Project: *Rate-regulated Activities*

Topic: **Results of outreach efforts**

Purpose of this agenda paper

1. This agenda paper provides information on the outreach efforts made by the staff related to the RRA project for the Board's consideration.

2. This paper should be read in conjunction with the other agenda papers 11–11H of the July 2010 Board meeting to assist the Board in its deliberations of the *Rate-regulated Activities* project.

3. This paper includes:

   (a) An overview of the outreach efforts; and

   (b) A summary of the outreach responses.

Outreach efforts

4. Given the diversity of responses included in the comment letters and lack of investor/ analyst respondents (considered in the Framework to be the primary users of financial statements), the staff performed significant outreach activities in order to solicit additional views from constituents and discuss in detail the rationale for those views. The staff focused on discussions with the investor/ analyst community; however, the staff also held several meetings and calls with utility preparers, utility industry trade organisations, international accounting firms, national standard setters and securities regulators.

5. Through these efforts, the staff had direct contact with constituents that can be summarised as follows:

   (a) separate meetings or conference calls with 13 investor/ analyst organizations covering 3 continents

   (b) individual presentations for 6 regulated industry trade organisations with audiences from several jurisdictions

   (c) individual presentations for 3 international accounting firms with audiences from several jurisdictions

   (d) separate meetings or conference calls with 4 utility regulators

   (e) countless meetings and conference calls with utility preparers in multiple jurisdictions

   (f) numerous other conference calls and informal correspondence with various individual constituents

   (g) correspondence with 7 national standard setters

6. As a result of the outreach efforts, the staff was able to discuss the regulations (ie ‘regulatory compacts’) in at least 18 countries. Several of these countries have multiple jurisdictions being both segregated by location (state, province, city, etc.) and also differentiated by type of goods and services provided (electricity, natural gas, water, etc.)

Outreach responses

Overview

7. As discussed at the February 2010 Board meeting, there was a significant split in comment letters received on the exposure draft with the North American utility industry strongly in favour of recognition of regulatory assets and liabilities in the statement of financial position and the rest of the world having mixed views as to the appropriateness of recognition in general purpose financial statements prepared for use in the capital markets. The results of outreach efforts enforced this division of views along the same lines.

8. While not absolute, the majority of investor/ analysts that cover utility entities in North America supported recognition of regulatory assets and liabilities in the statement of financial position. However, the rationale for their support varied. Conversely, the majority of investor/ analysts that cover utility entities outside of North America are not supportive of the recognition of regulatory assets and liabilities in financial statements prepared in accordance with IFRSs and for use in the capital markets. These investor/ analysts also had a diversity in rationale supporting their view.

9. Advocates of the recognition of regulatory assets and liabilities point out that it is because of the regulations (ie regulatory compacts) between the entity and regulator and implicitly with the customer who is bound by those regulations that an entity has a much higher probability of collection of future economic benefits to recover the current period costs. These advocates note that regulated activities force a 'smoothing effect' on rates charged to customers and that effect should be appropriately reflected in the financial statements of the entity to most accurately present its financial statements.

10. Alternatively, comments have also been received that the 'smoothing effect' permits the regulator and/ or the entity to mask inefficient operations through the deferral of these costs which, on average, continue to grow and do not appear to be smoothed back to a long-term average of costs incurred being included in an recovered by rates charged to customers (which represents a net regulatory asset and liability balance of zero). The continued deferral of an increasing balance of current period costs has the effect of permanently financing a portion of the current or prior period costs. While this is good for the customer in keeping rates low in the short-term, it is likely not a sustainable action by the regulator on a long-term basis. These constituents believe that inclusion in general purpose financial statements of requirements that defer transactions that would otherwise be recognised in the current period statement of comprehensive income (ie the 'smoothing effect' of regulations) is not appropriate for the capital markets.

Individual comments

11. Excerpts from the 7 national standard setters providing responses to my outreach requests are included in Appendix A to Paper 11C *Analysis of Scope (unit of account)* for the July 2010 Board meeting.

12. Following is a list of comments received from discussions with the investor/ analysts:

Comments supporting recognition of regulatory assets and liabilities

(a) Regulators are also a 'primary user of the financial statements' and therefore the impact of regulations should be incorporated.

(b) The regulatory structure (ie regulatory compact) in North America is different from regulations in other parts of the world. There is a required symmetry of rights and obligations as a result of regulations.

(c) The regulator is acting to balance the interests of the rate payers and the equity holders.

(d) There needs to be a legal structure in place upon which regulators force customers to pay for all of the costs of providing the goods and services. This environment results in the creation of regulatory assets and liabilities that should be recognised.

(e) Belief that the current *Framework* can be used to justify the recognition of regulatory assets and liabilities absent an authoritative standard providing guidance on this topic.

(f) Volatility in the statement of comprehensive income is not good because there's an over-arching concept of 'just and reasonable' that binds both the entity and the aggregate customer base.

(g) 'Smoothing' is not what's going on, rather it's the actual economics of the regulated entity.

(h) There is one overall rate of return; it's not determined on an asset by asset basis. Rather, it is determined on the aggregate assets approved for inclusion in the 'regulated asset base' and a review of the desired debt to equity ratio.

(i) One of the international accounting firms noted that in North America, auditors feel more comfortable with regulatory assets than some other categories of assets.

(j) The rate-making process really drives the economics of the entity and this should be captured in the general purpose financial statements.

(k) If North American entities are precluded from recognising regulatory assets and liabilities, they will likely expand the amount of non-GAAP information that is disclosed.

(l) The rate case review process often includes several individual items that are deemed to be 'pass through costs', then the numerous remaining items are reviewed in the aggregate through a very long and detailed review process to determine one overall aggregate rate.

(m) Requiring the entity to maintain two sets of books would result in a lot of extra work. [Although even all entities that presently recognise regulatory assets and liabilities have reconciling items between the general purpose financial statements and the regulatory filings.]

(n) The preclusion from recognition of regulatory assets and liabilities in financial statements prepared in accordance with IFRSs results in a lack of comparability to entities applying US GAAP (where recognition of regulatory assets and liabilities is required).

(o) Regulators are often ‘paternalistic’ and try to keep the entity whole for items outside of the entity’s control.

(p) Management teams that are not good at explaining the operations of the entity and the regulatory impacts really need these impacts to be recognised in the primary financial statements; otherwise a normal reader would not know what’s going on.

(q) Earnings is a primary driver/ metric that is used to value a utility entity (that recognised regulatory assets and liabilities). [However, when the staff asked the same valuation expert how they value a capital intensive (non-utility) entity, the expert noted that cash flow metrics would be very important and the expert would not calculate an enterprise value based on EBITDA (or a similar earnings metric) because there is too much variability/ volatility in those metrics.]

(r) Recognition of regulatory assets and liabilities is needed particularly for fuel variances because there can be significant amounts of volatility in these costs.

(s) If you have a lot of variances period over period it would result in ‘lumpy’ earnings.

(t) Many users of financial statements are sceptical of amounts that are disclosed only (as compared to being recognised in the primary financial statements) as the disclosed only amounts thought to be less valid or reliable.

(u) Not concerned about the statement of financial position or leverage ratios, etc as long as the ratings agencies ‘can get there’ [to a targeted entity rating]. The valuation expert is much more concerned about smoothing in the statement of comprehensive income to provide better year over year comparability.

(v) In one analyst’s opinion, by having differences between regulatory filings and general purpose financial statements, there are differences in publicly available information that ‘better analysts’ will be able to decipher the differences and take market actions (buy, sell, hold) which will create additional volatility in the capital market that does not presently exist because of the relative consistency of publicly available information.

(w) There’s a belief that capital markets volatility will increase if there is no recognition of regulatory assets and liabilities and this belief is based on the de-regulation of many power generation entities in the 1990’s.

[However, it can be argued that the event of de-regulation was the cause that created volatility and not simply a change in the application of general purpose accounting requirements that are being applied differently because of the change in circumstances.]

(x) In one analyst's opinion, investors/ analysts are 'lazy' and don't like to change their models and methodologies. Therefore, when entities currently recognising regulatory assets and liabilities adopt IFRSs those entities should be permitted to continue with the same accounting requirements.

(y) The ability to forecast future earnings per share would be much more difficult if there is no recognition of regulatory assets and liabilities.

(z) Belief that a lack of recognition of regulatory assets and liabilities would increase debt to equity ratios. [Given the net regulatory asset position of approximately $200 billion in the US, this is true; however, based on studies performed regarding the adoption of IFRSs in Europe, there has been no corresponding decrease in the debt or equity ratings by ratings agencies (as a result of the absence of regulatory assets and liabilities).]

(aa) One of the primary ratings agencies notes their global rating methodology focuses on cash flows and a grading of the regulatory environment in which the entity operates. Additionally, the volatility or lack of volatility in earnings was not considered to be important and there is a minimal focus on the regulatory assets and liabilities recognised in the statement of financial position. However, the individuals talked with still noted a preference for recognition of regulatory assets and liabilities based on the belief that information recognised in the primary financial statements was more credible and the amounts recognised as regulatory assets and liabilities provided insight into the aggregate amount of cash flows expected to be collected in future periods (which assists in more precise inputs to their cash flow analysis). They also strongly support the disclosure, in a tabular format, of information that is disaggregated by regulatory jurisdiction.

Comments not supporting recognition of regulatory assets and liabilities

(bb) Regulations have a different purpose than general purpose financial statement reporting to the capital markets.

(cc) Many utility entities have gone on acquisition sprees in recent years paying amounts well in excess of the underlying regulated asset base which results in very high debt levels of the reporting entity. The ability to both 'create assets' because of not recognising incurred costs in the current period assists the entities in masking reality. Instead show the current period transactions in the current period whether or not future transactions will fully cover any excess costs of current period transactions.

(dd) There is no certainty of consistency by regulators or in regulations. Significant changes have occurred in all jurisdictions around the world in the past few decades and will continue to occur.

(ee) The regulator should not drive/ control the capital structure of private entities and the recognition of regulatory assets and liabilities inappropriately assists the regulator in this purpose.

(ff) Comprehensive and consistent disclosures should capture the impact of regulations.

(gg) The IASB should be cognisant of deciding on an appropriate scope to minimise the potential that jurisdictions will re-write regulations just to be able to 'get in scope'.

(hh) A lot of work will be required to capture all of the inputs required for recognition of regulatory assets and liabilities although the underlying value of the entity will not change.

(ii) IFRS principles better capture the business vs all of the detailed rules that accountants have to deal with in US GAAP.

(jj) The rights and obligations created by regulations are different jurisdiction by jurisdiction, so it's a waste of time to try to create rules to capture everything just so it can be presented in the same way (when in reality the economics vary).

(kk) Politicians either directly or indirectly cause smoothing in the actual rates charged to customers.

(ll) Valuation experts already make adjustments to both financial statements that do and do not recognise regulatory assets and liabilities. Valuation adjustments will continue to be made based on the individual methods employed.

(mm) Many regulatory environments are asymmetric concerning regulatory assets and liabilities. The regulator as well as the customer base are more reluctant to accept tariff increases (than decreases).

(nn) Despite the 'regulatory guarantee' in North America some entities still fall into bankruptcy, although this is very rare.

(oo) Recognition of regulatory assets and liabilities is simply 'profit smoothing'.

(pp) One valuation expert primarily focuses on the regulated asset base multiplied by the rate of return permitted by the regulator (with additional minor variations) in a manner similar to how the regulator determines rates. The recognition or lack of recognition of regulatory assets and liabilities is not relevant.

(qq) Most regulatory filings are publicly available, so if an investor/ analyst desires information complied for the purpose of setting rates, that information is usually available.

(rr) The incorporation of specified disclosures (including a reconciliation from general purpose financial statements to amounts determined for rate making purposes) is valuable and an appropriate way to show the impact of regulations.

(ss) The recognition of regulatory assets and liabilities is not an accounting construct; it's a US GAAP created issue.

(tt) While some jurisdictions require the periodic filing of information to regulators, many jurisdictions do not have a set period when rates are reviewed (ie rate cases) and updated as appropriate to 'true-up' for previously incurred costs that were not anticipated and included in the current rates charged to customers.

(uu) Free cash flows, capitalisation rates and long-term liquidity of an entity will likely not be impacted by the recognition or lack of recognition of regulatory assets and liabilities.

(vv) This project appears to be very 'North American centric' and does not serve the best interests of the majority of users of financial statements prepared in accordance with IFRSs.

(ww) Decoupling and revenue cap mechanisms are being used more and more throughout the world (including in North America) and these mechanisms will be increasing more difficult to justify the recognition of regulatory assets and liabilities. Given this trend, why finalise an IFRS that requires recognition of regulatory assets and liabilities in such limited circumstances (when it's appropriateness is already a primary point of contention amongst constituents).

(xx) Australia and the UK are jurisdictions that have made significant changes in their regulatory mechanisms in the past 2 years. Other entities will continue to change in the future.

Staff summary

13. As can be seen based on the above comments, there are strong views both supporting and not supporting the recognition of regulatory assets and liabilities in the statement of financial position of entities preparing financial statements in accordance with IFRSs. This summary does not result in a clear answer. Rather, these comments should be used by the Board as one information point in the comprehensive analysis of this RRA project.

14. In the staff's opinion, the key counterpoints to consider include:

(a) regulations do economically 'smooth' the rates (and cash flows) of regulated entities, therefore the most appropriate general purpose financial statement reporting is to similarly capture these economic effects; vs

(b) current period expenses (impairment of assets, unanticipated addition costs, etc) should be recognised in the current period statement of comprehensive income and increased rates permitted for future period sales should be recognised in the future period.