



12 September 2002

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Mr Hans Nailor
Accounting Standards Board
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Dear Mr Nailor

Comments on FRED29 - Property, Plant and Equipment

I am writing in response to the FRED29 on the subject of Property, Plant and Equipment and in particular in relation to the important issue of renewals accounting raised in paragraph 38 ASB (iii) of the discussion document. As you are no doubt aware, the water industry currently takes advantage of the provisions in paragraphs 97 - 99 of FRS 15 to account for its infrastructure assets in a practical, cost effective and meaningful way. Furthermore, infrastructure renewals accounting represents an integral part of the economic, regulatory and accounting framework within which water companies operate in the UK.

The framework for accounting for the costs of maintaining the infrastructure in the water industry using infrastructure renewals accounting was established before privatisation in 1989. It covers assets which water companies are required to maintain in perpetuity to agreed levels of service. You will know that detailed discussions took place on the subject of infrastructure renewals accounting prior to the issue of FRS 15 when the water industry, OFWAT and auditors stressed the importance of retaining this method of "depreciation" for infrastructure networks. As a result, paragraphs 97 - 99 were incorporated into the standard and this has proved to be a workable solution which addresses the requirement to depreciate assets whilst still recognising the nature of assets concerned and the manner in which they are maintained.

The arguments which led to this approach being accepted by the ASB (the key aspects of which are reiterated in summary in the attached Appendix) are still as relevant today and the use of renewals accounting remains the only practical way in which to determine the “depreciation” on infrastructure assets. It is crucial therefore that the current provisions are retained within the main body of the new standard to enable water companies to continue with this method of accounting and ensure consistency of approach in the water industry.

The possibility of continuing to adopt infrastructure renewals accounting in the absence of the specific dispensation from the ASB would ultimately be a matter for auditors to decide. However, the risks involved would not make that an attractive option and could potentially lead to lack of consistency in treatment between companies which would be undesirable.

I know that you will receive similar comments from many companies within the water sector together with their auditors. This is an issue on which there is a very strong feeling reflecting the amount of work that has gone into developing the existing infrastructure renewals accounting framework. I hope you will recognise this in the finalisation of the Accounting Standard. I look forward to seeing the results of the ASB’s deliberations.



David Hipple
Finance Director

Key reasons for current approach

- Infrastructure renewals accounting was adopted by the water industry in 1989 to provide a consistent way in which to account for the underground network of mains and sewers which represents a single system to be managed, operated and maintained as a network in perpetuity. As individual components are of no separate economic use and have no determinable asset life, any attempt to estimate these would involve great subjectivity and would be open to manipulation.
- A significant proportion of infrastructure assets in the water industry were created prior to 1974 and insufficient records exist with which to calculate depreciation on a conventional basis. The use of an independently certified asset management plan to determine annual expenditure required to maintain the operating capacity of the network provides a robust auditable basis of calculating depreciation.
- OFWAT have indicated to date that they will continue to require the use of infrastructure renewals accounting in the regulatory accounts and as part of the price-setting mechanism. It is important to ensure symmetry between the statutory and regulatory accounts in order to avoid confusion for users, in particular arising from potentially different historical cost profit figures. Although the current system involves presentational differences in relation to infrastructure assets between statutory and regulatory accounts, these are easily reconcilable and result in consistent profit figures. In addition, the practicalities and cost of maintaining two separate sets of asset records and accounts would be prohibitive.

Prior to the issue of FRS 15, much valuable work was carried out involving the ASB, OFWAT and the water industry in developing a solution to address the need to depreciate infrastructure assets. The solution adopted, whereby renewals accounting was allowed as a method of determining the depreciation charge for infrastructure assets, should be retained and specific guidance to this effect should be included in the revised accounting standard. The omission of such guidance would present the water industry with major practical difficulties that would inevitably increase costs and therefore charges to customers in the long term.