Meeting Summary of UKEB's Rate-regulated Activities Technical Advisory Group meeting held on 13 December 2023 from 11am to 2pm

Item No.	Agenda Item
1	Welcome and apologies
2	IASB tentative decisions
3	Total Expenditure Mechanism Example
4	Enforceability
5	Inflation
6	Topics tracker
7	AOB

Present	
Name	**Designation**
Phil Aspin	UKEB member and RRA TAG Chair ("The Chair")
Robin Cohen	UKEB member
Seema Jamil-O'Neill	Technical Director, UK Endorsement Board
Claire Howells	RRA TAG member
Dean Lockhart	RRA TAG member
James Sawyer	RRA TAG member

Present	
Name	**Designation**
Sam Vaughan	RRA TAG member
Simon Davie	RRA TAG member
Stefanie Voelz	RRA TAG member
Stuart Wills	RRA TAG member
Suzanne Gallagher	RRA TAG member
Will Gardner	RRA TAG member
Mariela Isern	IASB staff

Relevant UKEB Secretariat team members were also present.

Welcome and apologies

1. The Chair welcomed the members and IASB staff member.

IASB tentative decisions

2. The UKEB Secretariat introduced the paper which provided:

   a) An update on the IASB's tentative decisions made at its September 2023 and October 2023 meetings which comprised credit and other risks and the boundary of the regulatory agreement.

   b) An overview of the IASB staff's feedback on the responses to their survey on the direct (no direct) relationship concept.

   c) An overview of the feedback received from the IASB's Consultative Group on Rate Regulation meeting on 13 October 2023 during which the discount rate was discussed.

Credit and other risks

3. Member views were sought on the IASB's tentative decisions regarding the estimation of uncertain future cash flows including credit and other risks (IASB Agenda Paper 9A – September 2023). In the ensuing discussion, the following points were highlighted:

a) There was general consensus that the IASB's tentative decisions appear reasonable and sensible. Most members noted that credit risk is not high in the energy and water industries.

b) One member noted that, for their entity, the credit risk was higher as their customers comprise a more transient population but that the regulator factors this into the agreement to reduce this risk. Concern is how the regulator's approach towards this may change.

c) A UKEB member commented that demand risk may be more significant for airports. This may have changed since post-Covid, however. The UKEB Secretariat responded that the traffic risk sharing mechanism addresses this risk by compensating the airports if passenger numbers (demand) are outside a certain band over or under the estimated numbers.

d) A member commented that, under Ofgem's Supplier of Last Resort (SoLR) Procedure, the SoLRs incurred additional costs to transfer customers to them while they also had to honour any credit balances customers had with the failed suppliers. The SoLRs were permitted to recover the additional costs through claiming a Last Resort Supply Payment (LRSP). The regulator issued a side letter permitting the SoLRs to defer the additional costs they incurred until the costs were recovered through the LRSP. In the absence of the side letter, entities would have had to recognise the costs but no revenue for the recovery of the costs. It was noted that under the new standard they would have been able to recognise, in the same period as the costs, an asset for the revenue to be received in future.

Boundary of the regulatory agreement

4. Member views were sought on the IASB's tentative decisions on the boundary of the regulatory agreement (IASB Agenda Paper 9B – October 2023). In the ensuing discussion, the following points were highlighted:

a) There was consensus that the tentative decisions on the boundary were sensible.

b) The IASB staff commented that they will be bringing further papers to the IASB Board to discuss this issue.

5. The Chair responded and said that it would be important to understand how the tentative decisions relating to boundary relate to some of the licences in the UK. For example, the UK water sector typically has indefinite (or perpetual) licenses with a 25-year notice period.

IASB staff feedback on the responses to the survey on the direct (no direct) relationship concept

6. There were no comments on the summary of the feedback by the IASB staff on the responses to the survey on the direct (no direct) relationship concept (IASB Agenda Papers 9B and 9C – September 2023 and IASB Agenda Paper 9A – October 2023)

IASB Consultative Group on Rate Regulation meeting

7. Member views were sought on the summary of the meeting of the IASB's Consultative Group on Rate Regulation (CGRR) held in October 2023 during which feedback was obtained on the discount rate (IASB CGRR Agenda Paper 1 and 2). The following comments were made:

   a) The Chair asked the IASB staff that, if there is no regulatory interest rate and no minimum interest rate, what is the backstop for a discount rate? The IASB staff responded that they will be looking further at this issue.

   b) A member commented that an explicit allowance for working capital is granted to rate-regulated entities in those jurisdictions where there is no regulatory interest rate.

Total Expenditure Mechanism Example

8. Member views were sought on whether the examples were a reasonable approximation of what happens in practice and, although not as detailed as the adjustments in practice, is a fair reflection of how the mechanism works in their sectors. In the ensuing discussion, the following comments were made:

   a) The Chair stated that this Totex adjustment mechanism is a material issue for the UK, especially when considering its proportion to the net asset value of the entity (as this is what shareholders would look at). Some preparer members confirmed that this will be material for their entities. In response to this, a user member noted that, when looking at the business plans for entities in the water sector and considering the adjustments expected to go through the RCB in the next price control period, this only amounts to around 4% of total assets. On this basis, it does not look very material. The Chair questioned whether it is correct to consider it against total assets as the shareholders will typically assess it from the perspective of the value of the business, which is the net asset value (or equity).

   b) The UKEB Secretariat stated that netting off is going against IFRS especially considering the size of these numbers so the materiality will also need to be looked at at a gross level (as a percentage of total assets).

c) The UKEB Secretariat also referred to the discussion of the discount rate that took place earlier in the meeting and stated that discounting shouldn't be removed without bearing in mind consistency with other IFRSs.

Appendix A: Example A (Operating expenditure overspend)

d) A member from the water sector confirmed that the example is in line with how it works in practice. The member mentioned that there is also now a discussion by the regulator to include gross tax in this type of mechanism. Currently, the regulatory model on tax is based on a cash tax basis. It was confirmed by the UKEB Secretariat the tax and deferred tax will be addressed at a later stage.

e) Members from both sectors were asked to check whether the mechanism works this way and they confirmed that they would do that.

Appendix B: Example B (Capital expenditure overspend)

f) A member asked whether the regulator would bundle up all the under and overspend on the different mechanisms into one "midnight adjustment". The Chair responded that this is the return on what would have been earned in regulatory depreciation and return on the regulatory capital base (RCB) in the current period (if the actual amounts had been used by the regulator when estimating the allowed revenue and RCB for that year). What gets adjusted to the RCB is the under or overspend and the allowed inflation. The entity will earn this in future years as regulatory depreciation and regulatory return is included in allowed revenue in future years.

g) Another member commented that this highlights that there is a disconnect between the amount of property, plant and equipment (PPE) and the amount of RCB. The member continued to say that, e.g. due to current political pressure, the energy regulator is tending to push a higher allocation of costs to the RCB [to be recovered over the regulatory depreciation period]. Regulatory mechanisms in future price control periods are likely to reflect this pressure. The UKEB Secretariat responded that this means that it is even more important to consider the impact of these decisions [to allocate expenses to RCB] on IFRS accounts.

Appendix C: Canadian utilities

9. Member views were sought on examples of the net regulatory balances and net assets (as at 31 December 2022) and the ratio of these two balances of some Canadian utilities (using US GAAP, which permits the recognition of regulatory account balances) in Appendix C. The member views were sought regarding the size of the regulatory balances they expect to have in their entities. In the ensuing discussion, the following comments were made:

a) The Chair said that, for the entities in the water sector, performance materiality is typically £20 million.

b) A member commented that, in their entity (energy sector) that the quantum of net regulatory assets/liabilities would be above performance materiality. They will check the impact on gross assets and gross liabilities.

c) Another member from the water sector said that the revenue adjustment for their entity would be around £250 million, ignoring the £1.5 billion deferred tax amount.

Enforceability

10. Member views were sought on the tentative decisions made by the IASB regarding enforceability (scope and recognition) as well as whether the regulators in the UK typically agree on the adjustments. In the ensuing discussion, the following issues were highlighted:

a) There was general consensus that the tentative decisions were reasonable. Regulators have legal standing and legal powers. The members were also in agreement that this is more a measurement issue than an enforceability issue as it is typically more about the amount the regulator agrees as an adjustment rather than whether the entity will be allowed the adjustment.

b) A member commented that the list provided in paragraph 27 of the ED is useful in assessing the enforceability and other members generally agreed.

Inflation

11. Member views were sought on whether the examples provided in the paper is a reasonable reflection of how the inflation adjustment works in practice. A number of questions were posed to the members.

12. The Chair commented that a “bottom-up” model would be difficult but that, possibly, a “top-down” approach could be operationalised that would address the cost/benefit issue with this adjustment.

13. Member views were sought on a number of questions asked in the paper. The following issues were highlighted in the ensuing discussion:

Question 1: Do members agree with the draft analysis of the Real inflation approach adjustment set out in the paper?

14. There was general consensus that the paper reflects the mechanism correctly.

15. One member commented that in Example C, the return on capital should be excluded from the RCB, as this goes into revenue and not the RCB as shown in the

example. There was agreement that this was correct, but also recognition that this correction to the worked example did not change the principal being illustrated.

Question 2: Does your regulatory agreement specify use of the Nominal approach or the Real approach when recognising inflation adjustments?

16. One member from the energy sector confirmed that the Nominal approach is used in their US operations.

17. Other members commented that, in future, there may be changes to this approach by the energy regulator with respect to the cost of debt element in the weighted average cost of capital (WACC) allowance for transmission and distribution. There are several media reports on this, one of which can be found here.

18. The Chair commented that, in the water sector, the Real approach will continue to apply but that there may be a claw-back that will apply from a debt perspective. The model is not under consultation, but there may be an additional adjustment.

Question 3: Are there any other inflation adjustments which your regulator permits that have not been included in this example (excluding the true-ups between the estimated inflation rate and the actual inflation rate)?

19. No comments were received.

Question 4: Do TAG members believe that the entire inflation adjustment to the RCB meets the criteria for regulatory asset recognition? And Question 6: Do you think that not recognising the inflation adjustment to the RCB may create a mismatch in the financial performance and/or financial position of entities with index-linked debt?

20. The was general consensus that the entire inflation adjustment does meet the criteria for regulatory asset recognition. This is consistent with the IASBs own deliberations.

21. A member expressed concerns about the lack of symmetry that would exist if the inflation adjustment is recognised without recognising other adjustments made through the RCB. The UKEB Secretariat responded by saying that it is important to establish the nature of other RCB adjustments.

22. The Chair commented that all finance costs are on a nominal basis in the income statement and that in recent reporting periods this had resulted in a very perverse situation with a low/negative EPS while economic returns were very high (as the inflation adjustment to the RCB was not recognised in the income statement). Specialist investors understand the inflation impact, but generalists (and machine trading algorithms) didn't. This was illustrated with the reaction to the share price at recent reporting dates. Specifically, there was a 10% share price decrease on

the morning of publishing their IFRS results (in 2022), and similar reactions in 2023, due to trading based on reported headlines of the IFRS results. At the 2022 results a broker analyst identified this issue as a buy opportunity for his clients in early trading. Once the broader market understood the share price recovered

23. A member from the energy sector commented on this by stating that the impact of the inflation uplift to the RCB is not reflected in the income statement and that this is not well understood by the press. His entity provides a reconciliation in their investor presentation to explain the impact of inflation on the accounts. The UKEB Secretariat asked whether this means that users are encouraged to move away from using the IFRS accounts. The Chair commented that generalist investors generally only look at the income statement. The Chair commented that this highlights that the IFRS accounts do not currently reflect the economics of rate-regulated entities, and this is a significant shortcoming in the current high-inflation economic environment. There is expected to be less volatility year-on-year during times of lower and stable inflation.

24. A member asked whether this is unique to the UK? Another member responded that Italy, France, Germany, Australia and some other countries also use the Real approach, while in the Netherlands there is a mix between Real and Nominal. The member made another observation that inflation being put through is actually outdated, so there will always be a mismatch anyway. As a specialist user, she would consider putting a nominal return through the accounts as misleading, but this may not reflect the views of other users.

25. The Chair pointed out that corporate entities' access to index-linked debt was significantly impacted by whether there was a liquid sovereign index-linked bond market. The UK has a very deep and liquid index-linked gilt market which supported issuance of corporate index-linked debt. The same was not universally true in other jurisdictions which would likely result in utilities in those jurisdictions not issuing index-linked debt and having to accept the basis risk in their capital structure. Given the issuance of index-linked debt in UK corporates the UK is more sensitive to the issue as there is more volatility in the income statement caused by index-linked debt.

Question 5: In a situation where inflation settled around 2-3% per year, would the inflation adjustment to the RCB be a material amount for your entity?

26. A member from the energy sector commented that it would still be material as their RCB is approximately £15bn, so 3% inflation would equate to around £450m, which represents more or less 10 times the performance materiality of their entity. He also said that with the growing capital investment programmes, this would remain the situation. Other members from the energy and the water sectors confirmed that the inflation uplift to RCB is expected to remain material to their entities.

Question 7: Does your entity use index-linked debt? If so, what is the proportion of index-linked debt to total debt?

27. Comments received from members is that the ratio of index-linked debt to total debt ranges widely. A user member commented that, for water entities, the ratio is around 50% on average, while it is slightly lower in the energy sector. The Chair stated that privately-owned entities have more index-linked debt so their average would be greater than 50% while listed entities would be lower.

28. The Chair asked members if they could share their entity's ratio of index-linked debt to total debt with the UKEB Secretariat. The members agreed.

Question 8: Do you consider that information relating to inflation adjustments is useful to users, e.g. an inflation-related regulatory asset?

29. There was general consensus that this is useful information as entities prepare investor presentations to explain this to their investors.

Question 9: Is the information available to track the inflation adjustments over time?

30. Members said that they would not have a list of inflation adjustments for the past and the IASB staff also commented that it would be challenging to show the split of the types of inflation that are being recognised and to which year it relates.

31. The Chair suggested that a top-down model may work operationally and provide useful information to users. This may involve tracking inflation at an overall portfolio level and recognising the difference between the PPE and the RCB.

32. A member commented that the "shadow RCB" is being tracked by entities and this could be used for bringing an amount onto the balance sheet.

33. The Chair said that it would be key to see whether this "top-down" approach can be operationalised and asked that the UKEB Secretariat look at it in more detail. He asked for members to volunteer assisting developing a model and a few members confirmed they would help with this.

34. The IASB staff said that an example would be helpful.

Topic Tracker

35. The topics tracker was not discussed.

Any other business

36. The Chair thanked everyone for their contributions and reminded the group that the next meeting is on 27 March 2024.

37. There being no other business, the meeting ended.