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Project: **Rate-regulated Activities**

Paper Topic: Results of research on the decision-usefulness of financial information that reflects the economics of rate-regulated activities

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This paper has been prepared for discussion at a public meeting of the Accounting Standards Advisory Forum (ASAF). The paper was developed at the direction of the AcSB as part of its research program, and is provided to ASAF members to further the work of the IASB and the national standard setters.

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Executive Summary

1. This paper takes a "fresh look" at the topic of rate-regulated activities. It explores what constitutes decision-useful information by assessing data taken from the practical experiences of users of the financial statements of entities with activities subject to rate regulation ("rate-regulated entities").

2. Section I of the paper demonstrates that rate-regulated entities are an important part of the equity and debt markets in Canada and beyond. Projected future global investment requirements in the power sector highlight the need for capital and, thus, the importance of useful financial information to assist users in making informed decisions.

3. The data in Section II emphasizes the need for users to understand the regulatory framework in which the rate-regulated entity operates. The regulatory framework governs the relationship between the rate regulator and the rate-regulated entity, and has many components. The main components are: the legislation underlying the framework; the rules and procedures established by the rate regulator; and the decisions that interpret the legislation and rules. The regulatory framework:

   (a) defines the environment in which the rate-regulated entity operates;

   (b) affects whether the entity has rights and obligations resulting from the performance of its rate-regulated activities; and

   (c) has a significant bearing on the entity's financial performance and future cash flows.

4. The components of the regulatory framework influence the form of rate regulation chosen by the rate regulator to establish the rates charged to customers for the regulated goods or services. More commonly today, the form of rate regulation includes attributes of both cost-of-service and incentive-based mechanisms in order to balance both entity and customer interests. Understanding the details of the form of rate regulation is necessary in order to account for the economics of the entity's rate-regulated activities.

5. Section III demonstrates that the strength of the regulatory framework affects the enforceability of the economic resources of, and claims against, the entity. In addition, the nature and risk profile of recognized balances arising from rate regulation can vary. This affects the degree of uncertainty associated with such balances and, as a result, their subsequent measurement to capture the economics of rate-regulated activities.

6. In Section IV, the data demonstrates that the regulatory framework in which an entity operates is a key factor considered by debt and equity analysts, as well as credit rating agencies. The various components of the regulatory framework can affect the financial performance and future cash flows of the entity. Prospective purchasers use financial information that reflects the economics of rate-regulated activities in determining the purchase price to acquire assets used in such activities. The data demonstrates that investors are paying a premium for these assets because they are viewed as capable of generating stable earnings and cash flows when the regulatory framework is strong. For jurisdictions, such as Canada and the U.S., that recognize balances arising from rate regulation on the face of the financial statements, the purchase price allocations examined revealed that the carrying value of these balances generally approximates their fair value.

7. The data presented in this paper supports the conclusion that financial information that reflects the economics of rate-regulated activities is useful. Such financial information has confirmatory and predictive value that is capable of making a difference in the decisions made by users.

Introduction

Objective of Research

8. The objective of this paper is to explore what constitutes decision-useful information by assessing data taken from the practical experiences of users of the financial statements of rate-regulated entities.

9. General purpose financial reporting should provide financial information about the reporting entity that is useful to existing and potential investors, lenders and other creditors in making decisions about providing resources to the entity.[1] The decisions of financial statement users depend on the returns they expect, which, in turn, depend on their assessment of the amount, timing and uncertainty of the entity's future cash flows. In order to make such an assessment, users need information about the entity's resources, claims against the entity, and how efficiently the entity's management and governing board have discharged their responsibilities to use the entity's resources.

10. In the case of rate-regulated entities, the amount, timing and degree of certainty or uncertainty of the entity's future cash flows is affected by the presence of rate regulation. The IASB's September 2014 Discussion Paper, "Reporting the Financial Effects of Rate Regulation" notes that users have told standard setters that they need information about the effects of rate regulation when such regulation affects both the price charged to customers, and the management and profitability of the business. The objective of the IASB's Rate-regulated Activities project is to identify what information about the financial effects of rate regulation is most relevant to financial statements users, and determine how best to reflect that information in IFRS financial statements.

11. "Balances arising from rate regulation" are the rights and obligations of an entity resulting from the performance of activities to provide goods or services subject to rate regulation. Users often refer to the strength of the regulatory framework in explaining why including the effects of rate regulation on the face of the financial statements provides useful information. They understand that these balances have risk attributes that can affect the amount and timing of their ultimate recovery or settlement. However, when the regulatory framework is strong, these risk attributes may resemble the risk attributes of other financial statement elements. As such, users view audited financial information that reflects the economics of rate-regulated activities as both vital and

[1] The *Conceptual Framework for Financial Reporting*, paragraph OB1

transparent. In turn, this financial information is helpful to their assessment of the entity's future cash flows and the returns they can expect.

12. In examining the decision-usefulness of financial information that reflects the economics of rate-regulated activities, this paper presents data in several areas pointing to:

    (a) the importance to the capital markets of entities subject to rate regulation; (Section I)

    (b) the importance of understanding the regulatory framework in place, which, in part, determines whether the entity has rights and obligations requiring a particular accounting treatment; (Section II)

    (c) the manner in which the strength or weakness of the regulatory framework can affect the enforceability of the recovery of the entity's economic resources and settlement of claims against it; (Section III) and

    (d) how users have factored financial information that reflects the economics of rate-regulated activities into their decision-making. (Section IV)

Focus

13. Given the time available to prepare this paper and the ability to access the data being sought, this paper focuses mainly on Canadian facts and circumstances. When possible, data from other jurisdictions has also been incorporated as a basis for comparison in a particular area. (See "Next Steps" for further work that could be done to widen the paper's focus and provide a global perspective.) In most cases, the data presented in this paper is from readily available sources such as publications, reports and financial statements. The paper identifies the few instances when published data is not available and anecdotal information has been provided instead.

14. Much information exists on the topic of rate-regulated activities, including information submitted to the IASB as part of its current project. For example, some of the data in this paper is derived from stakeholders' comment letters to the IASB. The AcSB staff has been able to review only a portion of the existing body of information, but thinks the paper addresses points of fundamental significance to the objective of this paper. A neutral approach was taken to collecting the data. That is, pertinent information was sought and included in the paper, regardless of whether a particular piece of information could be viewed by individual readers as either positive or negative in any sense.

Purpose of Discussion

15. The IASB and national standard setters will be asked to provide input on the extent to which:

    (a) the paper's findings apply to their jurisdictions, or

    (b) the data should be updated to be more inclusive from a global perspective.

Section I. Importance to the Capital Markets of Entities Subject to Rate Regulation

Key Observations

- In Canada, rate-regulated entities are mainly in the Utilities and Pipelines sector.
- As of December 31, 2015, approximately $137.3 billion (6%) of the total $2.3 trillion market capitalization in Canada comes from rate-regulated entities. Sizable portions of two of the largest Canadian rate-regulated entities (i.e., Enbridge Inc., and TransCanada Corporation) are owned by investors outside Canada.
- Government-owned rate-regulated entities have over $100 billion of outstanding debt. Investor-owned rate-regulated entities make up over $90 billion of the corporate bond market.
- From a global perspective, the 10 largest utilities (by market capitalization) are located in the U.S. and parts of Europe.
- The International Energy Agency estimates $16.4 trillion of global investment over 2014-2035 will be needed in the power sector to construct new, and refurbish existing, generation plants and transmission and distribution networks. The form of rate regulation used by the regulator will affect an entity's ability to raise capital.

Canadian Rate-regulated Entities

16. There are two main types of rate-regulated entities in Canada:

    (a) Government-owned (i.e., public sector entities that are classified as either "Government Business Enterprises"[2] or "other government enterprises")

    (b) Investor-owned (i.e., publicly-held or privately-held entities)

[2] CPA Canada Public Sector Accounting Handbook defines a Government Business Enterprise as follows: (a) it is a separate entity with the power to contract in its own name and that can sue and be sued; (b) it has been delegated the financial and operational authority to carry on a business; (c) it sells goods and services to individuals and organizations outside of the government reporting entity as its principal activity; (d) it can, in the normal course of its operations, maintain its operations and meet its liabilities from revenues received from sources outside of the government reporting entity.

17. Prior to Canada's adoption of IFRS in 2011, most of these two types of entities applied pre-changeover Canadian GAAP. Similar to United States (U.S.) GAAP, pre-changeover Canadian GAAP permitted the financial statement recognition of balances arising from rate regulation. However, since 2011, greater diversity has appeared in the accounting frameworks being applied by Canadian rate-regulated entities, due in part to efforts by standard setters and Canadian securities regulators to provide some stability for these entities while the IASB completes its work on this topic.

18. The accounting framework landscape for Canadian rate-regulated entities is currently diverse. For annual periods beginning on or after January 1, 2015, rate-regulated entities that are Canadian publicly accountable enterprises[3] are required to apply IFRS. Rate-regulated entities that adopted IFRS for the first time after IFRS 14 *Regulatory Deferral Accounts* was issued continue to recognize these balances. Government Business Enterprises (which operate to generate a profit or on a break-even basis) that are also rate-regulated entities are also directed to apply standards applicable to for-profit entities, and thus apply IFRS. Canadian securities legislation permits dual-listed entities (i.e., Canadian entities also registered with the U.S. Securities and Exchange Commission) to apply U.S. GAAP in the normal course. Temporary exemptive relief is also available from the Canadian Securities Administrators that permits rate-regulated entities that are not dual-listed to apply U.S. GAAP in place of IFRS.[4] If a rate-regulated entity is not a publicly accountable enterprise or a Government Business Enterprise, additional accounting framework options may also include Accounting Standards for Private Enterprises or Public Sector Accounting Standards.[5] A non-GAAP reporting framework is used when legislated by the provincial owner of a government-owned rate-regulated entity.

19. As of December 31, 2015, there were approximately 125 rate-regulated entities in Canada. These entities mainly range in size from small entities owned by municipal governments to large investor-owned entities or entities owned by provincial governments.

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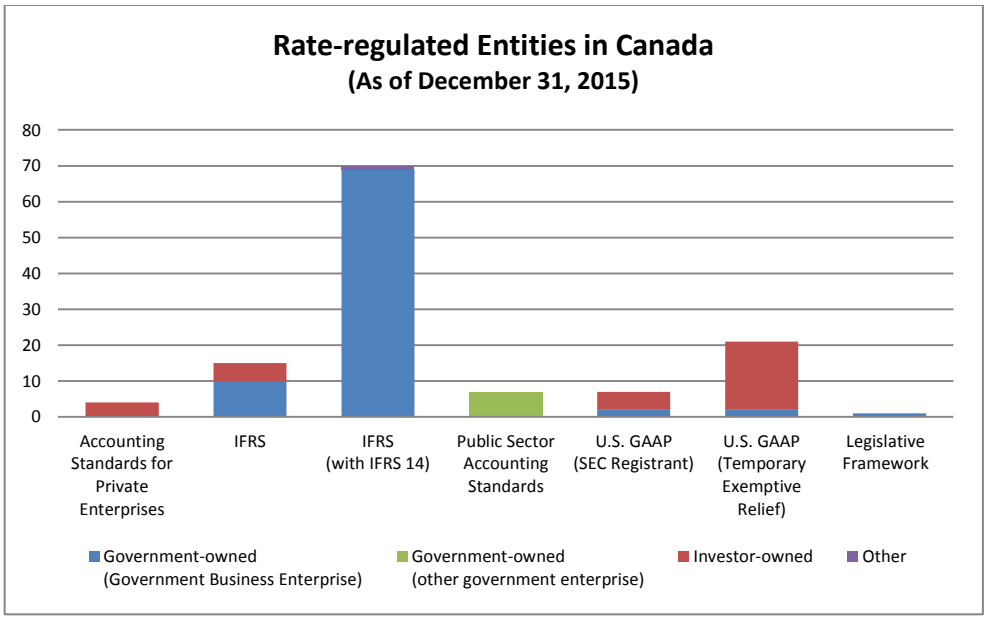
3 CPA Canada Handbook – Accounting defines a publicly accountable enterprise as an entity, other than a not-for-profit organization, that (i) has issued, or is in the process of issuing, debt or equity instruments that are, or will be, outstanding and traded in a public market (a domestic or foreign stock exchange or an over-the-counter market, including local and regional markets); or (ii) holds assets in a fiduciary capacity for a broad group of outsiders as one of its primary businesses.

4 The exemptive relief is in effect until the earlier of January 1, 2019 or the effective date prescribed by the IASB for mandatory application of an IFRS standard specific to entities with activities subject to rate regulation.

5 Accounting Standards for Private Enterprises are domestic standards written by the AcSB and Public Sector Accounting Standards are domestic standards written by the Public Sector Accounting Board, Canada's other accounting standard setter.



Source: Information compiled based on audited financial statements for fiscal year 2015, or information from rate filings that confirmed the accounting framework used by these entities. Due to data collection constraints, the population could be slightly larger.

20. The chart above highlights two key points:

(a) The majority of investor-owned entities have chosen U.S. GAAP over IFRS. A few entities that are not reporting issuers apply Accounting Standards for Private Enterprises. Both U.S. GAAP and Accounting Standards for Private Enterprises permit the recognition of balances arising from rate regulation. Several entities that apply U.S. GAAP have told us this choice was influenced by the need to provide their users with financial statements that accurately reflect the economics of their business. Further, some entities presently using the temporary exemptive relief described in paragraph 18 have said they are considering incurring the cost and effort necessary to become a registrant of the U.S. Securities and Exchange Commission in order to have the permanent ability to apply U.S. GAAP. While such a decision could be primarily for business reasons such as the entity expanding its operations into the U.S., it could also be attributed to the continuing uncertainty about the ultimate outcome of the IASB's Rate-regulated Activities project and the approaching expiry date of the securities regulators' exemptive relief.

(b) Public sector entities that are Government Business Enterprises tend to apply IFRS. The majority of these entities is made up several large provincially-owned utilities, and many small municipally-owned local distribution utilities that do not issue debt or list in the U.S. stock market, and are not subject to Canadian securities legislation. As a result, they cannot apply U.S. GAAP. As shown in the chart, many of these entities adopted IFRS for the first time after

the IASB issued IFRS 14, which allowed them to continue their previous accounting practices for rate-regulated activities.

21. Within the pool of government-owned rate-regulated entities, there are entities that do not meet the characteristics of Government Business Enterprises and are required to apply Public Sector Accounting Standards.

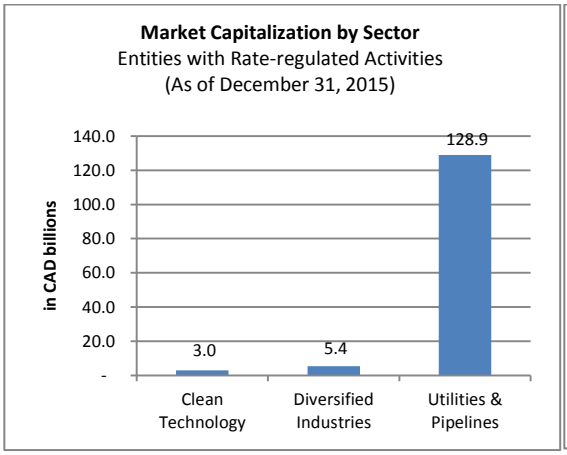
22. The data on the different accounting frameworks in Canada is unique. It demonstrates that when given a choice, rate-regulated entities select an accounting framework that captures the effects of rate regulation on their financial position and financial performance in order to communicate more decision-useful information to users.

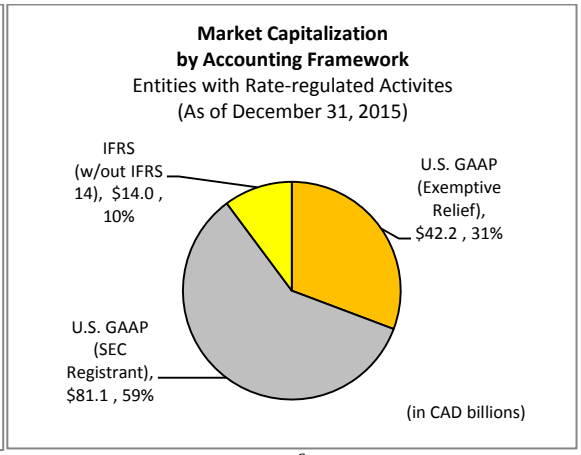
Equity Market

23. Investor-owned rate-regulated entities form an important part of the Canadian equity market.

24. As of December 31, 2015:

- $137.3 billion (6%) of the total $2.3 trillion market capitalization in Canada comes from rate-regulated entities.
- The majority of entities with rate-regulated activities are in the Utilities & Pipelines sector.
- Entities that represent 90% of the total rate-regulated entities' market capitalization apply U.S. GAAP.





Source: Information compiled using data from the entities' financial statements and from the TMX[6].

[6] TMX Group is an integrated, multi-asset class exchange group. TMX Group's businesses operate cash and derivative markets for multiple asset classes including equities, fixed income and energy. The Toronto Stock Exchange (TSX) and TSX Venture Exchange (TSXV) are part of the TMX Group.

25. The table below shows the amount of equity capital that continues to be raised year over year by the Canadian Utilities and Pipelines sector as a whole.

in CAD billions

Utilities and Pipelines Sector (includes both rate-regulated and non-rate regulated entities)	**2014**	**2015**
Market Capitalization	$189.0	$164.0
Equity capital raised since 2010	$25.1	$31.9
Equity capital raised in the year	$8.0	$6.8
Average offering size for issuers	$0.4	$0.5
Number of Financings	20	14

Source: TMX

26. Global investors also view rate-regulated entities in Canada as an investment opportunity. Staff looked at the two largest entities with rate-regulated operations in Canada (by market capitalization) and noted that, in each case, a sizable portion of the entity's ownership holdings is outside Canada, primarily in the U.S. The extent of U.S. ownership could be one of the reasons why some Canadian rate-regulated entities with operations in the U.S. have decided to apply U.S. GAAP. Also, Canadian rate-regulated entities compete for capital in the North American markets and want their financial statements to be comparable with their competitors in the U.S.

Enbridge Inc.
(Market Cap approximately $35 billion)

Top Geographic Ownership as of July 26, 2016	
United States	45.22%
Canada	44.46%
Germany	3.34%
Britain	1.53%
Switzerland	1.16%
Australia	0.96%
Norway	0.82%
Netherlands	0.68%
Japan	0.54%

TransCanada Corporation
(Market Cap approximately $47 billion)

Top Geographic Ownership as of July 24, 2016	
Canada	58.29%
United States	27.09%
Germany	5.51%
Britain	2.28%
Switzerland	2.05%
Norway	1.10%
Australia	0.72%
Japan	0.71%
Ireland	0.46%

Debt Market

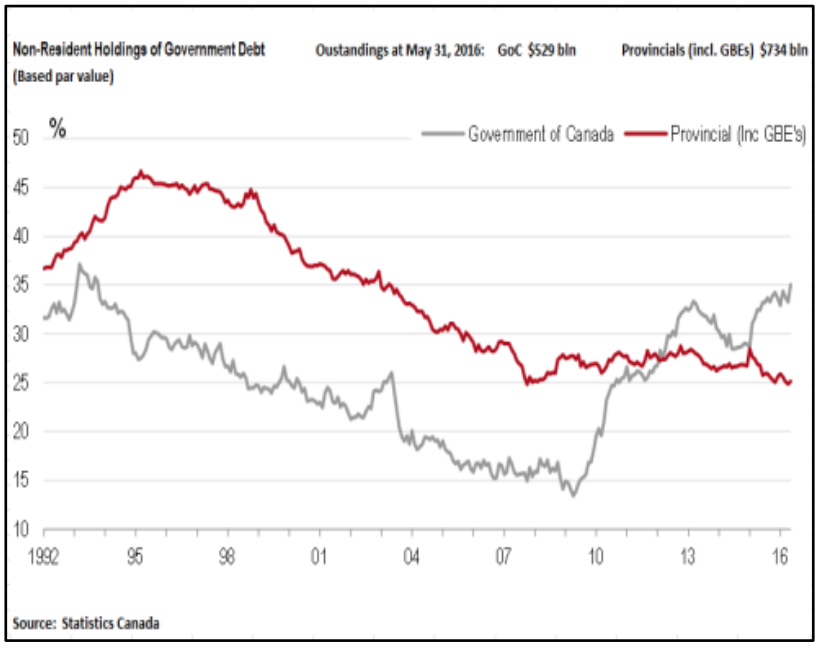
27. Government Business Enterprises are not prominent in the equity market.[7] However, they form an important part of the debt market, as they raise capital by issuing bonds or debentures, and through loan borrowings, in order to carry out their operations and fund their capital infrastructure projects.

28. The following table illustrates the debt outstanding for some of the larger government-owned rate-regulated utilities, and the accounting framework they apply:

Government-owned rate-regulated utility	**Accounting Framework**	**Debt (in CAD billions)**
Hydro-Québec	U.S. GAAP	$46
BC Hydro	Legislative GAAP	18
Manitoba Hydro	IFRS with IFRS 14	15
Hydro One	U.S. GAAP	9
Nalcor Energy	IFRS with IFRS 14	6
Ontario Power Generation	U.S. GAAP	5
New Brunswick Power	IFRS with IFRS 14	5
Toronto Hydro	IFRS with IFRS 14	2
Total of Sampled Entities		**$106**

Source: Information compiled based on the entity's financial statements as of December 31, 2015 (except for BC Hydro, Manitoba Hydro, and New Brunswick Power, which are as of March 31, 2016)

29. Although staff has not been able to gather data indicating how much of the government-owned utilities' debt is held by foreign investors, Statistics Canada shows that the non-resident holdings (i.e., holdings of owners residing outside Canada) of provincial debt that includes Government Business Enterprises was almost 30% in 2015. The chart to the right provides a sense of the percentage of non-resident holdings of government debt from 1992 to 2016.



[7] Due to the recent implementation of the Province of Ontario's privatization plan for Hydro One, this entity currently has shares traded on the TSX.

30. The corporate bond market is equally important for publicly held investor-owned rate-regulated entities in raising capital to fund their capital infrastructure and ongoing business operations. The table below roughly illustrates the portion of the corporate bond market index made up of sub-industry groups containing most of the publicly held investor-owned rate-regulated entities. (Note: The sub-industry groups could also include entities that are not subject to rate regulation.)

Canadian Corporate Bonds (As of July 27, 2016)	**Market Value (in CAD billions)**	**Percentage of Total**
Total Corporate Bonds from Canadian FTSE TMX Universe Bond Index[8]	**$417.4**	**100%**
Industry Group: Energy		
Distribution	19.5	4.7%
Generation	9.1	2.2%
Pipelines	30.5	7.3%
Industry Group: Infrastructure		
Utility	33.2	7.9%
Total Corporate Bonds related to Sub-Industry Groups with Rate-regulated Entities	$92.3	22.1%

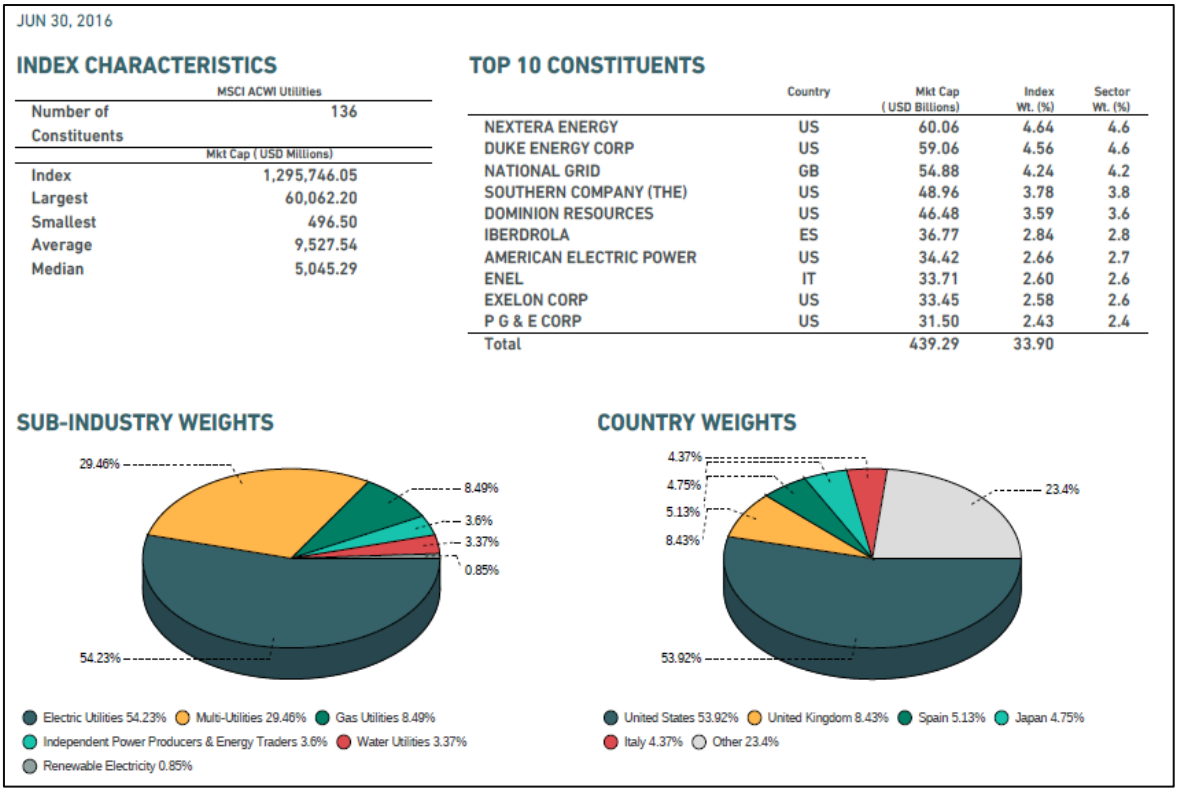
Source: Information compiled based on data from PC Bond.

Global Perspective – Market Capitalization by Geography

31. Staff also wanted to understand which jurisdictions make up a large part of the global market capitalization for utilities. Research efforts identified a utilities index that captures large- and mid-cap representation across 23 "Developed Markets" and 23 "Emerging Markets" countries.[9] This index has some limitations because certain utilities could be government-owned or privatized and, thus, would not be captured. Furthermore, the index could also contain entities that are both rate-regulated and non-rate-regulated. However, the information provides a general sense of the geographic distribution of utilities in the equity market. It appears that many of the large utilities are in the U.S., with several in Europe (for example, United Kingdom, Spain, Italy).

8 The Universe Bond Index is the broadest and most widely used measure of performance of marketable government and corporate bonds outstanding in the Canadian market. The table above only shows figures relating to Canadian corporate bonds.

9 As per the MSCI ACWI Utilities Index, "Developed Markets" countries include: Australia, Austria, Belgium, Canada, Denmark, Finland, France, Germany, Hong Kong, Ireland, Israel, Italy, Japan, Netherlands, New Zealand, Norway, Portugal, Singapore, Spain, Sweden, Switzerland, the UK and the US. "Emerging Markets" countries include: Brazil, Chile, China, Colombia, Czech Republic, Egypt, Greece, Hungary, India, Indonesia, Korea, Malaysia, Mexico, Peru, Philippines, Poland, Russia, Qatar, South Africa, Taiwan, Thailand, Turkey and United Arab Emirates.



Source: MSCI (The MSCI ACWI Utilities Index – All securities in the index are classified in the Utilities sector as per the Global Industry Classification Standard)

Future Trends and Investment Requirements

32. Through the research performed, staff has learned that various jurisdictions are undergoing energy reforms. For example:

(a) The regulatory environment of Europe, the Middle East, India and Africa is dynamic, with many countries focusing on opening their power sectors to competition and private investments.

(b) Reforms are occurring to break up monopolies in China. In 2014, China's National Energy Administration submitted plans to the State Council, advising the breakup of grid operators' monopoly in the distribution and retail sale of electricity to the end customer. These reforms will potentially open the power market to private capital and other investments.

(c) In Japan, it is expected that deregulation and the entrance of new players will transform the country's power market as there is a move towards breaking up vertically-integrated utilities and introducing full retail competition. There are plans to unbundle the 10 integrated utilities

into separate power generation, transmission, distribution and supply entities over the next few years. In June 2014, Japanese lawmakers voted to open up the residential electricity market to full competition.

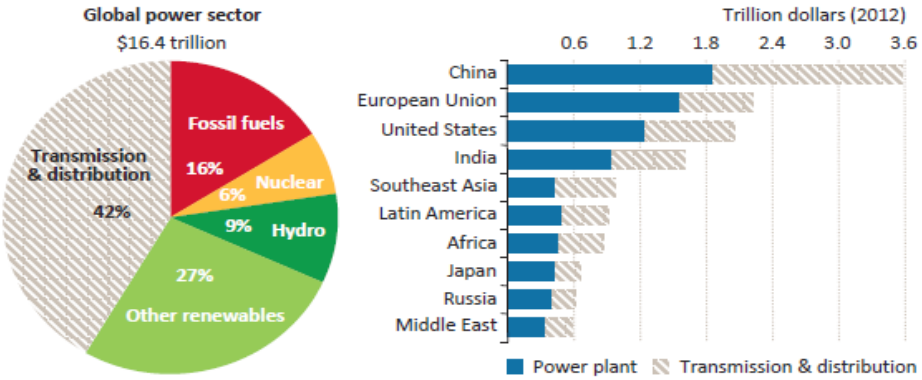
33. Based on statistics from the International Energy Agency, the projected global investment requirements in the power sector are in the area of $16.4 trillion over the period 2014-2035. The International Energy Agency's projections indicate:

> "…by far the greater part of the investment will be needed in markets that are mostly regulated. Over 2014-2035, with current market designs, less than $1 trillion will be required in the competitive parts of electricity markets out of the cumulative $9.6 trillion invested in power plants, with an additional $6.8 trillion needed for T&D [transmission and distribution] grids, for cumulative power sector investment of $16.4 trillion."[10]

Investment requirements

Global investment in the power sector amounts to $16.4 trillion over 2014-2035 in the New Policies Scenario, an annual average of about $740 billion per year. This represents some 40% of investment in energy supply infrastructure during that period. About 58% of power sector investment is allocated to the construction of new power plants and refurbishment of existing ones; the remainder is used to build and refurbish T&D networks. At the regional level, cumulative investment needs are largest in China ($3.6 trillion), followed by the European Union ($2.2 trillion), United States ($2.1 trillion), India ($1.6 trillion) and Southeast Asia ($1.0 trillion) (Figure 3.7).

Figure 3.7 ▷ Cumulative global power sector investment by type and selected region in the New Policies Scenario, 2014-2035



Source: Special Report World Energy Investment Outlook 2014

[10] Source: Special Report World Energy Investment Outlook 2014, Page 107

34. With aging infrastructure, government-imposed environmental targets and changing power demand, energy reforms will continue and the form of rate regulation will evolve to balance the needs of the customers and the financial viability of the entity in attracting capital. Providing information about the economics of rate-regulated activities will help investors and lenders to identify the opportunities and risks created by the regulatory framework in which the entity operates and assist them in making more informed decisions.

What this Section Demonstrates

35. Rate-regulated entities are important to the capital markets, and thus, to users making investment and lending decisions. Financial information that reflects the economics of rate-regulated activities, and is consistent between jurisdictions for entities with similar facts and circumstances increases comparability and is more decision-useful.

Section II. Importance of Understanding the Regulatory Framework

Key Observations

- The regulatory framework governs the relationship between the rate-regulated entity and the rate regulator. The regulatory framework has many components. Understanding those components is important in determining whether there are rights and obligations requiring a particular accounting treatment.
- Legislation forms the basis of the regulatory framework.
- The form of rate regulation can vary, and it is becoming more common that the rate-setting mechanism can include both cost-of-service and incentive-based attributes.
- Regulatory decisions, and subsequent court decisions, provide confirmatory and predictive value of the economic resources of, and claims against, the rate-regulated entity.

Identifying "Rate" Regulation

36. The term "regulation" can cover a broad range of activities. The Oxford Dictionary[11] defines regulation as "a rule or directive made and maintained by an authority." Many sectors (e.g., the financial, communications and media sectors) are regulated in some manner. The IASB's Rate-regulated Activities project, and this paper, focus only on rate regulation.

37. Rate regulation, as defined in the IASB's March 2013 Request for Information, is "the mechanism by which a rate regulator imposes a control over the setting of prices that can be charged for services of products." Generally, rate regulation is imposed when an entity has a monopoly or dominant market position that gives it excessive market power. Without rate regulation, the price that the entity can charge would not be constrained since effective market competition is lacking.

38. This paper does not reproduce or expand upon the complete description of rate regulation included in the IASB's September 2014 Discussion Paper, "Reporting the Financial Effects of Rate Regulation." It simply reminds readers of the importance of ascertaining whether all or part of an entity's activities is subject to rate regulation, as opposed to some other form of regulation.

[11] Website: http://www.oxforddictionaries.com/us/definition/american_english/regulation

Regulatory Framework

39. Users in Canada have said that the regulatory framework, of which the rate-setting mechanism is a part, has a significant bearing on the entity's financial performance and future cash flows. The regulatory framework governs the relationship between the rate regulator and the rate-regulated entity and has many components. The main components include:

- the legislation that underlying the framework,
- the rules and procedures established by the rate regulator through the design of the rate-setting mechanism (i.e., the form of rate regulation); and
- the regulatory decisions, and subsequent court rulings on those decisions, that interpret the legislation and rules.

40. Understanding the regulatory framework is important because it can affect the determination of whether the entity has rights and obligations that arise from the performance of its rate-regulated activities.

Regulatory Framework Component: Legislation

41. An overall objective of rate regulation in Canada is to balance the fair return earned by an entity, with reasonable rates charged to customers based upon prudently incurred costs. In addition, rate regulators attempt to ensure that customers of varying types pay their fair share of the costs incurred to service the entire customer base. The powers and mandates of rate regulators in Canada come from governing federal and provincial legislation. This legislation typically requires that the rate regulator approve tariffs or rates that are just and reasonable.

42. Even though the relationship between the rate regulator and the entity it regulates may not be contractual, the rate regulator has the ability to affect the entity's financial performance and future cash flows through its regulatory decisions. In light of this ability, the strength of the jurisdiction's regulatory framework becomes very important (as discussed in Section III of this paper).

43. In Canada, the legislation relating to rate regulation contributes to the strength of the regulatory framework because it provides a basis for either challenging or upholding a rate regulator's decisions (or "rulings") and the rates those decisions produce. If a rate regulator establishes rates that are contrary to the principles of the legislation, a rate-regulated entity can challenge the decision by a motion to the regulator, or in a court. Similarly, a rate regulator that disallows costs

that are not reasonable or prudently incurred demonstrates rigour in the system to establish reasonable rates for customers.

44. Following are examples of case law that demonstrate the objective of rate regulation, and how legislation can affect the rights and obligations of the rate-regulated entity, as interpreted by the Canadian courts.

Court Interpretations of Canadian Legislation (emphasis added)
The Supreme Court in *Northwestern Utilities Ltd v. Edmonton* [1929] S.C.R. 186 (Northwestern) defined the scope of the utilities' right to price their product and their right as a result to a fair return. The Court stated "By a fair return is meant that the company will be allowed as large a return on the capital invested in its enterprise (which will be net to the company) as it would receive if it were investing the same amount in other securities possessing an attractiveness, stability and certainty equal to that of the company's enterprise".[12]
A fair rate of return to the corporation is paramount and is all that can be considered in arriving at a fair rate. In the unrealistic situation that a fair return worked a hardship on the consumer, the choices before government to provide relief are unlimited but they should not lower the fair rate of return. Indeed the Federal Court of Appeal (FCA) in *TransCanada PipeLines v. Canada National Energy Board* 2004 F.C.A. 149 confirmed that a fair return need not be modified out of deference to its impact upon customers.[13]
In *Ontario (Energy Board) v. Ontario Power Generation Inc.*, the Supreme Court reviewed the Ontario Energy Board ("OEB" or the "Board")'s decision to disallow $145 million in labour compensation costs applied for by Ontario Power Generation ("OPG") in its 2011-2012 rates application. The OEB had disallowed these costs, which were related to OPG's nuclear operations, on the basis that OPG's labour costs were not in line with comparable entities in the nuclear industry. The principal question on appeal was whether the Board should have used the "no-hindsight" prudence test to determine whether the labour compensation costs were reasonable. Applying a standard of review of reasonableness, the Court overturned the decision of the Ontario Court of Appeal and reinstated the decision of the OEB and the Divisional Court, holding that the OEB's decision to disallow the $145 in labour compensation costs was reasonable. The Court found that the costs in question were "best understood as at least partly committed" (as opposed to entirely "forecast" costs) because they resulted from collective agreements entered into between OPG and two of its unions but were also subject to management discretion because OPG had some flexibility to manage total staffing levels by way of, among other things, attrition of the workforce.[14]

Regulatory Framework Component: Form of Rate Regulation

45. Pre-changeover Canadian GAAP defined rate regulation as existing when all of the following criteria were present:

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12 The Fair Return Standard for Return on Investment by Canadian Gas Utilities: Meaning, Application Results and Implications (March 2008), Page 4

13 The Fair Return Standard for Return on Investment by Canadian Gas Utilities: Meaning, Application Results and Implications (March 2008), Page 4

14 McCarthy Tetrault, Extracts, http://www.canadianappeals.com/2015/11/24/oeb-and-atco-blog-case-comments/ (November 2015)

(a) The rates for regulated services or products provided to customers are established by or are subject to approval by a regulator or a governing body empowered by statute or contract to establish rates to be charged for services or products.

(b) The regulated rates are designed to recover the cost of providing the services or products.

(c) It is reasonable to assume that rates set at levels that will recover the cost can be charged to and collected from customers in view of the demand for the services or products and the level of direct and indirect competition.

Based on the **cause-and-effect relationship** between the entity's costs and its rate-based revenue stream

46. Rate regulators in Canada and around the world choose from a variety of forms of rate regulation in order to achieve their objectives. The form of rate regulation is generally based on the terms of the governing legislation. For purposes of this paper, two common forms of rate regulation are described below using information from the IASB's September 2014 Discussion Paper, "Reporting the Financial Effects of Rate Regulation", and other sources.

Cost-of-Service

A mechanism that sets rate to ensure an entity recovers all of its reasonably incurred allowable costs plus a fair return and reasonable return on its capital investment.

Total allowable costs include specific operating costs, and capital costs of assets used to provide regulated goods or services.

The allowed rate of return is what the rate-regulated entity has the opportunity to earn. When applied to the rate base, the allowed rate of return provides an amount equal to the forecast cost of financing the investment required for regulated operations. The financing costs include both the cost of debt and the cost of equity (when an entity has no issued share capital, the rate regulator determines a deemed cost of equity).

Rates are set by means of a rate case based on budget, historical or test year information.

Incentive-Based

(Also referred to as performance-based regulation)

A mechanism that sets rates or components of rates in order to provide an incentive to maximize efficiency, allowing for retaining profits above target level but suffering downside of inefficiency or under-recovery of costs.

The mechanism uses:
- benchmark or target cost and revenue for determining initial rates
- adjusts input measures for inflation and for a variety of output-based objectives, with incentives or penalties applied through the rate formula

Price-cap regulation is a form of incentive-based regulation where limits are set on initial prices and a formula is put in place to allow for future increases in the maximum prices that can be charged.

Hybrid

Combination of cost-of-service and incentive-based mechanisms

47. Rate regulation is designed to ensure that the rate-regulated entity recovers a determinable amount of consideration (the "revenue requirement") in exchange for the rate-regulated activities that it performs.

48. The rate-setting mechanism is an explicit acknowledgement, by the rate regulator, that the original rate determination is provisional to some extent. That is, certain aspects of the approved future rates are adjusted for the difference between the entity's forecasted, and actual, results if the rate regulator has approved the use of variance or deferral accounts. The mechanism works in such a way that the entity has the right to increase, or obligation to decrease, the rate to be charged when the rate-regulated goods or services are provided in the future. Part of that increase or decrease is attributable to the difference between the previous period's provisional rate and actual results for the goods or services rendered in the past.

49. From the research undertaken, the form of rate regulation is constantly evolving as rate regulators try to strike a balance in determining which risks associated with rate-regulated activities:

- are part of the normal cost recovery process and should be assigned to customers; or
- are part of normal business risks that should be borne by an entity's investors or owners as a result of how efficiently the business is managed when providing the rate-regulated goods or services.

This effort to achieve a fair balance between investors and customers is resulting in new forms of rate regulation that are considered hybrid because they encompass attributes of both cost-of-service and performance-based mechanisms. In some cases, different components of an entity's rates could be subject to differing mechanisms.

50. In Canada, most rate-regulated entities are regulated through a cost-of-service mechanism. However, staff has observed that rate regulators are incorporating incentive-based mechanisms to encourage efficiency and productivity among the entities. Typically, the rates set under incentive-based regulation are determined based on the costs of providing the service plus a reasonable return. For subsequent periods, the rates are modified using a formula-based approach that establishes the rates the utility can charge to its customers. There is generally an opportunity to re-

base[15] rates on a cost-plus-return basis periodically and/or if the actual incentive return deviates too far from a fair return.

51. To illustrate how the form of rate regulation used can differ across Canada, staff looked at three provinces and the different components of the electricity business:

Business Component	**Province**		
	Ontario	**Alberta**	**Manitoba**
Generation	Partially deregulated (one dominant player)	Competitive / market-based (oligopoly in which there are two or more players)	Vertically-integrated regulated electric (and natural gas) utility that is government-owned
Transmission	Fully regulated (one dominant player)	Fully regulated (two major players)	
Distribution	Fully regulated (many local distribution companies that are municipally-owned)	Fully regulated (few major distributors)	
	Form of Regulation		
	Incentive Regulation Mechanism: (Combination of cost-based and incentive-based mechanism. Forecasted costs and revenue information are used to determine a base revenue requirement and the "base" rates that are set to recover the revenue requirement. In subsequent years, the base rates are adjusted by a formula that includes components for inflation, efficiency and productivity gains. At the conclusion of the term, the entity can rebase its rates under cost-of-service.[16])	Generation: not regulated Transmission: Cost-of-service Distribution: Performance-based regulation (Rates using formula that adjusts rate changes to inflation minus an enhanced efficiency or industry productivity factor. Except in limited circumstances, rates can only rise less than inflation.[17])	Cost-of-service

52. In Alberta, although electricity distribution is regulated using performance-based regulation (PBR), there are elements within the PBR that contain some cost-recovery mechanisms. For example, there are adjustments to rates outside the PBR formula involving accounts that are similar to flow-through items found in cost-of-service regulation. There could also be adjustments for events

15 In "rebasing", a utility submits a cost estimate to reset the rate based on a more recent reflection of costs than the ones used in the original rate determination.

16 Based on information from the Ontario Energy Board's Comment Letter to IASB's Request for Information (2013)

17 Alberta Utilities Commission, http://www.auc.ab.ca/items-of-interest/Performance-BasedRegulation/Pages/default.aspx

caused by external factors that are outside the control of the entity and for which there is no other reasonable opportunity to recover the costs within the PBR formula.

53. As for jurisdictions outside Canada, following is an example of an Australian entity that staff thinks helps to illustrate the rules of the rate regulator (see Note 2(g)) and how various components of the rate can have cost-of-service- or incentive-based-like attributes (see Note 2(d)).

TransGrid (Australia) – Extracts from audited financial statements (Accounting framework: IFRS)

2013-2014 audited financial statements

Note 2 – Summary of Significant Accounting Policies (g) Trade and Other Receivables

Prescribed Customer Receivables – As at 30 June 2014, TransGrid's total revenue received for prescribed transmission services, including intra-regional settlement residues and inter-regional settlement residue auction proceeds, was less than the revenue entitlement for the financial year. In accordance with the National Electricity Rules (NER), the under-recovered amount and associated interest was entitled to be recovered when setting future transmission service prices. The revenue under-recovery was recognised in Prescribed Customer Receivables.

2014-2015 audited financial statements

Note 2 – Summary of Significant Accounting Policies, (d) Changes in Accounting Policies

Voluntary Change in Accounting Policy – In 2015, TransGrid changed its accounting policy for recognized revenues from the rendering of prescribed services. The rationale for the change reflects the Australian Accounting Standards Board's (AASB) recent clarification of its position on the recognition of rate-regulated assets. Management believes the new accounting policy reflects the AASB view.

As a result of the change, TransGrid has recognized prescribed services revenue on the basis of amounts received or receivable with no amounts accrued for future receipts from (or credits to) customers allowed under any regulatory pricing mechanism.

Previously TransGrid recognized the Maxmium Allowable Revenue (MAR) determined by the AER by recognizing the amount of revenue exceeding the MAR as a payable or the amount of revenue below the MAR as a receivable.

Refer below for further details about deferred revenues or credits that have not been recognized in profit or loss.

i) Transmission Use of System (TUOS) revenue – TransGrid collects its Maximum Allowed Revenue (MAR) based on the transmission prices set in accordance with the pricing methodology approved by the AER and published in May each year for application in the following financial year. In any given year, revenue may exceed or not achieve the MAR due to differences between demand load forecasts and actual loads for TUOS and volatility in settlement residues. As at 30 June 2015, revenue is a total of $110.6m (2014 - $38.2m) below the MAR, which will be included in transmission prices in following years.

ii) Service Target Performance Incentive Scheme – TransGrid is subject to a Service Target Performance Incentive Scheme (STPIS) which provides for the AER to adjust TransGrid's Maximum Allowable Revenue (MAR) in a financial year by between -1% to +3% based on the performance in the previous calendar year. As at 30 June 2015, a STPIS adjustment of $12.1m (2014 - $8.7m) has been determined by the AER and has been built into 2015-16 transmission price.

iii) Network Support – Network support refers to non-network solutions used by transmission network service providers (TNSPs) as a cost effective means of deferring network augmentation. In the prior regulatory period 2009/10 to 2013/14, TransGrid received a network support pass-through allowance which is required to be adjusted for any under-expenditure. As at the reporting date, a total amount of $8.3m (2014 - $15.3m) is required to be credited in following years.

54. In addition to the different forms of rate regulation in use in Canada, it is common for an entity to have both rate-regulated operations and operations not subject to rate regulation. Although some may think of rate regulation as applying to certain industries or sectors, in reality, rate regulation affects specific business activities or services of the entity. Following is an example to illustrate this point.

- Telus Corporation – This entity undertakes activities subject to price cap regulation by the Canadian Radio-television and Telecommunications Commission (CRTC). Despite the price-cap regulation, Telus determined that the deferral account mechanism put in place by the regulator (according to its decision on amounts collected related to non-high cost serving areas) created an obligation.

Telus (Canada) – Extracts from 2011 annual report (Accounting framework: IFRS)
Management's Discussion & Analysis 10.3 Regulatory Matters TELUS' telecommunications and broadcasting services are regulated under federal legislation by the Canadian Radio-television and Telecommunications Commission (CRTC), Industry Canada and Heritage Canada. The CRTC has taken steps to forbear from the regulation of prices for services offered in competitive markets, such as local residential and business services in selected exchanges, long distance and some data services, and does not regulate the pricing of wireless services. Local telecommunications services that have not been forborne are regulated by the CRTC using a price cap mechanism.
Audited Financial Statements (emphasis added) Note 1 – Summary of Significant Accounting Principles (e) – Revenue recognition Non-high cost service area deferral account – On May 30, 2002, and on July 31, 2002, the CRTC issued Decision 2002-34 and Decision 2002-43, respectively, pronouncements that affected regulated services in the Company's Wireline segment. In an effort to foster competition for residential basic service in non-high cost serving areas, the concept of a deferral account mechanism was introduced by the CRTC, as an alternative to mandating price reductions. The deferral account arises from the CRTC requiring the Company to defer the statement of income recognition of a portion of the monies received in respect of residential basic services provided to non-high cost serving areas. The Company has adopted the liability method of accounting for the deferral account. This resulted in the Company recording incremental liability amounts, subject to reductions for the mitigating activities, during the Decisions' initial four-year periods. The deferral account balance also reflects an interest expense component based on the Company's applicable short-term cost of borrowing, such expense being included in the Consolidated Statements of Income and Other Comprehensive Income as Financing costs. The Company discharges the deferral account liability by undertaking qualifying actions including providing broadband services to rural and remote communities, enhancing the accessibility to telecommunications services for individuals with disabilities and providing customer rebates for the balance. The Company recognizes the drawdown and amortization (over a period no longer than three years) of a proportionate share of the deferral account as qualifying actions are completed; such amortization is included in Other operating income.

Regulatory Framework Component: Regulatory Decisions

55. The rate-setting process generally involves the negotiation of components to be included in the allowed rate. In a rate proceeding, it is common that the rate-regulated entity will not receive everything asked for in its rate case submission. Rate cases submitted by a rate-regulated entity can contain a significant amount of information to support the rate request put forth to the regulator. Similarly, a rate ruling published by a rate regulator is also typically very extensive, in order to explain the regulator's views and set out the reasons for its decision.

56. Regulatory decisions can have both confirmatory and predictive value, as demonstrated below with two examples from Canada. Financial information has confirmatory value if it provides feedback about (confirms or changes) previous evaluations and predictive value if it can be used as an input to processes employed by users to predict future outcomes.[18]

Example 1

57. Staff looked at the impact of a recent regulatory decision issued by the Alberta Utilities Commission on the Generic Cost of Capital on Canadian Utilities Ltd, a rate-regulated entity in that province. The entity's transmission and distribution business activities are subject to cost-of-service and performance-based regulation, respectively. This entity adopted IFRS before IFRS 14 was issued by the IASB, thus the financial effects of rate regulation are not recognized. The following table describes the effects of the regulatory decision.

Regulatory Decision	**Canadian Utilities Ltd.[19] – 2015 audited consolidated financial statements**
In Decisions 2011-474 and 2013-459, the Alberta Utilities Commission approved a placeholder of 8.75% for the 2013 and 2014 return on common equity pending a final decision as part of the 2013 Generic Cost of Capital proceedings. **March 23, 2015** **2013 Generic Cost of Capital** **AUC Decision 2191-D01-2015** The Alberta Utilities Commission recently issued its decision in the 2013 Generic Cost of Capital proceeding for all gas and electric utilities in the	Note 5 – Segmented Information (Extracts) Adjusted earnings are earnings attributable to equity owners of the Company after adjusting for the timing of revenues and expenses for rate-regulated activities and dividends on equity preferred shares of the Company. Adjusted earnings also exclude one-time gains and losses, significant impairments and items that are not in the normal course of business or a result of day-to-day operations. Adjusted earnings are a key measure of segment earnings used by the CODM to assess segment performance and allocate resources. The Canadian and Australian utilities recognize revenues from regulatory decisions when customer rates are changed and amounts are billed to customers. Under rate-regulated accounting, revenues from regulatory decisions that affect

[18] The *Conceptual Framework for Financial Reporting*, paragraphs QC8-QC9.

[19] Canadian Utilities Ltd. is a subsidiary of ATCO Ltd. (part of the ATCO Group of companies).

Regulatory Decision	Canadian Utilities Ltd.[19] – 2015 audited consolidated financial statements
Province. The allowed ROE for Alberta's gas and electric utilities was set at 8.3% for 2015. In addition, the Alberta Utilities Commission determined that the allowed ROE for 2013 and 2014 would be modified from the previous interim rate of 8.75% to 8.3%. The Alberta Utilities Commission also reduced the deemed common equity ratio by one percentage point for most Alberta regulated utilities and decided to forego returning to an automatic formula at this time. The Alberta utilities have filed applications to appeal this decision.[20]	current and prior periods are recognized when the decision is received. **Generic Cost of Capital Decision** The utilities recorded a reduction in adjusted earnings of $51 million in 2015 for an Alberta Utilities Commission decision which reduced the Return on Equity and deemed common equity ratios for 2013 to 2015. Of the $51 million recorded in 2015, $31 million related to 2013 and 2014. Under IFRS, earnings will be adjusted when the [Alberta Utilities Commission] approves revised customer rates and the amount payable to customers is refunded through future billings; $10 million has been refunded as at the end of the year 2015.

58. Although the interim allowed rate of return of 8.75% had already been billed to customers, through the subsequent regulatory decision, the entity was only permitted to earn an allowed return on equity of 8.3% in 2013 and 2014. This regulatory decision has confirmatory value because it provides feedback about the previous interim rate of return used, and affects the claims against the entity's economic resources. The regulatory decision also has predictive value because it would assist users to understand the effects on the entity's future cash flows, and their assessment of the regulatory framework in Alberta.

Example 2

59. Staff understands that while a rate regulator's decision can affect an entity's economic reality, sometimes certain parts of the decision do not have an immediate financial statement impact unless the entity's current economic resources or claims against it are affected. Nonetheless, because a regulatory decision illustrates how the rate regulator interprets and applies the legislation and rules, it assists the predictability of future cash flows.

60. Users such as credit rating agencies, and debt and equity analysts, take into consideration how such regulatory decisions, and other factors, could affect the risk profile of the entity. The results affect the entity's credit rating, or the analyst's buy/sell recommendation.

61. This example, relating to TransCanada Pipelines, demonstrates how a regulatory decision can have both confirmatory and predictive value. The following table includes excerpts from: a bond analyst report, a credit rating report, the entity's annual report, and the rate regulator's rate ruling (as

[20] Concentric Energy Advisors: Authorized Return on Equity for Canadian and U.S. Gas Electric Utilities, Volume III, May 1, 2015

pertaining to its interpretation of legislation). Together, this information highlights how certain components of a regulatory decision can have both a current financial effect and a future financial effect, and demonstrate the interpretation of legislation. Emphasis has been added to certain parts of the text below to highlight the areas that provide confirmatory and predictive value.

The National Energy Board's TransCanada Pipelines Mainline Decision

Corporate Bond Research

– Excerpts from Weekly Commentary of Scotiabank Global Views, April 5, 2013 (Pg. 11-14)

We think the National Energy Board's TransCanada Pipelines (A/ A-/ A3) Mainline Decision (which was released on Wednesday, March 27), is somewhat credit negative for TransCanada. The NEB granted some of the several changes TransCanada sought in its Restructuring Proposal, but denied some of TransCanada's most significant toll-reducing components, including the key request, the Alberta System Extension. The Decision also granted a key request of some interveners, setting 5-year fixed tolls, rather than TransCanada's application for tolls for 2012 and 2013. The Decision is long and exceptionally complicated, and TransCanada has yet to comment on its meaning for the Mainline's earnings and cash flow for the five-year period. However, this week, TransCanada announced that it will hold a binding open season to obtain firm commitments from shippers for West to East oil transportation service, which we think could materially raise earnings and cash flow, and would very effectively mitigate risks from the Decision.

Two deferral accounts will accumulate a specified cost deferral and annual variances in actual revenues for deferral and recovery in future tolls. The NEB approved an off-ramp, such that, if the Toll Stabilization Adjustment (TSA) deferral account approaches one-ninth of rate base, or if circumstances unfold that make TransCanada expect that the full TSA balance may be unrecoverable, TransCanada could file a new tolls application. The NEB's rationale for the off-ramp is to try to mitigate adverse credit rating actions from deferral of significant cash flows. The NEB also said that if TransCanada "repurposes" (converts to oil service) significant Mainline assets, "this would also likely warrant revisiting Mainline tolls."

The complex Decision includes a range of favourable actions. The NEB approved several elements of the RP, including all proposed changes to cost allocation, and elimination of toll zones and the Risk Alleviation Mechanism.

Regulatory Compact

Throughout the written and oral evidence and argument presented by TransCanada in its RP application, TransCanada played up the importance of the concept widely referred to as "the regulatory compact." TransCanada believed that the regulatory compact would prevent the regulator from setting rates that would prevent TransCanada from having an opportunity to recover its prudently incurred capital costs, including a return on capital.

The NEB disagreed with TransCanada's views on this important point. "We are not prepared to endorse the concept of the regulatory compact, as a concept that compels the Board to set just and reasonable tolls in a particular manner. In our view, the concept is ill defined. TransCanada's interpretation of the regulatory compact would have the effect of protecting the Mainline from the impact of competition." Further, the NEB said, "In adjudicating the current Application, we are mandated with establishing just and reasonable tolls, that are not unjustly discriminatory, in accordance with the provisions of the NEB Act." And further, "In our view, TransCanada's submission that only prudence determines the opportunity for cost recovery cannot be sustained in the context of NEB regulated pipelines."

We believe that the NEB was more concerned about future shippers' potential exposure than with keeping TransCanada's rate base intact. Although the current Decision does not result in any cost disallowance or writedowns, the Decision clearly opens the door to this happening in future: "If throughput is lower than expected … we would anticipate that TransCanada's next toll hearing would

deal with what costs, if any, should be disallowed from recovery in tolls." We believe that this theme in the Decision differs from the financial market's understanding and assumptions of the regulatory compact.

Credit Rating

– Excerpts from DBRS Rating Report, July 4, 2013

On June 18, 2013, DBRS downgraded the Issuer Rating and Unsecured Debentures & Notes rating of TransCanada PipeLines Limited (TCPL) to A (low) from "A", the Junior Subordinated Notes rating of TCPL to BBB from BBB (high) and the Medium-Term Notes & Unsecured Debentures rating of NOVA Gas Transmission Ltd. (NGTL), a wholly owned subsidiary of TCPL, to A (low) from "A", all with Stable trends.

The rating actions followed DBRS's review of the National Energy Board's (NEB) dismissal (the Recent Decision) of TCC's May 1, 2013, application for review and variance (R&V) of the NEB's March 27, 2013, decision (the Original Decision) relating to TCC's 2012-2013 restructuring proposal for tolls and service on its Canadian Mainline.

2013 Annual Report of TransCanada Corporation

– Excerpts (Accounting framework: U.S. GAAP)

2013 Financial Highlights

In March, Canada's National Energy Board (NEB) released its decision on our proposal for restructuring tolls and services on the Canadian Mainline following an extensive public hearing. The decision fundamentally altered some of the long-standing principles of the Mainline's regulated cost-of-service model. TransCanada successfully implemented the NEB decision and shippers have renewed 2.5 Bcf per day of firm contracts on the system through November 2016. In the fall of 2013 we reached a settlement with local natural gas distribution companies in Ontario and Québec that will allow us to continue expanding the eastern portion of the Mainline system to meet the future needs of this growing market. Settlements were also reached with shippers on the NGTL and Great Lakes systems in 2013.

Management's Discussion & Analysis

Canadian Mainline's comparable earnings this year increased by $90 million compared to 2012 because of the impact of the NEB decision. Among other items, the NEB decision approved an ROE of 11.50 per cent on 40 per cent deemed common equity for the years 2012 through 2017 compared to the last approved ROE of 8.08 per cent on 40 per cent deemed common equity that was used to record earnings in 2012.

Consolidated Financial Statement Note 9 – Rate-regulated Business

Canadian Mainline

In March 2013, TransCanada received a decision from the NEB on the comprehensive application it filed to change the business structure and the terms and conditions of service for the Canadian Mainline, including addressing tolls for 2012 and 2013 (the NEB Decision). The decision approved the 2011 revenue requirement as filed, approved tolls charged in 2012 as final with any variance between revenues and costs deferred for recovery in future years, and set tolls for 2013 through 2017 at competitive levels, fixing tolls for some services and providing unlimited pricing discretion for others. The decision established an ROE of 11.5 per cent on a deemed common equity of 40 per cent and included mechanisms to achieve the fixed tolls through the use of a Long Term Adjustment Account (LTAA) as well as the establishment of a Tolls Stabilization Account (TSA) to capture the surplus or the shortfall between our revenues and our cost of service for each year over the five-year term of the decision. In addition, the decision provides an opportunity to generate incentive earnings by increasing revenues and reducing costs. The NEB also identified certain circumstances that would require a new tolls application prior to the end of the five-year term. One of those circumstances is if the TSA balance

The National Energy Board's TransCanada Pipelines Mainline Decision
becomes positive, which occurred in 2013. In December 2013, TransCanada filed an application with the NEB that addresses tolls moving forward.
National Energy Board **– Excerpts from Reasons for Decision, TransCanada PipeLines Limited, NOVA Gas Transmission Ltd., and Foothills Pipe Lines Ltd., RH-003-2011, March 2013, (Pg. 39-40)** Section on "*Regulatory standards for cost recovery*" A rule that imposes an obligation upon the Board to approve tolls that allow recovery of all costs in all circumstances is inconsistent with Parliament's grant of discretion to the Board and may not result in tolls that are just and reasonable. In this regard, we disagree with TransCanada's submission to the effect that the Board must approve tolls that allow recovery of all prudently incurred costs, even if the Board knew that those tolls could not be charged in the market. This would be an inefficient and non-sensical outcome. In our view, a regulatory rule that compels the Board to set tolls that allow the return of and on investment, irrespective of whether assets associated with that investment are used and useful for providing service, erodes management's responsibility for its investment decisions and management's responsibility to keep depreciation rates current. This situation, in our view, does not lend itself to creating efficient energy infrastructure and markets. It also provides no incentive for a pipeline company to find better or higher uses for its assets. Given the foregoing, the prudency standard should not be the only standard that determines the opportunity for cost recovery for NEB-regulated pipelines in all circumstances.

62. As these two examples illustrate, regulatory decisions, which are based on the rate regulators' interpretations of the legislation and rules, have both predictive and confirmatory value regarding the economic resources of, and claims against, the entity. Thus, users of rate-regulated entities' financial statements have great interest in the decisions of the rate regulator, and the current and future financial effect of such decisions.

63. Following is an example of an entity outside Canada that has recognized credit balances arising from rate regulation on the basis of its regulatory framework, given its facts and circumstances.

Elia Group (Belgium) – Extracts from 2015 audited consolidated financial statements
(Accounting framework: IFRS, as adopted by the European Union)

Note 7.17 – Accruals and deferred income

Settlement mechanism

A calculation of the amount is given in Note 9.1.

The Group operates in a regulated context which states that tariffs must make it possible to realise total revenue consisting of:

1. a reasonable return on invested capital,
2. all reasonable costs which are incurred by the Group.

Since the tariffs are based on estimated figures, there is always a difference between the tariffs that are actually charged and the tariffs that should have been charged to cover all reasonable costs of the system operator and to provide shareholders with a reasonable profit margin on their investment.

If the applied tariffs result in a surplus or a deficit at the end of the year, this means that the tariffs charged to consumers/the general public could have been respectively lower or higher (and vice versa). A surplus or deficit arising from the settlement mechanism is therefore not classified as revenue or an expense, or as an item under equity.

On a cumulative basis, it could be argued that the public has made an advance payment (=surplus) for its future use of the network. As such, the surplus (deficit) is not a commission for a future loss (recovery) of income but instead a deferred/accrued revenue to (with regard to) consumers. On the basis of the Regulatory framework, the Group believes that the surplus (deficit) does not represent an item of revenue (cost). Consequently, the Group booked these amounts under section 'Accruals and deferred income'.

What this Section Demonstrates

64. Financial information is decision-useful when it helps users to understand the regulatory framework in which the entity operates. Such an understanding is important to determine the entity's rights and obligations, and, in turn, assess the amount, timing and uncertainty of its future cash flows.

Section III. Strength of Regulatory Framework and the Effects

Key Observations

- ❖ The strength of the regulatory framework can affect the enforceability of the economic resources of, and claims against, the entity.
- ❖ The nature and risk profile of balances arising from rate regulation can vary, resulting in differing degrees of uncertainty associated with those balances.
- ❖ Regulatory decisions that differ from the entity's interpretation of the legislation and rules can affect the subsequent measurement of recognized balances arising from rate regulation , and reduce the assessed strength of the regulatory framework.

65. One of the primary concerns expressed during the IASB's project on rate-regulated activities relates to the uncertainties about the recoverability of debit balances arising from rate regulation. Staff notes that the strength or weakness of the regulatory framework can affect the enforceability of the recovery of the rate-regulated entity's economic resources and settlement of claims against it.

The Canadian Experience

66. This section looks at data from a sample of rate-regulated entities demonstrating the Canadian experience with:

- the recovery of previously recognized debit balances arising from rate regulation (i.e., the periods over which balances are recovered, and the extent to which they become impaired or are written off);
- the trending of regulatory balances (i.e., are they growing or shrinking in total; how do debit balances arising from rate regulation compare in total with credit balances arising from rate regulation); and
- the different nature and risk profiles of debit balances arising from rate regulation that could influence recoverability patterns.

Write-offs or Impairments of Debit Balances Arising from Rate Regulation

67. Stakeholders have told us that write-offs or impairments of previously recognized debit balances arising from rate regulation have been minimal. Staff has heard anecdotally that a few rate-

regulated entities have obtained a legal opinion to demonstrate their right to recover prudently incurred costs, even in a scenario in which the entity ceases operations.

68. To explore the extent of write-offs or impairments of debit balances arising from rate regulation, staff selected a sample of 12 electric utilities and looked at their audited financial statements over a five-year period.[21]

Sample of Canadian Electric Utilities					
(in millions)	**Debit Balances Arising from Rate Regulation (Note 2)**				
Year	**2011**	**2012**	**2013**	**2014**	**2015**
Yukon Energy	$ 18.7	$ 21.5	$ 20.2	$ 22.9	$ 21.2
Toronto Hydro	143.0	121.2	241.5	197.1	241.7
Newfoundland Power	366.2	417.2	372.3	357.5	345.4
New Brunswick Power	943.0	1,072.0	1,051.0	1,034.0	1,021.0
Manitoba Hydro	330.0	321.0	371.0	410.0	486.0
Hydro-Québec (Note 1)	39.0	40.0	9.0	4,741.0	4,061.0
BC Hydro	4,314.0	4,741.0	4,928.0	5,714.0	6,324.0
ENMAX	123.0	77.2	83.7	66.6	34.5
Hydro Ottawa	12.0	9.6	12.5	20.6	14.4
Emera	453.8	474.1	616.1	602.7	699.5
Ontario Power Generation	5,017.0	6,478.0	5,400.0	7,191.0	5,907.0
AltaLink	33.0	42.7	66.8	117.3	165.9
	$ 11,792.6	$ 13,815.4	$ 13,172.0	$ 20,474.8	$ 19,321.6
	Write-offs or Impairments of Debit Balances Arising from Rate Regulation				
Year	**2011**	**2012**	**2013**	**2014**	**2015**
Yukon Energy	$ -	$ -	$ -	$ -	$ -
Toronto Hydro	3.8	-	-	-	4.4
Newfoundland Power	-	-	-	-	-
New Brunswick Power	-	-	-	-	-
Manitoba Hydro	-	-	-	-	-
Hydro-Québec	-	-	-	-	-
BC Hydro	34.0	-	-	-	-
ENMAX	-	-	-	-	-
Hydro Ottawa	0.3	-	-	-	-
Emera	-	7.2	-	6.0	-
Ontario Power Generation	-	-	7.0	-	-
AltaLink	-	-	-	-	-
	$ 38.1	$ 7.2	$ 7.0	$ 6.0	$ 4.4
Write-offs or Impairments as a percentage of Total Debit Balances Arising from Rate Regulation	0.32%	0.05%	0.05%	0.03%	0.02%

Note 1 - The increase from 2013 to 2014 was primarily due to the rate regulator authorizing changes to certain accounting policies for rate-setting purposes as a result of the entity changing from pre-changeover Canadian GAAP to U.S. GAAP.

Note 2 - Staff notes that there are also debit balances arising from rate regulation related to construction activities, which are capitalized within property, plant and equipment. Those balances are generally not part of the above debit balances (unless the entity applied IFRS 14 which requires regulatory deferral account debit balances to be presented as a separate line item). Regulatory decisions can also affect those non-deferral or non-variance type of accounts.

21 All the sampled entities have fiscal years ended December 31, except for New Brunswick Power, Manitoba Hydro, and BC Hydro, which have fiscal years ended March 31. For ease of presentation in this table and the table on page 33, the data relating to these three entities is displayed in the column headed the previous calendar year.

69. The data illustrates that write-offs or impairments of debit balances arising from rate regulation have been minimal in Canada. The disallowance of costs is generally a result of a regulatory decision after the rate regulator has further reviewed the cost. In other cases, the entity may decide to set up a provision if there is doubt about the recovery of existing balances arising from rate regulation.

70. Below are examples of note disclosures that explain the reason for writing off, or establishing a provision against, a debit balance arising from rate regulation:

Extracts from Note Disclosures of Audited Consolidated Financial Statement
Toronto Hydro – 2011 (Accounting framework: IFRS) Note 2 – Regulation, (d) Regulation, Contact Voltage (Note, figures below are in dollars) On December 10, 2009, the OEB issued an initial decision in regard to the costs incurred in 2009 for the remediation of safety issues related to contact voltage relating to LDC's electricity distribution infrastructure. The decision provided for the recovery of allowable actual expenditures incurred above the amount deemed as controllable expenses in LDC's 2009 approved electricity distribution rates. At the time of the decision, the Corporation estimated the allowable recovery of costs at $9,050,000. On October 29, 2010, the OEB issued a second decision in the matter, following further review of costs incurred by LDC. In this decision, the OEB deemed the balance allowable for recovery at $5,296,000. The variance from the Corporation's original estimate is mainly due to the OEB's interpretation of the definition of controllable expenses used to determine the final allowable recovery. In connection with this decision from the OEB, the Corporation revised its recovery estimate for contact voltage costs, resulting in an increase in operating expenses of $3,754,000 in 2010. On November 18, 2010, LDC filed a motion to review the decision with the OEB seeking an amendment to allow for recovery in accordance with the initial decision rendered on December 10, 2009. On March 25, 2011, the OEB issued its decision on the LDC motion, denying the requested additional recovery.
BC Hydro – 2011-2012 (Accounting framework: legislative GAAP) Note 4 – Regulation Other Regulatory Accounts – Under Direction 3, total Taxes Regulatory Account liability balance of $14 million was closed and fully amortized into rates and the remaining balance of the PEI asset of $34 million was fully amortized and closed as of March 31, 2012 and will not be included in rates.
Hydro Ottawa – 2011 (Accounting framework: IFRS) Note 7 – Net Regulatory Assets and Liabilities, (d) Provision for doubtful recovery (Note, figures below are in thousands) The Corporation continues to assess the likelihood of recovery of all regulatory assets subject to recovery through a future rate filing. The absence of OEB approval is a consideration in this evaluation. The Corporation has recorded a net provision of $331 [2010 – $2,252] against regulatory assets. If future recovery becomes assured, the Corporation will recognize the recovery in the income for the period during which such a decision is made.
Emera – 2014 (Accounting framework: U.S. GAAP) Note 5 – Regulated Fuel Adjustment Mechanism and Fixed Cost Deferrals The regulated fuel adjustment mechanism ("FAM") included in the Consolidated Statements of Income for NSPI includes the effect of prudently incurred fuel for generation and purchased power and fuel-related costs ("Fuel Costs") in both the current and preceding years, and as detailed in the table below:

- The difference between actual Fuel Costs and amounts recovered from customers in the current year. This amount is deferred to a FAM regulatory asset in "Regulatory assets" or a FAM regulatory liability in "Regulatory liabilities" on the Consolidated Balance Sheets; and
- The recovery from (rebate to) customers of under (over) recovered fuel costs from prior years.

Pursuant to the FAM Plan of Administration, NSPI's fuel costs are subject to independent audit. On July 2, 2014, the FAM audit findings and recommendations relating to fiscal 2012 and 2013 were publicly released and recommended four disallowances totalling $7.0 million. On January 20, 2015, the UARB disallowed $6.0 million of 2012 and 2013 fuel-related costs, which included interest of $0.9 million. The disallowances resulted in a reduction in the amount of FAM deferral at year-end and resulted in an after-tax impact to 2014 net income of $3.3 million.

Ontario Power Generation – 2013 (Accounting framework: U.S. GAAP)

Note 5 – Regulatory Assets and Regulatory Liabilities

In March 2013, the OEB approved the settlement agreement between OPG and intervenors on all aspects of OPG's September 2012 application requesting approval to recover balances in the authorized variance and deferral accounts as at December 31, 2012 (the Settlement Agreement). This resulted in approval of $1,234 million recorded in the authorized variance and deferral accounts as at December 31, 2012, deferral for future review of $34 million recorded in certain accounts as at December 31, 2012, and a write-off of $7 million of interest recorded in certain accounts as at December 31, 2012.

Trending of Balances Arising from Rate Regulation

71. While recoverability of debit balances arising from rate regulation is a primary concern, staff also wanted to understand the trend of balances arising from rate regulation in general. Staff looked at credit balances arising from rate regulation that were recognized by the same 12 electric utilities over the same five-year period.

Sample of Canadian Electric Utilities					
(in millions)	**Credit Balances Arising from Rate Regulation**				
Year	**2011**	**2012**	**2013**	**2014**	**2015**
Yukon Energy	$ 12.2	$ 15.6	$ 19.0	$ 20.3	$ 21.3
Toronto Hydro	211.2	196.8	183.1	173.0	171.6
Newfoundland Power	133.9	133.7	137.8	138.4	139.8
New Brunswick Power	-	-	-	-	-
Manitoba Hydro	53.0	24.0	22.0	23.0	52.0
Hydro-Québec (Note 1)	-	-	-	350.0	441.0
BC Hydro	279.0	307.0	229.0	281.0	416.0
ENMAX	1.2	3.3	1.9	2.5	13.5
Hydro Ottawa	58.1	67.0	52.8	34.2	40.8
Emera	131.0	110.7	151.2	201.9	370.6
Ontario Power Generation	154.0	41.0	24.0	44.0	60.0
AltaLink	27.0	34.5	33.0	8.1	62.5
	$ 1,060.5	$ 933.6	$ 853.8	$ 1,276.4	$ 1,789.1

Note 1 - The increase from 2013 to 2014 was primarily related to the rate regulator's review of useful lives for depreciation purposes of property, plant and equipment related to rate-regulated activities.

Credit Balances as a Percentange of Debit Balances (Arising from Rate Regulation)				
2011	**2012**	**2013**	**2014**	**2015**
9.0%	6.8%	6.5%	6.2%	9.3%

72. The data above demonstrates that credit balances arising from rate regulation are generally far less in magnitude than debit balances arising from rate regulation. This trend could suggest that under-recovery of an entity's revenue requirement (which results in the carry forward of regulator-approved debit balances for inclusion in future rates) is fairly common in Canada.

73. Another contributing factor could be that with aging infrastructure, the cost of replacement or renewal work needs to be spread over time so that customer rates do not fluctuate significantly. Capital infrastructure activities may result in debit balances arising from rate regulation. Rate regulators in Canada usually permit an allowance for funds used during construction to be capitalized as part of property, plant and equipment based on the rate-regulated entity's weighted average cost of capital. This enables the rate-regulated entity to earn a rate of return on these capital infrastructure costs such that the timing of when they are recovered is less significant. The growth in debit balances arising from rate regulation could also relate to temporary timing differences that are reversed when the rate impacts are realized.[22]

74. While increasing debit balances arising from rate regulation do not automatically mean these amounts cannot be recovered, significantly prolonged periods of collection do raise questions about the risk of recoverability, similar to receivables balances.

Influences on Recoverability Patterns of Debit Balances Arising from Rate Regulation

75. Based on the data collected, the period over which a particular debit balance arising from rate regulation is recovered and, indeed, the risks associated with its recovery, are influenced by:

(a) the nature of the debit balance; and

(b) the rate regulator's approach to ensuring that the period over which the balance is recovered neither creates rate shocks (i.e., significant increases in customer rates in a particular year) nor unfairly burdens an entity by delaying cash inflows associated with the debit balance.

76. The nature of the debit balance has a direct impact on the risks associated with its recovery, and could affect the period over which it is collected. Members of the IASB's Rate-regulated Activities Consultative Group have suggested that categorizing debit balances according to their risk profile would be more helpful to users of financial statements in predicting future revenue and cash flows.

[22] For example, some rate regulators may require entities to account for pensions or income taxes on a cash basis. In the case of income taxes, entities record a deferred income tax asset or liability for temporary differences, as well as balances arising from rate regulation, to reflect future recoveries from or refunds to ratepayers. These balances are reversed when the temporary differences reverse.

77. The following table describes the possible categories of balances (both debit and credit balances) arising from rate regulation identified by the Consultative Group: [23]

Possible categories of balances arising from rate regulation:
• 'mechanical' adjustment balances that are expected to be recovered/reversed in the short term, such as 'flow-through' commodity price adjustments, which involve little judgment and are relatively easy to measure;
• other adjustment balances that are expected to be recovered/reversed in the short term, but are somewhat subjective, such as bonuses for achieving qualitative performance targets; and
• adjustment balances that may be more readily quantifiable but are only recoverable in the longer term and may be subject to more uncertainty about recovery across multiple regulatory periods.

78. Staff looked at the recovery period and categories of debit balances arising from rate regulation for five of the 12 Canadian rate-regulated entities sampled to provide a general sense of how the recovery periods can vary. The first table presents data on the expected recovery of debit balances arising from rate regulation, broken down by length of recovery period. For each recovery period, the second table analyzes the nature of debit balance having that recovery period.

Recovery Period of Debit Balances Arising from Rate Regulation in Five Sampled Entities as at December 31, 2015 (except for New Brunswich Power and Manitoba Hydro, which is as at March 31, 2016) (in millions)

Remaining recovery/ reversal period (Note 1)	Hydro-Québec	%	New Brunswick Power	%	Manitoba Hydro	%	Newfound-land Power	%	Toronto Hydro	%
1 - 24 months	$ 361.0	8.9%	$ -	0.0%	$ -	0.0%	7.2	2.1%	$ 46.6	19.3%
25 - 60 months	17.0	0.4%	-	0.0%	9.0	1.9%	-	0.0%	112.1	46.4%
60 - 120 months	800.0	19.7%	-	0.0%	323.0	66.5%	45.6	13.2%	-	0.0%
121+ months	6.0	0.1%	1,021.0	100.0%	33.0	6.8%	-	0.0%	-	0.0%
Indeterminate*	2,877.0	70.8%	-	0.0%	121.0	24.9%	292.6	84.7%	83.0	34.3%
Total	$ 4,061.0	100.0%	$ 1,021.0	100.0%	$ 486.0	100.0%	$ 345.4	100.0%	$ 241.7	100.0%

Note 1 – There is a lack of uniformity in the way the recovery period is disclosed across the sampled entities (i.e., sometimes ranges or exact number of months are disclosed). When ranges were disclosed, the mid-point of the range was used for purposes of this table.

* There can be various reasons why the recovery period is indeterminate:
- Some debit balances are reversed when their rate impacts are realized.
- The recovery period is pending determination by the rate regulator as part of a future regulatory proceeding.

23 IASB Rate-regulated Activities Consultative Group, Meeting Summary (March 2015), Paragraph 28

Remaining recovery/ reversal period	Examples of nature of debit balances arising from rate regulation
1 - 24 months	Commodity cost variances
25 - 60 months	Specific items to be spread over longer period authorized by the regulator
60 - 120 months	Costs related to long-term projects and infrastructure planning
121+ months	Programs for construction or or reburbishment infrastructure assets
Indeterminate	Policy difference between the accounting specified by the regulator for rate-setting purposes and general purpose financial reporting requirements (e.g., as occurs sometimes with employee future benefits and income taxes)

79. The two tables above illustrate the diversity in nature of debit balances arising from rate regulation and plans for their recovery, and reaffirm that some balances may be subject to more uncertainty regarding the timeline for recovery than others. Knowledge of the expected recovery pattern for debit balances arising from rate regulation is important to determine whether there could be measurement challenges associated with the balances.

80. Below is an excerpt from a Standard & Poor's Rating Services publication that demonstrates the importance of timely recovery:

> "One of our primary concerns with U.S. regulatory accounting occurs when a company's regulatory assets materially grow with uncertain recovery prospects. The California energy crisis of 2000 and 2001 highlighted this when the regulated utilities could only collect a predetermined amount for electricity but had to purchase electricity at much higher market prices, leading to a material weakening of credit quality. Most companies now have some form of a fuel- or purchased-power adjustment clause that allows for timely recovery of these costs--greatly reducing the risks and enhancing credit quality.
>
> The high credit quality and (mostly) investment grade ratings for the utility industry are predicated on its monopolistic nature, providing an essential service, and credit-supportive rate regulation. Because a utility's ability to effectively manage regulatory risk is an integral component of credit quality, our assessment of a regulatory jurisdiction's credit supportiveness and a utility's ability to manage regulatory risk within its regulatory jurisdiction are major factors for determining a utility's credit risk (see "Utility Regulatory Assessments For U.S. Investor-Owned Utilities," Jan. 7, 2014.)"[24]

81. The concern pointed out in the excerpt above is shared by those who oppose the recognition of debit balances arising from rate regulation because of the uncertainty associated with their recovery. The concern highlights:

(a) the importance of a rate regulator deciding on reasonable and achievable recovery periods in order to mitigate the risk associated with prolonged growing balances; and

[24] S&P: Analyzing U.S. Rate-Regulated Utilities: The Magic of Regulatory Assets and Liabilities (August 2014)

(b) the need for adequate evidence from rate regulators demonstrating the enforceability of rights or obligations created through their regulatory decision that will result in an economic inflow or outflow within a reasonable period.

82. From an international perspective, below are two examples of entities outside Canada that have recognized debit or credit balances arising from rate regulation. Their note disclosures explain the nature of these balances and the expected period of recovery or settlement (emphasis added below).

Extracts from Financial Statements
Korea Gas Corporation (Korea) – 2015 audited consolidated financial statements (Accounting framework: Korean IFRS) Recorded in "Other non-financial assets" Note 15 – Non-Financial Assets In accordance with the standard for natural gas supply price and the guidelines for raw material cost passthrough adjustment system for city gas and power generation, the settled income, the difference between actual cost incurred and current year's revenues, is reflected in following year's rates upon the approval of the government. The Group recognizes settled income by adjusting cost of sales, and relevant assets and liabilities as other non-financial assets and non-financial liabilities, respectively.
CLP Holdings Ltd. (Hong Kong) – 2015 audited consolidated financial statements (Accounting framework: Hong Kong Financial Reporting Standards) Recorded in "Non-current liabilities" Note 22 – Fuel Clause Account Cost of fuel consumed by CLP Power Hong Kong is passed on to the customers. The variations between the actual cost of fuel and the fuel cost billed are captured in the fuel clause account. The balance of the account (inclusive of interest) represents amounts over-recovered or under-recovered and is treated as an amount due to or from customers. Interest charged to customers on the amount under-recovered is based on the actual borrowing cost of CLP Power Hong Kong, whilst interest is credited to customers at prime rate on the amount over-recovered. Note 23 – Scheme of Control Reserve Accounts The Tariff Stabilisation Fund, Rate Reduction Reserve and Rent and Rates Interim Refunds of the Group's major subsidiary, CLP Power Hong Kong, are collectively referred to as SoC reserve accounts. "Scheme of Control" is explained in the following extract from the entity's Annual Report: Since financial year 1964, the electricity-related operations of CLP Power Hong Kong and CAPCO (the SoC Companies) have been governed by a Scheme of Control Agreement (SoC) with the Hong Kong Government. The SoC specifies the SoC Companies' obligations to supply adequate and reliable electricity supplies to customers at the lowest reasonable cost and the mechanism for Hong Kong Government to monitor their financial affairs and operating performance. In return, CLP Power Hong Kong is allowed to charge tariffs designed to recover the operating costs (including tax) and allowed net return of the SoC Companies.

CLP Holdings Ltd. (Hong Kong) – continued

The current SoC took effect from 1 October 2008. The SoC covers a period of 10 years to 30 September 2018, and provides that the SoC Companies will continue to earn the permitted return until 30 September 2023 on all approved investments.

The current SoC includes a provision to give the SoC Companies protection for stranded costs, which may arise as a result of future changes to the market structure which adversely impact on the SoC Companies' ability to recover and to earn returns on existing investments made in good faith in accordance with the SoC. These costs will include the costs of investments, fuel and power purchase agreements previously approved by the Hong Kong Government. If stranded costs arise after the SoC Companies have implemented mitigation measures reasonably required by the Hong Kong Government, the SoC Companies are entitled to recover them from the market, consistent with international practice. Three years before market changes are introduced, the SoC Companies and the Hong Kong Government will agree on the amount of stranded costs and the mechanism for their recovery by the SoC Companies.

What this Section Demonstrates

83. In order to assess the amount, timing and uncertainty of a rate-regulated entity's future cash flows, users need financial information that signals changes in the entity's right or obligation to collect or return amounts identified in previous regulatory decisions. The strength or weakness of the entity's regulatory framework can affect the enforceability of those rights and obligations and, thus, their measurement.

Section IV. Decision-Making Effects of Financial Information on Rate-regulated Activities

Key Observations

- The regulatory framework is a key factor considered by debt and equity analysts, as well as credit rating agencies, because it can affect the entity's financial performance and future cash flows.
- Market participants in Canada and the U.S. have used financial information that reflects the economics of rate-regulated activities to determine the purchase price for acquiring assets used in such activities. The acquisition deals reveal that a premium is generally paid by the acquirer. Investors view rate-regulated businesses as capable of generating stable earnings and cash flows, taking into consideration the strength of the regulatory framework in which the entity operates.
- The purchase price allocation in jurisdictions, such as Canada and the U.S., that recognize debit and credit balances arising from rate regulation indicate that there is commercial substance to these balances because their carrying value generally approximates fair value. Based on anecdotal information, in jurisdictions that do not recognize balances arising from rate regulation, this value is reflected in goodwill or intangible assets.
- Academic research suggests that the strength of the regulatory framework can influence market valuation of debit balances arising from rate regulation.

84. This section of the paper looks at how users have factored financial information that reflects the economics of rate-regulated activities into their decision-making.

The User Perspective

85. Throughout the IASB's projects on rate-regulated activities, users analyzing rate-regulated entities have contributed their views on what makes the financial statements relevant for them. From their perspective, financial information on rate-regulated activities assists in:

    - predicting future cash flows;
    - estimating the enterprise value;
    - distinguishing the variability in performance that is compensated for through the rate-setting mechanism, from the variability in performance for which there is no compensation;
    - assessing the entity's financial stability and creditworthiness (e.g., ability to repay debts);

- assessing the strength of rate regulation in order to determine the track record of the entity in recovering costs and earning the allowed rate of return; and
- understanding the drivers that affect the allowed rate of return.

86. Through its September 2014 Discussion Paper on "Reporting the Financial Effects of Rate Regulation," the IASB has sought input from stakeholders to identify what information about the financial effects of rate regulation is most relevant to users of financial statements in making investing and lending decisions. Appendix A to this paper provides extracts from comment letters and other material to capture the essentials of this input. This information is grouped into the three main geographical regions: the Americas, EMEA (Europe, Middle East and Africa) and Asia-Pacific. The appendix is not meant to be exhaustive, and is intended to capture comments made from both sides of the views debated.

87. One comment made by users in the Americas region (see Appendix A) relates to how there could be an increased reliance on non-GAAP disclosures if debit and credit balances arising from rate regulation are not recognized under IFRS. Following are financial statement note disclosures of two entities that staff is aware have applied IFRS and provided an adjusted measure to communicate the financial impact of their rate-regulated activities.

Canada	United Kingdom
ATCO Ltd. – Audited Consolidated Financial Statements – December 31, 2015 (Entity adopted IFRS for the first time before IFRS 14 was issued. Staff notes that the segment note referenced below essentially provides the same information about the entity's rate-regulated activities as was provided in previous years under pre-changeover Canadian GAAP.) Note 5 – Segmented Information (excerpt) Adjusted earnings are earnings attributable to equity owners of the Company after adjusting for the timing of revenues and expenses for rate-regulated activities and dividends on equity preferred shares of the Company. Adjusted earnings also exclude one-time gains and losses, significant impairments and items that are not in the normal course of business or a result of day-to-day operations. Adjusted earnings are a key measure of segment earnings used by the CODM to assess segment performance and allocate resources. Other accounts in the consolidated financial statements have not been adjusted as they are not used by the CODM for those purposes.	**National Grid – Audited Consolidated Financial Statements – March 31, 2015** (Entity adopted IFRS for the first time before IFRS 14 was issued) Note 2 – Segment Analysis (excerpt) (Under the title "Unaudited commentary on the results of our principal operations by segment") As a business, we have three measures of operating profit that are used on a regular basis and disclosed in this Annual Report. **Statutory operating profit:** This is operating profit as calculated under International Financial Reporting Standards (IFRS). Statutory operating profit by segment is shown in note 2 on page 98. **Adjusted operating profit:** Adjusted operating profit (business performance) excludes items that if included could distort understanding of our performance for the year and the comparability between periods. Further details of items that are excluded in adjusted operating profit are shown in note 4 on page 103. **Regulatory financial performance:** This is particularly relevant for our UK operations and is a measure of operating profit that reflects the impact of the businesses' regulatory arrangements when presenting financial performance.

88. In jurisdictions where users have benefited from the knowledge gained through an understanding of the way rate regulation can affect an entity's financial performance and financial position, there is a possibility that if future financial statements do not provide such relevant information, non-GAAP disclosures could be used. This is because users need to understand the economics of rate-regulated activities in order to make investing and lending decisions.

89. Staff also notes that comments shown in Appendix A expressing concerns about recognizing balances arising from rate regulation are important and will need to be resolved as the project progresses.

Debt and Equity Analysts, and Credit Rating Agencies – What do they Consider?

90. Canadian debt and equity analysts, as well as credit rating agencies, have told us that utilities with regulated operations are viewed differently from those with non-regulated operations. They have also said that even if the financial effects of rate regulation were not recognized in the financial statements, they would continue to analyze and assess rate-regulated entities based on their view of an entity's economic reality. They would do so by making adjustments to the financial statements to compensate for the differences created by accounting standards.

91. In the case of credit rating agencies, different rating methodologies are used based on whether or not the entity is rate-regulated. The staff looked at the rating methodology for three credit rating agencies (i.e., Moody's, Standard & Poor's (S&P), and Dominion Bond Rating Service (DBRS)). Following is a table that illustrates Moody's rating methodology. The rating factors highlighted in blue are specific to regulated utilities.

Broad Rating Factors	Broad Rating Factor Weighting	Rating Sub-Factor and Sub-Factor Weighting
Regulatory Framework (For utilities which typically operate as a monopoly, the regulatory environment and how the utility adapts to that environment are the most important credit considerations.)	**25%**	Legislative and Judicial Underpinnings of the Regulatory Framework (12.5%): • Consider the scope, clarity, transparency, supportiveness, and rules as they apply to the issuer. • Strength of the regulator's authority over rate-making, other regulatory issues, the effectiveness of the judiciary or other independent body in arbitration • Body of legal precedent for rate-making. • The utility's ability to shape the framework and adapt to it.
		Consistency and Predictability of Regulation (12.5%): • Consider the track record of regulatory decisions in terms of consistency, predictability, and supportiveness.
Ability to Recover Costs and Earn Returns	**25%**	Timeliness of Recovery of Operating and Capital Costs (12.5%)
		Sufficiency of Rates and Returns (12.5%)
Diversification	**10%**	Market position (5%)
		Generation and Fuel Diversity (5%)
Financial Strength, Key Financial Metrics (Metrics focus on Cash Flow from Operations Before Changes in Working Capital (CFO pre-WC) because, unlike Funds from Operations, it captures the changes in long-term regulatory assets and liabilities.)	**40%**	CFO pre-WC + Interest/ Interest (7.5%) • Lower thresholds for regulated utilities (vs. unregulated utilities)
		CFO pre-WC / Debt (15%) • Lower thresholds for regulated utilities (vs. unregulated utilities)
		CFO pre-WC – Dividends / Debt (10%)
		Debt / Capitalization (7.5%)

Source: Information compiled based on Moody's Rating Methodology for Regulated Electric and Gas Utilities (December 2013)

92. Although the components in determining the credit rating in each of the three rating methodologies examined are somewhat different, the quality of the regulatory framework is consistently identified as one of the most important factors in the credit analysis.

Extracts from Credit Rating Agency's Publications
S&P – The regulatory framework/regime's influence is of critical importance when assessing regulated utilities' credit risk because it defines the environment in which a utility operates and has a significant bearing on a utility's financial performance. We base our assessment of the regulatory framework's relative credit supportiveness on our view of how regulatory stability, efficiency of tariff setting procedures, financial stability, and regulatory independence protect a utility's credit quality and its ability to recover its costs and earn a timely return. Our view of these four pillars is the foundation of a utility's regulatory support. We then assess the utility's business strategy, in particular its regulatory strategy and its ability to manage the tariff-setting process, to arrive at a final regulatory advantage assessment."[25]
DBRS – The quality of the regulatory regime is the main driving factor for regulated utilities as it is the most important [Business Risk Assessment] factor. The regulatory framework also influences a company's [Financial Risk Assessment] as the deemed capital structure and return on equity (ROE) are often set by the regulator.[26]

[25] S&P: Key Credit Factors For The Regulated Utilities Industry (November 2013), Pg. 6

[26] DBRS: Rating Companies in the Regulated Electric, Natural Gas and Water Utilities Industry (October 2015), Pg. 6

93. Understanding the risks of the regulatory framework is important because credit rating downgrades can result in increased borrowing costs for entities.

94. One similarity between the three rating methodologies is that a strong assessment of the regulatory framework can result in more favourable ranges being used in assessing the financial metrics of the entity. For example, S&P states:

> "While our final regulatory advantage assessment has a significant influence on a utility's business risk profile, it can have an even greater impact on its financial risk profile. As regulatory advantage declines, we expect higher cash flow volatility; as such, a utility's regulatory advantage score directly affects which of the three cash-flow volatility tables -- low, medial, or standard -- we'll use as a guideline when assessing the issuer's financial risk. Generally speaking, low cash-flow volatility allows for higher debt levels at the same rating category than medial volatility, and medial volatility allows for more debt than standard volatility."[27]

95. A number of factors are taken into consideration when assessing the regulatory framework. Below are the factors that DBRS considers:

	Considerations
Regulation (most important Business Risk Assessment factor)	**Deemed Equity** - Percentage of equity investment in the rate base on which utility can earn a return.
	Allowed ROE - In supportive regulatory environments, utilities' actual rate of returns are generally in line with, or exceed, the allowed rate of return.
	Energy Cost Recovery - Considers whether fuel and purchased energy costs are fully passed through to customers; how often is utility allowed to adjust retail rates; whether rate adjustments are subject to regulatory review.
	Capital and Operating Cost Recovery - Assesses likelihood of a utility's capital expenditure being added to rate base, whether there is mechanism to deal with cost overruns, etc.
	Cost of Service versus Incentive Regulation Mechanism Views cost of service as lower risk than incentive regulation mechanism.
	Political Interference - Influence on regulator's ability to independently arrive at decision, passing legislation to override a decision, and the regulator elected instead of appointed.
	Retail Rate - Average price for residential customers (not applicable for gas distribution, water and waster-water utilities).
	Stranded Cost Recovery - Represents costs incurred but faces uncertainty around recovery. Rating depends on frequency of write-downs, time it takes to recover the costs, magnitude of stranded costs, etc.
	Rate Freeze - Longer rate-freeze periods or higher frequency of occurrence increases risk assessment.
	Market Structure (Deregulation) - Rating depends on degree of regulation. The strongest utilities will have fully-integrated operations (generation, transmission and distribution).

Source: Information compiled based on DBRS Methodology for Rating Companies in the Regulated Electric, Natural Gas and Water Utilities Industry (October 2015)

[27] S&P Article, How Regulatory Advantage Scores Can Affect Ratings on Regulated Utilities (April 2015)

96. As shown in the table above, one of the factors considered is political interference. Below is an excerpt from S&P's rating of Maritime Electric Co. Ltd (MECL) in March 2016, illustrating how political intervention, along with other factors, is taken into consideration when determining this Canadian entity's credit rating (emphasis added below):

> Our view of MECL's business risk profile continues to be excellent, which in part reflects our assessment of the regulatory framework that supports a stable and predictable cash flow model. The [Island Regulatory & Appeals Commission] continues to administer a regulatory framework that allows full recovery of prudently incurred operating, capital and commodity costs. Under the most recent [General Rate Agreement] decision, which expires in February 2019, MECL's maximum allowed return on equity is 9.35% and the company needs to maintain an average equity base of about 40%, which are slightly lower than the previous rate decision but in line with our expectations, given the current low interest rate environment.
>
> The provincial government continues to play a significant and active role in energy policy and establishing rates for island customers. A sign of this is the PEI Energy Accord, which expired in February 2016 and was followed with the latest rate settlement between MECL and the PEI government, although this is subject to regulatory approval. We view the government's active involvement in rate-setting as generally less favorable than an independent regulator with a clear, consistent mandate and an established track record of credit-supportive policies. Due to the track record for political intervention (which could negatively or positively affect credit quality), the regulator's limited strength, and its independence, we view MECL's regulatory environment as less favorable compared with that of regulated utilities operating in other Canadian provinces.
>
> Further supporting the excellent business risk profile is that MECL is the legislated monopoly provider of electricity to about 78,000 customers in PEI, which we believe provides the company with a stable market position. In addition, rates are set on a cost-of-service framework, which allows MECL to fully recover its revenue requirement. The province has a mature-but-stable economy that relies primarily on the public sector, fishing, agriculture, and tourism. We believe that the company's limited scale, scope, and diversity are an offsetting factor, given the relatively small market, a limited number of sources of generation, and some customer concentration (with the largest customer accounting for 5%-6% of sales).
>
> In addition, prudently incurred electricity cost remains a flow-through to ratepayers via the energy cost adjustment mechanism. The utility has successfully renegotiated a power purchase agreement with NB Power, an electricity provider in the Province of New Brunswick, which expires in February 2019. This will ensure adequate supply of electricity at a reasonable cost, reducing regulatory risk of nonrecovery.

Source: S&P Ratings Report

97. Credit rating analysts have said that although the regulatory framework is a key factor in their assessment of an entity, there are many other inputs to their models. One area of focus is certainty of timely recovery of debit balances, or settlement of credit balances, arising from rate regulation, as a predictor of future cash flows. While current period cash flow metrics are not much affected by the recognition of these balances, an accumulation of material debit and credit balances is a "red flag" that communicates risks for the future. Debt and equity analysts have also indicated that without the recognition of debit and credit balances arising from rate regulation, earnings volatility would increase and valuation metrics such as the commonly used price/earnings ratio would be affected.

98. Staff understands that users seek out other sources of information, such as rate filings and regulatory decisions, to complete their assessment of an entity.[28] However, consulting these other sources is intended to corroborate or supplement financial information provided in the financial statements, rather than fundamentally adjust it to reflect the economic reality of the entity.

Acquisitions – Does Rate Regulation Affect Purchase Price?

99. Staff understands that in Canada and the U.S., when prospective purchasers look at the margins and growth of an entity, debit balances arising from rate regulation are viewed as having a greater degree of certainty of generating a defined return in the long term. Lower risk tends to be attached to debit balances arising from rate regulation because of the continuing demand for the essential goods and services being provided by the entity. The rate-setting mechanism provides predictability of the regulated asset's earnings during the regulatory period. Below are two extracts from EY publications that look at transactions in the Power and Utilities sector:

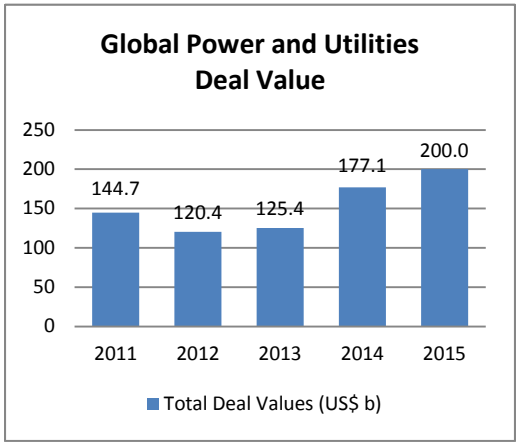
> "The reshaping of the US Sector continued as diversified utilities focused on regulated assets and independent power producers (IPPs) grew their presence. The US sector saw 15 billion-dollar-plus transactions – significantly more than in 2013 – with buyers paying a premium for prized rate-regulated assets." (emphasis added)
>
> ~Source EY: Power transactions and trends, 2014 review and 2015 outlook

> "**Regulated assets still command premiums:** During the year we saw utilities paying above average premiums on regulated assets, which were already trading at the high end of their historical averages — ~37%, higher than last year's average. While low natural gas prices and rising interest rates present a challenge to the sector, strong balance sheets and availability of low-cost debt are enabling utilities to acquire these assets at premium valuations. With predictable cash flows and rates of return, we expect regulated assets to grow more resilient in 2016 and continue to command high valuations."
>
> ~Source EY: Power transactions and trends, 2015 review and 2016 outlook

100. Regulated assets have higher valuation multiples compared with unregulated assets, suggesting market participants factor the effects of the regulatory framework into the purchase price. Following are two charts that provides information on global (i.e., Americas, Europe and Asia-Pacific) Power and Utilities transactions over the last several years.

[28] IASB Staff Agenda Paper 9A, September 2013, Paragraph 7

101. The chart to the left includes the transaction deals of entities in the segments of generation; transmission and distribution; renewables; and integrated, water and others. The chart to the right relates only to the transaction deals of entities in the transmission and distribution segment, which is commonly regulated.

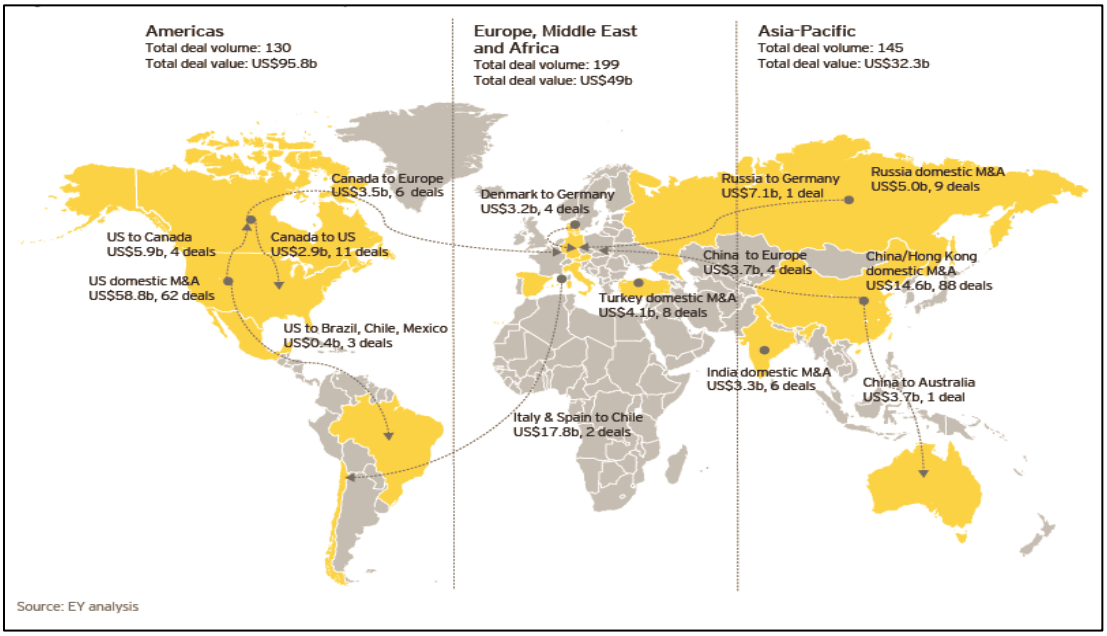


Source: EY Power transactions & trends
(2014 review and 2015 outlook, 2015 review and 2016 outlook)

Tranmission and Distribution (T&D) deal value in Americas, Europe and Asia-Pacific		
Year	US$ (in billions)	Average premiums paid for regulated T&D entities
2015	67.9	30%
2014	41.9	15-35%

Source: EY Power transactions & trends
(2014 review and 2015 outlook, 2015 review and 2016 outlook) and EY Capital outlook: power and utilities

102. Staff notes that while not all the deals over the last five years involve debit and credit balances arising from rate regulation (as it depends on the form of rate regulation and what is purchased), these deals span over different jurisdictions, signaling that investors are looking for opportunities around the globe. Below is a diagram extracted from "EY Power transactions and trends, 2014 review and 2015 outlook" to show the cross-border and domestic capital flow of the 2014 key investment destinations chosen by utilities and financial investors in this dynamic environment.



Canadian and U.S. Acquisitions

103. Since the predominant accounting practice in Canada and the U.S. is to recognize debit and credit balances arising from rate regulation, staff looked at the purchase price in recent acquisitions to determine how investors value these balances. The bidders below apply U.S. GAAP.

in USD millions (unless otherwise specified)

Date of Announcement	Deal Value (USD million)	Segment	Bidder Name & Country	Target Name & Country	Purchase Tender	Balances Arising from Rate Regulation Recognized in Purchase Equation?	Total Purchase Consideration	Fair Value of Net Assets Acquired	Goodwill	Goodwill as a Percentage of Total Purchase Consideration
11-Dec-13	$4,303	Integrated	Fortis Inc. (Canada)	UNS Energy Corporation (US)	Fortis acquired all of the outstanding common shares of UNS Energy for US$60.25 per common share in cash, for an aggregate purchase price of approximately US$4.5 billion, including the assumption of US$2.0 billion of debt on closing. Financing of the net cash purchase price of approximately $2.7 billion (US$2.5 billion) is substantially complete.	Yes - at carrying value (see note disclosure in the next table)	$2,745 CAD	$1,235 CAD	$1,510 CAD	55.0%
30-Apr-14	$12,186	Transmission & Distribution	Exelon Corporation (US)	Pepco Holdings Inc. (US)	The total purchase price consideration of approximately $7.1 billion for the PHI Merger consisted of cash paid to PHI shareholders, cash paid for PHI preferred securities and cash paid for PHI stock-based compensation equity awards.	Yes - at carrying value (see note disclosure in the next table)	$7,142	$3,118	$4,024	56.3%
1-May-14	$5,516	Transmission & Distribution	Berkshire Hathaway Energy Company (US)	AltaLink, L.P. (Canada)	Under the terms of the Share Purchase Agreement, dated May 1, 2014, among BHE and SNC Lavalin Group Inc. ("SNC-Lavalin"), BHE paid C$3.1 billion (US$2.7 billion) in cash to SNC-Lavalin for 100% of the equity interests of AltaLink. BHE funded the total purchase price with $1.5 billion of junior subordinated debentures issued and sold to subsidiaries of Berkshire Hathaway, $1.0 billion borrowed under its commercial paper program and cash on hand.	Yes - at carrying value (see note disclosure in the next table)	$2,728	$984	$1,744	63.9%
4-Sep-15	$10,366	Integrated	Emera, Inc. (Canada)	TECO Energy, Inc. (US)	On July 1, 2016, Emera acquired all of the outstanding common shares of TECO Energy Inc. for $27.55 USD per common share. The net cash purchase price totaled $8.4 billion ($6.5 billion USD), with an aggregate purchase price of $13.9 billion ($10.7 billion USD), including the assumption of $5.5 billion ($4.2 billion USD) in US debt facilities on closing.	Yes - at carrying value (see note disclosure in the next table)	$8,447 CAD	$2,707 CAD	$5,740 CAD	68.0%

Source: Information compiled based on data from EY's Power transactions and trends (2013 review and 2014 outlook, 2014 review and 2015 outlook), PwC North American Power & Utilities Deal (Q3 2015) and Financial Statements of the Bidder.

104. The corresponding note disclosures relating to these acquisitions have been extracted to explain the valuation of the debit and credit balances arising from rate regulation.

Extracts from Financial Statement Note Disclosure Relating to Acquisition
Fortis Inc. (Source: December 31, 2014 Consolidated Financial Statements) Note 29 – Business Acquisitions UNS Energy's operations are regulated by the ACC and FERC (Note 2). The determination of revenue and earnings is based on a regulated rate of return that is applied to historic values, which do not change with a change of ownership. No fair value adjustments, other than goodwill, were recorded for the net assets acquired because all of the economic benefits and obligations associated with them beyond regulated rates of return accrue to the customers.
Exelon Corp. (Source: June 30, 2016 Consolidated Financial Statements) Note 4 – Mergers, Acquisitions and Dispositions (Exelon, Generation, PHI and Pepco) Through its wholly-owned rate regulated utility subsidiaries, most of PHI's assets and liabilities are subject to cost-of-service rate regulation. Under such regulation, rates charged to customers are established by a regulator to provide for recovery of costs and a fair return on invested capital, or rate base, generally measured at historical cost. In applying the acquisition method of accounting, for regulated assets and liabilities included in rate base or otherwise earning a return (primarily property, plant and equipment and regulatory assets earning a return), no fair value adjustments were recorded as historical cost is viewed as a reasonable proxy for fair value. Fair value adjustments were applied to the historical cost bases of other assets and liabilities subject to rate regulation but not earning a return (including debt instruments and pension and OPEB obligations). In these instances, a corresponding offsetting regulatory asset or liability was also established, as the underlying utility asset and liability amounts are recoverable from or refundable to customers at historical cost (and not at fair value) through the rate setting process. Similar treatment was applied for fair value adjustments to record intangible assets and liabilities, such as for electricity and gas energy supply contracts as further described below. Regulatory assets and liabilities established to offset fair value adjustments are amortized in amounts and over time frames consistent with the realization or settlement of the fair value adjustments, with no impact on reported net income. See Note 5 — Regulatory Matters for additional information regarding the fair value of regulatory assets and liabilities established by Exelon and PHI.
Berkshire Hathaway Energy Company (Source: December 31, 2015 Consolidated Financial Statements) Note 3 – Business Acquisitions The operations of ALP are subject to the rate-setting authority of the AUC and are accounted for pursuant to GAAP, including the authoritative guidance for regulated operations. The rate-setting and cost recovery provisions establish rates on a cost-of-service basis designed to allow ALP an opportunity to recover its costs of providing service and a return on its investment in rate base. Except for certain assets not currently in rates, the fair value of ALP's assets acquired and liabilities assumed subject to these rate-setting provisions are assumed to approximate their carrying values and, therefore, no fair value adjustments have been reflected related to these amounts.
Emera, Inc. (Source: June 30, 2016 Condensed Consolidated Interim Financial Statements) Note 31 – Acquisition Except for unregulated long-term debt acquired and deferred taxes, preliminary fair values of tangible and intangible assets and liabilities subject to these rate-setting provisions approximate their carrying values. The goodwill reflects the value paid primarily for access to regulated assets, net income and cash flows in growth markets with constructive regulatory environments, opportunities for adjacency growth, long-term potential for enhanced access to capital as a result of increased scale and business diversity, and an improved earnings risk profile. Allocation of goodwill to the reporting units is not complete as at August 8, 2016.

105. Based on the analysis above, entities with rate-regulated businesses typically attract a premium in purchase price because of the stable earnings and cash flows those businesses can generate. The fair value assigned to the debit and credit balances arising from rate regulation is generally their carrying values, demonstrating there is commercial substance to these balances.

106. Shown in the next table, recent trends also suggest increasing deal activities in the Americas. In Canada, utilities and pipelines are heavily regulated with just a handful of key players in some geographical areas. Therefore, Canadian entities in this sector are looking for opportunities to expand their regulated asset portfolio. They are seeking higher returns in a larger market by buying assets in the U.S. This factor, coupled with the current interest environment, fuels the deal activities in the Americas.

> "As hybrid utilities and financial institutions sought stable earnings in the low interest rate environment by adding regulated assets to their portfolios, transactional activity in the regulated transmission and distribution (T&D) segment increased significantly."
>
> ~Source: EY Power transactions and trends, Q1 2016

Below are examples of some recent major deals that involve Canadian entities and investment funds buying outside the country. The cross border acquisitions demonstrate the need for comparable accounting in order to assist users in making investing and lending decisions.

Announcement		Segment	Bidder Name	Bidder Country	Target Name	Target Country	Rationale for deal
Date	Deal Value (USD million)						
24-Nov-15	$7,377	Transmission & Distribution (Grid)	Caisse de dépôt et Placement du Quebec; Hastings Funds Management Limited; Spark Infrastructure Group; Tawreed Investments Ltd.; Wren House Infrastructure Management Limited	Canada; Australia; United Arab Emirates; Kuwait	TransGrid	Australia	Bidders seeking to add high quality regulated assets with stable cash flows.
9-Feb-16	$11,305	Transmission & Distribution (Electricity)	Fortis Inc.	Canada	ITC Holdings Corp	US	Aligns with Fortis' strategy to diversify its business with regards to regulatory jurisdiction, business risk and regional economic mix.
9-Feb-16	$2,361	Integrated	Algonquin Power & Utilities Corp.	Canada	Empire District Electric Company	US	Strengthens APUC's existing businesses and strategically expands its regulated utility footprint in the Midwest US.
17-Mar-16	$13,076	Integrated	TransCanada Corporation	Canada	Columbia Pipeline Group, Inc.	US	Acquisition represents a rare opportunity to invest in an extensive, competitively-positioned, growing network of regulated natural gas pipeline and storage assets in the Marcellus and Utica shale gas regions.

Source: EY Power transactions and trends (Q1 2016, and 2015 review and 2016 outlook), PwC North American Power & Utilities Deals (Q1 2016), Entity's News Release

107. This research indicates that prospective purchasers look closely at an entity's rate base when considering an acquisition. The rate base is the amount of investment in a rate-regulated operation for which the entity is allowed to earn a return (emphasis added). The rate base generally affects two components of the entity's revenue requirement: depreciation that is allowed to be recovered, and return on capital (i.e., rate base multiplied by the allowed rate of return). Prospective purchasers consider the rate base to be a measure of the net value of the assets used by the entity in its rate-regulated operations. The recent acquisitions that we have seen in Canada are intended to grow the regulatory asset base in order to earn a higher rate of return.

Acquisitions outside Canada and the U.S.

108. We wanted to understand how entities that apply IFRS without recognizing debit and credit balances arising from rate regulation (i.e., the predominant IFRS practice) treat premiums paid for rate-regulated businesses. Accordingly, we made enquiries of a European valuations expert to understand how this difference in accounting possibly affects the purchase price equation.

109. Although anecdotal, the information we obtained was helpful. We were told that, consistent with our understanding, investors generally pay a premium to buy into a monopolistic industry. Theoretically, without the recognition of balances arising from rate regulation, their value would be captured in goodwill. A utility's right to charge a higher tariff in the future or obligation to reduce future prices, provides additional information about the value of the acquired business that could also be captured in the fair value of the licence recognized on acquisition. However, in both cases, it would be difficult to identify amounts attaching specifically to the value placed on the acquiree's rate-regulated activities in IFRS financial statements.

110. Staff corroborated this information by looking at the goodwill note disclosure of an entity in France (see the following table). This entity applies IFRS. While the note disclosure does not confirm that a portion of the goodwill relates to unrecognized debit and credit balances arising from rate regulation, it suggests that there could be a correlation between goodwill and the cash flows from the regulated asset base.

Engie (France) – Extract from 2015 annual consolidated financial statements
Note 12.3.1.2 Goodwill allocated to the Distribution CGU The total amount of goodwill allocated to the Distribution CGU was €4,009 million at December 31, 2015. The Distribution CGU groups together the Group's regulated natural gas distribution activities in France. The value-in-use of the Distribution CGU was calculated using cash flow projections drawn up on the basis of the 2016 budget and the medium-term 2017-2021 business plan, as approved by the Group Management Committee and Board of Directors. The terminal value calculated at the end of the medium-term business plan corresponds to the expected Regulated Asset Base (RAB) with no premium at the end of 2021. The RAB is the value assigned by the regulator (CRE) to the assets operated by the distributor. It is the sum of the future pre-tax cash flows, discounted at a rate that equals the pre-tax rate of return guaranteed by the regulator. The cash flow projections are drawn up based on the tariff for public natural gas distribution networks, known as the "ATRD 4 tariff", which entered into effect for a period of four years on July 1, 2012, and on the overall level of investments agreed by the French Energy Regulatory Commission (CRE) as part of its decision on the ATRD 4 tariff. Given the regulated nature of the businesses grouped within the Distribution CGU, a reasonable change in any of the valuation parameters would not result in the recoverable value falling below the carrying amount.

Academic Research – Views on Market Valuation of Debit Balances Arising from Rate Regulation

111. Staff looked at an academic research paper that examined how markets value debit balances arising from rate regulation. Although the research paper is somewhat dated, staff thinks certain observations made are still relevant in today's environment. Below are two extracts from the research paper, entitled "Market Valuation of Regulatory Assets in Public Utility Firms" (July 1996).

> "We provide evidence that the market values regulatory assets on average, but discounts the reported accounting values of regulatory assets conditional on the uncertainty inherent in the regulatory environment. In other words, investors of utilities operating in unfavorable regulatory environments appear to assign a non-zero probability to the possibility that the firm will fail to receive future revenues sufficient to recover the actual incurred costs that have been previously deferred. These findings are consistent both with those of Clinch and Magliolo (1992), who show that investors in oil and gas firms adjust for uncertainty in the pricing of required reserve disclosures, and with those of Khurana and Loudder (1994), who show that the market of utility firms to the exposure draft of SFAS No. 106 is inversely related to the favorableness of the regulatory environment." (emphasis added)

> "Market participants incur adjustment costs when accounting measures economic events with error, and as accounting measurement error increases, the usefulness of accounting information decreases. Adjustment costs and information quality have important implications for the cost of capital for the individual firm and the economy. Adjustment costs might be reduced and usefulness for utility investors increased by (1) considering the effect on information quality of multiple measurement attributes applied to essentially the same type asset, (2) requiring adequate footnote disclosure about regulatory risk issues, and (3) requiring disclosure of the time periods over which regulatory assets will be recovered." (emphasis added)

112. The above extracts highlight the concerns that some have with including debit and credit balances arising from rate regulation on the face of the financial statements. Mention of this point has already been made in connection with the measurement challenges of such debit balances (see paragraph 79).

What this Section Demonstrates

113. The decision-usefulness of financial information that reflects the economics of rate-regulated activities and the strength of the regulatory framework is evidenced by the fact that such information is factored into investment, lending and credit rating decisions. In acquisition scenarios, the capital markets appear to attach a premium to rate-regulated assets because of the stable earnings and cash flows they are capable of generating when the regulatory framework is strong.

Conclusions

114. Entities subject to rate regulation have a formidable presence in the capital markets, both in terms of market capitalization and bond issuances. Based on projected future investment requirements in the regulated markets, this presence is likely to only increase. Market participants view the rate-setting mechanism as a unique feature that provides stability in earnings and predictable cash flows.

115. The regulatory framework is a key determinant of the success of a rate-regulated entity because it defines the environment in which the rate-regulated entity operates. The regulatory framework governs the relationship between the rate regulator and the rate-regulated entity. The underlying legislation, the form of rate regulation, and the regulatory and court decisions that interpret the legislation and rules, all of which are a part of the regulatory framework, affect the determination of whether the rate-regulated entity has certain rights and obligations. Furthermore, the strength of the regulatory framework can affect the enforceability of those rights and obligations, translating into measurement challenges that affect the value of the economic resources of, and claims against, the rate-regulated entity. An understanding of the regulatory framework is essential in order to reflect the economics of rate-regulated activities in financial information.

116. Users, such as debt and equity analysts, and credit rating agencies, have all emphasized the importance of the regulatory framework. In their view, the components of the regulatory framework are capable of affecting the rate-regulated entity's ability to recover costs and earn a reasonable return for providing the regulated goods or services to customers.

117. Financial information assists users in making decisions when it helps them assess the amount, timing and uncertainty of future cash flows. In the case of rate-regulated entities, users take into consideration the financial effects of rate regulation when making their assessments. For example, entities contemplating an acquisition factor in financial information on rate-regulated activities when the potential acquiree operates in that sector. In fact, the data demonstrates that rate-regulated assets command a premium in purchase price given the stable earnings and predictable cash flows they can offer. In jurisdictions, such as Canada and the U.S., that permit the recognition of debit and credit balances arising from rate regulation, acquisitions demonstrate that there is commercial substance to these balances, as the carrying value of these balances generally approximates the fair value they are assigned in the purchase price allocation. For jurisdictions that do not account for these balances, staff has heard anecdotally that this premium is captured in goodwill or intangible assets.

118. The data in this paper provides evidence, from existing practice, demonstrating what information users need to understand the economics of rate-regulated activities, and how this information factors into their decision-making. This data supports evidence-based standard-setting and should assist the IASB's continued deliberations, and decisions, on how best to reflect the financial effects of rate regulation in IFRS statements.

119. As part of its deliberations, the IASB is encouraged to examine the adaptability of its proposed asset and liability definitions to regulatory frameworks that could give rise to rights and obligations. The manner in which such rights and obligations are reflected in financial statements, both qualitatively and quantitatively, can affect the transparency and comparability of the statements and, therefore, the degree to which they help users to make decisions. As evidenced by the data in this paper, information on the economics of rate-regulated activities appears differently in an entity's financial statements depending on the jurisdiction in which it operates. From a theoretical perspective, such diversity is only justified when the rights and obligations differ between entities.

Next Steps

120. The AcSB will be considering the findings in this paper at its September 21-22, 2016 meeting and discussing the appropriate next steps for the paper. These steps could include obtaining more data in a particular area (e.g., comparative information on the rate regulatory environment in other jurisdictions), or examining other aspects of rate-regulated activities they think the paper should also address.

121. In addition, the views of other national standard setters are being sought. This paper is being discussed at the September 2016 meetings of the International Forum of Accounting Standard Setters and the Accounting Standards Advisory Forum. The IASB and national standard setters will be asked to provide input. The AcSB's views on the paper will be shared orally at those meetings.

122. Once the paper has been updated for the feedback obtained, the AcSB will consider publishing the findings in order to serve as a formal reference document on the topic of rate-regulated activities.

Appendix A

Selected Comments by Region

EMEA (Europe, Middle East and Africa)			
Date	**Area & Group**	**Extract of Comments**	**Source**
Aug – Dec 2014	**Europe** Interviewed 19 equity and credit analysts - 18 from European countries, 1 from U.S.	"IFRS financial statements generally do not provide the information that users regard as relevant to understanding the impact of rate-regulated activities on an entity's revenue and related costs, cash flows and financial position associated with an entity's rate-regulated activities." "Most of the users broadly favour the inclusion of the financial effects of rate-regulated activities in the primary financial statements as this would enhance the usefulness of the information provided. Users believe that recognising the economic effects of rate regulation in the primary statements would: a) result in a measure of performance that reflects what an entity is entitled to earn; b) result in useful financial information to assess prospects of future cash flows; and c) portray the economic reality of entities operating rate-regulated activities. They support separate presentation of the effects of rate regulation on rate-regulated activities as they assess different risks profiles when entities also operate activities that are not rate-regulated."	EFRAG Feedback Statement – Interviews with Investors and Analysts
Dec 2014	Joint outreach event EFRAG, EFFAS, ABAF, IASB	"Some users noted that there are drawbacks to the recognition of these effects of rate regulation mainly because most rate-regulated regimes are complex and continually changing. In their view, the recognition of the effects of rate regulation at the at the expense of reliability and relevance would increase complexity and therefore reduce the understandability of financial statements." "Where enforceable rights and obligations exist, users preferred having this information recognised in the primary financial statements where a certain level of reliability is ensured; but they would be concerned about recognition if the definition of elements (e.g. assets and liabilities) in the Conceptual Framework were not met." "Where recognition of regulatory items in the primary statements were considered, sufficient, supplementary and quantitative disclosures should be mandatory to let users understand how management has exercised judgement and what risks are attached to the regulatory items."	Summary Report on User Event in Brussels
Jan 2015	**Norway** Standard-setter	"We believe that rate regulation schemes create rights and obligations, but think that regulatory assets and liabilities should only be recognized if they meet the definition of assets or liabilities in the framework. We do not believe that they meet the asset or liability definition in the current framework."	Comment Letter (2015)
Jan 2015	**South Africa** Accounting Body	"We are of the view that the IASB should adopt a conceptual approach by linking the rights and obligations created under rate regulation to the definition of assets and liabilities in the *Conceptual Framework for Financial Reporting (Conceptual Framework)*. We strongly feel that this should be the basis for any IFRS on rate regulation." "In our *Submission on the Request for Information on Rate Regulation* dated 29 May 2013, we expressed the view that one of the reasons why debates on this issue struggle to reach consensus, is not so much due to a difference of opinion regarding accounting principles but rather due to a difference in, or inadequate understanding regarding certain concepts and details of rate regulation applied by different rate regulators."	Comment Letter (2015)

EMEA (Europe, Middle East and Africa)			
Date	**Area & Group**	**Extract of Comments**	**Source**
Jan 2015	**Israel** Accounting Body	"Preparers, regulators, and auditors, in Israel are familiar, for almost two decades, with financial statements that recognize regulatory deferral account balances according to the guidelines of ASC 980 (previously "RE-6") in US GAAP. Such accounting is implemented mainly in the financial statements of entities providing utilities such as electricity and water. These entities, although operating as business entities, are owned and controlled by the government and regulated by special governmental authorities. We are not aware of special problems in investment or lending decisions stemming from the recognition of such deferral accounts by these entities. This may partially result from the fact that these entities are owned and controlled by the government and, therefore, lenders usually regard them as part of the government itself (even if the liabilities of such entities are not formally covered by governmental guarantees)."	Comment Letter (2015)

Asia-Pacific			
Date	**Area & Group**	**Extract of Comments**	**Source**
Jan 2015	**China** Standard Setter	"We believe regulatory deferral account balances should not be recognized in IFRS financial statements, therefore, we suggest the IASB not to develop specific accounting requirement for it. This is because regulatory deferral account balances don't meet the definitions of asset and liability in accordance with the Conceptual Framework. And there might be arbitrage opportunity of earning management if the entities are permitted to recognize such balances."	Comment Letter (2015)
Jan 2015	**Australia** Standard Setter	"The AASB considers that , in most cases, regulatory deferral account balances do not meet the definitions of assets and liabilities in the Conceptual Framework, and that an exception should not be introduced into IFRSs to allow their recognition. However, some specific disclosures in the financial statements regarding rate regulation could be useful to identify the financial effects of rate regulation."	Comment Letter (2015)
Jan 2015	**Korea** Standard Setter	"Financial statements should be prepared to provide useful financial information for decision making on supply of resources by the stakeholders such as investors and lenders. If rate regulated entities recognize regulatory deferral account, and sufficient classification and disclosure on notes for this are accompanied, more useful information can be provided to the stakeholders."	Comment Letter (2015)
Jan 2015	**Japan** Standard Setter	"… the ASBJ finds that users are relatively neutral as to whether an asset or a liability should be recognised, although they believe that information relevant to a rate regulation would be useful for users to assess the prospect for future cash inflows to an entity. Thus, the ASBJ is not sure if financial information would become more relevant and provide more faithful representation if assets or liabilities relating to rate regulatory schemes are recognised."	Comment Letter (2015)

Americas			
Date	**Area & Group**	**Extract of Comments**	**Source**
Dec 2014	**U.S.** Roundtable with analysts, preparers, auditors and rate regulators	Extract of some comments made by analysts in the meeting: • Courts support regulatory recovery of prudently incurred costs • Regulator's objectives include maintaining a low cost of capital for utilities • If there is no recognition of regulatory assets and liabilities under IFRS, - will result in an increased reliance on non-GAAP disclosures, thus increasing uncertainty, risk premiums and cost of capital - will require greater resources and costs for FS users to find information from other sources • Rate regulation creates a "new economic reality" • Noted that a major credit rating agency evaluates all 50 states from most supportive to least supportive regulatory environment, which impacts credit quality • Focus is on future cash flows and when expected to be recovered, so useful disclosures include: - analysis of how/why regulatory balances arise - a maturity schedule indicating when balances are expected to be recovered/reversed • Wants to see the information audited – non-GAAP disclosures are not consistent	Meeting summary of outreach event in Washington, D.C.
Jan 2015	**Brazil** Securities and Exchange Commission of Brazil	"… in our view, financial statements, especially those prepared by distribution companies, have been inaccurate since IFRS were adopted in 2010. Market players, such as financial institutions, ANEEL and others share this view and accordingly have required companies to adjust their financial statements by recognizing regulatory assets and liabilities since 2010 in order to analyze the companies' financial position. In this context, many companies have negotiated covenants with financial institutions based on financial information that included regulatory assets and liabilities."	Comment Letter (2015)
	Canada		
Jan 2015	Scotia Capital (Corporate Bond Research)	"…MD&A disclosure may not be uniform, hindering comparability across companies. I think it would be optimal to have recognition and disclosure of regulatory assets and liabilities in the financial statements. In the long run, this will enhance transparency and comparability, and in the long run, transparency and comparability play a big role in determining a firm's cost of capital."	Comment Letter (2015)
Jan 2015	DBRS (Credit Rating Agency)	"In order to properly assess the financials of these entities and to ensure consistency and comparability year-over-year, DBRS adjusts the IFRS financial statements of rate-regulated entities to include the effects of rate-regulated accounts as DBRS views that regulatory assets and liabilities will eventually be reflected in future rates."	Comment Letter (2015)
Nov 2009	RBC Dominion Securities (Equity Analyst)	"…I believe that not allowing companies in the sector to reflect regulatory assets and liabilities in their financial statements has the potential to be misleading, and that I also continue to be concerned about the increased use of non-GAAP measures to communicate financial results following the transition to IFRS."	Comment Letter (2009)

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