Regulatory Assets and Regulatory Liabilities
Early-Stage Effects Analysis – User Outreach Feedback

Objective

1 The objective of the session is to update the EFRAG TEG on the feedback received from the outreach to users on the early-stage effects analysis of the IASB's Exposure Draft (ED) *Regulatory assets and Regulatory Liabilities*.

Overview

2 On 28 October 2020, EFRAG launched an online survey inviting users of financial statements of rate-regulated entities to participate in an effects analysis outreach by completing a survey questionnaire with a response deadline of 8 January 2021. The outreach was intended for specialist users of financial statements of rate-regulated entities and it also aimed to build on the feedback from related past EFRAG user outreach highlighted in the **Appendix**.

3 EFRAG received eight responses from: sell-side analysts (four); a buy-side analyst; rating agency analyst (two); and an investment manager. These users covered equity (six respondents) and bond/fixed income (two respondents). The users covered utilities and the transport sectors and were mostly focused on the European area (EEA and UK), but a few also have a global focus. All users indicated that they are covering entities which report under IFRS. See the **Appendix** for more details on the user respondents' background.

4 In this paper, we refer to regulatory assets and regulatory liabilities taken together as "regulatory balances". In addition, we use the following terminology to describe the extent to which respondents provided particular feedback.

Term	Extent of response
Most	A large majority
Many	A small majority or large minority
Some	A small minority, but more than a few
A few	A very small minority

5 The rest of this paper is broken down into:

(a) Executive summary;

(b) Detailed findings;

(c) Appendix 1 with a detailed profile of user respondents; and

(d) Appendix 2 with summary of findings from past EFRAG user outreach.

Executive summary

Analysis of rate-regulated entities under current reporting regime

6 User respondents indicated that they are using different sources of information to analyse the economic implications of regulatory requirements on rate-regulated entities. All the user respondents rely on financial statements and most also rely on

regulatory reports. There was a lesser and varied level of reliance on corporate analyst briefings, sell-side reports, consultancy reports and data aggregators.

7 Apart from one respondent (rating agency analyst) that also indicated a focus on earnings-to-debt ratios as part of the overall assessment of creditworthiness, most user respondents noted that their analytical focus when reviewing financial statements is on:

(a) Performing an assessment of the enterprise value to influence buy or sell decision; or

(b) Assessing the financial return and risk profile including the earnings, the cash flow profile and the ability to recover costs.

8 The examples of non-GAAP metrics that the respondent users stated they apply (e.g., rate of return on regulated assets, regulatory asset base-RAB, regulatory earnings, enterprise value/RAB) and other useful information needed (e.g., basic make up and structure of regulation, outcome delivery incentives, cost of capital, total expenditures) — confirms that they consider the effects of rate regulation while assessing rate-regulated entities. It also corroborates the feedback gotten during the past EFRAG user outreach.

9 Most user respondents indicated that they do take the effect of rate regulation into account when valuing companies and performing a Purchase Price Allocation (PPA) during acquisitions.

10 Most user respondents noted that the disclosure of regulatory balances affects the type of analysis they perform on rate-regulated entities and that they normally include reported regulatory assets and regulatory liabilities in their quantitative analytical models.

11 On the supplementary disclosures needed, some user respondents noted the need to have disclosures that explain main items and calculation methodology, and the rationale behind management judgment in determining regulatory assets and liabilities. One respondent also highlighted the importance of increased transparency of IFRS financial statements due to the limitations of regulatory accounts in some jurisdictions. But a few respondents were concerned that supplementary disclosures could further obfuscate IFRS financial statements.

Possible high-level impacts of proposed model

12 Most users indicated that recognition of regulatory assets, regulatory liabilities and related regulatory income, regulatory expense improves understanding of regulated entities, improves valuation accuracy, and leads to a more efficient allocation of capital in markets.

13 The user respondents had mixed views on the impact of the proposed model on the extent of reliance on non-GAAP measures. There was no clear-cut view on whether it would increase, decrease, or have no impact on reliance on these measures.

14 On balance, the user respondents expected benefits, and many expected no drawbacks to the recognition of regulatory assets and regulatory liabilities. However, some of the user respondents expect some drawbacks including that it may fail to reflect the regulatory complexities and could lead to confusion, and it will likely not lead to comparability with US GAAP. This finding is consistent with the feedback from past EFRAG user outreach, where most users considered it would be beneficial to recognise regulatory balances on the financial statements, but some expressed concern that it could increase complexity and reduce the understandability of financial statements of rate- regulated entities.

Detailed findings

15 The feedback received has been presented based on questions posed in the survey questionnaire under the following two main sections:

(a) Analysis of rate-regulated entities under the current financial reporting regime; and

(b) Possible high-level impacts of the proposed model.

Analysis of rate-regulated entities under the current financial reporting regime

<u>*Sources of information*</u>

Related survey question- Where do you source the information you use to analyse the terms and key information on regulatory requirements/laws and understand whether these have economic implications for the entity such as impacts on cash flows stemming from the rates charged to customers?

16 Respondents indicated they depend on the following sources of information:

(a) Financial statements (eight respondents- 100%);

(b) Regulatory reports (seven respondents-87.5%);

(c) Corporate analyst briefings (five respondents- 62.5%);

(d) Sell-side reports (four respondents- 50%);

(e) Sector/industry consultancy reports (three respondents-37.5%); and

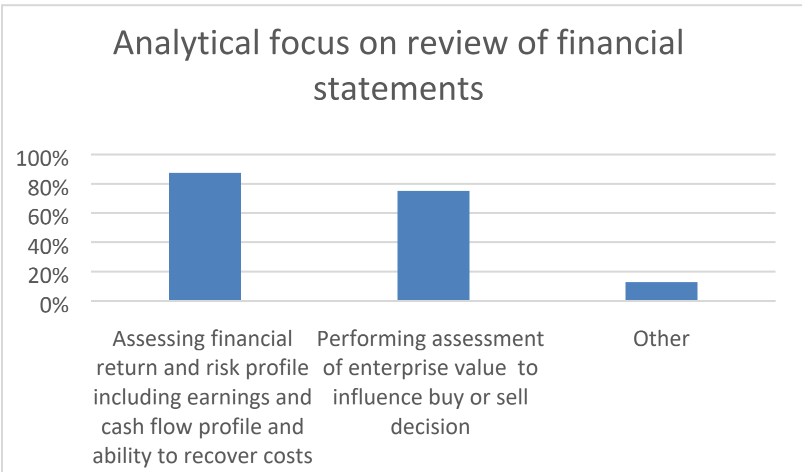
(f) Data aggregators (two respondents-25%).

<u>*Analytical focus during review of financial statements*</u>

Related survey question- What is your specific analytical focus when reviewing financial statements of rate-regulated entities?

17 As reflected in **Figure 1**, there are different aspects to users' analytical focus when reviewing financial statements of rate-regulated entities. Seven of the eight respondents (87.5%) indicated that it is for assessing financial return and risk profile including earnings and cash flow profile and the ability to recover costs. Six of the eight (75%) indicated that they are performing an assessment of enterprise value to influence a buy or sell decision.

18 Figure 1: Analytical focus when reviewing financial statements of rate-regulated entities[1]



[1] Users could indicate both options therefore the percentages in the graph does not add to 100%.

19 The respondent (rating agency analyst) that selected ‘Other’ indicated that they assess earnings-to-debt ratios of utilities as a key input into the financial risk of each utility, which is an important input into the overall assessment of creditworthiness.

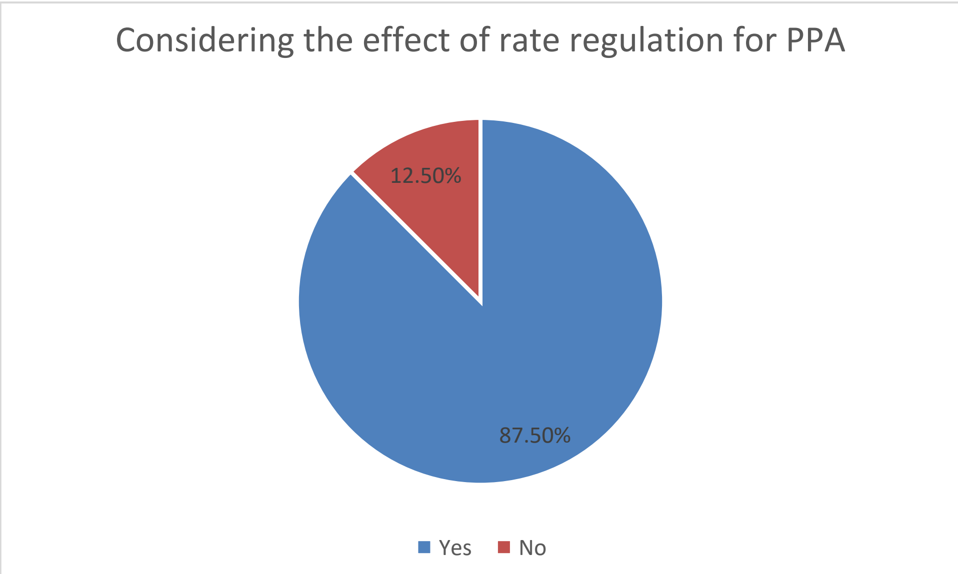
20 As reported in paragraphs 29 to 31, the metrics applied by the user respondents confirms that they focus on assessing performance, enterprise value, stewardship, and creditworthiness of rate-regulated entities. The identified metrics also confirm that users consider the effects of rate regulation when analysing companies.

Effect of rate regulation on valuation and PPA

Related survey question- Do you consider the effect of rate regulation during the valuation of and purchase price allocation to rate-regulated entities?

21 As reflected in **Figure 2**, seven respondent users (87.5%) indicated that they consider the effect of rate regulation during the valuation of and purchase price allocation to rate-regulated entities.

Figure 2: Considering the effect of rate regulation for valuation and PPA



22 The following elaborating comments were provided:

(a) A respondent (buy-side analyst) highlighted that Regulatory Asset Base (RAB) based approaches are applied to valuation.

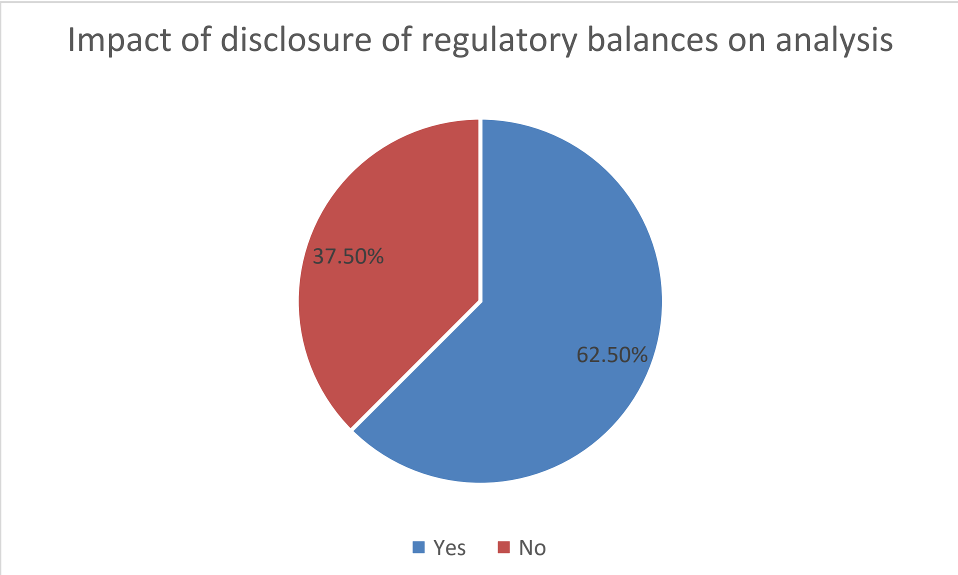
(b) A respondent (rating agency analyst) noted that in jurisdictions where regulatory balances are recognised (e.g. the U.S. and selectively in other regions), these are considered during the analysis of entities as no adjustments are made to U.S. GAAP earnings or balance-sheet figures to remove the effects of regulatory accounting. However, regardless of whether regulatory balances are recognised, the analyst expected to continue to analyse the effects of regulatory actions on a utility's financial health and there to be no change in the approach to fundamental financial analysis of utilities.

Impact of disclosing regulatory assets and regulatory liabilities on type of analysis

Related survey question- Does the decision of rate-regulated entities to disclose (or not disclose) regulatory assets or regulatory liabilities affect the type of analysis you perform on these entities?

23 As shown in **Figure 3**, for many of the respondents (five or 62.5%), disclosure of regulatory assets or regulatory liabilities affects the type of analysis they perform. Three respondent users (37.5%) that did not expect their analysis to be impacted by such disclosure.

Figure 3: Impact of disclosure of regulatory balances on analysis



24 Two respondents that expected their analysis to be impacted by disclosure of regulatory balances anticipated improved transparency and a lower cost of equity/risk. Another respondent highlighted that the impact would be pronounced for utilities but less so for transport and infrastructure asset entities. For the latter entities, volume (or quantity) of sales rather than the rate base is the driver of the share price.

25 Respondents that did not expect their analysis to be impacted by disclosure of regulatory balances provided the following elaborating comments:

(a) One respondent (rating agency analyst) noted that the fundamental financial analysis of utilities will not change due to recognition of regulatory balances.

(b) One respondent (sell-side analyst) expected no impact as the data on regulatory balances is available in regulatory filings.

(c) One respondent (sell-side analyst) noted that in the UK, there is already good disclosure of regulated assets and liabilities.

Applicability of regulatory balances to quantitative analytical models

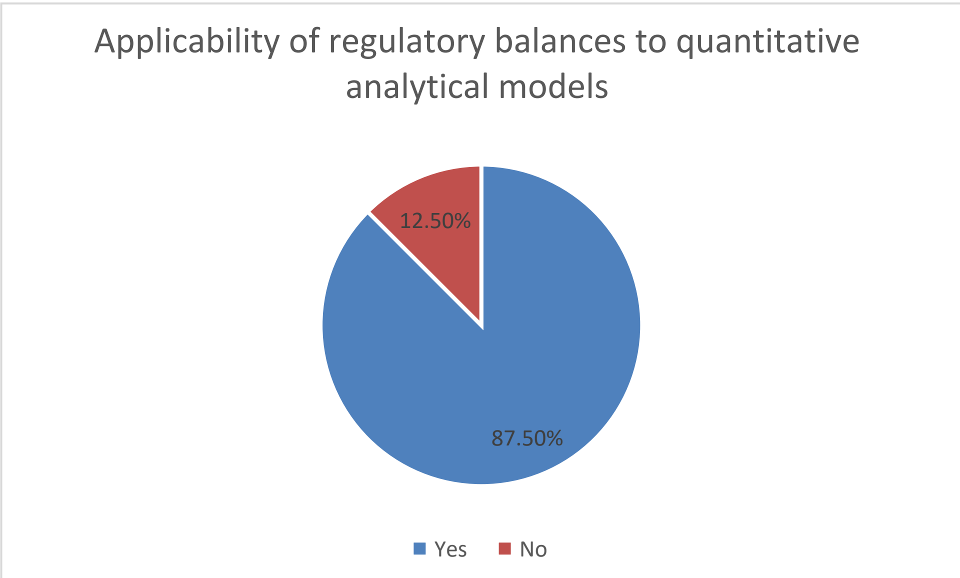
Related survey question- Do you explicitly include any reported regulatory assets and regulatory liabilities in your quantitative analytical models (i.e., valuation, credit analysis) related to rate-regulated entities?

26 As shown by **Figure 4** below, seven respondent users (87.5%) indicated that they include reported regulatory assets and regulatory liabilities in their quantitative analytical models (i.e., valuation, credit analysis) and only one (12.5%) did not.

27 One respondent (buy-side analyst) indicated they include regulatory assets and regulatory liabilities while performing a sum-of-the-parts valuation analysis.

28 The respondent (rating agency analyst) who indicated that they are not including reported regulatory assets and regulatory liabilities in their quantitative analytical models noted that they calculate ratios such as Funds From Operations/Debt for utilities in a comparable way across their global portfolio, regardless of the accounting framework. In other words, even though US GAAP requires recognition of regulatory balances, they are currently not including regulatory balances in their quantitative models because these are not recognised under IFRS.

Figure 4: Applicability of regulatory balances to quantitative analytical models



Financial statements and Non-GAAP metrics

Related survey question- What financial statement and non-GAAP metrics do you currently apply when analysing rate-regulated entities?

29 Users indicated that they currently apply the following non-GAAP metrics when analysing rate-regulated entities:

(a) Regulatory earnings (Sell-side analyst);

(b) Rate of return on regulated assets calculated from the raw data in the regulated accounts (Sell-side analyst);

(c) RAB which is the starting point of valuation, Regulatory Asset Value-RAV, RCV (Sell-side analysts);

(d) Regulatory asset, regulatory equity (Sell-side analyst);

(e) Enterprise Value/RAB (Sell-side analyst);

(f) Return on Equity (Investment manager, sell-aside analysts);

(g) Regulatory return on equity (Sell-side analyst);

(h) Funds From Operations/Debt, Debt/EBITDA (Rating agency analyst).

30 The above examples of non-GAAP metrics (sometimes obtained from regulatory accounts) that the respondent users stated they apply (e.g., rate of return on regulated assets, regulatory earnings, enterprise value/RAB) — confirms that they consider the effects of rate regulation while assessing performance, enterprise value, stewardship, and creditworthiness of rate-regulated entities. It also corroborates the feedback gotten during the past EFRAG user outreach.

Other useful information

Related survey question- What other information related to regulatory agreements including any disclosures that may be currently provided by rate-regulated entities, do you find to be useful?

31 Respondents' feedback on other useful information includes:

(a) Basic make-up and structure of regulation (Sell-side analyst);

(b) The presentations and Regulatory News Services (RNS) for preliminary and interim results (Sell-side analyst);

(c) Regulatory receivables (Buy-side analyst);

(d) Total expenditure (capital and operational expenditure) forecast, actuals and allowances (Sell-side analyst);

(e) Outcome delivery incentives (ODIs) (Sell-side analyst);

(f) Key financial metrics such as rate base (Sell-side analyst); and

(g) Allowed weighted average cost of capital (WACC) composition (Sell-side analyst).

32 The feedback on other useful information is indicative of analytical considerations on the effects of rate regulation during the assessment of rate-regulated entities.

Supplementary disclosure needs

Related survey question- If any, what supplementary disclosure would you consider necessary to understand how management has determined regulatory assets and regulatory liabilities if these are disclosed in the financial statements or the management commentary? Do you find some of this information, not provided in the IFRS financial statements, in the regulatory reports or elsewhere?

33 The following responses to the above question:

(a) One respondent (buy-side analyst) noted that it is important to understand the net impact on valuation of regulatory assets and liabilities. The respondent proposed that it is necessary to have a note in the annual reports to explain main items and calculation methodology. Another respondent (sell-side analyst) noted the need to use company-specified information (i.e., amounts).

(b) One respondent (rating-agency analyst) proposed that to the extent there is management judgement in determining regulatory assets and liabilities, the rationale behind these judgements should be disclosed.

(c) One respondent (sell-side analyst) noted that it would be great to have increased transparency under IFRS financial statements especially as continental European companies and regulators are less transparent, and regulatory documents (if there is disclosure) are often not in English (whereas company accounts are). The respondent noted that UK regulators are very transparent and publish this information so the lack of this information in IFRS accounts of a company is not an issue.

(d) However, one respondent (sell-side analyst) noted that the regulatory accounts are the main source of information. The respondent observed that current IFRS financial statements are only useful for items outside the regulated entity and in response to other questions was opposed to additional IFRS requirements as these would obfuscate IFRS financial statements.

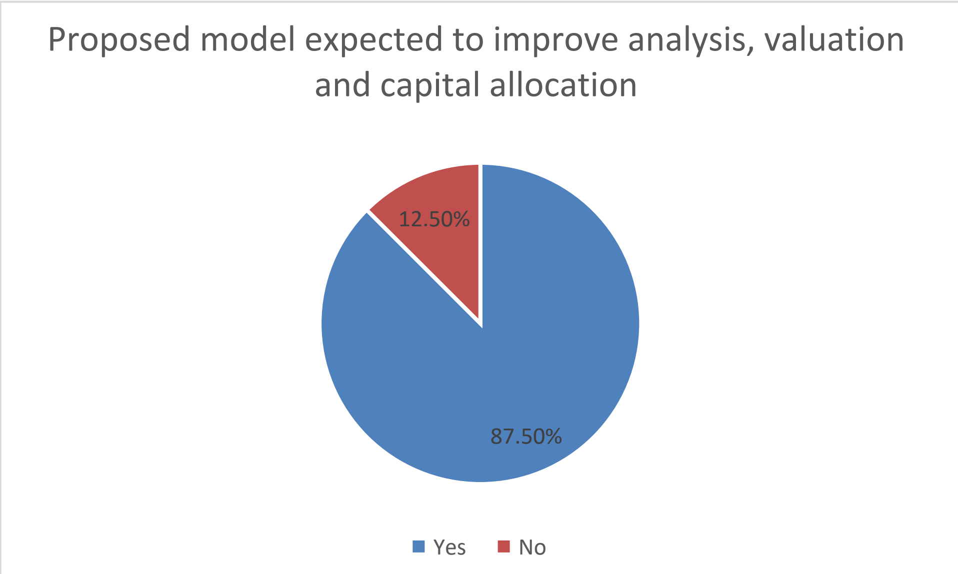
Possible high-level impacts of proposed model

Expected impact of proposed model on analysis, valuation and capital allocation

Related survey question- Would recognition of regulatory assets and regulatory liabilities and related regulatory income and regulatory expense in the income statement improve understanding of regulated entities, improve valuation accuracy and lead to a more efficient allocation of capital in markets?

34 As shown in **Figure 5** below, seven user respondents (87.5%) indicated that the proposed model improves understanding of regulated entities, improves valuation accuracy and leads to a more efficient allocation of capital in markets. One respondent (12.5%) did not expect the model to have a positive impact.

Figure 5: Proposed model expected to improve analysis, valuation and capital allocation



35 Those that expected the model to improve analysis, valuation and capital allocation noted the following:

(a) the model would make it easier to understand these entities;

(b) the model could lead to a clearer Regulatory Asset Base calculation;

(c) to the extent the proposed model converged with US GAAP, it could facilitate global comparisons;

(d) accounting for regulatory balances could potentially help to diminish artificial volatility in the income statement;

(e) transparency on what is inside versus outside the regulatory ring fence is welcome; and

(f) it would reflect reality.

36 The respondent (sell-side analyst) that did not expect the model to improve valuation and capital allocation had concerns that it would add a huge layer of obfuscation.

Impact of proposed model on reliance on non-GAAP measures

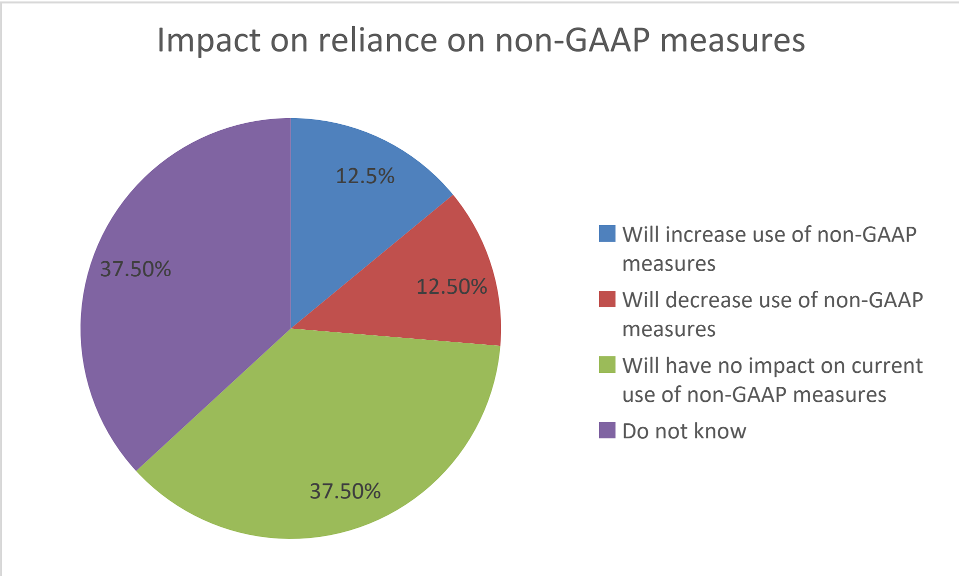
Related survey question- Would requirements to recognise regulatory assets and regulatory liabilities have any impact on your reliance on non-GAAP measures?

37 As shown in **Figure 6** below, the user respondents had mixed views on the impact of the proposed model on their reliance on non-GAAP measures. Three respondent users (37.5%) expected no impact, Three users (37.5%) indicated that they do not know the impact of the proposed model, one (12.5%) indicated that it would increase use of non-GAAP measures while another (12.5%) indicated that it would decrease the use of these measures.

38 The user respondent (sell-side analyst) that indicated that the recognition of regulatory assets and regulatory liabilities will increase the use of non-GAAP measures noted that IFRS accounts would become even more complex, and that they would likely rely on regulated accounts to a greater extent.

39 The user respondent (investment manager) that indicated that the recognition of regulatory assets and regulatory liabilities will decrease the use of non-GAAP measures noted that financial accounting provides a better understanding of the earnings power of the regulatory assets (excluding working capital movements which are included in IFRS) and would allow a better comparison with US stocks.

Figure 6: Impact of proposed model on reliance on non-GAAP measures

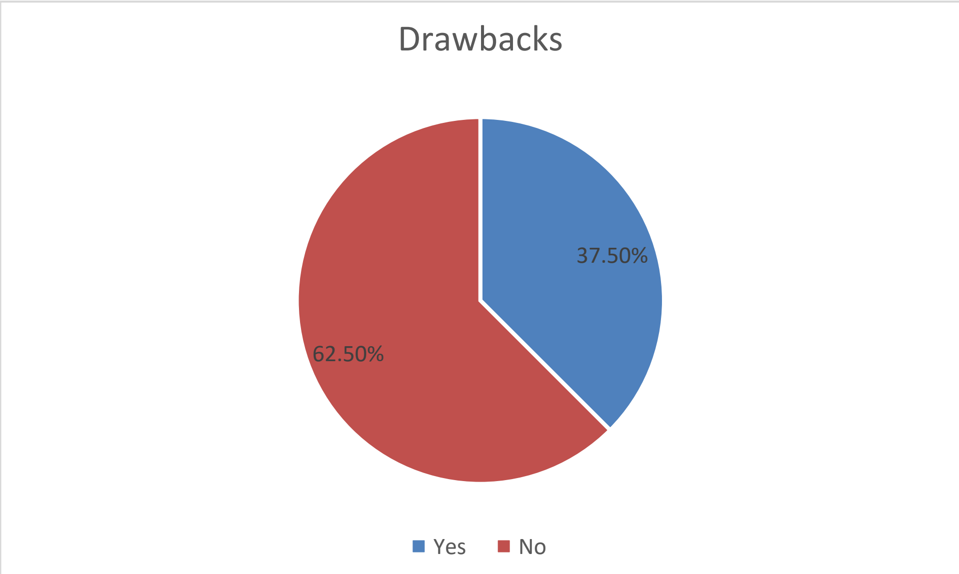


Expected drawbacks to the recognition of regulatory assets and regulatory liabilities

Related survey- Would you consider there to be any drawbacks to the recognition of regulatory assets and regulatory liabilities?

40 As shown in **Figure 7,** five user respondents (62.5%) considered there to be no drawbacks to the recognition of regulatory assets and regulatory liabilities while three (37.5%) expected some possible drawbacks.

Figure 7: Expect drawbacks with proposed model



41 The respondents that expected possible drawbacks cited the following reasons:

(a) a divergence from US GAAP would negate the expected benefits of the proposed model (rating-agency analyst);

(b) recognising regulatory assets and regulatory liabilities can be confusing especially if they fail to capture all the regulatory complexities (sell-side analyst); and

(c) general limitations of IFRS information could be exacerbated by the proposed requirements (two sell-side analysts).

42 The findings from this user survey are consistent with the feedback from users during the past EFRAG user outreach, where most users considered it would be beneficial to recognise regulatory balances on the financial statements, but some expressed concern that it could increase complexity and reduce the understandability of financial statements of rate regulated entities.

Appendix 1: Profile of user respondents

Introduction

1 This appendix provides the general information of users that respondent to the outreach activity.

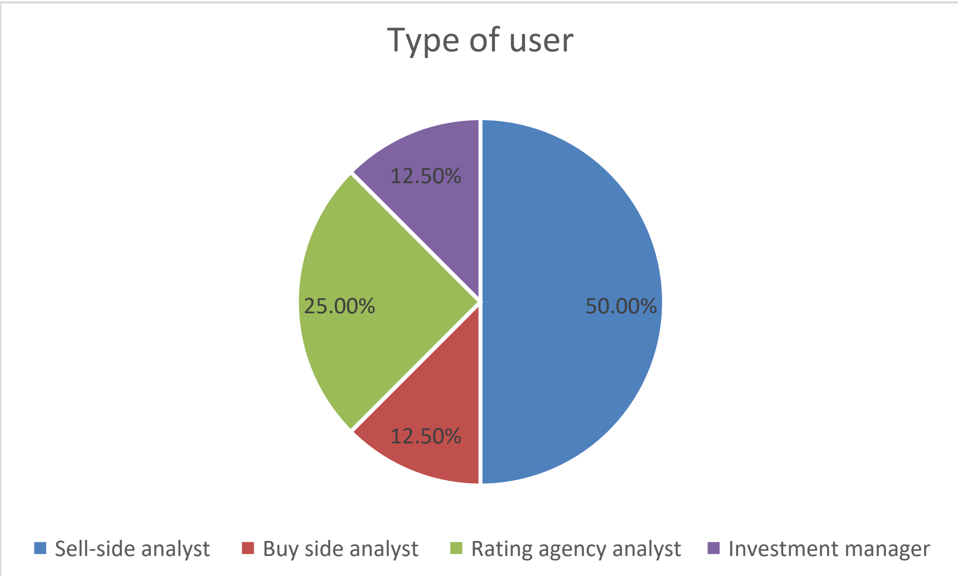
2 Users that responded to the survey included three sell-side analysts, two buy side analysts, two rating agency analysts and an investment manager. The users indicated that they mostly focus on the utilities and transport sectors and focus mainly on equity and bonds as asset classes. The users covered mostly the European area, but some also have a global focus. All users indicated that they are covering entities which report under IFRS.

General information

Related survey question-What type of user are you?

3 The user functional profile is illustrated in **Figure 8** below,

Figure 8: Type of user



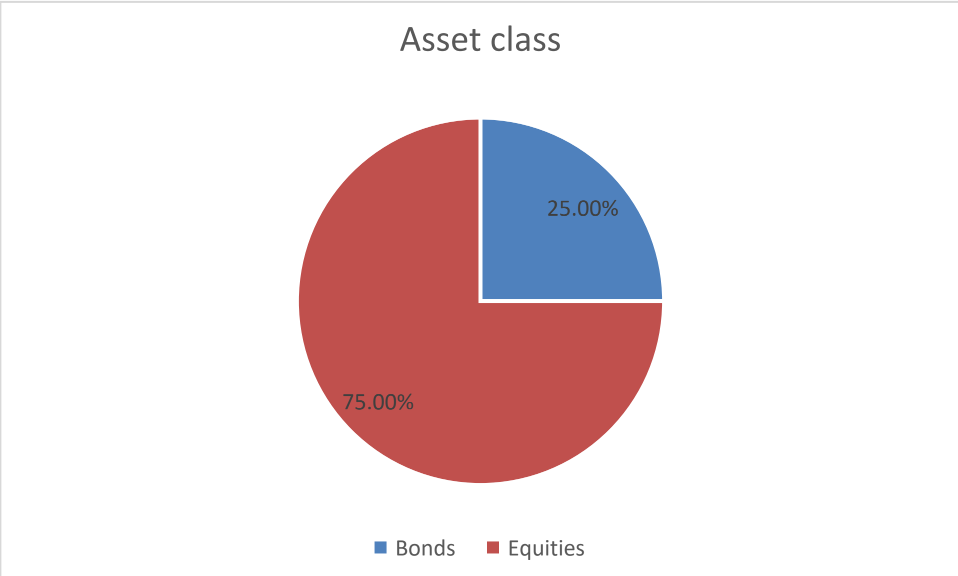
What sectors with rate regulated entities do you cover?

4 All respondent users indicated that they are following the utilities sector and three respondents (37.5%) cover the transport sector.

Asset classes

5 As reflected in **Figure 10** below, six respondent users (75%) indicated that they focus mainly on equities as an asset class while two respondents (25%) cover bonds.

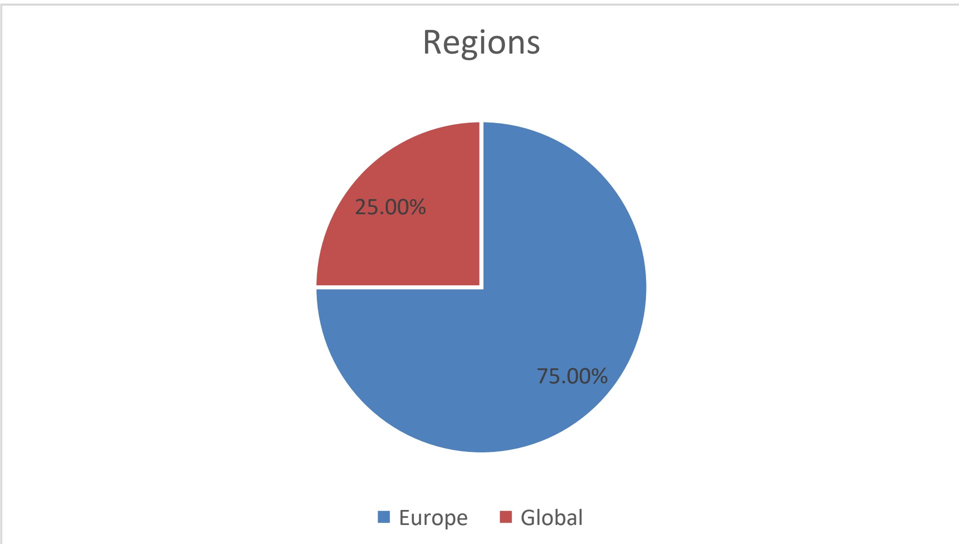
Figure 10: Asset classes



Regions covered by users

6 Six respondent users (75%) indicated that they cover mainly Europe, whilst the other two indicated they have a more global coverage. Please refer to the diagram below:

Figure 11: Regions



Financial reporting standards

7 All user respondents cover companies that apply IFRS.

Appendix 2: User feedback from past EFRAG outreach

8 In 2014, as input to its response to the IASB Discussion Paper, EFRAG obtained outreach feedback from 19 analysts from seven jurisdictions including six EU jurisdictions covering the following industries: toll roads, airports, utilities (gas, electricity, and water), infrastructure, waste management and heating (see Feedback Statement). In addition, in December 2014, EFRAG conducted a user outreach event with EFFAS and ABAF (see Event Report). The feedback from this past outreach is summarised below.

Information and analytical needs

9 Users want to understand the driving forces of rate regulation, how transparent and predictable it is, the financial effects it creates, and how it impacts the business model and the risk profile of an entity that operates with activities subject to rate regulation. Furthermore, users need to understand the reasons why reported results differ from budgeted figures and how reported differences could be translated into adjustments to future tariffs and therefore cash flows for the entity.

10 Users need detailed information to assess the return on capital employed, an entity's ability to repay debts and to assess future cash flows.

11 Information on rate regulation is used mainly to estimate future cash flows, enterprise value and assess the financial stability and creditworthiness of the entity operating in rate-regulated environment. In regimes where the regulatory asset base is used to assess the rate of return of entities operating rate-regulated activities, the regulatory asset base is the key indicator for users to develop their models.

Information sources and challenges

12 IFRS financial statements generally do not provide the information that users regard as 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. Therefore, to make their investing and lending decisions, users obtain the information from different sources other than the IFRS financial statements. However, the level of information provided by the regulator differs from regulation to regulation and within jurisdictions. This can significantly affect the accuracy and comparability of their analyses.

13 A major difficulty for users is the lack of comparability and consistency in the way financial information is currently presented where different regulations exist in different countries.

Expectations on financial reporting

14 Most of the users broadly favour the inclusion of the financial effects of rate-regulated activities in the primary financial statements as this would enhance the usefulness of the information provided. They expected that recognising the economic effects of rate regulation in the primary statements would:

(a) result in a measure of performance that reflects what an entity is entitled to earn;

(b) result in useful financial information to assess prospects of future cash flows; and

(c) portray the economic reality of entities operating rate-regulated activities. They supported separate presentation of the effects of rate regulation on rate-regulated activities as they assess different risks profiles when entities also operate activities that are not rate-regulated.

15 However, some users noted that there were drawbacks to the recognition of these the effects of rate regulation mainly because most rate-regulated regimes are very complex and continually changing. In their view, recognition of the effects of rate regulation at the expense of reliability and relevance would increase complexity and therefore reduce the understandability of financial statements.

16 Where enforceable rights and obligations exist, users preferred having this information recognised in the primary financial statements where a certain level of reliability is ensured; but they would be concerned about recognition if the definition of elements (e.g., assets and liabilities) in the Conceptual Framework were not met.

17 Where recognition of regulatory items in the primary statements were considered, sufficient, supplementary qualitative and quantitative disclosures should be mandatory to let users understand how management has exercised judgement and what risks are attached to the regulatory items.