

## **The role of regulatory accounts in regulated industries**

**A joint consultation paper by the:**

**Director General of electricity and gas supply;  
Director General of telecommunications;  
Director General of water services;  
Director General of electricity and gas supply (Northern Ireland);  
Rail Regulator; and  
Civil Aviation Authority;**

**October 2000**

## Introduction and Executive Summary

The Government's Green Paper on utility regulation 'A Fair Deal for Consumers' suggested that there would be benefits in companies producing regulatory accounts in a more standardised format. In particular this would facilitate wider understanding of regulatory issues. Following the Green Paper, an inter-regulatory working group was set up to identify and develop areas of consistency within published regulatory accounts.

The inter-regulatory working group's mandate covers the businesses regulated by the members of the working group. These businesses are active in gas, electricity, rail, telecommunications, water and sewerage and airport and air traffic control services, within the UK. Obligations to prepare regulatory accounts are usually only placed on companies with monopoly or market power in these industries.

The key themes of this consultation paper are that:

- ◆ there is broad agreement between regulators on the high-level principles for regulatory accounting arrangements;
- ◆ there is further scope to spread best practice between regulatory offices;
- ◆ the working group has identified areas where a consistent approach can be developed, for example in certain matters relating to audit and publication; and
- ◆ most regulators are also currently reviewing the adequacy of their sector specific regulatory accounting requirements. There are clear advantages for co-ordinating this work within the inter-regulatory working group.

The main areas where greater consistency can be achieved include:

- ◆ defining the purpose of regulatory accounts;
- ◆ producing a common regulatory accounting framework;
- ◆ providing a set of principles for the attribution, allocation and inter-business recharging of costs;
- ◆ defining the role of the Auditors;

- ◆ providing more descriptive analysis to explain the accounting statements; and
- ◆ reviewing publication issues.

Following consideration of the responses to this consultation paper a proposals document will be published in February 2001 and any consequential changes implemented by each regulator when practicable. It is envisaged that the working group will continue to meet throughout this process in order to discuss matters of common interest and identify issues where collective action would be appropriate.

The first chapter of this consultation paper provides background to the key issues and the second chapter identifies areas of general consistency and makes suggestions for further development. The third chapter identifies where specific changes can be made and the fourth chapter identifies the key issues on which consultees views are sought. The appendices include, an overview of regulatory accounts in each of the regulated industries, a proposal for a set of common regulatory accounting principles, a glossary, and a list of useful publications.

It would be helpful to hear from all those with an interest in the issues raised in this paper. Views are invited by 1 December and should be sent to:

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Responses will be published by placing them in the Ofgem library.

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# 1. Background

## *Overview*

- 1.1 Regulatory accounts are prepared to provide financial information about regulated businesses for use by the regulator, the industry, investors, consumers and other stakeholders. They provide information that is more focused than that contained in statutory accounts as they relate to regulated businesses or activities, whereas statutory accounts relate to the regulated company as a whole and are more focused on the requirements of investors. Where the regulated company is a subsidiary of a larger group the statutory accounting disclosure requirements are not as extensive as those for the ultimate parent company particularly where the ultimate parent company is listed on a major Stock Exchange.
- 1.2 Regulatory accounts may assist regulation in a variety of ways, depending on market structure and regulatory emphasis, the main ones being:
- ◆ monitoring performance against the assumptions underlying a current price control;
  - ◆ informing future price control reviews;
  - ◆ assisting in the detection of certain anti-competitive behaviour such as unfair cross-subsidisation and undue discrimination at levels of disaggregation appropriate to the relevant market; and
  - ◆ assisting in comparative competition, which is the process of benchmarking a company's performance in relation to other companies performance.

Chapter 2 provides more detail on the purposes of regulatory accounts.

### *Main issues from the overview of regulatory accounts in each industry*

- 1.3 Each regulator has a different emphasis when looking at regulatory accounts depending on the structure of the industry that it regulates.
- 1.4 Appendix 1 sets out an overview of the regulatory accounts in each industry, it can be seen from this appendix that the main focus of regulatory accounting arrangements is to provide information to assist in dealing with the monopoly or market power associated with network industries. Where there are significant differences between regulators these derive primarily from the structure of the industry rather than from differences of principle.
- 1.5 For example, in the telecommunications sector, regulatory accounting arrangements are designed to reflect the development of competition and the importance of monitoring and detecting anti-competitive behaviour such as unfair cross-subsidisation and undue discrimination. In areas where there is currently little competition between networks, such as water and sewerage, the focus is on ensuring that regulatory accounting arrangements provide consistency and transparency in order to monitor performance and support the resetting of price controls.
- 1.6 There is scope for developing the enforcement and monitoring of regulatory accounting arrangements on a sector specific basis, depending on the structure of each industry. Both OFWAT and OFTEL have developed detailed methodologies and guidelines relating to regulatory accounting principles and current cost accounting which set out in a detailed and transparent way the basis on which regulatory accounts are prepared. These include guidelines on cost attribution, cost allocation, inter-business recharging of costs and transfer pricing. Ofgem and ORR have recently published consultation papers that broadly support this approach. Ofreg and CAA are also considering ways of improving sector specific regulatory accounting arrangements.
- 1.7 Over time there have been significant changes in the structure of regulated industries following the development of competition, corporate restructuring, technological innovation and the evolution of regulatory policy. These developments have also resulted in changes to regulatory accounting in the industries concerned.

- 1.8 In particular the emergence of multi-utility groups has reinforced the importance of close co-operation between certain regulators with the main areas of concern relating to cost attribution, cost allocation and inter-business recharging of costs. At present Ofgem and Ofwat are the regulators most affected by multi-utilities following corporate restructuring involving water and sewerage companies and electricity distribution and supply businesses.
- 1.9 In general, the purpose of the working group is to create a framework under which the different treatments discussed above can be accommodated and to identify areas where best practice can be spread between regulatory offices and where appropriate, develop more consistent approaches.

## 2. General areas of consistency

- 2.1 The purpose of this chapter is to consider those aspects of regulatory accounting where consistency at a high level can be further developed. These include the purpose of regulatory accounts, a common regulatory accounting framework and the principles for cost attribution, cost allocation and inter-business recharging of costs.
- 2.2 A proposal for a set of general high level principles is included in appendix 2. The adoption of these general high-level principles will further develop consistency between the regulatory bodies whilst also being flexible enough to allow each regulator to determine industry specific requirements.

### *The purpose of regulatory accounts*

- 2.3 In determining the purposes of regulatory accounts the working group has considered the latest published views of the Accounting Standards Board (ASB), in particular its statement of principles for financial reporting. In essence, the main purpose of regulatory accounts should be to provide financial information about regulated businesses for use by the regulator, the industry, investors, consumers and other stakeholders. This would enhance the information available within the industry and aid in assessing the stewardship of management and informing economic decisions.
- 2.4 Some of the practical applications of regulatory accounts can include:
- ◆ monitoring performance against the assumptions underlying the current price control;
  - ◆ informing future price control reviews;
  - ◆ assisting in the detection of certain anti-competitive behaviour such as unfair cross-subsidisation and undue discrimination at levels of disaggregation appropriate to the relevant market;
  - ◆ assisting in comparative competition;
  - ◆ assisting in monitoring financial health; and



- ◆ improving transparency in the regulatory process, regulatory accounts are the main source of regular, published and audited information about regulated companies.
- 2.5 In order to achieve these objectives the regulatory accounts need to contain high quality information that is consistent both over time and within and across the relevant companies in the industry.

### ***Common regulatory accounting framework***

- 2.6 Statutory Accounts in the UK are prepared using a set of rules generally referred to as UK Generally Accepted Accounting Practice (UK GAAP), which is mainly based upon the accounting principles included in accounting standards issued or adopted by the ASB, that are currently in force in the UK, and UK Company Law. Similarly, for regulatory accounts, Regulatory Accounting Guidelines (RAGs) provide a set of rules to be used in the preparation of regulatory accounts.
- 2.7 The proposed common regulatory accounting framework will provide a structure for the preparation of regulatory accounts. Regulatory accounts will be prepared and audited using either the RAGs for that industry or, where a RAG does not cover the issue, UK GAAP. Where there is any conflict between RAGs and UK GAAP, then the RAGs will take precedence.
- 2.8 The basis of preparation of the regulatory accounts refers to the principles involved in the preparation of accounting information. The three main options are Historical Cost Accounting (HCA), Modified Historical Cost Accounting (MHCA) and Current Cost Accounting (CCA). The main differences between these options lie in the area of asset valuation. The majority of companies in the United Kingdom use HCA as the basis of preparation for their statutory accounts.
- 2.9 The valuation of the capital base is central to the formulation of price controls. For price control purposes most regulators have not relied upon reported asset valuations, whether based on HCA, MHCA or CCA principles, but instead have used their own estimates of an appropriate valuation for the capital base, which takes account of the circumstances of privatisation. This is commonly known as the regulatory asset base, regulatory capital value or regulatory asset value. Usually the RAV is based on rolling forward an initial privatisation or market

valuation by adjusting for depreciation, capital investment, disposals and inflation.

- 2.10 Nevertheless the approach adopted by each regulator reflects the specific circumstances of the industry concerned. Given this diversity of valuation methods it is not possible to achieve consistency in the basis of preparation of the regulatory accounts.
- 2.11 However, it would be more helpful to the users of the accounts if the full disclosure of the basis of preparation and the determination of the value of the RAV in the regulatory accounts or in supporting documentation was required. This disclosure will provide useful information for both the regulator and other stakeholders, whatever approach is taken.

### ***Discussions with the ASB***

- 2.12 The working group has discussed the technical accounting issues raised in this paper with the ASB. The development of a Statement of Recommended Practice (SORP) for each industry or an overall SORP for all regulated industries has also been considered by the working group. A SORP sets out current best accounting practice on accounting issues where it is not considered appropriate to issue an accounting standard. SORPs are issued by ASB recognised bodies and contain a statement from the ASB which they describe as a negative assurance statement.
- 2.13 The main advantage of a SORP that would cover some of the regulatory accounting issues, would be that the regulatory accounting arrangements to account for these issues would be incorporated into a recognised accounting framework. However, SORP's are designed for statutory accounts and in particular they cannot override an accounting standard. This would mean that a regulatory SORP could not cover certain areas because, where the particular circumstances prevailing in that industry indicate that a different approach should be taken, the RAG's for each industry may differ from UK accounting standards. As a consequence of this, it is unlikely that the working group will recommend the development of a SORP.

### *Cost attribution, cost allocation and inter-business recharging of costs*

- 2.14 The issues of cost attribution, cost allocation and inter-business recharging of costs are important to regulators. In order to avoid unfair cross-subsidy it is important that costs are allocated in an appropriate way, where possible on the basis of direct cost drivers, although there may be certain categories of costs where a greater degree of judgement is required. In many cases an appropriate approach to cost allocation will also facilitate comparative competition and comparisons with the assumptions made in setting price controls.
- 2.15 In order to enhance comparisons and consistency the attribution, allocation and inter-business recharging of costs for the different activities of the business in the regulatory accounts should be based on the same assumptions as in the RAG's.
- 2.16 It may be appropriate to consider whether more consistency can be achieved in the format of the regulatory accounts so that it is relatively straightforward for users of the regulatory accounts to compare companies from different industries. The published regulatory accounts should also include a comparison between the actual performance of the company and the assumptions underlying its price control.
- 2.17 Attributions, allocations and inter-business recharging should be based on a set of principles, the main ones being:
- ◆ Cost Causality; revenues, costs, assets and liabilities should be attributed in accordance with the activities which cause the revenues to be earned or costs to be incurred or the assets to be acquired or liabilities to be incurred;
  - ◆ Objectivity; all attributions, allocations and inter-business recharging of costs should be performed on an objective basis and should not be intended to unduly benefit the regulated company or any other company or organisation;
  - ◆ Consistency; where practicable all attributions, allocations and inter-business recharging of costs should be consistent from year to year,

where there are changes to the RAG's the regulated company should restate the previous years regulatory accounts; and

- ◆ Transparency; all the methods used in the attribution, allocation and inter-business recharging of costs should be transparent and the revenues, costs, assets and liabilities separately distinguishable from each other.

### 3. Specific areas of consistency

- 3.1 This chapter examines certain specific aspects of regulatory accounting where greater consistency can be achieved relatively quickly. These include the role of auditors, the provision of descriptive analysis and certain matters relating to publication.

#### *Role of the Auditors in regulatory accounts*

##### *Introduction*

- 3.2 Each regulated company that is required to prepare regulatory accounts also has to arrange for these accounts to be audited. The provision of an audit report is an important part of the requirements for regulatory accounts as it should enhance the quality, objectivity and credibility of the accounts, both to the regulator and to other users. At present, the auditors of a regulated company's statutory accounts typically audit its regulatory accounts. This, combined with problems relating to the consistency and quality of information contained in regulatory accounts, raises a number of issues regarding the effectiveness of the existing audit arrangements for regulatory accounts.

##### *Appointment of Auditors*

- 3.3 It is for consideration whether a company's statutory accounts auditors should be allowed to perform the audit of its regulatory accounts. In relation to the statutory accounts, statutory auditors are independent of management, but are appointed by and report to the shareholders on the directors' stewardship of the shareholder's interests. In the circumstances where the regulatory accounts are audited by the company's statutory accounts auditors it is not clear that the needs of the regulators will be met in relation to the audit of the regulatory accounts.
- 3.4 The objectivity and credibility of the regulatory accounts might be improved if the auditor of the regulatory accounts was different to the auditor of the statutory accounts. This may help to ensure that the needs of the regulator were taken more into account. It might also make it possible for the same firm to audit the regulatory accounts of all the companies in a sector so enhancing the

consistency of regulatory accounting information across companies. However, appointing such auditors might increase the costs of the audit if the auditors of the regulatory accounts needed to duplicate some of the work associated with the statutory audit and might also have implications for the timeliness of such reporting.

3.5 In the light of these possible extra costs it is necessary to consider whether other measures might be adopted that would nevertheless enhance the effectiveness of the existing arrangements. These might include modifying existing licence conditions to provide the regulator with the authority to:

- ◆ require the appointment of a different auditor if the existing audit arrangements prove unsatisfactory;
- ◆ require a second audit by the regulated company's auditors;
- ◆ require a second audit by a different auditor; and
- ◆ require a second audit of specific areas of concern, perhaps with the same auditors reporting on a number of different companies.

It will be important to consider the costs and benefits of these various measures before making final proposals with respect to these matters. If the regulator is going to require the appointment of a particular firm of auditors it would also be necessary to consider whether they should be remunerated by the regulator or the regulated company.

### ***Duty of Care, Materiality and the Audit Framework***

3.6 In the absence of an explicit duty of care to the regulator, the auditors may make judgements and issue an audit opinion on the regulatory accounts which reflects a reasonable position from the shareholder's point of view, even where this does not coincide with the interests of the regulator. In these situations the accounting treatments or disclosures adopted may not provide the regulator with the information they might expect or require.

3.7 It may be assumed that the auditors of the regulatory accounts of a regulated company have a duty of care to the shareholders of that regulated company.

However, it is not clear whether the auditors also have a duty of care to the regulators. As the regulators rely upon the audit report, it is likely that the auditor does also owe a duty of care to the regulator. This lack of clarity over the rights and responsibilities associated with the audit process needs to be resolved. It is also not clear what the auditors duty of care is to other interested parties.

- 3.8 At present it appears that the materiality level used for the audit of group level statutory accounts is sometimes used as the materiality level for the audit of the regulatory accounts. For some companies the group may be significantly larger than its regulated activities. In these circumstances the appropriate level for an issue to be material to the audit of the group may be significantly in excess of the appropriate materiality level for a regulated activity or business. Therefore, it may be more appropriate for the regulator to either set or approve the materiality levels for the audit of the regulatory accounts. Transparency could also be improved by disclosing either in the audit opinion or on the face of each accounting statement the materiality level used in the audit.
- 3.9 Although audit reports are addressed to the regulator, the wording of the audit opinion could be rationalised. Reflecting the fact that RAG's may take precedence over UK GAAP in the preparation of regulatory accounts, then it may no longer be appropriate to use "true and fair view" in the audit opinion. Another option would be "properly prepared in accordance with" which may not be appropriate, because it is relatively mechanistic and does not allow for the use of judgement on issues not covered by the RAG's. Probably the best option for the regulatory accounting audit opinion would be "presents fairly in accordance with", which is already used in some other similar regulatory situations.
- 3.10 Some of the issues identified above might be dealt with in the engagement letters with auditors. The existing engagement letters deal with the relationship between the regulated company and the auditor. These could be modified to include the regulator or there might be a separate engagement letter between the regulator and the auditor. The intention would be to place the relationships between all three parties on a more formal basis and the contents could include:

- ◆ the duty of care owed by the auditor to the regulator and liability levels;
- ◆ the disclosure of sensitive information to the regulator;
- ◆ the process for holding tri-partite meetings and written communication between the auditor, regulated company and the regulator and bi-lateral communications between the auditor and the regulator; and
- ◆ materiality levels.

***Provision of descriptive analysis***

3.11 At present, certain regulatory accounts lack a detailed commentary that would explain the figures included in the regulatory accounts. Some aspects of such commentaries are usually required in the accounts of companies listed on major stock exchanges. This deficiency can be resolved by requiring the following descriptive analysis, where relevant, to be included:

- ◆ a commentary discussing the results (where appropriate this commentary should be structured with regard to the ASB statement on operating and financial review);
- ◆ a comparison of actual results to the assumptions made in setting the price control;
- ◆ an explanation of the variances between the actual results, the results of the previous year and the assumptions made in setting the price control;
- ◆ discussion of results against plan and an outline of the forward plans for key business drivers such as principal capital expenditure projects, financing arrangements, organisational shape, quality of supply improvements and so on; and
- ◆ a formal statement of compliance with licence obligations such as charges being cost-orientated or that the Licensee has not unfairly cross-subsidised or unduly discriminated.



### *Publication issues*

3.12 Following corporate restructuring, in some industries there has been a consequent reduction in the amount of information available in statutory accounts, therefore the issues surrounding the publication of regulatory accounts have assumed greater importance. The current requirements vary across the regulatory bodies.

3.13 It will be for consideration what information should be included in the published regulatory accounts. In addition to the primary accounting statements, the associated notes and the auditors report it may be appropriate to include in the published regulatory accounts the information discussed in 3.11 as well as:

- ◆ a note setting out the regulated company's estimate of its RAV and how it was determined;
- ◆ a detailed statement of cost attributions, allocations and recharges;
- ◆ where appropriate, the additional information normally only required as part of a listed company's statutory accounts;
- ◆ a reconciliation between the information in the regulatory accounts and other relevant information, such as the statutory accounts, regulatory asset values or data on capital expenditure; and
- ◆ any other information that the regulator deems relevant such as references to licence conditions or RAG's.

3.14 In terms of the method of publication of the regulatory accounts, it will be at the discretion of each regulator as to how the regulatory accounts will be published, the options are

- ◆ as a stand alone document;
- ◆ as a part of the statutory accounts; or
- ◆ as part of another document.

- 3.15 The availability of the published regulatory accounts should also be properly publicised by the company so that stakeholders and the wider public are made aware that they are available. It would seem appropriate that all companies should be required to make them available on the internet.
- 3.16 Publication timetables vary across the regulated industries. Essentially, regulatory accounts should be published as soon as possible after the regulatory accounting year-end. The publication date should be no more than four months after the regulatory accounting year-end. However, the deadline may be delayed in a particular year, where a regulator consents to a request from the regulated company for additional time. An example of an acceptable delay may be where additional and complex disclosure requirements are added at a late stage in the reporting process.
- 3.17 At present certain companies prepare interim regulatory accounts on a half yearly basis. It is for consideration whether interim regulatory accounts should be prepared and if they are prepared, what information should be included in the published version.

## 4. Key Issues

- 4.1 Chapters 2 discusses areas where general consistency at a high level can be achieved and chapter 3 discuss the areas where specific issues can be addressed. In particular, we would like to hear your views on the following issues:

### *Areas of general consistency*

#### **1. The purpose of published regulatory accounts (paragraphs 2.3 - 2.5)**

- ◆ The main purpose of regulatory accounts is to provide financial information about regulated businesses for use by the regulator, industry, investors, consumers, and other stakeholders. Depending on market structure and regulatory emphasis regulatory accounts will mainly focus on price controls and or the prevention of anti-competitive practices such as unfair cross-subsidisation and undue discrimination.

#### **2. The proposed common regulatory accounting framework for the preparation of regulatory accounts (paragraphs 2.6 - 2.11)**

- ◆ The framework proposes that industry specific RAG's, which will be mandatory, will take precedence over UK GAAP, but where there are no industry specific RAG's then UK GAAP will apply.

#### **3. The cost attribution, allocation and inter-business recharging principles (paragraphs 2.14 - 2.17)**

- ◆ The main principles are that allocations of cost should be based on cost causality, objectivity, consistency, and transparency.
- ◆ The cost attribution, allocation and inter-business recharging of costs between the different activities of the business should where practicable, follow the assumptions made in the industry specific RAG's. The presentation of this information in the regulatory accounts should be consistent with the assumptions made in setting the price control.

### *Areas of specific consistency*

#### **1. The role of the auditors in regulatory accounts (paragraphs 3.2 - 3.10)**

- ◆ The main issues relate to the appointment of auditors, the duty of care that they owe and the audit opinion. Also, materiality levels and the audit framework are important issues to be considered.

#### **2. Provision of descriptive analysis (paragraph 3.11)**

- ◆ The main principle is that regulatory accounts should provide information, additional to that required by UK GAAP, that will enhance users understanding of the regulatory accounts.

#### **3. Publication issues (paragraphs 3.12 - 3.17)**

- ◆ The main issues relate to the publication timetable, the method of publication and what information should be published.

## Appendix 1 Overview of regulatory accounts in each industry

- 1.1 The purpose of this chapter is to provide a summary of the position in each industry, mainly with reference to:
- ◆ industry structure;
  - ◆ the current regulatory accounting reporting requirements;
  - ◆ an indication of how useful the regulatory accounts are; and
  - ◆ any future work on regulatory accounts that is planned by the regulator.

### *Ofgem*

- 1.2 Ofgem published a consultation paper on regulatory accounts in the gas and electricity industries in August 2000.
- 1.3 The network elements of both electricity transmission and distribution, and gas transportation are monopoly price controlled businesses. Electricity generation is now competitive. Subject to the satisfactory removal of barriers to entry, gas supply will no longer be subject to price control after March 2001. Assuming that competition develops as rapidly as expected in electricity supply, then electricity supply price controls will no longer be required after March 2002.
- 1.4 Regulatory accounts are prepared by the licensed businesses of the successor companies to the privatised utilities and also Independent Public Gas Transporters (IPGT's).
- 1.5 Regulatory accounts, in their present form in the gas and electricity industries, are generally considered to be inadequate by all the parties who use or prepare them, mainly because they do not provide sufficient information to monitor actual performance against the assumptions made in setting price controls.
- 1.6 In addition to this inter-regulatory project, Ofgem has also initiated its own review of regulatory accounts. The purpose of this review is to make regulatory accounts more relevant to stakeholders.

## *ofreg*

- 1.7 The transmission, distribution and supply businesses of Northern Ireland Electricity (NIE) are price regulated. At privatisation the three generating companies (which are not price regulated) signed long-term contracts for power and availability with NIE's Power Procurement Business (PPB). The PPB acts as a purchaser for all electricity generated for the franchise market in Northern Ireland. All of the Power Stations and NIE are required by licence to produce regulatory accounts.
- 1.8 Concern has been expressed by some of the parties in the electricity sector which produce regulatory accounts, as to their current relevance and usefulness because of the utilisation of Current Cost Accounting (CCA) principles. The regulator has found them increasingly insufficient in monitoring price controls and proposes to re-examine the licence commitments in order to ensure that the regulator receives more useful information from the regulated companies.
- 1.9 Requirements for regulatory accounts are different in the Northern Ireland gas industry. Natural gas is a newly emerging industry in Northern Ireland. Recent licence conditions require Premier Transco and Phoenix Natural Gas to produce accounts which can be reconciled with their statutory accounts. Unlike in the electricity sector, there is no requirement to produce Current Cost Accounts. Other gas supply companies with affiliates in Northern Ireland are also required to produce regulatory accounts.

## *ORR*

- 1.10 The main components of the rail industry are:
- ◆ railtrack, responsible for the operation, maintenance and enhancement of the public rail infrastructure in Great Britain;
  - ◆ train and freight operating companies;
  - ◆ rolling stock companies (ROSCOs), who lease rolling stock to the operators;

- ◆ sSRA, which is a governmental body responsible for forming a strategic focus for Britain's railways, encouraging investment and managing the passenger rail franchises;
- ◆ The Rail Regulator (ORR), who grant licences to operators of railway assets, grant access rights to rail infrastructure, exercise powers under the Competition Act and regulate Railtrack; and
- ◆ Department of the Environment, Transport, and Regions (DETR) and various other local/consultative bodies e.g. Passenger Transport Executives (PTE's).

1.11 The Rail Regulator is currently undertaking the first periodic review of Railtrack's access charges and draft conclusions were published in July 2000. The sSRA is currently engaged in the franchise replacement process.

1.12 In terms of regulatory accounting, ORR's primary focus is on Railtrack, although some information is also provided by the operating companies.

1.13 At present Railtrack publishes standard accounts for both Railtrack Group PLC and Railtrack PLC, as required by the Companies Act 1985. Supplementary regulatory information is also provided in accordance with Condition 10 of Railtrack's network licence and notices issued by the Regulator pursuant to that condition. These supplementary regulatory accounts include a CCA profit and loss statement (with reconciliation back to HCA), a balance sheet and a statement of total recognised gains and losses. The statements are reconciled back to the statutory accounts.

1.14 The Regulator considers that the current regulatory accounting arrangements do not provide the information that it requires. In particular, the financial statements are not consistent with the approach it proposes to use in setting the price controls and are therefore of limited relevance to its periodic review of access charges. This also constrains investors and other interested parties in their ability to interpret the underlying performance of the company in relation to assumptions made in the periodic review. The Regulator is concerned that this reduces the transparency of regulation and may have an adverse effect on Railtrack's regulatory incentives.

- 1.15 ORR has reviewed regulatory accounting arrangements in the rail industry, with the aim of improving their quality. Following this review, ORR has proposed a draft licence modification as part of the periodic review.

### ***OFTTEL***

- 1.16 The UK telecoms market is undergoing rapid change and consumers are demanding and using more, new and better services from an increasing range of suppliers. Competition between telecoms suppliers is developing rapidly with around 50 per cent of UK households now having a choice of direct-to-the-house fixed line telephone provider, although BT currently supply over 80 per cent of local copper loops to residential customers. Business customers in main city centres are likely to have a choice of 3 or more directly connecting suppliers. There are now over 25 million mobile phone customers who can choose between four mobile networks as well as between a number of independent service providers. The industry is also experiencing a convergence of technologies, for example between telecoms, broadcasting and IT, which blurs the distinction between markets, providing increased scope for competition and greater opportunities for customers.
- 1.17 OFTEL's strategy is designed to ensure regulation is justified and appropriate to the level of competition in the market. OFTEL must be clear where and why it needs to regulate to achieve the overall goal of the best deal for the consumer in terms of choice, quality and value for money. Obligations on telecoms operators to prepare regulatory accounts should be viewed in this context.
- 1.18 Licensed operators, in the telecommunications sector, designated as having market influence or significant market power will normally have some form of obligation to prepare regulatory accounts. The obligations placed on British Telecommunications plc (BT), the former incumbent operator, in this respect are the most extensive of any telecommunications operator.
- 1.19 BT's regulatory accounts are primarily prepared to ensure BT does not act anti-competitively (i.e. unfairly cross-subsidises or unduly discriminates) and that interconnection charges are reasonably and transparently derived from costs. The regulatory accounts are not currently used to monitor price or charge controls.



- 1.20 At present OFTEL has no plans to propose amendments to the licence obligations on BT to prepare regulatory accounts but is currently undertaking an investigation into three specific aspects of BT's regulatory accounts. If found deficient the Director General may direct BT to take specific action to remedy any shortcomings. This investigation will result in a consultation document being issued in the next few months. However, the usefulness of annual high level accounting information, is being questioned when robust up-to-date financial information at product or market level is much more helpful, and sometimes essential, to deal with competition issues in a fast moving business environment.

### ***OFWAT***

- 1.21 At present there are 10 water and sewerage companies and 15 water only companies in England and Wales. The whole of the business of these companies as water and sewerage undertakers is subject to a monopoly price control. Under the terms of their licences the companies are required to prepare and publish annual regulatory accounts. These are prepared on both a historical and current cost basis in accordance with a set of RAG's prepared by Ofwat (in practice the historic cost accounts are the same as the statutory accounts).
- 1.22 The regulatory accounts in their current format are generally considered to be useful and to meet a substantial proportion of the needs of the parties who use them. However, the accounts do not allow a proper comparison with the assumptions underlying the price control.
- 1.23 Complementary with this inter-regulatory project Ofwat intends to carry out its own review of the regulatory accounts and the RAG's with a view to increasing the links with the price control mechanism and to ensure the regulatory accounts meet more of the needs of users.

### ***CAA***

- 1.24 There are two distinct tiers of airport regulation. At the lower tier, all airport operators with a turnover of more than £1 million per annum are required to hold a permission to levy charges, and behaviour in respect of certain relevant activities may be subject to regulation by the CAA. In total, 47 airports are

subject to permissions to levy charges. At the higher tier, airports designated by the Secretary of State are subject to a maximum limit to airport charges in addition to the regulation of conduct. Heathrow, Gatwick, Stansted and Manchester airports are currently designated by the Secretary of State. Under the Transport Bill currently being considered by Parliament the providers of air navigation services (ANS) would be required to hold a Licence or an exemption granted by the Secretary of State. It is expected that the licence granted to National Air Traffic Services Ltd (NATS) will impose charge conditions on en route services and require the provision of specified information to the regulator including accounts information.

- 1.25 The regulatory accounts for airports have evolved piecemeal to address particular issues. The Airports Act 1986 stipulates that the operators of airports designated by the Secretary of State for price regulation have to provide certain information with their statutory accounts; this includes a statement of the aggregate income and expenditure attributable to the levying of airport charges and any subsidies furnished to or by the airport operator. Until 1997 CAA also used its discretionary powers to require this information from all airports as a condition attached to their permissions to levy charges. Following on from the last Monopolies and Mergers Commission (MMC) review of the three BAA plc South East airports, CAA has required a set of accounts which reflect the basis on which the charge conditions were set for the period 1997-2002 (subsequently extended to 2003) based on the indexation of a regulatory asset value by inflation. The airports are also required to provide and publish to users, costing and pricing information for specific activities, following a public interest finding by the MMC in 1991.
- 1.26 Thus while each set of requirements has been in response to a perceived regulatory need, the requirements are somewhat disjointed with some requirements linked to the statutory accounts and some linked to the approach used to set the charges condition.
- 1.27 The CAA is currently developing a set of accounting guidelines to be used in conjunction with a NATS licence as part of the arrangements for regulating NATS under the proposed Public Private Partnership. These are expected to form the basis for monitoring performance, informing future price reviews and

defining cost and revenue attribution between the licensed and unlicensed businesses.

- 1.28 The challenge for the future is to ensure that financial information including regulatory accounts, continues to provide an appropriate basis to support the evolving needs of regulation.

## **Appendix 2 Proposal for a set of common regulatory accounting principles**

- 2.1 The purpose of this appendix is to set out in draft form a proposal for the main high-level principles that the members of the group will adopt as common regulatory accounting principles.

### ***Purpose of regulatory accounts***

- 2.2 Regulatory accounts are prepared to aid regulation and inform stakeholders who have a number of information requirements that are different to those of the users of statutory accounts. These stakeholders will include consumers and industry.

- 2.3 Regulatory accounts aid regulation by, depending on market structure and regulatory emphasis:

- ◆ monitoring performance against the assumptions underlying the current price control;
- ◆ informing future price control reviews;
- ◆ assisting in the detection of certain anti-competitive behaviour such as unfair cross-subsidisation and undue discrimination at levels of disaggregation appropriate to the relevant market;
- ◆ assisting in comparative competition;
- ◆ assisting in monitoring financial health; and
- ◆ improving transparency in the regulatory process, regulatory accounts are the main source of regular, published and audited information about regulated companies.

### ***Common regulatory accounting framework***

- 2.4 Regulatory accounts will be prepared and audited using either the RAG's for that industry or, where a RAG does not cover the issue, UK GAAP. Where there is

any conflict between RAG's and UK GAAP, then the RAG's will take precedence.

- 2.5 Regulated companies will also be required to disclose the basis of preparation and the determination of the value of the RAV in the regulatory accounts.

### ***Cost attribution, Cost allocation and inter-business recharging of costs***

- 2.6 Where possible there should be consistency in the format of the regulatory accounts. The published regulatory accounts should also include a comparison between the actual performance of the company and the assumptions underlying its price control.
- 2.7 Where practicable the attribution, allocation and inter-business recharging of costs for the different activities of the business in the regulatory accounts should be based on the same assumptions as in the regulatory accounting guidelines.
- 2.8 Attributions, allocations and inter-business recharging of costs should be based on a set of principles, the main ones being:

- ◆ Cost Causality;
- ◆ Objectivity;
- ◆ Consistency; and
- ◆ Transparency.

### ***Role of the auditors in regulatory accounts***

- 2.9 The main common framework principles are:
- ◆ the auditor will owe a duty of care to the regulator;
  - ◆ the regulator will be involved in the process of appointing the auditor;
  - ◆ the regulator will have direct access to the auditor;
  - ◆ the regulator will be involved in the process of agreeing materiality levels; and

- ◆ the form of audit opinion to be included in the audit report will be determined by this working group.

### ***Publication issues***

2.10 The main common framework principles are that:

- ◆ the regulatory accounts should be published as soon as possible after the regulatory accounting year-end, with the publication date being no more than four months after the regulatory accounting year-end. However, the deadline may be delayed in a particular year, where a regulator consents to a request from the regulated company for additional time.

2.11 In addition to the primary accounting statements, the associated notes and the auditors report, the regulatory accounts will include, where relevant:

- ◆ a note setting out the regulated company's estimate of its RAV and how it was determined;
- ◆ a commentary discussing the results (where appropriate this commentary should be structured as an operating and financial review);
- ◆ where the monitoring of price controls is a main purpose of the regulatory accounts, a comparison of actual results to the assumptions made in setting the price control;
- ◆ an explanation of the variances between the actual results, the results of the previous year and where appropriate the assumptions made in setting the price control;
- ◆ a detailed statement of cost attributions, allocations and recharges;
- ◆ where appropriate, the additional information normally only required as part of a listed company's statutory accounts;
- ◆ a reconciliation should be available between the information in the regulatory accounts and other relevant information, such as the statutory accounts, regulatory asset values or data on capital expenditure;

- ◆ a formal statement of compliance with licence obligations such as charges being cost-orientated or that the Licensee has not unfairly cross-subsidised or unduly discriminated; and
- ◆ any other information that the regulator deems relevant such as references to licence conditions or RAG's.

## Appendix 3 Glossary

“APB” Auditing Practices Board. The audit standard setting body.

“ASB” Accounting Standards Board. The organisation that issues accounting standards in the UK.

“BT” British Telecommunications plc.

“CAA” Civil Aviation Authority. The regulator of the UK ‘s airports and air traffic control services.

“CCA” Current Cost Accounting. A set of principles for the preparation of accounts that provide for the effect of changing prices. Generally, assets are shown at their current cost which is usually based on replacement values.

“DETR” Department of the Environment, Transport, and Regions. The government department responsible for the Environment, Transport, and Regions.

“DGs” Director Generals.

“HCA” Historical Cost Accounting. A set of principles for the preparation of accounting statements. These are the most widely used set of accounting principles for the preparation of accounting statements. Assets are generally valued at their original purchase price less associated depreciation.

“IPGT” Independent Public Gas Transporter. IPGT’s are the new entrants to the gas transportation market in the UK, following the 1995 Gas Act.

“MMC” Monopolies and Mergers Commission (now the Competition Commission). The body that is responsible for certain aspects of the UK government’s competition policy.

“MHCA” Modified Historical Cost Accounting. Under historical cost rules assets can be revalued, companies that have revalued their assets usually refer to the accounts being prepared on a MHCA basis.

“NATS” National Air Traffic Services Ltd.

“NIE” Northern Ireland Electricity.



“Ofgem” The Office of Gas and Electricity Markets. The regulator of Great Britain’s gas and electricity industries.

“Ofcom” Office of Telecommunications. The regulator of the UK’s telecommunications industry.

“Ofreg” Office for the Regulation of Electricity and Gas. The regulator of Northern Ireland’s gas and electricity industries.

“ORR” Office of the Rail Regulator. The regulator of Great Britain’s rail industry.

“Ofwat” Office of Water Services. The regulator of the Water and Sewerage companies of England and Wales.

“PPB” Power Procurement Business. NIE’s Power Procurement Business.

“PTE’s” Passenger Transport Executives. Regional governmental transport bodies responsible for certain local transport issues.

“RAV” Regulatory Asset Value. The value of a regulated company’s net assets for price control purposes.

“RAG’s” Regulatory Accounting Guidelines. A set of typical Regulatory Accounting Guidelines would include the principles, policies, methodologies and procedures that are established between the regulated company and the regulator and which form the basis on which regulated accounts are prepared and audited.

“SORP” Statement of Recommended Practice. A SORP sets out current best accounting practice on accounting issues where it is not considered appropriate to issue an accounting standard. SORPs are issued by ASB recognised bodies and contain a statement from the ASB which they describe as a negative assurance statement.

“sSRA” shadow Strategic Rail Authority. The governmental body responsible for forming a strategic focus for Great Britain’s railways, encouraging investment and managing the passenger rail franchises.

“Statutory Accounts” The accounts required by UK company law.

“UK GAAP” United Kingdom Generally Accepted Accounting Practice, this is mainly based upon the accounting principles included in accounting standards issued or adopted by the Accounting Standards Board (ASB), that are currently in force in the UK and UK Company Law.

## Appendix 4 Useful publications

The UK Government's Green Paper on utility regulation 'A Fair Deal for Consumers'.

Ofgem's August 2000 regulatory accounts consultation paper.

OFWAT's Regulatory Accounting Guidelines.

ORR's Periodic Review of Railtrack's access charges: draft conclusions 27 July 2000.

CRI Research Report 9 "Accounting requirements for Regulated Industries".

ASB Accounting Standard FRS 15 Tangible Fixed Assets.

ASB statement of principles for financial reporting.

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