

# Regulatory accounts working group (RAWG)

Slides for workshop  
18 November 2016

Timing	Description	Lead
10:15	Introduction <ul style="list-style-type: none"> <li>Purpose of workshop</li> <li>Housekeeping</li> </ul>	Andrew Boardman
10:20	Recent developments <ul style="list-style-type: none"> <li>RAGs consultation to IN 16/09</li> <li>Water2020</li> </ul>	Rob Lee
10:35	Review of 2015-16 RAGs and general practical questions on compiling the financial tables in the APR	Rob Lee
11:20	<b>Coffee break</b>	
11:35	RAG5 disclosures and transfer pricing <ul style="list-style-type: none"> <li>Review of 2015-16</li> <li>Increased significance, especially with focus on tankered waste (sewage and sludge)</li> <li>Potential for increased disclosures for non-appointed activities</li> </ul>	Jenny Ngai Rob Lee
12:20	<b>Lunch</b>	
13:05	Cost assessment 1 – general developments and timelines Cost assessment 2 - more granular cost information for new price control units	David Young
14:00	<b>Refreshment break</b>	
14:15	Cost of new connections	Mark Jones
14:45	Looking forward; 2017-18 and beyond <ul style="list-style-type: none"> <li>IFRS developments</li> <li>Non-household retail</li> </ul>	Rob Lee
15:15	End	

Introduction

Andrew Boardman

ofwat

- **Purpose**
- **Housekeeping**
- **Contacting us;**

[FinanceAndGovernance@ofwat.gsi.gov.uk](mailto:FinanceAndGovernance@ofwat.gsi.gov.uk)

## RAGs consultation to IN 16/09

- Published in October, reporting requirements for 2016-17
- Changes to RAGs 1-4

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**IN 16/09: Regulatory accounting guidelines 2016-17**  
187.4 KB - PDF

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<b>Published</b>	<b>Detail</b>
31st October, 2016	This information notice summarises the changes we have made to the regulatory accounting guidelines that all monopoly water and wastewater and water-only companies in England and Wales must follow in preparing their annual performance reports.
<b>Kind</b>	
Publication	
<b>Type</b>	
Information notice	

## Water 2020

- Confirmation of new price control units
- More detailed boundary definitions, following close consultation with companies
  - Licence modifications; boundaries defined in the latest RAGs will form the basis of the new price control definitions
  - MEAV valuation; sludge boundary definitions will impact this workstream

## Methodology statement reviews

OFWAT consulted early in 2016 about future amendments to the Regulatory Accounting Guidelines (RAGs) including requirements for the MS for 2016-17. Some licensees have taken this an opportunity to adopt this early and align their MS in accordance with the consultation. Where this was done, generally speaking, the quality of the statements was much higher – giving greater transparency over costs being allocated to the price control units. We would consider these companies to be examples of best practice. However some companies are still providing minimal information such that some cost allocation is uncertain.

For some companies, from a policy perspective, there is very little detail about how fixed asset registers are populated and confirmation where assets sit vis-à-vis the prescribed boundary. This is particular issue for boreholes where co-located assets. It may also be beneficial to have auditors check the methodology statements agree to the RAGs asset classifications – so assets are not inadvertently placed in the wrong control.

## General practical questions on compiling the financial tables in the APR

Table	Question
1C	Are the categories aligned with the IFRS categories? Eg capex creditor
2B, 2E, 2I	Should 2B always agree to 2E? <b>To note the additional subheading included in the latest version of 2I.</b>
2D	How should companies deal with assets, which, under the principal use rule, may move between price controls year on year?
2D	Depreciation for third party services – what level of detail should be reported?
2G/2H	Where should wholesale charges to a non-incumbent retailer be included?
2G/2H	What happens when an incumbent exits the non-household retail market with respect to these tables?
2G/2H	How should the retail revenue be split by <u>connection</u> where charges are determined at a <u>customer</u> level?
4E	Combined sewers and apportioning costs/capex. A need for OFWAT guidance?
	High lift pumps; treatment or distribution <b>need to ask companies in advance to check how they classify these at present</b>
	Contracted out services and impact of FTE numbers as a driver – conflict?
	M&G assets and Principal user – do we need more guidance?
	WRFIM – see next slide

## General practical questions on compiling the financial tables in the APR - WRFIM

- WRFIM interaction with revenues reported in 2015-16 – these are potentially different to what they would have been under the revised guidance for 2016-17 eg adopted assets. [Simply a case of adjusting the reported 2015-16 numbers and disclosing the change in the commentary?]
- ‘Other grants and contributions’ are assumed (for APR table 2I purposes), to be **outside** of the price control. However some items being accounted for in this category may NOT be on the **condition B list of excluded charges** e.g. sewer adoption fees – and hence should be considered part of the price control?
  - Do you agree?
  - How were these income streams described in the business plans?
  - Should an additional line be added to 2E?

Analysis of capital contributions and land sales for the 12 months ended 31 March 20xx - wholesale				
	Fully recognised in income statement	Capitalised and amortised (in income statement)	Fully netted off capex	Total
<b>Grants and contributions - water</b>				
Connection charges (s45)	I	I	I	C
Infrastructure charge receipts (s146)	I	I	I	C
Requisitioned mains (s43, s55 & s56)	I	I	I	C
Diversions (s185)	I	I	I	C
Other Contributions	I	I	I	C
Total	C	C	C	C
Value of adopted assets		I		C

Pro forma 2E				
Analysis of capital contributions and land sales for the 12 months ended 31 March 20xx - wholesale				
	Fully recognised in income statement	Capitalised and amortised (in income statement)	Fully netted off capex	Total
<b>Grants and contributions - water</b>				
Connection charges (s45)	I	I	I	C
Infrastructure charge receipts (s146)	I	I	I	C
Requisitioned mains (s43, s55 & s56)	I	I	I	C
Diversions (s185)	I	I	I	C
Other Contributions	I	I	I	C
Total	C	C	C	C
Value of adopted assets		I		C
<b>Grants and contributions - wastewater</b>				
Infrastructure charge receipts (s146)	I	I	I	C
Requisitioned sewers (s100)	I	I	I	C
Diversions (s185)	I	I	I	C
Other Contributions	I	I	I	C
Total	C	C	C	C
Value of adopted assets		I		C

RAG 4 reference

## Proforma 2I

	Water	Wastewater	Total
Wholesale revenue governed by price control	C	C	C
Grants & contributions <sup>1</sup>	I	I	C
Total revenue governed by wholesale price control	C	C	C
Amount assumed in wholesale determination	I	I	C
Adjustment for in-period ODI revenue	I	I	C
Total assumed revenue	C	C	C
Difference <sup>2</sup>	C	C	C

## RAG 4.06; appendix 1

Excluded charges;

- Bulk supplies
- Stand pipes and water tanks
- Water cleansing
- Charges for reception and disposal of waste
- Unmeasured cattle troughs
- Unmeasured building water supplies
- Unmeasured supplies by water tankers
- Unmeasured farm taps
- Reservoir operating agreements
- Unmeasured supply hereditaments
- Diversions<sup>1</sup>

## General practical questions on compiling the financial tables in the APR

Ttds – definition

To clarify ttds = 1000 tonnes of dry solids

15	Total sewage sludge produced	ttds	1dp
Definition	The total amount of sewage sludge produced during the report year expressed in thousands of tonnes of dry solids of sludge produced by the whole service.		
Primary Purpose	Informing relative performance and efficiency assessments.		
Processing rule	Input		
Reference	MP05611		
Responsibility	Environment and Water Quality Team		

x

Tables		Dictionary		Audit	
<b>MP05611</b>					
Line Number	15				
Interval	2007-08				
Cell Type	Copy				
Formula					
<b>Details</b>					
Description	Total sewage sludge produced				
Purpose	Informing relative performance and efficiency assessments				
Rule Text					
Definition	The total amount of sewage sludge produced during the report year expressed in thousands of tonnes of dry solids of sludge produced by the whole service.				
Price Base	Price base does not apply				
<b>Format</b>					
Unit	ttds				
Decimal Places	1				

## Review of 2015-16

5 companies have disclosed amounts where £m values are rounded to 1dp. 2 companies did not provide details on 'Turnover of associate' and 'Terms of supply' for some of its transactions.

One company has amalgamated 'waste treatment, transport, accommodation, insurance, laboratory, central services' together and is >0.5% of turnover material threshold. It is not clear if any single transaction was > 0.5% threshold.

One company provided a template table for purchases but disclosed sales as a separate narrative.

### Reminder (from RAG3);

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 general, companies reported **Terms of supply** using a wide variety of wordings i.e. actual costs, negotiated, pass through, other market testing, employment costs, contract price, recharge of costs, no market, competitive letting, cost, third party, market tested, recharge of appropriate costs, cost allocation, monopoly provider, benchmarking, competitive tender, or cost pass through, with no further detail behind it.

Is it appropriate to have some **consistency** in reporting the means by which the price to associates has been established?

### **Why does this matter?**

Increased significance, especially for non-appointed activities. In the past Ofwat's transfer pricing focus was on associated companies. Associate activity is now much less than in the past. But the new price controls for PR19 means more scrutiny for other transactions.

Interest from WSSLs and potential retail market entrants on the transactions between incumbents and their retail operations.

## Reminder of the RAG 5.06 requirements

Principle - transfer prices for transactions between the appointed business and non appointed business are based on market price. Where no market exists, transfer prices are based on cost.

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.

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.

Application of the principles in RAG2 should prevent appointed activities cross subsidising non-appointed activities and also ensure no cross subsidy between price control units. All costs must ultimately be attributed or allocated, including, where appropriate, depreciation charges on assets and financing charges.

Allocations based on short run marginal costing techniques **should not be used** in ensuring the full allocation of costs within the appointee and providing the basis for transfer prices. In some instances it may be admissible to use long-run marginal costing techniques for transfer pricing purposes. For instance between appointed and non appointed business , where a water only company, uses appointed assets and staff to bill and collects payments for another 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 within a group, it will be expected to justify its reasons for using this technique.

## Future developments

Potential for increased disclosures for **non-appointed activities** e.g.

- basis of recharges,
- tankered waste element,
- sludge element,
- revenues from other WaSCs.

Interest from WSSLs and potential retail market entrants on the transactions between incumbents and their retail operations.

# Cost Assessment – part 1

David Young, Principal



- Cost assessment is an **extremely important and material** component of price reviews. At price reviews Ofwat sets an **efficient expenditure allowance** for the water companies for a five year period. The main tool in setting this allowance is a set of **benchmarking (econometric) models** which are developed by Ofwat.
- These models establish a statistical relationship between cost and (a small number of) “cost drivers” by looking at **historical data** over time and across companies.
- At PR14 our approach to cost assessment was based on top-down benchmarking of historical costs and special cost factors adjustments. Specifically, we developed **benchmarking (econometric) models** on the basis statistical relationships between historically incurred costs and ‘cost drivers’, as reported annually by companies. The benchmarking models are largely driven by inputs of **past costs over a series of years**. The models provided an initial cost baseline.
- The modelling has used capex smoothing which averages the capex over a given period to produce a smoother profile and reduce volatility in the modelling.
- The initial cost baselines were then subjected to **“special cost factor”** adjustments, which are factors that impact company costs but are not captured in the model (e.g. a very large capital scheme such as building a new reservoir).

- In 2015-16 Ofwat changed the **basis of reporting information** in the RAGs – including the move away from renewals accounting to totex reporting which allowed for the changes to UK GAAP as it aligned with IFRS.
- This potentially **introduced uncertainty in data set** – for years up to 2015-16 data is in “old” UK GAAP while for 2015-16 it is on the new basis.
- Ideally to mitigate this we would like to continue to identify **Infrastructure Renewals Expenditure (IRE)** post 2015 to continue the data set. But we do not want companies to formally recreate renewals accounting. We would like to discuss how this could be achieved within the current reporting requirement regime.
- We propose 2 new lines be created – **infrastructure and non-infrastructure repairs** in tables 4D and 4E (currently included within ‘other operating expenditure’). We believe this would be a proxy for IRE.

- Being able to continue to identify the equivalent of IRE would also allow Ofwat or companies to assess the efficiency of infrastructure maintenance through benchmarking.
- When assessing corporation tax forecasts at PR14 we found that companies' tax treatment regarding deductibility of infrastructure spend did not always follow the accounting logic. So by being able to identify this we can monitor actual corporation tax versus the PR14 forecasts.
- We also used this information at PR14 to support our assessment of financeability when we carried out financial modelling. So up to date actual cost information will help us to cross check these assumptions in the PR19 business plans on a forward looking basis.

# Extract Pro-Forma Table 4D – Wholesale Water

## Totex analysis for the 12 months ended 31 March 20xx - wholesale water

RAG 4  
reference

	Water resources		Network+				Total
	Abstraction licences	Raw water abstraction	Raw water transport	Raw water storage	Water treatment	Treated water distribution	
<b>Operating expenditure</b>							
Power	I	I	I	I	I	I	C 4D.1
Income treated as negative expenditure	I	I	I	I	I	I	C 4D.2
Abstraction charges	I	I	I	I	I	I	C 4D.3
Bulk supply	I	I	I	I	I	I	C 4D.4
Repairs - infrastructure	I	I	I	I	I	I	C
Repairs - non-infrastructure	I	I	I	I	I	I	C
Other operating expenditure (excl repairs)	I	I	I	I	I	I	C
Local authority and Cumulo rates	I	I	I	I	I	I	C
Total operating expenditure excluding third party services	C	C	C	C	C	C	C
Third party services	I	I	I	I	I	I	C
Total operating expenditure	C	C	C	C	C	C	C

# Extract Pro-Forma Table 4E – Wholesale Wastewater

## Totex analysis for the 12 months ended 31 March 20xx - wholesale wastewater

RAG 4  
reference

	Network+ Sewage collection			Network+ Sewage treatment		Sludge			Total	
	Foul	Surface water drainage	Highway drainage	Sewage treatment and disposal	Sludge liquor treatment	Sludge transport	Sludge treatment	Sludge disposal		
<b>Operating expenditure</b>										
Power									C	<b>4E.1</b>
Income treated as negative expenditure									C	<b>4E.2</b>
Discharge consents									C	<b>4E.3</b>
Bulk discharge									C	<b>4E.4</b>
Repairs - infrastructure									C	
Repairs - non-infrastructure									C	
Other operating expenditure (excl repairs)									C	
Local authority and Cumulo rates									C	
Total operating expenditure excluding third party services	C	C	C	C	C	C	C	C	C	
Third party services									C	
Total operating expenditure	C	C	C	C	C	C	C	C	C	

## Questions for Discussion:

- What are your thoughts on our proposal?
- Do you agree that the new line item for opex infrastructure repairs will, together with the capex equivalent, would be a good proxy for IRE?
- Are there any issues for your accounting systems?
- How much effort to collect and report?

More granular cost information for new price control units?

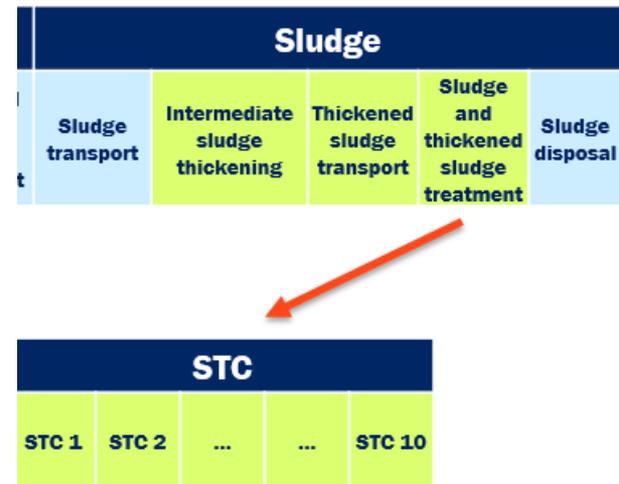
Potentially;

- Cost information by water resource zone (WRZ) for water resources?
- Site information for sludge?

Why?

- To provide transparency for potential new entrants,
- To provide information that supports the charging regime.

Possible **pilot information** for 2017-18?



# Cost of New Connections

Mark Jones



## Background

Stakeholders have concerns with the current arrangements –for example, that charges are too complex, unpredictable and unfair.

The government has an ambition for delivering one million new homes by 2020.

Enabling a clear and customer-centric charging framework will be key to ensuring trust and confidence in the sector, by providing:

- Clearer, more predictable and stable charges
- Fairer charges, as revenues and costs should balance over a rolling 5 year cumulative period, as far as is reasonably practical
- Increased transparency, as companies will be required to clearly explain how their charges have been calculated
- Effective competition
- Protection because the balance of costs must remain broadly as it is now.

## Background

Over the past year a Task and Finish Group convened by Defra have been meeting to consider the introduction of new rules with respect for charging for new connections being proposed by Ofwat.

In March 2016 we consulted on our emerging thinking for rules for new connections.

In July we consulted formally on our proposals, setting out amongst other things, our strategy, legal framework, government guidance, policy development process and related work streams

Following the response to our consultation, we have delayed the implementation of April 2017 to April 2018 to help facilitate a sector-led approach to implementation of the new rules and reduce unnecessary differences through some standardisation, but without restraining companies' ability to introduce innovative tariffs

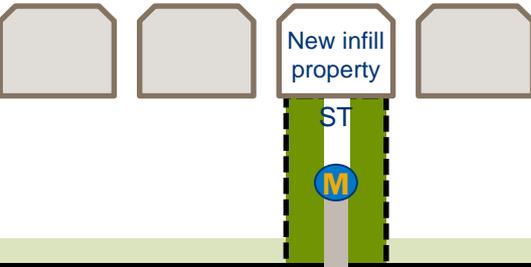
## **New connections** charges cover:

- requests to connect a property to an existing water or sewer main;
- requisitioning a new sewer or water main;
- charges relating to having a third party construct a sewer and having the incumbent company adopt it (Self-Lay); and
- Requesting a company to move an existing sewer.

# Proposed boundaries for new WATER connection charging (latest version)

- Key**
- M Meter
  - ST Stop tap
  - C Contestable
  - NC Non-contestable
  - Existing strategic assets
  - Existing network
  - On site / site-specific charging
  - Site boundary

## Existing properties



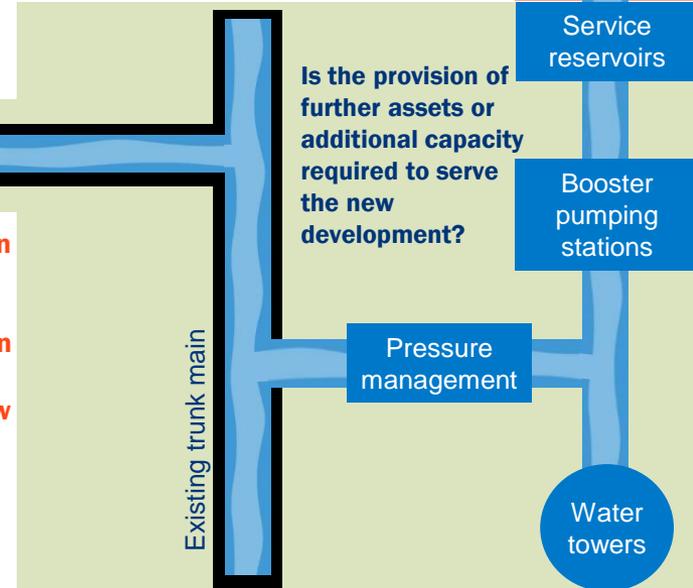
The costs of necessary reinforcement work required to these existing strategic assets or the provision of new water resources or treatment assets (including the transmission between them), **are to be borne by the water company** and not the developer

Raw water aqueducts, balancing tanks, other raw water distribution structures and booster pumping stations

Dams and impounding reservoirs

Intake and source pumping stations

Water treatment works and forwarding pumping stations



Is the provision of further assets or additional capacity required to serve the new development?

The costs of necessary reinforcement work required to the water company's existing network assets 'in consequence' of the new connections and as evidenced in water companies' business plans, **will need to be borne by the developer** through the water company's redefined infrastructure charge

Existing 'live' water distribution main

Connection to live main (mainly NC)  
Piece-ups to the live main (C)

**Point of connection** – the nearest practical location where the live main is the same size or larger than the new connecting main

## New development

**New connection (C)**

Supply pipe M Communication or service pipe

Stop tap and meter installation (mainly C)

New 'requisitioned' water main (C)

New road

‘...we will require companies to balance their costs with revenues received, as far as is reasonably possible, over a rolling 5-year cumulative period’

Reporting year	Cumulative variances between costs and revenues							APR review	Cumulative period
	2018-19	2019-20	2020-21	2021-22	2022-23	2023-24	2024-25		
2019	X							High level	1 year only
2020	X	X							2 years
2021	X	X	X						3 years
2022	X	X	X	X					4 years
2023	X	X	X	X	X			Detailed	5 years
2024		X	X	X	X	X			Rolling 5 years thereafter
2025			X	X	X	X	X		

*Note: A red box labeled 'Commentary' is positioned above the 2021-22 column, with red arrows pointing to the 'X' marks in the 2018-19, 2019-20, 2020-21, 2021-22, 2022-23, 2023-24, and 2024-25 columns.*

Companies provide a commentary in their annual performance reports on the balance of costs and revenue each year from 2018-19 onwards. This will be proportionate to the scale of variance each year and will be based on a single year in 2018-19 and then cumulative total variances thereafter.

However, we fully accept there are likely to be greater variances in the earlier years as the new charging rules are implemented and transitional arrangements are made.

‘...we will require a more granular level of cost information in relation to developer services in the annual performance report ’

**Totex analysis for the 12 months ended 31 March 20xx - wholesale water & wastewater**

	Water	Wastewater	Total
<b>Operating expenditure</b>			
<b>Capital expenditure</b>			
Maintaining the long term capability of the assets - infra	I	I	C
Maintaining the long term capability of the assets - non-infra	I	I	C
Other capital expenditure - infra	I	I	C
Other capital expenditure - non-infra	I	I	C
<b>Total gross capital expenditure (excluding third party)</b>	<b>C</b>	<b>C</b>	<b>C</b>
Third party services	I	I	C
<b>Total gross capital expenditure</b>	<b>C</b>	<b>C</b>	<b>C</b>

← Costs

Charges →

**Analysis of capital contributions and land sales for the 12 months ended 31 March 20xx - wholesale**

	Fully recognised in income statement	Capitalised and amortised (in income statement)	Fully netted off capex	Total
<b>Grants and contributions - water</b>				
Connection charges (s45)	I	I	I	C
Infrastructure charge receipts (s146)	I	I	I	C
Requisitioned mains (s43, s55 & s56)	I	I	I	C
Diversions (s185)	I	I	I	C
Other Contributions	I	I	I	C
<b>Total</b>	<b>C</b>	<b>C</b>	<b>C</b>	<b>C</b>
Value of adopted assets		I		C
<b>Grants and contributions - wastewater</b>				
Infrastructure charge receipts (s146)	I	I	I	C
Requisitioned sewers (s100)	I	I	I	C
Diversions (s185)	I	I	I	C
Other Contributions	I	I	I	C
<b>Total</b>	<b>C</b>	<b>C</b>	<b>C</b>	<b>C</b>
Value of adopted assets		I		C

## Key points from consultation responses

- General support for more cost information
- Mixed views on where this information should be reported – one company said that, because this cost information is commercially sensitive, it should not be reported in publically available regulatory reports such as the APR, whereas another company said the APR was sensible
- Clarity on cost allocation is needed as soon as possible

### **Working Group**

Chaired by Ofwat, the group will act in an advisory capacity to Ofwat. We expect all participants to actively contribute to the work of the group, when required.

### **Objective**

The key objectives of the group are to :

- Provide input into the level and detail of the infrastructure charge information to be collected in the APR
- Provide input into the format and content of the narrative to support the annual and cumulative revenue vs cost variance
- Advise as to the frequency of the setting and re-setting of the infrastructure charge, including minimum notice periods and explanations for change

## Membership

### Organisation

Ofwat (Chair)

Northumbrian Water

Bristol Water

Thames Water

Anglian Water

Affinity Water

United Utilities

Fair Water Connections

Home Builders Federation

Home Builders Association

### Representative

Alex Whitmarsh

Mark Jones

Paul Fox

Crawford Winton

Beverley Lawton

Samuel Larsen

Dr Andrew Cotterall

Darren Rice

Iain Amis

Amy Johnson

Heather Blamire-Brown

Lynne Gibson

Martin Speight (correspondence only)

Ray Farrow

Steve Wielebski

Dave Mitchell

Paul Voden

### Out of Scope

Areas that are deemed out of scope for the group are:

- Cost information for charges other than the infrastructure charge
  - these are less of a concern, because other than infrastructure charges, these charges are generally contestable
- Collection of non-financial information
  - although interesting supplementary information to aid the understanding of companies costs and charges it is unclear whether this is crucial or how it could be used.
- Incentive or penalty mechanisms, this will be followed up separately
- Definition of the infrastructure charge (this is being addressed elsewhere)
- Collection method
  - the information that all interested parties will want to use will be on an annual basis, so our starting point is to assume it is more efficient to require it as part of the APR rather an information request on an ad hoc basis.

Looking forward; 2017-18 and beyond

Rob Lee

## IFRS developments

Impact of new financial reporting standards (IFRS 9,15,16) - we raised three questions with regard to the new financial reporting standards IFRS 15 (Revenue) and IFRS 16 (Leasing):

- IFRS 16 (leasing): will the PR19 submission include requirement to comply with IFRS 16 in which case would need to consider early adoption?;
- IFRS 15 (revenue): will the regulatory accounts follow statutory IFRS 15 accounting policies or would Ofwat have a view on deferral or not of infrastructure charges in the reg accounts?; and
- IFRS 15 (revenue): will the consultations published by Ofwat necessitate a change the definitions of types of capital contributions as this may affect the presentation of ODI within the statutory accounts?

## Non-household retail

Non-household Default tariffs and Developer services.

WSSLs to report on these where market exit for an incumbent has taken place?