EFRAG

European Financial Reporting Advisory Group

DRAFT COMMENT LETTER

Comments should be sent to commentletter@efrag.org by 24 November 2009

21 October 2009

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

Dear Sir/ Madam

IASB ED *Rate-Regulated Activities*

On behalf of the European Financial Reporting Advisory Group (EFRAG) I am writing to comment on the IASB Exposure Draft *Rate-Regulated Activities* ('the ED'), which was issued in July 2009. This letter is submitted in EFRAG's capacity of contributing to IASB's due process and does not necessarily indicate the conclusions that would have been reached in its capacity of advising the European Commission on endorsement of the definitive IFRS.

The ED sets out proposals on accounting for regulated activities where they involve the provision of goods or services whose prices are subject to cost-of-service regulation. The ED proposes to recognise assets that, absent the proposals, would be recognised as expenses in profit or loss in the period those expenses were incurred; and to recognise liabilities that would be recognised as income in profit or loss, in the period the revenue was earned.

The ED goes on to explain that cost-of–service regulation is a form of regulation for setting an entity's prices (rates) in which there is a cause-and-effect relationship between its costs and revenues. For the ED to apply, the following two requirements need to be met:

(a) a regulator establishes the price (rate) for the goods or services the entity charges to its customers, and that price binds its customers; and

(b) the price (rate) is designed to recover the specific costs the entity incurs in providing the regulated goods or services and to earn a specified return.

EFRAG notes that the issue of regulatory assets and liabilities is not a new one. As raised previously with the IFRIC, there are concerns on whether regulatory assets and liabilities can be recognised under IFRSs, notwithstanding that some jurisdictions like the US, permit the recognition of regulatory assets and liabilities under certain circumstances.

We acknowledge that one of the project's objectives is to address divergence in practice on the accounting for rate-regulated activities and achieve to some extent closer convergence with US GAAP. EFRAG supports this objective therefore we do see some merits in having requirements on how to reflect the effects of rate-regulation in the financial statements.

Some EFRAG members do not see a need for a stand-alone IFRS on rate-regulated activities and think that it would be better to communicate the proposals through an interpretation of existing IFRS. In their view, such an approach would have better demonstrated why rate-regulation gives rise to assets and liabilities that an entity needs to recognise under existing IFRS. The IASB should explore this approach further before deciding to issue a final standard.

Our detailed comments on the ED are set out in the attached appendices, but to summarise:

- EFRAG members hold different views on whether the proposed definitions of regulatory assets and liabilities satisfy the definitions in the Framework, although the majority of EFRAG members believe that they do.

- Some EFRAG members are concerned that the scope in the ED may not be wide enough to balance the need to capture other forms of rate-regulation that are economically similar to cost-of-service regulation, and therefore have the potential to compromise the comparability of information. Some other EFRAG members believe that the proposals in the ED are inconsistent with the Framework and with aspects of IFRSs and see some merits in the proposed narrow scope. Some of these EFRAG members do not think that these inconsistencies justify a narrow scope because that would diminish comparability.

- We do not support the proposed removal of the recognition criteria because it deviates from the requirements in the current Framework. In our view, if changes to existing concepts are being considered, they should first be discussed in the context of the Framework debate.

- EFRAG does not support the expected present value approach proposed in the ED. We believe that such an approach does not produce more relevant information and therefore the degree of detailed work required to produce it is not justified. In our view, an entity should base the measurement of regulatory assets and liabilities on management's best estimate ('more likely' approach) of the cash flows that are expected to occur.

- Some EFRAG members support the proposal that an entity should include in the cost of self-constructed property, plant and equipment or internally generated intangible assets used in regulated activities, all other amounts included by the regulator. Other EFRAG members are less supportive, because they believe that regulatory assets do not have the same characteristics as other assets recognised in accordance with IFRSs and should therefore be presented separately.

If you would like to discuss our comments further, please do not hesitate to contact Mark Abela or myself.

Yours sincerely

Stig Enevoldsen
EFRAG, Chairman

Appendix 1

DOES RATE-REGULATION CREATE ASSETS AND LIABILITIES AS DEFINED IN THE FRAMEWORK?

1 The proposals included in the ED tentatively conclude that regulated assets and liabilities meet the definitions of assets and liabilities under the IASB's Framework. However, the IASB does not ask constituents whether they agree with this tentative view. We think that assessing whether assets and liabilities exist, is fundamental to evaluating the appropriateness of the proposals in the ED. The purpose of this appendix is to provide our views in this respect.

Notes for EFRAG's constituents

2 *The Framework currently defines an asset in paragraph 49(a) as "a resource controlled by the entity as a result of past events and from which future economic benefits are expected to flow to the entity."*

3 *The Framework currently defines a liability in paragraph 49(b) as "a present obligation of the entity arising from past events, the settlement of which is expected to result in an outflow from the entity of resources embodying economic benefits."*

4 *Appendix 1 of the ED defines a regulatory asset to be "an entity's right to recover specific previously incurred costs and to earn a specified return by increasing rates in future periods as a result of the actual or expected actions of the regulation". BC16-BC22 explains why the IASB thinks that "regulated assets" are assets as defined by the IASB's Framework.*

5 *The IASB explains that in a rate-regulation environment, the costs an entity incurs creates an enforceable right to set rates at a level that permits the entity to recover those costs, plus a specified return, from an aggregate customer base as a whole. The adjustment of future rates is the mechanism the regulator uses to implement its promise. It is this cause-and-effect relationship (between the entity's costs and its revenues) that exists in cost-of-service regulation that gives rise to an asset under the Framework.*

6 *Appendix 1 of the ED defines a regulatory liability to be "an entity's obligation to refund previously collected income and to pay a specified return by decreasing rates in future periods as a result of the actual or expected actions of the regulator". BC23-BC25 explains why the IASB thinks that "regulated liabilities" are liabilities as defined by the IASB's Framework.*

Summary of EFRAG's view:

- EFRAG members hold different views on whether regulatory assets and liabilities as defined by the ED satisfy the definitions of assets and liabilities in the Framework, although a majority of EFRAG members believe that they do.

7 EFRAG believes that rate-regulation has economic effects which impact the financial performance and position of an entity. Accordingly, such regulation may give rise to items

(or some items) that meet the definition of assets and liabilities under the Framework. Given that some of those economic effects might be significant, we agree that it is important to consider how they should be reflected in the financial statements.

8 EFRAG members are divided on this issue. Whist the majority of EFRAG members believe that rate-regulation gives rise to assets and liabilities under the Framework, a significant minority do not. Our two views are set out below.

View 1 – Rate-Regulation gives rise to assets and liabilities that meet the Framework's definitions

Regulatory Assets

9 Some EFRAG members agree that rate-regulation gives rise to regulatory assets as defined by the Framework.

10 The ED uses the concept of 'a group of customers' or 'customer base' to justify the link between the entity and its 'customer' and to assess whether there is a resource that the entity controls, and what that resource is. In BC19 the IASB states that in its view, because the regulation governs the entity's relationship with its customer base as a whole, it creates a present right to receive benefits from that customer base.

11 These EFRAG members believe that the notion of a "customer base" is fundamental to assessing whether the cause-and-effect relationship (between the entity's costs and its revenues) that exists in some forms of rate-regulation creates an asset as defined in paragraph 49(a) of the Framework. Using the customer base as a key starting point in their analysis, these EFRAG members believe that:

(a) In rate-regulation, a future economic benefit exists since the cost an entity incurs in the current period will be recovered from its customer base in the form of revenue in future through higher rates set (which have been promised/agreed) by the regulator, eventually resulting in higher cash flows. These EFRAG members agree with the ED that the adjustment of future rates is the mechanism the regulator uses to implement its promise.

In a rate-regulated environment, the amount of cash received by the regulated entity might not reflect the "agreed price" on the basis of the regulation because the entity will receive "some additional cash" as part of the "cost recovery process". Therefore, the regulated entity will need to consider how to reflect the actual revenue agreed with the regulator, in the period the "lower" revenue is recognised. One could argue that in order to do this, the regulated entity will need to recognise a regulatory asset.

Applying these arguments to a "cost plus return" recovery mechanism, once the costs have been incurred and there is a form of regulation which says that the costs are expected to be recovered in future through higher rates from the customer base, an enforceable 'right' is created.

(b) The past event is the incurrence of costs by an entity in order to provide the goods or services to its customer base.

(c) Since the entity has the power to obtain future economic benefits from the resource, namely, the right mentioned in (a) above and since no one else can exercise that right, it is a resource controlled by the entity.

(d) Resource and control of the resource aside, another key factor is whether the resource is expected to result in future economic benefits to the entity by generating future revenues. Undoubtedly the recoverability of the asset depends in part on whether the entity's customers (or customer base) will continue to buy its goods or services, because the right will not generate future cash flows unless there is a demand for entity's product in the future.

In case of rate-regulation, there is no definite contract between the entity and its customers that ensures a particular level of demand for future goods or services provided by the entity. Notwithstanding this concern, these EFRAG members think that the concept of a 'customer base' is such that it gives rise to reasonable certainty that the future demand will be sustained. It could also be argued that, the risk that future demand is insufficient to recover the right the entity has should be considered when the entity either recognises the right or when it measures it, depending on which measurement/recognition approach is applied.

12 Some EFRAG members believe there are a number of similarities in the accounting for the economic effects of rate-regulation with existing IFRSs. These are discussed below.

<u>Analogies drawn with existing IFRS</u>

13 In line with the arguments presented in BC36 of the ED, some EFRAG members believe that an analogy can be drawn with the concept of a cost plus contract as defined in IAS 11 *Construction Contracts* when assessing the economic effects created by rate-regulation and how these should be reflected in the accounting.

(a) Paragraph 3 of IAS 11 defines a cost plus contract as "a construction contract in which the contractor is reimbursed for allowable or other defined costs, plus a percentage of these costs or a fixed fee." Under a cost plus contract an entity recognises an asset, provided that it is probable that the costs incurred will be recovered. For a regulated entity the allowable costs and the specified return are not determined by the customers themselves but by the regulator who acts on their behalf.

(b) These EFRAG members believe that from the perspective of the regulated entity, the contracts with the customers together with the cost-of-service regulation have, in substance, economic effects similar to cost plus contracts directly negotiated with individual customers in a non-regulated environment. In other words, an entity has a similar right to be reimbursed for allowable other otherwise defined costs by charging higher prices, plus a percentage of these costs or a fixed fee. Under this reasoning, it could be argued that the regulated entity "controls" that right and therefore the related future economic benefits.

14 Other EFRAG members argue that an analogy can be drawn between a rate-regulated asset and an intangible asset that is recognised under IFRIC 12 *Service Concession Arrangements*.

(a) IFRIC 12 requires an entity to recognise an asset for a right to charge customers for use of a public service at a price controlled or regulated by the grantor. In such an arrangement, it is the entity that bears the demand risk. These EFRAG members think that the "right" that exists in IFRIC 12 is similar to the right in rate-regulation, because in both cases a 'right' exists. In rate-regulation the 'right' arises from the empowerment by statute or contract to set rates that bind an entity's customers.

(b) In line with the arguments set out in BC38, these EFRAG members agree that in a rate-regulated environment, the value of the license reflects the effects of regulation which includes a right that reflects the regulator's promise that, in return for the entity providing reliable service, the regulator will set 'just and reasonable rates' permitting the entity to recover its costs and make a fair return. The regulator's permission for the entity to recover specific costs that it has incurred (plus a return), creates an intangible asset separate from the license.

15 Given the above links to IAS 11 and to the Intangible Asset model in IFRIC 12, these EFRAG members believe that it would be inconsistent to say that the right that exists in rate-regulation is not an asset under the Framework.

16 These EFRAG members do not therefore see a need for a stand-alone IFRS on rate-regulated activities and think that a better approach would be been to deal with the issues in the context of existing IFRS. In their view, it would have been better to communicate the proposals through an Interpretation of existing IFRS material and encourage the IASB should explore this approach further before deciding to issue a final standard.

Regulatory Liabilities

17 For reasons similar to the ones explained above in our discussion of regulatory assets, some EFRAG members agree that rate-regulation gives rise to liabilities as defined by the Framework. Their views can be summarised as follows:

(a) Rate-regulation can result in an entity being 'obliged' by the regulator to return excess revenues (already collected) to its customers. The moment the excess revenue is earned, the regulator imposes a requirement for the entity to return such an amount through a reduction in the rates of future periods, thus creating a present obligation .

In line with the arguments presented in the analyses for regulated assets, in a rate-regulated environment, the amount of cash received by the regulated entity might not reflect the agreed price on the basis of the regulation. Such accounting does not reflect the economic effects of the transactions with its customers; if the excess cash received is to be returned to an entity's customers through lower rates in future periods, the regulated entity will need to recognise a liability in order to reflect the actual revenue of that period.

(b) The past event that gives rise to the obligation (to reduce future rates in future periods), is the excess income the entity has collected from its customers (which it now needs to return to its customers).

(c) The fulfillment of the obligation mentioned at (a) above leads to a reduction in the cash inflows in the form of revenue from levels it would otherwise be allowed to collect. Thus, the criterion of 'outflow of resources embodying economic benefits' can be said to be met.

View 2 – Rate-regulation do not give rise to assets and liabilities that meet the Framework's definitions

Regulatory assets

18 Some EFRAG members disagree that rate-regulation gives rise to assets as defined by the Framework, and share the alternative views expressed by the two IASB members in AV2-AV6.

19 These EFRAG members believe that one of the fundamental elements of deciding whether there is an asset that needs to be recognised is whether there is a resource that the regulated entity controls and from which economic benefits are expected to flow. The ED argues that entities subject to cost-of-service regulation have a right to recover specific previously incurred costs and to earn a specific return. For these EFRAG members an entity has such a right only if has a right of recovery that is independent of the level of future demand or it has the ability to control future demand. These members think that the entity has neither.

20 These EFRAG members understand that the notion of "control" as described in the Framework has led to different interpretations when determining whether an asset exits. Although both the existing definition and the proposed "new" definition of an asset focus on the notion of control over the resource and the economic benefits it produces, some say that in the proposed "new" definition of an asset is more about the entity's ability to prevent or limit the access of others to those future benefits – i.e. exclusivity of the right. However, these EFRAG members believe that, unless and until the IASB changes the definition of an asset, the test has to follow what is said in the existing definition.

21 In addition, these EFRAG members think that the event that gives rise to the right to the potential economic benefit (notably the costs incurred by an entity that are later allowed to be recovered through future rates) is not the past event; the event that "triggers" an entity being obliged to do something is the sale to its customers, which will only occur in future periods. They believe that the actions of a regulator do not create an event that leads to a regulated entity having an enforceable right.

22 In addition, in their view, it is incorrect to assume that the customers as a group will continue to use a given level of service at a given price in the future, because the rate allowed by regulation is not necessarily the rate that customers will be willing or able to pay for the level of demand envisaged, (regardless of whether, in some jurisdictions, the service provider is a monopoly and customers have no alternative supplier). These EFRAG members are not convinced that this argument justifies that an entity's customers will continue it buy its goods or services. Whilst acknowledging that the proposals in the ED include recoverability (i.e. impairment) tests, these EFRAG members believe that imposing such tests does not overcome their concerns.

23 These EFRAG members argue against the analogy with IFRIC 12 because they believe that rate regulation does not change the nature of an existing license to provide goods or services. Therefore there is no further intangible asset that meets the definition of an asset under the Framework.

Regulated liabilities

24 For reasons similar to the analyses and tentative conclusions reached on regulatory assets, some EFRAG members disagree that rate-regulation gives rise to regulatory liabilities as defined by the Framework, and share the alternative views expressed by the two IASB members in AV2-AV6

Question to constituents

As the paragraphs above show, EFRAG members are divided on whether rate-regulation creates assets and liabilities as defined by the Framework. We would therefore particularly welcome your views on the issue. Do you agree with the IASB that some forms of rate-regulated activities (operating within cost-of-service regulation) give rise to assets and liabilities under the existing Framework? If not what are your major concerns? And what view would you favour instead?

Appendix 2
EFRAG's response to the questions asked in the ED

Question 1 - Scope

The exposure draft proposes two criteria that must be met for rate-regulated activities to be within the scope of the proposed IFRS (see paragraphs 3–7 of the draft IFRS and paragraphs BC13–BC39 of the Basis for Conclusions).

Is the scope definition appropriate? Why or why not?

Notes for EFRAG's constituents

25 *The ED applies to entities whose operational activities meet the following two criteria:*

(a) an authorised body (the regulator) establishes the price the entity must charge its customers for the goods or services the entity provides, and that price binds the customers; and

(b) the price established by regulation (the rate) is designed to recover the specific costs the entity incurs in providing the regulated goods or services and to earn a specified return (cost-of-service regulation). The specified return could be a minimum or range and need not be a fixed or guaranteed return.

26 *The ED proposes that the prices established by the regulator, and which an entity will charge its customers, must bind its customers. The ED allows for different pricing structures for different categories of customers, provided the customers within the same category are bound by the same price. The ED also allows entities to provide discounts on set prices, provided that the discounts are not allowed to individual customers and are only applied on a temporary basis. This means that the prices set by the regulator cannot be negotiable on an individual customer basis.*

27 *As regards criterion (b), the ED concludes that <u>only cost-of-service regulation</u> in which rates are designed to recover the specific costs the entity incurs in providing the regulated goods or services and to earn a return would result in items that <u>meet the definitions of assets and liabilities</u>. The ED refers to this relationship between the entity's costs and its rate-based revenue stream as a cause-and-effect relationship and concludes that this is the principal economic effect of regulation on the accounting for regulated entities.*

28 *Appendix B paragraph 4 of the ED provides a list of indicators of cost-of-service regulation;*

(a) the regulation is designed to provide the recovery of specific costs;

(b) if the costs incurred are not used to establish rates, then the regulation provides for a true-up to actual costs incurred;

(c) in case of a 'price cap' plan, there is a true-up to actual costs through a rate of return-sharing mechanism;

(d) *if the entity is required to provide a rate discount, the rate discount is temporary rather than permanent; or*

(e) *if rate increases is imposed, it would be followed by a return to direct cost-based regulation.*

29 *Appendix B paragraph 6 of the ED includes indicators that may suggest that an entity is not receiving a "sufficient" return or "adequate" return, including the following:*

(a) *there is abnormal capacity;*

(b) *the rates per unit are higher, or are forecast to be higher, than other entities like competitors; or*

(c) *a change in environment, indicated by, for example, unrecoverable investments or regulatory disallowances.*

30 *As stated in BC11, the IASB has acknowledged that a number of regulatory methodologies exist and, for each, application can vary by regulator, the entity being regulated and the particular circumstances. The cost-of-service regulation is one type of regulatory methodology, which we understand is fairly common in the United States. Another commonly used regulatory methodologies are incentive-based regulatory methodologies (for instance 'price-cap' regulation). A third example is a hybrid cost-of-service regulation that is partly incentive-driven. It is our understanding that the latter types of methodologies are fairly common in European jurisdictions, and the IASB itself has confirmed our understanding by saying in BC12 that in recent years there has been a trend towards incentive-based regulatory methodologies, such as 'price-cap' regulation.*

31 *The ED does not apply to regulation that determines rates based on targeted or assumed costs, for example industry averages, rather than the actual costs incurred or expected to be incurred by the entity. The IASB explains that this is because the objective of such regulation is the recovery of costs based on industry averages or performance-based targets and not actual costs.*

32 *The ED requires rate-regulated entities to determine at the end of each reporting period whether its operating activities meet the criteria set out above.*

EFRAG's response

Summary of EFRAG's view:

- Some EFRAG members are concerned with the ED's scope, because they believe that the scope may not be wide enough to balance the need to capture other forms of rate-regulation that is economically similar to cost-of-service regulation and therefore has the potential to compromise the comparability of information, which we do not accept.
- Some other EFRAG members believe that the proposals in the ED are inconsistent with the Framework and with aspects of IFRSs and see some merits in the proposed narrow scope. However some of these EFRAG members do not think that these inconsistencies justify a narrow scope because that would diminish the comparability of the information.

33 The scope criteria set out in the ED are based on features that are common to a cost-of-service regulatory environment. EFRAG has analysed the two sets of criteria bearing this in mind. Our detailed comments follow.

Proposed scope criteria

First Criterion – authorised body and a binding price (rate)

Authorised body

34 EFRAG agrees with the proposal that an identifiable authorised body (a regulator) that sets prices for the regulated goods or services a regulated entity provides to its customers, needs to exist.

35 EFRAG also agrees that the regulator need not be a third party external body and that in some circumstances it could be a governing board in a co-operative utility that is empowered to set its rates in a manner consistent with the purpose and governance of the organisation.

Binding price

36 We generally agree with the proposal that all the customers of rate-regulated activities must be bound by the price established by the regulator.

37 However, we are concerned with one aspect of this criterion. We understand that the practice of setting different prices for different customer groups or categories of customers is common practice in rate-regulated industries. For example, wholesale customers may be charged a different price to retail customers. In other circumstances customers within the same category (for instance retail customers) may also be charged different prices. We think that even rate-regulated entities might have some level of freedom to lower the prices in the form of discounts within categories of customers (giving preferential rates to blue-chip type customers) or across the entire customer base. In such situations we think it is the 'discounted' price set by the entity that binds its customers, and not the price established by the regulator, thus the activities of such entities would in our view be outside the scope of the ED as suggested in BC31-32. However, we think that paragraph 4 of the ED is not clear on this point, and recommend the IASB to clarify whether price differentiations or discounting would breach the scope criteria, if so under which circumstances.

Second criterion – recovery of specific costs and specific return

Recovery of specified costs

38 As previously explained, EFRAG members share different views on criterion two. These are explained below.

View one (we have concerns with the proposal)

39 Some EFRAG members have some concerns with this part of the second criterion.

40 First, these EFRAG members believe that by focusing only on cost-of-service regulation, some (or many) entities in Europe (and perhaps elsewhere) will be scoped out of the ED.

This is a concern because even though their regulated activities may be economically similar to the ones that the proposals in the ED are intended to apply to. Accordingly, such activities will be accounted for differently creating concerns about the comparability of information of entities with similar activities.

41 These EFRAG members question why the ED does not scope in more modern rate-regulatory techniques like incentive-based and hybrid regulation when the effect of the techniques is economically similar to cost-of-service regulation, especially if other arrangements such as incentive-based regulation or hybrid arrangements are commonly used in some European jurisdictions. For instance, it is understood that incentive-based regulation is fairly common practice in many European jurisdictions. The IASB itself says, in BC12 that, in recent years, there has been a trend towards incentive-based or hybrid methodologies. These EFRAG members think that it is important that the scope is appropriately described and that its boundaries are clear, in order to ensure that the economic effects of similar regulatory methodologies are within the scope of the ED.

42 In addition, these EFRAG members share the concerns expressed by the dissenting IASB members in AV9. Specifically, these EFRAG members think that regulated activities with different sizes and different schemes that are evolving over time, and therefore are concerned that the proposed IFRS will be not interpreted and applied consistently. These EFRAG members think that the ED does not help them in this respect, because it does not provide sufficient background information about different rate-regulation schemes and how they operate in practice. Although we have found the illustrative examples that accompany the ED helpful in this respect, we still have difficulties in fully grasping which regulatory schemes would be impacted by the proposals in the ED and which ones will not, and the reasons why.

<u>View two – (broadly agree with the proposal)</u>

43 Other EFRAG members support the proposed scope. These EFRAG members think that the ED's proposals are based on aspects of accounting that are inconsistent with the Framework and with some aspects of existing IFRSs. And therefore the proposed IFRS's scope should be as narrow as possible.

44 However some other EFRAG members do not think that these inconsistencies justify a narrow scope because that would diminish the comparability of the information provided.

Question to constituents

45 We would particularly welcome your views on this issue. Do you think that there are other rate regulatory methodologies that could be addressed by the proposed IFRS? And if so, could you provide examples of these and explain why you think that they should be included in the scope of the proposed future IFRS?

Clarity about the application of the second criterion

46 In some respects we think that the ED is not sufficiently clear on the application of the second criteria.

(a) Our first concern relates to situations involving hybrid cost-of-service regulatory schemes (combination of cost-of-service and price-cap regulations). Although these are mentioned in the Basis for Conclusions (BC12), the ED does not provide specific guidance on whether hybrid schemes are within the scope of the ED. If they are excluded, then does it mean that the entire operating activities of the entity subject to the 'hybrid' cost-of-service regulation should be excluded? Or does it mean that the operating activities should be bifurcated so that the ones that are regulated by cost-of-service (and are based on the recovery of actual costs incurred) are within its scope and the ones that are not are outside the scope? We recommend the IASB clarify this issue.

(b) We also have some concerns in relation to the list of indicators in Appendix B4 of the ED. As pointed out the IASB in the ED, in some cases entities will be using targeted or assumed costs to establish rates, which are then 'trued-up' to the actual costs incurred. B4 suggests that such rates could arise under cost-of-service regulation. However, paragraph 6 of the ED leads us to believe that activities using 'targeted rates' would be outside the scope of the ED. We recommend the IASB clarify this issue.

(c) Finally, EFRAG is concerned about the inconsistency in which the ED describes the specified return in absolute terms in paragraph 3(b) and the qualitative nature of the indicators in paragraph B6 of the ED. EFRAG thinks that this inconsistency is likely to create some confusion in practice, and recommends the IASB to explain through an example the interaction between the terms used. For example, in some jurisdictions the "specified return" set by the regulator in the rate-making process, might be based on a "profit-type" formula. It is not clear to us how an entity would decide whether, in such a case, the regulated "profit formula" represents an adequate return on the entity's shareholder's investment and whether it is a so-called sufficient return under the indicatory guidance set out in B6?

Question 2 - Recognition criteria

The exposure draft proposes no additional recognition criteria. Once an activity is within the scope of the proposed IFRS, regulatory assets and regulatory liabilities should be recognised in the entity's financial statements (see paragraphs BC40–BC42 of the Basis for Conclusions).

Is this approach appropriate? Why or why not?

Notes for EFRAG's constituents

47 *The ED proposes that, once the scope criteria have been satisfied, assets and liabilities exist that meet the criteria for recognition. That is because, once the scope criteria have been satisfied, the actions of a regulator provide reasonable assurance that the economic benefit from the regulated activities will flow to or from the entity. In addition, regulatory assets and regulatory liabilities relate to specifically identifiable amounts, therefore they can be measured reliably. As a result, the Board decided not to propose a separate recognition criterion in the draft IFRS.*

48 *The IASB concluded that a separate recognition criterion would postpone the recognition of assets and liabilities with future cash flows that can be estimated. Consequently, the Board decided that it was preferable to include the probability of the cash flows in the measurement of the regulatory asset or regulatory liability.*

EFRAG's response

Summary of EFRAG's view:
• We disagree with the proposal. We think that the proposed change, to eliminate recognition criteria, deviates from the requirements in the current Framework. We do not support conceptual changes that are in conflict with the existing Framework.

49 EFRAG does not support the proposal. We note that the current Framework sets out the criteria that must be met before an asset or a liability can be recognised. They are that:

(a) it is probable that any future economic benefit associated with the item will flow to or from the entity; and

(b) the item has a cost or value that can be measured reliably.

50 It follows that the proposed change, to eliminate recognition criteria, deviates from the requirements in the current Framework. In EFRAG's view, if there is something in the Framework that needs amending, it is the Framework that must be changed and not the other way round.

51 The IASB also argues that reliable measurement is possible because regulatory assets and regulatory liabilities relate to specifically identifiable amounts previously expended or collected by the entity. On the basis of this rationale, the IASB argues that "additional" recognition criteria are unnecessary. However, the IASB does not articulate why it thinks this to be so. This is a significant concern for us. In our view, until a proper debate has taken place on whether recognition criteria are necessary, we cannot form a view on whether recognition criteria are necessary or not.

52 In our view, if changes to existing concepts are being considered, they should first be discussed in the context of the Framework debate, because introducing major changes in the way the exposure draft is proposing undermines the authority of the Framework and creates the risk that changes that may be appropriate in particular circumstances will at some future date be extended to other circumstances without proper debate.

53 Finally, concerning the recognition of regulatory assets, we note that the proposals in the ED are internally inconsistent. As discussed above, the ED proposes to omit recognition criteria for regulatory assets. However, in accordance with paragraph 16 of the ED, when for rate-setting purposes an entity is required to capitalise costs (that might otherwise be expensed under existing IFRSs), it can only include those 'regulatory costs' as part of other assets (for example property, plant and equipment), if it is 'highly probable' that the regulator will allow those costs to be included in the rate-setting process for the entity. We understand from the ED, that if an entity fails to meet the 'highly probable' recognition threshold, it recognises a separate regulatory asset instead. We find this inconsistency concerning, because we cannot see why there should be a different recognition threshold for similar types of "regulatory costs" which are in both cases recognised as assets under the ED.

Question 3 - Measurement of regulatory assets and liabilities

The exposure draft proposes that an entity should measure regulatory assets and regulatory liabilities on initial recognition and subsequently at their expected present value, which is the estimated probability-weighted average of the present value of the expected cash flows (see paragraphs 12–16 of the draft IFRS and paragraphs BC44–BC46 of the Basis for Conclusions).

Is this measurement approach appropriate? Why or why not?

Notes for EFRAG's constituents

54 *The ED proposes that on initial recognition and at the end of each subsequent reporting period, an entity shall measure a regulatory asset or regulatory liability at its expected present value at each reporting date*

55 *The expected present value is described as being the estimated probability-weighted average of expected future cash flows, taking into account all possible outcomes. Thus, an entity is required to reflect the following elements in the measurement of the regulatory asset/liability:*

- *(a) an estimate of the future cash flows that will arise in a range of possible outcomes;*
- *(b) an estimate of the probability of each outcome occurring, including the probability that in the entity's future rates, the regulator will allow the entity to include the actual costs incurred or require the entity to include amounts collected;*
- *(c) the time-value of money (represented by the current market risk-free rate of interest); and*
- *(d) the price for bearing the uncertainty inherent in the regulatory asset/liability.*

56 *The ED requires that both the time-value of money (represented by the current market risk-free rate of interest) and the price for bearing the uncertainty inherent in the regulatory asset/liability are taken into account in measuring the regulatory asset/liability. The ED proposes that the discount rate should be determined in accordance with the [draft] IFRS independently of the rate allowed for reimbursement by the regulator. The ED explains in BC47 that in some jurisdictions regulators allow entities to earn a return that is intended to be consistent with their market-based cost of capital. However, this may not allow be the case.*

57 *The IASB concluded that this measurement approach more faithfully reflects the entity's expectations of future cash flows than does an approach in which, satisfying a recognition requirement, results in the recognition of the entire asset or liability as if it was certain.*

58 *The ED proposes that an entity, in estimating future cash flows, must consider the probability that the regulator will allow or require the entity to include a specific item in the determination of future rates.*

EFRAG's response

Summary of EFRAG's view:

- EFRAG does not support the expected present value approach proposed in the ED.
- In EFRAG's view, an entity should base the measurement of regulatory assets and liabilities on management's best estimate (more likely approach) of the cash flows that are expected to occur.
- EFRAG members are divided on the issue in respect to the discount rate an entity should use to present value the regulatory asset or the liability.

Expected present value approach

59 EFRAG does not support the proposal. We do not support an approach that requires taking into account the probabilities of all possible outcomes, because we believe that such an approach entails a high degree of detailed work, thus imposing additional burden on preparers without producing information that is more relevant. Again the IASB does not explain why it thinks the proposed approach produces more useful information. Neither does it give sufficient emphasis on the difficulty of applying a probability-weighted approach to measure assets and liabilities.

60 In EFRAG's view, an entity should base the measurement of non-financial liabilities, including regulatory liabilities, on management's best estimate of the amount the amount expected to be recovered. The emphasis in relation to measurement should be on expected future cash flows, which are a central focus for users of financial statements. We believe that a 'more likely' approach does that because it will result in an estimation of cash flows that are expected to occur.

61 EFRAG agrees however, that in circumstances where a wide variety of divergent possible outcomes and probabilities exist, an entity might need to consider the various outcomes and the probability of occurrence attached to those outcomes. However, that should be a natural consequence of applying a principle-based measurement attribute, (such as the existing IAS 37 approach).

62 In addition, EFRAG notes that the probability-weighted approach (or expected value approach) has been the subject of some criticism when it has been proposed in other EDs issued by the IASB. For example, a number of constituents, including EFRAG, disagreed with a requirement to adopt an expected value approach to measure uncertain tax positions when responding to the IASB's ED *Income Taxes,* and instead argued in support of the existing IAS 37 approach. Similarly, EFRAG has expressed a preference for a measurement approach based on the most likely outcome approach when it commented on the accounting for contingent rentals as set out in the IASB's Discussion Paper on Leases.

63 The IASB argues (in paragraph BC44) that regulatory liabilities should be measured consistently with the guidance in IAS 37, that is, at 'the present value of the expected future cash flows'. However, these EFRAG members think the two approaches are not the same. IAS 37 requires the liabilities to be measured based on the best estimate of the expenditure required to settle the obligation, but goes on to claim that that amount would

be the amount that an entity would rationally pay to settle the obligation at the end of the reporting period (that is the immediate fulfillment value) or to transfer it to a third party at that time (which would be equal to the probability-weighted average of all possible outcomes). Therefore these EFRAG members emphasise that this ED is in effect proposing a change to the current IAS 37 approach by retaining only the transfer approach (based on expected value), whilst removing the fulfillment approach.

64 Finally, we agree that regulatory assets and liabilities should be remeasured at each reporting date.

Discount rate

65 The ED proposes that the expected present value be determined based on an 'asset/liability-specific' discount rate that considers the uncertainties inherent to the respective regulatory asset or liability which, is consistent with the discount rate applied in IAS 36 *Impairment of Assets* and IAS 37. As indicated in BC47, this ''asset/liability-specific' discount rate might not necessarily be the same as the same as the rate of return set by the regulator in the rate-making process.

66 Again, EFRAG members are divided on the issue of which discount rate to use. Some EFRAG members agree with the proposal; however others do not.

View one – In support of the IASB proposal (use an 'asset/liability-specific' discount rate*)*

67 Some EFRAG members support the proposal because they see no conceptual reason to use a different discount rate for regulated assets and liabilities, compared to other assets and liabilities recognised under IFRSs.

68 These EFRAG members believe that the present value of an asset or a liability does not change simply because the regulator is now using a different discount rate, and do not think that financial statement amounts should be dependent on regulatory inputs. If that were the case, it would be regulators that would mandate the discount rates that would need to be used in other regulatory environments, such as the banking and the insurance industry.

View two – do not support the proposal

69 Other EFRAG members do not support the proposal. In their view, it would not make sense to use an 'asset/liability-specific' discount rate if the 'regulatory discount rate' is available to the entity, because the regulatory asset or liability and the discount rate to be used to discount that asset or liability are closely related. These EFRAG members believe that regulatory assets and liabilities have different characteristics to 'normal' IFRS assets and liabilities, and thus it is appropriate to account for them differently.

70 In addition, these EFRAG members acknowledge that in some cases the rate of return the entity will earn under the rate-making process will be different to the entity's 'asset/liability specific', and a difference (debit or a credit) will arise on the day the regulatory asset or liability is recognised and measured initially and in subsequent periods. These EFRAG members argue that using the regulatory rate of return would avoid this 'difference' which they think might be economically hard to explain and create confusion to users as to what they represent.

Question to constituents

71 Again we would welcome your views on this issue. Which of the above two views for the determination of the discount rate do you support and why do you think it is preferable?

Question 4 - Cost of self constructed property, plant and equipment or internally generated intangible assets

The exposure draft proposes that an entity should include in the cost of self constructed property, plant and equipment or internally generated intangible assets used in regulated activities all the amounts included by the regulator even if those amounts would not be included in the assets' cost in accordance with other IFRSs (see paragraph 16 of the draft IFRS and paragraphs BC49–BC52 of the Basis for Conclusions). The Board concluded that this exception to the requirements of the proposed IFRS was justified on cost-benefit grounds.

Is this exception justified? Why or why not?

Notes for EFRAG's constituents

72 *In some cases a regulator requires an entity to capitalize, as part of the cost of self-constructed property, plant and equipment or internally generated intangible assets, amounts that would not be included by non-regulated entities. This will be in addition* to the *regulatory asset/liability discussed so far. This might be so even though IFRS (IAS 16 Property, Plant and Equipment, or IAS 38 Intangible Assets, or IAS 23 Borrowing Costs) would not normally allow such costs to be recognised as part of the asset.*

73 *These amounts would otherwise be recognised as regulatory assets in accordance with the draft IFRS and may be indirect overheads not permitted in accordance with IAS 16 or IAS 38 or the cost of financing construction or development that is not in accordance with IAS 23.*

74 *In considering how best to account for costs that would have been recognised as part of the 'right to recover specific, previously incurred costs and to earn a specified return' (the regulatory asset) the IASB considered two possibilities: recognise them as a separate asset from the IAS 16/IAS 38 asset or recognise them as part of the IAS 16/IAS 38 asset. The IASB chose the latter approach*.

75 *The IASB concluded that when it is highly probable that the regulator will require amounts to be included in the cost of self-constructed or internally generated assets that would not be permitted in accordance with IFRSs, those amounts should be included in the cost of the assets rather than being accounted for separately in accordance with the proposed IFRS. In such cases the amounts included in the cost of the asset for rate-making purposes shall also be included in its cost for financial reporting purposes, even if IFRS would not permit the entity to do so.*

EFRAG's response

Summary of EFRAG's view:

- Some EFRAG members support the IASB's proposal.
- Some other EFRAG members do not support the proposal. These members support the alternative view discussed in BC50; that is, regulatory assets that would be recognised as a result of the proposed IFRS do not have the same characteristics as assets recognised in accordance with other IFRSs. Therefore, these members believe that all regulatory assets should be presented separately from assets recognised in accordance with other IFRSs.
- A third category of EFRAG members do not support either of the approaches discussed in the ED. In these EFRAG members' view the best presentation would be to combine amounts that the regulator will allow to be included in the cost of self-constructed or internally generated assets with the underlying tangible asset under a separate balance sheet caption.

Exception to the general recognition and measurement requirements

76 EFRAG members have different views on the proposals in the ED. These are discussed in more detail below.

View one – agree with the proposal in the ED and present these assets together with other IFRS assets

77 Some EFRAG members support the proposal because they believe that regulatory assets (as defined by the ED) are so closely related to other assets and are complementary to other assets having similar useful lives of the entity that presenting them separately does not provide decision useful information to users.

View two – present these assets separate from other IFRSs assets

78 Other EFRAG members do not support the proposal because they believe that regulatory assets do not have the same characteristics as other assets recognised in accordance with IFRSs. Therefore they should be presented separately from those other assets.

79 These EFRAG members also share many of the views expressed by the IASB Board members that dissented on this issue which are explained in AV7-AV9. To summarise:

(a) There is no conceptual basis for overriding the principles that other IFRSs would require to be applied in such cases as described in the ED.

(b) Because of the inconsistent requirements with other IFRSs, this ED will lead to a lack of comparability: economically similar situations will be accounted for differently within a regulatory entity over time, or among different regulatory entities, and between regulated and unregulated entities.

View three – present all regulatory assets separate from IFRS assets

80 A third category of EFRAG members do not support either of the approaches discussed in the ED. These EFRAG members believe that the regulatory assets and liabilities are of a very different nature than other assets and liabilities and the IASB is proposing to mix 'IFRS assets' with 'regulated assets' that would not normally qualify as assets or liabilities under existing IFRSs.

81 However, in these EFRAG members' view, a strong link exists between the amounts that the regulator will allow to be included in the cost of self-constructed or internally generated assets and the underlying tangible asset and the best presentation would be to present these assets under one balance sheet caption.

82 Under this approach, a regulated entity that is also carrying out non-regulated activities would be required to bifurcate its tangible assets into 'tangible IFRS assets' and 'underlying regulatory tangible IFRS assets'. The 'underlying tangible IFRS assets' and the amounts that the regulator will allow to be included in the cost of self-constructed or internally generated assets would be presented together as a same category of assets in the financial statements. This would serve to keep a distinction between 'IFRS assets' and 'regulatory assets' and under this model, the 'IFRS asset' amount would not include any amounts related to rate-regulated assets.

<u>Question to constituents</u>

83 As the above paragraphs explain EFRAG has more than one view on this issue. We would welcome your views on this issue and in particular which of the views described above you prefer and why?

Question 5 - Recoverability of regulatory assets and liabilities

The exposure draft proposes that at each reporting date an entity should consider the effect on its rates of its net regulatory assets and regulatory liabilities arising from the actions of each different regulator. If the entity concludes that it is not reasonable to assume that it will be able to collect sufficient revenues from its customers to recover its costs, it tests the cash-generating unit in which the regulatory assets and regulatory liabilities are included for impairment in accordance with IAS 36 *Impairment of Assets*. Any impairment determined in accordance with IAS 36 is recognised and allocated to the assets of the cash-generating unit in accordance with that standard (see paragraphs 17–20 of the draft IFRS and paragraphs BC53 and BC54 of the Basis for Conclusions).

Is this approach to recoverability appropriate? Why or why not?

Notes for EFRAG's constituents

84 *Although a particular regulator may permit a variety of specific costs to be recovered, the IASB believes there may be situations in which the net effect of the regulatory assets and regulatory liabilities an entity recognises will result in significant increases in future rates to be charged to customers. In these cases, even though rates are increased, expected*

reductions in volume might mean that the entity will not achieve its total revenue requirements.

85 *The ED proposes that an entity shall consider the effect that the allowed regulatory assets/liabilities would have on the total rates. An entity shall determine whether it remains reasonable to assume that, based on the regulator's and customers' actions, the regulatory asset is recoverable. As explained in BC53, a significant increase in an entity's future rates may create a strong incentive for customers to reduce their consumption or switch to an alternative good or service.*

86 *The IASB concluded that, when it is not reasonable to assume that the entity will be able to collect sufficient revenues from its customers to recover its costs and earn a fair return, this is an indicator that a possible impairment exists. The regulatory assets and regulatory liabilities should then be included with the other assets and liabilities of the cash-generating unit and tested for impairment in accordance with IAS 36.*

EFRAG's response

Summary of EFRAG's view:

- EFRAG is unclear as to why an issue of impairment would arise subsequent to measurement.
- EFRAG members believe that repeated impairment triggers may indicate that the entity is not earning a fair return on its activities and could fail to meet the scope criterion in paragraph 3(b).

87 EFRAG does not support the proposals. Our concerns are discussed below.

88 First, we are unclear as to why the issue of impairment would arise if the regulatory assets/liabilities are measured at their expected future cash flows at each reporting period, because we would have expected that any recoverability issues would be taken into account into the probability-weighted estimates when the asset is measured initially and thereafter. However it may be that recoverability issues arise subsequent to probability-weighted measurement that relate to, for example, to the general state of the economy, which may trigger impairment testing of the regulatory asset as well as of the carrying amount of the related assets included in the CGU. We would recommend that the IASB clarifies this point.

89 Second, we think that consecutive impairment triggers may raise some doubts as to whether the scope criteria are still met by the regulated operations. That is because we think it might indicate that the entity is not earning a fair return on its regulated activities and therefore that it would fail to meet the scope criterion in paragraph 3(b). Again, we think clarity on this point would be helpful.

Question 6 - Disclosure requirements

The exposure draft proposes disclosure requirements to enable users of financial statements to understand the nature and the financial effects of rate regulation on the entity's activities and to identify and explain the amounts of regulatory assets and regulatory liabilities recognised in the financial statements (see paragraphs 24–30 of the draft IFRS and paragraphs BC59 and BC60 of the Basis for Conclusions).

Do the proposed disclosure requirements provide decision-useful information? Why or why not? Please identify any disclosure requirements that you think should be removed from, or added to, the draft IFRS.

Notes for EFRAG's constituents

90 *The IASB is proposing that an entity shall disclose information that:*

(a) *enables users of the financial statements to understand the nature and the financial effects of rate regulation on its activities; and*

(b) *identifies and explains the amounts of regulatory assets and regulatory liabilities, and related income and expenses, recognised in its financial statements.*

An entity shall disclose the fact that some or all of its operating activities are subject to rate regulation, including a description of their nature and extent.

91 *The ED proposes that entities should meet the minimum disclosure requirements by providing a tabular reconciliation, for the period, of the carrying amount in the statement of financial position of the various categories of regulatory items.*

EFRAG's response

Summary of EFRAG's view:

- In general EFRAG has been less supportive of disclosure requirements that specify the format in which disclosures should be provided. However, we think that the proposed reconciliation schedule will provide useful information.
- EFRAG is unsure whether the disclosure requirements in the ED apply only to separate regulatory assets and liabilities or also to regulatory assets/liabilities included in the carrying amount of PPE.
- Suggested disclosures from EFRAG's User Panel members include a Disclosure Framework based on the entities' regulatory filings and disaggregation of the gross revenue figure.

92 EFRAG is broadly supportive of the ED's proposals on disclosure. Some users have told us that they believe that rate-regulated activities could be better addressed by enhancing the disclosures provided in relation to regulated activities. Therefore, we support providing information that users think is useful for their work, bearing in mind the cost/benefit aspect of the requirements involved. However we have some concerns which we explain in the paragraphs below.

93 First, we are unsure whether the disclosure requirements in the ED are to be applied to regulatory assets and liabilities that have been included in the carrying amount of self-constructed property, plant and equipment or intangible assets (except for financing costs included in the current period), or whether they apply only to separate regulatory assets and liabilities. We recommend the IASB clarify this point.

94 Second, we are concerned that paragraphs 25-29 of the ED seem to be advocating a rules based approach to disclosures, which may encourage a checklist mentality. EFRAG is also concerned about the apparent conflict between paragraphs 24 and 30. We understand that paragraph 24 requires an entity to disclose information that explains the amounts of regulatory assets and liabilities as well as enables users to understand the effects of rate-regulation. Paragraph 30 then requires an entity to disclose additional information if it deems that the disclosures required by paragraphs 25-29 do not meet the objectives in paragraph 24. To us it seems that these are conflicting requirements because paragraph 30 could be interpreted in a way so as to limit the information provided on the basis that the objectives in paragraph 24 would have been met.

95 Furthermore, we note that members of EFRAG's User Panel have also told us that, assuming the ED results in a final IFRS, one of their main concerns would be to determine the expected future cash flows for the regulated entity. These expected future cash flows would not comprise any cash flows from the recovery of regulatory assets and similarly would exclude any over-billings in the current year, which would eventually result in a regulatory liability. Expected future cash flows would hence only comprise recurring cash flows from the entity's ordinary revenue generating activities.

96 These users have told us that one way to overcome their concern is to report a revenue figure that clearly reflects the effects of rate-regulation, which could be done by disaggregating the annual gross revenue figure into three components, being: total amortisation of regulatory assets, total revenue from supplies in the period and over-billings in the current period (regulatory liabilities). In addition, further disaggregation of the total amoritisation of regulatory assets figure into amoritisation of deferred allowable costs and allowed return on these costs would be very useful information.

Question to constituents

97 What disclosures do you think could adequately address rate-regulated activities?

Question 7 - Transition requirements

The exposure draft proposes that an entity should apply its requirements to regulatory assets and regulatory liabilities existing at the beginning of the earliest comparative period presented in the period in which it is adopted (see paragraph 32 of the draft IFRS and paragraphs BC62 and BC63 of the Basis for Conclusions). Any adjustments arising from the application of the draft IFRS are recognised in the opening balance of retained earnings.

Is this approach appropriate? Why or why not?

Notes for EFRAG's constituents

98 *The IASB considered whether it should provide an exemption from retrospective application of the proposed IFRS because entities must obtain information necessary to determine the probability-weighted present value of future cash flows. The IASB believes that this information might be available in many, but not all, instances given the regulatory environment in which such entities operate. The IASB noted that determining the probability-weighted present value of future cash flows in these instances would require the use of hindsight and might not achieve comparability.*

99 *Accordingly, the ED proposes not to require full retrospective application. Instead, the Board proposes to require application of the proposed IFRS to regulatory assets and regulatory liabilities existing at the beginning of the earliest comparative period presented in the period in which the entity applies the proposed IFRS.*

EFRAG's response

Summary of EFRAG's view:

- EFRAG agrees with the IASB's proposal not to require full retrospective application.

100 EFRAG's general view is that retrospective application of IFRS is preferable to other transition arrangements, because it ensures comparability and enhances understandability. Furthermore, if the choice is between prospective application now or retrospective application with a longer lead time, EFRAG's general policy would still be to support retrospective application.

101 However, we accept that there might be circumstances in which retrospective application is not possible (because the information needed is not available) or is undesirable (because it would be necessary to apply hindsight in a way that could significantly benefit the entity). We agree that this is will be the case for some of the proposals. For these entities, relief from retrospective application is granted.

102 Therefore, on cost benefit grounds we support the proposal not to require full retrospective application.

Question 8 - Other comments

Do you have any other comments on the proposals in the exposure draft?

EFRAG's response

103 We do not have any further comments to make on the proposals in the ED.