Trends in regulation
Based in our Paris office, Charles-Emmanuel Chosson has more than 20 years’ experience working with some of the world’s largest utilities. He supports clients in a number of ways, including advising on the sector’s key risks and reporting issues, and helps them come to grips with their regulatory and compliance requirements. Charles-Emmanuel says current regulatory trends have created a critical time for the sector.

US GAAP and IFRS variances

One of the biggest regulatory issues of recent times is back on the agenda at the International Accounting Standards Board (IASB). The IASB is considering possible resolutions to the accounting variances between US GAAP and Europe’s IFRS that burden global utilities and have hindered Canada’s transition to IFRS. Charles-Emmanuel, who is part of the Ernst & Young team involved in the talks, says it is critical that the differences are resolved.

“The issue is pretty simple,” says Charles-Emmanuel. “Should regulatory assets and liabilities — that is, those costs or revenues that the regulator permits a utility to defer to its balance sheet — be recognized in the accounts under IFRS rules?”

“If yes, they will be included in the balance sheet of a P&U, which, considering the size of the assets on these balance sheets, may have a significant impact for some companies,” he continues. “If they are not recognized, they will continue to be handled as off-balance-sheet items.”

The IASB is reactivating its rate-regulated activities research project and, in April, launched its “Regulatory Deferral Accounts” exposure draft in an attempt to resolve the variances between US GAAP and IFRS.

“We are involved at a high level in the consideration of this project,” Charles-Emmanuel says. “It’s important for us to be part of what could be the future standard on those regulated assets and liabilities.”

While he does not anticipate a speedy resolution, Charles-Emmanuel says the IASB’s decision will be felt across the sector.

Moves toward convergence

Charles-Emmanuel says the lack of development of a single European regulatory model to date is, in some ways, surprising, but he believes some points of convergence are arising due to the regional focus on efficiency, cost reduction and quality of service.

“Europe’s regulators are looking for more areas of comparison and opportunities to benchmark performance, which leads to a form of convergence in the rate-setting mechanisms,” he says. “Nevertheless, we will not see a single European regulatory model any time soon as each regulator continues to keep its own local specificities.”

“This clearly represents a challenge for utilities as operating a regulated business requires having a perfect understanding of specific local regulation, which can, in some cases, be pretty complex,” he continues. While he says regulation will remain “above all, of a national nature,” Charles-Emmanuel says the trend toward convergence on some matters is still a step in the right direction.
“It is certainly helping utilities anticipate how the regulatory system may evolve and how it may be applied to the geographies in which they operate,” he said. “Now is the opportunity to start a discussion with regulators and acquire some bargaining power, by using what is done in neighboring countries as a kind of benchmark.”

A broader approach

Charles-Emmanuel says today’s regulatory trends are particularly interesting because of the focus on efficiency, an issue he says was less of a priority for regulators a decade ago.

He says that it is part of a trend that sees regulators taking a far broader approach to the development of quality targets and incentives for utilities.

“Regulators are trying to encourage a more balanced approach to cost reduction,” he explains. “They are prepared to offer companies a fair return on their investments, but they want to ensure that financial objectives do not harm the overall quality of the operations.”

This trend is highlighted by the UK regulator’s introduction of its new RIIO (Returns = Incentives + Innovation + Outputs) price control framework, which incentivizes regulated utilities through quality and performance indicators focused on six outputs: safety, environment, customer service, connecting customers, social obligation in particular to vulnerable customers and the reliability of the network.

“RIIO probably represents the clearest example of how regulatory systems are likely to evolve in the future,” Charles-Emmanuel says. “We expect a growing focus on quality and incentives.

“Regulated companies will still be in a position to post good returns on investments but only if they achieve the targets set by the regulators,” he continues. “In other words, the old cost plus regulation will probably definitively disappear, and companies will have to be efficient to improve their results.”

Charles-Emmanuel says utilities will be challenged to monitor an increasing number of variables.

“They will also need to extend their operational targets beyond strictly economic angles,” he says. “This requires a coordinated effort from the various functions of a regulated company, including finance, operations, supply and quality management.”

Anticipating change

While keeping an eye on trends can help companies better manage their compliance and performance, Charles-Emmanuel cautions that utilities will “never be in position to know with certainty in advance how their regulatory models will evolve.”

“This is because external factors will always influence the regulators,” he says, “particularly regarding remuneration rates, which are clearly impacted by the financial market and the level of risk premium assigned to regulated activity, which can evolve over time.”

He says the best approach is vigilance.

“Keep comparing what is happening across Europe and not only in your primary geographies,” he says. “What is going on in other countries may represent what you will have to live with in a couple of years. Be proactive and try to anticipate how regulators may make changes.

“Reacting too late is always expensive.”

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Charles-Emmanuel has more than 20 years’ experience in audit and financial consulting and has in-depth knowledge of the power and utilities sector. He supports leading utilities on transactions including mergers and demergers and has also participated in the listing of several utilities on the New York Stock Exchange and Euronext.
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