EFRAG Secretariat: Isabel Batista
Ioana Kiss

Rate-regulated Activities
Issues Paper

Objective

1 The purpose of the session is to update EFRAG TEG and EFRAG CFSS on the IASB tentative decisions so far on the new accounting model being developed for defined rate regulation; and seek views on the rationale underlying those tentative decisions.

Overview of the accounting model

2 The objective of the IASB's project on rate-regulated activities (the project) is to capture the rights and obligations created by defined rate regulation which are not reflected by existing IFRS Standards.

3 Defined rate regulation applies to goods or services that are considered essential by governments for a reasonable quality of life for their citizens and for which there are significant barriers to effective competition for supply. The objective of defined rate regulation is to protect both:

(a) the customer by ensuring:

(i) quality, quantity and availability of supply; and

(ii) stability and affordability of pricing for customers.

(b) the rate-regulated entity by ensuring that the regulated rate established in the regulatory agreement supports the entity's financial viability by enabling it to charge customers rates that provide the entity with an adequate amount of the compensation in exchange for fulfilling the service requirements established by the regulatory agreement.

4 Defined rate regulation is established through a binding regulatory agreement between the entity and the rate regulator. To achieve the objectives of defined rate regulation in paragraph 3, the binding agreement establishes that the rate-regulated entity:

(a) **has a right** to supply the rate-regulated goods and services and charge a rate for those goods and services that is designed to protect the financial viability of the entity; and

(b) **has an obligation** to fulfil specified service requirements (usually related to quality, quantity and availability of supply) and accept the pricing framework.

5 The objectives of the binding regulatory agreement are operationalised through a rate-adjustment mechanism which sets the basis for the regulatory rate (also referred to in this paper as simply the rate).

6 The rate-adjustment mechanism uses a formula to adjust future rates for variances between estimated and actual inputs to the rate calculation. These variance adjustments create **timing differences** between when an entity fulfils its obligations (established by the regulatory agreement) and get compensated for them (reflected in the rate). For example, an entity might be compensated over a period of several years for goods or services it delivers in the current period.

7 The model aims to reflect those timing differences in the IFRS financial statements and give a complete picture of the effects of defined rate regulation on an entity's financial performance and financial position. The accounting model is being developed as a supplementary approach. This means that existing IFRS Standards, including IFRS 15 *Revenue from Contracts with Customers*, will be applied first without modification. The accounting model aims to recognise:

(a) in the statement of financial position, the incremental rights and obligations reflecting timing differences that will affect future rates; and

(b) in the statement of financial performance, the timing differences originating and reversing during the period.

IASB tentative decisions so far

8 So far, the IASB has made the following tentative decisions on its project:

(a) **General approach -** to continue using the general approach in the model. The general approach means that a rate-regulated entity will first apply other IFRS Standards, including IFRS 15, without modification, before applying the model. The model is only supplementary to existing IFRS Standards and will then recognise rights and obligations arising from the rate-adjustment mechanism.

(b) **Scope -** the scope criteria for the model should focus on enforceable rights and obligations created through a formal regulatory pricing framework. However, the IASB will be asked to tentatively decide which features of defined rate regulation are both necessary and sufficient for the creation of regulatory assets and liabilities at its meeting in March 2018.

(c) **Unit of account** – the IASB tentatively decided that:

(i) the accounting model **will use as its unit of account the individual timing differences** that create the incremental rights and obligations arising from the regulatory agreement;

(ii) the present regulatory right meets the definition of an asset in the *Conceptual Framework*; and

(iii) the present regulatory obligation meets the definition of a liability in the *Conceptual Framework*.

Unit of account

9 The IASB has tentatively decided that the model will use as its unit of account the individual timing differences arising from the operation of the rate-adjustment mechanism in the regulatory agreement. This will provide users of financial statements with information about the pattern of reversal and the effect on the entity's future cash flows.

10 The *Conceptual Framework for Financial Reporting* says that treating a group of rights and obligations as a single unit of account instead of treating each one as a separate unit may provide more relevant information in certain cases. Entities that operate under defined rate regulation generally track the individual timing differences separately in accordance with regulatory agreement requirements, which allows for the effect on future cash flows to be identified.

11 The IASB has considered the following possible units of account:

(a) the regulatory agreement;

(b) the net of all timing differences arising from the rate adjustment mechanism that affect the future rates; and

(c) the individual timing differences arising from the rate adjustment mechanism that affect the future rates.

12 The IASB has already tentatively decided not to develop a model for the regulatory agreement as a whole (ie a single intangible asset), and instead, focus on a ‘supplementary approach’.

Questions for EFRAG TEG and EFRAG CFSS

13 Does EFRAG TEG and EFRAG CFSS agree with the IASB’s tentative decision to use as its unit of account the individual timing differences arising from the operation of the rate-adjustment mechanism in the regulatory agreement? If not, please explain why.

Definitions of regulatory asset and regulatory liability in the rate-regulated activities model

Regulatory asset definition

14 The forthcoming *Conceptual Framework for Financial Reporting* defines an asset 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.

15 The regulatory right(s) is specified in the regulatory agreement and arises from a past event such as incurring allowable expenses, bonus or allowable estimation variances not included in the regulated rate for the current period but will be recovered (included in the regulated rate to be charged) in a future period.

16 In summary, **the present regulatory right is the right to charge a rate increased by an incremental amount as a result of past events.** The entity controls that right as it can direct the use of the right and is the only party that can obtain the economic benefits that flow from it.

Regulatory liability definition

17 The forthcoming *Conceptual Framework for Financial Reporting* defines a liability as ‘a present obligation of the entity to transfer an economic resource as a result of past events’.

18 The regulatory obligation(s) is specified in the regulatory agreement and arises from a past event such as the entity having received economic benefits for service requirements not yet fulfilled.

19 In summary, the regulatory obligation is the **present regulatory obligation to provide goods or services at a rate reduced by an incremental amount as a result of past events**, such as incremental amount received in advance, penalty or chargeable estimation variances to be deducted from the calculated rate in specified future periods.

20 The obligation is fulfilled as the entity deducts an incremental amount from the rate when delivering the goods and services in the future.

21 Consequently, the present regulatory obligation is the obligation to provide goods or services at a rate reduced by an incremental amount as a result of past events. The entity has the unconditional obligation to transfer goods or services at a lower

rate in the future period as it has already received the economic benefits for the service requirements not yet fulfilled.

Questions for EFRAG TEG and EFRAG CFSS

22 Does EFRAG TEG and EFRAG CFSS agree with the IASB's tentative decisions on the origination of regulatory assets and regulatory liabilities?

23 Are there other aspects on the definitions to include in the next consultation document for the rate-regulated activities project?

Scope of defined rate regulation

24 At its meeting in March 2018, the IASB will be asked to tentatively decide which features of defined rate regulation are both necessary and sufficient for the creation of regulatory assets and liabilities.

25 Up to now the IASB has discussed the scope of the project and its features at several meetings and has considered comments received from constituents on the definition included in the Discussion Paper *Reporting the Financial Effects of Rate Regulation* (September 2014).The views expressed by respondents to the Discussion Paper pointed to some operational difficulties as to how to determine which goods and services are considered essential for customers and whether limited competition from another supplier or a substitute product would qualify as lack of competition and choice for the customer.

26 The IASB Staff has proposed the following scope definition for defined rate regulation which the IASB will consider at its meeting in March 2018:

'*Defined rate regulation is a form of economic regulation established through a formal regulatory framework that:*

*a) is **binding** on both the entity and the regulator;*

b) *establishes a **basis for setting the rate** that includes a rate-adjustment mechanism that creates, and subsequently reverses, rights and obligations arising from **timing differences** when the regulated rate in one period includes amounts related to specified activities the entity carries out in a different period.*'

Binding nature of regulatory framework

27 The regulatory framework creates binding terms on both the rate-regulated entity and the regulator through its main elements:

(a) legislation;

(b) regulations or regulatory agreement; and

(c) regulatory decisions, including subsequent court rulings that interpret the legislation and the regulations.

28 The binding term of the regulatory framework support certain aspects within the asset (the aspect of 'control') and liability (the aspect 'no practical ability to avoid the obligation') definitions according to the forthcoming revised *Conceptual Framework for Financial Reporting*.

29 The binding nature of the regulatory framework would mean that 'self-regulation' would not be included in the scope of the model as an entity cannot create enforceable rights and obligations with itself. However, in some cases judgement would be required to determine whether the process for setting and enforcing the rates is subject to sufficient external oversight and/or approval through statute or regulation that creates terms binding both the entity and the regulator.

Basis for setting the regulated rate

30 The existence of a basis for setting the regulated rate is a necessary but not sufficient feature to differentiate defined rate regulation from other types of rate regulation. Price regulation which establishes a cap price does not give entities any rights or obligations that would result in the recognition of assets or liabilities because there is no specific past event that can be linked to an entity's present right to charge a higher rate, or present obligation to charge a lower rate, for goods or services to be delivered to customers in the future.

Rate-adjustment mechanism

31 The rate-adjustment mechanism creates timing differences when an entity fulfils service requirements and when it includes the related compensation in the regulated rate. It is the link between the entity's past or future transactions or other events and the rate the entity will charge to customers for goods or services delivered in the future. Therefore, the rate-adjustment mechanism is a necessary feature for the recognition of regulatory assets and regulatory liabilities.

Limitations on entry and on exit

32 Defined rate regulation is typically introduced for services that governments consider essential for a reasonable quality of life for their citizens and for which there are significant barriers to effective competition for supply. The limitations on effective competition can arise from the existence of natural monopolies or can be imposed by the government to improve quality and reliability of the goods or services and their not discriminatory provision among various groups of customers.

33 The IASB staff is of the opinion that the limitation on entry into a market is not necessary for the recognition of regulatory assets and regulatory liabilities. It is the binding terms in the regulatory agreement that establish the aspects for recognition of regulatory assets and regulatory liabilities.

Other features of defined rate regulation

34 When scoping the project, the IASB has also considered the following features of defined rate regulation:

(a) customers have little or no choice but to purchase the goods or services from the rate-regulated entity;

(b) there is no effective competition to supply;

(c) the goods and services are essential to customers.

Questions for EFRAG TEG and EFRAG CFSS

35 Does EFRAG TEG and EFRAG CFSS consider that the definition of 'defined rate regulation' in paragraph 26 above is sufficiently clear to enable entities to identify whether they have activities within the scope of the model? If not, are there matters in this definition that need further clarification?

36 Based on the rationale developed for unit of account, regulatory assets and regulatory liabilities, and scope of the project, what type of communication materials should the IASB develop? What particular aspects of the model should be the focus of those communication materials?

Agenda Papers

37 In addition to this issues paper, agenda papers for this session are:

(a) Agenda paper 09-02 – ASAF AP 01 - Cover paper TEG-CFSS 18-04-05 – for background only;

(b) Agenda paper 09-03 – ASAF AP 01A - Unit of account and asset liability definitions TEG-CFSS 18-04-05 – for background only; and

(c) Agenda paper 09-04 ASAF AP 01B - Scope TEG-CFSS 18-04-05 – for background only.