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STAFF PAPER

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Project	**Rate-regulated Activities**		
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Purpose of this paper

1. The purpose of this paper is to provide the further analysis requested by the Board at its July 2019 meeting on the determination of the boundary of a regulatory agreement in the accounting model for regulatory assets and regulatory liabilities (model).

Summary of recommendations

2. The staff recommend that:
   - (a) in determining the regulatory agreement boundary, an entity should consider all options that could affect that boundary, but:
     - (i) should disregard those options that the holder will not have the practical ability to exercise in any circumstances; and
     - (ii) should not consider the likelihood of exercise or either party's intentions in respect of any option.
   - (b) application guidance is developed on the factors that an entity considers in determining the boundary of the regulatory agreement.
   - (c) rights or obligations first meeting the definition of a regulatory asset or regulatory liability as a result of a change in the regulatory agreement

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boundary should be recognised at the date of the change and disclosed separately from other regulatory asset or regulatory liability originations.

Structure of this paper

3. This paper is structured as follows:

   (a) Background (paragraphs 4-10);

   (b) Determination of the regulatory agreement boundary (paragraphs 11-39);

   (c) Accounting once the regulatory agreement boundary has been determined (paragraphs 40-43);

   (d) Comparison to other IFRS Standards (paragraphs 44-49); and

   (e) Changes in the regulatory agreement boundary (paragraphs 50-55).

Background

4. The Board has tentatively decided that the model applies to defined rate regulation established through a formal regulatory framework that is **binding** on both the entity and the regulator.

5. The regulatory framework must establish 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.

6. The binding nature of the regulatory agreement has been identified as **necessary to support the recognition of these rights or obligations** as regulatory assets or regulatory liabilities (ie for these rights and obligations to meet the definitions of assets and liabilities in the *Conceptual Framework for Financial Reporting* [*Conceptual Framework*]).

7. However, any regulatory agreement is unlikely to continue indefinitely—that is, there will be some point at which its terms cease to confer enforceable rights, or to impose

enforceable obligations, on the entity. In the analysis presented in July 2019[1] we referred to this point the '**regulatory agreement boundary**'.

8. Therefore, an entity can hold a present right to add amounts to the rate(s) to be charged to customers, meeting the definition of a regulatory asset, only if those amounts will be charged to customers before the regulatory agreement boundary. Likewise, an entity has a present obligation to deduct amounts from the rate(s) to be charged to customers, meeting the definition of a regulatory liability, only if those amounts will be deducted before the regulatory agreement boundary.

9. Thus, the **determination of the regulatory agreement boundary will impact the recognition of regulatory assets and regulatory liabilities for entities applying the model**.

10. The staff paper presented to the Board in July 2019 set out an analysis of how an entity would determine the regulatory agreement boundary. However, the Board's discussion identified this as an area which could be challenging for entities, and thus the Board requested that staff carry out further analysis which would form the basis for application guidance to be provided with the model—this paper sets out this additional analysis.

Determination of the regulatory agreement boundary

11. In determining the regulatory agreement boundary, the staff suggest an entity would consider factors such as:

    (a) the existing period of the regulatory agreement (paragraph 12);

    (b) options impacting the boundary of the regulatory agreement (paragraphs 13-22);

    (c) make-whole mechanisms (paragraphs 23-34); and

    (d) consistency with judgements required to apply other IFRS Standards (paragraphs 35-39).

[1] July 2019 Agenda Paper ref 9B

Existing period of the regulatory agreement

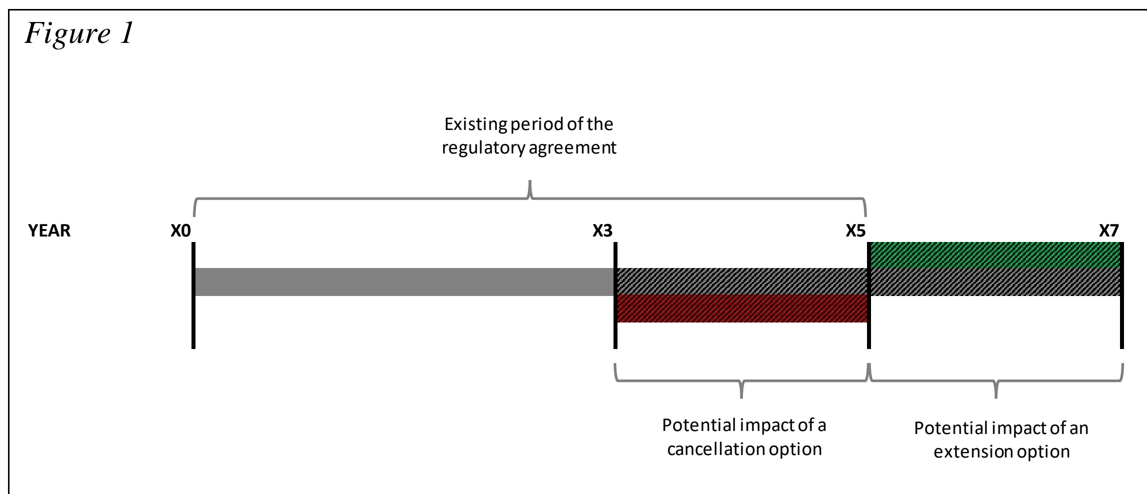
12. For our analysis, we describe the existing period of the regulatory agreement as the period over which the agreement is legally enforceable before the consideration of any extension, renewal or termination options. We expect that, in most cases, the terms of the agreement that determine this period will be explicit and thus the identification of this period will not be complex for entities.

Options impacting the boundary of the regulatory agreement

13. Regulatory agreements may contain a variety of terms which could impact their boundary. Such terms include extension, renewal or cancellation clauses which can be exercised by the entity, the regulator or both (referred to in this analysis as options). We anticipate that the analysis of these options will create the most complexity in determining the regulatory agreement boundary.

14. Figure 1 illustrates a situation where the outcome of this analysis could result in an entity determining any of years X3, X5 or X7 as the regulatory agreement boundary, depending on the terms of the regulatory agreement and the facts and circumstances.

Figure 1



15. The *Conceptual Framework* provides some discussion that we have considered in our analysis. Paragraph 4.60 of the *Conceptual Framework* discusses how to represent faithfully the rights and obligations created by a contract—it indicates that 'all terms in a contract are considered…unless they have no substance'.

16. Paragraph 4.61 of the *Conceptual Framework* states that (**emphasis added**):

> **Terms that have no substance are disregarded**. A term has no substance if it has no discernible effect on the economics of the contract. Terms that have no substance could include, for example:
>
> (a) terms that bind neither party; or
>
> (b) rights, including options, that the holder will not have **the practical ability to exercise in any circumstances**.

17. In the context of a discussion of whether an entity has an obligation, paragraph 4.34 of the *Conceptual Framework* discusses the factors used to assess whether an entity has a **practical ability** to avoid transferring an economic resource. That paragraph indicates that neither an intention to make a transfer nor a high likelihood of a transfer are sufficient reasons to conclude that an entity has no practical ability to avoid a transfer—and thus to conclude that an entity has an obligation.

18. On the basis of the discussion in paragraphs 15-17, the staff recommend that:

    (a) in determining the regulatory agreement boundary, an entity should consider all options that could affect that boundary, other than options that the holder (ie the entity or the regulator) will not have the practical ability to exercise in any circumstances; and

    (b) in assessing whether an option affects the regulatory agreement boundary, an entity should not consider the likelihood of exercise or either party's intentions.

Question for the Board

Options impacting the boundary of the regulatory agreement
1. Does the Board concur with the staff's recommendation in paragraph 18?

Assessing the practical ability to exercise

19. In assessing whether the party holding an option will have the practical ability to exercise the option, an entity should consider all the terms of the regulatory agreement and other facts and circumstances, including the environment in which it operates.

20. We anticipate that the environment in which the entity operates will be a significant consideration in assessing whether a party will have the practical ability to exercise an option. For instance:

    (a) regulated entities often inhabit a monopoly, or near-monopoly, position as a result of the significant barriers to entry imposed by the substantial levels of capital investment required to provide many regulated services—this could call into question whether the regulator has the practical ability to exercise an option which would require it to replace the regulated entity;

    (b) the regulator may be bound by legislation, or may have publicly committed to the provision of stable and affordable supply of a good or service which is considered essential to the local population, rendering it without the practical ability to exercise a cancellation option that would necessitate the replacement of the regulated entity without significant notice;

    (c) the entity may face such significant adverse economic consequences (eg liquidation) if it exercises an option to cancel the regulatory agreement (or does not exercise an option to renew it) that it has no practical ability to exercise that option; or

    (d) in many cases the regulatory agreement is clear that the entity cannot cease, suspend, restructure or transfer operations without the approval of the regulator, which may mean that an option held by the entity to cancel the provision of services subject to the regulatory agreement can be negated by the regulator.

21. The staff think that an entity should **revisit the assessment of the effect of options at each reporting date** because the passage of time, or other factors, may impact on whether either or both parties have the practical ability to exercise an option, or on the date at which they will have the practical ability to exercise that option. For example:

(a) as a renewal date approaches, a regulator may not be able to replace a regulated entity without significant adverse economic consequences (eg significant costs and/or significant disruption to service), leading to the conclusion that the regulator no longer has the practical ability to exercise the option at this stage.

(b) if a regulatory agreement is subject to a rolling cancellation option that one or both parties has the practical ability to exercise after 18 months, the regulatory agreement boundary will advance by 12 months at each annual reporting date.

22. **In rare cases**, despite applying the guidance above, it may be uncertain whether either party—the entity or the regulator—has an option with an effect on the regulatory agreement boundary (eg because the terms of the agreement are not clear), or whether there are any circumstances in which that party has the practical ability to exercise that option. In this situation, it is uncertain whether rights or obligations that would result from such an option exist. The Board has already decided tentatively to apply a recognition threshold of 'more likely than not' when it is uncertain whether a regulatory asset or regulatory liability exists (ie in cases of existence uncertainty). In the staff's view, that threshold would apply equally if it is uncertain either whether an option exists or whether there are any circumstances in which the entity or a regulator has the practical ability to exercise it. Therefore, an entity would recognise a regulatory asset or regulatory liability only to the extent that it is more likely than not that it has an enforceable right or obligation to adjust the rate(s) charged to customers for the period in question.

Make-whole mechanisms

23. A regulatory agreement may contain enforceable 'make-whole' mechanisms. These mechanisms are designed to ensure that, if the entity ceases to supply the regulated goods or services, it will be compensated/charged for any amounts it has been unable to adjust through the rate(s) charged to customers (ie the outstanding amounts of what would be regulatory assets or regulatory liabilities if the regulatory agreement had continued).

24. Make-whole mechanisms may operate in a variety of ways. The regulatory agreement may provide for cash settlement to or from the entity for any amounts which the entity has not been able to adjust through the rate(s) charged to customers.

25. Alternatively, if the entity is to be replaced by another supplier, our understanding—formed, in part, on the basis of responses to the 2013 Request for Information (as summarised in the 2014 Discussion Paper *Reporting the Financial Effects of Rate Regulation*)—is that the regulatory agreement will typically facilitate the transfer of all existing rights and obligations to a new operator, including any rights and obligations that have been recognised as regulatory assets and regulatory liabilities.

26. In such cases, the price agreed to transfer the business usually reflects, among other things, the incoming supplier's acquisition of the outgoing supplier's rights and obligations to add or deduct amounts from the future rate(s) charged to customers. In this way, the outgoing supplier is, in effect, 'made-whole' for any amounts it has not been able to adjust through the rate(s) charged to customers.

27. Enforceable make-whole mechanisms do not create a right or obligation to adjust the future rate(s) charged to customers. Instead, they create a right or obligation to make or receive payment for amounts not yet adjusted through the rate(s) when the agreement is terminated. That right or obligation does not itself meet the definition of a regulatory asset or regulatory liability because it would be recovered or fulfilled by receiving or paying cash, not by increasing or decreasing future regulated rates.

28. Nevertheless, **that right or obligation does result directly from the transaction that gave rise to the underlying regulatory asset or regulatory liability**—ie supplying goods or services (regulatory asset) or charging customers compensation (regulatory liability). The right or obligation also puts the entity in the same position as it would have been if the regulatory agreement had continued and so the entity still had the right or obligation to adjust the future rate(s) charged to customers.

29. In effect, **an enforceable make-whole mechanism extends the regulatory agreement boundary to the end of the period covered by that mechanism**, because it gives the entity the right or obligation to be compensated/charged for any amounts it has not yet been able to adjust through the rate(s) charged to customers (ie the outstanding amounts of what would be regulatory assets or regulatory liabilities if

the regulatory agreement had continued). Provided the make-whole mechanism is adequate, an entity would be economically indifferent between recovering a regulatory asset (a) partly or entirely by increasing future rates, and (b) partly or entirely by a make-whole mechanism.

30. Accordingly, the staff recommend that, in determining the regulatory agreement boundary, an entity considers the presence of any enforceable make-whole mechanisms in the regulatory agreement.

31. In the unusual situation where a material difference would arise between the cash flows arising from a make-whole mechanism and the cash flows from the continuation of the regulatory agreement and corresponding adjustments to the rate(s) charged to customers, staff recommend that an entity should reflect the potential impact of this difference in its measurement of the regulatory asset or regulatory liability, applying either the 'most likely amount' or 'expected value' method, depending on which best predicts the future cash flows.

32. In the staff's view, the recommendations in paragraphs 30 and 31 would provide the most relevant information and the most reliable presentation of the rights or obligations arising from the underlying transaction—ie supplying goods or services (regulatory asset) or charging customers compensation (regulatory liability).

33. We also recommend that the Board should not require entities to disclose the cash flows that would result from a make-whole mechanism separately from the cash flows that would result from increasing or decreasing future rates. The staff believe that such a distinction would not provide useful information.

34. This can be illustrated by an example:

Example 1

Fact pattern

Entity A is party to a regulatory agreement that continues indefinitely but can be cancelled by the regulator exercising an option with a two-year notice period. If the cancellation option is exercised, the terms of the regulatory agreement require Entity A to be 'made whole' by way of an enforceable right to a cash payment

from the regulator for any regulatory assets which are not yet fully recovered at the date of the cancellation.

The total allowed compensation earned by Entity A relating to input costs incurred in the supply of services in the current period exceeded the amount charged to customers. The regulatory agreement allows for recovery of that timing difference through the rate(s) charged to customers evenly over a period of five years. For simplicity, assume this is the only timing difference encountered by Entity A.

Application of the model to this fact pattern

Because of the enforceable 'make-whole' mechanism, Entity A has the right to recover the full amount of the difference between the total allowed compensation earned and the amount charged to customers for the current period, regardless of whether the regulatory agreement continues for the next five years and the amount is fully recovered through the rates, or whether the regulatory agreement is cancelled and the entity becomes entitled to a make-whole payment for the unrecovered portion.

Thus, Entity A determines the regulatory agreement boundary to coincide with the end of the period covered by the make-whole mechanism. Therefore, it measures the regulatory asset on the basis that the asset will be recovered through the addition of amounts to the future rate(s) charged to customers (unless there is a material difference between this outcome and the receipt of a make-whole payment—see paragraph 31).

Further analysis:

If and when the regulator actually exercises the cancellation option, this will definitively fix the regulatory agreement boundary. At such time, amounts to be received beyond the regulatory agreement boundary (now as a cash 'make-whole' payment rather than through the rates charged to customers) would be reclassified from a regulatory asset to a receivable. Unless the exercise of the option causes a material change in the present value of the future cash flows, no income or expense would be recognised at that time. Moreover, the entity would not recognise any regulatory expense when it recovers the make-whole payment, nor is the recovery

of that amount reflected in amounts charged to customers—and consequently in revenue—of any period.

Consistency with judgements made in applying other IFRS® Standards

35. The model has been developed using a 'supplementary approach', meaning that an entity first applies other IFRS Standards without modification before applying the model to recognise any regulatory assets or regulatory liabilities.

36. **In determining the regulatory agreement boundary, an entity would also consider any judgements it has made in applying other IFRS Standards**.

37. For example, suppose the following fact pattern:

    (a) An entity has recognised a provision, in accordance with IAS 37 *Provisions, Contingent Liabilities and Contingent Assets*, for an obligation to perform environmental remediation activities in the future to remediate damage it has caused in supplying the regulated goods or services.

    (b) The regulatory agreement treats this amount as an allowable expense that the entity may include in the rate(s) charged to customers, but only once it has made the relevant cash disbursements to settle the obligation. Those disbursements and the subsequent inclusion in rates may not occur for many years, beyond the date when the regulator has the practical ability not to renew the agreement or to award it to another entity.

38. In recognising the provision, the entity has concluded it is probable that it will have to make the disbursements (even though some of them would be made after the date when the regulator can decide not to renew the agreement). We think the entity would consider the judgements it made in reaching that conclusion, and all other relevant facts and circumstances, when it determines the regulatory agreement boundary. The entity would also consider any enforceable rights it has under the regulatory agreement to receive make-whole payments if the regulator exercises its option not to renew the regulatory agreement long enough for the entity to charge customers for all remediation costs already incurred.

39. As another example, an entity may need to make judgements both on the regulatory agreement boundary and on the useful life of infrastructure necessary to supply the

regulated goods or services. Suppose that an entity's preliminary assessment is that a major item of plant has a useful life of 20 years but that, because of cancellation options that the regulator has the practical ability to exercise, the boundary of the regulatory agreement is only three years after the reporting date. Before finalising those judgements, the entity would consider whether there is any inconsistency between them:

(a) For example, the entity might consider whether and how it would recover the carrying amount of the plant if the regulator exercises its cancellation option, and whether the outcome of that consideration has any implications for its estimate of the plant's useful life.

(b) It might also consider whether the judgements it made in estimating the plant's useful life have any implications for its judgement of whether the regulator has the practical ability to exercise the cancellation option.

Accounting once the regulatory agreement boundary has been determined

40. Once the regulatory agreement boundary has been determined, an entity would apply the model's requirements to the rights and obligations identified which meet the definition of a regulatory asset or a regulatory liability—ie the present rights to add, or the present obligations to deduct, amounts from future rate(s) charged to customers up until the regulatory agreement boundary.

41. **An entity will not have present rights or present obligations arising from the regulatory agreement beyond the regulatory agreement boundary**. Thus, amounts which might be added to, or deducted from, the future rates to be charged to customers beyond the regulatory agreement boundary do not arise from any regulatory asset or regulatory liability, and the resulting cash flows would not be included in the measurement of any regulatory asset or regulatory liability.

42. Therefore, if the recovery or fulfilment of an item through the rate(s) charged to customers spans the regulatory agreement boundary, the entity only has the enforceable right to add amounts to, or obligation or deduct amounts from, the rate(s) up until the boundary, and thus only those amounts are incorporated into the measurement of a regulatory asset or regulatory liability.

43. Although it is possible that an entity *may* ultimately acquire a right to add further amounts to, or an obligation to deduct further amounts from, the rate(s) charged to customers beyond the currently established boundary (eg because of a subsequent change in the boundary), those amounts do not result from the entity's present rights or present obligations and thus are not included in the measurement of any regulatory asset or regulatory liability.

Comparison to other IFRS Standards

44. IFRS 17 *Insurance Contracts* contains guidance regarding the identification of the insurance 'contract boundary'. Cash flows are within the boundary of an insurance contract if they arise from substantive rights and obligations that exist during the reporting period in which the entity can compel the policyholder to pay premiums or in which the entity has a substantive obligation to provide services. An entity includes only these cash flows in the measurement of a group of insurance contracts. A substantive obligation to provide services ends when the entity has the *practical ability* to reassess the risks of a particular policyholder (or, in some cases, a portfolio of insurance contracts) and, as a result, set a price or level of benefits that fully reflects those reassessed risks.[2]

45. Paragraphs B22-B23 of IFRS 10 *Consolidated Financial Statements* provide application guidance to assist entities in assessing whether they have power over an investee. This application guidance specifies that an investor considers only *substantive rights* in making its assessment, and specifies that for a right to be substantive, the holder must have the *practical ability* to exercise that right. This application guidance also provides a series of factors to consider that might lead to the conclusion that rights are *not substantive* if, for example, if there are barriers preventing the holder from exercising those rights.

46. The staff think that the guidance recommended in this paper for determining the regulatory agreement boundary is aligned with the principles in IFRS 17 and IFRS 10 noted above. We recommend that an entity determines the regulatory agreement boundary by considering only those options that it (or the regulator) has the practical

[2] Paragraph 34 of IFRS 17 *Insurance Contracts*

ability to exercise. Once this boundary has been determined, in measuring a regulatory asset or regulatory liability, an entity would include only those amounts that it expects to be able to add to, or deduct from, the rates charged to customers before the regulatory agreement boundary.

47. The staff also considered whether our views on the regulatory agreement boundary of the model are aligned with IFRS 16 *Leases*, particularly with respect to the requirements in that Standard for determining the lease term. We think they are not. IFRS 16 requires an entity to assess whether the lessee is 'reasonably certain' to exercise an option to extend (or not to exercise an option to terminate), after considering all relevant facts and circumstances that create an economic incentive for the entity. Assessing reasonable certainty of exercise is focussed on likelihood, not on whether an entity has the practical ability to exercise a right.

48. The Basis for Conclusions on IFRS 16 explains the Board's view and objective in developing the requirements on lease term—ie the lease term should reflect an entity's reasonable expectation of the period during which the underlying asset will be used. In achieving that objective and in the light of feedback received over the course of the leases project, the Board retained the 'reasonably certain' threshold and terminology that was previously in IAS 17 *Leases*.[3] Consequently, although that threshold is appropriate in determining the lease term in applying IFRS 16, we consider it to be more appropriate to determine where the regulatory agreement boundary lies on the basis of an assessment of whether an option exists, and whether the holder of the option has the practical ability to exercise it, rather than on whether there is reasonable certainty of exercise.

Recommendation and question for the Board

49. The staff recommend including in the proposed new standard application guidance on the factors that an entity considers in determining the boundary of the regulatory agreement. These factors are: the existing term of the regulatory agreement, any options impacting the boundary that the entity or the regulator has the practical ability

[3] Paragraphs BC156-BC157 of the Basis for Conclusions on IFRS 16.

to exercise, make-whole mechanisms, and consistency with judgements made in applying other IFRS Standards.

Determination of the regulatory agreement boundary
2. Does the Board concur with the staff's recommendation in paragraph 49?

Changes in the regulatory agreement boundary

50. In some cases, the boundary of a regulatory asset or regulatory liability changes from one period to the next, for example because of the passage of time, or because of the exercise (or non-exercise) of an option. As a result, some future cash flows previously outside the boundary may now occur within the boundary. For example, suppose the following fact pattern:

    (a) In X1, Entity A supplied goods or services and the regulatory agreement will allow it to increase the amount charged to customers in X4 by CU100 as a result. However, the entity concludes at the end of X1 that the boundary of the regulatory agreement is the end of X3. As a result, the entity does not have a present right to include the CU100 in the future rate(s) charged to customers, and thus does not recognise a regulatory asset for this amount.

    (b) At the end of X2, the entity reassesses the boundary of the regulatory agreement to be the end of X4. Thus, the CU100 has now come within the boundary and the entity now has the present right to add the amount to the rates charged to customers in X4.

51. At the end of X2, should the entity now account for this amount and, if so, how?

52. In this case, we think there are two potential alternatives for the accounting in X2:

    (a) The first alternative would be not to recognise anything and to only disclose the change in circumstances. Proponents of this view would argue that the regulatory asset or regulatory liability originally arose in X1. That period

has now passed and the economic impact of the regulatory agreement on the reported results for that period cannot be captured by recognising the regulatory asset or regulatory liability subsequently (in X2). In fact, subsequent recognition (in X2) may make it difficult for users of financial statements to understand the entity's financial performance in X2 because the entity would recognise in X2 regulatory income of CU100 relating to goods and services supplied in X1 and for which the revenue (of CU100) will be recognised in X4.

(b) The second alternative would be to recognise the amounts now (in X2) falling within the boundary and meeting the definition of a regulatory asset following the reassessment of the boundary. Proponents of this view would argue that it provides a more understandable depiction of the entity's financial performance in X4 because recognising regulatory expense of CU100 in X4 shows that revenue of that amount in X4 arose because of goods or services supplied in a different period. Moreover, recognising the CU100 as a regulatory asset in X2 (and throughout X3) shows that the entity has an enforceable right to increase future rates with the aim of recovering that amount.

53. The staff recommend the second alternative. However, to provide more useful information about the entity's financial performance in a period when the boundary changes, we recommend that the model require the recognition of such amounts to be disclosed in the notes separately from other regulatory asset or regulatory liability originations —that is, with a separate line item in:

(a) the breakdown of the regulatory income/ (regulatory expense) line item in profit or loss; or

(b) the reconciliation of the opening and closing carrying amount of regulatory assets and regulatory liabilities.

54. We also recommend that an entity is required to provide a narrative discussion regarding the circumstances that led to the recognition of such amounts, including the factors considered in updating its estimate of the regulatory agreement boundary, and the regulatory assets and regulatory liabilities recognised as a result.

55. Applying these recommendations to the example in paragraph 50:

Regulatory income for the year X2:	
Originations of regulatory assets	XXX
Originations of regulatory liabilities	(XXX)
Regulatory asset recognised following revision to the regulatory agreement boundary [1]	100
Recovery of regulatory assets	(XXX)
Fulfilment of regulatory liabilities	XXX
Changes in estimates	XXX
Regulatory income	**XXX**

[1] *Description of circumstances that led to the recognition of such amounts, including the factors considered in updating its estimate of the regulatory agreement boundary*

Question for the Board

Changes in the regulatory agreement boundary
3. Does the Board concur with the staff's recommendations in paragraphs 53 and 54?