



## Financial Reporting Committee

Hans Hoogervorst  
Chairman  
International Accounting Standards Board  
30 Cannon Street  
London  
EC4M 6XH

14 January 2015

Dear Hans

### **Discussion Paper DP/2014/2: Reporting the financial effects of rate regulation**

We welcome the opportunity to comment on the Discussion Paper.

#### **Who are we**

The 100 Group of Finance Directors represents the views of the finance directors of FTSE 100 and several large UK private companies. Our member companies represent around 90% of the market capitalisation of the UK FTSE 100 Index. Our aim is to contribute positively to the development of UK and international policy and practice on matters that affect our businesses, including taxation, financial reporting, corporate governance and capital market regulation. Whilst this letter expresses the views of The 100 Group of Finance Directors as a whole, those views are not necessarily those of our individual members or their respective employers.

#### **Our views**

We set out in Appendix 1 our responses to the specific questions included in the Discussion Paper. We summarise our views below.

#### **We welcome the research project**

We are supportive of the IASB's research project on reporting the financial effects of rate regulation within financial statements. A significant gap currently exists between the information contained within IFRS financial statements and that required to understand the economic performance of rate-regulated businesses. In our experience, investors want to understand the amount, timing and certainty of future cash flows resulting from the impact of rate-regulation.

#### **Focus should be on the effect on the income statement**

In our view, recognising that the key issue is about reporting the impacts of rate-regulation on an entity's financial performance, we believe that the future rate-regulation proposals should focus on the income statement rather than on the recognition of regulatory deferral assets and liabilities.

## **We broadly support the definition**

We broadly support the definition of 'defined rate-regulation' and believe this provides a sensible starting point for understanding the unique economic factors which such entities are exposed to, and to support the requirement for either the development of specific guidance within existing IFRS, or (as we currently believe to be more likely) the development of a new standard to enable the improved reporting of financial performance for defined rate-regulated entities.

## **Essentially it's a matter of revenue recognition**

Of the potential approaches described in the Discussion Paper, our view is that developing specific requirements to defer or accelerate the recognition of revenue would most effectively communicate the financial effects of defined rate-regulation. We do not believe that it is appropriate to defer or accelerate costs as we believe these should be reported in the period in which they are incurred and, as any recovery of costs would be by adjustment to future customer bills, adjustment of revenue would more align with the regulatory mechanism.

We recognise the various conceptual difficulties which exist with respect to reporting the financial effects of rate-regulation. We recommend that the IASB explores further the development of a new standard for rate-regulated entities which is based upon the revenue recognition model contained in IFRS 15. Of the various approaches within the Discussion Paper this seems to present the least conceptual challenges and best aligns to the economic effects of rate-regulation on rate-regulated entities (i.e. difference between the amounts billed to customers during the period and the amounts earned as a revenue adjustment in future periods under the regulatory contract).

Defined rate-regulated entities operate in a unique economic environment, whereby the goods or service they provide are considered essential by the customer, there is effectively little or no competition and as such, individual customers have effectively no control over pricing, availability or quality. An argument might be that due to this unique economic environment a defined rate-regulator is established through the regulatory contract as a representative of the customer, which in effect creates an implied or quasi-contract between the rate-regulated entity and the collective customers.

Through this recognition of the regulator as a representative of the customer, this might enable the recognition of the revenue adjustment mechanisms imposed by the regulator as performance obligations per the IFRS15 model. These performance obligations are associated with the provision of goods and services in prior periods and their recovery is often considered virtually certain. Indeed we believe that this approach may help deal with many of the conceptual issues discussed in paragraphs 5.14-5.31.

**Example of a rate-regulatory model**

To assist the IASB in its research project, we have attached an example of the regulatory mechanisms under which water and wastewater businesses will operate in England and Wales during the 2015-2020 regulatory determination period.

Please feel free to contact me through the 100 Group's website, [www.the100group.co.uk](http://www.the100group.co.uk), should you wish to discuss our comments.

Yours sincerely



**Russ Houlden**  
*Chairman*  
*Financial Reporting Committee*  
*The 100 Group of Finance Directors*

**RESPONSES TO SPECIFIC QUESTIONS****Survey participants**

Some of our member companies would be willing to take part in a survey or field test to help map the description of defined rate-regulation to the rate-regulation regimes under which those companies operate. Through our member companies we have experience of a variety of rate-regulation mechanisms, across different industries and countries. We will send through the contact details of those member companies to the IASB email address separately.

**Question 1**

**(a) What information about the entity's rate-regulated activities and the rate-regulatory environment do you think preparers of financial statements need to include in their financial statements or accompanying documents such as management commentary?**

**Please specify what information should be provided in:**

- (i) the statement of financial position;**
- (ii) the statement(s) of profit or loss and other comprehensive income;**
- (iii) the statement of cash flows;**
- (iv) the note disclosures; or**
- (v) the management commentary.**

**(b) How do you think that information would be used by investors and lenders in making investment and lending decisions?**

## Question 1(a)

Our members who are subject to rate-regulation have a good understanding of the informational needs of their investors and currently have to supplement the information contained within the financial statements in order to provide this information. A significant gap exists between the information contained within IFRS financial statements and the information required to understand the economic performance of regulatory businesses as a result of rate-regulation.

Companies tend to bridge this gap through the provision of additional qualitative narrative and disclosures in the management commentary and the use of non-GAAP measures.

The problems with this are that while our members may choose to disclose such information, invariably there will be some entities that choose not to. Also with this information being outside the financial statements, it is generally unaudited, with no standardised method of calculation. In addition, because the information is not incorporated within the Statement of profit or loss, it is more difficult for investors who are less informed to be able to ascertain the effects of rate-regulation upon performance. As a result, there is a strong public interest argument for requiring rate-regulated entities to include the effects of rate-regulation within their financial statements, which will improve transparency and comparability.

In our experience, investors want to understand the amount, timing and certainty of future cash flows resulting from the impact of rate-regulation, to enable them to better understand the returns the business has earned in the period and what it will recover in the future. The financial statements currently fail to provide sufficient information in relation to how the economic effects of rate-regulation on past transactions will affect future cash flows.

#### *Statement of profit or loss and other comprehensive income*

We believe that the primary importance of incorporating the impacts of rate-regulation within the financial statements is to better represent financial performance. The Discussion Paper however is principally focussed on the Statement of financial position and the recognition of regulatory assets and liabilities. We have raised our concerns previously that the IASB is generally too balance sheet focussed. Although ultimately it leads to the same conclusions, we believe that the emphasis should be more performance based.

Put simply, if the activity performed by the rate-regulated entity in the current period results in an increased/reduced recovery through customer bills raised in a future period (through the regulatory contract), then this should be reflected as a revenue adjustment to performance in the current period.

#### *Statement of financial position*

As detailed in the Discussion Paper, there are often a number of future revenue adjustments made through a rate-regulatory mechanism to take account of volume variances and performance against the regulatory contract in the period. We believe that these revenue adjustments and resulting assets and liabilities do not require separate presentation on the face of the primary statements (although preparers may choose to do so) as they can be adequately incorporated within existing presentational line items consistent with the nature of the transaction and the disclosure notes would provide investors with visibility over the effects of rate regulation on the primary statements. Based upon the expected timing of unwind, the assets and liabilities should be split between current and non-current categories within the Statement of financial position.

#### *Note disclosures*

We do not believe that IFRS14 provides a helpful starting point in relation to note disclosures, as our view is that the operational burden this standard places on preparers is not justified by the benefit to investors. Where an entity is involved in many rate-regulated activities under the jurisdiction of different regulators, the disclosures cover many pages and the benefits are reduced by the degree of clutter this creates. As a point of principle, our view is that disclosures should be provided to the extent that they are material.

The note disclosures should provide a summary of the movements in the rate-regulation deferral balance. This disclosure should disaggregate the material revenue adjustments made through the rate-regulatory contract into meaningful buckets and show how these have moved during the period for performance, adjustments made to balances recognised in previous periods, discounting (where applied) and recovery or repayment.

Against each material bucket, there should be information provided on the nature of the regulatory mechanism, the means of future recovery, the measurement basis that has been

applied (particularly any areas of estimation and the potential range of likely outcomes), and the expected timing of recovery.

The note disclosures should also provide a timing summary by material revenue adjustment, to enable investors to understand the timing of future recoveries.

#### *Management commentary*

Management commentary should assist investors in gaining a complete understanding of the impact of rate-regulation. For instance, this should include performance measures and targets set by the regulator and the entity's performance against these measures. This will enable investors to understand those regulatory performance measures which have not had an impact on reported financial performance in the period, which may be because the entity failed to achieve a particular target or failed to meet the recognition criteria within the accounting standards.

In addition, whilst the regulatory contract often allows for adjustments through the revenue mechanism, there are also mechanisms whereby the regulator allows recovery through adjustments being made to the regulatory asset base (RAB). The disclosure of these adjustments in the management commentary would enable investors to understand the wider impact on performance in the period and future cash flows.

The information above should enable investors to compare relative performance across entities operating in the same regulatory environment.

The management commentary should also include information on the regulatory frameworks within which an entity operates and the extent to which these cover its operating business, how these frameworks operate and impact the business, the RAB (as this is often used by investors as a means of valuing rate-regulated entities) and the allowable returns established by the regulator.

#### *Statement of cash flows*

We do not consider that any changes are required to the cash flow statement to adequately portray the effects of rate-regulation.

#### Question 1(b)

Investors would use the information to better understand and model future cash flows and the ability of the entity to outperform the regulatory mechanism and grow its returns. The disclosures would also enable the investors to determine the levels of risk that the entity is exposed to which would be particularly important when making longer term investment decisions (i.e. certainty of returns).

It would also reduce the need for the entity to use non-GAAP measures to show the effects of rate-regulation on its financial performance.

### Question 2

Are you familiar with using financial statements that recognise regulatory deferral account balances as regulatory assets or regulatory liabilities, for example, in accordance with US generally accepted accounting principles (GAAP) or other local GAAP or in accordance with IFRS 14? If so, what problems, if any, does the recognition of such balances cause users of financial statements when evaluating investment or lending decisions in rate-regulated entities that recognise such balances compared to:

(a) non-rate-regulated entities; and

(b) rate-regulated entities that do not recognise such balances?

We are familiar with the recognition of regulatory assets and liabilities under US GAAP. This has been in place for a number of years now and therefore the nature of such balances are well understood by investors. Under US GAAP, the method of recognising regulatory deferral balances is through 'cost deferral' which we do not consider the most appropriate method for modern-day regulation, as this excludes the recognition of many incentive-based performance mechanisms that do not involve the deferral of costs.

Many of the questions which are received from investors in relation to cost deferral balances are in relation to the timing of the related future cash flows.

### Question 3

Do you agree that, to progress this project, the IASB should focus on a defined type of rate-regulation (see Section 4) in order to provide a common starting point for a more focused discussion about whether rate-regulation creates a combination of rights and obligations for which specific accounting guidance or requirements might need to be developed (see paragraphs 3.6–3.7)? If not, how do you suggest that the IASB should address the diversity in the types of rate-regulation summarised in Section 3?

We support the IASB's decision to initially focus the Discussion Paper on accounting for what it describes as defined rate-regulation, to enable the understanding of the economic impacts on a limited range of entities and to identify potential accounting solutions, before developing the scope further in future papers.

#### Question 4

Paragraph 2.11 notes that the IASB has not received requests for it to develop special accounting requirements for the form of limited or market rate-regulation that is used to supplement the inefficient competitive forces in the market (see paragraphs 3.30–3.33).

(a) Do you agree that this type of rate-regulation does not create a significantly different economic environment and, therefore, does not require any specific accounting requirements to be developed? If not, why not?

(b) If you agree that this type of rate-regulation does not require any specific accounting requirements, do you think that the IASB should, alternatively, consider developing specific disclosure requirements? If so, what would you propose and why?

#### Question 4(a)

We agree that what is described as market rate-regulation (price capping) is very different to defined rate-regulation for the reasons stated in paragraph 3.30-3.33 of the Discussion Paper. The characteristics of market rate-regulation are significantly different to those of defined rate-regulation and are not significantly different to those of other commercial activities. As such, we believe that existing accounting standards adequately support the reporting of financial performance for market rate-regulated entities.

#### Question 4(b)

Investors would benefit from management commentary which describes the nature of the market rate-regulated activities and the effect this has on the financial performance and future cash flows of the entity.



## Question 5

Paragraphs 4.4–4.6 summarise the key features of defined rate-regulation. These features have been the focus of the IASB’s exploration of whether defined rate-regulation creates a combination of rights and obligations for which specific accounting guidance or requirements might be developed in order to provide relevant information to users of general purpose financial statements.

(a) Do you think that the description of defined rate-regulation captures an appropriate population of rate-regulatory schemes within its scope? If so, why? If not, why not?

(b) Do you think that any of the features described should be modified in order to include or exclude particular types of rate-regulatory schemes or rate-regulated activities included within the scope of defined rate-regulation? Please specify and give reasons to support any modifications to the features that you suggest, with particular reference to why the features may or may not give rise to circumstances that result in particular information needs for users of the financial statements.

(c) Are there any additional features that you think should be included to establish the scope of defined rate-regulation or would you omit any of the features described? Please specify and give reasons to support any features that you would add or omit.

### Question 5(a)

We consider that the description of defined rate-regulation provides a good starting point for understanding the economic impact of rate-regulation on a limited range of entities. The scope is appropriate in capturing those entities for which specific accounting guidance is required due to the unique economic factors which rate-regulation presents, whilst excluding those entities where such justification is not as strong or where there are unintended consequences of including certain entities.

### Question 5(b)

An important and valued concept underlying IFRS is that they are ‘principles- based’ and as such the features of defined rate-regulation should serve as ‘indicators’ rather than as a set of conditions that must be met. The benefit of this flexibility is primarily that it allows preparers to better determine the appropriateness of application for their regulatory models and to allow the standard to be applied for future developments in defined rate-regulatory models.

We suggest that the opening sentence of paragraph 4.4 should have ‘and quality’ inserted after ‘reasonable price’ to reflect the fact that governments often use rate-regulation for essential goods and services to ensure that customers receive these at a reasonable price as well as at a reasonable quality.

*Defined rate-regulation balances the needs of the customers to purchase essential goods or services at a reasonable price and quality with the needs of the entity to attract capital and remain financially viable.*

We would also suggest that the IASB reconsiders the use of the term ‘essential’, which we view as being too subjective to interpret and arguably does not cover the services which it intends to. We note that paragraph 4.32 lists some of those services which might be deemed ‘essential’, however some would question whether this is true of services such as postal services, certain public transport and insurance. If the term remains as ‘essential’, a principle based definition should be included rather than using examples.

We recommend that 4.4(c) (ii) should be replaced with, ‘*support the rate-regulated entity’s ability to finance its activities*’.

*‘Establishes parameters for rates (sometimes referred to as prices or tariffs) that provide regulatory protections that: i) support greater stability of prices for customers: and ii) support the rate-regulated entity’s ability to finance its activities ~~support the financial viability of the rate-regulated entity~~ [paragraph 4.4(c)]*

Question 5(c)

The definition should include reference to there being an ‘independent external regulatory body’. This is an important feature of defined rate-regulation and will remove from scope those entities which ‘self-regulate’ such as co-operatives (see question 12).

#### **Question 6**

**Paragraphs 4.62–4.72 contain an analysis of the rights and obligations that arise from the features of defined rate-regulation.**

- (a) Are there any additional rights or obligations that you think the IASB should consider? Please specify and give reasons.**
- (b) Do you think that the IASB should develop specific accounting guidance or requirements to account for the combination of rights and obligations described? Why or why not?**

Question 6(a)

Our view is that this section does identify the key rights and obligations that arise from the features of defined rate-regulation. However, as discussed in our response to Question 1, we are concerned that the Discussion Paper’s primary focus is the Statement of financial position rather than the improvement of reporting financial performance and estimation of future cash flows.

We support the view that the ‘right to recover the revenue requirement’ is the most distinguishable feature of defined rate-regulation and that the enforcement of rights and obligations by the regulatory contract through the ‘revenue requirement’ as being also an important defining feature.

Question 6(b)

The IASB should develop specific accounting requirements to enable the financial statements to incorporate the effects of defined rate-regulation activities on an entity’s performance and future cash flows. It is important that the financial statements capture this,

as defined rate-regulation in many, if not all circumstances, can have a large economic impact on the performance of an entity and its expected future cash flows.

### **Question 7**

**Section 5 outlines a number of possible approaches that the IASB could consider developing further, depending on the feedback received from this Discussion Paper. It highlights some advantages and disadvantages of each approach.**

**(a) Which approach, if any, do you think would best portray the financial effects of defined rate-regulation in IFRS financial statements and is most likely to provide the information that investors and lenders consider is most relevant to help them make their investing and lending decisions? Please give reasons for your answer?**

**(b) Is there any other approach that the IASB should consider? If so, please specify and explain how such an approach could provide investors and lenders with relevant information about the financial effects of rate-regulation.**

**(c) Are there any additional advantages or disadvantages that the IASB should consider before it decides whether to develop any of these approaches further? If so, please describe them.**

**If commenting on the asset/liability approach, please specify, if it is relevant, whether your comments reflect the existing definitions of an asset and a liability in the Conceptual Framework or the proposed definitions suggested in the Conceptual Framework Discussion Paper, published in July 2013.**

### Question 7(a)

Of the four options described in the Discussion Paper, our view is that developing specific IFRS requirements to defer or accelerate the recognition of revenue would most effectively communicate the financial effects of defined rate-regulation.

It will be noted that we have removed the reference to also deferring or accelerating costs. We believe this is conceptually inappropriate as costs fundamentally should be reflected in the period they are incurred, rather than being deferred until they are recovered through the revenue mechanism. In addition, cost deferral would only capture cost items which are recovered through the revenue mechanism and would exclude items such as volume variances and performance incentives.

With regard to the other three options in the paper, they are currently insufficiently developed to form a definitive view and do not appear to be as effective in reflecting the effects of rate-regulation as does the revenue approach.

In relation to the recognition of an intangible asset to represent the package of rights and obligations, we struggle to see how this would work as it would not allow for a liability position (negative asset) and conceptually any intangible asset should put a valuation on the broader regulatory licence itself, rather than representing the net rate-regulatory deferral balances adjusted for through the revenue mechanism.

In relation to the application of regulatory accounting requirements, we believe this approach would undermine the comparability between companies that operate under different

regulatory regimes. Moreover, we note that not all regulatory regimes specify their own accounting requirements.

In relation to prohibiting the recognition of regulatory deferral account balances in IFRS financial statements, this would merely continue to exclude from IFRS financial statements the often significant effects which defined rate-regulation has on an entity's financial performance.

#### Question 7(b)

We believe that a revenue approach could be developed based upon the IFRS15 model which might allow for recognition within revenue in a particular period, of the difference between the amounts billed to customers during the period and the amounts earned as a revenue adjustment through the regulatory contract (regulatory performance obligations), to be adjusted for in future periods.

Defined rate-regulated entities operate in a unique economic environment, whereby the goods or service they provide are considered essential by the customer, there is effectively little or no competition and as such, individual customers have effectively no control over pricing, availability or quality. An argument might be that due to this unique economic environment a defined rate-regulator is established through the regulatory contract as a representative of the customer, which in effect creates an implied or quasi-contract between the rate-regulated entity and the collective customers.

Through this recognition of the regulator as a representative of the customer, this might enable the recognition of the revenue adjustment mechanisms imposed by the regulator as performance obligations per the IFRS15 model. These performance obligations are associated with the provision of goods and services in prior periods and their recovery is often considered virtually certain. Indeed we believe that this approach may help deal with many of the conceptual issues discussed in paragraphs 5.14-5.31.

Question 7(c) - no further comments.

#### **Question 8**

**Does your organisation carry out activities that are subject to defined rate-regulation? If so, what operational issues should the IASB consider if it decides to develop any specific accounting guidance or requirements?**

There will ultimately be a cost involved for preparers to report the effects of rate-regulation in the financial statements, but we are of the view that the benefits would outweigh those costs. However there are two particular areas over which care should be exercised.

Firstly, in relation to the recognition of revenue adjustments within the financial statements and the disclosure of the various adjustments made to revenue. Some entities will operate in several defined rate-regulated markets, each with its own set of regulatory adjustments. It will be important to recognise and disclose only the material adjustments (rather than every adjustment), to ensure that disclosure does not become too onerous for the preparer and unclear for the users.

Secondly, care should be taken not to overburden preparers with unnecessary disclosure requirements. We envisage that there will be a small number of key disclosures that will be sufficient as detailed within our responses to Questions 1 and 11.

#### **Question 9**

**If, after considering the feedback from this Discussion Paper and the Conceptual Framework project, the IASB decides to prohibit the recognition of regulatory deferral account balances in IFRS financial statements, do you think that the IASB should consider developing specific disclosure-only requirements? If not, why not? If so, please specify what type of information you think would be relevant to investors and lenders in making their investing or lending decisions and why?**

We firmly believe that IFRS financial statements should recognise the economic effects of defined rate-regulation on an entity's financial performance, to address the key issues being raised by preparers and investors. In the absence of achieving this objective, we do not support the development of a disclosure-only standard.

#### **Question 10**

**Sections 2 and 6 discuss some of the information needs of users of general purpose financial statements. The IASB will seek to balance the needs of users of financial statements for information about the financial effects of rate-regulation on an entity's operations with concerns about obscuring the understandability of financial statements and the high preparation costs that can result from lengthy disclosures (see paragraph 2.27).**

**(a) If the IASB decides to develop specific accounting requirements for all entities that are subject to defined rate-regulation, to what extent do you think the requirements of IFRS 14 meet the information needs of investors and lenders? Is there any additional information that you think should be required? If so, please specify and explain how investors or lenders are likely to use that information.**

**(b) Do you think that any of the disclosure requirements of IFRS 14 could be omitted or modified in order to reduce the cost of compliance with the requirements, without omitting information that helps users of financial statements to make informed investing or lending decisions? If so, please specify and explain the reasons for your answer.**

IFRS 14 is an interim solution based on recognising regulatory assets/liabilities which companies historically recognised prior to transition to IFRS. We do not believe this is a helpful starting point. Rather we believe a full IFRS solution should be developed based on IFRS principles.

As regards disclosures, we believe that the operational burden IFRS 14 places on preparers is not justified by the benefit to investors and lenders. Indeed, we believe any benefits to investors and lenders are reduced by the degree of clutter in the disclosures and that disclosures should be included to the extent that they are considered material. Where an

entity is involved in many rate-regulated activities under the jurisdiction of different regulators, the disclosures would cover many pages. The resulting rate-regulated activities disclosures would be out of proportion in the context of the financial statements as a whole and the information users need.

We believe the information we have set out in response to Question 1 would be most useful to investors and lenders.

#### **Question 11**

**IFRS 14 requires any regulatory deferral account balances that have been recognised to be presented separately from the assets and liabilities recognised in the statement of financial position in accordance with other Standards. Similarly, the net movements in regulatory deferral account balances are required to be presented separately from the items of income and expense recognised in the statement(s) of profit or loss and other comprehensive income.**

**If the IASB develops specific accounting requirements that would apply to both existing IFRS preparers and first-time adopters of IFRS, and those requirements resulted in the recognition of regulatory balances in the statement of financial position, what advantages or disadvantages do you envisage if the separate presentation required by IFRS 14 was to be applied?**

We would advocate that separate disclosure within the Statement of profit or loss and the Statement of financial position of regulatory deferral account balances is not required. These balances are a normal part of business activity and therefore there is no reason to report these separately from other amounts recognised, although some preparers may choose to do so. Introducing new lines into the primary statements could add to the complexity of these statements and therefore may be unhelpful for users.

In terms of comparability of financial statement between other defined rate-regulated entities and entities which are not subject to such regulation, the information contained within the notes as set out in our response to Question 1, should enable investors to determine the effects of defined rate-regulation on an entity's performance and position and therefore adjust for these if necessary.

### Question 12

Section 4 describes the distinguishing features of defined rate-regulation. This description is intended to provide a common starting point for a more focused discussion about whether this type of rate-regulation creates a combination of rights and obligations for which specific accounting guidance or requirements should be developed.

Paragraph 4.73 suggests that the existence of a rate regulator whose role and authority is established in legislation or other formal regulations is an important feature of defined rate-regulation. Do you think that this is a necessary condition in order to create enforceable rights or obligations, or do you think that co-operatives or similar entities, which operate under self-imposed rate-regulation with the same features as defined rate-regulation (see paragraphs 7.6–7.9), should also be included within defined rate-regulation? If not, why not? If so, do you think that such co-operatives should be included within the scope of defined rate-regulation only if they are subject to formal oversight from a government department or other authorised body?

It would seem an appropriate and important feature of defined rate-regulation that the regulator is defined as an independent external body whose role and authority is established in legislation or other formal regulation, as suggested within our response to Question 5(c). This would create the contract between the entity and the regulator through which the revenue adjustments can be effectively enforced. As a result this would exclude 'self-regulated' entities such as co-operatives from the definition of a defined rate-regulated entity.

Finally we are concerned that the term 'enforceable rights' could be interpreted as 'legally enforceable rights' and for this to become a recognition criterion for assets and liabilities. This might create too high a hurdle for some rate-regulatory regimes, especially when mechanisms exist for appeal. As such we believe that recognition should be based upon a probability assessment by management, taking account of the regulatory contract that is in place between the entity and the regulator.

### Question 13

Paragraphs 7.11–7.22 highlight some of the issues that the IASB may consider if it continues to progress this project.

Do you have any comments or suggestions on these or any other issues that may or may not have been raised in this Discussion Paper that you think the IASB should consider if it decides to develop proposals for any specific accounting requirements for rate-regulated activities?

No further comments.



# Summary of water industry regulatory mechanisms in England & Wales (2015-2020)

helping life flow smoothly

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## AMP6 mechanisms:

- Wholesale price controls
- Retail price controls
- Retail service incentives (SIM)
- Stakeholder outcome incentives (ODIs)
- Wholesale expenditure incentives (Totex)

## Appendix: Definitions

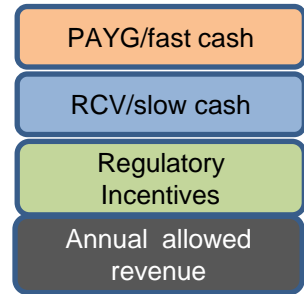
# Background

## Regulated nature of the water industry

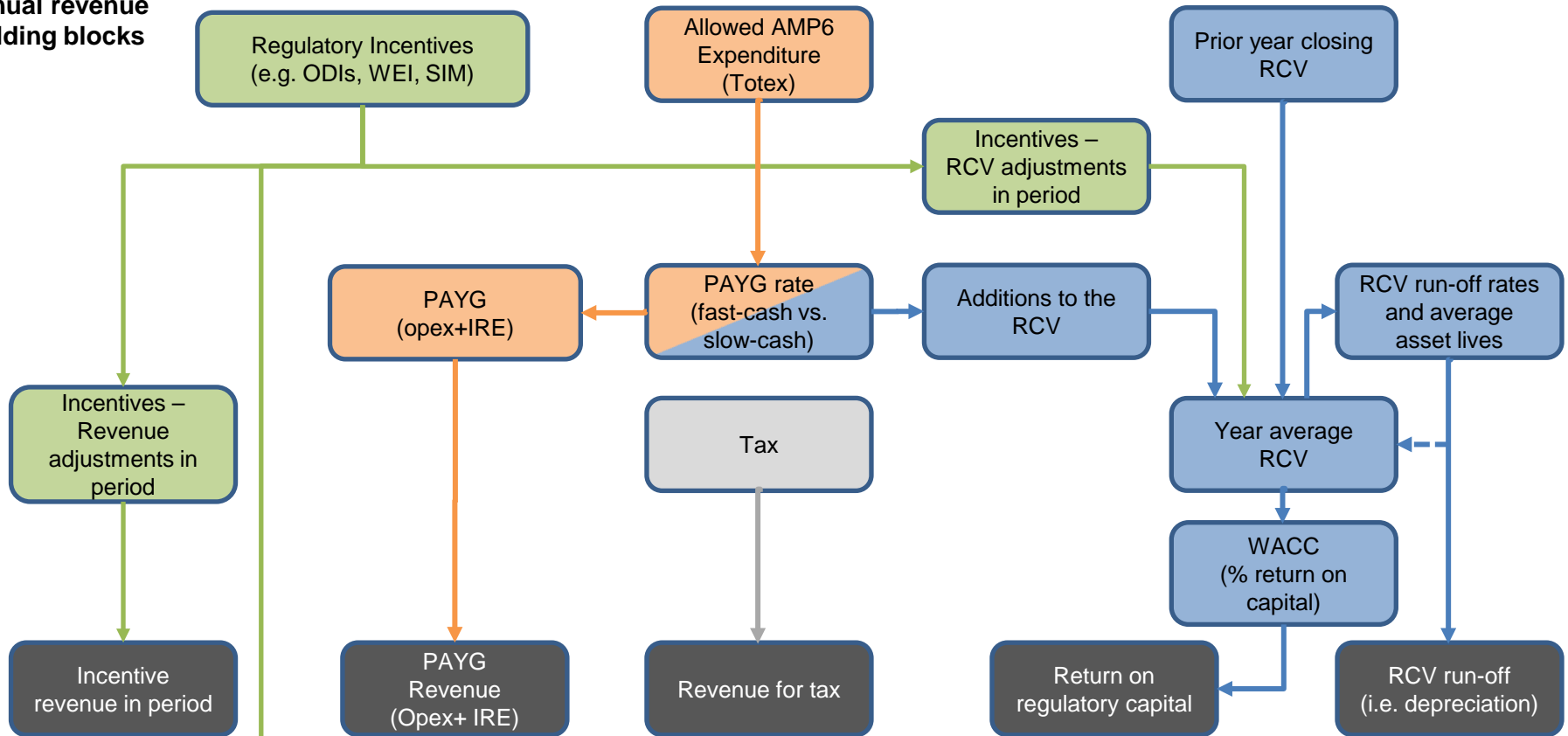
- Appointed water companies to comply with a suite of:
  - Statutory,
  - Licence<sup>1</sup> (contractual), and
  - Regulatory obligations<sup>1</sup> (obligations/interpretations set by the regulator)
- Regulators also expect companies to demonstrate that they have taken steps to understand and meet customer expectations
- Failure to comply with these obligations can lead to a suite of penalties and/or enforcement actions

<sup>1</sup> OFWAT retain the authority to revoke or alter the licence and regulatory obligations prospectively, and regulatory obligations retrospectively. In such an event water companies can appeal to the Competition and Market Authority (CMA) and/ or seek a judicial review.

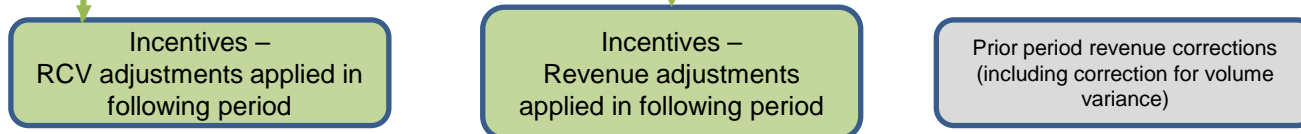
# Overview of water industry rate-regulatory mechanisms (2015-2020)



## Annual revenue building blocks



## Accrued future period revenue adjustments



# Regulated Asset Base (RAB) based regulation

Incentive mechanism	<b>Regulatory Capital Value</b>
Description	<p>The RCV has been developed for regulatory purposes and is primarily used in setting price limits. It is Ofwat's primary mechanism for determining the required return on the capital invested in regulated businesses. The RCV is remunerated through price limits at a cost of capital (on a real basis) that is set at each price review. The value of the RCV is adjusted for inflation each year by RPI.</p> <p>The RCV is now widely used by the investment community as a proxy for the market value of the regulated business and has, in some instances, become enshrined in bond covenants.</p>
Recoverability	<p>The current value of water industry RCVs is in excess of £64bn. Company licences explicitly require price setting to be based in part on an RCV, and during the current price setting process for the 2015-20 period Ofwat committed to honour the full value of company RCVs for the duration of the period.</p> <p>However the RCV is not mandated under primary legislation, and Ofwat have powers (subject to an appeals process) to impose changes on company licences.</p>
Measurement	<p>RCV calculations for the 2015-20 period were initially calculated using forecast levels of wholesale capex, depreciation, and any company accelerations to the draw down of the RCV.</p> <p>The RCV will then be trued-up to reflect actual company investment levels at the opening of the next price control period.</p>
Timing	<p>The RCV represents a very long term commitment from the Regulator, with no mandatory remuneration point for investors. Currently industry average asset lives of c.25yrs are used to estimate the run off rate of the RCV (analogous to a current cost depreciation of the RCV)</p>
Reassessment	<p>An annual true-up forecast of the RCV will be completed using historic and forecast expenditure levels and established regulatory calculations.</p> <p>However Ofwat have significant powers to investigate company historic expenditure, and could restate or reinterpret past reports when assessing company RCV corrections.</p>

# AMP6 mechanisms – Wholesale price controls

Incentive mechanism	<b>Wholesale revenue controls</b>
Description	<p>Ofwat has set two binding revenue caps for the wholesale elements of the business (water and wastewater) which link to RPI. The controls cap over 99% of all revenues from wholesale activities.</p> <p>The controls allow flexibility for companies to adjust specific customers charges annually. They include a revenue correction mechanism within the control period, allowing companies to recovery historic over/under recovery against the revenue cap by adjusting charges in future price control periods.</p> <p>The revenue correction mechanism also includes an accuracy incentive, penalising companies that materially over or under recover revenues in any given year.</p>
Recoverability	<p>The 2015-20 revenue cap constitutes a binding ex-ante price control as set out in primary legislation. Within legislation there is some limited provision for companies or Ofwat to reopen price controls within period, but only if predefined criteria are met (e.g. through an Interim Determination of Price (IDoK)).</p> <p>The revenue correction mechanism applied to the control is set out in Ofwat’s price review methodology. Ofwat retain the authority to revoke or retrospectively alter the correction mechanism, having due regard to their primary statutory duties to protect customers and ensure the financing of companies.</p>
Measurement	<p>Follows a formulaic calculation set out in companies’ final determination. Measurement is based upon total historic revenue to date, as reported and audited through regulatory accounts, and predictions for future years. Revenue corrections for future years are then aggregated to a price control level at the end of each charging year, with a net increase/decrease to water and wastewater tariffs being applied at the start of the next price control.</p>
Timing	<p>Impact in prior AMP period would typically be recovered on an annualised basis for the following five year period.</p>
Reassessment	<p>Once the final wholesale regulatory revenue for a charging period is closed a full and final assessment of the value and timescales of future revenue corrections can be derived. Ofwat have significant powers to investigate company historic reports, and could restate or reinterpret past revenues for the purposes of calculating compliance with regulatory revenue caps.</p>

# AMP6 mechanisms – Retail price controls

Incentive mechanism	<b>Retail price controls</b>
Description	<p>Ofwat has set two retail controls. The household retail control is based on allowed cost to serve plus margin, with an annual adjustment factor to reflect cost differences arising from differences between actual and expected customer numbers and levels of metering.</p> <p>The non-household retail control is an average revenue control with a limit on average revenue per customer for each customer type. These are referred to as ‘default tariffs’. Opening the market to competition in 2017 will allow companies to offer alternative service offerings (and different prices) to all non-household customers. The default tariff therefore provides a backstop protection for those customers which do not switch supplier.</p> <p>Both controls represent a fixed value control, and will not be adjusted in line with RPI.</p>
Recoverability	<p>The 2015-20 retail revenue caps constitutes a binding ex-ante price control as set out in primary legislation, with a modification factor to adjust for in period changes in household customer numbers. The retail household revenue annual adjustment factor applied to the control is set out in companies’ final determinations.</p> <p>Within legislation there is some limited provision for companies or Ofwat to reopen household retail price controls before 2020, but only if predefined criteria are met (e.g. through an Interim Determination of Price (IDoK)).</p>
Measurement	<p>Revenue controls are assessed based on calculations set out in companies’ final determinations. It is for companies to demonstrate compliance with price controls, based upon total historic revenue, as reported and audited through regulatory accounts.</p>
Timing	<p>Household retail revenue modifications will be applied on an ex-ante basis (using forecast changes in household numbers). It is unclear whether Ofwat will apply an ex-post true-up at the next price control (based on historic changes in household numbers).</p>
Reassessment	<p>Once the final retail regulatory revenue and customer numbers for a charging period is closed a full and final assessment of the value and timescales of future revenue adjustments can be derived. However Ofwat have significant powers to investigate company historic reports, and could restate or reinterpret past revenues and customer numbers for the purposes of calculating compliance with regulatory revenue caps.</p>

# AMP6 mechanisms

## Service incentives

Incentive mechanism	<b>Service Incentive Mechanism (SIM)</b>
Description	The service incentive mechanism (SIM) is an outcome-based customer service measure comprising a quantitative assessment, based upon six customer contact and handling metrics; and a qualitative assessment measured through a satisfaction survey of customers who have recently contacted the company. As part of the price setting process, companies are rewarded or penalised based upon their performance relative to the industry average over the price control period. In 2015-20, the maximum reward for an above average company is worth approximately 0.5% of appointed business revenue. The maximum penalty for a below average company is close to 1% of revenue.
Recoverability	Penalties/rewards associated with the period 2015-20 will be recovered through revenue controls for the period 2020-25. Commitments to the SIM are set out in Ofwat's price review methodology. Ofwat retain the authority to revoke or retrospectively alter any or all elements of the scheme, having due regard to their primary statutory duties to protect customers and ensure the financing of companies.
Measurement	Incident numbers are measured internally, performance levels are measured externally (by Ofwat), with all values subject to detailed audit, assurance and governance. Each companies performance is assessed relative to other companies, and calculated at the end of the price control period based on average performance over that period.
Timing	Impact in prior AMP period would typically be recovered on a straight line annualised basis for the following five year period
Reassessment	As performance is a relative measure and reflects average performance over a number of years the forecast rewards/penalties require retrospective reassessment at the end of each year.

# AMP6 mechanisms

## Stakeholder outcome incentives

Incentive mechanism	Outcome Delivery Incentives (ODIs)
Description	<p>For the period 2015-20, each company has been required to develop a suite of outcomes (customer experience measures) and “measures of success”, tangible deliverables/measurables, which can be used to demonstrate delivery against the outcomes. The measures provide an overall view of company performance and service delivery. The size of the associated outcome delivery incentives are based upon customer willingness to pay, with penalties in individual years being dependent upon actual performance against the annual performance target for that year. Dead bands are utilised to account for variability outside company control and penalty caps or reward collars are used to constrain the overall value of rewards and penalties.</p>
Recoverability	<p>Specific mechanisms proposed by companies, and agreed by Ofwat as part of the 2015-20 price control final determinations, are in place for each measure. Each company proposes their own individual mechanisms for the recovery of rewards/penalties. For most water companies all performance rewards for the 2015-20 period will be recovered through revenue controls for 2020-25, either directly as a revenue adjustment or indirectly through an adjustment to the RCV, however some companies will have in period revenues adjusted. Commitments to ODI mechanisms are set out in Ofwat’s price review methodology. Ofwat retain the authority to revoke or retrospectively alter any or all ODIs, having due regard to their primary statutory duties to protect customers and ensure the financing of companies.</p>
Measurement	<p>Performance or delivery of individual outcomes is generally measured and audited internally, although some outputs are recorded by third party regulators such as the EA or DWI. Currently Ofwat have provided little detail as to what assurance work they will seek to undertake on company reported performance against ODIs.</p>
Timing	<p>Impact against each measure is assessed annually based upon performance against the target for the year. Penalties and rewards are then aggregated to a price control level at the end of the period, with a net reward/penalty payable through revenue controls for 2020-25 for each separate price control.</p>
Reassessment	<p>As measurement is on an annual basis and assessed against companies’ specific targets there is limited scope for a company to retrospectively restate historic performance. However Ofwat have significant powers to investigate company historic performance, and could restate or reinterpret past performance when assessing company rewards/penalties under the ODI regime.</p>



# AMP6 mechanisms

## Wholesale expenditure incentives

Incentive mechanism	<b>Totex expenditure incentive scheme</b>
Description	For AMP6 Ofwat have independently determined each companies' efficient level of expenditure for water and wastewater wholesale activities. To do this they used a "Totex" based approach and utilise a single integrated incentive mechanism for all wholesale expenditure. "Totex" refers to "Total Expenditure", being the sum of both capital and operating expenditures. Once the totex assumption (baseline) has been set the impacts of over/(under) spend against this baseline will be shared between companies and customers. Approximately 50% of the impact of outperformance or underperformance will be passed to customers.
Recoverability	Penalties/rewards associated with the period 2015-20 will be recovered through revenue controls for the period 2020-25, either directly as a revenue adjustment or indirectly through an adjustment to the RCV. The exact mechanism for determining rewards and penalties is yet to be defined by Ofwat. Unlike in AMP5 and previous periods, there is no change protocol mechanism in place to retrospectively adjust the Totex baseline, meaning Ofwat could only alter the baseline within the 2015-20 period in the event of a full reopening of the price controls (using the IDoK provisions within companies' licences). Commitments to the Totex incentive scheme is set out in Ofwat's price review methodology. Ofwat retain the authority to revoke or retrospectively alter any or all elements of the scheme, having due regard to their primary statutory duties to protect customers and ensure the financing of companies.
Measurement	Mainly formulaic calculations with known variables. Measurement is based upon total wholesale expenditure in the price control period, using reported and audited costs . Penalties/rewards will then be aggregated to a price control level, with a net reward/penalty payable through revenue controls for 2020-25 for each separate price control. As revenue controls for 2020-25 are likely to be set in 2019 it is likely a further adjustment to revenues will be required after 2020 to true-up rewards/penalties for actual performance levels in 2020.
Timing	Impact in prior AMP period likely to be recovered on an annualised basis for the following five year period.
Reassessment	In theory penalties and rewards under the Totex incentive scheme will be based on a formulaic comparison of baseline and actual expenditure, with very limited discretion in reporting or calculation methodologies. However in practise Ofwat have not publically committed to a final calculation methodology for the mechanism, limiting the ability of companies to forecast final reward/penalties with certainty. As a result company annual assumptions could be subject to potential retrospective revisions. 10

# Appendix: Definitions

<b>AMP6</b>	Asset management period number 6 since privatisation (2015-2020)
<b>IRE</b>	Infrastructure renewals expenditure (maintenance expenditure, expensed in period)
<b>ODI</b>	Outcome delivery incentives
<b>PAYG</b>	Pay as you go rate (determines the split of expenditure between opex and capex)
<b>RCV</b>	Regulatory capital value
<b>SIM</b>	Service incentive mechanism
<b>Total</b>	Total expenditure (opex and capex)
<b>WACC</b>	Weighted average cost of capital
<b>WEI</b>	Wholesale expenditure incentives