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STAFF PAPER

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Project	Rate-regulated activities		
Paper topic	Scope and recognition principles		
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Purpose of this paper

1. The purpose of this paper is to:

   (a) assess whether the tentative decisions made to date by the Board for scope and recognition are consistent with the model's principles summarised in Agenda Paper 9A *Principles of the model: a summary* (paragraphs 2–13);

   (b) discuss staff's preliminary view on derecognition of regulatory assets and regulatory liabilities (paragraphs 14–15); and

   (c) discuss whether an extension of the model's recognition principles should be considered to require the recognition of a regulatory liability for a present obligation to pay fines through the mechanism of a deduction from the future rates (paragraphs 16–22).

Tentative decisions made to date

Scope

2. The Board tentatively decided, in its March 2018 meeting that the accounting model should apply to **defined rate regulation** established through a formal regulatory framework that:

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

(b) establishes a **basis for setting the rate** that gives rise to rights to add amounts to, and obligations to deduct amounts from, future rate(s) because of goods or services already supplied or because of amounts already charged to customers. That basis gives rise to those rights and obligations by determining when (ie in which periods) the **total allowed compensation** for specified goods or services supplied is included in the rate(s) charged to customers. ~~includes a **rate-adjustment mechanism**. That mechanism creates, and subsequently reverses, **rights and obligations** arising from timing differences when the regulated rate in one period includes amount related to specified activities the entity carries out in a different period.~~

3. We understand the term 'rate-adjustment mechanism' was causing some confusion and the scope definition lacked clarity. Consequently, we suggest refining the scope definition as indicated in paragraph 2 (new text underlined, deleted text struck through) to reflect the refined description of the model summarised in Agenda Paper 9A. We consider the updates improve the specificity and clarity of the proposed scope and enhance the understandability of the model but do not represent a fundamental change to the tentative decisions or the anticipated outcomes of the model as previously discussed. The changes are intended to be consistent with the proposed refinements to the definitions of regulatory asset and regulatory liability discussed in paragraph 9.

Necessary features of the scope

4. A regulatory agreement may take the form of a contractual licensing agreement or may be imposed through statute. Regardless of its form, the terms of the regulatory agreement establish enforceable rights and obligations for the entity. The need for the terms of the regulatory agreement to be **binding** is a necessary feature that excludes from the scope of the model activities subject only to 'self-regulation' (ie an entity cannot create enforceable rights and obligations with itself). In some cases, the rate regulator and the entity are related parties because they are both controlled by the same government. Such a relationship does not automatically exclude the entity from applying the model. Instead, facts and circumstances are considered to assess the

enforceability of the regulatory agreement, including evidence from regulatory decisions and subsequent court rulings on those decisions.

5. The existence of a **basis for setting the rate** within the regulatory agreement is a necessary feature for activities to be subject to defined rate regulation. However, on its own, it is not a sufficient feature to differentiate defined rate regulation from other types of rate regulation. In some cases, the existence of a basis for setting the rate affects only the rate per unit that an entity is permitted to charge for its goods or services. In these cases, the regulatory intervention is limited to establishing a cap price but the entity's management is then free to manage the business in order to maximise its profitability. We have previously labelled this type of rate regulation as 'general price regulation' and have noted that such regulation would not result in the recognition of regulatory assets or regulatory liabilities.

6. The feature that distinguishes defined rate regulation from other forms of rate regulation is that the basis for setting the rate gives rise to rights to add amounts to, and obligations to deduct amounts from, future rate(s) because of goods or services already supplied or because of amounts already charged to customers. These rights and obligations arise because the basis for setting the rate establishes not only the **amount** of **total allowed compensation** for goods or services supplied in a period but also determines **when** (ie in which periods) that total allowed compensation is included in the rate(s) charged to customers. Consequently, the regulatory agreement creates a **direct cause-effect relationship** between the supply of goods or services, the total allowed compensation for supplying those goods or services and the rate charged to customers.

7. The presence of a **binding** regulatory agreement and a **basis for setting the rate** that gives rise to rights to add amounts to and obligations to deduct amounts from future rate(s) because of goods or services already supplied or because of amounts already charged to customers are both **necessary and sufficient** to give rise to regulatory assets and regulatory liabilities.

Incremental rights and obligations: assets and liabilities

8. When the total allowed compensation for goods or services already supplied differs from the amounts already included in the rate(s) charged to customers, the regulatory

agreement gives rise to **incremental rights and incremental obligations** that are not currently accounted for using IFRS Standards.

9. The Board tentatively decided, in its February 2018 meeting, that these incremental rights and incremental obligations meet the definitions of assets and liabilities within the *Conceptual Framework*. Subsequently, we have refined our description of these rights and obligations and, as a result, we suggest that the definitions of regulatory asset and regulatory liability previously considered by the Board are updated to reflect those refinements (new text underlined, deleted text struck through):

    (a) **Regulatory asset**—~~a~~ the present ~~regulatory~~ right to ~~charge a~~ add an amount to the rate(s) to be charged to customers in future periods because the total allowed compensation for the goods or services already supplied exceeds the amount already charged to customers ~~increased by an amount as a result of past events~~.

    (b) **Regulatory liability**—~~a~~ the present ~~regulatory~~ obligation ~~to provide goods or services at a~~ to deduct an amount from the rate(s) to be charged to customers in future periods because the total allowed compensation for the goods or services already supplied is lower than the amount already charged to customers ~~reduced by an amount as a result of past events~~.

10. We consider the updated definitions enhance their understandability and consistency of application. These updates provide:

    (a) a clearer definition of the **past event** that gives rise to an incremental right or incremental obligation—ie when goods or services are supplied in the period;

    (b) clarification of how the monetary **amount** of the right or obligation arising from the timing difference is determined—ie the difference between right to the '**total allowed compensation**' and the amount already charged to customers; and

    (c) clarification of the **obligation**—to deduct an amount from the future rate(s), rather than to provide goods or services.

11. We consider the updates made to the definitions improve the specificity and clarity of the definitions and enhance the understandability of the model but do not represent a

fundamental change to the tentative decisions or the anticipated outcomes of the model as previously discussed. Consequently, we conclude that the updated definitions are consistent with, and clarify the original intention of, the definitions considered when the Board tentatively decided that the incremental rights and incremental obligations recognised by the model meet the definitions of assets and liabilities within the *Conceptual Framework*.

Recognition

12. The Board tentatively decided, in its March 2018 meeting that the model:
    - (a) should require the recognition of regulatory assets or regulatory liabilities if it is 'more likely than not' that they exist (ie the model sets a symmetrical recognition threshold in cases of existence uncertainty); and
    - (b) should not set thresholds that would prevent recognition of a regulatory asset or regulatory liability for which there is:
        - (i) low probability of an inflow or outflow of economic benefits; or
        - (ii) high measurement uncertainty.
13. As a result of the Board's tentative decision to set a recognition threshold only for existence uncertainty, an entity would reflect any outcome uncertainty—ie uncertainty about the amount or timing of an inflow or outflow—in the measurement of the regulatory asset or regulatory liability in the statement of financial position. Uncertainty about the amount or timing of the inflow or outflow would include any uncertainty arising from demand risk or credit risk (see paragraph 24 of Agenda Paper 9C *Measurement principles*).

Question for the Board

Continued appropriateness of the scope of the model and recognition principles
1. Does the Board agree that the descriptions of the scope of the model and its recognition principles are clear, understandable and remain aligned with the tentative decisions the Board has made?

Derecognition

14. It has been implicit in all our discussions of the model that when an entity recovers part or all of a regulatory asset by adding the related amount to the rate(s) charged to customers, or fulfils part or all of a regulatory liability by deducting the related amounts from the rate(s) charged to customers, the entity derecognises that (part of the) regulatory asset or regulatory liability, and recognises regulatory expense or regulatory income accordingly.

15. The model measures regulatory assets and regulatory liabilities recognised using a cash-flow-based measurement technique. That technique requires that estimated cash flows arising from the regulatory asset or regulatory liability are updated at each reporting date (see paragraph 25 of Agenda Paper 9C). If a change in estimate were to have the result that the estimated cash flows are now zero, the regulatory asset or regulatory liability would, in effect be derecognised. The staff see no reason to treat a change in estimate that results in derecognition differently from other changes in estimate. The Board has tentatively decided to require entities to disclose changes in carrying amounts of regulatory assets and regulatory liabilities due to changes in estimates, together with qualitative and quantitative information about the reasons for those changes.[1]

Question for the Board

Derecognition
2. Does the Board have any concerns with the staff's preliminary views on derecognition as set out above?

Fines

16. A regulated entity may, from time to time, be subject to fines imposed by the regulator or another government body. If the entity is obliged to pay the fine or levy

[1] Agenda Paper 9D discussed at the November 2018 Board meeting.

in cash, the obligation is typically recognised as a liability until payment, if the recognition requirements of IAS 37 *Provisions, Contingent Liabilities and Contingent Assets* are met. However, in some cases, the regulated entity may be required to deduct the amount of the fine from the future rate(s) to be charged to customers for the future supply of goods or services, instead of paying cash.

17. We understand that, in practice, some entities applying IFRS Standards do not recognise such fines until they are reflected in the rate charged to customers. At that time, the amount of the fine is reflected through the recognition of the lower revenue amount, rather than as an expense. This is consistent with the current predominant practice of entities that do not apply IFRS 14 R*egulatory Deferral Accounts* not to recognise the entity's rights or obligations to adjust the future rate to be charged to customers as an asset or liability.

18. Staff consider that users would receive more relevant information if an entity were to recognise a liability for the obligation to pay the fine, irrespective of the mechanism for payment. Consequently, we considered whether the tentative decisions made to date for the model would change the existing predominant practice and result in the recognition of a regulatory liability for a present obligation to pay fines through the mechanism of a deduction from the future rate.

19. As noted in paragraph 9, the model recognises as regulatory assets and regulatory liabilities the incremental rights and incremental obligations arising when the total allowed compensation for the goods or services already supplied either exceeds or is lower than the amount already charged to customers. We have previously identified that penalties imposed on an entity for failing to meet a performance target relating to goods or services supplied would be captured within the definition of a regulatory liability because such performance penalties relate to the total allowed compensation already charged. However, some fines may be imposed for actions that do not relate to the total allowed compensation for goods or services already delivered, for example, this might be the case for a fine for breaching employment law or health and safety regulations for employees. If a fine imposed on an entity will be 'paid' through a deduction from the future rate charged to customers but that fine does not relate to an amount of total allowed compensation already charged, the obligation to 'pay' that fine or levy would not be captured within the definition of a regulatory liability.

Consequently, the tentative decisions made about the model so far would not result in a change of the existing predominant practice for such fines.

20. We plan to ask the Board to consider whether to explicitly require entities to recognise a liability for an obligation to pay fines through a deduction from future rate(s) charged to customers. If the Board agrees to require recognition in such circumstances, it could either look to amend IAS 37 or to include such a requirement within the model.

21. In November 2018, the Board tentatively decided that any requirements and application guidance on interactions between the model and other IFRS Standards should be included in the future standard on rate-regulated activities, rather than added to those other Standards.[2] Consequently, we suggest that it would be consistent with that decision to consider including a requirement in the model, rather than looking to amend IAS 37.

22. Accordingly, the staff's initial view is that we would propose the Board consider providing the following in the model:

    (a) an extension to the model's definition of a regulatory liability that would include obligations to deduct fines from the future rate(s); and

    (b) guidance clarifying that an entity applies the requirements for the recognition of fines in IAS 37.

Question for the Board

Fines
3. Does the Board have any comments on the staff's intention to recommend an extension to the model's recognition principles to require recognition of a present obligation for fines which will be settled through the deduction of the amount from the rates to be charged to customers in future periods?

[2] Agenda Paper 9B discussed at the November 2018 Board meeting.