



Regulatory accounts in the Scottish water industry

Regulatory accounts were introduced into the Scottish water industry in 2005. They are one of the key sources of information we use to fulfil our statutory remit to promote the interests of customers. This document provides more information about how regulatory accounts are used in Scotland.



Introduction

Regulatory accounts are a series of financial reporting submissions that are designed to provide regulators with information about the performance and financial health of the companies and industries they regulate. Over the last decade they have become an increasingly important source of information for UK regulators.

Why we introduced regulatory accounts

Before we introduced regulatory accounts, we used statutory accounts to monitor Scottish Water's financial performance each year. Scottish Water is required by Scottish Ministers to prepare statutory accounts. These annual accounts are broadly consistent with the various UK and international accounting standards, and are therefore subject to any changes in practices and standards.

Such changes had an impact on our year-on-year monitoring of Scottish Water's performance. In order to align Scottish Water's reported performance with our regulatory targets we had to make significant and complex adjustments. This reduced the transparency of our work, and made it more difficult for stakeholders to form a reliable view of Scottish Water's performance.

As we have more control over the rules that govern the regulatory accounts, we can collect information from Scottish Water consistently over time, removing the need for complicated adjustments.

How regulatory accounts are used in Scotland

Our regulatory accounts are designed to take into account the specific circumstances of the Scottish water industry. They serve the following main purposes, in line with our statutory duties:

- monitoring Scottish Water's progress,
- informing price controls,
- revealing potential anti-competitive behaviour, and
- facilitating competition.



Monitoring progress

We monitor annual progress against the assumptions underlying price controls and other regulatory decisions. These cover areas such as the amount of revenue received from customers, the level of borrowing, interest payments, taxation, financial ratios, operating expenditure, depreciation, spending on capital maintenance and other capital investment.

Informing price controls

Our ability to maximise value for money to customers depends largely on setting prices that are consistent with challenging but achievable expectations on financial performance. In setting prices, it is very useful to compare the performance achieved by the water and sewerage companies in England and Wales and by other regulated utilities with that of the Scottish water industry.

Our regulatory accounts are fully consistent with those used by Ofwat, the economic regulator of the water and sewerage companies south of the border. This allows us to make robust comparisons of Scottish Water's performance with these companies.

Revealing potential anti-competitive behaviour

Scottish Water performs both core (the provision of water and wastewater services) and non-core activities (such as the provision of insurance for plumbing). Our statutory remit extends only to regulating Scottish Water's core activities. It is in the interests of Scottish Water's 'core' customers that revenue collected from them is not used to subsidise non-core activities. Any such cross-subsidisation could make Scottish Water vulnerable to legal challenge under European Competition law.

In order to help guard against any cross-subsidisation, our regulatory accounts clearly separate the costs and revenues associated with each element of the business. Where any transactions take place between the two, they must be completed according to a transfer pricing framework that is set out in our regulatory accounting rules (see below). This enables us to identify any irregularities.



Facilitating competition

In Scotland, licensed suppliers are able to compete to supply water and sewerage services to non-household customers. Scottish Water acts as the wholesaler, selling wholesale services to licensed suppliers who 'retail' them on to non-household customers. This competitive framework was introduced by the Water Services etc. (Scotland) Act 2005. Prior to that date, Scottish Water had provided both wholesale and retail services to all customers in Scotland.

We regulate wholesale charges to ensure that Scottish Water recovers all of its costs. We use regulatory accounts to define retail and wholesale activities in detail and to capture the costs associated with wholesale activities. This helps give players in the competitive market confidence that wholesale charges are soundly based and cost reflective.

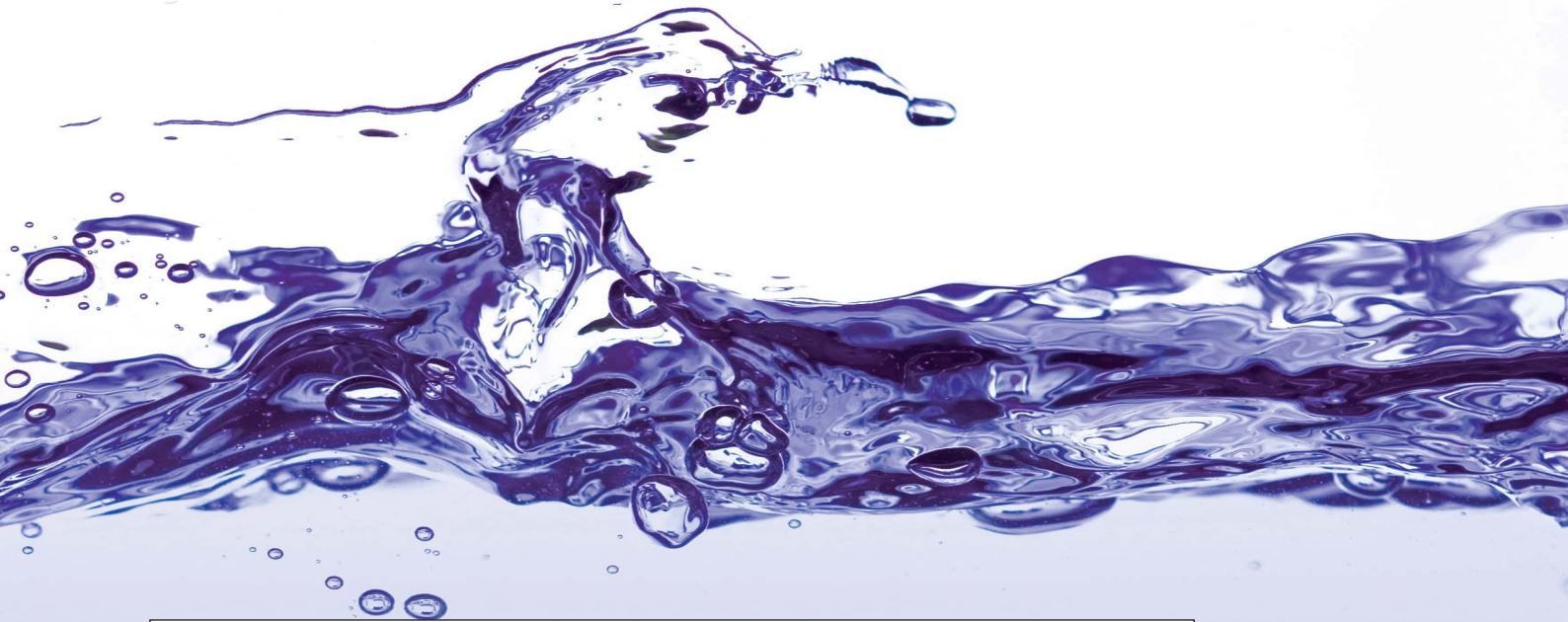
Regulatory accounting formats and rules

Each year Scottish Water provides us with an Annual Return submission. This includes 28 regulatory accounting tables (known as 'M' tables) that collect the following information.

- Historical cost income and expenditure accounts and balance sheets.
- Current cost income and expenditure accounts, balance sheets and cash flow.
- Reconciliation of historical cost balance sheet to the statutory accounts.
- Five-year rolling summaries on current cost income and expenditure accounts.
- Regulatory capital value.
- Current cost analysis of fixed assets by asset type.
- Activity based costing of the water and wastewater service.
- Analysis of revenue, interest, net debt and taxation.

The Annual Return submission also includes two 'N' tables. These tables summarise Scottish Water's transfer pricing – both capital expenditure and profit and loss.

To assist Scottish Water to complete these tables, we use five Regulatory Accounting Rules (RARs) and an introductory section. These RARs, which are broadly the same as Ofwat's regulatory accounting guidelines, are summarised in the table below.



	Title	Purpose
	Introduction to the RARs	Provides a brief overview of each RAR and a glossary of terms compiled from all five RARs.
RAR 1	Accounting for current costs and regulatory capital values	Sets out the requirements for current cost accounts, limitations on uses and various simplifications adopted for application in the Scottish water industry.
RAR 2	Classification of expenditure	Classifies expenditure by purpose category.
RAR 3	The contents of regulatory accounts	Covers the requirements for accounting information, and the rules by which regulatory accounts should be completed each financial year.
RAR 4	Analysis of operating costs and assets	Covers the form, content and principles of the analysis of operating costs, revenues and tangible fixed assets.
RAR 5	Transfer pricing	Provides guidance on the procedures and methodologies to be followed when completing transactions between the core and non-core activities and associate entities.

Audit and submission of regulatory accounts

Scottish Water submits its regulatory accounts in June each year. These accounts require greater disaggregation of costs than the corresponding statutory accounts. Scottish Water has developed a rigorous 'activity-based costing' accounting system, which allows it to allocate costs directly to the activities it has identified as being important to its business. The definition of activities in our regulatory accounts is consistent with Scottish Water's own accounting system. This provides us with assurance that the information Scottish Water submits is sufficiently accurate to be used for regulation.



We are provided with further assurance about the regulatory accounts as, like statutory accounts, they are audited externally. However, unlike statutory accounts, the auditors do not form an opinion based on whether Scottish Water has complied with 'Generally Accepted Accounting Principles in the United Kingdom' (UK GAAP), but rather on its compliance with the RARs. Only where the RARs are silent on an accounting issue would UK GAAP apply.

The auditor considers all of the information that he or she deems necessary in order to determine that the regulatory accounts are free from material misstatement. However, they do not assess the overall adequacy of the presentation of the information in the accounts, as they would with statutory accounts. This is because the form and content of the accounts are determined by us as the regulator.

Scottish Water also provides a signed declaration alongside its regulatory accounts. This declaration states whether Scottish Water has sufficient financial resources for the next 12 months. It also declares whether or not transactions and activities with associated companies were completed on an 'arm's length' basis. This provides us with additional reassurance about the nature of Scottish Water's financial activities.

Further reading

Information note 10 explains the role of regulatory accounts in a wider context.

Copies of all of Scottish Water's regulatory accounting submissions and the RARs are available in the Publications section of our website.

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