European Securities and Markets Authority

ESMA REGULAR USE

The Interim Chair
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Mr Andrea Barckow
Chairman
International Accounting Standards Board (IASB)
Columbus Building
7 Westferry Circus, Canary Wharf
London E14 4HD
United Kingdom

Ref: IASB's Exposure Draft Regulatory Assets and Regulatory Liabilities

Dear Mr Barckow,

The European Securities and Markets Authority (ESMA) thanks you for the opportunity to respond to the IASB's due process with regards to Exposure Draft ED/2021/1 Regulatory Assets and Regulatory Liabilities. ESMA welcomes the IASB's initiative to develop requirements for entities to provide relevant information on how regulatory assets and liabilities affect the entity's financial performance and financial position. We are pleased to provide you with the following comments with the aim of improving the consistent application and enforceability of IFRS.

Objective and Scope

ESMA supports the IASB's objective to develop an accounting model which should complement the information entities already provide by applying IFRS Standards with regards to regulatory assets and regulatory liabilities. However, ESMA recommends that the IASB carefully considers the feedback received from preparers as to whether the proposed requirements might have unintended consequences beyond the utilities sector. In addition, ESMA would recommend to clarify whether compensation could come from a third party (such as the government) even if rates are charged to customers, since it may not be clear whether this would be within the scope of the ED, and might be relevant for example in the transportation (e.g. railway) sector.

ESMA also encourages the IASB to provide additional guidance and specific examples on what constitutes a regulatory agreement and a description of the characteristics of a regulator, which are likely to be helpful to appropriately identify activities within the scope of the proposed model. ESMA recommends that the future standard should specify that a regulator needs to be an independent body, so as to avoid structuring opportunities and ensure that "self-regulation" is clearly not in scope of the standard.

Total allowed compensation

ESMA supports the proposed inclusion of the three components of target profit (profit margin, construction work in progress and performance incentives) in the total allowed compensation. ESMA also agrees with the deferral of regulatory return until the asset is operational so as to contribute to comparability across entities regardless of how regulatory return is structured within regulatory agreements. ESMA supports the IASB's view that total allowed compensation should reflect when the underlying asset is being used to provide goods or services and being consumed (through depreciation). ESMA expects that this approach will ensure a faithful representation of profit patterns, particularly for entities that have material and long-duration construction work in progress.

In addition, ESMA suggests that paragraphs B13-B15 should directly refer to the regulatory approach known as "allowance for funds used during construction" (AFUDC) - a term that is identified in example 7C.3 of the Illustrative Examples. Such reference would help clarify the intended scope of this guidance.

Recognition

ESMA agrees that an entity should recognise a regulatory asset or regulatory liability if it is more likely than not that they exist. We consider that a higher threshold such us "virtually certain", as required by IAS 37 *Provisions, Contingent Liabilities and Contingent Assets* to recognize a contingent asset, would be too high.

However, ESMA recommends that the IASB provides application guidance on how an entity would determine whether a regulatory asset and a regulatory liability exists as well as on the derecognition of regulatory assets and regulatory liabilities, as we are not persuaded that there will be "generally little uncertainty about whether regulatory assets or regulatory liabilities exist" (BC124).

Measurement

ESMA supports the use of the cash-flow-based measurement technique to measure the regulatory assets and regulatory liabilities and that an "expected value method" (rather than the "most likely outcome") should be used if cash flows are uncertain.

However, given that the measurement of regulatory assets and regulatory liabilities is based on the enforceable period of the regulatory agreement, we believe that more guidance or additional examples would be needed to address situations in which the expected recovery or fulfillment is likely to extend past the period formally set out in the regulatory agreement. This would be particularly relevant in situations in which regulatory agreements are typically short-term with frequent renewals.

Discount rate

ESMA agrees with the proposal to use the regulatory interest rate because that regulatory interest rate is negotiated with the regulator and considered objective by users.

However, ESMA has some concerns about how issuers should deal with the uncertainty of future cash flows and, consequently, with the measurement of the regulatory assets, according to the ED. ESMA finds that paragraph 32 and paragraph 50 of the ED are not fully consistent and that further guidance is needed to clarify how uncertainty should be addressed by estimating future cash flows and using the discount rate, especially to avoid double counting. In addition, it is not clear why the discount rate is tested for sufficiency for assets but not for liabilities. The 'unnecessary cost and complexity' argument described in BC169 could be just as valid for assets and reduce complexity of the standard.

Disclosures

ESMA recommends that the IASB explicitly requires issuers to disclose the significant judgements made by the management to conclude on the boundary of a regulatory agreement and how such boundary impacts the measurement of regulatory assets and liabilities. This is because the level of judgement to be applied is particularly high and the provisions included in IAS 1 *Presentation of financial statements* may not be sufficient to ensure full transparency on this. In addition, ESMA thinks that additional disclosures should be required with regards to the judgements made to establish that the entity falls within the specified circumstances where the discount rate would *not* be the regulatory interest rate.

ESMA considers that the disclosures proposed by paragraphs 77-83 of the ED are very useful, but we recommend that paragraph 80 (d) is expanded to also encompass disclosures about the amount deducted in the estimation of estimated future cash flows, if the entity bears the credit risk (paragraph 38), the method used to estimate uncertain cash flows (given the two possibilities allowed for by paragraph 39) and disclosure of whether the entity is assessing each regulatory asset and each regulatory liability separately, or is considering any of them together with others (paragraph 40).

Interaction with other standards

ESMA recommends that additional guidance is provided with regards to the interaction between IFRIC 12 and the future standard to better help preparers distinguish which arrangements within the scope of IFRIC 12 also create regulatory assets and regulatory liabilities as referred to by B47 of the ED.

ESMA supports and does not have additional comments on other aspects of the IASB's proposals.

In case you have any questions or comments please do not hesitate to contact me or Evert van Walsum, Head of the Investors and Issuers Department (Evert.vanWalsum@esma.europa.eu).

Yours sincerely,

Tuominen Anneli
912372492

Anneli Tuominen