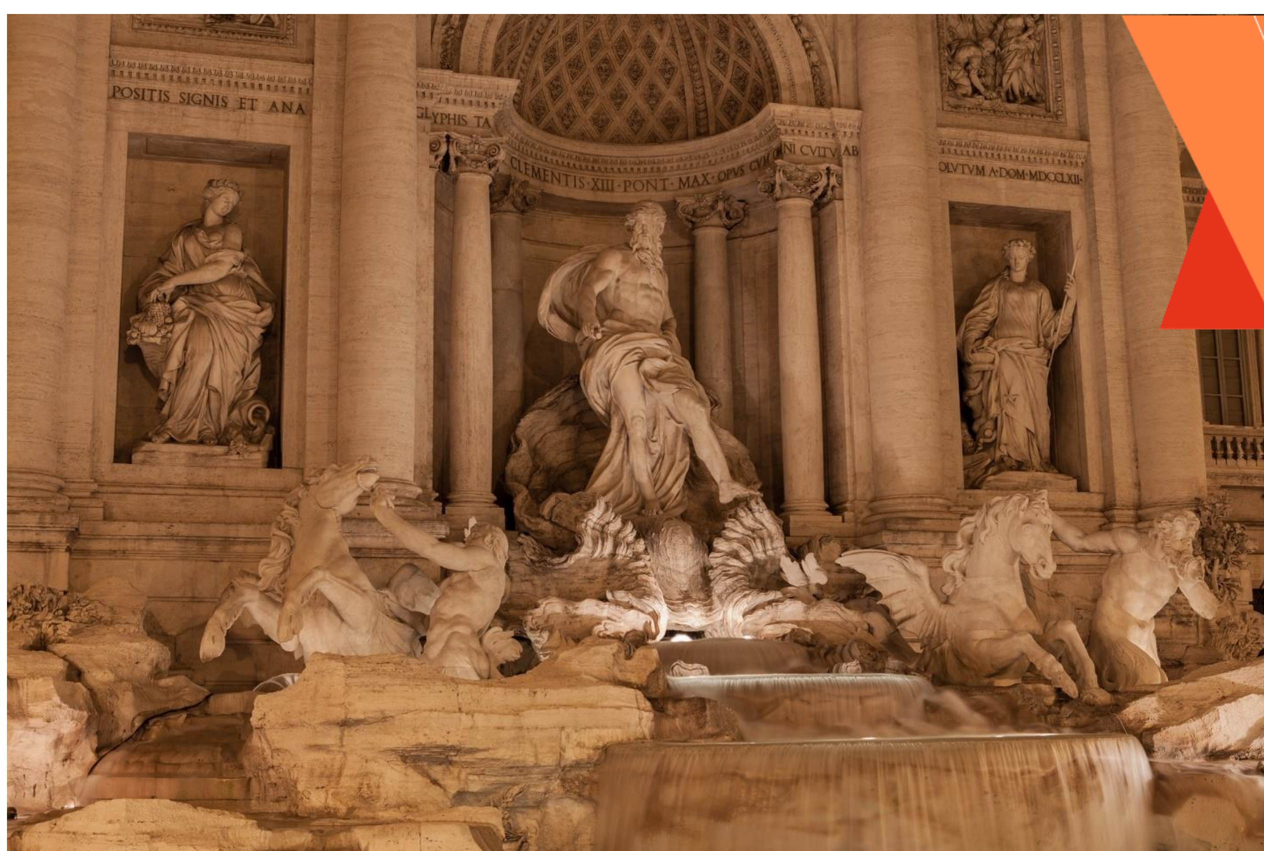
RATE-REGULATED ACTIVITIES: REGULATORY ASSETS AND REGULATORY LIABILITIES – ITALIAN PERSPECTIVE

SUMMARY REPORT

JOINT OUTREACH ONLINE EVENT – 6 MAY 2021



This report has been prepared for the convenience of European constituents by the EFRAG Secretariat and has not been subject to review or discussion by neither the EFRAG Board nor the EFRAG Technical Expert Group. It has been reviewed by the speakers at the event.

Introduction

In order to receive input from Italian constituents and to stimulate the discussion around the IASB Exposure Draft *Regulatory Assets and Regulatory Liabilities* ('ED'), EFRAG, OIC, and the IASB organised a joint outreach online event on 06 May 2021. This report has been prepared for the convenience of European constituents to summarise the event and will be further considered by the involved organisations in their respective due process on the IASB proposal.

Participants and panellists were welcomed to the meeting by **Angelo Caso**, Chairman of the Executive Board of the Organismo Italiano di Contabilità ('OIC').

The agenda covered the IASB proposals for accounting of regulatory assets and regulatory liabilities.

Angelo Caso made introductory remarks which were then followed by the presentations of:

- **Sue Lloyd**, IASB Vice-Chair and **Mariela Isern**, IASB Technical Staff;
- **Chiara Del Prete**, EFRAG TEG Chairwoman; and
- **Andrea Guerrini**, member of the Board of ARERA[1], the Italian Regulatory Authority for Energy, Networks and Environment, and President of WAREG - European Water Regulators ('the Authority').

The presentations were followed by a roundtable panel discussion and questions to panellists and audience which were moderated by **Alberto Giussani**, the OIC Vice-Chair.

Presentations by speakers

1. Introduction

Angelo Casò highlighted that the *Rate-Regulated Activities* project addressed a topic of particular interest to the OIC given the potential impact on Italian entities. Indeed, for the Italian-listed companies, approximately 30% of the market capitalisation is related to companies operating in rate-regulated sectors and therefore potentially affected by the proposed new accounting standard. The revenues of these companies, in 2019, at a consolidated level, totalled around 120 billion euros.

He pointed out that these data certainly reflected the attention that needed to be paid to the IASB proposal in order to prevent unintended consequences when the standard would be applied. Moreover, in Italy, there were many non-listed companies operating in regulated sectors that prepared their financial statements in accordance with local accounting standards. Therefore, to reduce the risk that different accounting treatments may generate inequality between companies, it will be important to start a reflection on local accounting standards in the light of the IASB project, taking into account, of course, the different frameworks between the two accounting systems.

Therefore, an impact analysis will be launched at the national level to give concrete support to the IASB in finalising the new accounting standard.

[1] ARERA carries out regulatory and supervisory activities in the sectors of electricity, natural gas, water services, waste cycle and district heating.

Established by Law No. 481 of 1995, ARERA is an independent administrative authority that operates to ensure the promotion of competition and efficiency in public utility services and protect the interests of users and consumers.

2. IASB and EFRAG presentations

Sue Lloyd and **Mariela Isern** presented the IASB proposed guidance on regulatory assets and regulatory liabilities.

Chiara del Prete presented key positions of the EFRAG draft comment letter with special emphasis on total allowed compensation ('TAC'), accounting for regulatory returns on construction work in progress ('CWIP'), discounting, and disclosure. The presentation also included a section asking for constituents' views on certain topics (fact patterns that highlight challenges in applying the scope of the project, the two views on CWIP, the two views on discounting, disclosures, and interaction with other IFRS standards - IFRIC 12 *Service Concession Arrangements* and IFRS 3 *Business Combinations* exception).

3. Italian Regulatory Authority for Energy, Networks and Environment (ARERA)

Andrea Guerrini highlighted that the topic under discussion was important for ARERA because although the regulator had no authority on accounting matters, it was fundamental to have coordination between the world of regulation and the way which the regulatory items were accounted for.

He observed that financial statements should reflect the regulatory framework in which a rate-regulated entity operates and an accounting standard, such as the one under discussion, seems to go in the right direction.

He further noted that in Italy, in the regulated sectors, about 7% of water operators, 10-12% of electricity, gas and multi-utility operators prepared their statutory financial statements in accordance with IFRS. The others used local accounting standards issued by the OIC.

He pointed out that from the Authority's point of view, the presence of an accounting standard for the treatment of regulatory items would improve financial reporting towards all stakeholders, including the Authority. Indeed, the Authority is a user of the financial statements on which it builds the regulatory framework and assesses the quality of its regulation. In this spirit, ARERA will participate in the consultation.

He emphasised that there were some open questions, including the regulatory income: a prudential approach (resulting from Civil Code) prevails in Italy and so entities tend not to recognise regulatory income when there is uncertainty on the amounts of this income.

He focused on construction work in progress, which is a central topic for the regulators. A regulatory agreement recognises rates of return on net invested capital (including work in progress). In this way, the regulator introduces an incentive to complete the work. However, an accounting requirement that postpones the recognition of the revenues to a subsequent period (i.e., when the asset is in use), would lessen the incentive introduced by the regulator.

He believed that cooperation between regulators and accounting standard setters is crucial in regulated sectors because accounting standards may neutralise the choice of the regulators and possibly undermine the financial viability of the entities in the sector. An example of constructive cooperation between a regulator and an accounting standard setter is the work made by ARERA and OIC on the Fund of New Investments ('FONI').

4. Round Table

Question 1 to the Panellists: what are the most critical aspects of the ED?

Alberto Giussani started with a question to the panellists on what the most critical aspect of the IASB Exposure Draft was.

Cosimo Guarini, Head of Financial Reporting of Gruppo Terna S.p.A., member of OIC and EFRAG Rate Regulated Activities Working Group, pointed out the accounting for the regulatory return on an asset not yet available for use. In general, according to the ED's proposals, if the regulatory agreement allows an entity to include regulatory returns in determining a tariff for goods or services supplied over a period, such regulatory returns do form part of the total allowed compensation for goods or services supplied in the same period and therefore the entity should be able to recognise a regulatory asset or a regulatory liability. There is an exception for returns on assets not yet available for use (so-called construction work in progress). In fact, according to the ED, in this case, the asset under construction forms part of the total allowed compensation only once the asset is available for use. The IASB specified in the Basis for Conclusions that the reason for this requirement is that during that period no goods or services are supplied to the customers.

Cosimo Guarini did not agree with this approach, as in his view, this was contrary to the regulatory agreement, where the regulator ensured a return for the construction activity. However, according to the ED, this margin is recognised only when the asset is used. Missing the recognition of this margin in the construction period, the revenue that covers the cost of construction is materialising only when the asset is amortised and, in this way, the incentive to complete the construction activity does not exist anymore.

Another critical aspect of the ED, albeit not directly pertaining to Gruppo Terna, is related to the requirement to have enforceable rights and obligations, as a condition for recognition and measurement of rate-regulated assets and liabilities. In fact, in Italy, in particular, in the electric sector, the entity has the right or obligation, created by a regulatory agreement, to add or reduce an amount in determining the future tariffs, but due to the process of setting up the tariffs, there is significant uncertainty about these amounts.

What happens is that the Authority communicates the tariffs only when the Authority has collected (and approved) the investments made by all the entities of a specific sector, so the single entity knows future tariff only after the publication of the financial statements. He expressed a fear that these regulatory assets may not qualify for recognition.

Fabiana Lungarotti, Head of Financial Statements and Administration at Ferrovie Dello Stato S.p.A., introduced another critical topic concerning the measurement of the regulatory assets and regulatory liabilities.

In particular, she observed that it may sometimes be challenging to reliably estimate the future cash-flows of a regulatory asset or liability, either using “the expected value method” or “the most likely amount method”.

A “faithful representation” required by the Conceptual Framework, linked to the “reasonable estimates” in paragraph 28 of the ED (“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”) could be difficult to achieve due to unexpected events (such as COVID-19) or the challenging task to define the risks, in particular the credit risk. This happens for example in the railway sector: the entity that manages the railway infrastructure does not know, at initial recognition, which companies will use a railway in the future. In their case, the regulatory agreement has been only recently established and they were currently in the first regulatory period. Accordingly, they still did not know who would be the entity paying for the future services, where the regulatory asset would have to be recovered. So, when the regulatory asset is initially recognised, an entity might not be able to identify who will be the customer and thus its credit risk.

In conclusion, as indicated in paragraph BC126 of Basis for Conclusions, the certainty of the measurement of the future cash flow is proportional to the strength of the framework. In the railway sector, there is not a matter of strength, but a matter of youth of the regulation system.

Giorgio Acunzo, EY Associate Partner– IFRS Italian Desk Leader, member of the consultative groups of the IASB, EFRAG and OIC on Rate Regulated Activities, observed that another critical aspect related to the interactions between the proposals and IFRS 15 *Revenue from Contracts with Customers*. He noted that in some cases the ED might require the recognition of regulatory income even if revenue should not be recognised in applying IFRS 15. Therefore, he believed that it would be helpful to further illustrate the requirements in the ED when the drivers of revenue recognition under IFRS 15 and those for regulatory purposes differ. For example, an entity may incur costs in relation to a revenue contract (e.g., training costs, mobilisation costs) that cannot be capitalised (e.g., because of cost requirements in IAS 16 *Property, Plant and Equipment*, IAS 38 *Intangible Assets* or IFRS 15) and are expensed as incurred. In addition, while these costs may relate to a revenue contract, they may not be incurred to fulfil a performance obligation (e.g., they may be a setup activity). In such circumstances, the entity may be recognising revenue at a future date (i.e., the timing of recognition of revenue differs from the timing of recognition of those costs) and, if the related performance obligation is satisfied over time, the entity may be recognising revenue using a measure of progress that is either: a) not based upon costs incurred (e.g., time-elapsed, units consumed); or b) based upon costs incurred, but excludes those costs from the measure of progress. In contrast, those costs may be allowable expenses under the applicable regulation.

As an auditor, he observed that there will be the need for entities to equip themselves with the processes and systems necessary to make the application of the proposed model traceable to a third party in areas where significant recourse to professional judgment may be required (recognition, measurement, definition of the boundaries of regulation). Furthermore, he noted that the model is currently based on a minimum unit of account that is equal to each timing difference; therefore, the administrative and accounting systems underlying the implementation of the model should ensure and allow the auditability of information arising from them.

Polling question: *What are the most critical aspects of the ED?*

More than 40% of respondents answered that it is related to the measurement of the regulatory assets and liabilities.

Question 2 to the Panellists: what are the implications of the IASB proposals for the separate financial statements?

Alberto Giussani asked **Alessandro Sura**, Adjunct Professor, La Sapienza University Rome, member of OIC national and international financial reporting committees, about the implication of the proposed new standard, considering that it is possible to apply IFRS standards also in separate financial statements in Italy.

Alessandro Sura noted that it was not clear whether dividends from a regulatory income may be distributed to shareholders of a rate-regulated entity. In addition, there was uncertainty about the fiscal treatment of regulatory income and expenses (i.e.: is a regulatory income taxable already when recognised or only when the relevant cash flows will materialise? Similarly, when is a regulatory expense deductible and will there be symmetry in the fiscal treatment?) He observed that to solve these issues, amendments to the existing laws on dividends and taxable profits will be necessary or at least appropriate.

Question 3 to the Panellists: what is emerging from the impact analysis?

Alberto Giussani introduced a new topic related to the impact analysis of the proposed new standard.

Fabiana Lungarotti noted that they performed some preliminary impact analysis. However, at the moment, they had not yet estimated the costs of the proposed new standard. They were analysing the different concession agreements in the railway sector to identify the ones that fall within the scope of the ED and the ones that are outside the scope. This assessment in some cases is not straightforward, such as in the following examples.

The regulatory agreements related to the management of the national railway infrastructure last 5 years and it is not easy to identify who will be the client (railway company that will use the infrastructure) that will pay tariffs that are modified according to the business volumes that prevailed in the previous regulatory cycle. The example relates to regulatory agreements that foresee a modification of the future tariff depending on the differences between forecast and actual levels of sale volumes, rather than on forecast levels of costs or investments.

She also mentioned an example of a regulated entity that has two different business units, one that manages the regional infrastructure and another that acts as the client, running the transportation business, both in the same group.

Another case is the agreement about the commuters' service with local transportation authorities: there is a 10-year business plan and in case the revenues from sales of tickets to the passengers are below the target, the local administration will compensate the rate-regulated entity, without increasing the price of the tickets. So, there are two classes of clients: the passengers and the local administration.

In her last remark, she appreciated the fact that the new standard is to be applied as an overlay to IFRS 15 so that it will not impact the revenues already recognised under IFRS 15.

Cosimo Guarini commented that Terna Group (the Italian Transmission System Operator) was carrying out an assessment to evaluate the impact of the new standard but at the moment this analysis was not yet completed. He thought that the Group would apply the standard but a detailed analysis of all the components of the tariff to properly estimate the impact of the ED was necessary.

Another important aspect in this initial phase was related to the implementation of the IT systems because the measurement of regulatory assets and liabilities will need complex systems to manage and account for all the components of the tariff.

Polling question: *What would be the impact of the proposed new standard?*

More than 80% of respondents answered that a significant impact is expected.

Question 4 to the Panellists: are there possible impacts on market and competition and what reactions would you expect from users?

Alberto Giussani asked **Alessandro Sura** about the expected impacts of a proposed new accounting standard on rate-regulated activities on the market and on the competitiveness between companies operating in the same sector. Moreover, what could be the reaction of the users?

Alessandro Sura observed that the impact of the new standard on the market should be positive, considering that analysts usually give relevance to regulatory assets and liabilities.

He noted that at the moment there was a divergence in practice (some entities recognised regulatory assets and liabilities, others – did not). The new standard will improve the comparability between entities that operate in rate-regulated sectors and this should help users of financial statements.

A further positive effect for the market could be that a new accounting standard that requires entities to measure regulatory assets and liabilities, will bring greater awareness and precision in the definition of tariff plans by the authorities. He expected that the regulatory agreements and tariff plans would have to be enhanced, where they are currently not precise on some aspects that are needed to support the accounting.

Question 5 to the Panellists: what are the implications for auditors?

Alberto Giussani asked **Giorgio Acunzo** about the impacts of a proposed new accounting standard on audit activities.

Giorgio Acunzo highlighted that, in this phase where detailed effect analysis by preparers was still in progress, it was only possible to do a theoretical assessment. It was necessary that entities would implement their processes and systems to permit auditors to carry out the appropriate audit procedures.

This was also necessary for preparers in terms of disclosures.

He highlighted another interesting area of debate: the so-called sufficiency test of the discount rate in the regulatory agreement. Evaluating the fairness of a rate is a sure element not unrelated to the Standards but in this case, it can become a highly discretionary exercise. The ED requires to use the higher of the regulatory interest rate and the "minimum interest rate". Generally, the regulatory interest rate will be the discount rate in circumstances where a risk premium is added to the time value of money (i.e., WACC). However, it is unclear if, in order to apply the proposals in the ED, an entity should unbundle the time value component from this unique rate of return. Furthermore, he noted that unbundling the time value component from the single rate to assess its sufficiency could be overly complex and may require additional effort to track items that may not be separately monitored under the regulatory agreement and would result in applying a rate that is unrelated to the regulatory agreement; similarly, the accounting outcomes would presumably not correspond to the regulatory agreement.

Another aspect is related to the boundary of the regulatory agreement. There are cases in which the entities operate in prorogation (e.g., when the conclusion of the new tender is pending). It is not clear if these entities should apply the model or not.

Finally, he noted that it was very important to understand how the new standard interacts with other standards. Regarding IAS 36 *Impairment of Assets*, he noted that it was not clear whether CGUs should include regulatory assets and regulatory liabilities. He noted that in the Basis for Conclusions it is clarified that corresponding cash flows are highly independent and consequently regulatory assets are inherently measured using future cash flows; however, those cash flows are ultimately arising from contracts with customers and therefore are also used to estimate the recoverable amount of other assets in a CGU.

5. Panellists concluding remarks

Alberto Giussani asked the panellists to share their conclusions.

Fabiana Lungarotti supported the draft accounting standard. However, in her opinion, it could be useful to verify the interactions with other standards, for example, IFRS 15, IAS 37 *Provisions, Contingent Liabilities and Contingent Assets*, IAS 36, IAS 16, IFRS 3 *Business Combinations*, IFRIC 12, particularly when the same regulatory agreement in scope of the future standard results also in rights and obligations in scope of the other IFRS standards. In her view, it would be fundamental for a homogeneous and organic application of all the standards applicable by companies included in the scope of the ED.

Finally, she believed that in the implementation phase, the establishment of a Transition Resource Group could be useful.

Cosimo Guarini welcomed the new principles, which will provide information on regulation and its quantitative impacts useful to users of financial statements. However, he noted that there were still many particular aspects that needed to be explained better, i.e., the differences between the depreciation of assets reported in the balance sheet according to IAS 16 and the regulatory values. It should be clarified how to deal with these differences in the balance sheet.

He also underlined that the time frame for the first-time adoption (18-24 months after the publication of the Standard) was not sufficient to deal with all the issues that will inevitably arise during the first application. He also suggested that it would be useful for the IASB to establish a Transition Group to support preparers in interpretative matters.

Giorgio Acunzo expressed his personal support for the project. He highlighted that if during the redeliberation process, sufficient elements will be provided based on the feedback of the constituents, to allow entities to robustly exercise judgment in applying the model, it would create accounting outcomes with a high degree of traceability and auditability. Furthermore, he invited the preparers to explore in detail the practical interactions with other IFRS standards in order to allow the IASB to consider them in time. Finally, he also supported the setting up of a Transition Group.

Finally, **Alessandro Sura** noted that it would be important to understand the implications in local accounting standards because there are many SMEs in Italy operating in rate-regulated sectors. The new standard could provide a relevant source of guidance, also before the development of an equivalent local GAAP.

6. Closing of the event

Alberto Giussani concluded the event, thanked the presenters and panellists and closed the meeting.