

31 March 2016

Trust in water

RAG 3.09 – guideline for the format and disclosures for the annual performance report

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1. Explanatory note

1.1 Introduction

1.1.1 This regulatory accounting guideline (RAG) relates to 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 provisions of the Licence.

1.2 Role of regulatory accounting guidelines

1.2.1 The accounting statements 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 There are 2 areas where we will require companies to deviate from these accounting standards;

- **Revenue recognition.** Companies should not de-recognise turnover for amounts billed which they deem to be uncollectable. This means that IAS18.9 or FRS102 (23.3) should be disapplied in this respect.
- **Borrowing costs.** IAS23.8 requires borrowing costs to be capitalised where they directly relate to the construction of an asset. We require this rule to be disapplied. Similarly the option to capitalise under FRS102 (25.2) should not be taken.

1.3 Annual information notice on the annual performance report

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 notice.

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.

Statutory statement of cashflows

2.1.2 A company may choose to take advantage of the exemptions available and not prepare a cashflow statement in their statutory accounts. In this situation, companies are not required to produce a statutory cashflow simply to satisfy pro forma 1D. A regulatory appointed business cashflow statement will satisfy Ofwat's requirements.

Pro forma tables

2.1.3 The licence requires that regulatory accounting statements should be prepared in accordance with the formats, accounting policies and principles which apply to the statutory annual accounts of the appointee.

2.1.4 The information in the regulatory accounting statements must be provided in a common format for all companies and with a 31 March year end. The pro forma tables for the submission of data are included in appendix 1.

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;
- annual performance report including the regulatory accounting statements; and
- statutory accounts (if not bound with the annual performance report).

2.2.2 Paragraph 9.3 of Condition F requires that the appointee shall deliver to the 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.

2.2.3 Companies may refer in the annual performance report to any relevant commentary provided as part of the latest available statutory accounts. A clear cross-reference and link needs to be provided.

Reports to be published on websites

2.2.4 Companies should publish their annual performance report 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; and
- accounting statements.

As a minimum the audit opinion should cover the pro forma tables in section one and section two of the annual performance report.

- 2.3.2 The required wording of the audit opinion will be set out in our annual information notice on the annual performance report.

Further information required from auditors

- 2.3.3 The licence requires that the contract of appointment with the auditors contains a term “that the auditors will provide such further explanation or clarification of their reports, and such further information in respect of the matters which are the subject of their reports, as the Water Services Regulation Authority (Ofwat) may reasonably require.”

2.4 Appointed business

Definitions

- 2.4.1 The licence separates the activities of an appointee into appointed and non-appointed activities.
- 2.4.2 Appointed 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. Please see Appendix 1 in RAG4.05 for more information on appointed and non-appointed activities. Companies should discuss areas of difficulty, in advance of preparing the accounts, with Ofwat.

3. Accounting disclosures

3.1 Disclosures required in the annual performance report

3.1.1 Companies should include:

- a note which describes the link between directors' pay and standards of performance (as required by section 35A of the Water Industry Act 1991 (inserted into that Act 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 policy note for price control segments;
- a note on revenue recognition;
- a note on capitalisation policy;
- a note on bad debt policy;
- a statement on Condition K compliance;
- a statement on diversification and protection of the core business; and
- the tax strategy for the appointed business
- a statement on differences between statutory and RAG definitions.

3.2 Statement of directors' remuneration and standards of performance

3.2.1 In January 2014 we published 'Board leadership, transparency and governance – principles' which set out the principles we expect appointees to apply. A key theme that overarches the principles is transparency. We consider that the Disclosure and Transparency Rules set out the standard of disclosure that regulated companies should operate – wherever applicable. For example, we expect companies' Boards to make sure that the form and contents of the corporate governance statement meets the requirements of the Disclosure and Transparency Rules for listed companies. We also expect reporting to reflect material issues. Typically, this would involve discussing areas such as:

- group structure;
- company performance; and
- the key risks to the business.

We expect companies to ensure that the information is accessible to the intended audiences. It will be for companies to determine the best means of

making this information transparent, which could be through the use of the annual performance report.

- 3.2.2 In relation to transparency around the remuneration of directors, we expect companies to consider whether and how to take account of the requirements (since 1 October 2013) that apply to the Directors' Remuneration Report for a quoted company.
- 3.2.3 The Water Act 2003 introduced 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. The annual performance report should contain this statement.
- 3.2.4 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 annual performance report.
- 3.2.5 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. Where the directors are also directors of another group or holding company they still need to be covered by this statement.
- 3.2.6 Remuneration means any form of payment, consideration or other benefit (including pension benefit). 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:
- the date the arrangements were made;
 - a description of all the standards of performance in question;
 - an explanation of the purpose of linking each particular standard of performance to remuneration;
 - a description of the targets set for each standard;
 - an explanation of how all the standards of performance are assessed and the source of the data;
 - 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 annual performance report must still disclose the details of any arrangements in force or any arrangements intended to be in force during the financial year. 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.

3.2.9 If no such arrangements are in place an explanatory paragraph should be provided detailing the reasons why no such arrangements are in place.

3.3 Statement as to disclosure of information to auditors

3.3.1 The Companies (Audit, Investigations and Community Enterprise) Act 2004 includes sections dealing with the auditor's rights to information. Relevant audit information is defined in s234ZA of the Companies Act 1985.

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' annual performance reports.

3.4 Dividend policy

3.4.1 Paragraph 6 and line 1A of the Appendix 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.

3.4.2 Some companies pay dividends to parent companies which offset amounts of interest receivable under inter-company loan arrangements. Where such an arrangement exists, companies' dividend policy note should describe both a description of the arrangement and the amounts paid and received in the year.

3.5 Accounting policy note for price control segments

3.5.1 Companies must include an accounting policy note for price control segments which are disclosed in section 2. This should summarise the basis of the allocation of operating costs and assets and any major changes in the year. Companies should state that the accounts have been drawn up in accordance with RAG2 – Guideline for classification of costs across the price controls.

3.6 Revenue recognition note

3.6.1 The revenue recognition note should cover the following.

- A description of any adjustments between amounts recorded as turnover in the statutory accounts and amounts recorded as turnover in the regulatory accounting statements. This should be split between adjustments relating to IAS18 deviation and any other adjustments.
- Whether or not the company bill void properties speculatively, that is to 'the occupier'. If so, it should confirm that this bill is then recorded in turnover.
- If the company does not speculatively bill, how it checks that the property is indeed unoccupied. It should also describe how it ascertains the identity of any occupier.
- A description of steps that the company takes to establish whether properties with no occupier information are void or occupied, e.g. visits to properties or searches using third party electronic data such as council tax/electoral role records.
- Any changes in methodology in calculating the measured income accrual.

- Any significant differences between a retrospective review of the previous years measured income accrual and the amounts actually billed in the year.

3.7 Capitalisation policy note

3.7.1 Companies should explain the basis for capitalising costs. Companies should also clearly state any general rules which have been used (e.g., a rule requiring the capitalisation of any expenditure on a physical asset 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 Where a change in the bad debt provisioning policy results in a material change in the bad debt charge, companies should explain the reasons for the movement. 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 annual performance report 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; and
- 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.

3.11 Tax Strategy for appointed business

3.11.1 The Finance Bill 2016 will introduce the requirement for large companies to publish their tax strategy annually. We are also requiring all companies to publish details of their tax strategy (relating to the appointed business) within the Annual Performance Report. The tax strategy should cover the following key areas.

- The approach to risk management and governance arrangements;
- The attitude of the company towards tax planning;
- The level of tax risk that the group is prepared to accept; and
- The approach of the company towards its dealings with HMRC.

References and links may be made to tax strategies published in the statutory or group accounts as appropriate.

3.12 Differences between statutory and RAG definitions

3.12.1 Proformas 1A, 1B, 1C and 1D all have a column to report any resulting differences between statutory and regulatory definitions of a line by line basis. Where any individual values recorded in these lines are considered material then a narrative explanation should be provided on what these differences relate to.

3.12.2 Companies should provide a reconciliation between the total borrowings figures included in the statutory accounts and the borrowings shown in the regulatory accounts with a brief explanation the reasons for the differences.

4. Narrative disclosures on performance

4.1 Outcomes

- 4.1.1 Companies should provide narrative commentary explaining how the information reported in pro forma 3A relates to the information on outcome performance it has published and reported to its customer challenge group or similar body and customers more generally.
- 4.1.2. Companies should provide narrative commentary where it thinks forecasting a reward or penalty in column 3A.6 would be inappropriate for a particular performance commitment. The commentary should explain why a forecast would be inappropriate.

4.2 Totex

- 4.2.1 Narrative commentary should be provided on any difference between the values reported in lines 4B.6 and 4B.7 (actual and allowed totex) of pro forma 4B. Separate commentary should be provided for both water and wastewater.
- 4.2.2 Commentaries should make reference to the following areas (this is not an exhaustive list):
- efficiency savings;
 - changes resulting from expenditure being delayed or brought forward;
 - expenditure on outputs which are not included in the PR14 baseline; and
 - other changes.
- 4.2.3 Where actual totex includes costs which the company believes to be exceptional or atypical, these should be disclosed separately in the commentary. The commentary should highlight clearly relevant links between the narrative on outcome performance and delivery and the totex costs reported in the year.

4.3 Retail

- 4.3.1 Narrative commentary should be provided on any material difference between the values reported in lines 2C.11 (total operating costs) of pro forma 2C and

the retail revenues allowed in price limits for 2015-20. Separate commentary should be provided for household and non-household retail.

4.3.2 Commentaries should make reference to the following areas (this is not an exhaustive list):

- efficiency savings;
- changes in customer numbers;
- changes in metering levels;
- material one-off / atypical items of expenditure; and
- other changes.

4.4 Wholesale revenue control reconciliation

4.4.1 Narrative commentary should be provided on the difference reported in line 2I.22 (difference between allowed and actual revenue under the wholesale control) of pro forma 2I. Companies should explain any subsequent consequences of any variations in revenue for future periods.

4.4.2 Commentaries should make reference to the following areas (this is not an exhaustive list):

- Changes in customer demand;
- Numbers of customers;
- Number of new connections; and
- Number of void properties.

4.4.3 Following the commencement of the competitive retail market (expected to be 1 April 2017), companies should disclose both the income and the payments relating to 'performance charges'. It is not sufficient for companies to disclose the net set-off position.

4.5 Current tax reconciliation

4.5.1 A reconciliation is required of the appointed current tax charge or credit reported in line 1A.12 to that resulting from applying the standard tax rate to the profit or loss on ordinary activities before tax as shown in table 1A. There should be no netting off of material positive or negative amounts.

4.5.2 A reconciliation is also required to explain any significant variations between the appointed current tax charge or credit reported in line 1A.12 to the total current tax charge allowed in price limits.

4.5.3 The reconciliation should make reference to the following areas (this is not an exhaustive list):

- Prior year adjustments
- Payments for group relief
- Effect of corporation tax rate changes

4.5.4 Details of factors affecting future tax charges should be given.

5. Small company accounting information requirements

5.1 Small company requirements

- 5.1.1 For new and existing small companies it may not be appropriate to request the full regulatory accounting information that we receive from larger companies, but we still require some regulatory accounting information to a 31 March year end.
- 5.1.2 The information requirements should be proportionate to the size of the company, but sufficient to enable us to effectively regulate these companies. A company with an annual turnover of less than £6.5m is defined as small in terms of regulatory accounting information requirements. This threshold only applies to regulatory accounting information required under Condition F and no other types of information.
- 5.1.3 In some circumstances, we may ask some small companies for more information than is set out below, to address certain company specific issues. If required, we will discuss this with the company to explain what information we require and when it should be submitted.
- 5.1.4 Table 2 below sets out the requirements for companies that fall within the 'small' threshold (turnover less than £6.5 million).

Table 2 Small company requirements

	When	Where
Accounts prepared to a 31 March year end. These should also be available on your website at the same time they are submitted to us	15 July	Condition F paragraph 4
Group company annual report and accounts, if appropriate	When available	
UK holding company accounts (where ultimate owner is an overseas company), if appropriate	When available	
Certificate of adequacy of financial resources	15 July	Licence condition F6A
Two pro forma tables 1. Split of turnover, operating costs and depreciation 2. Volumes and connections	15 July	Appendix 2 See RAG4 for line definitions
Statement on links between Directors' pay and standards of performance published in the accounts	15 July	paragraph 3.2

	When	Where
Statement of dividend policy published in the accounts	15 July	paragraph 3.4

6. Transactions with associates and the non-appointed business

6.1 RAG5 Principles

6.1.1 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 both associated companies and the non-appointed business.

6.1.2 In addition following the introduction of separate binding price controls at the 2014 price review, companies need to attribute or allocate costs between the controls. The revenue allowance for each price control is determined by the estimated costs specific to that particular price control and comparable information on actual costs will be needed for future price reviews. Therefore companies should also ensure that there is no cross subsidy between price control units.

6.1.3 Appointees are required to demonstrate, through the application of the principles set out in RAG5, the basis of arm's length trading and that cross-subsidy does not exist.

6.2 Transactions to be disclosed

6.2.1 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 if over the materiality limit:

- 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.

- 6.2.2 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.
- 6.2.3 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.
- 6.2.4 Additionally where more than one associate company has transactions which are below the threshold then these should not be amalgamated such that there becomes a disclosure between the appointee and ‘various’ associates, even for common transaction types.
- 6.2.5 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.
- 6.2.6 Amounts disclosed should not be rounded below the £1,000 level e.g. £0.652m rather than £0.7m.

6.3 Pro-forma table

- 6.3.1 The following details should be included in the published annual performance report:

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, e.g., competitive tendering.	Of service received by regulated business or service supplied by regulated business.

Appendix 1: Pro forma tables

Section 1 Regulatory financial reporting	
Pro forma 1A	Income statement
Pro forma 1B	Statement of comprehensive income
Pro forma 1C	Statement of financial position
Pro forma 1D	Statement of cash flows
Pro forma 1E	Net debt analysis at 31 March 20xx
Section 2 Price review and other segmental reporting	
Pro forma 2A	Segmental income statement for the 12 months ended 31 March 20xx
Pro forma 2B	Totex analysis for the 12 months ended 31 March 20xx - wholesale water & wastewater
Pro forma 2C	Operating cost analysis for the 12 months ended 31 March 20xx - retail
Pro forma 2D	Historic cost analysis of fixed assets (wholesale water, wholesale wastewater & retail business)
Pro forma 2E	Analysis of capital contributions and land sales for the 12 months ended 31 March 20xx - wholesale
Pro forma 2F	Household - revenue by customer type
Pro forma 2G	Non-household water - revenues by customer type
Pro forma 2H	Non-household wastewater - revenues by customer type
Pro forma 2I	Revenue analysis & wholesale control reconciliation for the 12 months ended 31 March 20xx
Section 3 Performance summary	
Pro forma 3A	Outcome performance table
Pro forma 3B	AIM table
Section 4 Additional regulatory information	
Pro forma 4A	Non-financial information for the 12 months ended 31 March 20xx Number of properties and volumes
Pro forma 4B	Wholesale totex analysis
Pro forma 4C	Forecast impact of performance on RCV
Pro forma 4D	Totex analysis for the 12 months ended 31 March 20xx - wholesale water
Pro forma 4E	Totex analysis for the 12 months ended 31 March 20xx - wholesale wastewater
Pro forma 4F	Operating cost analysis for the 12 months ended 31 March 20xx – household retail
Pro forma 4G	Wholesale current cost financial performance for the 12 months ended 31 March 20xx
Pro forma 4H	Financial metrics for the 12 months ended 31 March 20xx
Pro forma 4I	Financial derivatives

Section 1 Regulatory financial reporting

Pro forma 1A

Pro forma 1B

Pro forma 1C

Pro forma 1D

Pro forma 1E

Section 2 Price review and other segmental reporting

Pro forma 2A

Pro forma 2B

Pro forma 2C

Pro forma 2D

Pro forma 2E

Pro forma 2F

Pro forma 2G

Pro forma 2H

Pro forma 2I

Section 3 Performance summary

Pro forma 3A

Section 4 Additional regulatory information

Pro forma 4A

Pro forma 4B

Pro forma 4C

Pro forma 4D

Pro forma 4E

Pro forma 4F

Pro forma 4G

Appendix 2: Small company return

For companies who wish to submit an Excel file to us, please follow this link to the template in Excel: [Small Company Return](#)

Pro forma S1

Pro forma S2