

**TRANSFER PRICING IN THE WATER
INDUSTRY**

**REGULATORY ACCOUNTING
GUIDELINE 5.03**

Ofwat
Issued April 1997
Revised March 2000

TRANSFER PRICING IN THE WATER INDUSTRY REGULATORY ACCOUNTING GUIDELINE

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PART 1 ACCOUNTING GUIDELINE AND EXPLANATORY NOTE

1.1 INTRODUCTION

Appointees are under a duty to trade at arm's length and to ensure that there is no cross-subsidy with respect to transactions between the Appointed business and associate companies and the non-Appointed business.

The onus is on individual Appointees to ensure that their activities comply with this duty and this guideline is in place to assist Appointees. Appointees should be able to demonstrate transparently to Ofwat, and to the public and other audiences, that they are meeting their duty to trade at arm's length from associates and that cross-subsidy does not exist (A definition of terms is included in the Appendix).

Abuse of monopoly power, for example through the exclusive use of an associate at above market rates, may lead to unfair competition in local and national markets. It may lead to greater costs for the regulated business, and ultimately to higher bills for customers. It may also breach the Competition Act 1998. To guard against this Appointees should let contracts competitively.

The Director General monitors the performance of individual Appointees both through annual reports prepared by company Auditors, assisted where appropriate by Reporters, and through independent studies into company performance commissioned by Ofwat. The Director publishes his findings in the annual report *Financial Performance and Expenditure of the water companies in England and Wales*.

At Periodic Reviews the Director sets price limits on the basis of the costs involved in providing water and sewerage services. Where cross-subsidy is found, downward adjustments will be made to base costs in order that customers do not pay more than they should.

The aim of the guideline is to establish a framework with which Appointees must comply. The guideline describes the key principles with which companies should comply and also reflects key areas of non-compliance highlighted by investigations into company activities.

1.2 LICENCE AUTHORITY

Section 50 of the Competition and Service (Utilities) Act 1992 places a duty on the Director to ensure that transactions between Appointees and their associated companies are at arm's length and that the Regulatory Accounts are presented in such a way as to make this transparent. Revisions to Condition F of the Licence came into force on 4 March 1993 to reflect this duty, by prohibiting any cross subsidy between the Appointed and non-Appointed businesses, and from the Appointee to any associate company, including the parent, within the group. It also extends the disclosure of information on transactions.

1.3 THE COMPETITION ACT 1998

Under the Competition Act 1998 (the Act) the Director has concurrent jurisdiction with the Director General of Fair Trading in relation to the regulated water sector in England and Wales. The application of the Act to the water sector has been published jointly by Ofwat and the Office of Fair Trading in: *Competition Act 1998: Guidance on application in the water and sewerage sectors*.

When trading with associates, Appointees should pay particular regard to the specific application of the Act as outlined in the following sections of the report.

- Issues in pricing of water and sewerage services: Approach to Cost Assessment Section 4.9-4.10, Excessive Prices Section 4.14, Other Relevant Information Section 4.15, Refusal to Supply and Essential Facilities Section 4.21-4.24;
- Competition in providing Contestable Services, Section 4.25-4.29;
- Conduct relating to non-price terms, Section 4.30-4.33;
- Agreements that may restrict, distort or prevent competition, Section 4.53-4.54.

Where the Director considers that the relationship between an Appointee and an associate company may breach the prohibitions of the Water Industry Act 1991, he may choose to use his powers under either the Water Industry Act 1991 to enforce Licence Condition F and/or to use his powers under the Act. When using his powers under the Competition Act, such as imposing financial penalties, the Director is not required to have regard to his duty under the Water Industry Act 1991 to secure that undertakers are able to finance their functions.

1.4 GUIDELINE PRINCIPLES

The principles of this guideline are that:-

- the Appointed business pays a fair price for services and products received;
- transfer prices for transactions between the Appointed business and associate companies are based on market price or less. Where no market exists, transfer prices are based on cost;
- market testing¹ is used to establish market prices for supplies, works and services provided to the Appointee.
- costs are allocated in relation to the way resources are consumed;

Appointees are required to demonstrate, through the application of these principles, the basis of arm's length trading and that cross subsidy does not exist.

¹ The principles of market testing are set out in Section 1.7.

Within the framework of these guidelines, Appointees must develop processes and procedures to meet their own specific circumstances, and ensure that transactions are supported and documented. A full account of the processes should be retained to allow monitoring by the Director and the Appointee's Auditors. These records should demonstrate that the processes and procedures have been operated in an open and transparent manner.

These guidelines and principles will apply to all water only and water and sewerage companies. Within each Appointee the policies and methods adopted for cost allocation, transfer pricing, market testing and reporting should be consistent. Where it is anticipated that a re-appraisal will result in system and/or policy changes, Appointees should ensure that proposed modifications comply with this guideline and inform Ofwat of the modifications. Appointees should seek advice from Ofwat where they consider their proposals may differ from the spirit of the guideline.

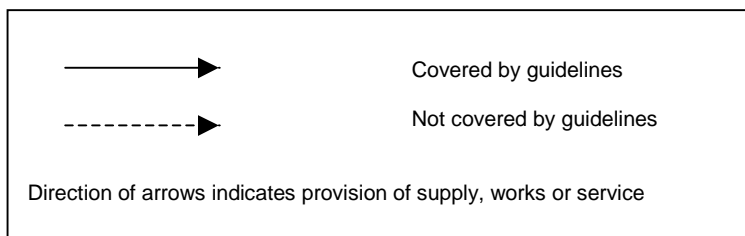
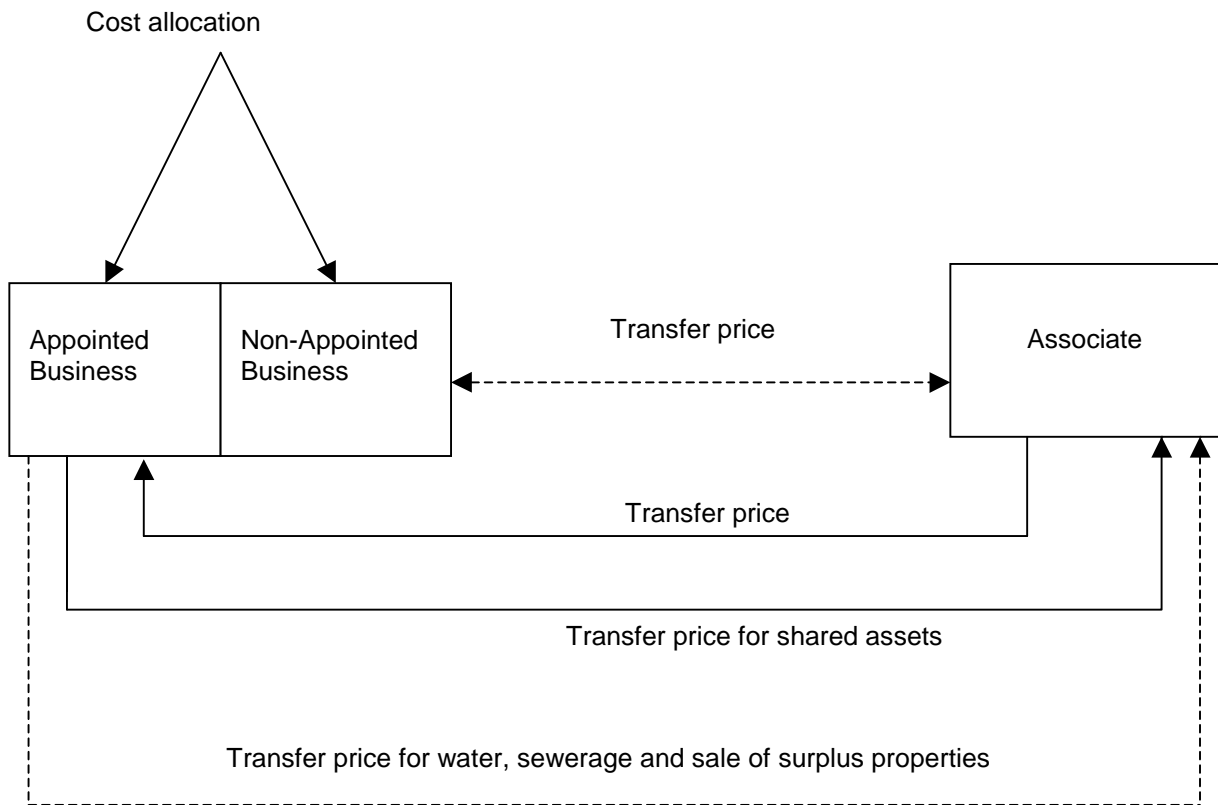
1.5 APPLICABILITY

These principles apply to:

- cost allocation within the Appointee between the Appointed and non-Appointed activities;
- transfer prices for the provision of supplies, works or services between the Appointed business and an associate company;
- transfer prices for rechargeable works where the Appointee is a monopoly supplier to the associate company, eg accommodation and other shared assets; or where the parent is monopoly supplier, eg shareholder costs to the Appointee and associates.

This is shown in diagram 1.

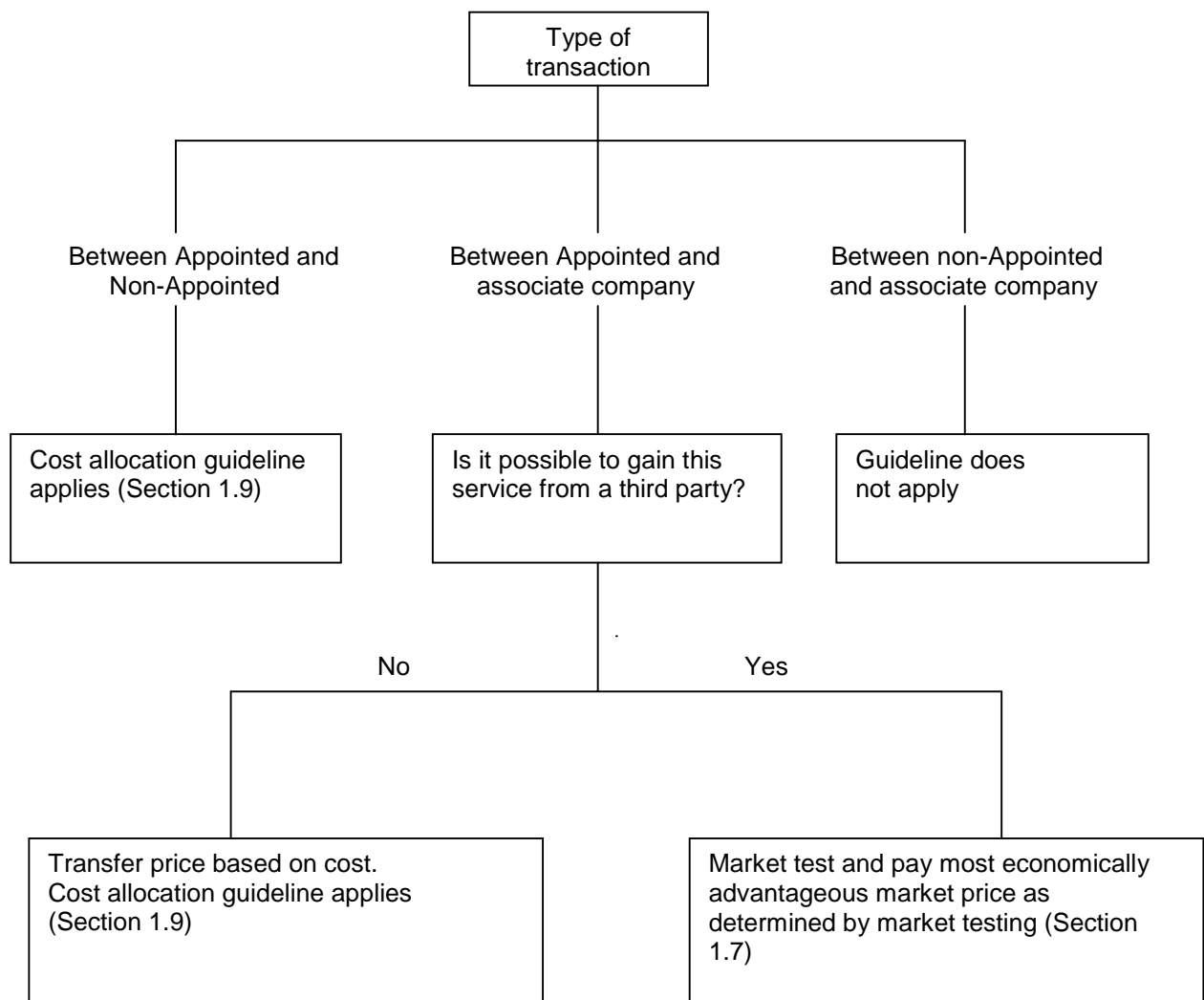
Diagram 1. Cost allocation and transfer pricing



This guideline will apply to transactions with all associate companies. For the purposes of this guideline, and to ensure complete transparency, an associate company should be determined in accordance with *Financial Reporting Standard 8 (FRS 8), Related party disclosures* as modified in Ofwat *Dear Regulatory Director* letter RD 29/97.

The onus will be on Appointees to determine whether or not any company with whom they trade is an associate company. In reporting transactions with associate companies Appointees should report all transactions regardless of how remote or otherwise the connection with that associate company. Appointees will need formalised procedures to check whether a company with whom they trade is an associate. Appointees should establish with Ofwat any departures from this reporting requirement. Diagram 2 provides an overview of the guidelines and the key decision points relating to cost allocation and transfer pricing.

Diagram 2. Overview of guidelines



1.6 PRINCIPLES OF TRANSFER PRICING

The primary principle is that transfer prices should be based on market price or less and that market price should be determined by market testing. The principles of market testing are described in Section 1.7. Subject to other factors being equal, market price should be the most economically advantageous price taking into account objective criteria such as completion date, quality, running cost, after sales service, technical merit, security of supply, effectiveness, whole life cost, capability, capacity, etc.

The market testing process must be applied in a fair, open and transparent manner with no guarantee of success for associate companies. This will facilitate fairness of treatment between potential contractors and ensure that a competitive edge is maintained within the process. This provides the greatest assurance that cross-subsidy of associates is not taking place. Where a service is market tested it should be a real market test and the work should be awarded to the tender² that is the most economically advantageous. This should be determined by reference to objective criteria such as quality, whole life cost, effectiveness, capacity etc.

Where an associate company gains a substantial proportion of its turnover from the Appointed business, ie more than half, the price the associate company charges should incorporate a discount from the external market price to reflect the following:

- inherent long-term guarantee of work;
- volume of work;
- lower marketing and sales costs;
- lower bad debt risk;
- lower commercial risk;
- reduced credit period.

Where no market exists for particular supplies, works or a service, the transfer price should be based on cost, and the cost allocation guidelines followed.

Where cost is used the Appointee should have access to the costs of that associate and should conduct validation exercises to ensure that transfer prices are at cost.

² All references to tender include related terms, such as bid or proposal to supply.

On occasion, the Appointee may choose to use the services of an associate for strategic reasons. For example, it may wish to retain intellectual properties within the group or it may require a particular product or service which can only be provided by an associate. Under these circumstances, the transfer price should also be based on cost.

If there is a market for a service/good and the Appointed business does not choose to test the market for that service/good then transfer prices should be at cost. In the medium term, Appointees should consider bringing the activity within the Appointed business. An Appointee that uses an associate company for a service, for which there is a market, without market testing the prices paid cannot demonstrate arm's length trading. For price setting purposes the Director will assume that such supplies, works or services under these circumstances are provided at cost to the Appointed business, as if the services have been delivered within the Appointee. Under these circumstances cost will be deemed as the actual cost to the supplier of the goods, works or services plus a rate of return on capital.

The Appointed business may be indirectly supplied with goods, services and supplies by an associate company via a third party. This may occur where an associate is sub-contracted to a third party, perhaps as a nominated sub-contractor. Appointees are required to report on the value of transactions undertaken by associate companies via a third party. Reporting should record the value of such transactions and the associates involved including the nominated sub-contractor.

1.6.1 Other Transfer Prices

Not only do transfer prices apply to goods, services and supplies, they can also apply to staff where they provide services or are seconded to associate companies and vice versa. Where Appointee staff undertake work for associates, the Appointee should be reimbursed to reflect the individual's salary and overheads associated with that individual's employment, ie accommodation, pension, car.

Appointees should have systems to record details of staff and time spent on non-appointed activities. Where the Appointee employs or trains associate staff, it should document the requirements for that individual and the basis of remuneration.

In some circumstances companies may choose to transfer assets into and/or out of the Appointee. Where assets are transferred out of the Appointee to an associate, the associate should pay a fair price, as determined by net book value or a fair market price, for those assets. Associates should not receive assets from the Appointee at a price below that which would be charged by a third party.

1.7 PRINCIPLES OF MARKET TESTING

Market testing is the process of determining a market price for particular supplies, works or services. Transfer prices for transactions between the Appointed business and associate companies can only be at a market rate if they are a result of market testing. This is essential to ensure that the price paid for a product or service does not exceed a fair market price. Appointees that let contracts in a competitive manner to associates and third parties alike are able to demonstrate that trade with associates is conducted at arm's length.

1.7.1 Methods of Market Testing

There are a number of methods of market testing:

- competitive letting;
- comparison to published list prices;
- third party evaluation;
- benchmarking.

The industry to date has used all of these methods to determine transfer prices, with varying degrees of success. A number of companies have been unable to demonstrate arm's length trading due to weaknesses in their market testing processes. As a result the Director assumed at the 1999 Periodic Review that some supplies, works and services were provided at cost to the Appointee.

The majority of adjustments made by the Director were as a result of poor market testing. In the main, companies had used comparison to published list prices, third party evaluation and benchmarking. Following investigations Ofwat concluded that market testing by these means did not demonstrate arm's length trading because a large element of subjectivity was involved. Comparisons were not always made on the basis of the same type and volume of supplies, works or services. These methods of market testing tended to involve a judgement of a fair market price and/or interference in the market. Ofwat was not satisfied that this form of market testing produced a fair market price.

The most robust means of determining a fair market price is to invite independent contractors to tender a price for given supplies, works or services, ie competitive letting of a contract. Competitive letting is the only means of market testing which objectively tests and preserves the competitive market. All other methods tend to compare a predetermined price with the market, as a means of justifying the original price. In these circumstances the Appointee has to make a judgement as to what a fair market price should be. Competitive letting avoids this problem as it inherently discovers the market price without interference in or judgement of the market.

Though competitive letting produces the most robust transfer price, there are circumstances where the competitive letting process is demonstrably impractical. For example, where a contract of small value is not suitable for inclusion in a framework agreement, or where, for example, group services may not be provided at cost. In these rare circumstances market testing by comparison to published list prices, third party evaluation and benchmarking could be used to demonstrate arm's length trading.

In exceptional circumstances the Appointee may need to engage the services of a third party at short notice to deal with operational needs. This would include dealing with emergency situations where the prompt action required would not enable a full procurement exercise to be undertaken. To alleviate concerns, the Appointee should fully document the operational emergency and the reasons for selecting the associate. This process should accord with the Appointee's stated emergency procedures.

The Appointee will be expected to make a strong case for using methods other than competitive letting and will need to demonstrate the robustness of the methods used. Only well-documented and cogent exercises will satisfy Ofwat that transfer prices are at market rates.

1.7.2 Market Testing Procedures

Appointees should establish and apply clear policies and procedures for market testing. The reasons for the methods, thresholds and criteria adopted should be transparent and should be capable of withstanding scrutiny by the Director, customers and competing contractors. The Director will examine the policies and procedures of individual Appointees and challenge the approach where necessary. Policies and procedures should be documented and include the following as a minimum:

- market testing methods to be used;
- procedures to be adopted with respect to each method;
- frequency of market testing;
- review procedures;
- responsibilities for conducting market testing; and
- documentation of procedures.

Arm's length trading can be best demonstrated by retaining a detailed audit trail addressing each of the above points. Prior to commencing the competitive letting process the Appointee should ensure the following decisions are taken:

- contractual arrangement to be used and the circumstances in which they will be used eg fixed price, schedule of rates, partnering, term, negotiated and call-off contracts;
- the minimum number of bids to be obtained dependent on materiality of the contract;
- qualification processes for potential contractors;
- an evaluation process;
- policy on informing tenderers of results.

At the 1999 Periodic Review the Director also adjusted companies costs where arm's length trading could not be demonstrated because the competitive letting process was not set down in advance. To demonstrate that associate companies undergo the same tender process as external companies, without preferential treatment or guarantee of success, the evaluation process should be set down in advance of any tenders being opened. When inviting companies to tender Appointees should ensure that the qualification requirements do not give any undue advantage to associates.

The criteria on which tenders will be assessed and the respective weightings for each criteria should be documented before tenders are reviewed. It will be difficult for the Appointee to demonstrate that trading has been at arm's length if cost is given a weighting of less than 50% compared to qualitative factors. Under the Competition Act 1998 the Appointee should ensure that it does not abuse a dominant position or enter into agreements or concerted practices which might breach the prohibitions in the Act.

Appointees that use transparent, well-documented market testing processes will be best placed to demonstrate compliance with these guidelines. Where Appointees are unable to provide sufficient evidence to demonstrate this, Ofwat may require access to the costs of associate companies who provide services to the Appointee. The Director needs to be content that the prices paid for the goods or services provided does not exceed a fair market price.

1.7.3 Frequency of Market Testing

To demonstrate a fair market price the Appointee will need to undertake frequent market testing that produces valid results. There is a balance between the advantages of frequent market testing of short-run contracts and the benefit of stability, continuity and possibly lower costs for longer term work. As a general guide, contracts should normally be market tested every one to three years. Contract periods longer than three years could lead to the Appointee paying prices that are very different from prevailing market rates. Where Appointees chose to let a contract for longer than three years they should refer to the market on an annual basis thereafter.

Repeat market testing will be necessary when there is any material alteration to an existing contract, or extra work is to be awarded. Market testing that does not match the current profile of work will not remain valid.

In general, the greater the likelihood of fresh competition and new technology emerging, then the shorter the period between market testing. Appointees should have regard to these issues in determining their strategy.

1.7.4 Unacceptable Practices

Market testing procedures should comply with EU and prevailing standards. Appointees should not split contracts or use artificial methods to calculate the value of contracts in order to circumvent applicable thresholds or the aggregation rules of the EU.

Market testing, should be used to award contracts to the most economically advantageous tender, not as a device to justify prices paid to associate companies. Where examples of this practice are found, the Director will assume these works, supplies and services are provided at cost, as arm's length trading cannot be demonstrated. This could also constitute grounds for an investigation under the Competition Act 1998.

Third parties will not continue to offer competitive bids to the Appointed business if they perceive that the company is not seeking the most economically advantageous bid or that third party bids are mostly used to establish market prices to be paid to associate companies.

1.8 PARTNERING

It is recognised that partnering arrangements are becoming more common. Where Appointees pursue partnering arrangements with associate companies they should take account of the following principles:

- selection of partners should be made following a competitive letting process;
- the partnering arrangement should run for a stated period of time (this should be made clear in the competitive letting documents); and
- any partnering agreement should include mutually agreed and reasonable targets for improving performance and reducing costs;

Partnering arrangements with an associate company run the risk of appearing 'cosy'. Appointees will therefore need to take steps to enable them to demonstrate that such arrangements operate at arm's length and are producing tangible benefits in terms of improved performance and reduced costs. This can best be achieved by:

- proper documentation of the competitive letting and selection exercise;
- clearly defined targets for reducing costs and improving performance including incentives;
- rules for rewards and penalties where targets are surpassed or underachieved to reflect the risk borne by each party to the contract;
- an open book policy providing details of the costs involved in providing the service and the level of profit achieved on the contract.

1.9 PRINCIPLES OF COST ALLOCATION

Cost allocation is the means by which costs are divided between the Appointed and non-Appointed activities within the Appointee, and to specific products and services. Cost allocation rules apply to transfer prices from associate companies where no external market exists, including services received from the parent company, or where costs are incurred commonly by Appointed and non-appointed activities.

The key principle is that costs should be allocated in relation to the way resources are consumed. Allocations based entirely on turnover, volume or direct labour rates should not be used as they are unlikely to reflect the activities involved. Allocation must also be consistent with other Regulatory Accounting Guidelines, in particular RAG 4 (issued 5 June 1992).

Costs can be considered as:

- direct costs of activities (eg materials and wages);
- indirect costs which are directly consumed or allocated to activities (eg space occupied, IT resource used by an activity) and those not related to activities (eg management fees).

Allocating costs in relation to the way resources are consumed provides a means of building up service and product costs. This approach views a business as a series of activities, each of which consumes resources and, therefore, generates costs. An activity based approach should result in the majority of the total costs being allocated on a meaningful basis. It is expected that at least 80 per cent of costs will be allocated by activity. All costs must ultimately be allocated, including, where appropriate, depreciation charges (CCD charges in CC Reports and HC costs in HC Reports) on assets and financing charges.

Cost allocation must be fair and reasonable and there must be consistent treatment of costs for Appointed and non-Appointed activities. These principles should prevent Appointed activities cross subsidising non-Appointed activities.

Each Appointee should have policies and procedures for a clear cost allocation methodology. These should specify:

- activities;
- cost drivers for allocating costs to activities;
- cost drivers for allocating activity costs to products and services;
- departures from guideline/implementation process;
- review procedures;
- documentation of procedures.

The onus is on companies to ensure that all costs are ultimately allocated in accordance with this guideline.

The allocation of indirect costs should be achieved by:

- identifying the activities that comprise a particular service or product and what drives the level of activity;
- determining the relationships between activities and resources consumed;
- costing the activities by costing the resources consumed;
- pooling costs that cannot be related to activities and allocating them on a subjective basis, eg turnover or proportion of direct costs.

All Appointees pay a charge to the parent company for services provided. The services provided to individual Appointees vary. It is important that the basis of charging used by the parent company reflects the group structure at the time charges are being levied and actual services provided. The charges paid to the parent must be related to the services provided and should be charged at cost, eg legal services and treasury services. The onus is on the Appointee to demonstrate charges reflect the costs incurred by the provider of the service. Management fees should not cover additional costs, eg where the parent treasury function provides a guarantee to the Appointee, a charge should not be made for the provision of that guarantee beyond that paid by the parent.

Although a significant proportion of costs can be allocated in relation to the way resources are consumed, it is recognised that a point of diminishing returns will be reached where the cost of further allocation outweighs the benefit. Where companies apply a deminimis level below which they will not seek to allocate costs, this should be declared in the commentary to Tables 30 & 31 of the June Return.

In addition, it is recognised that some costs will not be driven by activities and that some subjective allocation will be necessary to arrive at the full cost. Where a subjective allocation is applied the principles governing this allocation should be set out in the commentary to Tables 30 & 31 of the June Return.

Where it is not possible to charge for services on an activity basis; eg for shareholder management cost (Register, Company Secretary, AGM etc). Costs of this type should be distributed fairly between each subsidiary of the parent and in a way that reflects the activities the parent undertakes on behalf of the individual subsidiaries. Distributing charges to associates on the basis of profitability or turnover of individual associates will not provide a proxy for activity, and apportionment on this basis should be avoided. Discrepancies between treatment in the regulatory and statutory accounts should be avoided.

Allocations based on short run marginal costing techniques should not be used. In some instances it may be admissible to use long-run marginal costing techniques, for instance where a water only company bills and collects payments for sewerage services on behalf of a water and sewerage company. In cases where a company considers that a marginal costing technique is the most suitable means of charging for a particular service, it will be expected to justify its reasons for using this technique and should explicitly report this (see Section 2).

The differences between traditional cost allocation approaches and an activity based approach are illustrated in Diagrams 3 and 4.

Diagram 3. Traditional Costing

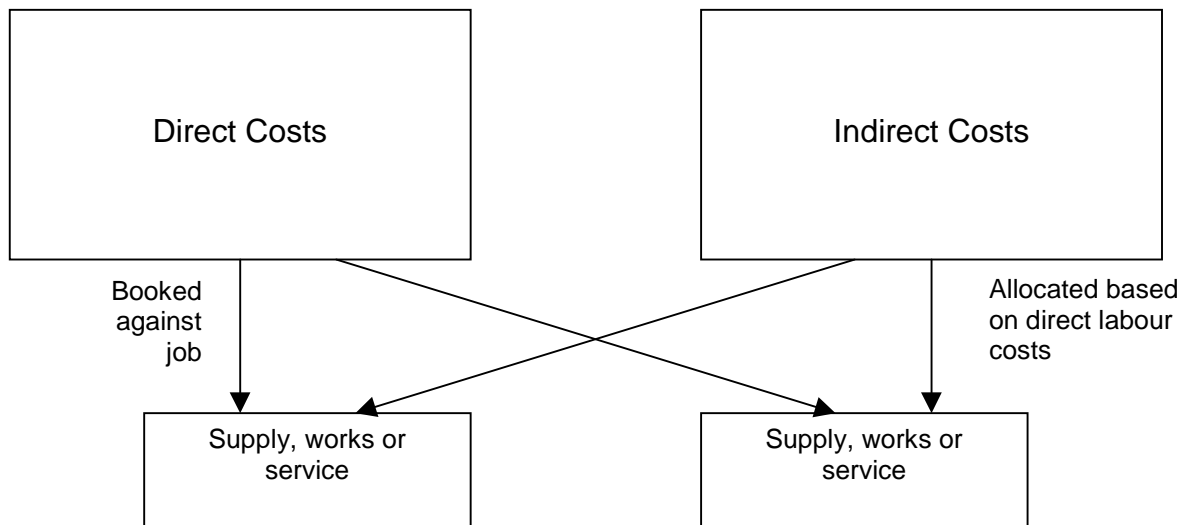
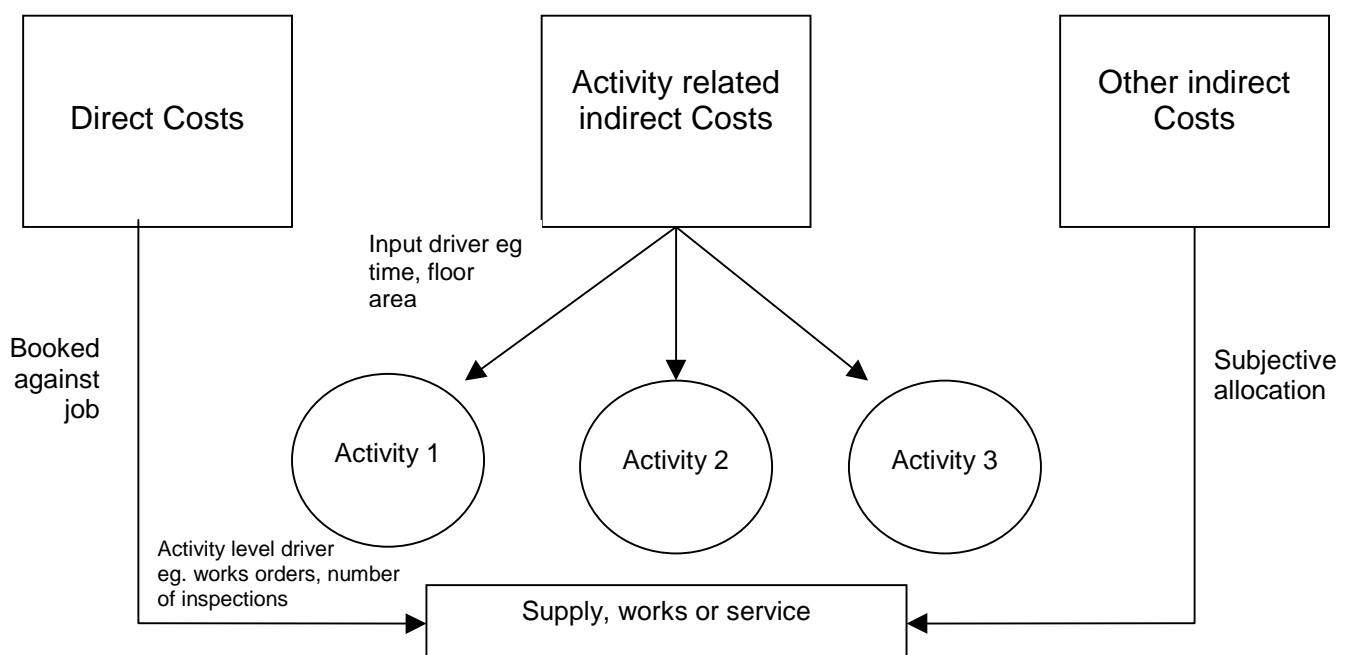


Diagram 4. Activity Based Costing



1.10 APPOINTEE STRUCTURE

Systems should be in place to ensure that directors or senior managers who have responsibilities in both the Appointee and associate companies, or companies with whom the Appointee trades, do not face a conflict of interest.

No individual, in such a position, should be able to influence either the purchase or supply of goods, services and supplies. Where cross-directorships exist these should be described in the commentary to Tables 30 and 31 in the June Return and in the Regulatory Accounts. Transparency with regard to the existence of such cross-directorships will mitigate public concerns.

PART 2 REPORTING REQUIREMENTS

2.1 INTRODUCTION

Appointees must demonstrate that they comply with Condition F of their Licence and that trade with associate's is at arm's length and cross subsidy is not occurring.

Policies and procedures should satisfy this guideline. Appointees should advise Ofwat, in their June Returns, of any areas where policies and procedures may not comply with the revised guideline and the time frame for ensuring that they will.

2.2 APPOINTEES' JUNE RETURN REPORTING REQUIREMENTS

Licence Condition F requires Appointees to trade at arm's length from associate companies, to ensure that no cross-subsidy occurs. To demonstrate that this condition has been met, Appointees have a duty to provide Ofwat with information on transactions that have taken place between the Appointed business and associate companies.

Appointees should have policies and procedures governing the procurement of supplies, works and services which comply with the principles of RAG 5.03. Appointees should put in place systems enabling all transactions with associate companies to be recorded and reported in line with the requirements set out below.

Appointees will be expected to provide the following information with the June Return each financial year:

1. A statement of compliance that the Appointee has complied with Condition F of its Licence;
2. A declaration by the Directors and Senior Managers of the Appointee of interests in associates with whom the Appointee trades;
3. Details on procedures used to award the contracts to associates which are declared in Tables 30 and 31;
4. Details on transactions with associates other than for the direct provision of supplies, works or services to the Appointee.

Details of these four key requirements are set out below:

1. The Directors of the Appointed business should state that the Appointee complies with the objectives and principles of RAG 5.03, namely that transactions with associate companies are at arm's length and that cross subsidy is not occurring.

2. The Directors of the Appointed business should accompany their declaration of interests with a statement that no Director has acted as both purchaser and supplier in any transaction with an associate company. The Appointee should give a description of procedures that it has put in place to ensure that conflicts of interest do not occur.
3. For transactions with associate companies, the Appointee should set out the following information in the relevant chapters of the June Return: Chapter 30 should be used to record capital expenditure and Chapter 31 should include profit and loss expenditure.

For each contract in excess of 1% of the Appointed business turnover the following details should be provided in the commentary to Table 30 & 31. Also where the aggregate value of trade with an associate represents more than 50% of the associates turnover, but individual contracts are less than 1% of the Appointed business turnover, the following details should be provided for a sample number of contracts.

- The value of supplies, works or services supplied in the current year.

The total value of the contract. Any significant variations between the anticipated contract value and actual expenditure should be explained.

The date when the contract began and the date when it is due to expire. Any options to extend or terminate that were included in the original contract should be recorded;

- Details of the advertisement of the contract;
- The method of selection that was used to award the contract;
- Where other market testing was used state who conducted the evaluation or benchmarking. The method and the number of comparators used;
- When the contract was advertised and the number of parties which expressed an interest;
- The number of companies that were invited to submit a tender and the basis for their selection;
- The number of tenders³ that were submitted and the number and basis for those tenders which were excluded or withdrawn;
- The number of tenders that were evaluated and the method used, including details where applicable of the tender evaluation score sheet or other similar matrices. This should demonstrate that all tenders were evaluated on a consistent basis;

³ All references to tender include related terms, such as bid or proposal to supply.

- The outcome of negotiations undertaken with interested parties;
- The reason for the award of the contract.

For those contracts not covered above, the following details should be provided. Please provide this commentary by reference to line numbers in Table 30 & 31.

- The value of supplies, works or services supplied in the current year.
- The procurement policy used and the number of tenders received and rejected. Where other market testing was used state the method and number of comparators used.
- The rationale for the selection of the successful party, including the basis of the tender evaluation.

The commentary should also include the overall value of transactions with each individual associate and that associate's turnover as required by Licence Condition F6.5.

4. The commentary to the June Return should provide details on the following transactions with associate companies. None of the information described below should be included in the tables:

- Income received from associates or recharges made by the Appointee where it supplies goods, services or supplies to associates, eg accommodation, IT services, personnel services, etc. This should also be recorded as non-appointed income in the Regulatory Accounts where it is in excess of the thresholds for reporting.
- Indirect transactions with associates via a third party should be reported in the commentary to Tables 30 & 31. The commentary should record the value of such transactions, the associates involved and whether or not the associate was nominated as a sub-contractor. All transactions involving a nominated associate should be recorded. Where it is not possible to include details of associates sub-contracted to the Appointee, an explanation should be provided. Appointees should provide proposals to Ofwat of any materiality levels that they consider to be appropriate to the recording of this information.
- All transfers of assets, land or property that took place within the financial year should be recorded in the commentary. Any significant difference between 'fair market price' or net book value, and the price at which assets are transferred should be recorded.
- Details of loans, capital, issues or redemptions and dividends should be recorded, in the commentary to Table 31 where they relate to trade between the Appointee and associate companies.

- A statement of turnover for associates with whom the Appointee has traded. A summary of the total transactions, by associate, between the Appointee and associates and details of the percentage of the associate's turnover that this represents.
- The commentary should describe the terms of any partnering arrangements that exist between the Appointee and associate companies. This should set out the method used to select the Partner; the period of time for which it will run; mutually agreed and reasonable targets for improving performance and reducing costs.

If the Appointed business is unable to provide any of the information above, it should make this, and the reasons for not providing the information, clear in the commentary. For each of the requirements that does not apply to the company, a 'nil return' should be included.

2.3 AUDITORS' REPORTING REQUIREMENTS

Auditors should prepare a long form report with the Appointee's June Return. The format will be of an 'agreed upon procedures' engagement. This should identify material areas of judgement and any other material circumstances which appear to the Auditor to be relevant having regard to the guidelines and to the scope of work agreed with the Director including relevant levels of materiality.

Ofwat may require Auditors to adopt a particular focus in examining compliance with this guideline. To that end Auditors will be required to provide for Ofwat's agreement, prior to each financial year, proposals which they have discussed with the Appointee, detailing the areas they propose to cover in relation to this guideline in the course of the audit in the forthcoming year. The audit plan will need to be prepared in accordance with 'Terms of Reference' issued annually by Ofwat. These will provide the framework of the Auditors' reporting requirements each financial year.

The scope of the work to be conducted should enable the Auditor to provide a long form report that covers the areas;

- set out in the agreed terms of reference;
- matters which may be relevant to the Appointee and its compliance with the guideline, as informed by the Director to the Auditors;
- sample transactions should be performed as identified in the agreed terms of reference.

The purpose of the long form report is to provide the Director with information to allow him to form a judgement on the compliance or otherwise of the Appointee with the guideline in respect of those matters reported and having regard to the scope of work performed. Ofwat will provide feedback to the Auditors in writing on the compliance of the Appointee with the guidelines.

In addition, this report should identify any findings that were drawn to the attention of the Appointee and what steps have, or will be, taken to remedy any departures from this guideline.

Reporting compliance with this guideline falls to the Auditors. Reporters do not currently have an obligation or duty to report to the Appointee's Auditors. Appointees and their Auditors should establish clear responsibilities for Reporters. For instance, use can be made of a Reporter for examination of market testing of engineering services, where the Auditors may not have the appropriate skills. Ofwat may, on occasion, also require the Reporters to examine such transactions.

APPENDIX - DEFINITION OF TERMS

A number of terms have been used throughout the guidelines. To avoid confusion, they are defined as follows:

Accounting terms

The definitions to be used are as set out in Regulatory Accounting Guideline 3 (RAG 3).

Activity

A logical grouping of tasks.

Appointed business

The Appointed business comprises the regulated activities of the Appointee which are activities necessary in order for an appointee to fulfill the function and duties of a water or sewerage undertaker under the Water Industry Act 1991.

Arm's length trading

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

Associate company

For the purposes of compliance with these guidelines and to ensure complete transparency, an associate company should be determined in accordance with *Financial Reporting Standard 8 (FRS 8)*, *Related party disclosures* as modified in *Ofwat Dear Regulatory Director* letter RD 29/97.

Competitive letting

Letting contracts as a result of a tendering process.

Cost

The actual cost to the supplier, in a transaction with the Appointee, of the goods, works or services, plus a reasonable rate of return on capital employed. This will be the cost of capital on new investment for all water and sewerage companies (4.75%) as stated in *Final Determinations: Future water and sewerage Charges 2000-05*. The small company premium as set out in the Final Determination will also apply, where appropriate.

Cost allocation

Cost allocation is the means by which all costs are allocated to Appointed and non-Appointed businesses or specific supplies, works and services, ensuring a fair share of overheads.

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 the Appointee to the associate which is not merited by services received.

Economically advantageous price

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

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 the Appointee has a contract with a third party and that third party has made use of an associate company of the Appointee to provide that service. In this instance the Appointee does not have a contract with the associate company, but part of the turnover of the associate company is indirectly provided by the Appointee.

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.

Small contract value

A contract whose total expected value is the lower of either 0.1% of the turnover of Appointee for the reporting year immediately preceding the date it is awarded, or a contract value of under £100,000.

Transaction

For the purposes of RAG 5.03, a transaction occurs where the Appointee and its associates supply goods, works or services to each other, directly or indirectly via a third party.

Transfer pricing

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