# Rate-regulated Activities

# EFRAG's preliminary views on the IASB's Discussion Paper

## Introduction and purpose of this paper

1 The IASB's Paper *Reporting the Financial Effects of Rate Regulation* ('DP') was published on 17 September 2014. On 27 October 2014, EFRAG published its draft comment letter seeking comments by 31 December 2014.

2 The purpose of this paper is to provide ASAF members with a summary of EFRAG's preliminary views included in its draft comment letter on the DP. The Appendix to this paper includes a summary of the findings from the user outreach undertaken by EFRAG in developing its tentative response to the IASB's DP, and subsequent outreach.

## EFRAG's preliminary views

3 EFRAG considered the views from users in developing its preliminary views. EFRAG's final views will be developed when the consultation period with its constituents has closed.

*Information users need to understand an entity's rate-regulated activities*

4 Based on outreach conducted with users that cover rate-regulated entities, EFRAG has learned that IFRS financial statements currently do not always provide the information users regard as useful and relevant to understand the impact of rate-regulated activities on an entity's revenue and related costs, cash flows and financial position. As a result, users obtain the information from different sources – for example directly from the entities, local GAAP financial statements, investor presentations and public information provided by the rate regulator.

5 Some of the users[1] that cover rate-regulated entities stated that they would like to see the financial effects of rate-regulated activities reflected in the primary financial statements, particularly when it has a direct impact on an entity's revenue, costs and financial position.

6 Overall, users suggested that the quantitative information included in the primary financial statements be supplemented by qualitative information reported in the notes to the financial statements. Most users noted that they would need to have an understandable description of the rate-regulated regime in which an entity operated to enable them to effectively perform their analysis of the entity.

7 Information about the regulatory environment and the impact of rate-regulation on an entity's activities was mainly used by users to develop an understanding of the regulatory and financial stability of the entity and to forecast future earnings.

[1] Feedback received after EFRAG published its draft comment letter indicates that this view is shared by most users that cover rate-regulated entities.

*Focus on activities affected by defined rate regulation*

8 EFRAG supports the IASB's decision to focus the debate initially on accounting for a specific type of rate regulation referred to as defined rate regulation. EFRAG also supports the focus on rate-regulated activities as some entities undertake both regulated and unregulated activities.

9 However, EFRAG believes that the DP only represents a starting point. As the project progresses, EFRAG believes that the IASB will need to consider all circumstances in which an entity's right to recover an agreed amount of revenue and has obligations to perform certain activities creates enforceable rights and obligations that should be recognised in the financial statements.

10 The IASB might also need to consider whether it should eventually widen the scope of a potential future Standard, in order to require disclosures about forms of regulation that impact economic activity but do not lead to recognition of assets and liabilities.

*Description of defined rate regulation*

11 EFRAG thinks the description of defined rate regulation is a good basis for starting to identify which features of rate-regulatory schemes lead to economic circumstances that create rights and obligations that distinguish rate-regulated activities from other commercial activities.

12 Therefore, EFRAG believes that any enforceable rights and obligations that stem from the rate-regulation mechanism are the most important elements for distinguishing the types of rate regulation that require recognition in the financial statements.

13 In EFRAG's view the connection between the legislation, an external rate-regulator, the entity, and the regulated activities needs to be reflected within the definition of rate regulation. In this respect, EFRAG has made the following suggestions:

(a) The legislation that sets and enforces the revenue requirement.

The definition of rate regulation should focus more predominantly on the legislation that creates the rate-setting framework that an entity can turn to if it needs to enforce the rate or tariff it is allowed to charge. There also needs to be an external rate regulator that enforces the legislation.

(b) The agreement that binds the customer and the unit of account

In the majority of cases in the European regulatory environment, the rights and obligations stem from the agreement between the rate regulator and the rate-regulated entity. The customer is not a party to that agreement. It is therefore necessary to explain how defined rate regulation binds the customer.

Another important factor is whether the existence of defined rate regulation might trigger a change in the unit of account and the recognition of revenue under IFRS. For example to apply IFRS 15 *Revenue from Contracts with Customers* the entity would need to identify the performance obligation(s) it has with the customer base. That is a 'customer base' virtual contract would supersede individual customer contracts for financial reporting purposes. Under this perspective, delivery of rate-regulated goods or services to customers would be seen as the distinct performance obligation in this overall virtual contract. It is therefore important to link the rights and obligations that stem from the rate-setting framework with the customer base.

(c) The rate-regulated activities an entity needs to undertake to be entitled to the revenue requirement, including performance to the customer.

The DP states that an entity must undertake certain activities to be entitled to the revenue requirement. These activities can be both direct (supplying the regulated goods or services) and indirect (for example satisfying government/rate regulator objectives such as changes to the infrastructure network). In EFRAG's preliminary view, requirements to undertake both direct and indirect activities can create obligations.

*Features of defined rate regulation*

14 In EFRAG's view, the main purpose of the features listed in paragraph 4.4(a) – (c) of the DP is to ensure enforceability of the rights and obligations created by defined rate regulation. Therefore, these features should be used as indicators to assess whether an entity operates within defined rate regulation.

15 EFRAG provided the following suggestions about how these features might be improved so as to achieve this purpose:

(a) Customers have little or no choice but to purchase the goods or services. To make this feature workable, it is necessary to have 'very low demand risk' (i.e. relatively inelastic demand), rather than 'no effective competition'.

(b) Rate regulation establishes parameters:

(i) to maintain the availability and quality of the supply of the rate-regulated goods or services and other rate-regulated activities of the entity. Although this feature is common to the type of regulation that the DP is trying to capture, maintaining the quality of the supply is not part of the legislation in all cases. Therefore, EFRAG recommends this feature should not be mandatory.

(ii) to provide regulatory protections (paragraph 4.4(c) of the DP). Although EFRAG supports this feature, it recommends not making it mandatory for similar reasons to those above.

16 Finally, EFRAG believes that the 'tariff adjusting mechanism' discussed in the DP is a major source of rights and obligations for the rate-regulated entity and should be included in the description of defined rate regulation.

*Accounting approaches proposed in the DP*

17 EFRAG supports an approach that is principle-based and is able to be applied to different regulatory regimes as they evolve over time.

18 EFRAG generally supports the approach that considers deferring or accelerating the recognition of a combination of costs and revenue. In EFRAG's view:

(a) The revenue approach discussed in the DP has an important role to play when an entity has 'performed' to its customers; and

(b) Whilst remaining open to a cost deferral approach, EFRAG does not fully understand in which cases it should apply, and recommends the IASB to identify when such an approach will produce relevant information.

*Presentation*

19 EFRAG believes that any the accounting effects (i.e. regulatory deferral balances) and changes in those balances that rate regulation creates should be presented separately in the financial statements as it enhances the relevance and understandability of financial information.

## Appendix

### Summary of the user outreach

*Objectives*

20 The objectives of the user outreach were to understand:

(a) what qualitative and quantitative information users of financial statements (that cover rate-regulated entities) regard as useful and relevant in order to understand the impact of rate-regulated activities on an entity's financial statements;

(b) whether users preferred that 'regulatory deferral balances' were recognised in the financial statements or whether disclosures in either the notes or the management commentary would meet their information needs; and

(c) whether the rate regulation they were familiar with, was similar to 'defined rate regulation' described in the DP.

*Users*

21 EFRAG staff has interviewed eight[2] users namely analysts (mainly sell-side equity analysts, financial and credit analysts) from different European countries. All the users interviewed cover rate-regulated entities in the following (utility) industries: Power and Gas, Telecommunication, Water, Air Traffic Control and Waste Management.

22 The summary of the user outreach in this paper includes both the feedback used in preparing EFRAG's draft comment letter and also feedback from user outreach performed *subsequent* to the publication of EFRAG's draft comment letter. The additional feedback may have resulted in changes to the feedback reported in the draft comment letter.

23 EFRAG staff also consulted with the EFRAG User Panel, which includes mainly generalist users, the majority of whom do not specifically cover rate-regulated entities. The feedback below focuses mainly on what EFRAG had learned from the 'industry-specialist' users EFRAG staff has interviewed.

*Summary of the feedback received*

<u>General comments</u>

24 All users stated that IFRS financial statements currently do not always provide the information users regard as useful and relevant to understanding the impact of rate-regulated activities on an entity's revenue and related costs, cash flows and financial position associated with an entity's rate-regulated activities.

25 Users noted that they obtain the information from different sources – for example directly from the entities, local GAAP financial statements, investor presentations and public information provided by the rate regulator. The information obtained from the regulatory accounts and directly from management was deemed to be very useful for their analysis.

[2] At the time this paper has been prepared, the EFRAG staff had conducted four other interviews with users in which consistent feedback was provided.

26 Some users noted that in some jurisdictions, the regulatory deferral balances were well explained in the regulatory accounts, and would require less supplementary information from management. However, for ‘bigger groups’ with multiple activities – some subject to rate regulation and others not – the information was sometimes less transparent and users needed to obtain more ‘disaggregated’ information to understand the impact of rate regulation on the particular entity.

27 Many of the users stated that they would like to see the financial effects of rate-regulated activities reflected in the primary financial statements. This would enhance their understanding of how rate regulation affects an entity’s performance, financial position and return on assets generated by rate-regulated activities, and consequently the usefulness of the information provided[3]. They suggested that the quantitative information included in the primary financial statements be supplemented by qualitative information reported in the financial statements.

28 Only a few users stated that they would prefer regulatory deferral balances to be reflected only through disclosure in the notes to the financial statements or the management commentary.

29 All users agreed that they need an understandable qualitative description of the rate-regulated regime in which the entity operates because, without such a description, the financial statements cannot be analysed effectively. Specifically, users indicated that the following information would be useful:

(a) How defined rate regulation works for each rate-regulated activity and in each jurisdiction in which the entity operates, including an explanation of the ‘legislation’ or regulatory framework that drives the regulatory agreement (that is binding on both the rate regulator and the entity);

(b) Expected changes to that ‘legislation’ and what effects (financial and otherwise) such changes could cause;

(c) The risks that entities face as a result of rate regulation, whether regulators (and potentially governments) are committed to supporting the revenue requirement, how rate calculations are made, and how stable/strong the regulatory framework is in terms of, for example, legal enforceability of the regulatory deferral balances that are created by rate regulation; and

(d) The relationship between the rate regulator, the entity and the track record of the entity in recovering costs and earning the return allowed by the rate regulation.

<u>Financial Position</u>

30 Many users considered that regulatory deferral balances should be recognised in the statement of financial position. This is because they need to know whether an

[3] This view, is however, not necessarily consistent with the views held by more generalist users from EFRAG’s User Panel who express the concern that regulatory regimes could be extremely complex and subject to significant uncertainty about how external factors could affect regulations and how regulatory requirements apply to entities. This creates complexity with regards to any recognition of ´regulatory deferral balances´ and raises questions about whether information would be comparable between jurisdictions. As a result they tend to favour having the information through disclosure – either in the notes to the financial statements or in the management commentary.

entity will be able to recover its costs and to generate sufficient returns to cover its cost of capital.

31 Some rate-regulatory schemes manage the rate setting mechanism through a 'Regulatory Asset Base', while other regulatory schemes are based on a form of a revenue cap, without a formal reference to a Regulatory Asset Base.

32 When a Regulatory Asset Base is used, users informed us that *disclosure* about the entity's Regulatory Asset Base for each asset class in each geographical region is useful because:

(a) Entities generally run their rate-regulated operations, including expenditure/cost policies, by managing their Regulatory Asset Base.

(b) The Regulatory Asset Base is a valuation tool for assessing enterprise value and forecasting future earnings, dividends and cash flows based on the return that the entity is entitled to earn.

33 Users generally acknowledged that it might be challenging to present in the statement of financial position an amount that reconciles IFRS assets and liabilities with the regulatory accounting, which is often based on frameworks such as local GAAP or regulatory reporting. Furthermore, users thought this could obscure financial information that results from applying IFRS (e.g. IAS 16 *Property, Plant and Equipment*), and increase complexity in assessing the timing mismatch between the revenue requirement and recognised (billed) revenue.

34 Therefore, we understand that an explanation of the main causes of differences between the Regulatory Asset Base and the equivalent assets for financial reporting would provide relevant information without adding the complexities highlighted in paragraph 33 above.

35 Where there is no Regulatory Asset Base, determining what might constitute such a Regulatory Asset Base for the rate-regulated entity (or a specific rate-regulated activity) could involve a high degree of judgement and the use of management assumptions which is likely to affect the relevance and reliability of the information provided. Furthermore, such an analysis would imply that the regulatory framework relies on some form of Regulatory Asset Base.

36 Users also stated that information on future plans that the rate-regulated entity is already committed to undertake would be useful as it helps predict future investment cash outflows.

<u>Performance</u>

37 Users generally thought that defined rate regulation reflects a number of regulatory frameworks in force in Europe.

38 Many users supported having information on regulated revenue included in profit or loss as this would link revenue to the cash flows that an entity is entitled to receive under the regulatory agreement.

39 Most users stated that they needed to understand the differences between the billable revenue and the revenue requirement, and suggested the following *disclosure* as being useful for this purpose:

(a) The causes of variability in revenue and related costs (performance) reported by an entity that depend on factors *outside* the control of both the entity and the rate regulator (such as a drop in demand for the rate-regulated good or service).

(b) The main differences between revenue reported in the IFRS financial statements for rate-regulated activities and the corresponding revenue to which an entity is entitled through the revenue requirement applicable to those activities, in the current and future periods.

(c) Which costs are recoverable, which costs are not recoverable, in relation to rate-regulated activities, and the rate per unit (tariff) the entity will be entitled to charge through the revenue requirement in future periods and the expected return on the respective rate-regulated goods or services. Users are interested to understand how a "tariff" constraint would affect future cash flows, for example:

   (i) the uncertainty in future rate-setting that impacts the revenue requirement;

   (ii) the rate-regulated activities an entity must perform to earn the revenue requirement and the period in which it is required to perform those activities; and

   (iii) a breakdown of the revenue requirement depending on the nature of the components: for example, return on the Regulatory Asset Base when applicable, bonuses on qualitative performance and claw-back of non-controllable costs.

(d) Separate presentation of results from rate-regulated activities and from non-regulated activities.

(e) Segment information per jurisdiction/country on the revenue requirement with an explanation of the factors incorporated in each revenue requirement.

*How information is used*

40 Users stated that the information is used mainly to assess the following relating to an entity subject to defined rate regulation:

(a) estimating future cash flows;

(b) regulatory stability;

(c) efficiency of tariff setting procedures;

(d) financial stability of the entity;

(e) measuring the enterprise value; and

(f) regulatory independence (i.e. the level of influence that regulated entities have when liaising with the rate regulator sometimes also referred to as regulatory leverage).

41 Furthermore, users expressed a view that rate-regulated entities operate in a relatively stable market where the main risk that needs to be assessed is 'regulatory risk'. Regulatory risk is generally influenced by the regulatory stability which is the impact of political influences on the enforceability of the regulation and the entity operating rate-regulated activities (e.g. investments in green energy

instead of in coal-fired plant; deferral in the rise of tariffs due to unfavourable economic cycle).