November 2017

Trust in water

RAG 1.08 – Principles and guidelines for regulatory reporting under the 'new UK GAAP' regime

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1. Introduction

1.1 Background

1.1.1 This version of the regulatory accounting guidelines has been developed to take into account changes to the UKGAAP reporting regime (which came into effect for the 2015-16 reporting year onwards) and to take into account the changes in the way we regulate companies as a result of the 2014 price review (PR14). It also has changes which are as a result of policy changes made in advance of the 2019 price review (PR19).

1.1.2 The regulatory accounting statements will now form part of a wider regulatory report, which companies will be required to submit annually. The report is split in to 4 sections;

1. Regulatory financial reporting
2. Price control and additional segmental reporting
3. Performance summary
4. Additional regulatory information

1.1.3 Statutory accounts on their own are insufficient to assess the performance of vertically integrated, price-controlled monopolies. This is particularly relevant in a water and wastewater sector with long-life assets. The regulatory accounting statements can be reconciled back to statutory accounts in section 1.

1.1.4 To present a clear, comparable picture of appointee financial performance to stakeholders, companies will be required to present a baseline level of financial information that is aligned to the way in which price controls (and associated regulatory performance commitments and incentives) are being set for the control period. This information will be in section 2 but derives from the statutory accounting disclosures in section 1. This allows stakeholders to be able to review performance on a consistent basis.

1.1.5 The regulatory accounting statements consist of historic cost and current cost accounting statements. This RAG defines treatment of particular items (for example; revenue and interest) where Ofwat requirements differ from those normally required under UKGAAP and Companies Act legislation.

1.2 Licence authority

1.2.1 As part of the conditions in company licences, appointees are required to prepare current cost accounting (CCA) statements in addition to historical cost accounting statements in accordance with guidelines notified by the Water Services Regulation Authority (Ofwat).

1.2.2 These guidelines may:

- specify the form and content of CCA statements;
- require reconciliations between the CCA statements and the historical cost statements;
- specify the accounting principles and the basis of calculation to be used in preparing CCA statements; and
- specify the nature of the auditor's report required in respect of CCA statements.

1.2.3 More specifically these guidelines enable regulatory reporting to be more consistent with statutory accounts than has been the case previously. CCA accounting statements now form a much reduced role due to the evolution of the price setting methodology for 2015-20, but still provide important additional information to support effective regulation of the sector.

1.3 Objectives

1.3.1 The general objective of Ofwat in issuing these revised guidelines is for companies to publish accounting statements which will be consistent with the economic framework in which they are regulated. More specifically, Ofwat is seeking to achieve the following objectives:

- to provide a comparable measure of the real costs of supply, including the cost of capital, across companies;
- to provide realistic measures of asset values and the trends in the returns earned on these assets; and
- to promote transparency of costs.

1.3.2 At PR14, we set four separate binding price controls for the appointee business (three for water only companies);

- wholesale water
- wholesale wastewater

- retail household
- retail non-household

1.3.3 This was done in order to target incentives and facilitate competition in specific parts of the value chain. So we now require companies to present financial information for each of the 4 price control units (3 for water only companies). This includes disaggregation of revenue and costs, to allow stakeholders to review companies' performance against final determinations.

1.3.4 For further guidance and clarification on the activities under each wholesale control, please see the 'Disaggregation of Wholesale activities – upstream services' definitions in RAG 4, section 2.

1.3.5 For further guidance on splitting costs of retail activities between household and non-household, please see RAG 2.

1.3.6 It is possible that price controls will be further disaggregated from the 2019 price review (PR19). As such, cost reporting for the segments within companies' wholesale businesses is needed to understand these costs and inform future regulation.

1.4 Principal differences to statutory accounts

1.4.1 We regulate companies with a price control framework that requires financial information to be used and presented in a way that is sometimes different from the way information is reported in statutory accounts.

1.4.2 The year ended 31 March 2016 was the first time that all water companies will be reported under the 'new' UKGAAP for statutory reporting purposes (ie using IFRS, FRS101 or FRS102). FRS 102 is a 'new' UK GAAP with a number of similarities to, but also some subtle differences from, IFRS and FRS 101

1.4.3 Ofwat's aim is to minimise differences in reporting between regulatory and statutory accounts unless it is absolutely necessary for regulatory purposes.

1.4.4 For historic cost accounting statements, Ofwat requires deviations from UKGAAP in the following areas;

- Revenue recognition
- Capitalisation of interest

- Derivatives
- Grants and contributions

1.4.5 Current cost accounts are only required to be used for an income statement in section 4. A current cost statement of financial position is not required.

1.5 Revenue recognition

1.5.1 We first addressed the issue of revenue recognition in 'RD 05/08: Regulatory accounts for 2007-08: reporting requirements RAG 3.06'. We investigated incidents where companies had not complied with this policy in the 2008 regulatory accounts.

1.5.2 Our requirement is that companies should bill all properties where a service is being received unless confirmed as void, and should fully recognise the billed amounts in the reported turnover figures in the regulatory accounting statements. For clarity, this ensures that properties only fall into one of the following **two** categories for regulatory accounting statement purposes:

- billed **and** recorded in turnover; or
- void properties.

1.5.3 Therefore companies should assume that for regulatory reporting purposes where an amount is billed it is probable that cash will be collected. For instance in IAS18 (or IFRS15 if adopting early), the requirement is that 'Revenue is recognised only when it is probable that the economic benefits associated with the transaction will flow to the entity'. So Ofwat requires a deviation from that requirement in that there is no judgement applied to the probability of collection, it should all be considered collectable.

1.5.4 This approach ensures the desired outcome for price setting purposes and will allow stakeholders to review companies' performance against final determinations for 2015-20. It will ensure that all bad debt costs are fully recorded in the retail cost data and turnover is recorded correctly for the purposes of revenue reporting.

1.5.5 Some companies receive revenue from customers via an agent, for example a WaSC may receive sewerage income from a WoC where the WoC raises a combined water and sewerage bill. In such circumstances, the recipient company should record both the billed amount (in turnover) and the full amounts of bad debt cost. Where a company is acting as an agent it should

not include billed amounts for other companies in its turnover and bad debt figures.

1.5.6 Commentary requirements for this area are set out in RAG 3.

1.6 Capitalisation of interest

1.6.1 Our requirement is that companies should not capitalise interest. Therefore companies should disapply any requirement in accounting standards (such as IAS23) to capitalise interest incurred during the construction phase of an item of 'property, plant and equipment'. Companies reporting under FRS102 in the statutory accounts have an option to capitalise interest – if this option is exercised in the statutory accounts then it should be disapplied in the regulatory accounting statements.

1.6.2 In such circumstances, the income statement will record a greater amount of interest costs than the statutory accounts.

1.7 Derivatives

1.7.1 Our requirement is that companies should disclose the fair value adjustments for financial instruments separately in the regulatory accounting statements so that the profit/loss before such adjustments can be seen clearly on the face of the income statement. This change is for the presentation of the regulatory accounting statements, rather than an adjustment which would affect the financial results.

1.8 Grants and contributions

1.8.1 We recognise that UKGAAP allows different accounting treatment of grants and contributions received by companies. Some companies may recognise grant income directly to the income statement. We acknowledge this particular treatment in the column format in table 2E. When income is treated in this way, it should be shown under 'other income' in the annual performance report financial tables. Companies should use the adjustment column in table 1A to apply this treatment. Grants and contributions should not be shown as 'revenue' or 'other operating income' in the annual performance report.

1.8.2 Similarly where deferred income for these items is held as a liability on the balance sheet, then the amortisation of this liability should be recognised as 'other income'.

1.9 IFRIC 18

1.9.1 Water companies adopt assets from customers and developers for zero payment. The assets will be recognised at fair value in the statutory accounts. The deferred income that arises from this transaction will be amortised over the life of the asset.

1.9.2 If a company recognises this income when received in the income statement then this should be shown as 'other income' in pro forma table 1A. This will ensure that the recording of 'revenue from customers' is not distorted.

1.9.3 Similarly where deferred income for such assets is held as a liability on the balance sheet, then the amortisation of this liability should be recognised as 'other income'.

2. Current cost accounting

2.1 Principles

2.1.1 Historical cost accounts ('HCA') are recognised universally as a legitimate method of financial reporting but have a variety of limitations, in particular with 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.

2.1.2 Up to 2014-15, Ofwat had used CCA as a basis for setting a depreciation charge element of the revenue building blocks for setting price limits in price reviews, as well as using CCA profit as a percentage of RCV in order to assess the profitability compared with the allowed cost of capital. The RCV is used by the investment community and others in helping to determine a company's market value. The rate of return on the RCV is therefore more widely used and a better understood measure than the return on the replacement cost of the assets. This is in part due to earlier privatisation consequences meaning that the total RCV is much lower than the total replacement cost of assets in the water sector.

2.1.3 At PR14 the move to total expenditure (totex) as a basis for assessing wholesale costs meant that current cost depreciation was no longer a direct feature of the price setting process and we do not expect to use it in the way we did previously in future price reviews for the same reason. This means that we can reduce the amount of information that we collect on this basis.

2.1.4 There is no longer a requirement to produce full CCA financial results. However we are retaining the requirement to disclose summary financial results as the information will remain of value to us in our wider regulatory work at least for the time being. In section 2.2 we reproduce some CCA guidance that was extant to 2014-15 as a guide to continuing to use CCA accounting for regulatory purposes on this more limited basis going forward.

2.1.5 However companies may wish to use estimates of the CCD and IRC charges rather than maintain a full current cost accounting system. For CCD this could

be done by indexing the 2014-15 values and adjusting for additions. The difference between this average level and the average amount expensed over the AMP should be shown as the capital maintenance charge. For infrastructure assets as a minimum companies should use business plan information to average non-expensed infrastructure spend over the AMP to give an indicative calculation for a medium term cost. Such an approach will clearly not give as true a representation as to the medium term profits as full current cost accounting but will give some indication with a significantly smaller administrative burden. Companies can employ more thorough calculations if they wish.

2.1.6 Similarly, a simplified approach can be adopted for the finance and other costs below the operating profit line. It would be acceptable to assume that all of the appointee debt is attributable to the wholesale business. In turn, the split between water and wastewater could be made on the basis of the RCV split between water and wastewater.

2.1.7 Companies are not expected to calculate financing adjustments and working capital adjustments.

2.2 CCA guidance

2.2.1 The adoption of infrastructure renewals accounting by the industry overcame only in part such limitations of traditional HCA for infrastructure assets. Infrastructure renewals accounting is used for long-life network assets (called infrastructure assets). It effectively regards the whole quantum of individual assets as a single infrastructure asset. Infrastructure renewals accounting is based on an operational assessment of activity needed to maintain the serviceability of the underground infrastructure over a medium to long-term period.

2.2.2 The CCA value of particular tangible assets to a business can be used as a proxy for what potential competitors would find it worth paying for them in the absence of barriers to entry and exit from the business, even if the competition is hypothetical. This will be the cost of an asset of equivalent productive capability to satisfy the remaining service potential of the asset being valued - a Modern Equivalent Asset (‘MEA’) - if the asset would be worth replacing, or the recoverable amount if it would not.

2.2.3 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, and is stated gross of third party contributions.

2.2.4 The CCA value of assets to a regulated business may however be affected by the nature of the regulation. In the water industry the requirement that regulation should allow for the financial viability of an efficient operator means that new investment can be valued on normal CCA principles ignoring potential restrictions imposed by the regulator. However, the constraints on price levels mean that the true value to the business of initial assets is actually the recoverable amount. This would normally be the present value of the associated cash flows, discounted at the cost of capital, ie, the economic value. However, the estimation of the future cash flows is subjective and could be circular since the regulator sets price limits.

2.2.5 Accordingly, in valuing initial operational assets used in the appointed business, existing at the time of privatisation, it is assumed that the effect of regulatory constraints can be disregarded. The value to the business under such circumstances will generally be the MEA. Furthermore initial assets are to be valued at their full MEA, whether or not they were originally, or would now be, paid for by third parties.

2.2.6 For the purposes of the regulatory accounting statements, the asset revaluation using RPI should be carried out on an annual basis in line with the current approach to updating RCV values.

2.2.7 Third party contributions are to be treated like grants. Consequently for example, adopted assets are to be brought in as an asset in the year of adoption at their MEA cost.

2.2.8 It has also been assumed for additions to fixed assets that RPI indexation is immaterial; in other words all additions occur at the year end, and assets in use with a historic cost net book value of zero should be valued at net MEA value.

Appendix 1: Wholesale current cost – example calculation

For the 12 months ended 31 March 2017

Table 1A

	Units	Total ap[p] activities
Revenue	£m	512.0
Operating costs	£m	-299.0
Other operating income	£m	27.0
Operating profit	£m	240.0
Other income	£m	5.0
Interest income	£m	12.0
Interest expense	£m	-100.0
Other interest expense	£m	-5.0
Profit before tax and fair value movements	£m	152.0
Fair value gains/(losses) on financial instruments	£m	6.000
Profit before tax	£m	158.000

Table 2A

	Water	Wastewater
Revenue - price control	200.000	300.000
Revenue - non price control	5.000	7.000
Operating expenditure	-115.000	-142.200
Depreciation - tangible fixed assets	-17.000	-20.000
Depreciation - intangible fixed assets	-3.000	-3.000
Other operating income	15.000	12.000
Operating profit before recharges	85.000	153.800
Recharges from other segments	0.000	0.000
Recharges to other segments	0.500	0.700
Operating profit	85.500	154.500

Table 4G

	Water	W[a]	
Revenue	205.000	307	
Operating expenditure	-115.000	-142	
Capital maintenance charges	-35.886	-42	
Other operating income	15.000	12	
Current cost operating profit	69.114	134	
Other income	2.303	2.697	
Interest income	5.528	6.472	
Interest expense	-46.068	-53.932	
Other interest expense	-2.303	-2.697	
Profit before tax and fair value movements	28.574	86.821	
Fair value gains/(losses) on financial instruments	2.764	3.236	
Profit before tax	31.338	90.057	121.395

d

CCD roll forward

		Water	Wastewater
CCD charge 2014-15		30.00	35.00
Index to 2015-16	a	30.32	35.38
Add impact of new assets		0.40	0.50
		30.72	35.88
Index to 2016-17		31.15	36.37
Add impact of new assets		0.36	0.62
		31.51	36.99

New asset depreciation

	Water	Wastewater
Average asset life	25	26
Additions 2015-16	10.00	13.00
Charge for year	0.40	0.50
Additions 2016-17	9.00	16.00
Charge for year	0.36	0.62

Use of RCV to split finance costs

	Water	Wastewater
RCV at 31 March 2017	702.354	822.233
	46.1%	53.9% e

Tables 1A and 2A provide the start point for the current year UKGAAP based results. The 2014-15 current cost accounts are used to provide the final CCD and IRC charges under current cost accounting in the regulatory accounts.

1. Index up the CCD charge using year average RPI. For each year following 2014-15, add in an estimated CCD charge on asset additions. <a> Use capex for above ground assets divided by an average asset life.

2. For IRC, simply index up the 2014-15 charge using average year RPI. <b>

3. The abolition of renewals accounting means that the IRE that was formerly used in the IRC calculation may now be all or partly recorded as opex from 2015-16 onwards. An estimate of the extent of this will have been made for the PR14 business plan. To get an estimate of that amount multiply the IRC estimate for the year by the percentage used at PR14. This is then deducted from the IRC estimate <c>. The total is then entered into table 4G <d>.

4. For income and costs (including interest) below the operating profit line, use the RCV split to give a water and wastewater value. This will mean that all financing costs are deemed to be attributable to Wholesale for the purposes of this table <e>.

IRC roll forward

		Water	Wastewater
IRC charge 2014-15		9.50	13.50
Index to 2015-16	b	9.60	13.65
Index to 2016-17		9.73	13.83
Total CCA capital maintenance charges		41.24	50.82
Adjust for IFRS treatment of IRE	c	-5.35	-8.30
Proxy CCA capital maintenance charges		35.89	42.52

IFRS treatment of IRE

	Water	Wastewater	
Proportion of former IRE classed as opex 2015-20	55%	60%	
Opex per table 2A	85.50	154.50	240.00
Estimated IRE in opex (using IRC)	5.35	8.30	