Rate-regulated Activities IASB Exposure Draft

EFRAG User Panel Presentation

21 April 2021

EFRAG

European Financial Reporting Advisory Group

OBJECTIVE OF THIS SESSION

- PROVIDE AN OVERVIEW OF THE ED PROPOSALS
- PRESENT EFRAG TENTATIVE POSITION IN THE DRAFT COMMENT LETTER (DCL)
- QUESTIONS TO EFRAG USER PANEL MEMBERS

OVERVIEW

- OBJECTIVE AND SCOPE
- REGULATORY ASSETS, REGULATORY LIABILITIES AND TOTAL ALLOWED COMPENSATION
- RECOGNITION AND MEASUREMENT
- PRESENTATION AND DISCLOSURE
- INTERACTION WITH OTHER IFRS

OBJECTIVE AND SCOPE

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The regulatory agreement defines

The amount which can be charged for the goods and services supplied

The timing when the compensation for the goods and services supplied can be charged to customers through the rates

In the same period as the supply of goods or services

In a different period than the period of supply => **timing difference**

Expenses recognised when goods or services are supplied

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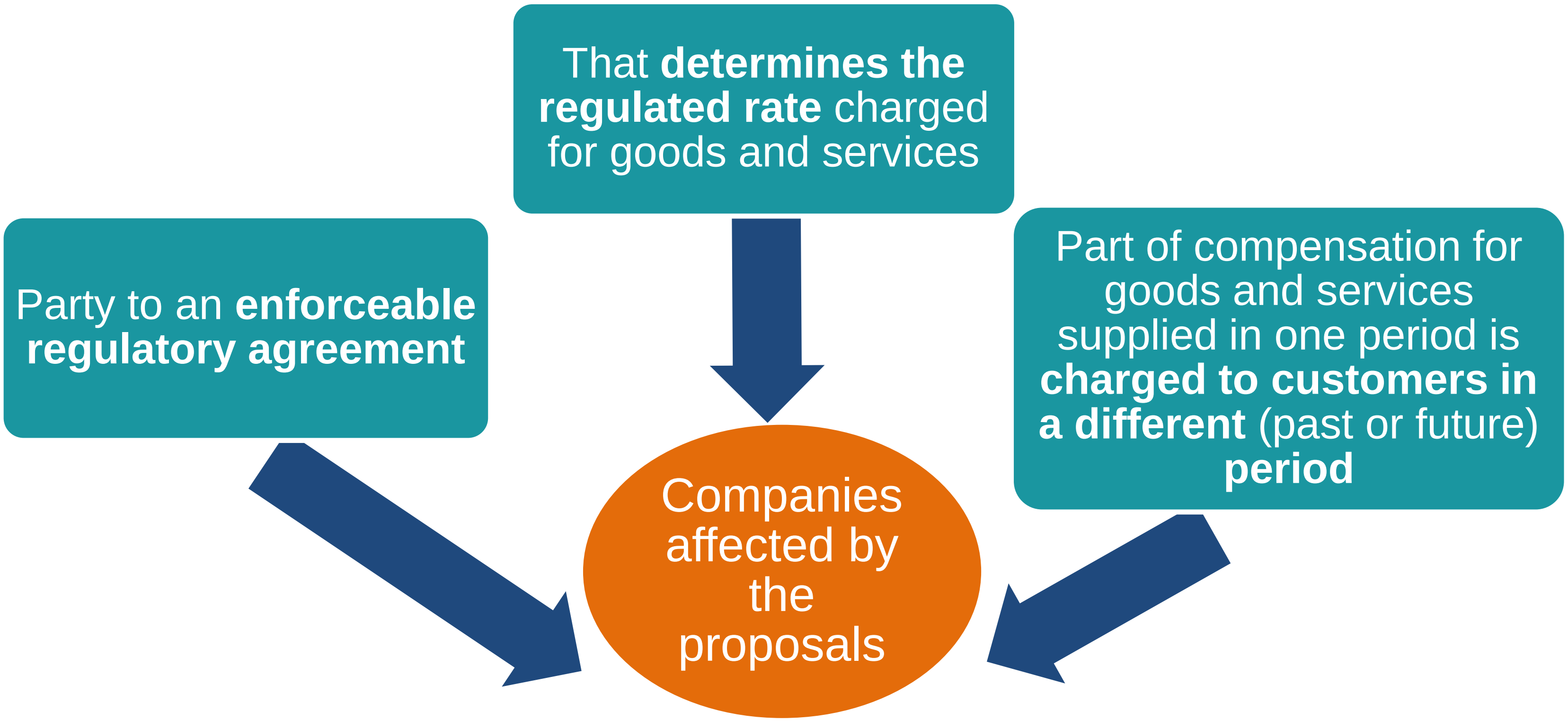
Revenue recognised when compensation for those goods or services is charged through the rates

difficult for users to understand the relationship between revenue and expenses

Source: the IASB Presentation

OBJECTIVE AND SCOPE



These differences in timing give a company :

- Right to add amounts to future rates because of goods and services already supplied
- Obligation to deduct amounts from future rates because of compensation already charged

Source: the IASB Presentation

HOW WOULD THE PROPOSALS SOLVE THE PROBLEM?

Statement of profit or loss	Year 1 CU	Year 2 CU
Revenue	100	120
Regulatory income minus regulatory expense (slide 26)	**20**	**(20)**
Input costs	(120)	(100)
Profit (loss)	**-**	**-**

- **Regulatory income of CU20 in Year 1** to reflect compensation for goods supplied in Year 1.
- **Regulatory expense of CU20 in Year 2** to reflect amounts in regulated rates charged, and hence in revenue, in Year 2, that relates to compensation for goods supplied in Year 1.

Balance sheet		
Regulatory asset	**20**	**-**

- **Regulatory asset of CU20 in Year 1** to reflect Company A's right to increase regulated rates in Year 2.
- **Derecognise regulatory asset in Year 2** when it increases the regulated rates to recover the input costs under-recovered in Year 1.

The information about regulatory income and regulatory expense would – in this case – provide investors with a basis for understanding that Company A's financial performance did not change from Year 1 to Year 2.

Source: IASB presentation

OBJECTIVE AND SCOPE

EFRAG TENTATIVE POSITION

- EFRAG supports the overall objective of the project and agrees that it would enable users to understand how the financial performance and the financial position of a reporting entity is affected by its rate-regulated activities
- EFRAG is still assessing possible unintended consequences including on the possible impact of the scope outside the utilities sector
- EFRAG considers that more specific guidance and examples on what constitutes a regulatory agreement and a description of the characteristics of a regulator would be helpful to appropriately identify activities within the scope of the proposed model.

REGULATORY ASSETS, LIABILITIES AND TOTAL ALLOWED COMPENSATION

REGULATORY ASSETS, LIABILITIES AND TOTAL ALLOWED COMPENSATION

Regulatory Asset

- An enforceable present right, created by a regulatory agreement, **to add an amount** in determining a regulated rate to be charged to customers **in future periods** because part of the **total allowed compensation** for goods or services already supplied will be included **in revenue in the future**

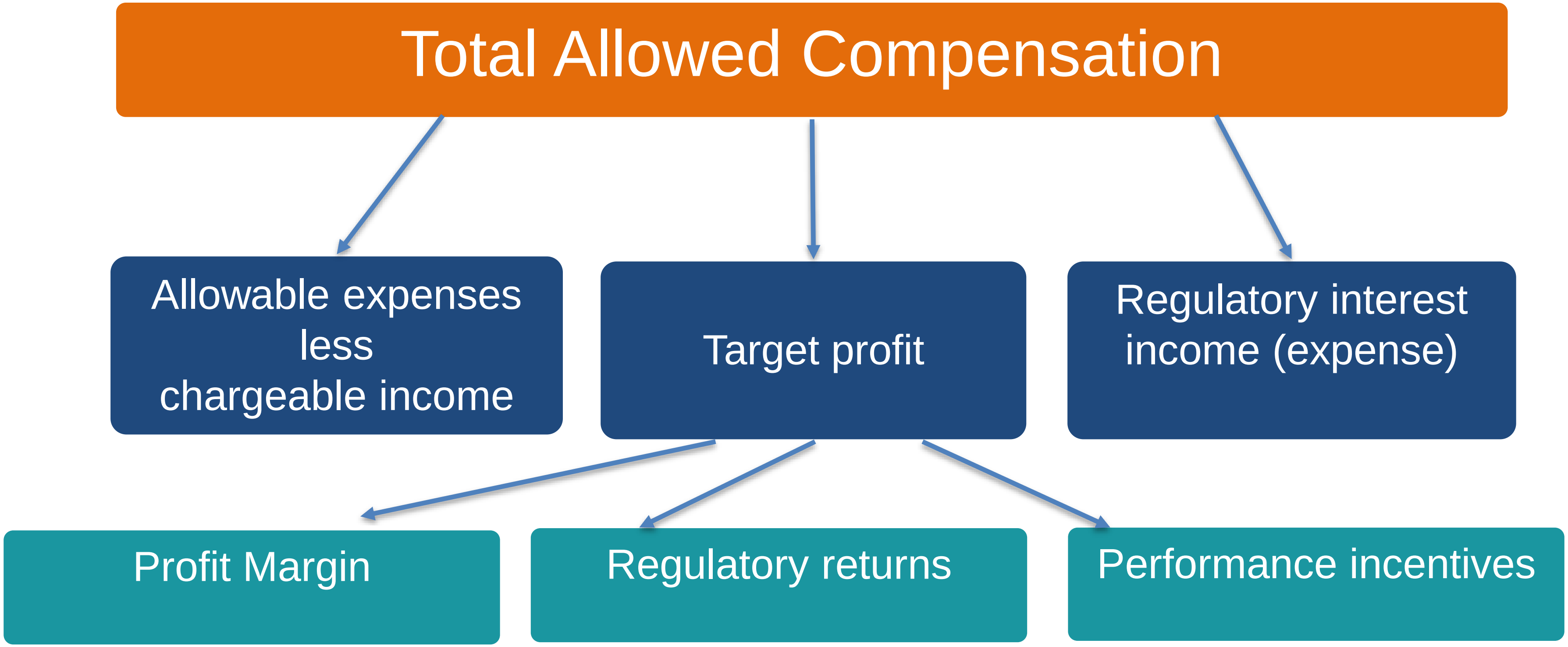
Regulatory Liability

- An enforceable present obligation, created by a regulatory agreement, **to deduct an amount** in determining a regulated rate to be charged to customers in future periods because the revenue already recognised includes an amount that will provide part of the **total allowed compensation** for goods or services to be supplied **in the future**

Total Allowed Compensation

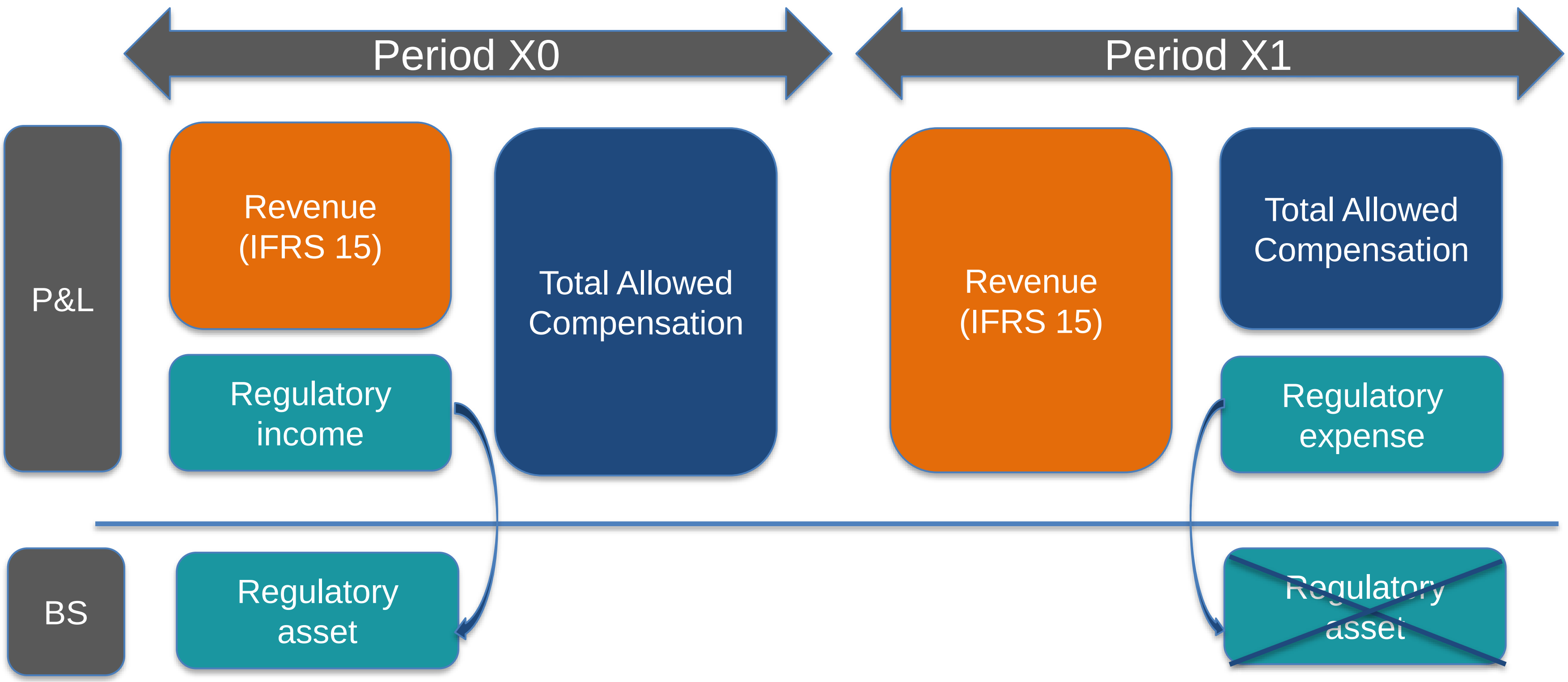
- The full amount of compensation for goods or services supplied that a regulatory agreement entitles an entity to charge customers through the regulated rates, in either the period when the entity supplies those goods or services or a different period

REGULATORY ASSETS, LIABILITIES AND TOTAL ALLOWED COMPENSATION



Source: the IASB Presentation & ED

REGULATORY ASSETS AND TOTAL ALLOWED COMPENSATION PRESENTATION

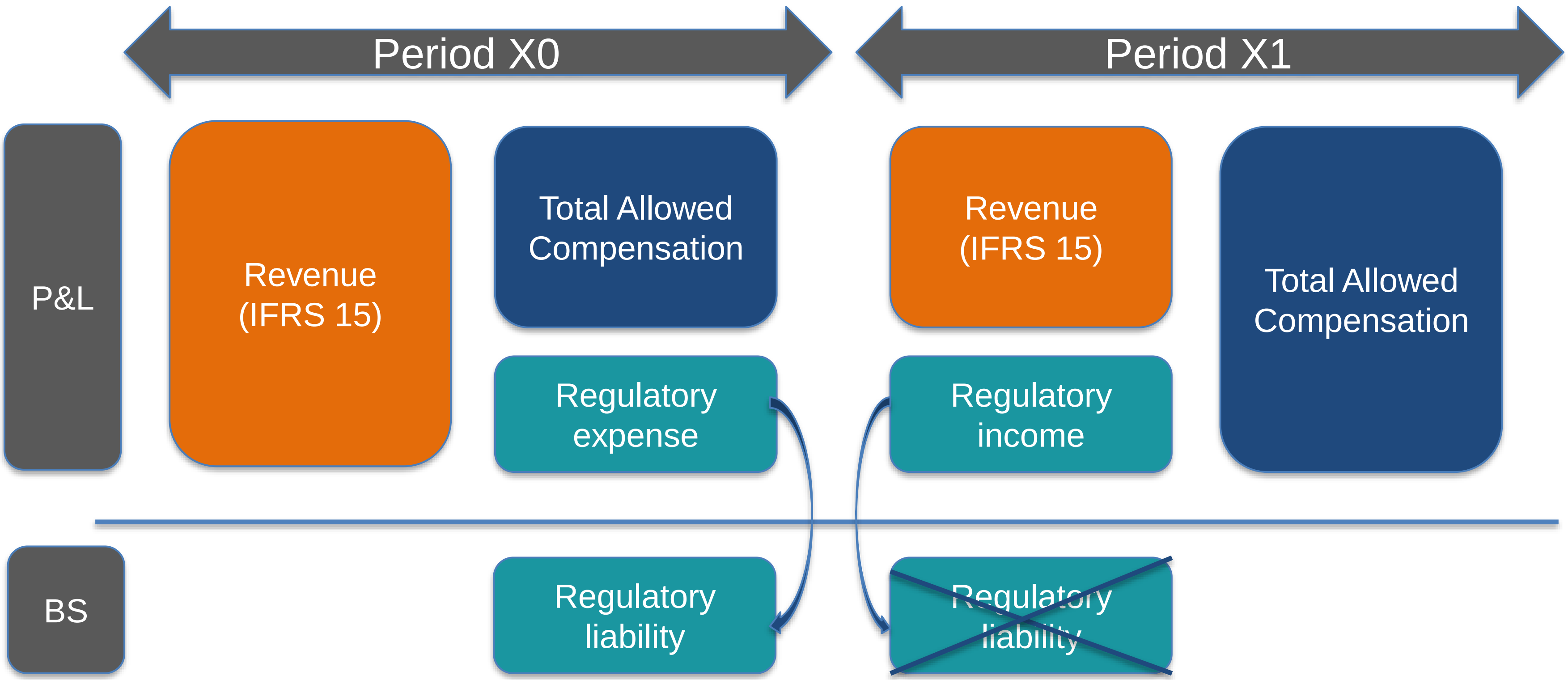


Under-recovery of the compensation in the current period creates regulatory asset:
Dr Regulatory Asset
Cr Regulatory Income

This regulatory asset is reversed in the future period(s) as it is recovered through the rates and reflected in revenue:
Dr Regulatory Expense
Cr Regulatory Asset

Source: the IASB Presentation

REGULATORY LIABILITIES AND TOTAL ALLOWED COMPENSATION PRESENTATION



Over-recovery of the compensation in the current period creates regulatory liability:
Dr Regulatory Expense
Cr Regulatory Liability

This regulatory liability is reversed in the future period(s) as it is deducted from the rates and not reflected in revenue:
Dr Regulatory Liability
Cr Regulatory Income

Source: the IASB Presentation

REGULATORY ASSETS AND REGULATORY LIABILITIES

EFRAG TENTATIVE POSITION

- EFRAG agrees with the proposed definitions of regulatory assets and regulatory liabilities
- EFRAG agrees that the accounting model should focus on total allowed compensation, including the recovery of allowable expenses minus chargeable income, a profit component and regulatory interest which compensates or charges the entity for the time value of money
- EFRAG agrees that regulatory assets and regulatory liabilities meet the definitions of assets and liabilities under the *Conceptual Framework*
- EFRAG agrees that an entity should account for regulatory assets and regulatory liabilities separately from the rest of rights and obligations arising from the regulatory agreement.

TOTAL ALLOWED COMPENSATION

EFRAG TENTATIVE POSITION

- EFRAG supports the proposed definition of total allowed compensation
- EFRAG supports the proposal in the ED that performance incentives form part of the total allowed compensation for goods or services supplied in the period(s) over which the performance criteria are monitored and evaluated
- EFRAG outlines two views and seeks stakeholders' feedback on the IASB proposal that the regulatory returns for CWIP, in cases where the regulatory agreement allows regulatory returns to be charged to customers during construction, **are only included in profit or loss when the asset is in use**
  - **View 1 –** against the proposal (Do not support deferring recognition of regulatory returns for CWIP when such returns can be charged to customer prior to asset being in use)
  - **View 2 –** support the proposal (Supports deferral of regulatory return until asset is operational)

TOTAL ALLOWED COMPENSATION

EFRAG TENTATIVE POSITION - continued

View 1: Against the proposal

EFRAG notes concerns on the proposed treatment of CWIP regulatory returns in situations where the regulatory agreement allows regulatory returns to be charged to customers during construction

- The proposal departs from the alignment of the accounting treatment with the regulatory treatment of regulatory returns
- Potential operational challenges of recognising regulatory returns related to CWIP only when the asset is in use - assets are used on a portfolio rather than individual basis to generate revenue and it is difficult to attribute revenue to a single asset
- Some entities have high volumes of initiated assets under construction and high volumes of these that become operational- and it will be challenging for these entities to apply the proposed treatment of CWIP regulatory returns

TOTAL ALLOWED COMPENSATION

EFRAG TENTATIVE POSITION - continued

View 2: Support the proposal

EFRAG acknowledges that the IASB proposal will reflect total allowed compensation when the underlying asset is being used to provide goods or services and being consumed (through depreciation) and this will result in a faithful representation of profit patterns particularly for entities that have material and long-duration CWIP

- For such entities, due to the proposed treatment of CWIP, the profit will be misleadingly understated when the asset becomes operational if the regulatory returns were recognised as part of the total allowed compensation during construction

- EFRAG notes that the proposal will contribute to comparability across entities regardless of how regulatory return is structured within regulatory agreements.

RECOGNITION AND MEASUREMENT

RECOGNITION AND MEASUREMENT

Cash-flow based measurement technique

Initial recognition

Estimate all future cash flows (including cash flows from regulatory interest)
Using 'most likely amount' method or 'expected value' method

Discount the estimated future cash flows
Using the regulatory interest rate unless this rate for a regulatory asset is insufficient

Subsequent measurement

Update estimates

- to reflect recovery of the regulatory asset or fulfilment of the regulatory liability
- for changes in estimates

Continue to use the discount rate determined at initial recognition, **unless** the regulatory agreement **changes** the regulatory interest rate

Source: the IASB Presentation

RECOGNITION

EFRAG TENTATIVE POSITION

- EFRAG agrees with the proposal that an entity should recognise all its regulatory assets and regulatory liabilities
- EFRAG agrees that if it is uncertain whether a regulatory asset or a regulatory liability exists, an entity shall recognise the regulatory asset or regulatory liability if it is more likely than not that it exists
- EFRAG considers that it would be useful for the IASB to provide application guidance on how to implement the various circumstances outlined (paragraph 27 of the ED) about how an entity would determine whether a regulatory asset and a regulatory liability exists
- EFRAG recommends that IASB provide further guidance on derecognition of regulatory assets and regulatory liabilities

MEASUREMENT

EFRAG TENTATIVE POSITION

- EFRAG supports the proposed cash-flow measurement technique because it is closely aligned with the amounts an entity is entitled to receive or obliged to fulfil under the regulatory agreement.
- EFRAG agrees with the proposal to reflect the credit risk that an entity bears when estimating the future cash flows arising from a regulatory asset
- EFRAG considers the requirements on the boundary of the regulatory agreement to be confusing and could be mixing up the entity's licence to operate with the enforceable rights and enforceable obligations arising from the regulatory agreement
- EFRAG considers that the guidance on the regulatory boundary should be included in the recognition part of the ED, and not in measurement
- EFRAG supports using either the most likely amount or the expected value method, depending on which approach provides more relevant information.

DISCOUNTING

EFRAG TENTATIVE POSITION

- Supports discounting of regulatory assets and liabilities but disagrees with the proposal for different discounting approaches for regulatory assets and liabilities
- Recommends that the IASB consider introducing a practical expedient to exempt entities from discounting if the effects of discounting are not significant (similar to IFRS 15)
- EFRAG is concerned by the complexity of the proposal, particularly regarding the minimum rate
- EFRAG has not formed a view on which discount rate an entity should use and seeks constituents' feedback on how regulatory assets and regulatory liabilities should be discounted
  - **View 1** – Use the regulatory interest rate for regulatory assets and regulatory liabilities
  - **View 2** – Use the general discounting principles in IFRS

DISCOUNTING

EFRAG TENTATIVE POSITION - continued

View 1 – Use the regulatory interest rate

- The regulatory interest rate is negotiated with the regulator and considered objective by users.
- Supporters of this view disagree with the proposed application of a minimum adequate rate as the discount rate for regulatory assets, when the regulatory interest rate provided for a regulatory asset is insufficient. What matters ought to be the discount rate agreed with the regulator, as this represents the rate the entity is entitled to recover (fulfil) when measuring its regulatory assets and regulatory liabilities
- Application of a minimum adequate rate would not be relevant information for users to understand regulatory assets and regulatory liabilities.

DISCOUNTING

EFRAG TENTATIVE POSITION - continued

View 2 – Follow IFRS discounting requirements

- The objective of discounting is to appropriately reflect the effects of the time value of money – the regulatory interest rate might have a different objective.
- In case of a significant financing component and the regulatory interest rate differs from the market rate, an entity should apply the requirements in IFRS 15 and use the prevailing interest rates in the relevant market

PRESENTATION AND DISCLOSURE

PRESENTATION

To present as a separate line items

Statement of financial position

- Regulatory Assets
- Regulatory Liabilities
- Split between current and non-current

Statement of financial performance

- Regulatory income minus regulatory expense
- Immediately below the revenue line item
- Including regulatory interest income and regulatory interest expense

In limited cases, some regulatory income or regulatory expense would be presented in other comprehensive income (OCI) if the underlying item is also presented in OCI

Source: the IASB Presentation

PRESENTATION – OFFSETTING

Paragraph 71 of the ED:
An entity is permitted to offset regulatory assets and regulatory liabilities that form separate units of account only if the entity:

- has a legally enforceable right to offset those regulatory assets and regulatory liabilities by including them in the same regulated rate; and
- expects to include the amounts resulting from the recovery or fulfilment of those regulatory assets and regulatory liabilities in the same regulated rate for goods or services supplied in the same period

Source: the IASB Presentation

DISCLOSURE

Disclosure requirements – paragraphs 72 - 85 of ED

Breakdown of regulatory income (expense)

- Additions
- Recovery/ fulfilment
- Regulatory income (expense)
- Change in estimates

Maturity analysis and risks

- Maturity profile of recovery/ fulfilment
- How risk and uncertainty affect recovery/ fulfilment

Discount rates

- Discount rates (or range) used
- Regulatory interest rate if minimum interest rate used

Reconciliation of regulatory asset (liability) balances

- Changes for reasons other than regulatory income (expense)

Source: the IASB Presentation

PRESENTATION

EFRAG TENTATIVE POSITION

- EFRAG agrees with the proposal to **present all regulatory income minus all regulatory expense as a separate line item immediately below revenue and to include regulatory interest** income and regulatory interest expense within this line item

- The proposed presentation is consistent with the objective of reflecting in the statement(s) of financial performance the compensation that the entity is entitled to for a given period regardless of when the related amounts are reflected in the regulated rate(s) charged to customers in that period

- EFRAG questions whether the gross presentation of the regulatory assets and liabilities on the statement of financial position would be useful for users

- In case an entity choses to offset EFRAG considers the off-setting requirements of paragraph 71(b) of the ED to be complicated

DISCLOSURE

EFRAG TENTATIVE POSITION

- EFRAG generally agrees that the proposed disclosures will provide relevant information to users of financial statements to understand the relationship between an entity's revenue and expenses resulting from its rate-regulated activities and provide insights into its prospects for future cash flows
- However, EFRAG considers that the level of detail required of some proposed disclosures might impose a significant burden on reporting entities if this information is not readily available
- EFRAG considers that there will be a **need to identify and prioritise** from the proposed disclosures, only those that will be ascertained to be beneficial to users of financial statements and will not impose an undue burden for preparers

QUESTIONS TO EFRAG USER PANEL MEMBERS

OBJECTIVE, SCOPE, RECOGNITION AND MEASUREMENT

- **Do you have concerns about entities recognising regulatory assets or regulatory liabilities when they should not be (and vice versa)?**
- **Do you think that there should be additional criteria in the scope definition (e.g., limited competition, regulator committed to support the financial viability through the rate-setting process, customer having no ability to avoid price increases) for eligibility to be within the scope of the proposed Standard?**
- **Do you agree with the recognition of regulatory assets and regulatory liabilities?**
- **Which of the two views on discounting regulatory assets and regulatory liabilities (slides 22-24) do you support and why?**

PRESENTATION

- **Do you agree that a company present all regulatory income minus all regulatory expense as a separate line item immediately below revenue? If not, what approach do you support and why?**
- **Do you agree with the proposed inclusion of regulatory interest income and regulatory interest expense within the line item immediately below revenue? If not, what approach do you suggest and why?**
- **Which of the two views on discounting (slides 22-24) do you support and why?**

DISCLOSURE

- **Do you agree that the overall disclosure should focus on information about an entity's regulatory income, regulatory expense, regulatory assets and regulatory liabilities? If not, what focus do you suggest and why?**
- **Do you have any comments on the proposals for specific disclosure objectives and disclosure requirements? Would requiring any other disclosures help a company better meet your information needs?**
- **Which of the proposed disclosures is most useful and which is the least useful? [paragraphs 72 -85 of the ED)**

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THANK YOU FOR YOUR ATTENTION !

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