

# Information notice

IN 17/08 November 2017



This is a formal document that alerts our stakeholders to a change in the way that we regulate the water sector in England and Wales.

## Regulatory accounting guidelines 2017-18

This information notice summarises the changes we have made to the regulatory accounting guidelines that water and wastewater and water-only companies in England and Wales must follow in preparing their annual performance reports where required by Licence Condition F of their Instruments of Appointment.

The annual performance reports show both operational and financial information that companies are required to publish about their regulated business. This is in addition to the statutory accounts required in the UK under the Companies Act.

### Background

Statutory accounts on their own are insufficient to assess the performance of price-controlled water companies as their assets typically have a much longer life than an average UK company. The regulatory accounting guidelines (RAGs) define in detail the treatment of particular items (for example, revenue and interest) where Ofwat disclosure and accounting requirements differ from those normally required under UK accounting standards and applicable legislation.

Companies use these guidelines to complete their annual performance report (APR). We then use the information in the annual performance report to monitor performance and to inform future policy in relation to the regulated activities.

We expect companies to report this information in a clear and transparent way. Ensuring that stakeholders understand how companies are performing is important in providing trust and confidence in the sector and allowing Ofwat and stakeholders to hold the sector to account.

RAGs 1-5 have been revised for 2017-18 following a consultation in April this year. This information notice sets out the changes introduced to our revised RAGs. This will impact on the annual performance report for the reporting year ending 31 March 2018. Companies must publish their reports by 15 July 2018.

We had 18 [responses](#) to our consultation. These have been published on our website. Some companies have helpfully observed anomalies and gaps in our proposed table

definitions. Some suggestions relate to existing guidelines which companies have raised as a result of preparing the 2016-17 APR. We have taken these into account and modified RAG4 to give more clarity.

### **Cost assessment**

Cost assessment is an extremely important and material component of price reviews. Developing high quality econometric models is crucially dependent on the quality of information that companies provide. We consider that by collecting cost information through the APR process we can improve the quality of data used for these purposes and provide greater support to our cost modelling.

We have added 14 new tables - tables 4J to 4W to the reporting requirements. Some companies had concerns that the additional data could make the APR difficult to read for some stakeholders. We have therefore decided to allow companies to publish these tables separately from the main APR if they consider this will make it easier for stakeholders.

However, RAG3 has been amended to confirm that where companies publish tables 4J to 4W separately from their main APR, these tables must still be prepared in accordance with the RAGs. This information should not be considered less important than information published in the main APR and we expect the same high quality of assurance to be applied.

### **New connections – infrastructure**

In our [Update on new connections charging rules](#) in July 2016 we consulted companies

and stakeholders about allowing new connection charges to be fully reflective of network reinforcement costs when these are excluded from other charges. Our charging rules require water companies to balance their revenues from infrastructure charges with the costs they are intended to cover over a rolling 5-year cumulative period (starting on 1 April 2018), as far as is reasonably possible.

We said in our [charging rules for new connection services](#) that we would consider how best to address these issues through the APR. We have introduced a new table (2J – Infrastructure Network Reinforcement Costs) which details expenditure on network reinforcement. This expenditure is split between water and wastewater as there are separate infrastructure charges for each.

Developers responded to the July 2016 consultation telling us that they want to see that the new connections charging rule is being adhered to and want to understand how their money is being spent. If there is a difference between expenditure and receipts in one year, developers will want to understand the reasons behind it. The provision of information in this table will enable us to monitor companies' compliance with the new rules, so that we can step in if they are not being observed and ensure the process is transparent (a concern expressed by developers in a previous RAG consultation).

### **Bioresources transfer pricing**

We want to facilitate the development of a market in bioresources. A well-functioning market should deliver benefits which should

ultimately flow through to customers as lower prices or improved service delivery.

Some companies had also expressed concerns that our current RAGs may be inhibiting trades in bioresources and preventing the market from developing.

In our [April 2017 consultation](#) we proposed that incremental costs plus a margin would be an appropriate way of setting transfer prices for such trades. This would mean that revenues from such trades would make a contribution to the costs of both the appointed and the non-appointed business.

We have included the proposed changes to RAG 5 guidelines to clarify the use of incremental costs to set transfer prices for bioresources.

Companies will need to consider what share of the margin made on the sale of bioresources processing should be allocated to the appointed business (over and above incremental costs). This share should reflect the balance of risks between the appointed and non-appointed business.

Companies now have the scope to use incremental cost prices and to align the time horizon for defining incremental costs such that it is appropriate to the nature of the transaction.

## **Other changes for 2017-18 reporting**

Significant areas where we have made changes to the RAGs are set out below. A comprehensive [list of changes to the RAGs](#) and another for the technical changes to the tables has been published alongside this

Information Note. Each of the lists are in 2 parts;

- changes incorporated in the version of the RAGs proposed in the April 2017 consultation; and,
- changes made after consideration of the responses to the consultation.

## **Disclosure requirements**

We have clarified and expanded our disclosure requirements for:

- transactions with the non-appointed business and associate companies;
- non-appointed revenue analysis;
- corporation tax – including disclosure for group relief transactions; and
- return on regulatory equity (RORE).

## **Changes to Outcomes reporting**

We have been developing consistent reporting guidance for three metrics (leakage, supply interruptions and sewer flooding) to help inform setting outcome performance commitments from 2020 onwards. This reporting guidance is now finalised, and companies have submitted data for 2016-17 for the first time. These requirements have been formalised in table 3S. Like the cost assessment tables, this table is not required to be published in the APR itself.

There are also minor presentational changes to tables 3C and 3D and to RAG 4 in respect of outcomes.

## Retail eligibility for switching

We proposed that a new definition of “households” be adopted in the RAGs for 2017-18 so that we could ensure that all customers who were not eligible to switch suppliers would continue to be protected by a retail price control. This meant that the RAGs definition of “households” would need to change to be the same as the legal definition of “household premises” in section 17C of the Water Industry Act 1991. Premises falling within that definition are not eligible to switch supplier. We have updated RAG 4 to include this new definition.

The 2015-20 **average cost to serve (ACTS)** control for household retail activities automatically adjusts according to the number of customers, so the newly classified households (who were previously non-households) will be assimilated under the household control without the need for further changes.

We intend to retain the original definition of “households” in the RAGs for water companies whose areas are wholly or mainly in Wales (Welsh water companies). This is needed to protect customers of Welsh water companies. At PR16 our final determinations for Welsh water companies set price controls for business retail activities in relation to premises other than households using the same definition as at PR14. This is because, reflecting the policy position of the Welsh Government, the new business retail market has not been extended to customers of Welsh water companies. Customers of Welsh water companies continue to only be able to switch their water supplier if they are supplied with at least 50MI of water per year.

## Small company threshold

We have raised the threshold above which a company is required to meet all of the regulatory accounting information requirements in our updated RAG3. This is now set at £10.2m turnover. This will ensure that our reporting requirements remain proportionate for smaller companies. It is also the turnover threshold below which the government allows limited companies to file **abridged** accounts with Companies House.

## Grants and contributions

We have clarified the definition of ‘revenue’ in the annual performance report following previous changes intended to prohibit the recognition of grant income as revenue. This better captures the breadth of company accounting treatments in this area.

## Information capture system (ICS)

Companies will be required to complete our 2017-18 annual performance report table templates alongside the publication of their regulatory accounts and annual performance report. The 2017-18 annual performance table templates will be published in early 2018.

Companies below the £10.2m threshold must complete a separate template which will be published at the same time.

## Next steps and future developments

We are thinking about the following topic areas where it may be appropriate to make changes to the RAGs in the future;

- New connections – infrastructure;
- IFRS16 leasing; and
- Improving transparency concerning financial flows.

We will continue to work with the regulatory accounts working group (RAWG) to identify any issues that companies have when completing the revised APR tables. We have not scheduled the next RAWG meeting, but we are happy to hear from companies if there are topics that they think it would be useful for the working group to consider for future changes to the RAGs. If there is sufficient interest we will schedule a meeting for early 2018.

## New connections – Infrastructure

For 2017-18 we are beginning to collect cost data in respect of new connections. To further enhance the monitoring of the requirement to balance **both infrastructure revenue and costs** a new table will be proposed for 2018-19 (2K – Infrastructure Reconciliation). The table will collect revenue information and will be split between water and wastewater as there are separate charges for each.

## IFRS 16 – leasing

We note that companies are working to understand the impact of this accounting standard for the 2019-20 reporting year. We will work with companies and propose changes to the RAGs if necessary.

## Improving transparency concerning financial flows

We expect to see in future a clear comparison in annual reports between the financial flows to investors on the basis of actual capital structures and what these flows would have been under our notional structure. We are developing an appropriate metric to enable consistent reporting on a trial basis for 2017-18.

## Enquiries

If you have any questions about this information notice please email [FinanceAndGovernance@ofwat.gsi.gov.uk](mailto:FinanceAndGovernance@ofwat.gsi.gov.uk).

## More information

Links to any documents cited in the briefing note and any other information that may be of interest to a wider audience

Consultation on regulatory reporting for the 2017-18 reporting year (April 2017)

Water 2020: our regulatory approach for water and wastewater services in England and Wales (May 2016)

New connection charges consultation (July 2017)

Delivering Water2020 – consulting on our methodology for the 2019 price review (July 2017)

Water 2020 working groups

List of changes to the RAGs

Regulatory accounting guidelines;

- RAG 1.08
- RAG 2.07
- RAG 3.10
- RAG 4.07
- RAG 5.07

Ofwat (The Water Services Regulation Authority) is a non-ministerial government department. We regulate the water sector in England and Wales. Our vision is to be a trusted and respected regulator, working at the leading edge, challenging ourselves and others to build trust and confidence in water.

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