UK Endorsement Board

Rate-regulated Activities Technical Advisory Group

Meeting Summary - 24 March 2023 (in-person with virtual option)

Attendees

Name	Designation
Phil Aspin	TAG Chair
James Sawyer	TAG member
Kelly Martin	TAG member
Samuel Vaughan	TAG member
Stefanie Voelz	TAG member
Stuart Wills	TAG member
Suzanne Gallagher	TAG member
Will Gardiner	TAG member
Dean Lockhart	TAG member
Paul Lee	TAG member
Simon Davie	TAG member
Pauline Wallace	UKEB Chair
Robin Cohen	UKEB Board member
EFRAG staff	Observer (joined virtually)
IASB staff	Observers (joined virtually)

Apologies: Claire Howells (RRA TAG member)

Introduction

1. The Chair of the UKEB's Rate Regulated Activities Advisory Group (RRA TAG) welcomed the members to its inaugural meeting on 24 March 2023.

2. The RRA TAG received induction from the UKEB Chair, TAG Chair, UKEB Technical Director and UKEB Secretariat on the following topics:

   a) The role and remit of the UKEB;

   b) The role and remit of the RRA TAG; and

   c) The role and responsibilities of the RRA members.

3. The RRA TAG members agreed the due process for agenda setting, changes to appointment and other relevant matters set out in the Terms of Reference.

Technical discussion

4. The RRA TAG then considered a number of papers on topics where the IASB's outreach to stakeholders on the ED 2021/1 *Regulatory Assets and Regulatory Liabilities* raised significant concerns, being:

   a) Scope

   b) Total Allowed Compensation

   c) Discount rate

Scope

5. Members considered the various concerns about the scope of the proposed standard set out in the ED. It was concluded that an entity would only be within the scope of the proposed standard if it was party to a regulatory agreement that gives rise to a regulatory asset or regulatory liability resulting from a true-up to the regulatory rates charged to customers in future.

6. With respect to the interaction with IFRIC 12 *Service Concession Arrangements*, the IASB staff noted the tentative decision made by the IASB reflected the supplementary nature of the final standard—that is, an entity would apply IFRIC 12 first and then apply the requirements of the standard to any remaining rights and obligations to determine if the entity has regulatory assets or regulatory liabilities.

Total allowed compensation

7. The members agreed that the IASB's tentative decision to provide guidance on the timing differences instead of describing the various components of Total Allowed Compensation (TAC) was appropriate and a reflection of how regulation worked in the UK.

The direct or no direct relationship

8. The concept of whether there is or is not a direct relationship between the regulatory asset base/regulatory capital value (RAB/RCV) and the property, plant and equipment (PPE) recorded in the balance sheet is a fundamental part of the redeliberations on the proposals. The IASB staff noted that their outreach to date has shown that the direct relationship concept is common for cost-based regulatory schemes, while the no direct relationship concept is more common for incentive-based regulatory schemes.

9. The RRA TAG considered whether the regulatory agreements in the UK have the direct or no direct relationship characteristic. During the discussion, it became clear that the UK operated under incentive-based regulation whereas the proposed standard has more aligned to cost-based regulation. It therefore would be unlikely that a direct relationship would exist for majority of UK entities.

10. Members noted the following in respect of their sectors:

    a) Water: UK operations had no direct relationship. The regulator uses the RCV to determine the regulated rates. Reconciling the PPE with the RCV would be very complex and costly. There is also no specific link between the capex incurred and the RCV, while the RCV is also adjusted for inflation.

    b) Energy: UK operations had no direct relationship. Entities with US operations noted that they typically had a direct relationship. It was noted that the New York regulator requires a reconciliation between RCV and PPE. This disparity of treatment of different regulated entities within a group would make understanding the implications for the consolidation a key consideration.

11. The IASB staff confirmed that this feedback was consistent with the evidence received so far in response to their preparer survey regarding the direct/no direct relationship.

12. Subsequent discussion at the TAG raised the following points:

    a) Where no direct relationship exists, there would typically be no alignment of depreciation between PPE and the RCV.

    b) Where the regulator did not differentiate between capital and operating expenditure (as is typical of the incentive-based agreements in the UK), any performance adjustments may feed into either the RCV which would be increased at the end of the price review period with the remainder of the performance adjustment reflected through revenue.

    c) Some performance adjustments had the potential to have revenue timing difference, whilst others did not.

d) The above meant that while the IASBs proposed accounting model would provide a better representation of the economic performance it may still result in a mismatch between economic performance and its reflection in the IASB's proposed accounting model.

e) The IASB model may also lead to lack of comparability between two entities with the same regulator, as each entity would report its performance based on its own regulatory capital base or its revenue. There would therefore be slight differences on the accounting between entities.

Unit of account

13. A member noted that the unit of account is an important issue for consideration for the RRA TAG, that is whether it would be the asset base (RCV) as a whole or a specific subset? Other members concurred that this will be an important topic for future consideration.

Other aspects of TAC

14. Members also raised the following points about other aspects of the TAC.

a) Real cost of capital vs nominal cost of capital. The real cost of capital is typically linked to incentive-based agreements, while the nominal cost of capital is more typical for cost-based agreements.

b) Regulatory performance incentives for the entities and their interaction with the RCV may be very important for the proposed standard. In the water sector, for example, there are more than 25 performance mechanisms such as totex allowance, where the regulator does not differentiate between capex and opex. Over and underspends on totex may result in true-up which may be split between "fast" money and "slow" money (e.g., 60%/40%), where the fast money comes back to the company in the revenue, while the slow money comes back through an adjustment to the RCV. So, whilst some performance incentives have an impact on future revenue for the entity others do not.

c) The IASB staff noted that at its December 2022 meeting, the IASB tentatively decided that, if there is no direct relationship between PPE and the RCV, incentives added to the RCV would not result in a regulatory asset. This means that the company will only recognise a regulatory asset if it relates to revenue but not if it leads to an adjustment to the RCV (so may only recognise a partial recovery). This will lead to a mismatch between the accounting and the underlying economics (the latter will only be reflected in the regulatory returns).

d) Adjustments contained in regulatory agreements are also an important consideration.

15. Discussion amongst members also highlighted that, despite the potential for lack of complete comparability (between entities in the same sector and for the same entity from one period to another), the use of the proposed standard for rate regulated entities producing their annual accounts could help level the playing field for some investors. Currently, institutional investors have an advantage over other investors because they have specialist teams comparing regulatory accounts with accounting profit and forecasts which did not incorporate this complexity around regulation.

Inflation

16. Members highlighted that the current economic climate meant that inflation had become a significant factor. The regulatory capital base for UK entities is currently adjusted for inflation but is not recognised in the income statements, resulting in differences between the two.

17. The IASB's tentative decision is that an entity is neither required nor permitted to recognise as a regulatory asset inflation adjustments to the regulatory capital base.

Capitalisation of borrowing costs

18. It was also noted by members that the capitalisation of borrowing costs proposed in the IASB's model would be complex to apply in practice.

19. The IASB's tentative decision in November 2022 states that, if there is a direct relationship between the regulatory return on an asset not yet available for use and the borrowing costs incurred during construction and if regulatory returns include both a debt and an equity return and an entity capitalises borrowing costs incurred during construction, the entity would reflect in profit or loss those returns that are:

    a) in excess of the capitalised borrowing costs during the construction period. This will typically approximate to the equity return on the amounts invested in the construction of the assets.

    b) equal to the capitalised borrowing costs during the operation period.

20. It was agreed that the fact that the majority of UK entities within the scope of the proposed standard do not have a direct relationship between PPE and RCV would eliminate this expected complexity.

21. The IASB staff noted that, although the tentative decision was made in November 2022 regarding borrowing costs, they are still working through what this will mean for entities.

Tax and deferred tax

22. A member queried whether any decisions had been taken in relation to treatment of tax and deferred tax. The IASB staff clarified that this topic has not yet been discussed by the IASB. Another member noted that this is another issue with potential significant implications for UK entities due to the cash tax adjustment in regulatory agreements. Heavy investment in assets and the resulting capital allowances for tax purposes will result in recovery through a regulatory asset, which is expected to result in a significant uplift in the net worth of many companies. Members highlighted to the IASB staff that the issue of tax should not be underestimated. Members requested that this topic should be discussed by the group and the resulting paper shared with the UKEB for consideration.

Discount rates

23. The IASB staff highlighted that the IASB has not had the opportunity to discuss discount rates. Members had the opportunity to highlight the current use of discussion rates by relevant entities in the sectors as follows:

    a) discount rates in the water sector in the UK are typically set in the 5-year regulatory agreements and the real discount rate (as opposed to a nominal rate) is applied.

    b) It was also noted that the real rate is recovered through revenue, while the inflation component goes through the RCV.

24. The IASB staff noted that regulatory agreements generally determine the type of return on the RCV and the interest rate they may provide on regulatory assets and regulatory liabilities. When applying the standard, the first point of reference should be the terms in the regulatory agreement. Typically, a weighted average cost of capital (WACC) is provided as the regulatory return on the RCV. The regulatory agreement may provide different regulatory returns on assets in use and on assets under construction.

25. It was concurred that it would be important for the TAG to understand and explain to the UKEB the different approaches to discount rates on the regulatory agreements currently in place in the UK.

Benchmarks

26. Members views were sought on benchmarks, which are typically also used by the regulators to make adjustments to the regulatory returns. Sometimes a final benchmark is only published at a later date, e.g., customer satisfaction benchmark. Would this be known when the entity prepares interim accounts?

27. A member confirmed that it is typically easy to make a reasonable estimate as the companies usually have quarterly forecasts. The IASB staff said that the IASB's tentative decision on benchmarks referred to benchmarks determined after the

financial statements were authorised for issue and that the entity could not reasonably estimate before their determination.

Measurement and presentation

28. Measurement has not yet been discussed by the IASB, so no significant comments were made.

29. Presentation is still to be discussed by the IASB. A member noted that the proposed residual approach in the ED is useful as the relevant amounts can then be stripped out and providing further transparency to investors.

Forward agenda

30. TAG members agreed that the UKEB would have to prioritise the technical issues to discuss in the order the IASB uses for discussion of the topics.

AOB

31. There being no other business, the meeting closed at 14h00.

32. The next meeting is scheduled for 21 June 2023.

Glossary

Acronym:	Term:
Capex	Capital expenditure
ED	Exposure draft
EFRAG	European Financial Reporting Advisory Group
IASB	International Accounting Standards Board
IFRIC	International Financial Reporting Interpretations Committee
IFRS	International Financial Reporting Standards
Opex	Operating expenditure
PPE	Property, Plant and Equipment
RAB	Regulatory asset base
RCV	Regulatory capital value

RRA TAG	Rate-regulated Activities Technical Advisory Group
Totex	Total expenditure (both capital and operating expenditure)
UKEB	UK Endorsement Board
WACC	Weighted average cost of capital