

## **WATER INDUSTRY COMMISSION FOR SCOTLAND**

### **REGULATORY ACCOUNTING RULES**

#### **INTRODUCTION**

The Water Industry Commission for Scotland (WICS) has introduced five separate Regulatory Accounting Rules (RARs) for application to the water industry in Scotland. The purpose of these RARs is to provide rules for the compilation of Regulatory accounts and to assist, where appropriate, in the compilation of other returns to WICS. The RARs are applicable to data submitted for the year 2003-04 onwards.

A brief description of the content of the Regulatory Accounting Rules is given below. A glossary of common terms is also provided.

**Regulatory Accounting Rules 1 (RAR 1)** - Accounting for Current Costs and Regulatory Capital Values.

This Regulatory Accounting Rule discusses the objectives of the requirements for current cost (CC) accounts, the rationale behind the form of modified real terms accounting required and the limitations on the uses and interpretation of the accounts in their present form. It also flags various simplifications being adopted for application in the Scottish water industry.

**Regulatory Accounting Rules 2 (RAR 2)** - Classification of Expenditure.

This Regulatory Accounting Rule covers the classification of expenditure by purpose category under infrastructure renewals accounting.

**Regulatory Accounting Rules 3 (RAR 3)** - The contents of Regulatory Accounts.

This Regulatory Accounting Rule covers the requirements for accounting information, with the exception of the current cost accounting methodology which is covered by RAR 1, the classification of expenditure (RAR 2) and the activity cost analysis and methodology which is addressed in RAR 4. Regulatory accounts should be prepared in accordance with these rules for each financial year.

**Regulatory Accounting Rules 4 (RAR 4)** – Analysis of Operating Costs, Revenues and Assets.

This Regulatory Accounting Rule covers the form, content and principles of the analysis of operating costs, revenues and tangible fixed assets to be produced as part of the Annual Return Information Requirements, Section M.

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#### **Regulatory Accounting Rules 5 (RAR 5) – Transfer Pricing**

This Regulatory Accounting Rule provides guidance on the procedures and methodologies to be followed when completing transactions between the core activity and non-core activities and associate entities.

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#### **GLOSSARY OF TERMS**

##### **Definitions of Scottish Water Activities**

###### **Activity**

A logical grouping of tasks.

###### **Core activity**

Core business activities comprise the regulated activities of Scottish Water which are activities necessary in order for it to fulfil the functions and duties of a water and sewerage undertaker as defined in the Water (Scotland) Act 1980, as amended by any subsequent legislation and the Sewerage (Scotland) Act 1968 as amended by subsequent legislation. See RAR 4 for further clarification.

###### **Non core activity**

Non-core activities are those activities engaged in by Scottish water, which are not necessary in order for Scottish Water to fulfil the functions and duties of a water and sewerage undertaker as defined in the Water (Scotland) Act 1980 as amended by subsequent legislation and the Sewerage (Scotland) Act 1968 as amended by subsequent legislation. See RAR 4 for a fuller definition.

###### **Retail**

The customer facing activities of Scottish water including Scottish Water Retail - Household and Scottish Water Retail – Non-household. See RAR 4 for further guidance.

###### **Wholesale**

Scottish Water Wholesale includes the individually identified (primary) activities which must be pursued separately in order to provide water and sewerage services i.e., water resources and treatment, water distribution, sewerage, sewage treatment and sludge treatment and disposal.

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#### Definitions Relating to Current Cost Accounting

##### **Real terms accounting.**

The combination of valuing assets at value to the business with the inclusion of all realised and unrealised gains in the measurement of profit after real financial capital maintenance.

##### **Real financial capital maintenance**

The measurement of profit after allowing for maintaining the real value of capital and reserves.

##### **Modified real terms accounting**

Real terms accounting modified by the exclusion of unrealised gains and the inclusion of initial operational assets at their value to the business ignoring the impact of the regulatory regime and the extent of third party contributions.

##### **Retail price index**

RPI is the % change in RPI in a financial year =  $\frac{\text{Closing RPI} - \text{Opening RPI}}{\text{Opening RPI}}$

##### **Current cost operating profit**

Calculated on a real terms basis at the pre tax, pre interest level.

##### **Recoverable amount.**

The greater of the net realisable value of an asset and where applicable, the amount recoverable from its further use, discounted as appropriate.

##### **Value to the business.**

Net current replacement cost or if a permanent diminution below net current replacement cost has been recognised, recoverable amount.

##### **Gross Modern Equivalent Asset Value**

The gross MEA value is what it would cost to replace an old asset with a technically up to date new asset with the same service capability, allowing for any difference both in the quality of output and in operating costs.

##### **Net Modern Equivalent Asset Value**

The net MEA value is the depreciated value taking into account the remaining service potential of an old asset compared with a new asset, and is stated gross of third party contributions.

##### **Investment plan adjustment**

The revision in the real value arising periodically from improved information notably in the investment plans.

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#### **Working capital**

The aggregate of stocks, trade debtors, trade creditors and working cash balances, if material. Trade creditors include short-term creditors for capital goods, the infrastructure renewals accrual and any creditor balances relating to expenditure, which is charged to the profit and loss account before operating profit. It also includes trade accruals, prepayments, intra-group trading balances, payments in advance, payroll related taxes and social security contributions.

#### **Working Capital Adjustment**

The working capital adjustment is the adjustment for the impact of general inflation on the real value of the working capital of the business.

The working capital adjustment is  $RPI \times \text{opening working capital}$ .

#### **Net finance**

All monetary assets and liabilities other than to Scottish government, which are not included in working capital. It therefore includes investments, including cash held as an investment, all creditors other than trade creditors but excludes proposed dividends.

#### **Financial Adjustment**

The financing adjustment is the real gain or loss arising for providers of capital from the impact of general inflation on monetary assets and liabilities (i.e. the real value of net finance for the business).

The financial adjustment is  $RPI \times \text{opening net finance}$ .

#### **Regulatory Capital Value**

The initial RCV will be established as at 1 April 2006. This is then rolled forward to take account of new capital investment, net of depreciation.

RCV is the capital base used in setting price limits for the core business, being the value of the core business which earns a return on investment. The value is adjusted each year to take account of net investment. Capital expenditure to enhance and maintain the network which has been assumed in setting price limits is added to the value. This is after deducting the amount of depreciation (based on the MEA values of the assets) which is assumed in setting price limits. Any grants and contributions and associated amortisation are also taken into account. Infrastructure renewals expenditure is not added to the RCV but the movement in the infrastructure renewals accrual or prepayment is included. Adjustments are also made in respect of disposals of land to remove the value of this from the RCV. The RCV is adjusted each year by RPI to take account of inflation.

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#### **Logging up/down of capital expenditure.**

Between strategic reviews, if Scottish Water is required to meet additional statutory obligations the capital costs associated with this work are logged up and are added to the RCV at the next review. Similarly reductions in required outputs are logged down.

#### **Infrastructure renewals expenditure**

IRE is net planned maintenance expenditure on the infrastructure network, i.e. net of any grants and contributions. The IRE is taken together with the infrastructure renewals charge (IRC) to ensure that the movement in the infrastructure renewals accrual/prepayment is included. This reflects the extent to which more (or less) money has been spent in maintaining the infrastructure asset base thus increasing (or decreasing) the value to be remunerated.

#### **Infrastructure renewals charge**

The annual accounting provision for expenditure on the renewal of infrastructure assets charged to the profit and loss account. It should reflect Scottish Water's assessment of its long-term infrastructure renewals expenditure needs.

An infrastructure renewals charge (IRC) is made to the profit and loss account to represent the maintenance of asset value by the business during the year.

The IRC should reflect Scottish Waters assessment of its long-term capital maintenance needs to maintain infrastructure asset serviceability and operating capacity. The IRC is taken to the balance sheet as a provision (for liabilities and charges) and actual expenditure (IRE) on infrastructure assets is set off against this provision as it occurs. Any difference from year to year between IRC and IRE is accumulated in the balance sheet as a cumulative accrual (IRA) or prepayment as appropriate.

#### **Infrastructure renewals accrual/prepayment**

The provision for the accumulated shortfall (overshoot) between actual renewals expenditure and the infrastructure renewals charge.

The infrastructure renewals accrual or prepayment is included in working capital in the balance sheet. The renewals accrual may indicate that Scottish Water will need to carry out higher levels of maintenance sometime in the future for which it has already been remunerated. The renewals prepayment indicates that Scottish Water is ahead of the original plan and there will be a likelihood of lower levels of maintenance in the short term.

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#### **Infrastructure assets.**

Mainly underground systems of mains and sewers, impounding and pumped raw storage reservoirs, dams, sludge pipelines and sea outfalls. Information about infrastructure assets is also to be regarded as an infrastructure asset (e.g. Zonal investigation records).

#### **Initial assets**

Those in place at 1 April 2005.

#### **Third party contributions since 1 April 2005**

Grants and third party contributions received in respect of infrastructure assets and any deferred income relating to grants and third party contributions for non infrastructure assets.

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#### **Definitions Relating to Profit and Loss Account**

##### **Turnover**

All revenue derived from standard charges for inclusion in the tariff basket calculation, together with revenue from non-tariff basket charges, revenue grants and other sources as defined below.

##### **Household unmeasured water supply**

All revenue derived from charges for the sale of water to household customers based on the Council tax band of their home.

##### **Household unmeasured wastewater services**

All revenue derived from charges to household customers based on the Council Tax band of the property for the provision of sewerage services. This includes surface water and roads drainage.

##### **Household measured water supply**

All revenue derived from the sale of water at standard rates billed to household customers, where all or some of the charges are based on measured quantities of volume.

##### **Household measured wastewater services**

All revenue derived from the provision of sewerage services to household customers (which includes revenue raised by any rateable value element of measured sewerage tariff), where all or some of the charges are based on measured quantities of volume. Sewerage services include surface water and roads drainage and exclude reception, treatment and disposal of trade effluent.

##### **Non household unmeasured water supply**

All revenue derived from the sale of water to non-household customers based on the connected property rateable value.

##### **Non household unmeasured wastewater services**

All revenue derived from the provision of sewerage services to non-household customers based on the connected property rateable value. Sewerage services include sewage treatment and disposal and exclude reception, treatment and disposal of trade effluent.

##### **Non household measured water supply**

All revenue derived from the sale of water to non-household customers, where all or some of the charges are based on measured quantities of volume.



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#### **Non household measured wastewater services**

All revenue derived from the provision of sewerage services to non-household customers, where all or some of the charges are based on measured quantities of volume.

#### **Trade effluent**

All revenue derived from the reception, treatment and disposal of trade effluent including the annual fixed charge and the charge based on the Mogden formula.

#### **Revenue grant**

All revenue grants received for the provision of water and sewerage services, split between services.

#### **Other sources (excluding third party services)**

All other sources of turnover including non - tariff basket charges, rechargeable works, special agreements. Compensation, contributions from developers (of a revenue nature), excluding third parties.

#### **Third party services**

Revenue derived from the provision of water or wastewater (as applicable) services to third parties. It includes the provision of bulk supplies of raw or treated water to other water utilities, producing and delivering non-potable water, treating and disposing of imported sewage and sludge, water mains diversion and all rechargeable works.

#### **HCA operating costs**

HCA operating costs including exceptional items, depreciation and the infrastructure renewals charge but excluding extraordinary items. (Both exceptional and extraordinary items are defined below). HCA operating costs should include:

#### **Manpower costs**

Gross salaries and wages of all employees, including on costs such as superannuation, but excluding manpower costs that are capitalised or included in the infrastructure renewals charge.

#### **Other costs of employment**

Cost of private health care insurance, unfunded pension liabilities, travel and subsistence, training, entertaining, staff recruitment, conference expenses, retirement awards and death in -service benefits but excluding other costs of employment relating to manpower costs that are capitalised or included in the infrastructure renewals charge.

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#### **Power**

All energy costs other than energy used for transport.

#### **Rates**

The cost of Local Authority rates.

#### **Base service provision**

Base service expenditure is required to maintain the current (most recently established base) level of serviceability to customers; or as quality where expenditure is required to comply with new (i.e. since the base service level was established) legally enforceable quality obligations.

#### **Enhanced service level**

Expenditure which provides an identifiable, measurable and permanent step change in overall level of service to existing customers above the standard previously provided.

#### **Supply/demand balance**

Expenditure which provides water and sewerage services for new customers with no net deterioration from the current level of service provided to existing customers; and/or accommodates the increased use of water by existing customers at the current level of service.

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#### **Definitions Relating to Transfer Pricing**

##### **Arm's length trading**

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

##### **Associate Entity**

An associate entity should be determined in accordance with Financial Reporting Standard 8 (FRS 8).

##### **Cost**

The actual cost to an associate/ non core activity in a transaction with Scottish Water of the goods, works or services. Where the associate or non core activity also provides services to third parties then a reasonable rate of return on capital employed may be included. This will be the cost of capital on new investment as stated in the Strategic Review of Charges.

##### **Cost allocation**

Cost allocation is the means by which all costs are allocated to core and non core businesses or core and associated entities.

##### **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 Scottish Water to the associate or non-core activity which is not merited by services received or for which the core business has not received full reimbursement of costs incurred by it for the use of its assets or resources by the associate or Non-core activity.

##### **Economically advantageous price**

The economically advantageous price is the net cost to Scottish Water 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 services, technical merit, aesthetics, security of supply, effectiveness, whole life cost, capability, etc.

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#### **Framework agreement**

Framework agreements are as defined by the EU Utilities Directives. Broadly these are agreements covering terms, prices and, where appropriate, envisaged quantities for contracts to be awarded over a specified time period.

#### **Indirect transaction**

A transaction where Scottish Water has a contract with a third party and that third party has made use of an associate entity of Scottish Water to provide that service. In this instance Scottish Water does not have a contract with the associate entity, but part of the turnover of the associate entity is indirectly provided by it.

#### **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 RAR 5, a transaction occurs where Scottish Water and its associates supply goods, works or services to each other, directly or indirectly.

#### **Transfer pricing**

A transfer price is the price paid by one group entity to another for transactions between the two companies.