

FEEDBACK STATEMENT

DISCUSSION PAPER REPORTING THE FINANCIAL EFFECTS OF RATE REGULATION

INTERVIEWS WITH INVESTORS AND ANALYSTS

AUGUST - DECEMBER 2014

Introduction

The IASB issued a Discussion Paper *Reporting the Financial Effects of Rate Regulation* on 17 September 2014, with comments due by 15 January 2015. To respond to the Discussion Paper, EFRAG has conducted outreach with users to understand users' information needs in respect of an entity's rate-regulated activities.

1. Objective of this Feedback Statement

This Feedback Statement summarises the feedback received during the outreach activities conducted with users based on information received as at mid-December 2014 and has been prepared for the convenience of European constituents.

2. Outreach activities

What we did

To prepare its response to the IASB's Discussion Paper, EFRAG consulted a number of European investor and analyst users of financial statements (and one user from the US) through telephone meetings aimed at obtaining evidence from users on:

- a) Where users presently source the information they use, such as:
 - (i) the IFRS financial statements of rate-regulated entities; or
 - (ii) other sources of information such as local GAAP financial statements, investor presentations, direct contact with entities and public information provided by the rate regulator.
- b) How investors and lenders use this information in making investment and lending decisions.
- c) The information about the entity's rate-regulated activities and the rate-regulatory environment that users want included in financial statements or accompanying documents such as management commentary.
- d) Whether users think it is preferable to include the effects of rate regulation in the statements of financial position, profit or loss and other comprehensive income with supporting note disclosures, or in the note disclosures or management commentary.

EFRAG staff also consulted the EFRAG User Panel.

The feedback received at these meetings is consolidated and included in this report.

A separate feedback statement will be prepared for the outreach event '*Rate-Regulated Activities: is there anything missing from the Balance Sheet?*' that took place on 18 December 2014.

Interviews conducted

EFRAG staff interviewed 19 **users** namely investors (equity analysts both on the sell and the buy side) and analysts (buy-side and the sell-side equity analysts and credit analysts) from a range of European countries and one analyst from the US. The names of the individual users and their respective organisations have been treated on a confidential basis.

Interviews were structured based on a questionnaire, which broadly covered all questions regarding users' needs that are in the Discussion Paper.

The table below presents the number of respondents by country and respective background.

Respondent by country:		Respondent by background:	
Belgium	2	Equity analysts	13
Italy	3	Credit analysts	6
Netherlands	1		
Norway	1		
Spain	4		
UK	7		
USA	1		
	19		19

These users covered the following industries: toll roads, airports, utilities (gas, electricity, and water), infrastructure, waste management and heating.

Summary

The main observations made by users is summarised as follows:

- *Scope and description of defined rate regulation* – The description of rate regulation in the Discussion Paper is likely to apply to entities that operate airports, air traffic control and waste management and is not limited to the electricity, gas and water utility sector.
- *Where information about rate regulation is currently obtained by users* - 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. 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.
- *Use of information* - 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.

- *Where users would like to see the effects of rate regulation* – 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. Users believe 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 support 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.

Some users have noted that a rate-regulated entity has rights and obligations that arise from the regulation, which other non-rate-regulated entities do not have. These rights and obligations result in assets and liabilities that need to be recognised in the financial statements in order to appropriately capture the economics of the regulation and reflect how it affects an entity that operates within that regulation.

- *How current disclosures in IFRS could be improved to cater for users' needs* - Users that support recognition in the primary financial statements also want note disclosure that includes a qualitative description of the rate-regulated regimes in which the entity operates, information regarding the regulatory asset base and the factors affecting the rate-regulated revenue requirement agreed by the rate regulator.
- *Issues and needs of users* - In the absence of specific guidance in the IFRS literature, there is divergence in practice in providing a consistent set of financial information on the effects of rate regulation on an entity's financial position, performance and cash flows.

Some users noted that there are 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.

3. Detailed feedback

Most users would like the financial effects of rate-regulated activities to be reflected in the primary financial statements.

Where users would like to see the effects of rate regulation

Most users stated that they would like the financial effects of rate-regulated activities to be reflected in the primary financial statements, whilst some users stated that they were indifferent.

Users that supported recognition said that rate-regulated entities had rights and obligations created by the framework agreement under which they operated, and which needed to be reflected in the financial statements. This would enhance their understanding of how the applicable rate regulation affects an entity's performance, financial position and future cash flows of the entity. These users stated that the accounting should reflect the economic effects of rate regulation. They suggested that the quantitative information included in the primary financial statements be supplemented by note disclosure in the financial statements or in the management commentary.

Those users that favoured recognition of the effects of rate regulation in the primary financial statements believed that:

- by recognising the effects of rate regulation in the statement of financial position, the predictive value of financial information would increase as users could know whether an entity expected to be able to recover its costs and the investments in infrastructures, to earn an agreed fixed amount of revenue (the revenue requirement) under the regulatory agreement and to generate sufficient returns to cover its cost of capital;
- presenting the financial effects of rights and obligations that rate regulation creates would ease their analyses as currently they adjust the IFRS numbers, mainly using information from outside the IFRS financial statements that is not audited;
- by presenting adjusted revenue in profit or loss, users could understand how to link reported revenue to the future cash flows that an entity is entitled to receive under the regulatory agreement. In addition, presenting only billed revenue in profit or loss could reduce the usefulness of information on performance as it shows earnings volatility that is not factual; and

- by portraying the effects of rate regulation on the financial situation, the unique rights and obligations would result in significant amounts that need to be considered by users that analyse rate-regulated entities.

Some users were indifferent about whether the financial effects of rate-regulated activities should be reflected in the primary financial statements or only in a disclosure note in the financial statements, as long as this information would be available in the IFRS financial statements.

A few users said that the combination of complex rate-regulatory regimes, different types of rate-regulation affecting different industries/sectors and jurisdictions would hinder the possibility of developing an accounting standard that would produce reliable and understandable information for users.

Only a few users stated that they would prefer to obtain the information about the economic effects of rate-regulated activities from the notes in the financial statements or the management commentary. In their view, recognition of these economic effects of rate regulation have significant drawbacks mainly because most rate-regulated regimes are very complex and because of the ongoing changes to the rate regulation which are not always well communicated and sometimes difficult to predict. The combination of complex rate-regulatory regimes and different types of rate-regulation affecting different industries/sectors and jurisdictions would hinder the possibility of developing an accounting standard that would produce reliable and understandable information for users. Some examples provided of the issues associated with recognition in the primary financial statements were:

- recognition of the effects of rate regulation could obscure financial information that results from applying IFRS (e.g. IAS 16 *Property, Plant and Equipment*), and increase complexity in order to address the timing mismatch between the revenue requirement and recognised (billed) revenue; and
- determining fundamental numbers such as the regulatory asset base for the rate-regulated entity (or 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.

How current disclosures in IFRS could be improved to cater for users' needs

General disclosures

Users need general disclosures on the mechanics of rate regulation and on how these affect an entity's performance, cash flows and financial position.

The majority of the 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 in a transparent and comparable manner between entities affected by the same or similar rate regulation. Users noted that rate regulation is often complex and generally available only in local languages. Having note disclosure within the IFRS financial statements would ease their analyses on the economic effects that rate-regulation has on an entity's performance, financial position and cash flows.

The majority of users noted that they would encourage entities, to the extent possible, to consolidate the information in a single section/note in the financial statements. However, they would also favour cross references to other parts of the annual report (i.e. management commentary) in circumstances where entities already provide this information due to local requirements – for instance – information about regulatory risks.

Furthermore, users indicated that the following general information would be useful:

- an explanation of the regulatory framework and how this affects an entity's performance, cash flows and financial position. This is relevant as users consider that rate-regulated activities have a different risk profile from other types of activities;
- information on regulatory uncertainty and stability. The risks that entities face as a result of rate regulation, whether regulators (and potentially governments) are committed to supporting the revenue requirement and how stable/strong the regulatory framework is in terms of, for example, legal enforceability of the effects that are created by rate regulation;
- specific rights and obligations for a rate-regulated entity that are created by the rate-regulatory agreement under which an entity operates; and

- the track-record of the entity's recovery and/or settlement of economic effects of rate regulation.

Performance

Most users stated that they needed to understand the differences between the billed revenue and the revenue requirement in the current and future periods

Regarding performance, most users stated that they needed to understand the differences between the billed revenue and the revenue requirement in the current and future periods. suggested the following disclosures as being useful for this purpose:

- The causes of variability in the billed 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 or seasonality effects).
- How consolidated results are affected by rate-regulated activities.
- Which costs related to rate-regulated activities are recoverable. This would permit users to assess how incurred costs would affect future cash flows through the revenue requirement.
- The factors that affect the revenue requirement. For instance, some users consider that the regulatory asset base is the key to determining the revenue requirement a rate-regulated entity will be entitled to earn.
- The source of bonuses and penalties based on performance.
- Segment information per jurisdiction/country on the revenue requirement with an explanation of the factors incorporated in each revenue requirement.

Financial position

Users that supported the recognition of the effects of rate regulation in the primary financial statements would like disclosures to assess the timing to recover and collectability of the economic effects of rate regulation.

Regarding financial position, users that supported the recognition of the effects of rate regulation in the primary financial statements, noted that they need to understand:

- the expected timing to recover and settle the economic effects of rate regulation; and
- management's assessment on their collectability, including any estimate regarding changes in regulation.

When a regulatory asset base is used, users would like disclosures about the entity's regulatory asset base

Where regulation permits the use of specific financial undertakings to recover economic effects of rate regulation (e.g. the securitisation of tariff deficits are recognised as receivables in some countries), users would like to understand how this type of transaction affects the entity's financial position.

When a regulatory asset base is used, users would like disclosures about the entity's regulatory asset base for each asset class in each geographical region, the components of the regulatory asset base and their residual useful life, and the evolution of the regulatory asset base over time. Users find these disclosures about the regulatory asset base useful because:

- entities generally run their rate-regulated operations, including expenditure/cost policies, by managing their regulatory asset base; and
- the regulatory asset base is a tool for assessing enterprise value and forecasting future earnings, dividends and cash flows based on the return that the entity is entitled to earn.

Users generally acknowledge 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. Furthermore, users noted that in some rate-regulatory regimes the exact amount of the regulatory asset base is not made available by the rate regulator. Finally, users noted that usually the regulatory asset base is determined using conceptual frameworks that are significantly different from principles in IFRS. Some users were concerned that recognising highly judgemental amounts in the primary statements may generally reduce the reliability of financial information.

To counteract some of these challenges, users suggested that entities should provide, where practicable, an explanation of the composition of the regulatory asset base and explain why it was different to the IFRS numbers (e.g. inflation indexation). Understanding the elements that made up the regulatory asset base was considered vital information for users as the amount of revenue an entity can earn and allowable costs (such as depreciation) depended on the regulatory asset base.

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 plans that will affect cash outflows.

Issues and needs of users

Complexity

The IASB should consider how to address the complexity of rate regulation when developing an accounting model and disclosure requirements.

The users that supported a disclosure-only approach to providing information about the economic effects of rate regulation either in a note or the management commentary, were concerned how the changing regulation and its complexity could be addressed.

A few users noted that recognition of the economic effects of rate regulation have significant drawbacks mainly because most rate-regulated regimes are very complex and because they are continuously 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.

However, other users believed that the inherent complexity of rate regulation should not hinder the debate on the accounting for rate-regulated activities as the performance and the financial position of these entities is influenced by the regulation.

These users noted that, in order to understand the mechanics of the rate regulations and how these affect the business model, financial statements and economics of a rate-regulated entity, it was necessary that the economic effects were recognised in the IFRS financial statements.

Comparability, consistency and transparency

Users noted that information included in the financial statements would increase comparability, and transparency and would enable a level playing field.

A few users noted that, in the absence of a common practice, divergence exists and it distorts comparability of information for rate-regulated entities across European jurisdictions. These users encouraged the IASB to develop specific accounting guidance, in order to enhance comparability across entities and across jurisdictions.

These users noted that while in some jurisdictions sufficient information is already available – even if currently outside the IFRS financial statements – circumstances exist where they are unable to perform independent analyses without obtaining information from the entities operating rate-regulated activities.

However, some users stated that information would not be useful if the assumptions (i.e. rights and obligations, collectability, enforceability, time for settlement and recovery) underlying the reported regulatory information were not clear. In their view, this may hinder comparability and reduce understandability.

Level playing field

Some users stated that in some circumstances the rate-setting framework could be embedded into a service concession arrangement

Furthermore, having some entities recognising the effects of rate regulation in the primary financial statements and others not creates an uneven playing field for investors and analysts who often have different levels of access to information (for example, large investor institutions are granted access to more information by an entity's management than smaller investors).

Some users stated that in some circumstances the rate-setting framework could be embedded into a service concession arrangement in which the grantor acts as a regulator. These users believed that there are similarities between a rate-setting framework typical to a utility entity and a service concession arrangement, particularly in respect to meeting the 'public interest' and the mechanics of the regulatory regimes. As an example, in some jurisdictions the revenue requirement in concession agreements is calculated using the regulatory asset base.

Use of information

Users stated that the information about rate regulation is used mainly to assess:

Users need to assess the economic effects of rate regulation on a rate-regulated entity to assess its creditworthiness and measure the enterprise value.

- future cash flows;

Users can model their cash analysis if they have information about the timing of cash conversion of the revenue requirement together with an understanding of the financial effects of the obligations that needs to be settled to earn the revenue requirement.

- what causes volatility in earnings;

Earnings could be affected by a number of causes (e.g. seasonality, regulator actions, changes in volumes and prices). Users need to understand whether and how the regulation considers these, for instance, whether any adjusting mechanism exists that will modify future tariffs.

- enterprise value;

Users noted that they use discounted cash flows to assess the enterprise value of rate-regulated entities. However, they also apply premiums and discounts to the regulatory asset base measure – where it is used – as an alternative or control method.

- financial stability of the entity – that is, a company’s credit worthiness and its ability to repay debt;

Where entities have to comply with the obligations set by the regulation and tariffs are modified for other (i.e. political) reasons, the financial situation of an entity is affected (for example, the recoverability of regulatory assets) and users need to understand whether the regulations support the financial viability of the entity going forward.

- regulatory stability;

Uncertainties in the regulatory framework hinder users’ capacity to make forecasts. Therefore, users need to understand whether the regulatory environment is stable.

- efficiency of tariff setting procedures;

Users want to understand whether rights and obligations that stem from the regulation are enforceable. Some users would like to see a track-record of the entity’s ability to recover and settle the economic effects of rate regulation to assess this.

- regulatory independence;

Users need to understand the level of influence that regulated entities have when liaising with the rate regulator (sometimes also referred to as regulatory leverage). For instance, it is considered to be an advantage if entities are able to claw back exceptional costs.

Separate presentation

Users support separate presentation of the effects of rate regulation.

Regardless of where the information is presented, users would like regulatory financial information presented separately from non-rate-regulated financial information because the risk profile of these activities differ.

Where information about rate regulation is currently obtained by users

Users currently obtain information on rate regulation from various sources.

IFRS financial statements generally do not provide the information that 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.

As a result, users currently obtain the information they need from various sources, including:

- public information provided by the rate regulator;
- information provided by the entities;
- local GAAP financial statements;
- investor presentations and reports; and
- the annual report that includes the IFRS financial statements.

The information obtained from the regulatory accounts and directly from management was deemed to be relevant for their analyses as it permits users to assess current and future effects on an entity's financial position, performance and cash flows. Generally the information obtained from the regulator explained the mechanics of the regulation to enable users to understand how the regulation affected an entities rate-regulated activities.

Scope and description of defined rate regulation

Defined rate regulation is likely to impact airports, air traffic control and waste management

Based on the telephone meetings with users, the description of rate regulation in the Discussion Paper is likely to apply to entities that operate airports, air traffic control and waste management and is will therefore not be limited to the electricity, gas and water utility sector.