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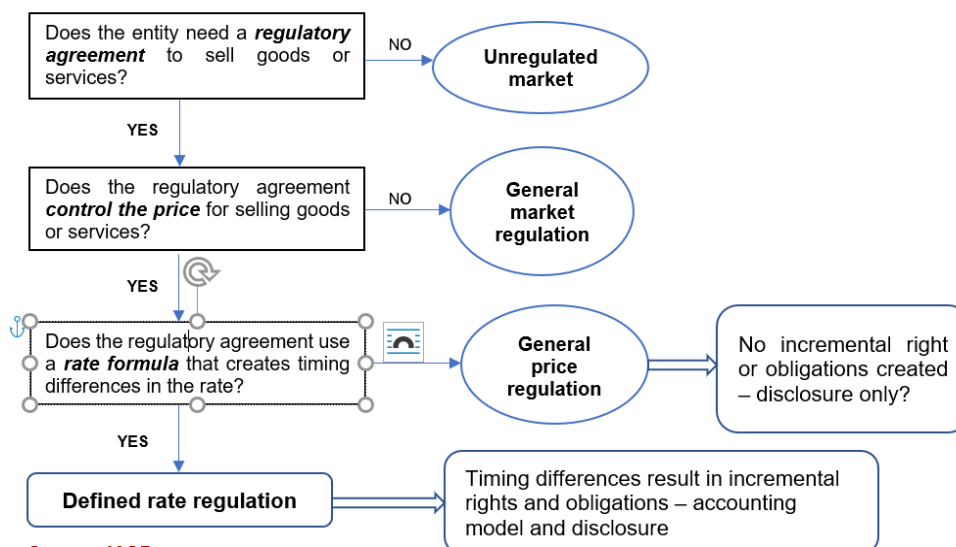
Scope of the Rate-regulated Activities project Issues Paper

Objective

- 1 The objective of this session is to **raise awareness with the EFRAG User Panel** that the scope of the upcoming exposure draft on the IASB's rate-regulated activities project (RRA project) **might affect entities that operate in a regulated industry other than the utility sector** (for which rate-regulation is typically more common). This paper is not intended to discuss the RRA project in detail.

The scope of the RRA project

- 2 Some entities are subject to regulation that states how much and when they can charge their customers for goods or services provided. Typical examples are entities supplying water and electricity services (utilities).
- 3 The scope of the RRA project will apply to **activities** that are subject to what the IASB refers to as "defined rate regulation". This type of regulation is established through a formal regulatory framework that:
 - (a) is **binding** on both the entity and the regulator;
 - (b) **defines a basis for setting the rate** to be charged to the entity's customers for goods or services; and
 - (c) gives rise to **enforceable rights and obligations**.
- 4 The following decision tree summarises the [proposed] steps to determine whether price regulation establishes a defined rate regulation:



- 5 The scope definition of defined rate regulation has been subject to several changes and revised wording over the course of the RRA project, following the IASB's Discussion Paper *Reporting the Financial Effects of Rate Regulation* (DP/2014/02) issued in September 2014. The Discussion paper noted that the regulatory agreement would need to establish a regulated rate that balances financial viability of the entity and price stability for the customers. However, the current wording of the scope definition does not specifically mention financial viability.
- 6 Under existing IFRS requirements, entities with activities subject to defined rate regulation recognise revenue under IFRS 15 *Revenue from Contracts with Customers* (and corresponding assets and liabilities) for goods or services provided to customers based on the contract with customers.
- 7 Any increase (or decrease) in revenue arising from the regulatory agreement with the regulator, for those same goods or services provided, not covered by the contract with customers, is not recognised under IFRS 15 in the period in which the goods or services are provided. The aim of the RRA project is to address the recognition of this additional (or lesser) revenue (and corresponding regulatory assets and regulatory liabilities).

Background

- 8 The IASB expects to issue an exposure draft on the RRA project in H2 2020.
- 9 The purpose of the RRA project is to provide users of financial statements with clearer and more complete information about the financial performance, financial position, and prospects for future cash flows of entities' operating activities subject to defined rate regulation.
- 10 Entities operating within a defined rate regulation environment are subject to price control: meaning that the price paid by the customer for goods and services delivered by the supplier (regulated entity) is set by a third party (the regulator) and cannot be determined by the supplier based on its independent pricing policies.
- 11 The RRA project will require entities subject to defined rate regulation to recognise as assets the rights to add amounts to future rates (regulatory assets) and as liabilities the obligations to deduct amounts from future rates (regulatory liabilities) when determining the future rates to be charged to customers for goods or services already supplied.
- 12 The RRA project is a supplementary accounting model and will apply after the requirements of other IFRS Standards have been applied such as IFRS 15 *Revenue from Contracts with Customers*, IFRIC 12 *Service Concession Arrangements* and IAS 20 *Accounting for Government Grants and Disclosure of Government Assistance* etc.
- 13 The RRA project provides recognition and measurement requirements for regulatory assets and regulatory liabilities as well as guidance on the interaction with IFRSs. Specifically, the RRA project informs that the impairment requirements under IAS 36 *Impairment of Assets* will not apply to regulatory assets. However, it is not clear how this exclusion will apply to regulatory assets within a cash-generating unit (CGU) that includes other (non-regulatory) assets. Discussions so far have stressed the need for clearer guidance on the interaction with IAS 36 to CGU's that include a mix of regulatory assets and other assets, and whether there may be broader impairment implications for assets used by the entity to provide regulated goods or services (such as a power plant) that are accounted for under existing IFRS Standards.

Activities impacted by defined rate regulation

- 14 Preliminary views indicate that there could be non-utility entities such as transport, airline services, pharmaceuticals, real-estate services etc. which operate activities subject to some form of price control that could meet the definition of defined rate regulation.
- 15 Back in 2018, the EFRAG Secretariat asked EFRAG TEG members to provide examples of potential regulated activities, outside the utility sector, with similar characteristics to activities subject to defined rate regulation. The following examples were provided:
 - (a) Example A – Transfer pricing agreement between a parent company and its subsidiary;
 - (b) Example B – Pricing mechanism agreement between a water Cooperative and its customers; and
 - (c) Example C – Concession agreement between a municipality and its school cafeteria.
- 16 These examples are presented in Appendix 1. We note that the analysis by the EFRAG Secretariat of whether the examples met the definition of defined rate regulation, was based on the previous definition of defined rate regulation. The analysis and preliminary conclusions were mainly for discussion with EFRAG TEG. The analysis and discussion highlighted that determining whether an activity could qualify as defined rate regulation would strongly depend on the interpretation of a regulator and consequently whether a binding regulatory agreement existed. Furthermore, it might be that the contractual agreements (in the example) meet the definitions of assets and liabilities under the IASB's Conceptual Framework, although they might not qualify as defined rate regulation.
- 17 The EFRAG Secretariat considers that the actual definition of defined rate regulation in the forthcoming exposure draft on the RRA project will have an important role to play when determining whether an activity is inside or outside of the scope of the project. We therefore plan to start outreach activities with users and prepares only once we have the final working of the scope of the RRA project.

Appendix 1 – Examples of activities that could potentially be within the scope of the IASB’s RRA project

Example A on “Transfer pricing agreement between a parent company and its subsidiary”

Fact Pattern

- 1 The fact pattern is summarised below:
 - (a) Group A’s subsidiaries sell its products to end customers at prices determined by the parent company. The selling prices are based on a formula (cost plus) and the transfer pricing is approved by the parent company
 - (b) The determination of the selling prices to the end customer is one element of the transfer pricing agreement. The objective is to obtain an average stable profit margin, over a specified period.
 - (c) Consequently, the parent company compensates or receives compensation from the subsidiaries based on an unconditional right or an obligation set out in the transfer pricing agreement.
- 2 Group A prepares consolidated financial statements in accordance with IFRS Standards. Its subsidiaries also prepare their financial statements under IFRS.

EFRAG Secretariat analysis

- 3 EFRAG Secretariat performed the analysis from the perspective of the rights and obligations of the subsidiary entity.

*Does the entity operate through a formal regulatory framework with a **binding regulatory agreement** to sell goods or services?*

- 4 The EFRAG Secretariat observed that the transfer pricing agreement between the parent company and its subsidiary is not established by a regulatory body through a formal regulatory framework. This means that there is no tripartite relationship with an independent regulator and the activity is not regulated under a particular law or regulatory framework.

*Does the regulatory agreement **control the price** for selling goods or services by establishing a basis for setting the rate?*

- 5 The transfer pricing agreement ensures that the subsidiary sells goods and services to its customers at an agreed profit margin. The agreement establishes a basis for setting the selling price at a subsidiary level through a pricing formula.

- 6 It could be argued that in cases when the subsidiary has delivered the goods and services and the price is corrected in a future period, a timing difference arises. The formula in the agreement adjusts the profit margin, either retrospectively or prospectively.

*Does the regulatory agreement establish a regulated rate that **balances financial viability of the entity and price stability for the customers**?*

- 7 The agreement represents a transfer pricing agreement to guarantee a profit level for the subsidiary (and ultimately the parent as it controls the subsidiary). It has not been established through a regulatory body to serve a wider regulatory objective regarding price stability and reasonable prices for the customers. The objective appears one-sided as it focuses on the interests of the subsidiary and its parent.

EFRAG Secretariat preliminary conclusion

- 8 The EFRAG Secretariat’s preliminary conclusion is that the Example does not meet the definition of defined rate regulation. This is because there is no independent rate

regulator and because the objective of determining a 'stable' profit margin for the subsidiary is to ensure a constant subsidiary/group profit margin which can be considered as a mechanism that is intended to balance the financial vitality for the entity.

- 9 However, financial viability is not included as part of the definition of defined rate regulation. Moreover, there is no indication that the economic interest is to ensure that the customers can acquire the goods or services at a reasonable price, and no indication that the goods or services are essential in nature which is part of the financial viability definition.

Example B – Pricing mechanism between a water Cooperative and its customers

Fact pattern

- 10 In certain countries cooperatives are very common in sectors such as agriculture and utilities and are established to serve the members of the cooperatives' community. In this example, Cooperative B is privately owned and supplies water to its members. Cooperative B prepares consolidated financial statements in accordance with IFRS Standards.

- 11 The fact pattern is summarised as follows:

- (a) Cooperative B is obliged to sell water to its members and the members of the cooperative, which are also its owners, are required to purchase water from it. Often, the members are not allowed to purchase water from a different water supplier as long as they are members of the cooperative.
- (b) Cooperative B establishes the price of water it delivers to its members based on a pricing mechanism included in the articles of association of the cooperative or based on an agreement between the cooperative and its members.
- (c) The pricing mechanism often reflects the overall objective that the cooperative's profit margin on average should be nil or relatively low based on a specific cost formula. When setting the water prices, the cooperative is not under the supervision of a regulator, although the objective is to ensure that it provides water services at a reasonable price to its members, which are also the owners of the cooperative.

EFRAG Secretariat analysis

- 12 The EFRAG Secretariat performed the analysis from the perspective of the rights and obligations of Cooperative B.

*Does Cooperative B operate through a formal regulatory framework with a **binding regulatory agreement** to sell goods or services?*

- 13 The EFRAG Secretariat observes that the pricing mechanism included in the articles of association of Cooperative B or based on an agreement between the cooperative and its members is not established by a third party or formal regulatory framework. The EFRAG Secretariat does not consider that the cooperative's articles of association are the equivalent of a formal regulatory framework.

*Does the regulatory agreement **control the price** for selling goods or services under a rate-setting mechanism?*

- 14 The selling price is based on a cost formula that is established through a pricing mechanism included in the articles of association or agreement between the cooperative and its members.

Does the regulatory agreement establish a regulated rate that balances financial viability of the entity and price stability for the customers?

- 15 The EFRAG Secretariat understands that the pricing mechanism established through the cost formula aims to guarantee supply of water services at affordable prices to customers and at the same time enabling the cooperative to maintain its financial viability through a guaranteed a profit level. In other words, the indication is that the mechanism aims to balance the viability of Cooperative B and price stability for the customers.

EFRAG Secretariat preliminary conclusion

- 16 We think that the water services provided by Cooperative B have similar features to defined rate regulation – firstly because they are subject to a rate-setting mechanism and secondly because the objective of that mechanism is to balance the financial viability for Cooperative B and the price stability for the customers.
- 17 However, although there is a binding agreement, we think that there is no evidence of a regulatory framework. Cooperative B is privately owned by its members who are also the customers. On this basis, our preliminary conclusion is that the activities would not qualify for defined rate regulation.
- 18 Furthermore, because the members are also the owners of the cooperative, one could argue that any benefits or costs imposed on the members (in the form of the rate adjustments), could result from their capacity as owners of the cooperative. To assess whether existing IFRS Standards apply, a more detailed fact pattern of how this works in practice would be needed, including information on the rights and obligations the members have as owners of the cooperative.

Do the rights of Cooperative B meet the definition of an asset?

- 19 Under the articles of association of the cooperative or based on an agreement between the cooperative and its members, Cooperative B appears to have the unconditional right to receive compensation from its members by increasing the price in future years or by retrospective adjustment when the profit margin for a particular year is lower than the level specified in the agreement.
- 20 Consequently, the cooperative controls the right to receive compensation (present economic resource) when its members consume less water and the cooperative achieves lower profit margin (past event) than the one set out in the agreed price mechanism.
- 21 In the EFRAG Secretariat's view, Cooperative B's unconditional right to receive economical compensation meets the definition of an asset as defined in the Conceptual Framework.

Do the obligations of Cooperative B meet the definition of a liability?

- 22 Conversely, Cooperative B has the unconditional obligation to give compensation to its members by reducing the price in future periods when the profit margin for a particular year is higher than the agreed margin.
- 23 Consequently, Cooperative B appears to have the unconditional obligation to compensate (transfer an economic resource) when its members consume more water and the cooperative achieves higher profit margin (past event) than the agreed margin.
- 24 In the EFRAG Secretariat's view, the Cooperative B's unconditional obligation to compensate its members for any shortfall of realised profit margin meets the definition of a liability as defined in the Conceptual Framework.

In summary

- 25 In Example B, in the EFRAG Secretariat's view:
- (a) The subsidiary is not subject to defined rate regulation; although we acknowledge that it is a 'borderline' case given the similar features; and

- (b) The rights and obligations of the subsidiary meet the definitions of assets and liabilities in the Conceptual Framework.

Example C – Concession agreement between a municipality and its school cafeteria

Fact pattern

26 The fact pattern is summarised as follows:

- (a) Municipality A owns and runs a school cafeteria.
- (b) Municipality A outsources the operation of the school cafeteria to a commercial operator ('the operator'). The activities of the operator are based on a lease contract and a service agreement with Municipality A. Under the lease contract the operator leases the facilities and buys certain pieces of equipment which will be returned at fair value at the termination of the lease.
- (c) Under the service agreement the Operator is reimbursed by Municipality A:
 - (i) based on targeted per-unit cost to produce and serve the meals plus a pre-determined profit margin less revenue received from the sale of the meals; and
 - (ii) for the cost and profit margin for free meals delivered to students who are not able to pay the target price.
- (d) The Operator of the school cafeteria offers meals to students at reduced (subsidised) prices considered affordable for the students. The prices are based on a target price per meal established by Municipality A and is less than the per-unit cost to produce and serve the meal. The targeted per-unit cost of the meal is based on an estimated number of meals and is calculated based on a minimum occupancy of the school and not on a minimum number of meals served.
- (e) If the Operator sells the estimated number of meals or more, it will fully recover its period costs. However, if occupancy is below the guaranteed minimum, the reimbursements will be reduced proportionally. The Operator receives its reimbursements monthly, however, because the reimbursements are based on historic data, subject to audit and reviewed every 3 years, it is possible that the operator may face situations where the period costs will be reimbursed after the end of the review period.

27 The lease and service agreements may have additional features that might grant the Operator exclusive right to sell certain goods and services apart from the reimbursable lunch meals. The pricing of these items is at the operator's discretion.

28 Assume the Operator reports under IFRS.

EFRAG Secretariat analysis

29 The EFRAG Secretariat performed the analysis from the perspective of the rights and obligations of Operator.

*Does the Operator operate through a formal regulatory framework with a **binding regulatory agreement** to sell goods or services?*

30 The Operator fulfils its responsibilities to deliver meals to the students at subsidised prices based on the service agreement with Municipality A. There is no third party regulator that observes and regulates the activities of the operator under a formal regulatory framework.

*Does the regulatory agreement **control the price** for selling goods or services under a **rate-setting mechanism**?*

- 31 The pricing mechanism is one of a price control that is adjusted when pre-determined profit margins are not achieved. The EFRAG Secretariat understands that the per-unit cost of a meal for a particular period is 'capped' so that it guarantees affordability of meals to students.
- 32 The fact that the Operator is compensated for the difference between the per-unit cost to produce and serve the meals including a certain profit margin and revenue received from the sale of meals is a pricing mechanism to regulate the price of meals over the period of the service contract with the municipality.
- 33 The revision of meal prices over the period of the service contract is a change in estimate of canteen occupants from the initially considered historical number of students and school staff.

*Does the regulatory agreement establish a regulated rate that **balances financial viability of the entity and price stability for the customers**?*

- 34 The service agreement between the operator and the municipality effectively caps the unit price per meal. In addition, any shortfall in the cafeteria demand which would not allow the operator to recover its unit costs plus promised profit margin is reimbursed by the Municipality and not from the customers.

EFRAG Secretariat preliminary conclusion

- 35 The EFRAG Secretariat is of the opinion that the fact pattern described in this example could be within the scope of existing IFRS Standards such as IAS 20 *Accounting for Government Grants and Disclosure of Government Assistance* and IFRIC 12 *Service Concession Arrangements* based on the following:
- (a) *Subsidised canteen services* - the shortfall in the agreed profit margin is reimbursed by Municipality A and not the customers, which indicates that Municipality A pays subsidies to the operator to carry out the canteen service.
 - (b) *Public-to-private arrangement* – the contractual agreement between the operator and Municipality A appears to be a public-to-private arrangement. The municipality regulates the type of services (some of the services) that the operator provides to the students, the quality of food and dietary requirements and the price per unit of meal.
 - (c) *Control of infrastructure* - the infrastructure given by the municipality to the operator under the lease contract is *de facto* not controlled by the operator as Municipality A partly controls the price per meal and this affects whether the operator controls the infrastructure.

Do the rights and obligations of the operator meet the definitions of an asset and a liability?

- 36 The EFRAG Secretariat is of the view that the activities in Example C would fall under IFRIC 12 and IAS 20. Because the customers are not responsible for the shortfall, we do not think they would fall under the scope of the IASB rate-regulated activities project.
- 37 If the service agreement is within the scope of IFRIC 12, the operator might use the financial asset model or the intangible asset model to account for its rights and obligations arising from the agreement. If IFRIC 12 could not be applied, then IAS 20 might apply to the financial support received from Municipality A.

In summary

- 38 In Example C, in the EFRAG Secretariat's view:
- (a) The Operator is not subject to defined rate regulation; and

- (b) The activities are likely to fall within existing IFRS Standards.

Overview of EFRAG Secretariat preliminary conclusions

39 The following table summarises the EFRAG Secretariat preliminary conclusions for each of the examples:

| | Defined rate regulation | | | Assets under the CF | Liabilities under the CF |
|-----------|------------------------------|------------------------|--|---------------------|--------------------------|
| | Binding regulatory agreement | Rate-setting mechanism | Balances financial viability for the entity and price stability for the customer | | |
| Example A | X | ✓ | X | ✓ | ✓ |
| Example B | X | ✓ | ✓ | ✓ | ✓ |
| Example C | Existing IFRS Standards | | | | |