February 2021

RAG 1.09 – Principles and guidelines for regulatory reporting under the ‘new UK GAAP’ regime

Ofwat

About this document

Version control

Version	Date published	Description
V1	30 November 2020	First version published after consultation as set out in IN 20/08
V2	16 February 2021	Presentational changes only to make the document accessible; • New fonts; and, • Paragraph re-numbering; and, • Cross referencing updated in paragraphs 3.4, 4.13, 4.19.

Contents

1. Background

1.1 This version of the regulatory accounting guidelines has been developed to take into account changes to the UKGAAP reporting regime and to take into account the changes in the way we regulate companies as a result of the 2019 price review (PR19).

1.2 The regulatory accounting statements form part of a wider regulatory report, the 'annual performance report' (APR) which companies will be required to submit annually. The report is split in to 9 sections;

- Regulatory financial reporting
- Price control and additional segmental reporting
- Performance summary
- Additional regulatory information – service levels
- Additional regulatory information – water resources
- Additional regulatory information – water network plus
- Additional regulatory information – wastewater network plus
- Additional regulatory information – Bioresources
- Additional regulatory information – Innovation competition

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.

1.4 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.

1.5 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.

2. Licence authority

2.1 As part of the conditions in company licences, appointees are required to prepare accounting statements in accordance with the regulatory accounting guidelines.

2.2 More specifically these guidelines enable regulatory reporting to be reconciled with statutory accounts.

3. Objectives

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 the trends in the returns earned by companies; and
- to promote transparency of costs.

3.2 We set separate binding price controls for the constituent parts of the appointee business;

- Water network plus
- Wastewater network plus
- Water resources
- Bioresources
- retail household
- retail non-household (Welsh companies only)

3.3 This targets incentives and facilitates competition in specific parts of the value chain. This includes disaggregation of revenue and costs, to allow stakeholders to review companies' performance against final determinations.

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, chapter 10.

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

3.6 Further disaggregation within price controls is needed to help us to inform future regulation, which may require an increase in the number of price controls.

4. Principal differences to statutory accounts

Framework

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. Ofwat's aim is to minimise differences in reporting between regulatory and statutory accounts unless it is absolutely necessary for regulatory purposes. Ofwat requires deviations from UKGAAP in the following areas;

- Revenue recognition
- Capitalisation of interest
- Derivatives
- Grants and contributions
- Asset adoption
- Leases
- Direct procurement for customers

Revenue Recognition

4.2 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.

4.3 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.

4.4 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.

4.5 This approach ensures the desired outcome for price setting purposes and will allow stakeholders to review companies' performance against final determinations. 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.

4.6 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

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

Capitalisation of interest

4.8 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.

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

Derivatives

4.10 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.

Grants and contributions

4.11 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 in statutory accounts. When income is treated in this way, it should be shown under 'other income' in section one of 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 table 1A of the annual performance report.

4.12 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' in table 1A.

4.13 In section two of the annual performance report financial tables, grants and contributions should be reported in table 2E (for all types of statutory accounting treatment) and grants and contributions relating to the price control in table 2M. They should not be included in any other revenue or income lines in section 2.

IFRS 15

4.14 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.

4.15 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.

4.16 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'.

Leases

4.17 Most water companies are required to account for leases in accordance with IFRS 16 through the 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.

4.18 Our requirement is that all companies should account for leases in accordance with IFRS 16 in the regulatory accounting statements. This is consistent with the approach to setting totex allowances for 2020-25 and the one-off adjustments made to RCV for operating leases in existence as at 31 March 2020.

Direct procurement for customers

4.19 Paragraph 4.18 requires companies to capitalise leased assets and record both an asset and a liability in the balance sheet in the regulatory accounting statements. There is one exception for leased assets procured through a direct procurement for customers process and which are paid for by customers through the operation of a specific condition B clause should be excluded from regulatory accounts. For clarification, all lease accounting associated with these assets provided by a competitively appointed provider should not be reported in the regulatory accounts.

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