Information notice

IN 18/09 May 2018

This is a formal document that alerts our stakeholders to a change in the way that we regulate the water sector in England and Wales.

Guidance for reporting operating leases in PR19 business plans

This information note sets out how companies should treat operating leases in the PR19 business plans following the application of a new accounting standard by the International Accounting Standards Board.

Background

The International Accounting Standards Board (IASB) issued IFRS 16 Leases in January 2016. IFRS 16 will impact on reporting periods from 1 January 2019.

Changes to accounting standards mean that operating leases, whose costs were previously expensed, will be brought onto company balance sheets for statutory accounting purposes. The rationale for the change is to improve comparability between companies irrespective of the way assets are funded and to increase transparency of future liabilities.

We have already clarified companies should follow accounting standards for annual reporting purposes. Following requests through the PR19 query process, we provide further clarification for treatment of operating leases in PR19 business plans.

Most water and wastewater and water companies will be required to report using the new standard either through adoption of full international accounting standards or through FRS101 Reduced Disclosure Framework.

We recognise that those companies that report under the FRS102 financial reporting standard will continue to report operating leases in accordance with current accounting practice. However, we seek to ensure a consistent treatment of leases for price setting purposes, therefore this guidance which applies to PR19, applies to all companies.

Issues arising

The change to lease reporting raises issues associated with the consistency of totex allowances used in price setting and totex incurred in period.

The new accounting standard requires companies to capitalise leased assets and record both an asset and a liability in the balance sheet. Water companies with existing operating leases that remain in place will see an increase in debt liabilities once the new accounting standard takes effect and a reduction in operating expenses. In the absence of corresponding adjustment to cost allowances and to the Regulatory Capital Value (RCV), profits may change, and gearing will increase without any change in costs or risk faced by the company.

We propose to address these issues by following the IFRS 16 accounting treatment for the purposes of price setting for operating leases that will remain in place for all or part of 2020-25. This will require adjustments to be made to the RCV and cost allowances which we discuss below.

Companies will need to report information about the future cash payment commitments of existing operating leases in a new business plan table, App 33.

RCV adjustments

A one-off RCV adjustment will be made for each wholesale control that has operating leases in existence as at 31 March 2020 that will remain in place for all or part of 2020-25.

We will collect the data necessary to calculate the RCV adjustment in business plan table App 33. The table calculates the present value of the future lease payments for the RCV adjustment at 31 March 2020. It contains separate lines for existing leases and new leases (expected to be entered into between 31 March 2018 and 31 March 2020), which should be reported according the maturity profile, for leases that expire:

- before 31 March 2020;
- between 1 April 2020 and 31 March 2025; and,
- those that expire after 31 March 2025.

The net present value (NPV) of the future cash flows for operating leases in existence as at 31 March 2020 is calculated as:

$$NPV = (C_{t1}/(1+r^{t1}) + (C_{t2}/(1+r)^{t2}) \ldots (C_{tn}/(1+r)^{tn})$$

Where C is the future committed cash flow at each period (t_1, t_2 … t_n), r is the discount factor to be applied and n is the number of future committed cash flows.

The **discount factor** used for the calculation should be the real WACC for the price control (blended 50:50 between the real RPI WACC and the real CPIH WACC). This is because this equates to the rate of return that will be earned on lease liabilities that are capitalised to the RCV.

The cash flows included in the calculations should be the lease only element of future premiums. Consistent with IFRS 16, any element related to service charges or maintenance contracts should continue to be recorded in opex and excluded from App 33. Cash flows should be stated at base year values discounted by forecast CPIH.

In order to assess the accuracy and the appropriateness of the proposed adjustment, companies should provide summary data used to calculate the adjustment, clarify the nature of the leases, their duration and explain any assumptions made, particularly where this relates to forecast costs. Companies should set out the assurance undertaken to support the accuracy of the calculation, which may include third party assurance (such as from the company's external auditors).

We expect companies will make small adjustments to PAYG and RCV run-off rates to take account of the impact of the change to approach on revenues and customer bills.

The RCV adjustment calculated for each wholesale control flows to business plan table App 8. The business plan table guidance has been updated to reflect this. We will update the RCV adjustments feeder model in early June 2018 when we publish the company specific business plan templates.

Approach to wholesale cost assessment

The changes to lease accounting do not impact on our cost assessment approach based on historical data. However, where RCV adjustments are made, we must consider adjustments to wholesale costs baselines to ensure costs are not double counted.

We said that we would consider forecast data in determining efficient cost baselines in PR19. To ensure forecast data is comparable to historical data, we will require companies to submit business plan tables WS1 and WWS1 on two bases, one in accordance with IFRS 16 and one in accordance with current accounting rules regarding operating leases. This will allow us to understand the impact of IFRS 16 on reported costs in AMP7.

As we propose to capitalise existing operating leases as a midnight adjustment to the RCV as at 31 March 2020, we will remove the forecast annual cash costs of existing operating leases from our cost allowances for companies where RCV adjustments are made. We will do this after our efficiency assessment to ensure costs are not omitted from our totex cost models.

Approach to retail

There is no RCV in the retail control. Companies should be able to fund the costs of newly capitalised assets from operating leases from the efficient cost to serve regardless of the change in accounting treatment. We expect companies to include depreciation of the newly capitalised assets within tables R1, R4 and R5 for the period 2020-25.

Initial assessment of business plans

We will assess the proposed RCV adjustments and the supporting information provided in the Initial Assessment of Plans (IAP) under the "Targeted controls, markets and innovations" test 5:

How appropriate is the company's proposed pre-2020 RCV allocation between water resources and water network plus – and, if relevant, between bioresources and wastewater network plus – taking into account the guidance and/or feedback we have provided?

In assessing the proposed RCV adjustments within this test, we will take into account evidence of:

- Sufficiency and quality of evidence provided to support the calculations.

- Level of assurance provided over the proposed adjustments.

Reporting leases in Annual Performance Reports to 2020

There is a requirement for consistency for the totex reconciliation between PR14 final determinations and totex reported in 2015-20. Therefore for purposes of totex reconciliation we will require companies to report operating leases under the current accounting standards for APR tables that relate to totex reconciliation.

Guidance for annual performance reporting for 2018-19 and beyond will be issued in due course, taking account of the issues stated in this note.

Next steps

We expect companies to take account of this guidance in preparing their business plans for PR19. Where companies consider issues arise with the approach set out in this note, these should be explained in business plans.

Ofwat (The Water Services Regulation Authority) is a non-ministerial government department. We regulate the water sector in England and Wales. Our vision is to be a trusted and respected regulator, working at the leading edge, challenging ourselves and others to build trust and confidence in water.

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