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STAFF PAPER

ASAF Meeting

Project	**Rate-regulated Activities**
Paper topic	Background and summary of decisions to date

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Purpose of this paper

1. The purpose of this paper is to provide background information about the accounting model we are developing for ‘defined rate regulation’ (the model) and to summarise the Board’s tentative decisions to date.

Structure of the paper

2. This paper is structured as follows:

    (a) Defined rate regulation—basis for setting the rate (paragraphs 4–9);

    (b) Timing differences—regulatory assets and regulatory liabilities (paragraphs 10–16);

    (c) Tentative decisions about the model (paragraph 17–18); and

    (d) Next steps (paragraph 19).

3. This paper includes two appendices:

    (a) Appendix A summarises all the tentative decisions made by the Board while developing the model; and

    (b) Appendix B provides an overview of the project plan.

Defined rate regulation—basis for setting the rate

4. The model aims to provide users of financial statements with useful information about those rights and obligations that are created by defined rate regulation and are not captured in a sufficiently useful way by existing IFRS Standards (see paragraphs 10–16).

5. Defined rate regulation is typically applied for goods or 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. In such cases, the defined rate regulation typically has objectives that include **protecting customers** by:

   (a) ensuring:

      (i) quality, quantity and availability of supply (done through establishing service requirements in the regulatory agreement); and

      (ii) stability, predictability and affordability of pricing (done through the basis for setting rates established by the regulatory agreement).

   (b) supporting the rate-regulated entity's (entity) ability to fulfil the service requirements established in the regulatory agreement by **protecting the entity's financial viability** (done by ensuring the regulated rate (rate) enables the entity to obtain an adequate amount of compensation from customers in exchange for fulfilling its service requirements).

6. To achieve those objectives, there is a **binding regulatory agreement** through which:

   (a) the entity has a right to:

      (i) supply the rate-regulated goods or services (goods or services); and

      (ii) charge a **rate(s)** for those goods or services that is designed with the aim of making it viable for the entity to fulfil the specified service requirements (see paragraphs 5(b) and 7).

and **in exchange**

(b) the entity is obliged to:

(i) fulfil specified service requirements (usually related to quality, quantity and availability of supply); and

(ii) accept the basis for setting rates established in the regulatory agreement.

7. The basis for setting rates operationalises the regulatory objectives (paragraph 5) and forms part of the binding regulatory agreement (paragraph 6). The basis for setting rates helps to support the objective of protecting an entity's financial viability by giving the entity some protection against both input price risk and demand risk. As a result, the rate formula uses a **rate-adjustment mechanism** to adjust future rates for variances between estimated and actual inputs to the rate calculation. These adjustments for variances create **timing differences** between the time when a transaction or event takes place and the time when some of the effects of that transaction or event are reflected in the rate.

8. Further timing differences may arise when the rate regulator uses the rate-adjustment mechanism to reduce the volatility of rate fluctuations, which contributes to stability, predictability and affordability of pricing for customers.

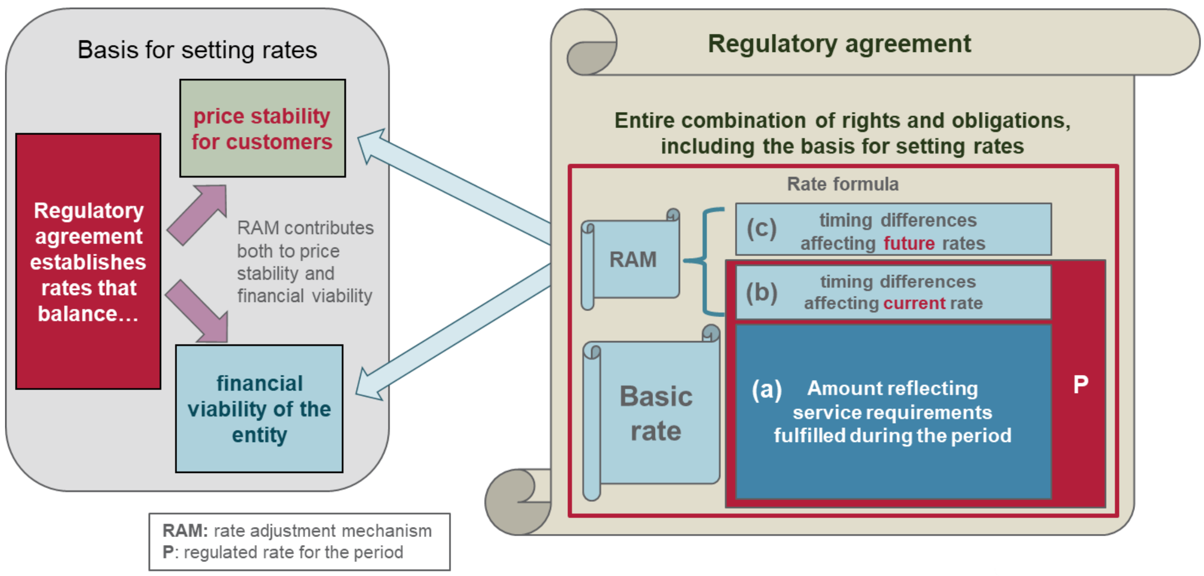
9. The regulatory agreement creates a direct and specific **cause-and-effect relationship** between the time when an entity carries out a rate-regulated activity (activity) to fulfil its service requirements and the time when amounts related to that activity are included in the rate(s) charged to customers. The direct and specific cause-and-effect relationship means that the rate formula can be used to identify (see Diagram 1):

(a) the amount of compensation included in the **current period rate** in exchange for service requirements fulfilled in the current period (**basic rate**), represented by (a) in Diagram 1;

(b) positive and negative adjustments to the **current period rate** reflecting service requirements fulfilled in earlier period(s) or to be fulfilled in later period(s), represented by (b) in Diagram 1; and

(c) positive and negative adjustments that will be made to **future period rate(s)** reflecting service requirements fulfilled in or before the current period, represented by (c) in Diagram 1.

Diagram 1



Timing differences—regulatory assets and regulatory liabilities

10. The regulated rate chargeable in the current period consists of items (a) and (b) in paragraph 9. The resulting revenue is recognised in accordance with IFRS 15 *Revenue from Contracts with Customers*.

11. Our research indicates that reporting revenue using IFRS 15 provides useful information to users of financial statements. The information both is relevant and faithfully represents what it purports to represent—the entity satisfies its customer performance obligations by delivering a quantity of goods or services (Q) in a specified period at a specified price (the regulated rate, P). When the entity delivers the goods or services, customers are obliged to pay, and the entity is entitled to receive, the amount charged (P x Q). As a result, we are not proposing to amend IFRS 15 or other existing IFRS Standards.

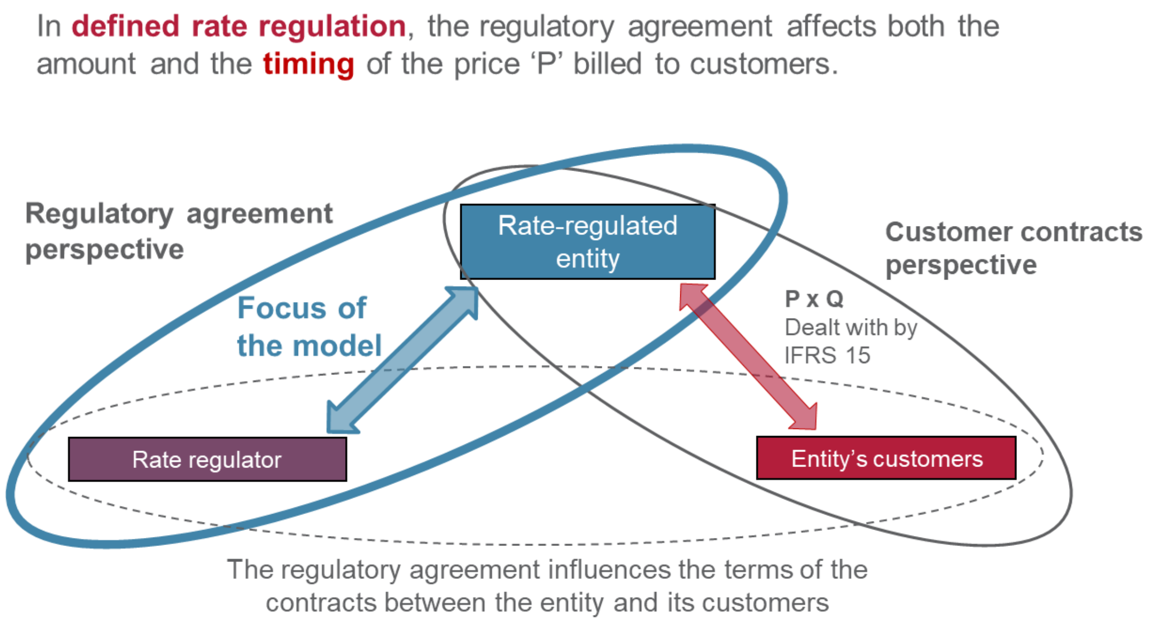
12. However, our research has also found that applying only existing IFRS Standards, without recognising the rights and obligations created by the timing differences highlighted in paragraphs 7–9, does not give a complete picture of the effects of

defined rate regulation on an entity's financial performance during the period or its financial position at the end of the period. This is because those timing differences mean that some effects of some transactions or other events are reported as income or expenses in a different period than the period in which other effects of the same transaction or event are reported.

13. Not recognising the assets or liabilities that result from the timing differences creates artificial volatility in the statement of financial performance that may mask any real economic volatility. This makes it difficult for users to assess the entity's performance for the period and the implications of that performance for the entity's ability to generate future cash inflows from its activities.

14. In developing the model, we are using a '**supplementary approach**' (see Diagram 2). This means that existing IFRS Standards, including IFRS 15, will continue to be applied without modification (ie using the customer contracts perspective in the case of IFRS 15). The model will then be applied to provide information about the effects of those timing differences (ie using the regulatory agreement perspective).

Diagram 2



15. The rights and obligations created by the timing differences are **incremental** to those reported using existing IFRS Standards and can be analysed as:

(a) present rights to charge a rate increased by a specified amount[1] as a result of past events; and

(b) present obligations to provide goods or services at a rate reduced by a specified amount[1] as a result of past events.

16. The supplementary approach used by the model recognises:

(a) in the statement of **financial position**, the incremental rights and obligations resulting from existing timing differences that will affect **future** rates (paragraph 9(c)); and

(b) in the statement of **financial performance**, the timing differences originating or reversing **during** the period (paragraph 9(b) and (c)).

Tentative decisions about the model

17. So far, the Board has reached tentative decisions on proposals for:

(a) Scope;

(b) Unit of account;

(c) Recognition of regulatory assets and regulatory liabilities; and

(d) Measurement of regulatory assets.

18. The Board's tentative decisions to date on the model are included in Appendix A.

Next steps

19. A summary of the next steps in this project can be found in Appendix B.

[1] The 'specified amount' is calculated using the rate formula, which identifies the monetary amount of the timing differences created by the regulatory agreement.

APPENDIX A—summary of tentative decisions to date

A1. The following table summarises the Board's tentative decisions made while developing the model. The bolded meeting references also include a hyperlink to the Board meeting webpages.

Topic	**Tentative decisions** (extracts from IASB Update)	**Comments**
General approach in the model	**February 2017 (Agenda Paper 9A)** The Board examined how the principle proposed in the model, as well as its general approach, make use of principles in IFRS 15 *Revenue from Contracts with Customers* and of the Board's latest thinking in the *Conceptual Framework* project. The Board tentatively decided that the staff should continue developing the model using the general approach. However, it asked the staff to rework the analysis describing the principles supporting the approach.	The model's general approach provides financial information that supplements information provided by other IFRS Standards. This means that a rate-regulated entity will apply other IFRS Standards, including IFRS 15, without amendment, before applying the model. The supplementary approach means that, using the model, an entity will then recognise rights and obligations arising from the rate-adjustment mechanism. The Board confirmed this approach in its February 2018 meeting (see unit of account section of this table).
Scope	**March 2018 (Agenda Paper 9B)** The Board tentatively decided that the accounting model should apply to defined rate regulation established through a formal regulatory framework that: (a) is binding on both the entity and the regulator; and (b) establishes a basis for setting the rate for specified goods or services that includes a rate-adjustment mechanism. That mechanism creates, and subsequently reverses, rights and obligations caused by the regulated	This tentative decision is consistent with a previous Board decision to focus on enforceable rights and obligations discussed at the Board's **February 2017** meeting. The features of defined rate regulation described in points (a) and (b) of the tentative decision in March 2018 are both necessary and sufficient for the origination of regulatory assets and regulatory liabilities.

Topic	**Tentative decisions** (extracts from IASB Update)	**Comments**
	rate in one period including amounts related to specified activities the entity carries out in a different period.	At a later meeting, the Board will discuss whether, for disclosure purposes only, it wishes to extend the scope of the resulting IFRS Standard to require disclosures about forms of rate regulation other than defined rate regulation.
Unit of account	**February 2018 (Agenda Paper 9A)** The Board tentatively decided that: (a) 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. (b) the present regulatory right—to charge a rate increased by an amount as a result of past events—meets the definition of an asset in the *Conceptual Framework*. (c) the present regulatory obligation—to provide goods or services at a rate reduced by an amount as a result of past events—meets the definition of a liability in the *Conceptual Framework*.	The rate-adjustment mechanism creates timing differences between: (a) the time when the entity fulfils the service requirements established in the regulatory agreement; and (b) the time when the entity includes the related compensation in the rate(s). Consequently, at the end of each reporting period, the entity may have some rights and obligations that are not recognised in the entity's statement of financial position using existing IFRS Standards, even though the transaction or other event that created them has already occurred. These outstanding rights and obligations are **incremental** to those reported using existing IFRS Standards. For presentation and disclosure in financial statements, the Board will consider whether, and if so when, to group timing differences with similar characteristics and risks and similar reversal patterns.

Topic	**Tentative decisions** (extracts from IASB Update)	Comments
Recognition of regulatory assets and regulatory liabilities	**March 2018 (Agenda Paper 9B)** The Board tentatively decided that the accounting model: (a) should require the recognition of regulatory assets or regulatory liabilities if it is more likely than not that they exist—the model sets a symmetrical recognition threshold in cases of existence uncertainty; and (b) should not set thresholds that would prevent recognition of a regulatory asset or regulatory liability for which there is: (i) low probability of an inflow or outflow of economic benefits; or (ii) high measurement uncertainty.	These tentative decisions build on examples discussed at the Board's **June 2017** meeting.
Measurement of regulatory assets	**May 2018 (Agenda Paper 9B)** The Board tentatively decided that the measurement of regulatory assets should reflect: (a) estimates of the future cash flows the regulatory assets will generate. These cash flows include amounts that result from: (i) the costs of assets used and operating expenses incurred; (ii) any margins on the operating expenses incurred; and (iii) any interest on the operating expenses incurred or returns on the costs of assets used. (b) discounting the estimates of future cash flows if there is a significant financing component.	In its May 2018 meeting, the Board discussed **whether** regulatory assets should be measured on a basis that uses: (a) a cash-flow-based measurement technique; (b) discounting when there is a significant financing component; and (c) updated estimates of future cash flows. In its July 2018 meeting, the Board discussed **how** to: (a) estimate future cash flows; (b) establish the discount rate to be used at initial recognition and subsequently; and (c) account for changes in the estimates of future cash flows.

Topic	Tentative decisions (extracts from IASB Update)	Comments
	The Board also tentatively decided that: (a) the measurement of regulatory assets should reflect changes, if any, in the estimates of the future cash flows the regulatory assets will generate. (b) the discount rate established at initial recognition should remain unchanged during the subsequent measurement of the regulatory assets.	
	July 2018 (Agenda Papers 9B and 9D) ***Estimating future cash flows*** The Board tentatively decided that, for each regulatory asset recognised, an entity should: (a) estimate future cash flows using either the 'most likely amount' method or the 'expected value' method, depending on which method the entity concludes would better predict the amount of the cash flows arising from a particular timing difference; and (b) apply the same method consistently from the origination of the timing difference until its reversal. The Board also discussed how an entity should determine whether to consider the outcome of each timing difference separately or together with one or more other timing differences. The Board tentatively decided such determinations should be	***Suggestions for drafting*** The Board asked the staff to develop suggestions to simplify, clarify and add guidance to the tentative decisions made at the July meeting when describing the model.

Topic	**Tentative decisions** (extracts from IASB Update)	**Comments**
	based on the approach that would better predict the amount of the resulting future cash flows. ***Significant financing component and discount rate*** *No explicit financing component* The Board tentatively decided that, if a regulatory agreement does not provide explicit compensation for the effects of time between the origination and reversal of a timing difference, an entity should use judgement to determine whether the financing component of the timing difference is significant. Such judgement should be based on the entity's facts and circumstances. If the entity concludes the financing component is not significant, discounting the future cash flows is not required. However, if the entity concludes the financing component is significant, the entity should use a 'reasonable rate' to discount the estimated future cash flows and recognise any loss in profit or loss immediately. The Board asked the staff to develop guidance on factors to consider when determining a 'reasonable rate'. *Explicit financing component* The Board tentatively decided that, when a financing component is explicit, an entity should measure the regulatory asset by discounting the estimated future cash flows using the interest rate or return rate established by the regulatory agreement for those cash flows. However, that requirement would not apply where clear	

Topic	**Tentative decisions** (extracts from IASB Update)	Comments
	evidence shows that the regulatory interest rate or return rate is set at a level that provides an excess or deficit in compensation because of an identifiable event or decision. In this circumstance, an entity should recognise the excess or deficit in compensation in the period in which the identifiable event or decision occurs. ***Changes in estimated cash flows, including changes caused by changes in the discount rate*** The Board tentatively decided that the model should adopt the treatment required by IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors* to account for changes in estimated future cash flows. Consequently: (a) the effect of a change in estimated future cash flows should be recognised prospectively in profit or loss in: (i) the period of change, if the change affects only that period; or (ii) the period of change and future periods, if the change affects both; and (b) if the change gives rise to a change in a regulatory asset, the change should be recognised by adjusting the carrying amount of the related asset in the period of change. When a regulator changes the interest rate or return rate used to compensate an entity for the period between the origination and reversal of a timing difference, the Board tentatively decided that the entity should:	

Topic	**Tentative decisions** (extracts from IASB Update)	Comments
	(a) measure the outstanding regulatory asset balance using the revised interest rate or return rate to discount the estimated future cash flows; and (b) recognise any resulting change in the carrying amount of the regulatory asset in the period of change. ***Measurement of regulatory liabilities*** The Board also tentatively decided that the model should apply the same measurement requirements for regulatory liabilities and regulatory assets.	
Presentation and Disclosure	**July 2018 (Agenda Paper 9C)** The Board started its discussions about an objective to guide the development of presentation and disclosure requirements for the model. The Board was not asked to make any decisions.	

APPENDIX B–project plan

The following table provides an overview of the project plan.

	Topic	Time
Step 1	Supplementary approach	Feb 2018
Step 2	Unit of account	Feb 2018
Step 3	Asset & liability definitions	Feb 2018
Step 4	Recognition	March 2018
Step 5	Measurement	May/July 2018
Step 6	Presentation & disclosure objectives	July 2018
Step 7	Presentation & disclosure	Nov 2018[2]
Step 8	Interaction with other IFRS Standards	Nov 2018
Step 9	Transition, consequential amendments	Nov 2018
Step 10	US GAAP comparison	Dec 2018
Step 11	Discussion Paper or Exposure Draft	Dec 2018
Step 12	Due process	Dec 2018

Discussed
Outstanding

[2] We have changed the planned sequence of discussion since the Board's July meeting so that we can report to the Board in November on advice we are seeking from ASAF members at this meeting.