

## EFRAG STAFF PAPER FOR PUBLIC MEETING

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# **Final comment letter on Discussion Paper** ***Reporting the Financial Effects of Rate Regulation***

## **Note to EFRAG Board Members**

### **Introduction**

- 1 The IASB issued the Discussion Paper *Reporting the Financial Effects of Rate Regulation* in September 2014, with comments due to the IASB by 15 January 2015.
- 2 As discussed at the meeting of the EFRAG Board in December 2014, 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.
- 3 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 to customers;
  - (b) It establishes parameters to maintain the availability and quality of the supply of the rate-regulated goods or services and other rate-regulated 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
  - (d) It creates rights and obligations that are enforceable on the rate-regulated entity and the rate regulator.

### **EFRAG TEG discussions and advice to the EFRAG Board**

- 4 EFRAG TEG established the EFRAG Rate-regulated Activities Working Group (RRAWG) in 2013 to provide specialist advice on issues related to rate-regulated activities.

- 5 EFRAG's draft comment letter was published on 27 October 2014 with a closing date of 31 December 2014. Three final comment letters, four draft comment letters and informal feedback had been received by the closing date. Further comment letters are expected to be received within the next three weeks, but informal advice as to their likely content does not suggest that the views expressed in the draft final comment letter are inappropriate.

*Summary of feedback received*

- 6 It is noteworthy that there is a high degree of consistency between the advice from the RRAWG, the outreach conducted by EFRAG staff, the outreach event in December 2014 and the views expressed in the comment letters (and draft comment letters). As a result, the views expressed in the draft final comment letter are very similar to the views in the draft comment letter issued for consultation.
- 7 The major changes from the draft comment letter are that in the draft final comment letter, EFRAG:
- (a) Recognises that, in many jurisdictions, rate regulation is complex and is not static, which enforces the need for principle-based standards to provide the basis for a level playing field;
  - (b) Increases the emphasis on the existence of enforceable rights and obligations derived from the adjusting mechanism based on the revenue requirement that would lead to the recognition of the economic effects of rate regulation;
  - (c) In respect of the other approaches described in the Discussion Paper that might be used to account for the effects of rate regulation, doubts that rate regulation creates an intangible asset and does not support the use of regulatory accounting in IFRS financial statements;
  - (d) Calls for some field testing to ensure that no rate-regulation scheme inappropriately falls outside the scope of the project; and
  - (e) Notes that information about the impact of rate regulation provides useful information about management's performance of stewardship.
- 8 The major comment from some members of the RRAWG and some constituents that was not included in the draft final comment letter was that performance leading to the recognition of revenue can also be towards the regulator, even though no payment would flow to the entity until the delivery of goods or services to the customer. This would arise in circumstances such as an enhancement in a distribution network or keeping regulatory assets in good condition. These activities indirectly benefit the customer and are included in the revenue requirement under the regulation. Accordingly, some argue that such obligations are performance obligations of the entity in their own right and should be seen as triggering recognition of revenue. EFRAG TEG almost unanimously rejected this view (one member abstained and two members were absent), as the indirect obligation to the regulator may impact the revenue requirement under the regulatory agreement (i.e. gives the right to the entity to charge higher prices in the future) but does not impact revenue until the rate-regulated entity performs its obligations related to delivering goods and services (in conformity with IFRS 15 *Revenue from Contracts with Customers* transfer of control principle). EFRAG TEG has remained open to the possibility that compliance with settling these obligations may have to be reflected one way or another in profit or loss. A separate paper summarises the EFRAG TEG discussion on this issue.

- 9 In summary, the draft final comment letter that has been agreed by EFRAG TEG:
- (a) Supports the IASB's decision to initially focus the debate on accounting for rate-regulated activities on a particular type of rate regulation referred to as 'defined rate regulation' in order to understand the economic impact of rate regulation on a limited range of entities before moving to the next stage of the project.
  - (b) Notes that the Discussion Paper represents only a starting point in this project and that, as the project progresses, the IASB will need to consider in which circumstances an entity's right to recover an agreed amount of revenue and obligations to perform certain activities creates enforceable rights and obligations that should be recognised in the IFRS financial statements. The IASB might also need to consider whether it should eventually widen the scope of any potential future accounting guidance, in order to require disclosures of a wider range of schemes, and not restrict disclosures to information about defined rate regulation.
  - (c) Whilst broadly supporting the description of defined rate regulation, considers that the existence of a rate-setting framework that includes an adjusting mechanism based on the revenue requirement has a pivotal role to play in the scoping of the Rate-Regulated Activities project. The enforceable rights and obligations that stem from this rate-setting framework are those that should be considered for recognition in the IFRS financial statements. It follows that the features listed in the Discussion Paper should be used as indicators to determine whether the rights and obligations that arise from the rate-setting framework ought to be recognised. The draft letter also provides a number of suggestions about how these features might be improved so as to achieve this purpose.
  - (d) With regard to the accounting approaches proposed in the Discussion Paper:
    - (i) Generally supports an approach that is principle-based and which can be applied to different rate regulatory regimes that evolve over time.
    - (ii) Considers that the revenue approach has an important role to play, especially given the recent issue of IFRS 15.
    - (iii) Remains open to considering the cost deferral approach described in the Discussion Paper.
    - (iv) Considers that it is unlikely that the package of rights and obligations established by the regulatory agreement is an intangible asset.
    - (v) Does not support reporting using regulatory accounting.
  - (e) In relation to disclosures:
    - (i) Emphasises that the understanding by users of regulatory balances requires a high level of granularity in the disclosures.
    - (ii) Recommends that disclosures required as part of financial statements be limited to the understanding of recognised and unrecognised effects of the rate-regulation and to information that would not be otherwise accessible.

*Discussion Paper: Reporting the Financial Effects of Rate Regulation*

- (iii) Considers that IFRS 14 *Regulatory Deferral Accounts* could provide a good starting point if it was decided to issue specific guidance for rate-regulated activities and supports separate presentation of regulatory balances in the IFRS financial statements. If such specific guidance were to be provided as an interpretative amendment of IFRS 15 *Revenue from Contracts with Customers*, duplication of disclosure requirements should be avoided.

*EFRAG TEG advice to the EFRAG Board*

- 10 EFRAG TEG advises the EFRAG Board to approve the final comment letter as drafted. All members of EFRAG TEG present at the meeting supported this recommendation.

**Agenda Papers**

- 11 In addition to this paper, the agenda paper for this session is:
  - (a) Agenda paper 12.02 – Obligations of a rate-regulated entity to the regulator
  - (b) Agenda paper 12.03 – Comment letter to the IASB.