

EFRAG STAFF PAPER FOR PUBLIC MEETING

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Rate-regulated Activities

Objective

- 1 To consider the issues involved in the preliminary stages of the IASB's rate-regulated activities project with a view to being in a position to approve a final comment letter at the Board's January meeting.

Background

- 2 The IASB issued Discussion Paper *Reporting the Financial Effects of Rate Regulation* in September 2014, with comments due on 15 January 2015.
- 3 The EFRAG draft comment letter was issued in October 2014 with comments requested by 31 December 2014.
- 4 The IASB's had previously considered issues relating to rate-regulated activities in 2008-2010. The EFRAG comment letter supported the need for the project, but had a number of critical comments including:
 - (a) The accounting model was restricted to a cost-of-service regime;
 - (b) The arguments in the Exposure Draft were not sufficiently persuasive to support the recognition of assets and liabilities; and
 - (c) Significant outreach work is required to further develop the project.

The IASB discontinued the project after the comment period closed.

- 5 The current project was established in September 2012 and, in line with the EFRAG recommendation, is dealing with a significantly wider scope than proposed in the 2009 Exposure Draft.
- 6 In December 2012, the IASB acknowledged that the established IFRS practice not to recognise any impact from rate-regulated activities, together with the lack of explicit guidance in IFRS about rate regulation, "could be a significant barrier to the adoption of IFRS for entities with significant regulatory deferral balances". This is, for example, an area of significant divergence with US GAAP, and Canada exempted Canadian rate-regulated entities from compliance with IFRS for as long as no recognition was authorised.
- 7 EFRAG established a Rate-Regulated Activities Working Group in July 2013 that proved very instrumental in building understanding of the diversity in regimes existing in Europe and gathering input from the practitioners most knowledgeable on the issue. Based on this input EFRAG TEG has benefited from educational sessions supporting the preparation of the draft comment letter.

- 8 Subsequently, the IASB issued its temporary standard IFRS 14 *Regulatory Deferral Accounts* in January 2014. This standard permits (but does not require) first-time adopters of IFRS to retain previous practice in adopting IFRS.

What is rate regulation?

- 9 In certain industries, most notably utilities such as power and water that are natural monopolies or quasi-monopolies, many governments impose price controls to ensure that a provider of these services cannot use its market power inappropriately. This may take the form of rate regulation where legislation establishes a regulator to regulate the prices that the entity may charge its customers. Because rate regulation is based on legislation, practices across jurisdictions vary.
- 10 In the case of the regulation that is the topic of this project, the regulator commonly sets the total revenue that an entity is allowed to receive in a reporting period. Because the rate-regulated entity charges its customers on a provisional price per unit basis, the total revenue received may not equal the total allowed revenue. Under this form of regulation, the regulator will then allow the regulated entity an increase in future prices to make up for any shortfall in total allowed revenue that was received from the past provision of goods or services. In the case of over-recovery of revenue, the regulator will impose a decrease in future prices to make up for any excess revenue above that permitted.
- 11 In other forms of rate-regulation, the regulator may additionally specify the costs that the regulated entity is entitled to recover from its customers and/or capital expenditures that the regulated entity must undertake.
- 12 The financial reporting issue is whether the economic impact of rate regulation is such that it creates assets and/or liabilities that should be recognised in the financial statements. That is, do the promised future price changes to adjust for the under- or over-recovery of the approved total revenue create assets and/or liabilities? These future under- or over-recoveries are commonly referred to as 'regulatory deferral accounts'.
- 13 Prior to the adoption of IFRS, practice varied: some jurisdictions recognised regulatory deferral accounts as assets and liabilities, whereas others did not.

The Discussion Paper

- 14 The Discussion Paper develops a notion of 'defined rate regulation' to provide a basis for discussion as to whether the impact of a strictly limited form of rate regulation creates a combination of rights and obligations for which the IASB should consider specific accounting guidance.
- 15 Defined rate regulation includes all of the following features:
- (a) It applies in situations in which customers have little or no choice but to purchase the goods or services from the rate-regulated entity because there is no effective competition and the goods or services are essential;
 - (b) It establishes parameters to maintain the availability and quality of the supply or the rate-regulated goods or services and other activities of the entity;
 - (c) It establishes the parameters for rates that support greater stability of prices for customers and support the financial position of the rate-regulated entity; and

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(d) It creates rights and obligations that are enforceable on the rate-regulated entity and the rate regulator.

16 The Discussion Paper then develops a number of possible approaches to the financial reporting of the effects of rate regulation.

The EFRAG draft comment letter

17 Based on preliminary outreach, the EFRAG draft comment letter notes that users are seeking to have information about both the rate-regulatory environment and the economic effects of rate regulation included in the financial statements. Users that specialise in entities with rate-regulated activities generally prefer that these economic effects are recognised in the financial statements. More generalist users without specific knowledge of the sector would favour a disclosure-only regime, as they are concerned about potential effects on comparability.

18 In discussing defined rate regulation, the EFRAG draft comment letter identifies the existence of enforceable rights and obligations (paragraph 15(d) above) as the key feature from a financial reporting perspective. The other features identified in the Discussion Paper are only relevant to financial reporting to the extent that they contribute to the existence of such rights and obligations.

19 The draft comment letter also notes as a preliminary view that, with regard to the accounting approaches proposed in the Discussion Paper, EFRAG generally supports the approach that considers deferring or accelerating the recognition of a combination of costs (especially those related to capital expenditure that is required of the rate-regulated entity) and revenue (based on services performed). The comment letter notes that the revenue approach has an important role to play when an entity has 'performed' to its customers.

20 Finally, the draft comment letter identifies that the Discussion Paper is only a preliminary step. Further work is required in relation to the scope of the regulation addressed by the project to ensure that all regulation with similar economic impacts are included.

Questions to EFRAG Board members:

21 Do you support the preliminary views of EFRAG as expressed in the draft comment letter? If not, what different views do you hold?

22 In your view, are there any potential areas of concern from a European public good perspective that are not encompassed by the search for more transparent and useful financial reporting?

Next steps

EFRAG

23 EFRAG staff have continued to interview users to establish further their views as to the appropriate treatment of rate regulation in financial reporting. The final outreach is the EFRAG-EFFAS/ABAF-IASB User Event: *Rate-regulated activities: is there anything missing from the balance sheet?* to be held in Brussels on 18 December.

24 The draft comment letter will be amended for the feedback received from all constituents through both the interviews with users and comment letters. This draft final comment letter will be considered by both the EFRAG Rate-regulated Activities Working Group (5 January 2015) and EFRAG TEG (7 January 2015) before being presented to the Board for approval at its meeting on 14 January.

IASB

- 25 The IASB is expected to consider a preliminary summary of the comments received at its meeting in February 2015. Further redeliberations are expected to occur during 2015, when it will become clearer whether the next steps in this project are to issue another due process document (Discussion Paper or Exposure Draft) or to withdraw IFRS 14.

Question for EFRAG Board

- 26 Does the EFRAG Board require any further information before being asked to approve the draft comment letter at its meeting in January?

Agenda Papers

- 27 In addition to this paper, the agenda papers for this session are:
- (a) Agenda paper 10.02 – IASB Snapshot: *Reporting the Financial Effects of Rate Regulation*
 - (b) Agenda paper 10.03 – EFRAG draft comment letter.