

EXPERIENCE IN OTHER UK SECTORS — WATER AND RAIL

THE WATER INDUSTRY

Infrastructure assets recognised

The UK water industry has for many years had to deal with the issue of accounting for water infrastructure assets. Within the industry, such assets generally comprise:

- Underground systems of mains and sewers;
- Impounding and pumped raw water storage reservoirs;
- Dams;
- Sludge pipelines;
- Sea outfalls; and
- Information and infrastructure assets e.g. zonal investigation records

(Source: OFWAT Regulatory Accounting Guideline 2.03)

Water companies prepare two different forms of financial statements. Their statutory company accounts are compiled in accordance with either UK GAAP or with International Financial Reporting Standards (IFRS), as required by the Companies Act. They also prepare Regulatory Accounts which are submitted to the Office of Water Services (OFWAT) for the purposes of regulatory monitoring.

Measurement and accounting

i) Statutory accounts — UK GAAP

Where the statutory company accounts are prepared under UK GAAP, it is common for companies to use historic cost accounting and within this to use the renewals accounting provisions under FRS 15. i.e.

- The assets are recorded at historic cost with an adjustment to take account of the asset's condition.
- The estimated annual expenditure required to maintain the asset in its steady state is derived from the company's asset management plan and represents the depreciation amount for the year.
- This depreciation amount is deducted from the cost of the asset and charged to the profit and loss account.
- The actual expenditure on the asset during the year is then capitalised and added to the asset's cost.

ii) Statutory accounts — IFRS

IFRS must be used where the water company is a listed entity that prepares group accounts, and it may be used in other cases where the company so elects. At the time of transition to IFRS, there was consensus within the water industry that renewals accounting was not possible under the international standards. Most water companies have therefore adopted historic cost accounting for their infrastructure assets by utilising the provision that allows them to treat the carrying value at the date of transition as the 'deemed cost' under IFRS. Thereafter, the assets are not revalued but are depreciated over their estimated useful lives. There is, however, no

real consensus in the industry as to the extent to which the overall infrastructure asset should be broken down into significant components, and the full spectrum exists — from companies treating their network as one entire asset to others disaggregating theirs into multiple components.

iii) Regulatory accounts

For the Regulatory Accounts, the requirements for infrastructure accounting are set out in the 'Regulatory Accounting Guidelines' issued by OFWAT. These accounts cover only those elements of a water company's operations which are subject to the regulatory regime and comprise both current cost and historic cost accounts. The current cost accounts mirror the price-setting regime, and the historic cost accounts are used to assess financial performance in a manner similar to the statutory accounts.

Both sets of regulatory accounts use a modified form of renewals accounting for the infrastructure assets, as follows:

- The asset is recorded at current replacement cost or historic cost as appropriate, with an adjustment to the asset value to reflect the asset's condition.
- For the current cost accounts, the asset values are subject to annual indexation.
- The estimated annual amount from the asset management plan necessary to maintain the asset in its steady-state condition is charged to the profit and loss account with the credit entry establishing a provision. For the current cost accounts, the amount from the plan is updated to current prices.
- The actual expenditure on the asset during the year is charged to this provision. On a rolling basis, therefore the accounts may contain a provision or an 'payment in advance'.

In practice, the difference between the historic cost regulatory accounts and the historic cost UK GAAP accounts using renewals accounting is that any shortfall or excess between the estimated and the actual expenditure on the asset in any one year is reflected within 'net current assets' in the regulatory accounts and within the fixed asset balance in the UK GAAP accounts.

NATIONAL RAIL NETWORK

The national rail network is owned and operated by Network Rail through its subsidiary infrastructure company. Network Rail prepares its statutory group accounts in accordance with IFRS and measures its infrastructure asset at its 'value in use' rather than depreciated replacement cost. For financial reporting purposes, it treats its infrastructure as one entire asset, and thus comprises all elements such as track, track bed, embankments, cuttings, signalling systems etc.

Network rail's income is derived wholly from the track access charges paid to them by the Train Operating Companies (TOCs). The fees are set in agreement with the Office of the Rail Regulator (ORR) and reflect the operating costs, the cost of investment in the asset and a return on the net assets. The infrastructure asset is therefore an income-generating asset and is thus unlike most other public sector assets which are held for the purposes of service delivery.

Network Rail consequently applies 'IAS 36: Impairments' to consider whether the 'recoverable amount' of the asset is less than the carrying amount (Depreciated replacement cost). The recoverable amount is the greater of the value that could be

obtained from selling the asset ('net realisable value'), and the present value of future income that can be obtained from continuing to use the asset ('value in use'). For Network Rail, the former measure is not relevant, so the value in use is calculated based on the present value of future track access charges, assuming that the asset is maintained in the required condition. The value in use of the asset is indeed lower than the DRC and thus this is the value at which the asset is measured in Network Rail's accounts.

The asset is then depreciated over its useful economic life of 25 years, which is calculated on a weighted average basis of the underlying network components.