in the “water licence” service.

Raw water transport

Start: raw and partially treated (non-potable) water that has been pumped or gravity fed through an outlet valve.

End: raw and partially treated (non-potable) water entering treatment works or raw water storage facilities or being delivered to the end customer or to a third party water company.

This service includes the activities related to transporting the raw water from the boundaries of the abstraction site to a treatment plant, a raw water storage facility, or to large industrial customers that require untreated water in their production processes.

The activities allocated to this service include primarily the development and maintenance of the physical raw water transport network.

Raw water storage

Start: raw water and partially treated (non-potable) water entering the storage facility.

End: raw water and partially treated (non-potable) water pumped or gravity fed out of the storage facility.

This service includes activities related to the construction, operation and maintenance of raw water storage facilities. In general, no transport costs should be allocated to this service, since the cost of transport should be included within the 'raw water transport' service. Impounding reservoirs that do not have an abstraction licence attached to them should be included under raw water storage. Associated activities, such as control of the inflow to prevent overflowing and outflow (which ensures continuity of availability of supply) and planned and emergency drawdown and discharge facilities (with associated permitting) should also be included in this service. Activities related to determining losses due to leakage and to ensuring security of the site from contamination are also expected to be included.

Water treatment

Start: input of raw and partially treated (non-potable) water from raw water distribution system into treatment plant.

End: discharge of treated water through a pump or gravity fed into the treated water distribution network.

This service includes all the activities involved in the treatment of raw water, including both chemical and physical treatment. This also includes activities within the treatment plant.

The water treatment process may result in the production of sludge. In such cases, an appropriate share of the costs incurred during treatment and/or disposal of this sludge should be allocated to the water treatment service, regardless of whether the treatment and disposal of this sludge occurs at the water treatment or at the sludge treatment plant.

Trunk treated water transport

Start: treated (potable) water that has been pumped or gravity fed into the treated water distribution network.

End: input of treated (potable) water into DMA distribution network or delivered to a third party company.

Trunk treated water transport includes activities related to transporting treated water from the treatment works to District Metered Areas (DMAs). This service includes all trunk network repair and maintenance activities, as well as activities associated with any new network development. In addition to directly attributable costs, other activities that might need to be considered within this service may include the provision and maintenance of ancillaries such as booster pumps, pressure reduction, hydrants, air release valves, washouts and flow measurement.

Local treated water distribution

Start: discharge of treated (potable) water within a DMA area.

End: supply of treated (potable) water to retail customer.

Local treated water distribution includes the activities related to distributing treated water to customers within DMAs. This service includes all distribution network repair and maintenance activities, as well as the activities associated with any new network development.

Other activities that may be considered within this service include the provision and maintenance of ancillaries such as booster pumps, pressure reduction, hydrants, air release valves, washouts and flow measurement.

Sewage collection – foul

This service includes the activities related to collection of foul sewage from customers' properties. The activities included in this service relate to the development, repair and maintenance of the sewage collection infrastructure. Other activities that should be considered within this service may include the provision and maintenance of ancillaries such as overflows, screens, on-line and off-line retention tanks, rising main wells and pumps and flow measurement

Sewage collection – surface water drainage

This service includes the activities related to the collection of surface water from exterior areas of customers' properties. The activities included in this service relate to the development, repair and maintenance of the sewage collection infrastructure. Other activities that should be considered within this service may include the provision and maintenance of ancillaries such as overflows, screens, on-line and off-line retention tanks, rising main wells and pumps and flow measurement

Sewage collection – highway drainage

This service includes the activities related to collection of surface water that runs off roads and pavements. The activities included in this service relate to the development, repair and maintenance of the sewage collection infrastructure. Other activities that should be considered within this service may include the provision and maintenance of ancillaries such as overflows, screens, on-line and off-line retention tanks, rising main wells and pumps and flow measurement

Sewage treatment and disposal

Start: sewage arriving at the boundary of sewage treatment works.

End: discharge of treated wastewater to receiving watercourse and discharge of sludge from sewage treatment works into pipework or holding tanks for transport to sludge treatment processes.

This service includes all the activities related to the treatment and disposal of sewage. This includes the costs of development, repair and maintenance of treatment plants, as well as any intra-plant transport required.

Sludge transport

Start: point of discharge of sludge from sewage treatment process into pipework or holding tanks for tankering to sludge treatment processes.

End: input of sludge into sludge treatment works.

This service includes the transport of sludge from the sewage to the sludge treatment plant. All types of transport are included within this service. However, transport **within** the treatment plant is not included in this service, which is instead an activity of the “sludge treatment” service.

Sludge treatment

Start: storage of sewage sludge in holding tanks and input into sludge treatment sites.

End: Point at which the treated sludge is collected for disposal.

This service includes all the activities related to sludge treatment. While different technologies exist for sludge treatment, sludge treatment is defined as a technology-neutral service for the purpose of AS.

Liquor treatment

Start: Pipework from sludge treatment process to liquor treatment plant or sewage works

End: Discharge of treated liquor to receiving watercourse

Includes all activities in transporting and treating liquors generated during the sludge treatment process. The liquors may be treated either on site at a sludge treatment plant or at a sewage treatment plant.

Sludge disposal

Start: point at which the treated sludge is collected.

End: sludge disposed.

This service includes all the activities related to the storage and disposal of treated sludge, regardless of the method of disposal. The most commonly used sludge disposal methods include land spreading, incineration, landfilling, forestry, land reclamation and combustion.

Pro forma for 2012-13 trial

Business unit	Water resources	Raw water distribution	Water treatment	Treated water distribution
Total operating costs £m (3dp)				
Service	Abstraction licence	Raw water transport	Water treatment	Local treated water distribution
Total operating costs £m (3dp)				
Business unit	Sewage collection	Sewage treatment	Sludge treatment, recycling and disposal	
Total operating costs £m (3dp)				
Service	Foul	Highway drainage	Sludge transport	Sludge disposal
Total operating costs £m (3dp)				



Ofwat
Centre City Tower
7 Hill Street
Birmingham B5 4UA

Phone: 0121 644 7500
Fax: 0121 644 7699
Website: www.ofwat.gov.uk
Email: mailbox@ofwat.gsi.gov.uk
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