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Note to TEG and CFSS members

This paper was discussed at the TEG-CFSS meeting in June 2017. It provides a description of the accounting model for rate-regulated activities being developed by the IASB and is provided as background material.

Building an accounting model for rate-regulated activities

Issues paper

Description of the model

- 1 The purpose of the model is to address the financial effects of defined rate regulation. The model represents a supplementary approach that will require an entity to apply IFRS Standards, including IFRS 15 *Revenue from Contracts with Customers* before it applies the model. The model would replace IFRS 14 *Regulatory Deferral Accounts*. The IASB's work plan indicates that the IASB will issue a Discussion Paper or an Exposure Draft in the first half of 2018.
- 2 In defined rate regulation, a regulatory agreement between the rate regulator and an entity sets out **regulatory requirements** that transfer rights to and impose obligations on the entity that may be in addition to the delivery of goods and services to a customer. The purpose of the model is to require an entity to account for these additional rights and obligations which are not addressed by existing IFRS.
- 3 The regulatory requirements are generally required to be met over different periods, which could mean that the regulated rate charged to the customer reflects an amount to cover these 'supplementary' regulatory requirements (and not merely reflect the price of the goods delivered during the same period). For accounting purposes, these different set of obligations need to be considered separately. In order to address these additional regulatory requirements the model should consider:
 - (a) the characteristics of defined rate regulation (scope of the project);
 - (b) the regulatory agreement;
 - (c) definitions of asset and liability; and
 - (d) accounting for the rights and obligations arising from the rate-adjustment mechanism.

Characteristics of defined rate regulation (scope of the project)

- 4 The IASB staff are using 'defined rate regulation' as a label for a form of economic regulation established through a formal regulatory framework, which:

- (a) is binding on both the entity and the rate regulator;
 - (b) establishes a basis for setting the regulated rate (ie a rate-setting mechanism/rate-adjustment mechanism) chargeable by the entity to its customers for the transfer of specified goods and/ or services that comply with minimum quality levels or other service requirements.
- 5 Defined rate regulation is commonly used for services that governments consider essential for a reasonable quality of life for its citizens, such as the provision of clean and waste water services, electricity, some transport and communication services. The provision of such services are also subject to significant barriers to competition for supply because they require significant investment in infrastructure assets and networks and/ or there are physical and other barriers to the creation of more than one infrastructure network.

Regulatory agreement

- 6 The regulatory agreement between the rate regulator and the entity imposes regulatory requirements on the entity. These regulatory requirements are not restricted to the delivery of goods or services to customers during the current period. Instead, they may include service requirements for more than one period and may also include other requirements relating to government-imposed social or environmental policies.
- 7 The regulatory agreement also establishes the entity's entitlement to be compensated in exchange for satisfying its regulatory requirements. As such, the regulatory agreement establishes the basis for setting the price that the entity will charge its customers – the regulated rate. In principle, the regulatory agreement must include a rate-setting mechanism that establishes how the **regulated rate** to be charged to customers is calculated and identify the basis of the rate calculation in terms of the entity's regulatory obligations.
- 8 When establishing the regulated rate, the rate regulator considers two different perspectives:
- (a) Customer contract – Specifies a regulated rate chargeable to customers for goods and services received by individual customers during the period (PXQ). The customer contract is accounted for under IFRS 15.
 - (b) Regulatory agreement – specifies that the regulated rate used in individual contracts with customers is in fact an 'estimated price' because the rate regulator will adjust the future rate to reflect regulatory requirements in the regulated rate used to charge the customer.
- 9 The main purpose of the model is to focus on the rights and obligations that stem from the regulatory agreement.
- 10 The model indicates that there are two types of adjustments arising from the rate-setting mechanism in the regulatory agreement, that are reflected in the regulated rate (P):
- (a) **Estimation variances** - differences between actual and estimated amounts that give the entity a right to increase a future regulated rate ('allowable estimation variance') or an obligation to reduce a future regulated rate ('chargeable estimation variance').
 - (b) **Temporary differences**¹ that arise when:

¹ This is the term currently being used in the IASB agenda papers.

- (i) the entity fully or partially fulfils a regulatory requirement but the related compensation amount has not yet been included in the regulatory rate for the current period (ie a right to increase a future regulated rate); or
 - (ii) the regulated rate for the current period includes an amount relating to a regulatory requirement that has yet to be fulfilled (ie an obligation to reduce a future regulated rate).
- 11 Estimation adjustments and temporary differences give rise to rights and obligations that potentially meet the definitions of assets and liabilities in the IASB revised *Conceptual Framework (Conceptual Framework)*.

Assets and liabilities in the context of defined rate regulation

- 12 The preliminary analysis of a combination of characteristics of defined rate regulation suggests that the rights and obligations created by the rate-setting mechanism are assets and liabilities under the *Conceptual Framework*. The analysis is summarised in the paragraphs below.
- 13 Under the (revised) *Conceptual Framework*:
- (a) An asset is defined as – a present economic resource **controlled** by the entity as a result of **past events**. An economic resource is a **right** that has the potential to **produce economic benefits**.
 - (b) A liability is defined as – a **present obligation** of the entity to transfer an economic resource as a result of **past events**.

Binding on both the entity and the rate regulator

- 14 The model focuses on reflecting the entity's rights and obligations created by a regulatory agreement that binds both the entity and the rate regulator. Those binding terms establish rights and obligations for the entity that have commercial substance because they clearly have a discernible effect on the economics of the regulatory agreement. They also help to ensure that:
- (a) an entity's supplementary rights created by the rate-adjustment mechanism in the regulatory agreement have the potential to produce economic benefits; and
 - (b) an entity's supplementary obligations created by that mechanism have the potential to require the entity to transfer economic benefits.

Establishes a basis for setting the regulated rate

- 15 Defined rate regulation establishes a basis for (1) setting the regulated rate (ie a rate-setting mechanism) chargeable by an entity to its customers for the transfer of specified goods and/ or services and (2) includes a mechanism that adjusts the regulated rate to reflect the correction of estimation variances and/or temporary differences.
- 16 The IASB Staff considers that both these characteristics are necessary for defined rate regulation to give rise to assets and liabilities under the *Conceptual Framework*.
- 17 In summary:
- (a) A right arises from the rate-adjustment mechanism if the entity has already partially or fully fulfilled a regulatory requirement (**past event**) but the current regulated rate does not yet reflect the compensation that the entity is entitled to in exchange. Even though the entity cannot compel its customers to buy the regulated goods or services, the entity's right to charge an increased future regulated rate has the potential to produce for the entity an inflow of economic benefits that are not available to other parties. That **right** will be consumed as the entity includes the rate increase in future regulated rates and will **lead to**

an inflow of economic benefits if customers pay the increased future regulated rate for the future delivery of goods or services.

- (b) An obligation arises from the rate-adjustment mechanism if the entity has already received economic benefits through billings to customers (**past event**) that will require it to supply regulated goods or services at a reduced future regulated rate (ie to transfer an economic resource by charging a reduced regulated rate for that supply). The **entity has no practical ability to avoid** making that transfer because of the binding terms of the regulatory agreement.

Accounting for these supplementary regulatory requirements

- 18 The principle of the model is to recognise the rights and obligations arising from the rate-adjustment mechanism specified in the regulatory agreement and which are not reflected in the accounting under IFRS 15.
- 19 Those rights and obligations result from activities undertaken by the entity during the reporting period and constitute a right or an obligation to charge a higher or lower regulated rate in a future period.
- 20 The IASB staff do not propose to amend IAS 38 *Intangible Assets* to reflect any rights or obligations arising from the regulatory agreement. Few respondents to the IASB Discussion Paper on rate-regulated activities expressed support for developing an intangible asset model, for both conceptual and practical reasons.