

## STAFF PAPER

September 2013

## IASB Meeting

Project	Rate-regulated Activities: Research project		
Paper topic	Rate regulation: User needs		
CONTACT(S)	Jane Pike	jpike@ifrs.org	+44 (0)20 7246 6925

This paper has been prepared by the staff of the IFRS Foundation for discussion at a public meeting of the IASB and does not represent the views of the IASB or any individual member of the IASB. Comments on the application of IFRSs do not purport to set out acceptable or unacceptable application of IFRSs. Technical decisions are made in public and reported in IASB *Update*.

## Introduction

1. The objective of general purpose financial reporting is to provide financial information about the reporting entity that is useful to existing and potential investors, lenders and other creditors in making decisions about providing resources to the entity. Those decisions involve buying, selling or holding equity and debt instruments, and providing or settling loans and other forms of credit.<sup>1</sup>
2. As part of the research for this project, we are investigating what information users need to help them assess the financial position and performance of rate-regulated entities. We are focusing on the needs of the primary users of financial statements.<sup>2</sup> However, other users may also find general purpose financial reports useful. In particular, we have been told that some rate regulators use general purpose financial statements as a valuable source of information for regulatory purposes.
3. We are at the early stages of our research but so far we have:
  - (a) discussed user needs with the Rate-regulated Activities Consultative Group; and

<sup>1</sup> *Conceptual Framework* paragraph OB2.

<sup>2</sup> Primary users are existing and potential investors, lenders and other creditors who cannot require reporting entities to provide information directly to them and must rely on general purpose financial statements for much of the financial information that they need (*Conceptual Framework* paragraph OB5).

- (b) started to examine the methodologies employed by some credit and equity analysts.

### **Purpose of the paper**

- 4. The purpose of this paper is to inform the IASB of our initial findings, which are helping to inform our thinking on other aspects of the project. The paper summarises the main messages that we heard during the user needs session of the first Consultative Group meeting, held in July 2013. It also outlines some of the aspects of the analysts' methodologies that we think could be useful to consider in the Discussion Paper that is planned to be published as part of the IASB's Rate-regulated Activities project (the planned DP).
- 5. We will prepare a more detailed analysis for the IASB to consider at a later meeting after we have completed more work in this area.

### **Messages from the July 2013 Consultative Group meeting**

- 6. The Consultative Group members discussed what information is considered necessary for users to understand the rate-regulatory framework and how it affects the reporting entity. The main messages heard were:
  - (a) users are looking primarily for transparency of information about the amounts, timing and certainty of future cash flows;
  - (b) rate regulation is usually designed to smooth out the impact of volatility for the customers, which influences the timing and pattern of cash flows for the supplier;
  - (c) a major objective of rate regulation is to ensure that the supplier is allowed to recover its costs and, in most cases, to earn a fair or reasonable return on its investment. The allowed rate of return is usually fairly stable and not subject to much volatility. It is important for users to be able to understand the rate-regulatory environment and its impact on the entity's financial position and performance. In particular, users are interested in distinguishing variability in

performance that is compensated for through the rate-regulatory mechanism from variability in performance for which there is no compensation. Consequently, users need to be able to reconcile the earnings reported in financial statements to the ‘stabilised’ or ‘permitted’ earnings achieved through the rate regulation;

- (d) as well as quantitative information based on amounts recognised in financial statements, users (particularly credit analysts) rely heavily on qualitative information about the strength of the rate regulation, the relationship between the rate regulator and the entity, and the track record of the entity in recovering costs and earning the return allowed by the rate regulation;
- (e) both credit-analysts and equity analysts will use rate filings (if available) to obtain the regulatory information that they consider is necessary to supplement the financial statements information currently made available to them; and
- (f) some entities provide additional information within their management commentary or the segmental information note in the financial statements. For IFRS preparers in particular, this sometimes involves the extensive use of non-GAAP measures and disclosures in the financial statements, including ‘proforma’ statements of income and financial position that include regulatory balances.

7. We also heard that, even in jurisdictions where ‘regulatory assets’ and ‘regulatory liabilities’ are currently recognised in the statement of financial position, such as in the USA and Canada, the financial statements rarely provide the information needed to complete the analysts’ assessments. Information about the timing and certainty of cash flows and the reconciliation of reported earnings to the earnings permitted by the rate regulation is more often found in rate filings or other sources of information.

8. Although inclusion of ‘regulatory assets’ and ‘regulatory liabilities’ in the statement of financial position is not considered essential, ease of availability, consistency and transparency of the information were considered very important to user members of the Consultative Group.

## Methodologies used by analysts

9. We are seeking to establish whether credit and equity analysts view rate-regulated entities differently from other commercial entities and, if so, what distinguishing features are important in their credit or investment analyses. Although a variety of forms of rate-regulation can apply to a wide variety of industries or activities, the following observations focus on rate-regulated entities that exhibit the features that we propose to include in the scope of the planned DP:<sup>3</sup>
- (a) rate-regulated entities are not primarily subject to influence from market forces and, consequently, cannot be directly compared to competitive entities. Instead, the supportiveness of the regulatory framework in which a regulated utility operates is a key consideration;
  - (b) the supportiveness of the regulatory framework encompasses the predictability and stability of the framework, the transparency and efficiency of the rate-setting procedures, and the regulators' strength and independence;
  - (c) in addition to the general supportiveness of the regulatory framework, analysts also give significant consideration to the more specific ability of the regulated utility to recover its costs in a timely manner and to earn a return. This involves an assessment of the statutory or regulatory mechanisms and protections in place to ensure full and timely recovery of 'approved' revenues; and
  - (d) such mechanisms and protections include:
    - (i) predictable rate-review outcomes, based on transparent and objective rate-setting formula and procedures;
    - (ii) automatic annual (or more frequent) rate adjustments and 'pass through' provisions for certain types of costs;

---

<sup>3</sup> For the purposes of this paper, a rate-regulated entity is, in summary, an entity that has an exclusive right to provide essential or near-essential goods or services and is subject to regulation by an authorised body. The regulation grants rights to, and imposes obligations on, the entity related to the rates charged to customers and to the quality and terms of supply of the regulated goods or services (see Agenda Paper 9B for further details about the proposed scope criteria of the planned DP).

- (iii) timely automatic adjustments or provisions to initiate a rate-review for volatile or unexpected events or cost/revenue differences;
  - (iv) pre-approval of capital investment programmes and timely recovery of investment cash flows through rates; and
  - (v) the rate-setting mechanism provides for a stable, compensatory rate of return in cash that is sufficiently insulated from political intervention.
10. At this stage, we are not able to propose whether, and if so how, the information that is used by credit and equity analysts (or other users) should be presented in general purpose financial statements. However, we are using the information that we are receiving from users in our analysis of the proposed scope of the planned DP.
11. In addition, we are considering the features of rate regulation that users consider are important to distinguish rate-regulated entities from competitive entities in our analysis of whether certain features of rate-regulation can create assets and liabilities, as defined in the *Conceptual Framework*.

## Next steps

12. We will continue our research of credit and equity analysts' methodologies, together with informal outreach with users and further discussions with members of the Consultative Group. We are also hoping to obtain further input through the responses to the proposed interim Standard, Exposure Draft *Regulatory Deferral Accounts*, published in April 2013 (the interim ED), in particular through comments on the presentation and disclosure proposals.<sup>4</sup>
13. The staff will develop proposals for presentation and disclosure matters to be included in the planned DP and ask the IASB to discuss these at a future meeting later in 2013.

---

<sup>4</sup> The deadline for comments is 4 September 2013. An initial analysis of responses to the interim ED is presented in IASB Agenda Paper 9C: *Interim ED Early feedback from comment letters*, September 2013.