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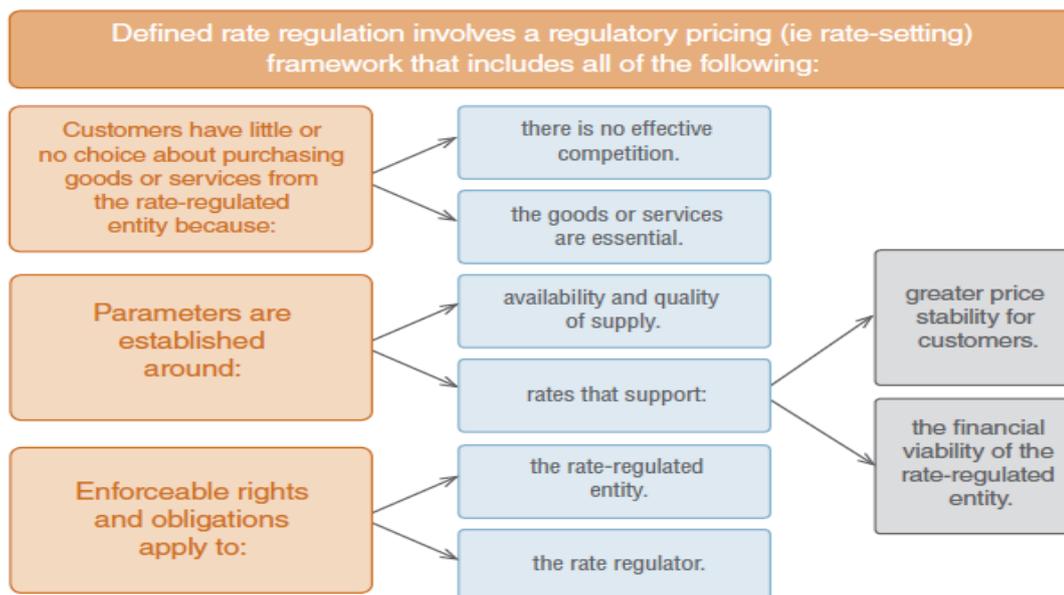
Rate-regulated Activities Scope developments

Objective

- 1 The objective of this paper is to discuss the IASB Staff proposed changes to the scope of the IASB project on rate-regulated activities.
- 2 The proposed changes were discussed with the Accounting Standards Advisory Forum (ASAF) and the IASB at their December 2016 meetings. The IASB December 2016 meeting was an educational session and no decisions were taken.
- 3 The IASB Staff proposals respond to concerns previously expressed by ASAF members and by respondents to the IASB Discussion Paper DP/2014/2 *Reporting the Financial Effects of Rate Regulation* ('the DP').

A reminder of defined rate regulation

- 4 The DP focused on a type of rate regulation referred to as defined rate regulation. The DP explored which of the common features of defined rate regulation – if any – create a combination of rights and obligations that is distinguishable from the rights and obligations arising from activities that are not subject to defined rate-regulation. The key features of defined rate regulation identified in the DP are summarised in the diagram below.



- 5 The appendix to this paper an overview of each of the features of defined rate regulation.

Comments from respondents including EFRAG

- 6 Respondents to the DP agreed that defined rate regulation, as defined in the DP, was an appropriate starting point for developing an accounting model for activities subject to rate regulation.
- 7 In their view, defined rate regulation described a type of rate regulation that operates in a unique economic environment in contrast to other commercial entities, in that revenue is determined in advance, by a rate regulator, and there is effectively no competition in the supply of the rate-regulated goods or services. This unique economic environment was what made activities subject to defined rate regulation different from other commercial activities and therefore required specific accounting requirements to reflect its effects in the financial statements.
- 8 However, while many respondents agreed that the features outlined in paragraphs 4.4(a) – (c) of the DP typically support the existence of the rate-regulatory framework, they highlighted that there may be operational difficulties in applying the features if they were set as mandatory scoping criteria. For example, several respondents noted that the determination of which goods or services are deemed essential is very subjective and can vary in different regulatory regimes. Similarly, the terms “customers have little or no choice” and “no effective completion to supply” could be difficult to apply in practice, particularly in cases in which there is some limited competition from another source of supply or substitute product(s) exist.
- 9 Furthermore, ASAF discussions have considered that the description of defined rate regulation is not sufficiently precise to determine the scope of an accounting model for rate-regulated activities and to provide a basis to recognise regulatory assets and regulatory liabilities.
- 10 In its comment letter, the EFRAG position was summarised as:
- Whilst we broadly support the description of defined rate regulation, we believe that the existence of a rate-setting framework that creates enforceable rights and obligations and includes an adjusting mechanism based on the revenue requirement (as defined in the DP) has a pivotal role to play in the scoping of the IASB’s Rate-regulated Activities project. In our view, it is the enforceable rights and obligations that stem from this rate-setting framework that should be considered for recognition in the IFRS financial statements and **therefore we see the main purpose of the features listed in paragraph 4.4(a)–(c) of the DP as ensuring enforceability of those rights and obligations.** We have also provided a number of suggestions about how these features might be improved so as to achieve this purpose, which may also assist in developing any potential future accounting guidance.*
- 11 That is, EFRAG considered that the enforceable rights and obligations (together with an adjusting mechanism) were key to determining whether defined rate regulation exists in specific circumstances. The other features identified in the DP provide useful indicators of the existence of defined rate regulation.
- 12 EFRAG’s view was consistent with many similar comments and recommendations for the IASB to focus on the existence of a regulatory pricing (i.e. rate-setting) framework that creates enforceable rights and obligations and includes an adjusting mechanism to reverse specified differences between the amount of the revenue requirement and the amounts billed to customers.

Market regulation

- 13 Regulation of entities is not limited to defined rate regulation. For example, many entities, especially in the financial services industries, are subject to some form of regulatory oversight such as prudential regulation. There are also different forms of ‘rate regulation’ some of which are referred to as market regulation. For example,

industries such as postal services, airport terminals, and hospitals are often subject to a form of regulation that governs the maximum rate/amount an entity can charge the customer for the goods or services it provides.

- 14 Under market regulation, an entity is free to manage its business in order to maximise its profitability and may select the price it charges up to the regulated price cap. The key difference from defined rate regulation is that market regulation does not promise a specific level of profit to the regulated entity, even though the regulation is designed to address deficiencies in the market place for the relevant product and protect the consumer.
- 15 Market regulation can be applied in a competitive market or to a monopoly. When applied in a competitive market, the price cap is most probably based on some form of standard costs rather than the specific costs of the regulated entity.

Comments from respondents including EFRAG

- 16 Respondents to the DP generally agreed that market regulation should not be included in the scope of the IASB project.
- 17 In its comment letter on the DP, EFRAG stated:
EFRAG broadly agrees that market rate regulation has characteristics that differ significantly from defined rate regulation. We also agree that it does not create an economic environment that differs significantly from other commercial activities because it does not give rise to rights and obligations which are found in defined rate regulation. On this basis, we believe that existing IFRS are sufficient to faithfully depict the financial position and performance of those activities.
- 18 Therefore, EFRAG did not support the extension of defined rate regulation to include market regulation.

IASB Staff proposed changes to scope

- 19 According to the IASB Staff, the key factors of defined rate regulation used in the DP are still useful, as they will be incorporated into the model as factors or indicators of the type of regulation the IASB is trying to address. Based on feedback received, the IASB Staff noted that the other features identified in the DP provide useful indicators of the existence of defined rate regulation.
- 20 In summary, for adjustments to be within the scope of the model, the rate regulator must have the power to bind both the entity and the customer base to a rate and the rate regulation must establish:
 - (a) the obligations that the entity must satisfy; and
 - (b) the entity's right to charge the customer base a determinable amount in exchange for satisfying those obligations.
- 21 To link the right to charge the customer base a determinable amount to the obligations to be satisfied in exchange for that amount, the regulatory agreement must include a rate-setting mechanism that:
 - (a) establishes how the regulated rate is calculated, which identifies the basis of the rate calculation in terms of the entity's regulatory obligations; and
 - (b) adjusts the future regulated rate for the effects of past transactions, events or conditions.

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- 22 Furthermore, the IASB Staff propose to recognise only those regulatory adjustments¹ that:
- (a) relate to specified past transactions and events;
 - (b) reflect the rate regulator's intervention in establishing the rate(s) to be charged to the customer base; and
 - (c) are enforceable by either or both the entity or the rate regulator.
- 23 For the rights and obligations contained in the regulatory agreement to lead to assets and liabilities, it is necessary for them to be enforceable. Enforceability leads to the probability that any reversal of a regulatory adjustment (whether an asset or a liability) will be achieved fully through the regulated rate, i.e. will be reflected in the entity's future cash flows. Users of financial statements consider probability when assessing the entity's operating risks and the timing and certainty of the entity's cash flows.

EFRAG CFSS/TEG discussion in November 2016

- 24 At the EFRAG CFSS/TEG meeting in November 2016, EFRAG CFSS/TEG members discussed a paper on the scope of the IASB project as well as the IASB Staff proposed changes.
- 25 One EFRAG CFSS member suggested that if the IASB project would allow defined rate-regulated entities to recognise regulatory assets and liabilities but not those entities that had activities subject to other forms of regulation, it might result in similar activities being accounted for differently.
- 26 One EFRAG TEG member thought it was necessary to have an independent rate regulator otherwise service-type contracts might be included in the scope.
- 27 There was general agreement with the IASB Staff proposal that the scope should not be determined by a particular regulatory regime. In contrast, the IASB should consider where there were regulatory adjustments created by the rate-setting mechanism.

EFRAG Secretariat observations

- 28 The EFRAG Secretariat agrees that the IASB Staff proposed changes are broadly in line with EFRAG's position in its comment letter responding to the DP and the initial comments made by EFRAG CFSS and EFRAG TEG members at their November 2016 meeting.
- 29 However, if the key features of defined rate regulation become indicators of the type of regulation the IASB is trying to address, rather than required features, the scope of the project may broaden to include some activities subject to various forms of regulation. Unlike defined rate regulation, market regulation for example, can be applied in a competitive market or to a monopoly and activities to which it applies might or might not be essential goods or services. Nonetheless market regulation is likely to involve a regulator and some form of rate-setting mechanism (for example setting a maximum price an entity can charge) and could create enforceable rights and obligations. We note that the discussions so far have focused primarily on activities that commonly fall within the description of defined rate regulation, such as utility goods or services.
- 30 Furthermore, the EFRAG Secretariat considers that the changes proposed by the IASB Staff highlight an important interaction with other IFRS Standards, in particular IFRIC 12 *Service Concession Arrangements* and IAS 20 *Accounting for*

¹ Term used by the IASB Staff in the IASB Board meeting of December 2016. Sometimes referred to as 'tariff adjustments'.

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Government Grants and Disclosure of Government Assistance. Some forms of regulation apply to activities operating under service concession arrangements, for example toll-road and airports, and/or activities that are subsidised by the Government and which are accounted for under IAS 20.

- 31 Although we understand that the IASB Staff's proposed accounting model for rate-regulated activities would be a 'supplementary' approach - meaning that existing IFRS are applied first – we think that the potential overlap between the activities accounted for under IFRIC 12 and IAS 20 would need to be considered in order to ensure that similar activities are accounted for in a similar matter.

EFRAG Secretariat recommendation

- 32 Given that the IASB has not taken any decisions on the scope of the project, we recommend to wait until the IASB has discussed the scope in more detail before undertaking further work.

Questions to EFRAG TEG

- 33 Does EFRAG TEG agree with the EFRAG Secretariat observations in paragraphs 28 to 31?
- 34 Does EFRAG TEG agree with the EFRAG Secretariat recommendation to wait until the IASB has discussed the scope further before undertaking additional work on scope?

Appendix 1: Description of defined rate regulation

Introduction

- 1 The IASB Discussion Paper (DP/2014/2) *Reporting the Financial Effects of Rate Regulation* set out the features of defined rate regulation in the paragraphs 4.4 – 4.7.

Defined rate regulation—an overview

- 2 Paragraph 4.4(a) – (d) of the DP explained that defined rate regulation balances the needs of the customers to purchase essential goods or services at a reasonable price with the needs of the entity to attract capital and remain financially viable. Defined rate regulation involves a regulatory pricing (i.e. rate-setting) framework that includes all of the following:
 - (a) it applies in situations in which customers have little or no choice but to purchase the goods or services from the rate-regulated entity because:
 - (i) there is no effective competition to supply; and
 - (ii) the rate-regulated goods or services are essential to customers (such as clean water or electricity).
 - (b) it establishes parameters to maintain the availability and quality of the supply of the rate-regulated goods or services and other rate-regulated activities of the entity.
 - (c) it establishes parameters for rates (sometimes referred to as prices or tariffs) that provide regulatory protections that:
 - (i) support greater stability of prices for customers; and
 - (ii) support the financial viability of the rate-regulated entity.
 - (d) it creates rights and obligations that are enforceable on the rate-regulated entity and on the rate regulator.
- 3 Paragraph 4.5 of the DP explained that the rate-setting framework for defined rate regulation establishes:
 - (a) a ‘revenue requirement’ (sometimes called ‘allowable revenue’ or ‘authorised revenue’): this is the total consideration to which the entity is entitled in exchange for carrying out specified rate-regulated activities over a period of time; and
 - (b) a regulated rate, or rates, per unit that the entity charges to customers for delivering the rate-regulated goods or services during the regulatory period.
- 4 Paragraph 4.6 noted that for defined rate regulation, the mechanism used to calculate the regulated rate(s) includes a regulatory adjustment mechanism to reverse specified differences between the amount of the revenue requirement accrued to date and the amounts billed to customers. This regulatory adjustment mechanism seeks to ensure that the rate-regulated entity earns no more and no less than the amount of the revenue requirement and any related profit or return to which it is entitled. The regulatory adjustment to the rate also seeks to reflect the time value of money when increases or decreases in the rate are deferred.

Paragraph 4.7 explained that consequently, some suggest that defined rate regulation creates a combination of rights and obligations that supports the recognition of the entity’s right to recover, or obligation to reverse, the specified differences as assets or liabilities in the statement of financial position. The remainder of this Section outlines the features of defined rate regulation and the combination of rights and obligations that relate to the rate-regulatory mechanism.