A Guide to Understanding Water Company Accounts

Produced for the Consumer Council for Water by

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# Contents

<table>
<thead>
<tr>
<th>Section</th>
<th>Page</th>
</tr>
</thead>
<tbody>
<tr>
<td>Preface</td>
<td>3</td>
</tr>
<tr>
<td>Introduction</td>
<td>4</td>
</tr>
<tr>
<td><strong>Using the accounts</strong></td>
<td>6</td>
</tr>
<tr>
<td>- Annual accounts</td>
<td></td>
</tr>
<tr>
<td>- Current cost accounts</td>
<td></td>
</tr>
<tr>
<td>- Which accounts?</td>
<td></td>
</tr>
<tr>
<td><strong>Use of headline figures</strong></td>
<td>7</td>
</tr>
<tr>
<td>- Domestic consumer contribution</td>
<td></td>
</tr>
<tr>
<td>- Operating costs and operating profit</td>
<td></td>
</tr>
<tr>
<td>- Pre-tax profits</td>
<td></td>
</tr>
<tr>
<td>- Dividends</td>
<td></td>
</tr>
<tr>
<td>- Special dividends</td>
<td></td>
</tr>
<tr>
<td>- Borrowing</td>
<td></td>
</tr>
<tr>
<td>- Return on capital employed (ROCE)</td>
<td></td>
</tr>
<tr>
<td>- Cost of capital</td>
<td></td>
</tr>
<tr>
<td>- Cash flow statements</td>
<td></td>
</tr>
<tr>
<td><strong>Further analyses</strong></td>
<td>16</td>
</tr>
<tr>
<td>- Capital restructuring</td>
<td></td>
</tr>
<tr>
<td>- Capital charges</td>
<td></td>
</tr>
<tr>
<td>- Transfer pricing</td>
<td></td>
</tr>
<tr>
<td>- Investment in fixed assets</td>
<td></td>
</tr>
<tr>
<td><strong>Parent companies</strong></td>
<td>23</td>
</tr>
<tr>
<td>- Financial relationships</td>
<td></td>
</tr>
<tr>
<td>- The broader context</td>
<td></td>
</tr>
<tr>
<td><strong>Collated questions</strong></td>
<td>26</td>
</tr>
<tr>
<td><strong>References and further reading</strong></td>
<td>28</td>
</tr>
</tbody>
</table>
Preface

1. This short guide is intended to help CCWater to take an independent and informed view of corporate financial behaviour and of price regulation in the water and sewerage sector. Analysis of the companies’ finances and financial strategies is essential in order to identify whether there is equity of treatment between the interests of consumers, water companies and the shareholders of their parent companies.

2. The guide is also aimed at assisting CCWater in the development of a common framework for carrying out financial analyses of the individual companies and of the sector as a whole. This should aid CCWater in responding to and making inputs into the next price control review at regional and national levels.

3. The purpose of taking an independent view of the companies’ finances is not to replicate the work of the regulator, not least because the regulatory role is different from that of consumer representatives. The objective is to develop an understanding and means of analysing the companies’ finances and financial behaviour and the adequacy of price regulation in meeting consumers’ interests and needs. This work should not only assist the drawing up of conclusions about whether consumers are receiving a fair deal but also enable CCWater to pose key questions to one or more companies and, where appropriate, to the regulator. Tracking and analysis of figures from the financial accounts should form a cornerstone of CCWater’s general work in representing consumers’ interests, alongside other information from Ofwat, consumers, the companies and other sources such as press commentary.

4. In this guide, examples generally appear in text boxes to illustrate specific points. Questions are suggested at various stages in the text that could be put to the companies and/or Ofwat: these are signposted by the letter Q. In addition the questions have been collated together at the end of the guide.
Introduction

5. An annual analysis of the regulatory accounts of each company from a consumer standpoint is worthwhile, not only to check each company’s financial performance and behaviour and thereby lay the basis for questions or conclusions about any particular year, but also to build up a longer-term analysis. This is essential to build up an evidence base which can be used to determine whether companies and the regulator are treating consumers fairly.

6. For example, comment in September 2006 about Ofwat’s report, Financial performance and expenditure of the water companies in England and Wales 2005-06 - including that by CC Water - focused on the fact that in 2005/06 the companies invested in £3.4 billion instead of the £4.3 billion assumed by Ofwat when setting the price limits for 2005-2010.

7. In this report Ofwat commented that it was concerned about the sector’s tendency to raise investment levels towards the end of each 5 year periodic review, and then invest less in the first years of the next review period. The regulator pointed out that such behaviour was not necessarily the most cost-efficient way of running a necessary and major investment programme; for instance the numerous contractors employed by the water companies might be likely to accept lower contract prices if investment programmes were longer-term and more predictable.

Q1 This illustrates neatly the importance of tracking the companies’ financial behaviour. Put at its simplest consumers, who provide the appointed companies with most of their income, were paying them more, while the companies were spending nearly £1 billion less on investment than was assumed in the price limits:

- is this good value for us?
- what are companies doing with this ‘excess’ income, and will their actions benefit us in the end?
- are consumers getting a ‘fair deal’?
- are we getting a ‘fair share’ – for instance in comparison to shareholders?
- is the company spending enough of ‘our’ money on, for example, water quality measures, on plugging leaks, and on customer service in general?

What this guide does

8. This guide identifies and explains a number of key financial elements through which it is possible to gain an understanding of the financial state and behaviour of each company and of the sector as a whole. Such an analysis is essential in judging whether consumers are being treated fairly by the companies; whether the companies’ behaviour is justifiable within the regulatory framework; and, ultimately, in determining the fairness of price
regulation. This work also serves to highlight the implications of financial and corporate decisions for consumers in the short or long term.

9. Tracking companies’ performance in this way should assist CCWater to comment on the actions of individual companies in relation to the assumptions made in setting price limits. For instance, if the regulatory accounts over the period 2005-2009 show that a company has spent far less on infrastructure renewals than allowed in the 5-year period, this should trigger serious questions about its behaviour and the justification for consumer charges.

10. This guide should also help provide a body of evidence to back up CCWater’s input into the 2009 price review. Critically this is about developing consumer perspectives regarding whether price controls have been sufficiently rigorous to ensure that water, environmental and other key outcomes have been delivered at a reasonable cost to consumers.

11. Clearly the companies do employ bargaining tactics, particularly when approaching each price control review. By building up key financial (and other) data based on a common analytical framework, CCWater should be able to judge and comment on assertions or arguments put forward by the companies and make the consumer case to Ofwat.

12. The regulated companies are part of corporate entities and it is those parent companies which are ultimately responsible for issuing shares, paying dividends to shareholders etc. How financial markets view the performance of the parent companies or groups obviously has a significant impact, amongst other things, on the cost of borrowing and the cost of equity. In many instances, attention has also has to be paid to the financial inter-actions between the regulated companies and their parent companies and also to the financial status and strategies of the PLCs. As discussed later in the guide, this is not necessarily always a straightforward matter as the sector is now characterised by important corporate activities, including takeovers, and some of the appointed companies are now owned by multi-company groups.

13. A caveat needs to be added with regard to Welsh Water, as this company’s structure differs fundamentally from the other companies in that it is owned by Glas Cymru - a single purpose company with no shareholders and which is run solely for the benefit of consumers.

14. The guide commences by noting the need to focus on current cost accounts of the companies and the three main financial statements in these accounts (Using the accounts). The next section presents some of the most useful ‘headline’ financial figures to be found in those statements, explains their relevance, and sets out how to identify them (Use of headline figures). This is followed by a presentation and explanation of other key financial factors which are particularly significant for this sector (Further analyses). The following section addresses the role and importance to the companies of the parent companies’ corporate strategies and behaviour (Parent companies). References and further reading are summarised in the next
section. Finally suggestions for questions for the companies and/or Ofwat are collated together at the end of the guide.

**Using the accounts**

**Annual accounts**

15. Annual reports and accounts of both the appointed companies and the parent companies are independently audited, whereas half-year or interim statements are not (usually of the parent companies), and obviously cover a very short period in a sector that requires longer term perspectives. As a result, it is usually best practice to focus on the annual audited accounts.

**Current cost accounts**

16. As the regulatory framework for setting price limits is now firmly rooted in an examination of the appointed companies’ performance in current cost accounting terms, it is logical for CCWater to use the current cost accounts (CCA) of the companies. Essentially CCA tries to compensate for the effects of inflation.

17. As Ofwat has stated: “*Historical cost accounts (‘HCA’) are recognised universally as a legitimate method of financial reporting but have a variety of limitations, in particular in regard to the return on capital earned in capital intensive industries with long asset lives such as the water industry. In the presence of inflation these limitations typically lead to:*  
   - *understated asset values;*  
   - *overstated profit measures; and consequently*  
   - *overstated returns on capital and distorted measures of total costs which persist even if inflation falls to zero.*” *(Guideline for Accounting for Current Costs and Regulatory Capital Values, Regulatory Accounting Guideline 1.03).*

18. How the companies present their CCA statements is, in large part, determined by the regulatory accounting guidelines (RAGs). While there may be questions about the consequent adjustments and reconciliations between HCA and CCA, this Guide focuses on the regulatory CCA accounts as utilised in the regulatory regime.

**Which accounts?**

19. When analysing the regulatory accounts of the appointed companies, the three key current cost account (CCA) tables or statements to analyse are:

- **Profit and loss account** (sometimes called ‘Income statement’): shows the income during the year (turnover); the operating costs; interest payments and other financial adjustments; pre-tax profits; taxation; dividend payments; and retained profit or loss.

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1 At the time of writing, Ofwat was reviewing regulatory accounting guidelines 1, 3 and 4.
- **Balance sheet**: shows the value of the fixed assets in the company; debtors and creditors at the year-end (including pension liabilities); and the value of share capital and any reserves.
- **Cash flow statement** (sometimes called `Source and application of funds`): as its name implies, it shows the sources of income and application of expenditures during the year. It includes the cash flow from operating activities - primarily operating profits and depreciation charges; returns from any investments; interests received and interest paid; capital expenditure; acquisitions and disposals of any other companies or non-core activities; dividend payments; movements of short-term assets; and other financing such as new bank loans or repayment of existing loans.

20. There are numbered notes to each of these three, which explain in more detail how the figures were arrived at. Also, it is useful to read the Directors' reports at the beginning of each set of accounts - of both the regulated company and the parent company - because these can help to clarify the nature of significant financial and other corporate events during the year.

**Use of ‘headline’ figures**

**Domestic consumer contribution**

21. From the consumer standpoint a useful starting point is to work out ‘our’ contribution to the revenues obtained by each company by **multiplying customer numbers by the average household bill and comparing this with total revenues received by the company (turnover)**. Ofwat publishes both customer numbers and the average household bill every year for each company (see Ofwat's *Tariff structure and charges 2005-06 report*).

For example, in 2005-06 Thames Water had 3,241,000 household consumers receiving water services, and 5,010,000 receiving sewerage services. The average annual bill for the former group of consumers was £150, and £102 for the latter.

The company obtained £486 million in revenue from household water charges: 3,241,000 x £150, and £511 million from household sewerage charges: 5,010,000 x £102

= £997 million in all.

Its turnover was £1,351 million in 2005/06. Taking £997 million as a percentage of its turnover for that year (£1,351 million) shows that revenues from domestic households provided 74% of the company’s total revenues for that year (see its profit and loss account, and Note 2 to the account).

22. This basic analysis reveals the importance to the appointed company of its domestic consumers, and equally of the price controls set by Ofwat. It is
easy to track from year to year (and over time) the amount contributed to the company’s total revenues (‘turnover’).

**Operating costs and operating profit**

23. Operating profits and operating profit rates (operating profits divided by turnover) are generally seen by the regulator as among the many indicators to be considered. These figures are of particular significance for consumer bodies – for example a steady or dramatic rise in operating profits could indicate that a company is underspending on aspects of its core company, which could have adverse effects for such matters as quality of service.

24. In addition, examination of this aspect of the profit and loss account is useful because sometimes companies can apportion what are essentially ‘one-off’ costs as operating costs (such as a round of redundancies) – if this occurs, questions should be raised: such one-off costs should usually appear in the accounts as `exceptional items’.

25. To arrive at the operating profit the company made from its water/water-and-sewerage operations – which can be understood to constitute its fundamental rate of profit from everyday core operations – its operating costs obviously need to be deducted. Recently, the regulator has secured agreement from many of the companies to include more capital investment, especially that involved in infrastructure renewal programmes, in their operating costs; consequently from 2005/06 onwards some companies will be showing higher operating costs than previously. Examination of operating costs – detailed in notes to the profit and loss account - can also help to reveal how much, year by year, a company is spending on labour costs, infrastructure renewals, etc.

26. This element of the accounts is particularly important because Ofwat includes assumptions about the companies’ efficiency when setting price limits, both relating to everyday costs (such as employment or energy), and expenditures in the process of maintaining and improving infrastructural systems. As explained below, it is not possible to use figures for operating expenditure (Opex) in isolation to assess efficiency. However, it is worth checking operating costs in total and in detail over time to identify and possibly question any significant or sudden increases or reductions.

27. In the final price determinations for 2005-10, Ofwat assumed the scope for efficiency improvements is around 2.4% per year for operating expenditure and 3.6% per year for capital maintenance, and has assumed about half of this in price limits. The efficiency improvements assumed for each company are set out in Ofwat’s final determinations. These also give the expected five-year total capital and operating expenditures for each company including base service: infrastructure renewals expenditure and non-infrastructure capital maintenance.
28. However, because Ofwat’s assessment of efficiencies (operating and capital) are based on econometric modelling and information about the age etc of assets, it is not possible simply to examine and utilise the notes to the operating costs to determine whether a company is meeting the assumptions in price limits.

29. The operating profit or income figure may also be affected (usually by a small amount) by the inclusion of ‘operating income’ – which in the case of appointed company is likely to consist of the disposal of fixed assets (eg amounting to £9 million in the Thames Water example above).

Pre-tax profits

30. Pre-tax profits (often termed in the regulatory accounts ‘current cost profits before taxation’) are declared after operating profits are adjusted for interest on borrowings payable, and other (usually fairly minor) financial adjustments. In an industry where financing through loans is such an important feature of the companies this figure draws a lot of attention – as it does for the Group or Parent company.

31. The pre-tax profit rate is calculated by taking the pre-tax profits divided by turnover. Similarly an operating profit rate is the operating profit figure divided by turnover.

For example, in Thames Water 2005/06 regulatory accounts, the pre-tax profit rate was nearly 25%: by dividing the pre-tax profit of almost £333 million by the turnover figure of £1,351 million.

This may appear to be high, when compared to profit rates in other sectors. It is often argued that in such a capital and investment-intensive industry a significant rate of return is necessary in order to ensure that the companies can finance their short and long term investments in infrastructure, new supplies, etc.

32. However, from the consumer standpoint it may be worth pointing out that such high rates of profit might be considered by other companies – which are not regulated (‘protected’ from liquidation, it could be argued), and are operating in a competitive environment – as unusual, given that consumers are essentially captive.

33. Obviously the companies can use their profits in a number of ways. Ofwat’s focus is on setting price limits and on trying to ensure that these are at an appropriate level for the companies to meet their obligations as efficiently as possible. As Ofwat states, “For companies to finance their functions, profits need to be sufficient to remunerate investors and lenders, and to attract additional funds to finance capital programmes.” (Financial performance and expenditure of the water companies in England and Wales, 2005-06, Ofwat).
34. In some parent companies, the water company is the most important, or single biggest, aspect of their operations and profitability and profit rates of the appointed companies are of very obvious and direct concern to investors and potential investors. In other parent companies, the water company is only one of a number of company activities and, while in practice the water company are usually a key part of these companies’ operations, investors will not only be examining the returns from the water company.

35. Although Ofwat does not directly regulate profits, it does point out that “…companies must expect to justify any increases in price (in real terms) and, consequently, the level of profits and dividends achieved.” (Financial performance and expenditure of the water companies in England and Wales, 2005-06, Ofwat)

36. From the consumer standpoint, if a company reports consistently low profits and low dividends, this will tend to make the company less attractive to investors and consequently the ability of the parent company to raise funds on the equity market is likely to be reduced. This could mean that it has to seek more funds through borrowings – in this situation, the cost of those borrowings could be higher than they would otherwise be, and increase the company’s cost of capital. Conversely, if consistently low profits are reported alongside high dividend payments, questions need to be asked about how the dividends are being financed and whether such transfers are to the detriment of the regulated company.

Q2 Where profits and dividends are consistently low, questions need to be asked about the implications for the company’s ability to raise funds. If profits are low but dividend payments are high, the company should be questioned about how the dividend levels are being financed and any implications for the water company and its consumers.

Q3 Where profits are high, the obvious question is whether they are higher than is necessary to finance the efficient operations of the company, and this could indicate that consumer charges are unnecessarily high. Where there are high profits and high dividend payments, the companies should be asked to justify the transfer of so much out of the appointed company. For example, if the parent company’s other company activities are showing losses or very poor profit rates, questions could be asked about whether the water company is effectively shoring up poor financial performance elsewhere in the group.

Dividends

37. The next ‘headline’ figure worth examining – to be found in both the appointed company’s accounts and in its parent company’s accounts, again in the profit and loss account – is the amount paid in dividends (£270 million in 2005/06 in the case of Thames Water, compared to £42 million in the previous year). Occasionally the amount paid in dividends may be placed in the cash flow statement. Dividends paid by appointed companies usually
contribute to the parent companies or groups – ie the corporate entities which have shareholders.

38. It should be noted that an accounting change has affected the way that dividend figures were reported in 2005/06. The dividends declared in 2005/06 were reported on a different basis to previous years due to a new UK accounting standard, which required that any dividend declared post-year end should not be recognised in the accounts for that year, even if it related to that year’s performance. According to Ofwat, total dividends across the industry were 8% higher in 2005/06 than in the previous year, and this increase was largely due to this change in accounting standards.

39. In a way it is impossible to say what the ‘appropriate’ levels of dividends are for each company. Much can depend on the position of the parent company, for instance it may need to boost shareholder confidence in a face of poorer-than-expected financial performance, in which case it is reasonable to question whether the regulated company is contributing its ‘fair share’. More broadly, while some dividend transfers are to be expected, higher-than-average or rising dividend payments should be questioned, for they represent the removal from the water company of resources, which, it could be argued, would be better spent elsewhere.

40. In addition, high levels of dividends transfers out of the companies could have the effect of raising the cost of borrowing (lenders and potential lenders are likely to take such corporate behaviour into account in lending decisions and in setting terms for loans). If interest rates and charges on loans are increased, then the cost of capital to the company will also increase and more of the profits will go to meet interest charges.

Special dividends

41. Another feature of dividend transfers is the phenomenon of ‘special dividends’. For example, in 2005/06, Yorkshire Water increased its dividend payout by £161 million by means of declaring a ‘special dividend’, described as relating to ‘efficiency savings’. In such cases it clearly raises questions as to whether this was really due to efficiency outperformance or whether the price control was insufficiently rigorous. In the former situation the company could be questioned about why its consumers did not receive a financial benefit as well. In the latter situation, Ofwat could be pressed to re-examine its price cap for that particular company. (Also see paragraphs 72-75.)

42. Ofwat has recently announced that it is planning to amend the companies’ licences to include a ‘cash lock-up’: to prevent the regulated company making dividend or other external payments if the company’s credit rating fell close to or below investment level (Utility Week, 15 September 2006). According to Ofwat, the aim is to ensure that the additional risk of high gearing is borne by investors, not consumers. Ofwat has confirmed this, stating that: ‘The principle of the cash lock up is to maintain the appointees’ liquidity ie access to capital (in order to deliver its capital investment programme) when its investment grade rating is threatened. This is achieved
by restricted cash payments such as equity dividends from the appointee to other companies within the group. We are currently working with Thames Water on developing the text of the cash lock up provision and will roll it out to other companies as opportunities arise. A similar provision already exists in the energy licences and we are developing our licence condition based on this.’ (e-mail correspondence, 16 October 2006).

Borrowing

43. Borrowing is clearly a crucial means by which investment is financed in this sector. Debt attributable to borrowing can be found in the notes to the cash flow statement.

44. The usual way of measuring the level of borrowings is through examining the ‘gearing ratio’: net debt expressed as a percentage of its total capital. Ofwat calculates the gearing level by taking net debt as a percentage of the regulatory capital value of the company:

45. Regulatory capital value (RCV): this is used to measure the company’s capital base when setting price limits. In simple terms, the RCV represents the initial market value, including debt at privatisation, plus subsequent net new capital expenditure including new obligations imposed since 1989 less disposed assets. Ofwat has a detailed methodology for calculating the RCV. The companies’ figures for their RCV are set out in the notes to the regulatory accounts.

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<td>Closing RCV (March 2006) £5,891 million</td>
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<td>Closing net debt (£2,613 million)</td>
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<td>Gearing ratio = 44.4% (by dividing net debt by RCV)</td>
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46. Net debt: This covers items such as cash in hand and at the bank; overdrafts; loans due within one year and after one year; finance leases; and current asset investment. The way in which net debt should be calculated is set out in Ofwat’s Regulatory Accounting Guidelines (see References and Further Reading).

The importance of gearing

47. Borrowing - or debt – has been, and continues to be, a cheaper source of finance than equity for the companies.

Q4 If a company’s gearing ratio appears to be low in comparison with the other appointed companies or the water industry average, questions could be raised as to whether the company has sufficient funds to finance necessary
investment, or whether it is relying too much on revenues from present-day consumers as sources of finance instead of increasing its borrowing.

**Q5** If a company's gearing ratio is relatively high, it may be appropriate to question the company's financial strategy. This could mean that a company tries to minimise other important expenditures in order to meet high interest payments – this could have adverse repercussions for a variety of quality of service outcomes. In extreme circumstances, too high a gearing level might hamper a company's ability to raise funds, for example, to deal with short-term unexpected demands for expenditure.

48. In the determinations of price limits for the current period 2005/10, Ofwat decided that a range of 55% to 65% would be sustainable. Between 2001/02 and 2005/06, average gearing in the industry rose to 58.5%. But this average masks a wide range of variation between individual companies. (See *Future water and sewerage charges 2005-10, Final determinations*, Ofwat, 2004)

**Interest charges**

49. Year-on-year interest charges on borrowings are shown in the profit and loss account. It is worth also looking at the detail of how the interest charge is broken down in the relevant note to the financial statements.

For instance, in South West Water's 2005/06 accounts, details of the net interest payable is in note 5, where for example the single largest interest payment was made to the parent company.

If there is a significant change, it is worth checking with the accounts of the parent company as well to try to understand more about the terms of the loan to the appointed company.

**Size of loans**

50. Some companies, for example Southern Water, shows the amount by which borrowing increased during the year, in the Current Cost Cash Flow Statement (see below). Whereas others, such as South West Water, detail the increases or decreases in debt in notes to the accounts (note 29 in the company's 2005/06 accounts). However, for more detailed and comprehensive information about borrowing, there is a note to the financial statements referring to 'Loans and other borrowings' for all the companies.

**Return on capital employed (ROCE)**

51. The ROCE is often regarded as the single most important measure of a company's profitability. What constitutes a reasonable ROCE is a matter of lively debate.
52. Ofwat’s calculation of a company’s return on capital employed is based on the current cost operating profit divided by the average RCV.

<table>
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<th>For example: Thames Water 2005/06</th>
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<td>Operating profits = £386 million (from its regulatory accounts) divided by RCV of £5,695 million (See Financial performance and expenditure of the water companies in England and Wales, 2005-06, Ofwat)</td>
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<td>Return on capital = 6.8%</td>
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53. The average ROCE for the water and sewerage companies was 6.5% for 2005/06; and it was 8.4% for the water-only companies, giving an industry average of 6.6% for the year (based on 2005/06 prices). The lowest ROCE for the WASCs in 2005/06 was 4.8% and the highest 7.5%; for the water-only companies the lowest was 5.9% and the highest, 11.2%. For example, the ROCE for Thames was 6.8% in 2005/06. (See Financial performance and expenditure of the water companies in England and Wales, 2005-06, Ofwat)

54. Whilst looking at each year’s ROCE, it is also important to examine whether there are any substantial changes over time, for instance, if a company’s ROCE shows a sustained decline over a period of years. It could mean that a company attempts to slash its costs, with potentially adverse effects on its services or quality of service. On the other hand, if a company is showing high and steadily rising ROCEs – especially above the industry average – it would be reasonable to question whether consumers are paying more than they need.

**Q6** If a company’s ROCE is low - declining – it might signal the need to check quality of service. If the ROCE is relatively high and rising, questions should be raised about whether consumers are paying too much.

55. The regulatory regime is meant to help ensure that the water companies are run as efficient companies that are able to finance their functions. As Ofwat has stated, a company which is efficiently managed and financed should be able to earn a return at least equal to the cost of capital (Future water and sewerage charges 2005-10, Final determinations, Ofwat, 2004). So, over the 5 year period of the current price control period, the companies’ ROCEs should be at or around Ofwat’s assumed cost of capital of 5.1% (post-tax in real terms) plus a small premium for the water-only companies (ranging from 0.3% to 0.9%).

56. Alongside this expectation, Ofwat states that a company’s “...revenues, profits and cashflows should allow it to raise finance on reasonable terms in the capital markets.” Ofwat describes this as financeability. (See Future water and sewerage charges 2005-10, Final determinations, Ofwat, 2004)
Clearly CCWater will need to track this aspect of the companies’ financial returns.

Q7 For instance, if for two or more years, a company’s ROCE diverges significantly from Ofwat’s assumptions, further investigations will be needed.

Cost of capital

In setting the price limits every five years, the regulator decides on an appropriate figure for the cost of capital of the companies. Essentially this is a measure of how much it costs to obtain funds for the company. As Ofwat stated in the final determinations of price limits for 2005-10: “The cost of capital is the minimum return investors will accept for investing in a particular company, taking account of its risk, both absolute and relative to other potential investments.”

The cost of capital is a key factor in setting the price limits and is consequently a much more significant financial element for these regulated companies than it is for non-regulated companies in other sectors. Fixing on the appropriate figure for the cost of capital is of critical importance for consumers because if it is set too high, consumers pay more than they need to. Conversely if it is set too low, there is a possibility that the companies will say they have insufficient funds to carry out important investment programmes.

The process by which the cost of capital is determined by Ofwat cannot be captured through an examination of the regulatory accounts. This is because the decision is arrived at by using econometric modelling techniques and financial market assumptions/expectations.

In the current price limit period 2005-10, Ofwat has decided that most companies have an expected weighted average cost of capital of 5.1% (post-tax in real terms), plus a small premium for the water-only companies (ranging from 0.3% to 0.9%). This is the assumed percentage cost to the companies of ensuring that they can attract and maintain sufficient funds from investors and lenders. (Ofwat defines the weighted average cost of capital as the average of a company’s cost of debt and cost of equity capital, weighted according to the balance of debt and equity that finances the company’s assets.) By sufficient funds, the regulator is trying to ensure that the companies are financially viable and that they can carry out investment to fulfil a wide range of programmes, including environmental and water quality improvements and leakage reductions etc. This is in accordance with Ofwat’s duty to secure that the companies are able to finance the proper carrying out of their functions as licenced undertakers.

One of the key characteristics of this sector is that it has significant year-on-year and longer term requirements to repair, renew, and develop its asset base: capital expenditure is an essential obligation of the companies. As a result, they are required to find the optimal ways of obtaining the finance
to do so, including loans, money from equity markets, and revenues from the company (mainly from consumers).

**Cash flow statements**

63. This statement (often termed source and application of funds) shows where a company has obtained its money during the last financial year, and how it has spent it. It provides information that is usually additional to that shown in the profit and loss account and balance sheet:

64. **Net cash flow from operating activities**: this is not simply how much surplus the company has made. It is calculated by taking the current cost operating profit but with a range of adjustments for various items, of which depreciation of assets is often the most important.

65. If there are any significant changes year-on-year, it is often worth looking at the notes to the cash flow statement.

| For example, United Utilities’ Regulatory Accounts for 2005/06 show that, although cash flow from profits increased over the previous year, this was more than offset by a large increase in the amount owed to debtors. |

66. **Capital expenditure**: usually the largest aspect is the cost of purchased fixed assets. For instance, this will cover investments aimed at improving water quality, upgrading water treatment works, environmental improvements etc.

**Infrastructure renewals charge**

67. This is a charge made in the accounts in order to more accurately reflect the fact that, at least some of the renewal of underground assets, is regarded as part of the everyday operating costs of running the company.

68. It provides for a charge to be made each year against profits. In the price limits, Ofwat has assumed that the infrastructure renewals charge and expenditure should balance out over the 15-year period 2000-2015 (see paragraph 86).

**Further analyses**

69. From the consumer standpoint there may well be further relevant points to draw from the accounts. This will not necessarily be the same for all water companies for every year. For example, if a company has received a major loan from its parent company or group – or has loaned the parent company significant amounts - it might be worth checking the financial rationale to ensure that the arrangement is not to the detriment of the appointed company. If the notes on loans and borrowings do not provide
sufficient detail on the terms on which these arrangements have been made, it may be useful to pursue this further with the company or parent company.

**Capital restructuring**

70. A number of companies in this sector have, and are likely to continue to, engage in capital restructuring: that is altering the balance and terms of key sources of finance, namely borrowings of all kinds, equity capital and bonds. This can be done for a variety of reasons, many of which could be related to improve the financial performance or stability of the company’s parent company. In other situations, restructuring will be undertaken to reduce the cost of capital, change the gearing level, etc of the appointed company - or a mixture of the two.

71. Although it may appear on the surface that capital restructuring is aimed at benefiting the parent company or its shareholders to the detriment of the water company and its consumers, for instance, through the payment of special dividends, this may not necessarily be the case. Before commenting on the possible impacts on consumers - in these often complex programmes, it is usually necessary to establish the companies’ rationale and the possible implications for consumers.

**Special purpose vehicle companies**

72. A number of companies have arranged extra loan finance via inter-group loans which are often associated with bonds or other financial instruments. From the consumer standpoint, the crucial issue is whether the companies’ gearing level might give cause for concern as a result. Some companies have increased debt through the use of so-called special purpose vehicle companies (SPV) created for this purpose by parent companies. The borrowings for the appointed water company are held by the SPVs, which then pass the money to the water company. Subsequently the water company pays the SPV ‘dividends’ equal to the interest payments on the loans which are paid by the SPV.

73. When questioned about this Ofwat replied that: ‘A number of companies have chosen to replace equity with more debt at the appointed company ie “geared up”. The rationale put forward by the companies is that this results in a lower overall cost of finance for the company. Therefore the appointed company issues new debt, often in the form of bond. For some companies the mechanism for getting the cash proceeds from the new debt issuance out of the appointed company has been via an intercompany loan from appointee a holding company SPV. The appointee then pays a dividend to the SPV to enable it in turn to pay the interest on this loan back to the appointee. These two payments essentially cancel each other out. This approach avoids depleting distributable reserves of the appointee that results if it paid a special dividend.

For other companies (for whom using distributable reserves is less of a constraint) the mechanism for getting the cash proceeds from the new debt
issuance out of the appointed company has been via a special dividend. It is important to note that whatever a company’s chosen level of gearing, or the mechanism by which it was achieved, there is no impact on consumers’ bills. We set price limits assuming a generic level of gearing for all companies.’ (e-mail from Ofwat 16 October 2006)

74. It is understood that companies are more likely to use SPVs if, because of high gearing and possibly other financial factors, the water company’s credit rating might be damaged if further borrowings are undertaken (formally the SPV ‘holds’ the loan on behalf of the appointed water company).

75. The above example is just one of several ways in which the appointed companies and their parent companies can restructure their financing. The regulatory accounts will not necessarily capture the significance and complexity of financial restructuring programmes. It should be possible to spot changes in borrowing levels or sources, or unusual changes in dividends. However, in order to obtain a fuller picture of what is going on, it is also necessary to examine the parent company’s/group financial report and accounts.

Q8 The mechanisms and rationale for financial restructuring can be complex but if a water company issues special dividends or engages in other measures that will affect its gearing level, credit rating, and ultimately its cost of capital, questions should be raised about the financial implications, especially whether consumers receive a fair share of any subsequent cost savings.

Share capital

76. Another important way of restructuring is for companies to increase share capital: this may take the form of issues of new shares in general or to existing shareholders through rights issues. At the time of writing, only United Utilities has so far raised money on the equity market since privatisation for investment in the appointed company.

77. It is the parent company – United Utilities plc – which has raised the equity from the rights issue (that is, from their shareholders). The money is then allocated by the parent company to whatever subsidiaries it owns: in the case of United Utilities, it owns regulated water and electricity companies.

78. Equity financing may be more expensive than servicing loan debt. It depends very much on the terms on which rights, or other equity issues, are made, and on the cost of borrowing. It also may depend on whether a company is already very highly geared: the projected interest on new loans may be higher than the cost of servicing equity (that is, the amount of dividends expected by shareholders each year and dividend value).
Share buy back

79. Parent companies buy back shares for a number of reasons. They may do so in order to reduce their cost of capital by reducing future dividend costs. They can reduce the number of shares in order to help boost their earnings per share figures. Share buy backs can help boost a flagging share price, ie fewer shares might be accompanied by promises to increase dividend payments per share. Buy backs can also shift financing away from equity financing. A company which did this would obviously raise the level of its indebtedness, but in itself this may not be a problem (eg if the consequent increase in the level of gearing is not problematic). However, share buy backs clearly raise questions about whether consumers have been treated fairly in comparison with a parent company’s shareholders.

For example, AWG Plc (current owner of Anglian Water) announced a £75 million share buy back programme in 2005/06. Pennon Group Plc (current owner of South West Water) returned £200 million to shareholders, which included around £55 million through a share buy back programme. As reported at the time: “Pennon justified the payments to shareholders as a one-off gain resulting from a decision to reduce its financing costs through taking on more debt and retiring some of its equity. As part of the move, South West Water, which provides regulated water and sewerage services to 1.6m people in Devon and Cornwall, is giving customers a one-off £20 per household payment. But the south west branch of the consumer council for water was sceptical about how much customers were benefiting.” (Guardian, 9/12/05)

Q9 If a parent company engages in share buybacks in order to pass on some or all of cost savings to investors, the company should be questioned about any policies which appear not to give consumers a fair share of such savings.

80. There can be many reasons why companies engage in financial restructuring, and these may have little to do with the financial state of the appointed companies but instead relate to the parent company’s position or perceived needs. Ofwat is likely to take an interest and view on such programmes only if the regulator judges that such activities could have detrimental effects on the financeability of the water company. However, it is up to CCWater to decide whether or not to accept Ofwat’s judgement in these cases, or to endeavour to examine further the reasons and any possible consequences for consumers.

Capital charges

81. A substantial part of the companies’ operating costs consists of capital charges and therefore these charges have a significant impact on the profit and loss account, namely by affecting the profits. Also the charges have a direct impact on consumers’ bills.
82. These charges comprise depreciation charges and infrastructure renewal charges:

Depreciation charges

83. Ofwat states that capital expenditure on above ground assets is recovered through consumers’ bills over the life of the asset through depreciation charges, rather than immediately the investment is incurred. The amounts charged for depreciation are usually found in notes to the accounts relating to operating costs. In an industry where there is so much capital investment, depreciation charges are significant.

For example, the current cost depreciation charge for South West Water in 2005/06 was nearly £82 million, about a third of its operating costs.

84. The charges cover existing and new assets. Obviously any sudden increase or decrease in depreciation charges year-on-year should be questioned because it can affect a year’s profit figures. More generally if a company is charging less in its accounts for depreciation than allowed for in the price limits, it will be accruing higher profits, ultimately from consumers. Indeed, in Ofwat’s 2005/06 report on financial performance, it reports that eight of the companies have seen decreases in the annual current cost depreciation charge compared with the previous year, and it is reviewing this further to understand the reasons for the decrease.

Q10 Water companies should be asked for the reasons for any significant changes in depreciation charges year-on-year.

Infrastructure renewal charges

85. Basically infrastructure renewal accounting is a way of building into the price limits an annual provision for the cost of renewing infrastructure assets – mainly underground pipes. The charges are normally to be found in the cash flow statements of the appointed companies.

86. In the price limits Ofwat assumes that infrastructure charges are equal to the average level of infrastructure renewals expenditure over the 15 year period 2000-15. For the 2005-10 price control period, the companies’ business plans allowed for total infrastructure renewals charges of £3.1 billion. Ofwat decided to allow £2.8 billion in price limits, reflecting its view of infrastructure renewals expenditure up to 2015, an increase of over 37% compared with the last review (see Future water and sewerage charges 2005-10, Final determinations, Ofwat).

87. This is another area that is worth examining because consumers are paying these charges in their bills.
Q11 If a company is consistently spending less on infrastructure renewals than it is charging, questions should be asked about whether consumers are paying for renewals work that has not taken place as yet.

For example, in 2005/06 Thames Water in its cash flow statement reported that it had spent £61 million on infrastructure renewal but, in the note to the statement concerning net cash inflow, it stated that its infrastructure renewals charge for that year was nearly £94 million. Here it would be worth checking over a number of years to see if this discrepancy is a continuing process and, if so, it should raise questions about whether consumers are paying too much.

88. Ofwat’s financial performance report for 2005/06 says that companies’ IRCs (infrastructure renewals charges) should equal their medium to long term views of their IRE (infrastructure renewals expenditure).

Q12 Any accrual or prepayment (basically consumers paying in advance and maybe too much) would consequently need to be justified in relation to the companies’ medium-to long-term view.

Transfer pricing

89. The appointed companies are under a statutory duty to trade at arm’s length with their parent company and with associate companies in their group, and to ensure that there is no cross-subsidy with regard to such transactions. As Ofwat states, one of the main reasons for this is to ensure that price limits are set on the basis of actual costs of services to consumers and are not inflated by cross-subsidy (Financial performance and expenditure of the water companies in England and Wales, 2005-06, Ofwat). Clearly such practices can result in higher bills for consumers, and may also breach the Competition Act 1998.

90. Since 1 April 2005, Ofwat has powers to fine companies for breach of a licence condition, including Licence Condition F on transfer pricing. The Water Act 2003 gave Ofwat (and the Secretary of State and the National Assembly for Wales) powers to impose financial penalties of up to 10% of turnover on statutory undertakers and licensed water suppliers. From 1 April 2005, Ofwat’s Regulatory Accounting Guideline on Transfer Pricing in the Water Industry 5.04 (RAG 5) has applied to all transactions. It sets out the procedures and industry best practice for trading with associate companies. Ofwat is continuing to monitor the companies’ trading arrangements with their parent and associate companies.

91. The regulatory accounts now contain a statement of compliance with Licence Condition F which sets out services supplied to and from the parent companies and associated companies.
Investment in fixed assets

92. In setting the price limits, Ofwat makes assumptions about the capital expenditure for each of the companies over the 5-year period. The price limits for 2005-10 are based on assumed increased levels of investment by nearly all the companies to maintain their assets, and also include significant further investment related to water quality and environmental improvements. In order to allow the companies to maintain current services and to meet new obligations, Ofwat has assumed that the capital investment programme will amount to almost £17 billion over the current 5-year period: in comparison, the companies had sought £21 billion in their company plans.

93. Ofwat’s financial performance report for 2005-06 showed that actual gross expenditure on capital investment was 22% lower than assumed when the price limits were set. The companies assert that 90% of this shortfall was due to changes in the timings of projected schemes: “…delays, re-profiling, slippage in setting up AMP4 delivery teams, etc”. (Financial performance and expenditure of the water companies in England and Wales, 2005-06, Ofwat)

94. In the regulatory accounts, the cash flow statement provides a figure for gross cost of purchase of fixed assets. Ofwat’s final determinations for each company applies to the whole of the 5-year price control period, and therefore it would be unwise to take a gross capital expenditure figure for one year; instead this figure should be tracked year-on-year. Significant changes in this figure may or may not be reasonable: in some instances, there may be valid reasons why capital expenditure is delayed or brought forward. However, in other instances, companies can ‘back-end’ expenditure, delaying it to the latter part of the price control period.

Q13 If companies ‘back-end expenditure, it is legitimate to question whether the revenues received from consumers for capital expenditure programmes may have been used for purposes other than those intended.

95. It is worth noting that the companies may refer to the fact that gross capital expenditure is not easily reconciled with the value placed on capital assets (mainly fixed assets). This is because such values may be subject to adjustments under regulatory accounting rules. The adjustments are usually to be found in notes to the accounts, which identify the following – additions (investments in fixed assets during the year); disposals; and RPI adjustment. They also include an AMP adjustment: used to revalue the assets based on the ‘Modern Equivalent Asset’ value (MEA).

96. In 1999, Ofwat asked all the companies to revalue their asset base. According to Ofwat, 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. The net MEA value is the depreciated value taking into account the remaining service potential of an old asset compared with a new asset (June Return Reporting Requirements and Definitions Manual, Ofwat, 2006). Most companies reassessed their MEA values for the 2004 price
review, which was then included in the 2004/05 accounts (Financial performance and expenditure of the water companies in England and Wales, 2005-06, Ofwat).

Parent companies

97. Although water and water and sewerage companies are meant to stand alone as appointed companies, operating under a regulatory regime, it is nevertheless necessary to consider their position within parent companies or groups, some of which operate many companies and may be based outside the UK. This is clearly a changing landscape, with takeovers, attempted takeovers, mergers and de-mergers.

98. The fact that the sector is subject to such interest by other companies and financial institutions highlights the attraction of the companies - one of the least risky industry sectors in the country. The water companies are major generators of revenues, profits, and other financial value with a largely captive customer base. The fact that they operate within a legal and regulatory framework, requiring them to meet water quality and environmental standards and to invest heavily, has clearly not diminished their attractiveness to many companies and to financial markets in general.

99. One of the main driving factors, as industry commentators have stated, is that potential buyers are looking towards loading the companies with cheap debt and reaping the difference between cheap money and allowed regulatory returns (see for instance, Guardian 11 October 2006). Consequently some consortia and groups regard the companies as short to medium term high yield investment opportunities: this reinforces the importance of examining what is happening to the companies’ finances and the implications for consumers.

Financial relationships

100. It is possible to see the importance of the appointed company to the parent company in a variety of ways. The simplest way is to examine revenues - see the notes to the parent company’s profit and loss account, often called ‘segmental information analysis’.

For instance, for Northumbrian Water Group plc, revenues provided by the appointed company accounted for over 91% of the parent company’s total revenues in 2005/06.

101. Similarly the notes to the profit and loss account will also reveal the contribution made by the appointed companies to the profits declared by the parent companies.

For example, South West Water contributed 80% of the operating profits posted by the Pennon Group plc in 2005/06, and also just under 80% of pre-tax profits in that year.
102. Dividend payments from the appointed companies are transferred to the parent companies but how these payments are utilised or apportioned is up the parent companies. Consequently there may be little value in comparing the dividend payments by the companies and the dividends declared by the parent companies. Nevertheless, significant mismatches between the two figures could be questioned and, in general, industry commentators have remarked frequently on the financial attractiveness of the appointed companies — of which one element is obviously the monies transferred in the form of dividends. For example, in 2005/06, United Utilities paid £215 million in dividends while the parent company declared dividends of £208 million.

Q14 Care must be taken about drawing any hasty conclusions but, as stated above, it is legitimate to question the size of dividends transferred from the water companies to their parent companies.

103. Overall, the financial health of the parent companies have a potential impact on the financial environment within which the appointed companies operate. For example, if a parent company has consistently high rates of profit and rates of return, it is more likely to be able to access cheaper financing through equity and/or borrowings which should be beneficial for the appointed company. From the consumer standpoint, if the appointed company is owned by a ‘wealthy’ parent company, this can mean there is less pressure to extract the maximum possible revenues from the company. On the other hand, it is quite likely that such a parent company will be expecting to do precisely that.

104. In contrast, a struggling parent company (or one that has unprofitable subsidiaries) could find it hard to attract reasonably priced finance, and this could increase the cost of capital for the appointed company. In reality it may have no option but to utilise every means to maximise the revenues from the appointed company.

105. Similarly if the parent company is already highly geared, this could reduce the capability of an appointed company to finance capital programmes through reasonably priced finance. To calculate the gearing ratio:

- an appointed company, Ofwat uses the ratio of net debt to regulatory capital value (see paragraph 44).
- non-regulated companies in general, a common method of calculating a company’s gearing ratio — and one which is nearest to the type of gearing calculation used in the regulatory framework — is to calculate the percentage of capital employed which is represented by borrowing. Basically this is borrowings divided by capital employed (commonly current and long-term assets minus current liabilities). These figures can be found in the parent company's balance sheet.
sheet and relevant notes to the balance sheet. Note that there is a variety of other interpretations of gearing.

106. In addition, the liquidity of the parent company (whether the company can pay debts due within a year from assets that it expects to turn into cash within that year) might have an impact on the appointed company. The most basic liquidity ratio is **current assets divided by current liabilities** – figures found in the balance sheets. A ratio of less than 1 is often cause for concern. A parent company’s liquidity could be low, for example, because it has another subsidiary that is performing very badly or because it has invested in another company where the financial returns are uncertain or longer term. In such situations it is plausible that this could result in the deferment of spending by the appointed company so that the parent company can improve its liquidity position.

**Q15** If a parent company’s liquidity appears to be low, it is worth questioning the water company about whether this has affected its timetable and programme for infrastructure renewals and capital expenditures, for instance, its water quality improvement plans.

**The broader context**

107. There are many other aspects of parent companies’ behaviour which might from time to time have implications for the appointed companies. Key amongst these are the overall stability of the parent company, especially if its corporate behaviour is causing concern to financial markets in general and to investors in particular (a simple example might be that a parent company has made one or more poor investments in other ventures). The consequences should show up in the accounts of the parent company in a variety of ways, including accounting items such as bad debts. In such an eventuality, an appointed company could find itself under financial pressure.

108. For instance, if ‘market sentiment’ goes against a parent company, it may well need to find ways of bolstering its position in the market by promising dividend growth in the future. Although there is a degree of ring-fencing around the water companies and they have detailed regulatory obligations, they are still operating in a company environment and have flexibility – in this example – to declare higher dividend payments and/or to postpone investment spending. Scenarios such as the one above are not that uncommon. As the sector becomes increasingly subject to takeover bids, takeovers, mergers and de-mergers - and industry commentators have remarked on potentially ‘brittle’ ownership structures for example – it is especially important to be alert to possible consequences for appointed companies of the financial behaviour of the parent company or group.
Collated questions

Q1. If consumers, who provide the appointed companies with most of their income, were paying them more, while the companies were spending nearly £1 billion less on investment than was assumed in the price limits:

• is this good value for us?
• what are companies doing with this ‘excess’ income, and will their actions benefit us in the end?
• are consumers getting a ‘fair deal’?
• are we getting a ‘fair share’ – for instance in comparison to shareholders?
• is the company spending enough of ‘our’ money on, for example, water quality measures, on plugging leaks, and on customer service in general?

Q2. Where profits and dividends are consistently low, questions need to be asked about the implications for the company’s ability to raise funds. If profits are low but dividend payments are high, the company should be questioned about how the dividend levels are being financed and any implications for the water company and its consumers.

Q3. Where there are high profits and high dividend payments, the companies should be asked to justify the transfer of so much out of the appointed company. For example, if the parent company’s other company activities are showing losses or very poor profit rates, questions could be asked about whether the water company is effectively shoring up poor financial performance elsewhere in the group.

Q4. If a company’s gearing ratio appears to be low in comparison with the other appointed companies or the water industry average, questions could be raised as to whether the company has sufficient funds to finance necessary investment, or whether it is relying too much on revenues from present-day consumers as sources of finance instead of increasing its borrowing.

Q5. If a company’s gearing ratio is relatively high, it may be appropriate to question the company’s financial strategy. This could mean that a company tries to minimise other important expenditures in order to meet high interest payments – this could have adverse repercussions for a variety of quality of service outcomes. In extreme circumstances, too high a gearing level might hamper a company’s ability to raise funds, for example, to deal with short-term unexpected demands for expenditure.

Q6. If a company’s ROCE is low - declining – it might signal the need to check quality of service. If the ROCE is relatively high and rising, questions should be raised about whether consumers are paying too much.
Q7. If for two or more years, a company’s return on capital employed (ROCE) diverges significantly from Ofwat’s assumptions, further investigations will be needed.

Q8. The mechanisms and rationale for financial restructuring can be complex but if a water company issues special dividends or engages in other measures that will affect its gearing level, credit rating, and ultimately its cost of capital, questions should be raised about the financial implications, especially whether consumers receive a fair share of any subsequent cost savings.

Q9. If a parent company engages in share buybacks in order to pass on some or all of cost savings to investors, the company should be questioned about any policies which would appear not to give consumers a fair share of such savings.

Q10. Water companies should be asked for the reasons for any significant changes in depreciation charges year-on-year.

Q11. If a company is consistently spending less on infrastructure renewals than it is charging, questions should be asked about whether consumers are paying for renewals work that has not taken place as yet.

Q12. Any accrual or prepayment on infrastructure renewals (basically consumers paying in advance and maybe too much) would consequently need to be justified in relation to the companies’ medium-to long-term view.

Q13. If companies can ‘back-end’ expenditure, delaying it to the latter part of the price control period, it is legitimate to question whether the revenues received from consumers for capital expenditure programmes may have been used for purposes other than those intended.

Q14. Care must be taken before drawing conclusions but it is legitimate to question the size of dividends transferred from the water companies to their parent companies.

Q15. If a parent company’s liquidity appears to be low, it is worth questioning the water company about whether this has affected its timetable and programme for infrastructure renewals and capital expenditures, for instance, its water quality improvement plans.
References and further reading

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*Financial performance and expenditure of the water companies in England and Wales, 2005-06 report, and supplementary tables, Ofwat (2006)*

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*RAG 2 Guideline for classification of expenditure [version 2.03] Ofwat (2003)*

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*RAG 4 Guideline for the analysis of operating costs and assets. [version 4.02], Ofwat (2003)*

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