



**European Financial Reporting Advisory Group**

To the attention of Isabel Batista, Sapna Heeralall and Giorgio Acunzo

35 Square de Meeûs  
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BELGIUM

Brussels, 24<sup>th</sup> of December 2014.

Reference : ***DP/2014/2 Reporting the Financial Effects of Rate Regulation***  
Reply to the request for comments on the Draft Comment Letter issued by EFRAG

Dear,

The International Energy Accounting Forum ('IEAF') much appreciated the opportunity to exchange views with Isabel on the DP 'Reporting the Financial Effects of Rate Regulation' during our meeting of November, 27<sup>th</sup> in London and welcomes your request for comments on the Draft Comment Letter issued by EFRAG on October, 27<sup>th</sup> 2014.

The IEAF is an organization that counts amongst its members numerous major European utility companies (see the list of our members in appendix 2). The goal of the IEAF is to discuss and formulate best practices and reduce areas of difference in accounting in the energy sector, to advocate the energy industry's point of view, and to make specialist energy industry knowledge available to the International Account Standards Board and other standard-setters.

This comment letter represents the view of the marked majority of the IEAF members, and especially of those members that have rate-regulated activities and have participated in a dedicated task force on this subject.

Please note that IEAF will also reply directly to the IASB on the DP. Therefore, we focus in our reply on the EFRAG's draft comment letter on a limited number of key elements, and provide you in this cover letter also with the IEAF's main conclusions.

IEAF members consider following ***key elements for guidance on rate-regulated activities*** :

- Guidance should be principle based, and consistent with other IFRS's ;
- Guidance should lead to financial reporting that reflects the underlying economics and the performance of the rate-regulated activity ;
- Considering the two previous elements, a separate (activity-specific) standard may not be the right answer. We think there is a need to clarify for these activities the application of current IFRSs, and in particular IFRS 15. Therefore we would like to see this further investigated, together with the question of the compliance with criteria for assets and liabilities.

The main comments of IEAF on the ***features of defined rate regulation*** as proposed by the IASB can be summarized as follows :



- IASB describes in the DP the context of rate regulated activities, i.e. the possible situations where regulation may create enforceable rights and obligations. However, it is not the context that is essential for IFRS guidance. Guidance should therefore not focus on context, but only on the key features of rate regulated activities. IEAF members consider following features as key :
  - The rate-regulated entity provides a public service in exchange for an authorized revenue. The authorized revenue, that results from a rate setting mechanism, is the main feature of rate regulation ;
  - Regulation creates enforceable rights and obligations on the rate-regulated entity and the rate regulator, but also on the customers ;
  - Rates and regulation support the financial viability of the rate-regulated entity (protective environment for the entity, next to price stability for customers).
- The guidance should be principle based, and have a sufficiently wide scope, so that :
  - the guidance is valid for different regulatory objects and in different situations and circumstances. Regulation and circumstances can evolve, and case-specific guidance would not provide a stable solution.
  - The guidance should not only cover the enforceable rights and obligations under 'cost plus' models but also under 'incentive-based' and mixed models. Regulation often has a mixed character and elements of the two models 'cost +' and 'incentive-based' that are referred to in the DP. Principle based guidance should be able to deal with mixed models and with the evolution of regulation models over time.

IEAF has a clear point of view on the ***question if specific guidance is needed*** and on ***interactions with other IFRS's*** :

- IEAF members think that it is advisable not to have separate standards for specific activities or industries, and prefer that guidance for rate-regulated activities is fitted into the existing/general standards.
- In our opinion, the most appropriate way to fit rate-regulated activities into existing standards, is a clarification of how IFRS 15 should be applied to these activities. IFRS 15 does not scope out these activities, and entities that have to publish financial reports under IFRS and that have rate regulated activities seem to have no choice but to apply IFRS 15. Moreover, one of the key challenges concerning accounting for rate regulated activities, is to correctly reflect their performance in the accounts. Thus IFRS 15 seems a 'natural' entry point for this issue.

Adequate guidance for rate regulated activities therefore likely consists in a clarification or interpretation (comparable to IFRIC 12 – service concession agreements) of how existing standards, and especially IFRS 15, should be applied for these activities.

Some members have started an internal project to prepare the implementation of IFRS 15. Given timing constraints, we have not been able to integrate in the comments on the DP any robust conclusions of a detailed analysis how the 5 steps in the IFRS 15 model apply to rate-regulated activities. We think, however, that it is essential that the IASB performs a thorough analysis of which clarifications are needed to allow an adequate application of IFRS 15 for these activities, before preparing an ED on reporting the financial effects of rate regulation.



- The IASB identified in the DP two issues regarding interactions with IFRS 15, in a view where regulation is considered as a contract with the collective customers, and revenue would be recognized up to the consideration for which the entity is entitled in exchange for the rate-regulated activities performed to date (the 'revenue requirement'). IASB considers that in such case, the difference with the 'billable revenue' (billable as the control of goods/services are transferred to individual customers), would be considered as a variable component of the consideration.

IEAF members are convinced that the regulation should indeed be seen as a contract with the collective customers ('customer base'), and that the 'revenue requirement' should be seen as the consideration for the obligations performed towards these collective customers.

Thus, we think that the main issues that should likely be assessed in view of clarifying the application of IFRS 15 for rate-regulated activities are (1) carefully identify the performance obligations and (2) integrate the 'revenue requirement' as a consideration for the past performance obligations towards the 'customer base'.

As for the two issues regarding interaction with IFRS 15, identified in the DP, IEAF comments on the considerations of IASB can be summarized as follows :

1. Issue 1 : recognition of revenue adjustments

IASB considers that revenue adjustments that would result from future rate adjustments would be deferred if positive (correction of under-billing) or would lead to recognition of a liability if negative (correction of over-billing).

IEAF members think that systematically deferring positive adjustments would be too prudent and would not correctly reflect the underlying economics of the activity. In as far as adjustments reflect enforceable rights and obligations, their recoverability is not highly judgmental. Recognition of an asset that represents an adjustment for a correction of under-billing should not be systematically prohibited and symmetry for correction of under-billing and correction of over-billing is recommendable.

One of the key issues regarding IFRS 15 relates to the allocation of adjustments for year N realized through tariff increases or decreases applied to goods or services delivered after year N : allocation to performance obligations realized in year N or to performance obligations after year N. In our view, the rationale of the regulation is the key for the answer. The 'revenue requirement' is defined in the DP (par. 2.13) as the total amount of consideration to which the entity is entitled in exchange for all of its rate-regulated activities. As the tariff and the revenue requirement for a given period are calculated based on estimates, this may lead to adjustments that are calculated at the end of the period. Thus, the final 'revenue requirement' for year N includes the adjustments that will be realized through tariff increases or decreases in following years, and these adjustments are closely monitored by the regulated entity as well as by the regulator. The adjustments are a remuneration of past performance obligations, notwithstanding the fact that the resulting cash inflows or outflows are realized through billings for obligations performed in later periods. *Note : the customer may not see in his bills any distinction between amounts for past or current goods/services, but in general the rate setting mechanism (including adjustment mechanism) is public information.*



In as far as the regulated entity is confident that the adjustments have been reliably estimated and that their recoverability is highly probable (which is generally the case for activities in going concern and with mature regulation), we consider that in the accounts for year N, the entity should reflect the final 'revenue requirement', i.e. including adjustments that will lead to cash inflows or cash outflows in following years. This is the only adequate approach to ensure that the underlying economics and the performance of the rate-regulated activity are correctly reflected in the accounts.

2. Issue 2 : identification of (different) performance obligations

According IASB, 'rate-regulated activities performed to date' can include other elements than goods or services transferred to customers or to regulators, such as changes in the entity's property, plant and equipment, etc. and that it is not clear how IFRS 15 could or should be implemented for such elements.

IEAF members are not convinced that 'keeping the regulated assets in good state' should be disconnected from the transfer of goods or services (for which the regulated assets are used and thus essential). As mentioned before, an analysis in view of IFRS 15 will be required to (amongst others) clearly identify the performance obligations.

We also ask for special attention for other regulatory rights and obligations that can be significant. In addition to rights and obligations that are settled through tariffs, regulatory frameworks can also include other rights and obligations. One IEAF member informed us of the example of a Transmission System Operator in the Netherlands who is obliged to use proceeds from auctioning cross-border transmission capacity to finance future investments in cross-border interconnectors. Consequently, both these proceeds and these investments are in principle not settled through tariffs, and as such are not part of the regulated revenue. The impact of such other regulated rights and obligations can be significant and even exceeding the effects from rights and obligations that are settled through tariffs.

We have integrated our comments in yours in appendix 1. As mentioned before, we focus in our reply on the EFRAG's draft comment letter on a limited number of key elements.

In case you would like to obtain further explanations, or to exchange in the coming months on observations resulting from analysis of application of IFRS 15, please do not hesitate to contact us.

Kind regards.

On behalf of the IEAF,

A handwritten signature in blue ink, appearing to read 'Miriam De Loose', is written over a horizontal line.

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## Draft Comment Letter

Comments should be submitted by 31 December 2014 to [commentletters@efrag.org](mailto:commentletters@efrag.org)

27 October 2014

International Accounting Standards Board  
30 Cannon Street  
London EC4M 6XH  
United Kingdom

Dear Sir/Madam,

### **Re: DP/2014/2 Reporting the Financial Effects of Rate Regulation**

On behalf of the European Financial Reporting Advisory Group (EFRAG), I am writing to comment on the Discussion Paper, *Reporting the Financial Effects of Rate Regulation*, issued by the IASB on 15 September 2014 (the 'DP').

This letter is intended to contribute to the IASB's due process and does not necessarily indicate the conclusions that would be reached by EFRAG in its capacity as advisor to the European Commission on endorsement of definitive IFRS in the European Union and European Economic Area.

### **Notes to constituents**

EFRAG's comment letter on the Discussion Paper *Reporting the Financial Effects of Rate Regulation* will be finalised by the EFRAG Board, which is expected to be in place by 31 October 2014. The EFRAG Board results from the recent and ongoing governance reform. It will be responsible for all EFRAG positions after considering the technical advice provided by the EFRAG Technical Expert Group and the outcome of EFRAG's due process.

### *General comments*

EFRAG welcomes the IASB's comprehensive project on rate-regulated activities and the publication of the above mentioned DP. IFRS financial statements do not necessarily produce the information users regard as useful to understand the effects of rate regulation on a rate-regulated entity's revenue and related costs, cash flows and financial position associated with the entity's rate-regulated activities. In the absence of specific guidance in the IFRS literature, the established practice is for rate-regulated entities not to recognise the effects of rate-regulation in the IFRS financial statements. As a result, users obtain the information they need for their analysis from different sources – including local GAAP financial statements, investor presentations and public information provided by the rate regulator.

We have learned from some users that cover rate-regulated entities that they prefer these effects to be recognised in the primary financial statements, rather than communicated through disclosure-only requirements. This would enhance their understanding of how rate regulation affects an entity's rate-regulated activities, and consequently the usefulness of the information provided in the financial statements. EFRAG therefore believes it is necessary for the IASB to consider how to account for the effects of rate regulation.

*Detailed comments on the DP*

Our detailed comments and responses to the questions in the DP are set out in the Appendix.

We support 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'. By focusing on a specified type of rate-regulation, the IASB attempts to understand the economic impact of rate regulation on a limited range of entities before moving to the next stage of the project. We also broadly agree that 'defined rate regulation' forms a good basis to identify which features of rate-regulatory schemes distinguish rate-regulated activities from other commercial activities and create a combination of rights and obligations.

However, we believe that the DP represents only a starting point in the discussion. As the IASB progresses on the project, we believe it 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 a potential future Standard, in order to require disclosures on a wider range of schemes, and not restrict disclosures to information about 'defined rate regulation'.

⇒ IFAF agrees that the DP represents only a starting point in the discussion. IFAF is strongly convinced that appropriate guidance for rate-regulated activities consists in a clarification or interpretation (comparable to IFRIC 12 – service concession agreements) of how existing standards, and especially IFRS 15, should be applied for these activities. We think that it is essential that the IASB performs a thorough analysis of which clarifications are needed to allow an adequate application of IFRS 15 for these activities.

Whilst we broadly support the description of 'defined rate regulation', we believe that any enforceable rights and obligations that stem from the rate-regulation mechanism are the most important elements for distinguishing the types of rate regulation that require recognition in the financial statements. In our view, the main purpose of the features listed in paragraph 4.4(a) – (c) of the DP is to ensure enforceability of the rights and obligations created by 'defined rate regulation' and therefore should be used as indicators to assess whether an entity operates within 'defined rate regulation'. We have also provided a number of suggestions about how these features might be improved so as to achieve this purpose, which may also assist in supporting a particular accounting approach in a future Standard.

With regard to the accounting approaches proposed in the DP, we generally support the approach that considers deferring or accelerating the recognition of a combination of costs and revenue. We believe that the revenue approach discussed in the DP has an important role to play when an entity has 'performed' to its customers. However, we would be concerned with an approach that required revenue to be recognised before an entity has delivered the respective good or service to the customer. We remain open to discussing a cost deferral approach described in the DP, and recommend the IASB to explore in more detail cases where such an approach might produce relevant information. Furthermore, we support an approach that is principle-based and which can be applied to different rate regulatory regimes that evolve over time.

⇒ IFAF thinks that it is advisable not to have separate standards for specific activities and prefers that guidance for rate-regulated activities fits in the existing standards. ./.

./ The most appropriate way to fit rate-regulated activities in existing standards is in our view a clarification of how IFRS 15 should be applied to these activities. This would lead to a principle based solution for the question of recognition or deferral of revenues and costs, in line with IFRS's in general, rather than an activity-specific exception.

We believe that the disclosures in IFRS 14 *Regulatory Deferral Accounts* are a good starting point. We also support separate presentation of 'regulatory balances' in the primary financial statements, on the basis that it will enhance the relevance and usefulness of the information about the financial effects of rate regulation.

If you would like to discuss our comments further, please do not hesitate to contact Isabel Batista, Giorgio Acunzo, Sapna Heeralall or me.

Yours faithfully,

Françoise Flores  
**EFRAG Chairman**

## APPENDIX

### Question 1

- (a) What information about the entity's rate-regulated activities and the rate-regulatory environment do you think preparers of financial statements need to include in their financial statements or accompanying documents such as management commentary?

Please specify what information should be provided in:

- (i) the statement of financial position;
  - (ii) the statement(s) of profit or loss and other comprehensive income;
  - (iii) the statement of cash flows;
  - (iv) the note disclosures; or
  - (v) the management commentary.
- (b) How do you think that information would be used by investors and lenders in making investment and lending decisions?

### Notes to constituents

*What is the issue the DP tries to address?*

- 1 *Many rate-regulated entities do not recognise 'regulatory deferral balances' in the IFRS financial statements. However, they argue that the financial effects of (some) rate-regulated activities should be reflected in the entity's performance and the statement of financial position. In the view of these entities, (some) rate-regulated activities are economically different from commercial activities and these differences need to be reflected in the IFRS financial statements.*
- 2 *However, a key question is what these different economic effects are and how they arise in a rate-regulatory environment. In responding to this question, the DP identifies a number of common features of rate regulation – referred to as 'defined rate regulation' – that distinguish rate-regulated activities from commercial ones for which specific IFRS guidance might be necessary.*
- 3 *'Defined rate regulation', as described in the DP, is designed to ensure that the rate-regulated entity recovers a determinable amount of consideration (the 'revenue requirement') in exchange for the rate-regulated activities that it performs. In addition, the rate regulation establishes, through the rate/tariff per unit chargeable to customers, the time at which the entity can bill customers for that consideration (the 'regulatory period').*
- 4 *Consequently, the period at which the revenue and related costs are recognised in the regulated rate per unit is deferred or accelerated in order to reduce rate volatility for customers. This results in differences between the time when particular revenue or costs are recognised for regulatory purposes and when they are recognised in the statement of profit or loss in the IFRS financial statements. These differences are sometimes referred to 'regulatory deferral balances'.*

*Users' needs*

- 5 *Section 2 of the DP considers users' needs and sets out what the IASB has heard about what information users of financial statements find helpful about defined rate regulation. The DP states that the IASB has heard that users of financial*



statements have the following information needs with regards to entities that operate in a rate regulated environment:

- (a) *Information that helps them to distinguish variability in performance that is adjusted through the rate-regulatory mechanism from variability for which the mechanism provides no adjustment. This information is needed to help them to understand the effect of the rate regulation on the revenue, profit and related cash flows of the entity, and to assess how reliable the rate regulation is in ensuring that the entity can earn its targeted returns through its billings to customers.*
- (b) *Providers of both debt and equity capital to the supplier need confidence that rate regulation will enable the entity to recover its appropriate costs and to generate sufficient returns to cover its cost of capital. In addition, the providers of capital must have confidence in the entity's ability to collect the cash generated from the rate-regulated activities in order to repay borrowings and to pay interest and dividends. Expectations about returns depend on their assessment of the amount, timing and uncertainty of (the prospects for) future net cash inflows to the entity.*

### EFRAG's response

**EFRAG welcomes the IASB's project. We have heard that IFRS financial statements do not provide relevant and useful information on rate-regulated activities that meets users' needs.**

#### Question 1(a)

- 6 EFRAG has undertaken some outreach with analysts that cover rate-regulated industries and consulted with EFRAG's User Panel to understand what information users need when analysing rate-regulated activities that are subject to 'defined rate regulation'.
- 7 During the outreach, we have learned that IFRS financial statements currently do not always provide the information users regard as useful and relevant to understand 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. Users obtain the information from different sources – for example directly from the entities, local GAAP financial statements, investor presentations and public information provided by the rate regulator.
- 8 We also understand that management of rate-regulated entities uses information that is significantly different to that reported in the IFRS financial statements to explain to investors and other users the financial effects of rate regulation on performance, cash flows and financial position of the entity.
- 9 In the subsections below, we summarise the main messages we have heard from users about (a) information they need about the effects of rate regulation; and (b) where and how this information should be presented or disclosed in the financial statements. We have not heard that users are seeking specific rate-regulated information in the statement of cash flows.

#### Information users need

- 10 EFRAG has learnt from some users that cover entities in the rate-regulated industries that they would like to see the financial effects of rate-regulated activities reflected in the primary financial statements. This would enhance their understanding of how rate regulation affects an entity's financial position and

return on assets generated by rate-regulated activities, and consequently the usefulness of the information provided.

- 11 On the other hand, more generalist users express the concern that regulatory regimes could be extremely complex and subject to significant uncertainty about how external factors could affect regulations and how regulatory requirements apply to entities. This creates complexity with regards to any recognition of 'regulatory deferral balances' and raises questions about whether information would be comparable between entities across jurisdictions. As a result they tend to favour having the information through disclosure – either in the notes to the financial statements or in the management commentary.
- 12 All 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 effectively. Specifically, users indicated that the following information would be useful:
  - (a) How defined rate regulation works for each rate-regulated activity and in each jurisdiction in which the entity operates, including an explanation of the 'legislation' or regulatory framework that drives the regulatory agreement (that is binding on both the rate regulator and the entity);
  - (b) Expected changes to that 'legislation' and what effects (financial and otherwise) such changes could cause;
  - (c) The risks that entities face as a result of rate regulation, whether regulators (and potentially governments) are committed to supporting the revenue requirement, how rate calculations are made, and how stable/strong the regulatory framework is in terms of, for example, legal enforceability of the 'regulatory deferral balances' that are created by rate-regulation; and
  - (d) The relationship between the rate regulator and the entity, and the track record of the entity in recovering costs and earning the return allowed by the rate regulation.

#### *Financial position*

- 13 'Regulatory deferral balances' under defined-rate regulation result from differences between the time when particular revenue or costs are recognised for regulatory purposes (based on the 'revenue requirement' and the agreed regulatory period) and when they are recognised in the statement of profit or loss in the IFRS financial statements.
- 14 Some users argue that such 'regulatory deferral balances' should be recognised in the statement of financial position. This is because users need to know whether an entity will be able to recover its costs and to generate sufficient returns to cover its cost of capital. The revenue requirement is intended to ensure it does.
- 15 Some regulatory schemes monitor the 'rate setting mechanism' through a 'Regulatory Asset Base', while other regulatory schemes are based on a form of a revenue cap, without a formal reference to a Regulatory Asset Base.
- 16 When a Regulatory Asset Base is used, users have informed us that *disclosure* about the Regulatory Asset Base (of the rate-regulated activity) for each asset class in the respective geographical region is useful because:

*IASB DP: Reporting the Financial Effects of Rate Regulation*

- (a) Such entities generally run their rate-regulated operations by managing their Regulatory Asset Base.
- (b) The Regulatory Asset Base is also used as a valuation tool, as a guide to evaluating the enterprise value and in setting up a forecast of future earnings and cash flows in order to assess the return that a rate-regulated entity is entitled to earn. There are also wider implications of the Regulatory Asset Base which users need to understand such as dividend and expenditure/cost policies.
- (c) We understand that an explanation of the main differences between the Regulatory Asset Base and the IFRS numbers relating to the underlying rate-regulated activities would be relevant information for users.
- (d) Defined rate regulation not only regulates the rate per unit to be charged to customers for the rate-regulated goods or services provided to the customers, but also regulates the activities that an entity must perform to be entitled to that rate per unit. As a result, this influences the future investment plans of the entity. Such information on future plans would be useful for users as it helps predict future investment cash outflows.

**Question to Constituents**

- 17 If the IASB were to introduce specific accounting and/or disclosures requirements to account for the effects of defined rate-regulation, do you believe that users would still use the Regulatory Asset Base as a valuation/analysis tool? Please explain.
- 18 Where there is no Regulatory Asset Base, determining what might constitute such a 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 provided.
- 19 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, which is often based on other frameworks of accounting (i.e. local GAAP, specific regulatory reporting). Further this 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.
- 20 Some of the potential difficulties noted above, might explain why some users would prefer to obtain this type of information through a form of a single-note disclosure instead of aligning the amounts presented on the IFRS balance sheet to the ones determined under the regulatory regime (the regulatory balance sheet).

*Performance*

- 21 'Defined rate regulation', as described in the DP, is designed to ensure that the rate-regulated entity recovers a determinable amount of consideration (revenue) referred to in the DP as the 'revenue requirement' in exchange for the rate-regulated activities that it performs. In addition, the rate regulation establishes, through the rate/tariff per unit chargeable to customers, the time at which the entity can bill customers for that consideration (the regulatory period).

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- 22 Revenue is impacted because, rate regulation affects the amount of revenue an entity is entitled to charge its customers, under the regulatory agreement, over a period of time (i.e. the regulatory period) for a rate-regulated good or service. Some users argue that it is relevant to have information in profit or loss on revenue numbers that are linked to the cash flows that an entity is entitled to receive under the regulatory agreement and determined through the 'revenue requirement'.
- 23 Furthermore, to understand the impact of rate regulation, EFRAG believes that users need to understand what causes the differences between the billable revenue and the 'revenue requirement'. For instance, the following *disclosure* would be useful:
- (a) The causes of variability in 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).
  - (b) The main differences between revenue reported in the IFRS financial statements for regulated activities and the corresponding revenue to which an entity is entitled through the 'revenue requirement' applicable to those activities, in the current and future periods.
  - (c) Which costs are recoverable, which costs are not recoverable, in relation to regulated activities, and the rate per unit (tariff) the entity will be entitled to charge through the 'revenue requirement' in future periods and the expected return on the respective rate-regulated goods or services. Users are interested to understand how a "tariff" constraint would affect future cash flows. Such as:
    - (i) the uncertainty in future rate-setting that impacts the 'revenue requirement';
    - (ii) the rate-regulated activities an entity must perform to earn the 'revenue requirement' and the period in which it is required to perform those activities; and
    - (iii) a breakdown of the 'revenue requirement' depending on the nature of the components: for example, return on the Regulatory Asset Base when applicable, bonuses on qualitative performance and claw-back of non-controllable costs.
  - (d) Separate presentation of results from rate-regulated activities from non-regulated ones.
  - (e) Segment information per jurisdiction/country on the 'revenue requirement' with an explanation of the factors incorporated in each 'revenue requirement'.

### *Disclosure of effects of rate-regulation*

- 24 We note that some of the information about the 'financial position' and 'performance' of an entity that operates in an environment where some (all) of its activities are subject to rate-regulation could be reported in the notes to the financial statements or the management commentary.
- 25 However, as previously noted, we have heard that some users would prefer to have the information, particularly when it has a direct impact an entity's revenue

and cost numbers and financial position, be reflected in the primary financial statements.

*Placement of rate-regulation disclosures in the annual report*

- 26 In the sub-sections above, we have described a set of disclosures that we understand are useful to users of entities operating rate-regulated activities; regardless of what their placement should be in the annual report, e.g. whether they should belong to the notes to financial statements or rather be part of the management commentary.
- 27 If the IASB were to develop specific accounting guidance on the effects of rate-regulations on an entity's performance, cash flows and financial positions; we recommend the IASB to consider EFRAG's past recommendations included in the a Discussion Paper *Towards a Disclosure Framework for the Notes*<sup>1</sup> to identify:
- (a) what should be required as part of financial statements; and
  - (b) what should be recommended as part of the management commentary.

*Question 1(b)*

- 28 We have been advised that the information is used by users of financial statements mainly to assess the following relating to an entity subject to defined rate regulation:
- (a) estimating future cash flows (and valuation inputs);
  - (b) regulatory stability;
  - (c) efficiency of tariff setting procedures;
  - (d) financial stability of the entity; and
  - (e) regulatory independence (i.e. the level of influence that regulated entities have when liaising with the rate regulator).
- 29 Furthermore, EFRAG understands that rate-regulated entities often operate in a relatively stable market where the main risk that needs to be assessed is the regulatory one. Regulatory risk is seen to be twofold:
- (a) *Regulatory stability* – this depends on how political influences could affect the enforceability of the regulation and the actions of the entity operating rate-regulated activities (e.g. investments in green energy instead of in coal-fired plant; deferral in the rise of tariffs due to unfavourable economic cycle); and
  - (b) *Regulatory leverage* - this depends on the negotiation power that the entity operating rate-regulated activities has over the regulator.

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<sup>1</sup> This discussion paper was published in 2012. In the discussion paper EFRAG and its partners ANC and the FRC proposed the following definition that should guide the standard setter in setting disclosure requirements that would make financial statements a well-defined component of financial reporting: '*The purpose of the notes is to provide a relevant description of the items presented in the primary financial statements and of unrecognised arrangements, claims against and rights of the entity that exist at the reporting date*'.

**Questions to Constituents**

- 30 Are you aware of other information regarding the entity's rate-regulated activities and the rate-regulatory environment that you think preparers of financial statements need to include in their financial statements or accompanying documents such as management commentary? Please explain how users would use this information.
- 31 Where would you prefer to find the information about the entity's rate-regulated activities, the rate-regulatory environment, and related financial effects on an entity's financial position, performance and cash flows? Which information would you rather find (1) in the primary financial statements and (2) disclosed in the notes or in the management commentary? Please explain your answer.

**Question 2**

Are you familiar with using financial statements that recognise regulatory deferral account balances as regulatory assets or regulatory liabilities, for example in accordance with US generally accepted accounting principles (GAAP) or other local GAAP or in accordance with IFRS 14? If so, what problems, if any, does the recognition of such balances cause users of financial statements when evaluating investment or lending decisions in rate-regulated entities that recognise such balances compared to:

- (a) non-rate-regulated entities; and
- (b) rate-regulated entities that do not recognise such balances?

**Notes to constituents**

- 32 *US GAAP has specified recognition and measurement requirements for the effect of certain types of rate regulation since at least 1962. In 1982, the US national standard-setter, the Financial Accounting Standards Board, issued SFAS 71 Accounting for the Effects of Certain Types of Regulation (now Topic 980-605 on regulated operations). SFAS 71 formalised many of those principles.*
- 33 *In the absence of specific national guidance, practice in many other jurisdictions followed SFAS 71. In the financial statements of rate-regulated entities that apply such guidance, regulatory deferral account balances are often incorporated into the carrying amount of items such as property, plant and equipment and intangible assets, or are recognised as separate items, similar to receivables or payables, in the financial statements. This changes the timing of when these amounts are recognised in profit or loss.*
- 34 *Since the first-time adoption of IFRS in Europe in 2005, IFRS have been generally interpreted as prohibiting the recognition of 'regulatory deferral balances'. Appendix A of the DP provides a background on previous requests for IFRS guidance about rate-regulated activities.*

**EFRAG's response**

**[Answer to be based on feedback from constituents].**

- 35 [Answer to be based on feedback from constituents].

**Questions to Constituents:**

- 36 Are you familiar with using financial statements that recognise regulatory deferral account balances as regulatory assets or regulatory liabilities in accordance with your local GAAP? If so, what problems, if any, does the recognition of such balances cause users of financial statements when evaluating investment or lending decisions in rate-regulated entities that recognise such balances compared to:
- (a) non-rate-regulated entities; and
  - (b) rate-regulated entities that do not recognise such balances?

**Question 3**

Do you agree that, to progress this project, the IASB should focus on a defined type of rate regulation (see Section 4) in order to provide a common starting point for a more focused discussion about whether rate regulation creates a combination of rights and obligations for which specific accounting guidance or requirements might need to be developed (see paragraphs 3.6–3.7 of the DP)? If not, how do you suggest that the IASB should address the diversity in the types of rate regulation summarised in Section 3 of the DP?

**Notes to constituents**

- 37 *The DP states that a major objective of the IASB's Rate-regulated Activities project is to identify whether rate regulation sufficiently changes the financial position, performance and cash flows of rate-regulated entities to support modifying the general requirements of IFRS that apply to the entities. One important factor noted in the DP is that the distinguishing rights and obligations created by rate regulation have not, so far, been clearly identified in previous IASB standard-setting efforts.*
- 38 *Consequently, the IASB has tentatively decided to focus initially on a specified type of rate regulation named 'defined rate regulation'. This is because the IASB considered defined rate regulation to be most likely to create a combination of rights and obligations that is distinguishable from the rights and obligations arising from other activities.*
- 39 *In the IASB's preliminary view, defined rate regulation is considered to provide the clearest case for discussing whether the IASB should provide guidance for rate-regulated activities. However, this tentative description of defined rate regulation is not intended to define permanently the scope of the project. Paragraphs 4.4-4.6 in the DP summarise the key features of defined rate regulation. The features of defined rate regulation are discussed in Question 5 of the DP.*

**EFRAG's response**

**EFRAG agrees that 'defined rate regulation' forms a good basis to identify which features of rate-regulatory schemes distinguish rate-regulated activities from other commercial activities and create a combination of rights and obligations for which specific accounting guidance or requirements might need to be developed.**

➡ IAAF also agrees that IASB should focus on 'defined rate regulation'.

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The fact that 'defined rate regulation' creates enforceable rights and obligations is the key characteristic, and it justifies this focus because it differentiates defined rate regulation from (amongst others) the more limited 'market' rate regulation'.

IEAF also draws the attention to the fact that regulation often has a mixed character (elements of a 'cost plus' model next to elements of an 'incentive-based' model). Principle based guidance with a sufficiently wide scope should be able to deal with mixed models and with the evolution of regulation models over time.

- 40 We support the IASB's decision to focus the debate initially on accounting for a specific type of rate regulation referred to as 'defined rate regulation'. This makes it easier for the IASB to understand the economic impact of rate regulation on a



limited range of entities before moving to the next stage of the project. We also support the focus on 'rate-regulated activities' rather than 'rate-regulated entities' as some entities undertake both regulated and unregulated activities.

- 41 In our view, such an approach is helpful to identify which features of rate-regulatory schemes distinguish rate-regulated activities from the other commercial activities, and whether 'defined rate regulation' creates a combination of rights and obligations for which specific accounting requirements might need to be developed. This is explained in more detail in our response to Question 5.
- 42 However, we believe that the DP represents only a starting point in the discussion. As the IASB progresses, we believe it will need to consider in which circumstances an entity's right to recover an agreed amount of revenue in exchange for performing certain activities creates rights and obligations where guidance should be recognised in IFRS.

#### Question 4

Paragraph 2.11 notes that the IASB has not received requests for it to develop special accounting requirements for the form of limited or 'market' rate regulation that is used to supplement the inefficient competitive forces in the market (see paragraphs 3.30–3.33).

- (a) Do you agree that this type of rate regulation does not create a significantly different economic environment and, therefore, does not require any specific accounting requirements to be developed? If not, why not?
- (b) If you agree that this type of rate regulation does not require any specific accounting requirements, do you think that the IASB should, alternatively, consider developing specific disclosure requirements? If so, what would you propose and why?

#### Notes to constituents

- 43 *Market rate regulation is a term that is often used to indicate an incentive-based regulation, which often takes the form of a 'price cap' that applies to all suppliers in a competitive market. The rate regulator establishes a maximum level for the price per unit that all suppliers in the market can charge customers for the goods or services (i.e. a price cap) but does not set a 'floor' for that price.*
- 44 *Although this type of rate regulation provides some protection for customers in the form of a capped price per unit, it does not provide assurance to the suppliers in the market that they will be able to recover their costs or make a reasonable return on the goods or services that are sold subject to the regulation. Examples of such regulation include the capping of prices that:*
- (a) *banks in some jurisdictions can charge for processing credit card transactions; and*
- (b) *telecommunication providers in some jurisdictions can charge for mobile telephone 'roaming' services.*
- 45 *Using market rate regulation, the regulator does not restrict the total amount of revenue or profit that an entity can earn during the 'regulatory period' (i.e. the period over which the restricted price is required to be applied). Consequently, an entity may be able to increase profitability by reducing costs. In addition, the entity may gain a competitive advantage by reducing its selling price below the cap in order to gain market share and increase the volume of sales.*

## EFrag's response

**EFrag broadly agrees that 'market' rate regulation has characteristics that differ significantly from defined rate-regulation. It also does not create an economic environment that differs significantly from other commercial activities. On this basis, we believe that the existing IFRS are sufficient to faithfully depict the financial position and performance of those activities.**

### Question 4 (a)

46 EFRAG agrees that 'market' rate regulation has characteristics that differ significantly from defined rate-regulation. In addition, market rate regulation does not create a significantly different economic environment from other commercial activities for reasons stated in paragraphs 3.30 – 3.33 of the DP. Therefore, we believe that existing IFRSs are able to faithfully depict the financial position and performance of those activities.

### Question 4 (b)

47 However, EFRAG encourages the IASB, in the course of its comprehensive project on rate-regulated activities, to investigate whether there are features of so-called market rate regulation that have similarities to 'defined rate regulation'. In such cases, the IASB might need to consider whether it should eventually widen the scope of a potential future Standard to include disclosure about other forms of rate regulation (that do not fit within 'defined rate regulation') that will be useful for users of financial statements.

48 For example, during our outreach with industry specific users, we heard that it might be useful to explain the regulatory framework under which 'market' regulated entities operate. This would be consistent with the requirements in paragraph 112(c) of IAS 1 *Presentation of Financial Statements* which require an entity to provide information in the notes where such information is not presented elsewhere in the financial statements, but is relevant to an understanding of any of them.

## Question 5

Paragraphs 4.4–4.6 of the DP summarise the key features of defined rate regulation. These features have been the focus of the IASB's exploration of whether defined rate regulation creates a combination of rights and obligations for which specific accounting guidance or requirements might be developed in order to provide relevant information to users of general purpose financial statements.

- (a) Do you think that the description of defined rate regulation captures an appropriate population of rate-regulatory schemes within its scope? If so, why? If not, why not?
- (b) Do you think that any of the features described should be modified in order to include or exclude particular types of rate-regulatory schemes or rate-regulated activities included within the scope of defined rate regulation? Please specify and give reasons to support any modifications to the features that you suggest, with particular reference to why the features may or may not give rise to circumstances that result in particular information needs for users of the financial statements.
- (c) Are there any additional features that you think should be included to establish the scope of defined rate regulation or would you omit any of the features described? Please specify and give reasons to support any features that you would add or omit.

**Notes to constituents**

- 49 *The features described in defined rate regulation were identified from the types of schemes that respondents to the IASB's Request for Information suggested give rise to a combination of rights and obligations that create economic conditions that are distinguishable from those found in environments that are not rate-regulated. Some suggest that this combination of rights and obligations creates specific assets and liabilities for which accounting requirements should be developed. For ease of reference, paragraphs 4.4 to 4.6 of the DP that summarise the key features of defined rate regulation are duplicated in paragraphs 50 - 52 below.*
- 50 *Defined rate regulation involves a regulatory pricing (i.e. rate-setting) framework that includes all of the following:*
- (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:*
    - (i) *there is no effective competition to supply; and*
    - (ii) *the rate-regulated goods or services are essential to customers (such as clean water or electricity).*
  - (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 parameters for rates (sometimes referred to as prices or tariffs) that provide regulatory protections that:*
    - (i) *support greater stability of prices for customers; and*
    - (ii) *support the financial viability of the rate-regulated entity.*
  - (d) *it creates rights and obligations that are enforceable on the rate-regulated entity and on the rate regulator.*
- 51 *The rate-setting framework for defined rate regulation establishes:*
- (a) *a 'revenue requirement' (sometimes called 'allowable revenue' or 'authorised revenue'): this is the total consideration to which the entity is entitled in exchange for carrying out specified rate-regulated activities over a period of time; and*
  - (b) *a regulated rate, or rates, per unit that the entity charges to customers for delivering the rate-regulated goods or services during the regulatory period.*
- 52 *For defined rate regulation, the mechanism used to calculate the regulated rate(s) includes a regulatory adjustment mechanism to reverse specified differences between the amount of the revenue requirement accrued to date and the amounts billed to customers. This regulatory adjustment mechanism seeks to ensure that the rate-regulated entity earns no more and no less than the amount of the revenue requirement and any related profit or return to which it is entitled. The regulatory adjustment to the rate also seeks to reflect the time value of money when increases or decreases in the rate are deferred.*

## EFRAG's response

**We broadly agree with the description of 'defined rate regulation'.**

**However, we believe that any enforceable rights and obligations that stem from the rate-regulation mechanism are the most important elements for distinguishing the types of rate regulation that require recognition in the financial statements. It is these rights and obligations that identify an appropriate population for the IASB's Rate-regulated Activities' project.**

**Furthermore, we provide some suggestions about how to improve the description of 'defined rate regulation'.**

⇒ IEAF also agrees with the description of 'defined rate regulation'. However, we think that certain features listed in the DP describe only the context and are not key for determining the scope. IEAF members consider following features as key :

- Rates and regulation support the financial viability of the rate-regulated entity (protective environment for the entity, next to price stability for customers) ;
- Regulation creates **enforceable rights and obligations** on the rate-regulated entity and the rate regulator, but also on the customers ;
- The rate-regulated entity provides a public service in exchange for an **authorized revenue**. The authorized revenue, that results from a rate setting mechanism, is a key feature of rate regulation.

*Question 5(a) – does defined rate regulation captures an appropriate population?*

53 As noted in our answer to Question 3, EFRAG supports the IASB's decision to focus on 'defined rate regulation' in the DP. We acknowledge this provides a common starting point for a focused discussion to help understand the economic impact of rate regulation on a limited range of entities and specifically whether rate regulation creates a combination of rights and obligations.

54 However, we believe that the DP represents only a starting point in the discussion. As the IASB progresses on the project, we believe it 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 description of 'defined rate regulation'*

55 EFRAG broadly supports the description of 'defined rate regulation' in the DP and note that the features included in paragraph 4.4 of the DP are important characteristics of rate-regulated activities.

56 During our discussions on this topic, we have heard from preparers in the utility sector that an entity's 'distinguishable right' to a revenue adjustment – or 'distinguishable obligation' to have an entity's total return set by the regulator – is what differentiates rate-regulated activities from other activities (including regulated activities that do not contain this right). We therefore believe that enforceable rights and obligations that stem from rate regulation should be the most important element for establishing the type of rate regulation that the DP is designed to capture.

57 In our view, the features listed in paragraph 4.4(a) – (c) of the DP should be used as *indicators* to assess whether enforceable rights and obligations exist for those activities that operate in 'defined rate regulation'. It is these rights and obligations

that identify an appropriate population for the IASB's Rate-regulated Activities' project.

58 Paragraph 3.6 of the DP explains that 'defined rate regulation' is designed to ensure that the rate-regulated entity recovers a determinable amount of consideration (the 'revenue requirement') in exchange for the rate-regulated activities that it performs. We note that the connection between the legislation, the entity, the regulated activities are important factors that need to be reflected in the definition of 'defined rate regulation':

- (a) The legislation that sets and enforces the 'revenue requirement';
- (b) The agreement that binds the customer; and

- (c) The rate-regulated activities an entity needs to undertake to be entitled to the 'revenue requirement', including performance to the customer.



IEAF thinks that paragraph 3.6 of the DP is key.

The connection mentioned by EFRAG in point 58 above is essential, but should in our view also include a link to regulation and especially to the rate setting mechanism, including the method used for the recovery of any adjustments related to the revenue requirement for past performance.

- 59 We explain our reasoning in the paragraphs below.

The legislation that sets and enforces the 'revenue requirement'

- 60 Paragraph 4.5 of the DP describes a rate-setting framework as a means to establish a 'revenue requirement' in the form of a rate or tariff that grants a rate-regulated entity a right to receive from or a present obligation to pay its customers for delivering the rate-regulated goods or services. We broadly agree with this description. However, in order to further justify that rights and obligations can be made 'enforceable' by the rate-setting framework, we believe that the definition of rate regulation needs to:

- (a) focus more predominantly on the legislation that enforces the rate-setting framework. In other words, legislation that an entity can turn to in case it needs to enforce the rate or tariff it is allowed to charge must be the starting point in the definition of 'defined rate regulation'. As a result, we believe that the rate-setting framework needs to be clearly embedded within the description of defined rate regulation; and
- (b) require an external rate regulator (or similar body) that sets and enforces the rights and obligations (i.e. need an enforcement mechanism outside of the entity).

The agreement that binds the customer

- 61 We think it is important to link the rights and obligations required by 'defined rate regulation' with the customer or the 'customer base' of the entity. The rights and obligations discussed in paragraphs 4.62 – 4.79 of the DP stem from the agreement between the rate regulator and the rate-regulated entity.

- 62 The customer is not a party to the agreement between the rate regulator and the entity in the majority of cases in the European regulatory environment. It is therefore necessary to explain how 'defined rate regulation' binds the customer. This is discussed further in the paragraphs below.

- 63 We also note that a supplier can be the intermediary between the rate-regulated entity and the customer, for instance a regulated gas distribution entity would invoice the usage of the gas distribution network to the gas supplier, who will in turn invoice the customer. Therefore, we believe that the proposed definition should consider regulatory regimes which involve direct or indirect supply of the rate-regulated goods or services to end-customers.

*The unit of account*

- 64 EFRAG also believes that the IASB should consider whether the unit of account has an important role to play in either the description of 'defined rate regulation' or within one of the 'indicative' features of 'defined rate regulation'. If it were to be

considered within the features; we think it should be included in the feature discussed in paragraph 4.4(a) of the DP.

- 65 Some argue that, under current IFRS, the unit of account for a utility entity is the provision of services to the individual customer. In their view, this is consistent with any other commercial activity. However, given the essential nature of the service, the lack of competition and the existence of the rate regulation, the question is

whether the unit of account changes to the customer base, rather than the individual customer.

- 66 We believe it is fundamental to understand how and whether the existence of 'defined rate regulation' might trigger a change in the unit of account and the recognition of revenue under IFRS. For example to apply IFRS 15, the entity would need to identify the performance obligation(s) it has with the customer base as it would supersede individual customer contracts with a 'customer base' virtual contract. Under this perspective, delivery of rate-regulated goods or services to customers would be seen as the distinct performance obligation in this overall virtual contract. It is therefore important to link the rights and obligations that stem from the rate-setting framework with the customer base.
- 67 We understand that there are two agreements that a rate-regulated entity needs to consider with respect to revenue recognition:
- (a) The agreement it has directly with the customer to supply rate-regulated goods or services; and
  - (b) The agreement it has with the rate regulator.
- 68 EFRAG notes that in the exposure draft ED/2009/8 *Rate-regulated Activities* the IASB noted in paragraph BC19 of the Basis for Conclusions that '*regulation governs the entity's relationship with its customer base as a whole*'; and '*although the individual members of that group may change over time, the relationship the regulator oversees is between the entity and the group*'. Therefore, the IASB concluded that the requirements in the ED should be applied at '*the aggregate customer level*'.
- 69 Given the above reasoning, we believe the IASB needs to explore further how to link the agreement an entity has with the rate regulator with the agreement it has with its individual customer and/or with its customer base as a whole.
- Rate-regulated activities an entity needs to undertake to be entitled to the 'revenue requirement', including performance to the customer
- 70 As explained in paragraph 4.14 of the DP, an entity must satisfy certain activities to be entitled to the 'revenue requirement'. These activities can be both direct and indirect obligations (for example satisfying government/rate regulator objectives such as changes to the infrastructure network) related to rate-regulated activities. In our view, direct and indirect activities, as described in the DP, can create different types of obligations, some of which involve 'performance' to a customer (for example, delivered electricity); and others involve satisfying an obligation required by a rate regulator or a government.
- 71 We note that in paragraph 4.66 of the DP, the nature of rights that arise from undertaking these activities that settle indirect obligations with the regulator is analogised to those assets that '*creates an opportunity to generate an inflow of cash or another financial asset, but it does not give rise to a present right to receive cash or another financial asset*' (e.g. paragraph AG10 of IAS 32 *Financial Instruments: Presentation*). In our view, this further distinction between rights and obligations would permit the IASB to develop its project further.
- 72 We therefore believe it is important to link the performance of rate-regulated activities to 'a customer' to the definition of 'defined rate regulation'. This is particularly important when assessing if revenue should be recognised for services or goods delivered to the customer. Indirect activities as described in the DP are



not directly linked to the satisfaction of the performance obligations with the end-customers, and could therefore not result in the recognition of revenue.

- 73 Overall, we believe that a clearer view of the rate-regulated entity's 'obligations' to receive the 'revenue requirement' is needed as the IASB progresses with this project. For example, the IASB should separately assess which type of rights and obligations arise from the fulfilment of other obligations (i.e. indirect obligations mentioned in the DP).



IEAF members are not certain whether indirect obligations (such as 'keeping the regulated assets in good state') should be disconnected from the transfer of goods or services (for which the regulated assets are used and thus essential). As mentioned before, an analysis in view of IFRS 15 will be required to (amongst others) clearly identify the performance obligations.

*Question 5(b) – should any of the features be modified?*

- 74 In the paragraphs below we have provided a number of suggestions about how these features might be improved so as to achieve this purpose, and which may also assist in supporting a particular accounting approach in a future Standard.

Customers have little or no choice but to purchase the goods or services (paragraph 4.4(a) of the DP)

- 75 EFRAG understands that determining 'how much competition' would be viable to achieve a competitive environment that is similar to that of non-rate-regulated entities is difficult. However, we also believe that there is room for this feature to be less prescriptive with regards to (1) there being no effective competition and (2) the rate-regulated good or service being essential to customers.

- 76 We believe that a strong driver of this feature is that the customer has little or no choice but to buy the goods or services from the rate-regulated entity. We therefore think that to make this feature workable, it is necessary to have 'very low demand risk' (i.e. relatively inelastic demand), rather than 'no effective competition'. Indeed, it is the 'very low demand risk' that ensures that the entity can benefit from the rights and obligations that stem from the rate setting agreement. We recommend the IASB to consider incorporating 'very low demand risk' in the description of this feature, rather than focus on the absence of competition.

- 77 We also question whether the reference to an 'exclusive right' in paragraph 4.35 of the DP is compatible with no 'effective competition'. In our view, an exclusive right is a right reserved exclusively to a particular person or group. Therefore no other entity could have that right. However, the DP notes in paragraph 4.41 that defined rate regulation could be also applied when there is more than one supplier if the demand for the rate-regulated goods or services exceeds the supply capacity of a single entity (this is typical in regimes that have introduced capacity payments as forms of remuneration).

- 78 Finally, we believe that the IASB should analyse this feature in the context of our comments in the subsection 'the agreement that binds the customer' above, given the interaction between the demand for rate-regulated goods and services, and the agreed tariffs (rates per unit), which are set by the regulator.

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 (paragraph 4.4(b) of the DP)

- 79 We support this feature being included in the definition of 'defined rate regulation'.

80 EFRAG agrees that one of the objectives of rate regulation is to balance the needs of the customers with the needs of the supplier and with other government objectives (such as environmental objectives). For example, shortages in the supply, or reductions in quality, could have an adverse effect on customers. In

order to avoid this, there are contractual obligations imposed by rate regulators on entities.

- 81 The underlying objective of defined rate regulation is to ensure that the tariff (rate per unit) set under the 'revenue requirement' ensures the availability and quality of supply of essential goods or services to customers, at rates that are reasonable and stable rate regulatory for customers and financially viable for the rate-regulated entity (in order to attract capital and investment). We therefore agree this feature is common to the type of regulation that the DP is trying to capture.
- 82 However, we would be concerned if for example, a rate-regulated activity was excluded from any future Standard because maintaining the quality of the supply was not part of the legislation. Therefore we recommend not making this feature a mandatory one.

It establishes parameters for rates (sometimes referred to as prices or tariffs) that provide regulatory protections (paragraph 4.4(c) of the DP)

- 83 EFRAG broadly supports this feature. In our view, a key aspect of defined rate regulation is that a rate regulator that can impose a particular rate that will entitle an entity to earn an authorised return. This is to ensure that the entity continues providing the regulated services/activities, and provides stability of prices for the customers. Unlike non-regulated activities, the customer is not involved in agreeing a price it will pay for the rate-regulated goods or services it receives.
- 84 For reasons similar to our comments about the feature relating to 4.4(b) above, we recommend not making this feature a mandatory one.

Creates rights and obligations that are enforceable on the rate-regulated entity and on the rate regulator (paragraph 4.4(d) of the DP)

- 85 As previously mentioned, EFRAG believes that the existence of rights and obligations that arise from rate regulation is the most important element in 'defined rate regulation', and should not be considered a 'feature' per se but rather as being part of the definition.
- 86 We also note that the terminology in the description of 'enforceable rights and obligations' is consistent with the one used in IFRS 11 *Joint Arrangements* that refers to rights that are contractually or legally enforceable. We encourage the IASB to consider the interactions with the terminology that is already used in other IFRSs, for example:
- (a) IFRS 15 that refers to the probability threshold to recognise a variable consideration that is set at a high level of probability<sup>2</sup>; and
  - (b) IAS 37 regarding the recognition of liabilities for constructive obligations.

This is because we understand that the enforceability of rights and constructive obligations that arise from regulations are also affected by regulatory risk and by regulatory leverage.

⇒ IEAF is not convinced that recovery of any adjustments related to the revenue requirement for past performance should be seen as a variable consideration according IFRS 15. However, we do agree that a high level of probability is an important element in considering the recognition of deferral accounts in the financial statements. We repeat that we recommend a thorough analysis of how IFRS 15 should be applied to rate-regulated activities.

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<sup>2</sup> Paragraph 56 of IFRS 15 requires that an entity includes in the transaction price some or all of an amount of variable consideration only to the extent that it is highly probable that a significant reversal in the amount of cumulative revenue recognised will not occur.

- 87 Finally we suggest amending the wording for the feature in paragraph 4.4(d) of the DP, as follows: *'creates rights and obligations that are enforceable on the rate-regulated entity and, on the rate regulator and on the customers/end users'* because the tariff is binding on the customers as well. We believe that these improvements are consistent with the feature suggested in paragraph 61 - 63 above.

*Question 5(c) – are there other features that should be included?*

- 88 The 'tariff adjusting mechanism' is described in the definition of the 'revenue requirement' in paragraph 4.5 of the DP as the total amount of consideration to which an entity is entitled in exchange for providing rate-regulated activities over an agreed period of time. We consider that this is a major source of rights for the rate-regulated entity.
- 89 We recommend the IASB includes the right to receive the revenue requirement in the description of defined rate regulation.
- 90 EFRAG notes that there is no definition of a rate regulator in the DP and we consider that this term should be defined. One suggestion would be a definition similar to that in IFRS 14.
- 91 EFRAG also believes that the terms of service should be incorporated in the definition of defined rate regulation as it establishes the entity's rights and obligations (including the amount of revenue that the entity is entitled to charge to customers in exchange for satisfying those obligations) and ensures that the rights and obligations are enforceable.

**Questions to Constituents:**

- 92 Do you think that the regulation that you are aware of is scoped out of the description of defined rate regulation when it should be included? If so, why? How should the current description in the DP be improved to address this case?
- 93 Are there any additional features that you think are needed to establish the scope of defined rate regulation? Please specify and give reasons to support any features that you would add.
- 94 Are there any features in defined rate regulation that are unnecessary or should be modified? Please explain.

**Question 6**

Paragraphs 4.62–4.72 contain an analysis of the rights and obligations that arise from the features of defined rate regulation.

- (a) Are there any additional rights or obligations that you think the IASB should consider? Please specify and give reasons.
- (b) Do you think that the IASB should develop specific accounting guidance or requirements to account for the combination of rights and obligations described? Why or why not?

**Notes to constituents**

- 95 *Clear legislation and regulatory policies, including the right to challenge the rate regulator's decisions, function as a limit to regulatory judgement and discretion.*

- 96 *An analysis of the rights and obligations that arise from the features of defined rate regulation as described in the DP is included below.*

*Exclusive right to supply essential goods or services*

- 97 *Paragraph 4.64 of the DP states that not all ‘essential’ goods or services are subject to defined rate regulation in every jurisdiction. This is because, in some jurisdictions, there may be a plentiful supply of the essential goods or services, together with competition among suppliers. In such cases, rate regulation is unnecessary. Consequently, it seems reasonable to conclude that the essential nature of the goods or services supplied does not, in itself, create any specific rights or obligations for the suppliers nor any specific needs for information for users of financial statements.*

*Obligations to achieve the defined minimum service level*

- 98 *Some obligations imposed by defined rate regulation could be considered to be unique and may, therefore, distinguish rate-regulated activities from general commercial activities that are not subject to defined rate regulation. These obligations may include:*
- (a) the requirement for the entity to supply the rate-regulated goods or services to customers on a non-discriminatory basis, as directed by the rate regulator;*
  - (b) the requirement for the entity to provide the rate-regulated goods or services in accordance with the minimum service levels and at the regulated price; and*
  - (c) the inability of the entity to cease, suspend, restructure or transfer operations (and the rights and obligations attached to those operations) without the approval of the rate regulator.*

*Right to recover the revenue requirement*

- 99 *Paragraph 4.5 of the DP defines the revenue requirement to be ‘the total consideration to which an entity is entitled in exchange for carrying out specified rate-regulated activities over a period of time’. Paragraph 4.14 of the DP adds to this definition by stating that the ‘rate-regulated activities’ include those that both directly and indirectly relate to delivering the rate-regulated goods or services.*
- 100 *Some suggest that the most distinguishable feature of defined rate regulation is the entity’s right to recover the revenue requirement over time, using the rate-setting mechanism to adjust for under-billings or over-billings. This right ensures that the entity (and its capital providers) can rely on the rate regulation to recover its reasonable costs over the operational life of the assets that are used in providing the rate-regulated goods or services.*

**EFRAG’s response**

**We are not aware that there are any additional rights and obligations that the IASB needs to consider. Therefore, EFRAG agrees that the IASB has identified the key rights and obligations that create a specific economic environment for entities operating rate-regulated activities and for which require specific IFRS guidance might be required.**



IEAF has not identified any additional rights or obligations that should be considered.  
IEAF is not convinced that specific IFRS guidance is required. As mentioned before, we think the most adequate approach is to clarify application of existing standards, and especially IFRS 15, for these activities.

*Question 6(a) – are there additional rights or obligations that need to be considered?*

101 We are not aware that there are any additional rights and obligations that the IASB needs to consider. Therefore, EFRAG agrees that the IASB has identified the key

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rights and obligations that create a specific economic environment for entities operating rate-regulated activities.

- 102 EFRAG agrees that the entity's rights and obligations that arise in a rate-setting framework to recover or settle the revenue requirement is the key factor that distinguishes entities operating rate-regulated activities from commercial ones. As explained in paragraph 4.72 of the DP, this right, that stems from the rate setting mechanism and ensures that the entity (and its capital providers) can rely on the rate regulation to recover the amount of its 'revenue requirement'.
- 103 We also agree that any obligation to achieve a defined minimum service level, differentiates these types of entities from commercial ones because of – for instance - the inability of the entity to cease, suspend, restructure or transfer operations (and the rights and obligations attached to those operations) without the approval of the rate regulator.

#### Question to Constituents

- 104 Are there any additional rights or obligations that you think the IASB should consider? Please explain.

*Question 6(b) - should the IASB develop specific accounting guidance or requirements to account for the combination of rights and obligations?*

- 105 EFRAG supports the IASB's project on rate regulation and recommends the IASB to develop specific IFRS guidance or requirements to account for the combination of rights and obligations that arise in defined rate regulations in order to meet the objective of financial reporting as defined in the Conceptual Framework.
- 106 This is because, in our view, currently IFRS financial statements do not produce the information users regard as relevant for an understanding of the impact of rate-regulated activities on a rate-regulated entity's performance, cash flows and financial position.

#### Question 7

Section 5 outlines a number of possible approaches that the IASB could consider developing further, depending on the feedback received from this Discussion Paper. It highlights some advantages and disadvantages of each approach.

- (a) Which approach, if any, do you think would best portray the financial effects of defined rate regulation in IFRS financial statements and is most likely to provide the information that investors and lenders consider is most relevant to help them make their investing and lending decisions? Please give reasons for your answer?
- (b) Is there any other approach that the IASB should consider? If so, please specify and explain how such an approach could provide investors and lenders with relevant information about the financial effects of rate regulation.
- (c) Are there any additional advantages or disadvantages that the IASB should consider before it decides whether to develop any of these approaches further? If so, please describe them.

If commenting on the asset/liability approach, please specify, if it is relevant, whether your comments reflect the existing definitions of an asset and a liability in the Conceptual Framework or the proposed definitions suggested in the Conceptual Framework Discussion Paper, published in July 2013.



## Notes to constituents

### *The asset and liability debate*

- 107 *Many of those who do not support recognising 'regulatory assets' and 'regulatory liabilities' have argued that the right to increase or the obligation to decrease the rate chargeable for future sales does not create a present resource/right or a present obligation for the entity. Instead, the regulatory deferral account balances would be classified as contingent assets or contingent liabilities because, although they may arise from past events and transactions, their existence as assets and liabilities will only be confirmed by the occurrence of a sufficient volume of future sales.*
- 108 *Those who support recognising regulatory deferral account balances as regulatory assets and regulatory liabilities disagree with the view that these are contingent amounts. The regulatory deferral account balances constitute differences between the amount of consideration to which the entity is entitled in exchange for performing its rate-regulated activities and the amount of revenue billed to customers. Consequently some suggest that the entity has a present right to recover, or an obligation to refund, amounts that have been under-billed or over billed.*
- 109 *Below are a number of possible financial reporting approaches that the IASB could consider developing further.*

### *Recognising the package of rights and obligations as an intangible asset*

- 110 *This approach entails recognising the package of rights and obligations created by defined rate regulation as an intangible asset - namely the 'regulatory licence'. In order to reflect the balance of rights and obligations and the changing value of this intangible asset, the IASB would need to consider amending IAS 38 Intangible Assets.*

### *Reporting using regulatory accounting requirements*

- 111 *This approach would adopt the accounting requirements established by the rate regulation in the IFRS financial statements of the rate-regulated entity. The IASB would therefore need to consider an exemption from applying some of the existing IFRS for such entities in order to allow rate-regulated entities to present some aspects of their 'regulatory financial statements' as their IFRS financial statements.*

### *Developing specific IFRS requirements*

- 112 *This approach would recognise the impact of the rate regulation through specific IFRS requirements. This approach would require the IASB to modify IFRS to either defer or accelerate the recognition of costs, revenue or both. The DP discusses the following approaches:*
- (a) *costs: This approach reflects the traditional 'cost-based' nature of rate regulation in several jurisdictions. Amounts billed or billable to customers during the accounting period using the regulated rate per unit are recognised as revenue. The recognition in profit or loss of incurred costs is deferred, or expected costs are accelerated to match their recognition for regulatory purposes. This is explained in paragraphs 5.62 – 5.70 of the DP.*
  - (b) *revenue: Using this approach, entities recognise costs in accordance with the general requirements of IFRS. Amounts billed or billable to customers during the accounting period using the regulated rate per unit are recognised initially as revenue. An adjustment to revenue is also recognised to reflect*

*the future compensatory adjustment to the rate chargeable to customers. This is explained in paragraphs 5.71 – 5.76 of the DP.*

- (c) combination of costs and revenue: *This approach would defer/accelerate costs for some items, such as the capitalisation of costs related to property, plant and equipment, and defer/accelerate revenue for other items, such as storm damage repairs and incentive bonuses/penalties. This is explained in paragraphs 5.77 – 5.90 of the DP.*

*Prohibiting the recognition of regulatory deferral account balances*

- 113 *This approach would prohibit the recognition of regulatory deferral account balances (similar to current practice). The IASB would not develop specific recognition and measurement requirements, but would consider disclosures to explain the effect of rate regulation. This is explained in paragraphs 5.91 – 5.109 of the DP.*

**EFRAG's response**

**EFRAG supports an approach that is principle-based and is able to be applied to different regulatory regimes that evolve over time.**

**We generally support the approach that considers deferring or accelerating the recognition of a combination of costs and revenue, and believe that the revenue approach discussed in the DP has an important role to play when an entity has 'performed' to its customers.**

⇒ IEAF thinks that the clarification of the application of IFRS 15 is the most adequate solution. In certain cases, this will likely result in the recognition of a 'contract asset' or a 'contract liability'. We strongly argue against introducing an 'exception' whereby costs or revenues are deferred or accelerated based on specific guidance for rate-regulated activities, and recommend to apply for these activities the existing IFRS principles and standards.

*Question 7(a)*

- 114 EFRAG acknowledges that there is a wide range of rate-regulatory frameworks in Europe, which typically include 'hybrid' regimes - i.e. elements of cost-based and incentive-based regimes are used in setting the revenue requirement. Such schemes may also change over time as described in paragraph 3.37 of the DP. Accordingly, we support an approach that is principle-based and which can be applied to different regulatory regimes that evolve over time.
- 115 We generally support a combination of deferring/accelerating the recognition of costs and revenue. However, we believe that the revenue approach discussed in the DP has an important role to play when an entity has 'performed' to its customers. Although we remain open to a cost deferral approach, we do not fully understand in which cases it should apply, and recommend the IASB to identify when such an approach will produce relevant information.
- 116 In EFRAG's view, a revenue approach could aim at modifying the amount of revenue recognised when a transaction with the customers has occurred (i.e. the delivery of goods and services). In paragraphs 70 to 72 above we have noted that the current Standard on revenue recognition could be analogised if the IASB were to consider that rate-setting frameworks create specific economic environment for entities operating rate-regulated activities that meet the description of defined rate regulation.

117 However, we have also highlighted in paragraph 73 above that we believe that some rate-setting frameworks create indirect obligations that do not directly relate to the delivery of goods and services. In these circumstances, we believe that the IASB should explore whether the fulfilment of these obligations (e.g. maintenance that does not qualify for recognition under IAS 16) gives rise to a right that could be capitalised as it *'creates an opportunity to generate an inflow of cash or another*

*financial asset, but it does not give rise to a present right to receive cash or another financial asset’.*

Question 7(b)

118 We are not aware of any other approach that the IASB should consider.

**Questions to Constituents:**

119 Are you aware of any operational difficulties in applying an accounting method based on deferring/accelerating the recognition of a combination of costs and revenue in your regulation?

120 Are there any other approaches that the IASB should consider? Please explain.

Question 7(c)

121 [Answer to be based on feedback from constituents.]

**Questions to Constituents:**

122 Are you aware of any other advantages and disadvantages on the accounting approaches that the IASB should consider? Please explain.

**Question 8**

Does your organisation carry out activities that are subject to defined rate regulation? If so, what operational issues should the IASB consider if it decides to develop any specific accounting guidance or requirements?

**Notes to constituents**

123 *The DP notes the following operational issues for the financial reporting approaches.*

Recognising the package of rights and obligations as an intangible asset

124 *The existing requirements in IAS 38 provide an option to measure intangible assets at fair value to be determined by reference to an active market (paragraph 75 of IAS 38). For entities that are subject to defined rate regulation, there is no active market, as defined in IAS 38, for the licence. Such a revaluation approach raises a number of practical difficulties, which may outweigh the potential benefits of this approach.*

125 *Another operational issue is that identifying the impact on the value of the regulatory licence resulting from each rate determination separately from other changes in value of the business could be complex.*

Reporting using regulatory accounting requirements

126 *Some who support the regulatory accounting approach state that it is onerous to require a rate-regulated entity to prepare financial statements on two bases: one for the rate regulator using regulatory accounting requirements and another for general purpose financial reporting. Allowing entities subject to defined rate regulation to prepare their IFRS financial statements using the regulatory accounting requirements would be less onerous and might save costs for rate-regulated entities.*

- 127 *It may also be difficult to distinguish the effect of the rate regulation on items for which there are specific regulatory accounting requirements from the effect of general market conditions and management decisions.*

**EFRAG's response**

**[To be answered based on feedback from constituents].**

IEAF thinks that it is advisable not to have separate standards for specific activities and prefers that guidance for rate-regulated activities fits in the existing standards. The most appropriate way to fit rate-regulated activities in existing standards is in our view a clarification of how IFRS 15 should be applied to these activities.

- 128 For the reasons set in paragraphs 5.35 to 5.51 and 5.91 to 5.109 of the DP we do not support the development of the following methods:
- (a) Recognising the package of rights and obligations as an intangible asset;
  - (b) Reporting using regulatory accounting requirements; and
  - (c) Prohibiting the recognition of regulatory deferral account balances and assessing whether only disclosures requirements could be developed.
- 129 As stated in paragraph 115 above, we support the development of a combination of deferring/accelerating the recognition of costs and revenue.
- 130 [To be finalised based on feedback from constituents].

**Question to Constituents**

- 131 Does your organisation carry out activities that are subject to defined rate regulation? If so, what operational issues would you like EFRAG to consider in its response to the IASB? We would be particularly interested if you focus on a hybrid method that consists of a combination of deferring/accelerating the recognition of costs and revenue.
- 132 If there are other approaches identified as per Question 7(b) of the DP, what operational issues should the IASB consider if it decides to develop those approaches?

**Question 9**

If, after considering the feedback from this Discussion Paper and the *Conceptual Framework* project, the IASB decides to prohibit the recognition of regulatory deferral account balances in IFRS financial statements, do you think that the IASB should consider developing specific disclosure-only requirements? If not, why not? If so, please specify what type of information you think would be relevant to investors and lenders in making their investing or lending decisions and why.

**Notes to constituents**

- 133 *Although some parties' do not support modifying the requirements of IFRS for rate-regulated activities because they consider that rate regulation does not create a sufficiently distinguishable economic environment, they nonetheless accept that*

*some additional disclosure requirements may be appropriate in some circumstances. This may be the case, for example, if the rate regulation restricts the entity's ability to react to changing circumstances in a timely manner. This typically applies when the rate regulation permits rate changes to be applied only at predetermined intervals, and those intervals are substantially longer than would apply in a competitive environment.*

- 134 *The DP provides an example (paragraphs 5.108 - 5.109) of global price increases for oil which is used by an entity to generate electricity and the entity is subject to defined rate regulation. With respect to the example, disclosures about the delay in recovery and the ultimate right to increase prices to recover past costs would help users of the financial statements to understand the effects of the rate regulation on future cash flows.*

#### EFRAG's response

**EFRAG believes that IFRS financial statements should include relevant disclosure where an entity is impacted by rate regulation.**

IEAF considers that financial statements should adequately reflect the performance of the entity, and therefore strongly recommends that the current IFRSs should apply to these activities. As stated before, the application of IFRS 15 will in certain cases likely result in the recognition of contract assets or contract liabilities. We argue against the prohibition of the recognition of regulatory deferral account balances in IFRS financial statements, especially in cases where application of IFRS 15 would justify such recognition.

Moreover, if the regulatory deferral balances are significant enough to justify a disclosure, we don't see an objective reason to prohibit their recognition in the accounts (especially if such recognition would be justified under adequate application of IFRS 15).

- 135 As explained in the response to Question 1, the outcome of our discussions with users has shown that irrespective of the decision to develop specific accounting guidance, users do not find the current disclosures about the effects of rate-regulation sufficient for their analysis. Furthermore, management of rate-regulated entities with 'defined rate-regulation' have informed us that they use information that is significantly different to that reported in the IFRS financial statements to explain to investors and other users the effects of rate regulation.
- 136 In our view, the minimum requirements to be imposed on entities with rate-regulated activities should be disclosure about the economic impacts of rate-regulation.

#### Question 10

Sections 2 and 6 discuss some of the information needs of users of general purpose financial statements. The IASB will seek to balance the needs of users of financial statements for information about the financial effects of rate regulation on an entity's operations with concerns about obscuring the understandability of financial statements and the high preparation costs that can result from lengthy disclosures (see paragraph 2.27).

- (a) If the IASB decides to develop specific accounting requirements for all entities that are subject to defined rate regulation, to what extent do you think the requirements of IFRS 14 meet the information needs of investors and lenders? Is there any additional information that you think should be required? If so, please specify and explain how investors or lenders are likely to use that information.
- (b) Do you think that any of the disclosure requirements of IFRS 14 could be omitted or modified in order to reduce the cost of compliance with the requirements, without omitting information that helps users of financial statements to make informed investing or lending decisions? If so, please specify and explain the reasons for your answer.

## **Notes to constituents**

137 *The requirements in IFRS 14 are set out in three categories:*

- (a) *the presentation of amounts recognised in the statements of financial position, profit or loss and other comprehensive income;*
- (b) *disclosures about the activities that are subject to rate regulation; and*
- (c) *disclosures about the amounts recognised in the statements of financial position, profit or loss and other comprehensive income.*



*Presentation of amounts recognised in the statements of financial position, profit or loss and other comprehensive income*

138 *IFRS 14 requires an entity applying that Standard to isolate the effect of recognising regulatory deferral account balances by presenting the totals of all such balances, and the movements within them, as separate line items in the statements of financial position (after subtotals for total assets and total liabilities), and profit or loss and other comprehensive income.*

*Disclosures about the activities that are subject to rate regulation and the amounts recognised in the statements of financial position, profit or loss and other comprehensive income*

139 *IFRS 14 requires some qualitative disclosures to help users of financial statements to assess the nature of, and risks associated with, the entity's rate-regulated activities. These disclosures include:*

- (a) a brief description of the nature and extent of the activities that are subject to rate regulation and the nature of the rate-setting process; and*
- (b) information about risks and uncertainty in the future recovery or reversal of each type of regulatory deferral account balance that has been recognised.*

140 *IFRS 14 requires some disclosures about the amounts of regulatory deferral account balances that have been recognised in the financial statements. As well as the accounting policies used to recognise and measure such balances, the entity is required to disclose, for each class of regulatory deferral account balance:*

- (a) a reconciliation of the carrying amount at the beginning and end of the period, with movements segregated between amounts arising in the period, amounts recovered or reversed in the period and other reconciling items;*
- (b) the rate of return or discount used to reflect the time value of money; and*
- (c) the remaining periods over which the entity expects to recover or reverse the regulatory deferral account balance recognised.*

141 *The IASB concluded that the combination of the IFRS 14 presentation requirements and the qualitative and quantitative disclosure requirements helps users to:*

- (a) better understand the relationship between the results reported to the rate regulator and the results reported in financial statements prepared in accordance with general IFRS requirements;*
- (b) distinguish variability in performance that is adjusted through the rate-regulatory mechanism from variability for which there is no regulatory adjustment; and*
- (c) more readily predict the amount, timing and certainty of future cash flows related to the entity's rate-regulated activities.*

## EFRAG's response

**EFRAG believes that the disclosures required in IFRS 14 provide a good starting point for comprehensive disclosures. We identified additional information that we consider to be useful to users in our answer to Question 1.**

⇒ IEAF shares the view of EFRAG, that the disclosures required in IFRS 14 provide a good starting point for comprehensive disclosures.

### Question 10 (a)

- 142 In our comment letter on the IASB's exposure draft ED/2013/5 *Regulatory Deferral Accounts*, while not supporting the exposure draft, we agreed with the general disclosure objectives and the disclosure requirements proposed in it.
- 143 We therefore agree that the disclosures required in IFRS 14 provide a good starting point for comprehensive disclosures.
- 144 However, in addition to the disclosure requirements in IFRS 14, EFRAG understands that the users of financial statements require additional information. Our response to Question 1 of the DP describes this additional information required. We reiterate our point relating to the disclosure framework in paragraph 27 above.

### Question 10 (b)

- 145 EFRAG does not believe that any of the disclosure requirements of IFRS 14 should be omitted. Some modifications will presumably be needed to align the existing disclosure requirements to the specific IFRS requirements should the IASB decide to follow such an approach.

## Question 11

IFRS 14 requires any regulatory deferral account balances that have been recognised to be presented separately from the assets and liabilities recognised in the statement of financial position, in accordance with other Standards. Similarly, the net movements in regulatory deferral account balances are required to be presented separately from the items of income and expense recognised in the statement(s) of profit or loss and other comprehensive income.

If the IASB develops specific accounting requirements that would apply to both existing IFRS preparers and first-time adopters of IFRS, and those requirements resulted in the recognition of regulatory balances in the statement of financial position, what advantages or disadvantages do you envisage if the separate presentation required by IFRS 14 was to be applied?

## Notes to constituents

- 146 *The DP mentions that perhaps in the statement of financial position the biggest impact of separate presentation that results in applying IFRS 14 relates to property, plant and equipment. Some possible differences identified between the regulatory carrying amount and the IAS 16 carrying amount are as follows:*
- (a) *Some indirect costs are included in the regulatory carrying amount that would be immediately recognised as an expense in accordance with IAS 16.*
  - (b) *There is a difference in the amounts of finance costs that are capitalised in the regulatory carrying amount compared to those capitalised in the IAS 16 carrying amount, which is determined in accordance with IAS 23 Borrowing*

*Costs. IAS 23 does not permit an actual or imputed cost of equity to be capitalised.*

## IASB DP: Reporting the Financial Effects of Rate Regulation

- (c) *Rate regulation applies an inflation adjustment or price index to the regulatory carrying amount. However, this practice varies between rate-regulatory schemes.*

147 *The IASB has not decided whether separate presentation of the IAS 16 carrying amount and the regulatory differences should be required if the IASB decides to amend IFRS as a result of the rate regulation project. Below are advantages and disadvantages stated in the DP for the separate presentation of regulatory deferral account balances required by IFRS 14.*

### *Advantages*

148 *The separate presentation of regulatory deferral account amounts is required in order to address the potential reduction in comparability that was perceived to be created by making IFRS 14 available on an elective basis to a limited group of entities. IFRS 14 is not available to first-time adopters of IFRS that do not recognise regulatory deferral account balances in accordance with their previous GAAP, and neither to any existing IFRS preparers.*

149 *In developing IFRS 14, the IASB concluded that presenting the regulatory deferral account balances and net movements separately would provide more useful information about the regulatory environment.*

150 *Separate presentation may more clearly identify the adjustments required by the rate regulation. This could enhance comparability between rate-regulated entities because the underlying property, plant and equipment carrying amounts will be calculated on a consistent basis, with the amount of the regulatory adjustment clearly identified as a separate item.*

### *Disadvantages*

151 *Separating the regulatory carrying amount into the IAS 16 carrying amount and a separate regulatory balance may be costly for a rate-regulated entity and may be less clear for users of financial statements, who may prefer to see the regulatory carrying amount as a single item.*

### **EFRAG's response**

**In EFRAG's view, separate presentation of regulatory balances will permit users to understand better how the effects of rate regulation modify both the revenue and expenses that an entity has reported and associated impacts on cash flows and financial position, and therefore enhance the relevance of the information provided.**

IEAF agrees that a separate presentation of regulatory balances can be relevant. Another solution would be to 'simply' include them in contract assets and contract liabilities in application of IFRS 15, and provide further information in the disclosures.

152 EFRAG believes that the accounting effects (i.e. regulatory balances) and changes in those balances that rate regulation creates should be presented separately in the financial statements as it enhances the understandability of financial information. This is supported by the requirement in paragraph 57 (a) of IAS 1 that supports separate presentation for items that are sufficiently different in nature or function. This view is similar to EFRAG's view in its response to the IASB's ED *Regulatory Deferral Accounts* (now IFRS 14). We note that users who we have spoken to prefer that the regulatory balances are presented separately in

the financial statements.

- 153 EFRAG has learned that some constituents do not support separate presentation, as they believe that presentation should follow their inherent nature that stems from the revenue requirement. In their view, regulatory revenue and expenses should be presented together with other revenue and expenses that arise from the

ordinary/trading activities of the rate-regulated entity. EFRAG does not consider that this enhances comparability between rate-regulated activities and other activities.

- 154 In our view, users should be able to understand how the effects of rate regulation modify a rate-regulated entity's revenue and expenses, cash flows and its financial position. Accordingly, we believe that these line items should be presented separately from other revenue or expenses and corresponding items (rate-regulated versus non-regulated) in the cash flow statement and statement of financial position. This would assist users when comparing information (revenue, costs and balance sheet items) of entities that have a 'mix' of rate-regulated and non-regulated activities as well as comparing information for those entities that operate mostly in rate-regulated activities.

### Question 12

Section 4 describes the distinguishing features of defined rate regulation. This description is intended to provide a common starting point for a more focused discussion about whether this type of rate regulation creates a combination of rights and obligations for which specific accounting guidance or requirements should be developed.

Paragraph 4.73 suggests that the existence of a rate regulator whose role and authority is established in legislation or other formal regulations is an important feature of defined rate regulation. Do you think that this is a necessary condition in order to create enforceable rights or obligations or do you think that co-operatives or similar entities, which operate under self-imposed rate regulation with the same features as defined rate regulation (see paragraphs 7.6–7.9), should also be included within defined rate regulation? If not, why not? If so, do you think that such co-operatives should be included within the scope of defined rate regulation only if they are subject to formal oversight from a government department or other authorised body?

### Notes to constituents

- 155 *Defined rate regulation requires that the existence of a rate regulator whose role and authority is established in legislation or other formal regulations is an important feature. This raises questions about whether co-operatives that are not subject to external regulation could be considered to be subject to defined rate regulation or whether they would instead be considered to be 'self-regulated' and consequently be outside the scope of defined rate regulation.*
- 156 *A co-operative is an autonomous association of persons or entities united voluntarily to meet their common economic, social, and cultural needs, and aspirations through a jointly owned and democratically controlled enterprise.<sup>3</sup> Co-operatives are commonly self-regulated when it comes to setting prices for goods or services that they supply, which are usually supplied to the members of the co-operative.*
- 157 *The IASB staff has heard that, when the goods or services being supplied by the co-operative are considered to be essential, the co-operative is commonly subject to some form of regulatory oversight. This oversight is designed to encourage or ensure that the co-operative provides those goods or services on a non-*

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<sup>3</sup> Based on the definition provided by the International Co-operative Alliance (ICA), <http://ica.coop/en>

*discriminatory basis and at a price that prevents excessive profit-making. For example, oversight may be exercised by a government department or other authorised body that provides loans, tax relief or other incentives to encourage the co-operative to achieve similar objectives to those often identified in defined rate-regulatory frameworks.*

- 158 *The IASB is seeking input about whether self-regulating entities such as co-operatives should, if the other features of defined rate regulation are present, be included within the population of entities that are subject to defined rate regulation.*

#### **EFRAG's response**

**EFRAG believes that the existence of a rate regulator who is an external party and whose role and authority is established by law or other enforceable acts (is a necessary feature of 'defined rate regulation' in the DP.**

- 159 EFRAG believes that the existence of a rate regulator who is an external party and whose role and authority is established by law or other enforceable acts (i.e. grant, concession agreements) is a necessary feature of 'defined rate regulation' in the DP.
- 160 As explained in the DP, co-operatives are commonly self-regulated in terms of setting prices for goods or services that they supply, which are usually supplied to the members of the co-operative. We therefore conclude that co-operatives will not be classified within the scope of defined rate regulation since there is no external rate regulator.
- 161 Although we agree that it is important for the IASB to assess that it has appropriately captured the 'right' rate-regulated activities when developing further the scope of the project, we do not consider that all entities that are subject to some form of regulation should be within the scope of this project. All entities are subject to some regulation and attempting to address all regulation could lead to the need for guidance that is industry or entity-specific.

#### **Question 13**

Paragraphs 7.11–7.22 highlight some of the issues that the IASB may consider if it continues to progress this project.

Do you have any comments or suggestions on these or any other issues that may or may not have been raised in this Discussion Paper that you think the IASB should consider if it decides to develop proposals for any specific accounting requirements for rate-regulated activities?

#### **Notes to constituents**

- 162 *The DP notes that the purpose of this section is to highlight some of the issues that, in addition to those discussed in Section 5 of the DP, the IASB may need to consider if, as a result of the feedback from this DP, it decides to develop proposals for amending IFRS. The DP states that it is premature to present an analysis of the issues or suggestions for their resolution at this time. They are highlighted in the DP to raise awareness and to seek input about whether there are other interactions that the IASB should take into account in any further deliberations.*
- 163 *The DP discusses the following interactions with IFRS.*

*Interaction with IFRIC 12 Service Concession Arrangements*

- 164 *As noted in paragraph 3(c) of IFRIC 12, a common feature of a service concession arrangement is that the [service concession] contract sets out the initial prices to be levied by the operator and regulates price revisions over the period of the service arrangement'. This feature is confirmed within the scope criteria in paragraph 5(a) of IFRIC 12.*
- 165 *The terms and conditions of some service concession arrangements have many similarities to those seen in defined rate regulation, particularly when the operator relies solely on sales of the concession service in order to generate sufficient revenue over the period of the arrangement to recover its costs and earn a reasonable rate of return. Consequently, the issues faced by operators in such service concession arrangements are likely to be similar to entities that are subject to defined rate regulation.*
- 166 *However, a significant difference is that the property, plant and equipment or infrastructure assets used to provide the concession service are not recognised as assets of the operator because the service concession arrangements within the scope of IFRIC 12 do not convey the right to control the use of the assets to the operator.*

*Interaction with IFRS 15 Revenue from Contracts with Customers*

- 167 *The DP mentions that some suggest that, because the rate regulator acts on behalf of the customers, the rate regulation may be considered to be an implied or quasi-contract between the rate-regulated entity and the collective customers (sometimes called the 'customer base'). In support of this view, they suggest that, in defined rate regulation, specified differences arising between the revenue requirement and amounts billed to customers that are expected to be incorporated into the future tariff(s) charged to customers could be considered to be a variable component of the consideration billed to customers. IFRS 15 restricts recognising variable consideration as revenue to the extent that it is highly probable that the consideration will not reverse (see paragraph 56 of IFRS 15). This view would support deferring the recognition of revenue, together with recognising a related liability to reflect the reversal of amounts over-billed (i.e. amounts above the revenue requirement that are expected to be adjusted through future rate reductions).*
- 168 *Paragraph 31 of IFRS 15 requires an entity to 'recognise revenue when (or as) the entity satisfies a performance obligation by transferring a promised good or service (i.e. an asset) to a customer. An asset is transferred when (or as) the customer obtains control of that asset'. In defined rate regulation, as described in the DP, many of the rate-regulated activities for which the consideration is included in the revenue requirement do not involve the transfer of promised goods or services to the rate regulator or to the customers, either individually or collectively as the goods or services have already been transferred.*
- 169 *Consequently, even if rate regulation was to be viewed as a contract between the rate-regulated entity and the collective customers, it is unclear how this would affect the recognition of revenue in accordance with IFRS 15. As a result, if the IASB decides to develop specific IFRS requirements involving the deferral or acceleration of revenue, it could consider whether, and if so, how the principles of IFRS 15 could be adapted to form the basis of a tailored revenue recognition model for rate-regulated activities.*



*Interaction with IAS 12 and IAS 20*

- 170 *In some situations, the rate required to compensate the entity for carrying out all of its required rate-regulated activities may be so high that it is not considered to be affordable by the customers. In such cases, the rate regulator needs to use alternative ways to compensate the entity, e.g., the rate regulator may provide government grants or other subsidies to the entity or using taxation to provide additional funding to the entity.*
- 171 *Consequently, if the IASB decides to develop specific requirements for reporting rate-regulated activities, it may need to consider how to allocate the total revenue requirement between the amounts that will be recovered through amounts billed to customers and those that will be recovered through other forms of settlement with the government or rate regulator. This may involve some interaction with the existing requirements of IAS 12 Income Taxes and IAS 20 Accounting for Government Grants and Disclosure of Government Assistance.*

*Interaction with IFRS 3 Business Combinations*

- 172 *If the IASB decides to develop specific requirements for reporting rate-regulated activities, it may need to consider how to recognise and measure regulatory deferral account balances acquired or assumed in a business combination.*

*Interaction with IFRS 9 Financial Instruments*

- 173 *In defined rate regulation, the entity does not have a right to receive cash from, or an obligation to pay cash to, the rate regulator in order to settle revenue mismatches. Instead, the entity settles such mismatches by increasing or decreasing the rate charged to customers for future sales. Many proponents of recognising such mismatches as regulatory assets and regulatory liabilities acknowledge that the balances are unlikely to meet the definitions of financial assets and financial liabilities because the entity does not have a present right/obligation to receive/pay cash or other financial asset. Instead, they suggest that the balances are more in the nature of accrued revenue and deferred revenue.*
- 174 *If the IASB decides to develop specific requirements as a result of this project, the nature of any regulatory balances to be recognised would need to be established in order to identify the appropriate measurement basis for them.*

**EFRAG's response**

**EFRAG agrees that the IASB should consider interactions with current IFRS in advancing this project.**



IEAF members think that the best way forward is to focus on the application of current IFRSs in general, and especially of IFRS 15, for the rate-regulated activities.

We are convinced that the application of IFRS 15 for rate-regulated activities should be clarified, and that such clarification is a key element in setting guidance for these activities. One of the main reasons for guidance on rate-regulated activities is to ensure that their performance is correctly reflected in their IFRS financial statements. Thus the application of IFRS 15 seems the 'natural' entry point for this issue, and therefore we think that this issue deserves more focus.

*Interaction with IFRIC 12 Service Concession Arrangements*

- 175 EFRAG acknowledges that there may be an overlap between the IASB's rate-regulated activities project and IFRIC 12 given the similarities between services provided under service concession arrangements and rate-regulated activities. For instance, that in the case of IFRIC 12, the regulator and the grantor of the concession are normally the same entity and rate regulation is set in the concession arrangement.
- 176 Furthermore, a rate-regulated entity may have some flexibility for charging different prices if the rate regulator approves the pricing structure to ensure that it is consistent with the rate-setting mechanism. However, in concession arrangements, the regulator sets the tariff and the entity is not able to set the tariffs

freely. The entity is only able to review that the tariff is in accordance with the concession agreement.

- 177 For IFRIC 12, the grantor guarantees the balance of the concession if there is a material impact in the economics but tariffs are not automatically adjusted to recognise deviations due to demand risk.
- 178 Finally, we note that in reaching the consensus in IFRIC 12, the IASB supported (a) the recognition of the intangible asset that relates to concession arrangements; and (b) the recoverability of the tangible fixed assets that are employed in providing services and goods. In EFRAG's view, revenue from service concession agreements are usually agreed with the grantor, which has also the power to affect the timing of investments in the assets of the entity.
- 179 We believe that, in progressing with this project, the IASB will need to consider the interaction with IFRS 12. For instance, we note IFRIC 12 does not have wording relating to rights and obligations but it mentions key features.

*Interaction with IFRS 15 Revenue from Contracts with Customers*

- 180 As noted in paragraph 5.21 of the DP, under defined rate regulation many regulatory deferral account balances arise from differences between the revenue requirement and the revenue billed to customers using the regulated rate.
- 181 During EFRAG's discussions on how to reflect rate-regulated activities in the IFRS financial statements, EFRAG has learned that some constituents operating in rate-regulated industries believe that a solution to rate regulation could be achieved using the requirements and guidance in IFRS 15.
- 182 Some of these constituents argue that the interaction with the 'revenue requirement' is one of the most important issues the IASB will need to address in this project. For a utility provider, the service rendered to a customer is the provision of electricity transmission, gas transmission or distribution. Such an entity earns revenue from these rate-regulated services. However, there are a number of issues that made the principles in IFRS 15 incompatible with defined rate regulation:
- (a) As described in paragraphs 64 to 69 above, we believe that the IASB needs to explore further how to link the agreement an entity has with the rate regulator with the agreement it has with its individual customer and/or with its customer base as a whole; and
  - (b) IFRS 15 considers contracts where terms and conditions are negotiated between the entity and its customer. It could be argued that regulated tariffs are, in substance, such a contract with the regulator representing the customer base.
  - (c) Current IFRS 15 permits the recognition of contract assets and liabilities<sup>4</sup>, depending on the relationship between the entity's performance and the customer's payment. We believe that if the customer base is considered to

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<sup>4</sup> Paragraph 105 of IFRS 15 requires that 'hen either party to a contract has performed, an entity shall present the contract in the statement of financial position as a contract asset or a contract liability, depending on the relationship between the entity's performance and the customer's payment'.

## *IASB DP: Reporting the Financial Effects of Rate Regulation*

be the unit of account (see discussion in response to question 5(a)), the financial effects of indirect obligations that an entity need to fulfil to be entitled to earn the 'revenue-requirement' could be analogised to current recognition principles for contract assets and liabilities.

- 183 We therefore believe that the IASB ought to consider whether there are common areas between the scope and requirements in IFRS 15, and rate-regulated activities in making progress with the DP and the longer term project on rate-regulated activities.

### *Interaction with IAS 12 and IAS 20*

- 184 We agree that it will be necessary to consider the interaction with the existing requirements of IAS 12 and IAS 20 for the reasons mentioned in paragraphs 7.18 - 7.19.

#### IAS 12 Income Taxes

- 185 The interaction with IAS 12 will largely depend on how tax expense/income is determined in the applicable jurisdiction. For example, EFRAG understands that in the UK, tax expense is determined based on the accounting treatment of rate-regulated activities. Therefore, regulatory differences would not affect the tax balances.
- 186 As a general comment, we think that applying the mechanics in IAS 12 to address the accounting issue related to rate-regulated activities (i.e. the mismatching between the revenue requirement and billed revenue) could result in increased complexity in the application of IAS 12. Therefore, the interaction with IAS 12 needs to be carefully considered.

#### IAS 20 Accounting for Government Grants and Disclosure of Government Assistance

- 187 Under IAS 20, Government grants related to assets are presented as deferred income or as a deduction from the carrying amount of the related asset.
- 188 Some could argue that bonuses (or some bonuses) granted in pure incentive-based schemes could be seen as 'grants' as they are transfers of resources to an entity by a government entity in return for compliance with certain efficiency conditions. Similarly, some argue that some of the elements in the tariffs that aim to compensate the finance costs of an entity could also be seen as grants. Again, we believe that this is something that the IASB will need to consider.

### *Interaction with IFRS 3 Business Combinations*

- 189 EFRAG considers that there are likely to be a number of interactions between IFRS 3 and the rate-regulated activities project. For example, recognition and measurement of acquired regulatory balances - application of the 'purchase price allocation' under IFRS 3 and determining goodwill on the acquisition – would need consideration.

### *Interaction with IFRS 9 Financial Instruments*

- 190 Paragraph 7.21 of the DP explains that in some cases, the rate regulator or other designated body pays cash to the entity as consideration for the performance of specified tasks or settles revenue mismatches (and therefore amounts receivable or payable could be classified as financial assets and financial liabilities). In other cases, and probably more common ones, a rate-regulated entity does not have a right to receive cash from, or an obligation to pay cash to, the rate regulator in order to settle revenue mismatches.

- 191 Regulatory schemes can vary significantly within Europe and beyond. We therefore agree that understanding the potential interaction with IFRS 9, and any accounting implications, is important.

**Question to Constituents**

- 192 Are there additional issues that you believe are important for the IASB to consider with respect to the interaction with other IFRS standards? Please explain.

**Other matters**

*Terminology*

- 193 In order to enhance the understandability of stakeholders of rate-regulated activities and to achieve high quality reporting, EFRAG recommends the IASB to ensure that the terminology that will be used in future developments of the project should be consistent. For example, the DP refers to the terms 'rates' and 'prices' and 'tariffs' interchangeably.



## **Appendix 2: Members of the International Energy Accounting Forum**

Alpiq	<a href="http://www.Alpiq.de">www.Alpiq.de</a>
Axpo	<a href="http://www.axpo.ch">www.axpo.ch</a>
BG Group	<a href="http://www.bg-group.com">www.bg-group.com</a>
EDF	<a href="http://www.edf.com">www.edf.com</a>
EnBW	<a href="http://www.enbw.com">www.enbw.com</a>
EWE	<a href="http://www.ewe.de">www.ewe.de</a>
Fortum	<a href="http://www.fortum.com">www.fortum.com</a>
Gas Natural	<a href="http://www.gasnatural.com">www.gasnatural.com</a>
Gazprom Marketing & Trading	<a href="http://www.gazprom-mt.com">www.gazprom-mt.com</a>
GDF SUEZ	<a href="http://www.gdfsuez.com">www.gdfsuez.com</a>
Iberdrola	<a href="http://www.iberdrola.es">www.iberdrola.es</a>
OMV	<a href="http://www.omv.com">www.omv.com</a>
RWE	<a href="http://www.rwe.com">www.rwe.com</a>
Scottish Power	<a href="http://www.scottishpower.com">www.scottishpower.com</a>
TenneT TSO	<a href="http://www.tennet.eu">www.tennet.eu</a>
Unesa	<a href="http://www.unesa.es">www.unesa.es</a>
Vattenfall	<a href="http://www.vattenfall.com">www.vattenfall.com</a>
Verbund	<a href="http://www.verbund.com">www.verbund.com</a>
Veolia	<a href="http://www.veolia.com">www.veolia.com</a>