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International Accounting Standards Board

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These notes are based on the staff papers prepared for the IASB. Paragraph numbers correspond to paragraph numbers used in the IASB papers. However, because these notes are less detailed, some paragraph numbers are not used.

INFORMATION FOR OBSERVERS

Board Meeting: **December 2008, London**

Project: **Agenda proposal: rate-regulated activities (Agenda paper 12)**

INTRODUCTION

1. The Board has received requests to add to its technical agenda a project on rate-regulated activities. The issue is whether regulated entities could or should recognise a liability (or an asset) as a result of rate regulation by regulatory bodies or governments.

2. This agenda paper:

   (a) provides background information;

   (b) describes the possible scope of a project on rate-regulated activities and the issues to be addressed;

   (c) considers whether such a project would meet the IASB's agenda criteria;

   (d) asks the Board whether it wishes to add a project on rate-regulated activities to its agenda; and

(e) sets out a draft project plan.

3. The following appendices are also attached to this paper:

(1) Detailed background information on rate regulation;

(2) Illustrative examples;

(3) Letter from an association of US electric companies [omitted from observer note].

Section A—BACKGROUND INFORMATION

a) Rate regulation

4. The staff provide detailed background information on rate regulation in Appendix 1 to this paper. The following is a brief summary.

5. Rate regulation is a restriction in the setting of prices that can be charged to customers for services or products. The goal of rate regulation is to set "just and reasonable rates," that is, rates that charge the customer a reasonable price and that allow the entity to earn a fair rate of return. Generally, rate regulation is imposed when an entity has a monopoly or a dominant market position that gives it excessive market power. In the past, rate regulation tended to be applied to an entire entity. With acquisitions, diversification and deregulation, rate regulation may now be applied to only a portion of an entity's activities. In some cases, an entity may have both regulated and non-regulated activities.

6. There are a number of basic regulatory methodologies and, for each, there can be applications that vary with the regulator, the entity being regulated and the circumstances faced. In the past, the primary regulatory methodology for the major utilities was cost-of-service regulation, also referred to as return-on-rate-base regulation. Under this approach, rates are set to give the entity the opportunity to recover its costs of providing the public service plus a fair return. In such a scheme it is important to note that the rates are set by a process of working backwards from the desired return on the rate base, to derive a revenue requirement and using a volume estimate to set the rate. In recent years, however, there has been a trend to performance-based regulatory methodologies, such as price-cap regulation. With price-cap regulation, initial rates often reflect the cost of service, but are allowed to increase, or are required to decrease, in accordance with a formula over time. The hybrid methodology is a combination of the price-cap and cost-of-service methodologies.

b) Standards and practices in the United States

7. Accounting standards and practices in the United States recognise the effects of rate regulation and provide detailed guidance to rate-regulated entities. Canadian accounting pronouncements and practices also recognise that, in certain circumstances, rate regulation can affect what should be reported in the financial statements. The staff have enquired of various National Standard Setters and is not aware of one other than the US that has issued an accounting standard or an interpretation on a similar issue.

8. Principles to recognise the economic effect of rate regulation have been applied to US rate-regulated entities since at least 1962, when they were authorized by an addendum to Accounting for the "Investment Credit," AICPA Accounting Principles Board Opinion 2. In 1982, *Accounting for the Effects of Certain Types of Regulation*, Statement of Financial Accounting Standards (SFAS) 71, formalized many of those principles, and also modified some of them.

9. Since its issuance, SFAS 71 has been the principal authoritative source of guidance on accounting and financial reporting requirements for rate-regulated entities in the United States. In addition, several other Statements have been issued over the years to provide guidance on specific topics. Two points are especially worth noting:

   - SFAS 71 does not exempt rate-regulated entities from following other standards. Rather, it requires them first to follow all relevant standards and then to consider whether regulatory actions should result in the recognition of additional assets or liabilities.

   - SFAS 71 was developed after the FASB completed the portion of its conceptual framework defining assets and liabilities. Thus, the FASB specifically considered the question of whether asset and liability definitions virtually identical to those in the IASB *Framework* were satisfied and, at that time, concluded that they were.

10. SFAS 71 provides guidance on preparing general purpose financial statements for most public utilities. Certain other entities with regulated activities that meet specified criteria are also covered. Although the business activities of utility companies are essentially the same as those of other companies that manufacture products or provide services, their regulated status creates operational and accounting situations that are peculiar to regulated companies. In this regard, SFAS 71 refers to the "economic dimension" that regulation brings to utilities and the need for accounting to reflect that dimension. In general, the type of regulation covered by SFAS 71 requires allowed rates (prices) to be set at levels intended to recover the estimated costs of providing regulated products or services including the cost of capital, that is, the cost of service/return-on-rate-base type of regulation discussed in the previous section.

11. According to SFAS 71, recovery of certain costs may be provided for by regulation either before or after the costs are incurred. If regulation provides assurance that incurred costs will be recovered in the future, companies are required to capitalise those costs. If current recovery is provided for costs expected to be incurred in the future, companies are required to recognise a liability equal to the amount received.

12. A significant conclusion reached in SFAS 71 is that rate regulators can determine the timing of recovery of costs through rates and, therefore, can affect the value of assets and liabilities recognised in accordance with GAAP. Specifically, rate actions of a regulator can provide reasonable assurance of the existence of an asset and can also reduce or eliminate the value of an asset. Furthermore, rate actions of a regulator can impose a liability on a regulated entity. A regulator, however, cannot eliminate a liability that it did not impose.

13. SFAS 71, paragraph 5, establishes three criteria for determining whether an entity is within the scope of the Statement:

(1) an entity's rates for regulated services must be established by or subject to approval by an independent third-party regulator or by its own governing board empowered by statute or contract to establish rates that bind customers;

(2) the regulated rates must be designed to recover the specific entity's costs of providing the regulated services or products;

(3) in view of the demand for the regulated services or products and the level of competition, it must be reasonable to assume that rates set at levels that will recover the entity's costs can be charged to and collected from customers.

c) Practice in jurisdictions using IFRSs

14. For entities reporting in IFRSs, the current practice supported by the major accounting firms in their internal or external guidance indicates that no regulatory assets or liabilities are recognised, unless they meet the definition of a financial asset or a financial liability – these arise in a few regulatory regimes. As a result, it does not seem that significant divergence has arisen in jurisdictions using IFRSs.

15. The staff also have examples of entities that report in both US GAAP and IFRSs that concluded that regulatory assets and liabilities did not fulfil the recognition criteria for assets and liabilities in accordance with IFRSs.

d) Request submitted to the IFRIC

16. In January 2008, the IFRIC was asked for the second time to consider whether regulated entities could or should recognise a liability (or an asset) as a result of rate regulation by regulatory bodies or governments. In this case the request came from the European Roundtable on the Consistent Application of IFRS. The National Standard Setters group has also discussed this question at several of its meetings and requested that the IFRIC consider adding it to the IFRIC agenda.

17. Since the issue was added to the IFRIC Issues list, the staff has received a steady stream of correspondence and requests for meetings from North American regulated entities (see for example the letter from an association of US electric companies in appendix 3 to this paper). Although these came mainly from Canadian companies to begin with, the Board should be aware that the North American industry is relatively integrated, with many cross-border investments. In particular, the industry associations that have contacted us recently represent member companies in both the US and Canada.

18. We have also received letters from analysts who specialise in covering this industry supporting the existing accounting. Thanks to Stephen Cooper, we have discussed the important factors in analysing European utilities with an industry analyst as well.

19. In September, in an education session, the IFRIC discussed a background paper outlining the issues and arguments the staff had considered. At its November meeting, the IFRIC noted that:

    - Rate regulation is widespread and significantly affects the economic environment of regulated entities;

    - In jurisdictions using IFRSs, divergence does not seem to be significant because practice does not support the recognition of regulatory assets or liabilities;

- Resolving the issue would require interpreting the definitions of assets and liabilities set out in the *Framework* and their interaction with one or more IFRSs;

- Although the issue is not specifically being considered in an active Board project, it relates to more than one active Board project (the conceptual framework and insurance contracts).

20. At its November meeting, the IFRIC concluded that its agenda criteria were not met, mainly because divergence in practice in jurisdictions using IFRSs does not seem to be significant. Therefore, the IFRIC tentatively decided not to add the issue to its agenda. The IFRIC also specifically considered whether it should recommend that the Board add a project to its agenda to deal with this topic and decided not to do so. The IFRIC will consider any comments received and make a final agenda decision at its next meeting.

e) November SAC meeting

21. At the November 2008 SAC meeting, the SAC was asked whether the staff should develop an agenda proposal on this topic for the Board to consider. Several SAC members stressed the need to address the issue of rate-regulated activities because it was quite significant in Europe and in the US.

22. A few SAC members expressed concerns that such a project might have large implications, in particular with the conceptual framework. One SAC member noted that this issue was actually an interesting test for the conceptual framework project and advised the Board to analyse further the interactions between both that project and the issue of rate-regulated activities.

23. A few SAC members were concerned that such a project could overload the IASB's agenda while the IASB should focus on issues in connection with the credit crisis.

24. Overall, the SAC expressed support for the Board to consider adding this item to its agenda, having noted that such a project could be undertaken within the existing capacity of IFRIC staff.

Section B—SCOPE AND ISSUES TO BE ADDRESSED

Scope

25. The staff recommend that a project on rate-regulated activities should focus on cost-of-service or other forms of regulation according to which an entity has a right to recover all or part of its costs and to earn a specified return (or has an obligation to refund all or part of excess profits) through future rate adjustments.

26. The project would not address price-cap regulations that only consist of a price setting mechanism with no 'guarantee' that the entity will recover its costs plus a specified return. Under a price-cap regulation, an obligation may arise as a result of an onerous contract but in this case IAS 37 would apply.

Issues

27. Several issues will need to be addressed:

    (a) Are rate-regulated activities different from other activities?

    (b) Are the definitions of an asset or a liability met?

    (c) Can an analogy with IFRIC 12 be drawn?

    (d) Can an analogy with a cost plus contract as defined in IAS 11 be drawn?

    (e) Are there cross cutting issues with other standards or current projects?

28. What follows are the alternative views and arguments considered by the staff to date.

a) Are rate-regulated entities different from other entities?

The key role of the regulator

29. The goal of rate regulation is to set 'just and reasonable rates'. Generally, rate regulation is imposed when an entity has a monopoly or a dominant market position that gives it excessive market power. In such situations, there is a lack of effective competition to constrain the prices that the entity can charge. To compensate, governments impose rate regulation by setting up a regulatory authority and giving it jurisdiction to approve the rates of a specific entity or categories of entities (for example, electric distribution utilities). Entities falling within the jurisdiction of the regulatory authority are not allowed to charge prices other than those approved by the regulatory authority.

30. In these circumstances, the staff think that it can be argued that *the regulator acts on behalf of the customers* who individually have no bargaining power with the utility company. Agreements between a rate-regulated entity and its customers cannot be understood without reference to the regulation in place. Therefore, it can be argued that such agreements are different from agreements between an entity and its customers in a non-regulated environment. Another view is the one adopted by the Board in its revenue recognition project when it concluded that a customer contract did not need to include all the terms of relevant regulation for them to be considered in the accounting. Thus, it can also be argued that customer contracts in regulated entities are the same as those in a non-regulated environment in that surrounding terms imposed by legislation/regulation have to be considered. In either case, the staff believe that the effect of regulation needs to be considered as part of the agreement with the customer.

Rate-setting mechanisms

31. Some argue that the ability to charge a higher or lower price is not a differentiating feature. In fact, all entities have this ability and it does not give rise to an asset or a liability. For example, as a result of a new competitor entering the market, an entity may decide to decrease its prices and such a decision does not give rise to the recognition of a liability.

32. The staff note that rate-regulated entities are not allowed to charge rates other than those approved by the regulator. The use of higher or lower future rates to collect excess costs (or refund excess profits) is often a practical consideration as explained by the association of US electric companies in its letter attached in Appendix 3 to this paper:

'The use of lower future rates is simply a payment mechanism to implement the settlement of the liability. This mechanism is a practical consideration given that the exact population of customers in an entity's service territory may change over the time. Notwithstanding these changes in the specific composition of the customer base, the entity's obligation to repay the entire amount of the liability to its customers as a group is undisputed and well established.'

33. It may also be a mechanism used by the regulator to shield customers from significant variability in rates. For example, an entity may be entitled by the regulation to collect/remit differences between actual and estimated costs from customers. The regulator may require the receivable to be collected in rates over time rather than in a separate billing immediately after the difference arises. Therefore, the staff's view is that the rate-setting mechanism is specific to the regulation and differs from pricing decisions in a non-regulated environment.

b) Are the definitions of an asset or a liability met?

Asset Definition

34. An asset is defined in paragraph 49 of the *Framework* as follows:

> An asset is a resource controlled by the entity as a result of past events and from which future economic benefits are expected to flow to the entity.

35. Regarding the issue of regulatory assets, some who do not support the recognition of regulatory assets argue that the rate-regulated entity does not have control over the recoverability of the future economic benefits because it does not control whether the customers will use the service.

36. The staff disagree with this argument for a number of reasons. First, the background discussion in the current *Framework* notes that control over the future economic benefits is sufficient for an asset to exist, even in the absence of legal control. Second, during phase B of the project on the conceptual framework, the FASB and the IASB agreed that some constituents misinterpret the term 'control' and use it in the same sense as that used for purposes of consolidation accounting, ie the power to obtain benefits.

37. The conceptual framework project team think that that notion of control over an entity differs from the manner in which control is used in the definition of an asset. In many examples involving the definition of an asset, an entity will have power, as well as the ability to obtain cash inflows. For example, in the case of some economic resources owned by an entity, the entity has the power to cause cash inflows to arise from those resources either from sale or use. However, in other examples, the entity need not have the power to cause the cash inflows to arise (that is, while the power criterion is a sufficient condition, it is not a necessary condition). The key notion is that the entity has access to a resource and can limit others' access to that resource.

38. For example, assume an entity has contractual rights to future music revenues from future recordings. The staff thinks that the entity has an asset, even though it might have no power to require future recordings to be made or, if made, to require customers to buy those recordings. So long as future recordings are made and copies sold, the entity will get cash inflows from them. In the case of established customer relationships, an entity does not have the power to force its existing customers to continue to do business with the entity but if they do, the entity will obtain future cash inflows. The entity has an asset resulting from the existing relationship between the entity and the customer that can result in future cash inflows to the entity. The staff note that this conclusion is already reflected in accounting for customer relationship intangible assets in business combinations.

39. For these reasons, the FASB and the IASB agreed to remove the misunderstood notion of control and to focus the definition of an asset on whether the entity has some rights or privileged access to the economic resource.

Liability Definition

40. A liability is defined in paragraph 49 of the Framework as follows:

> A liability is a present obligation of the entity arising from past events, the settlement of which is expected to result in an outflow from the entity of resources embodying economic benefits.

41. Regarding the issue of whether a regulatory liability exists, some argue that there is an obligation, arising from the arrangement with the regulator, but the existence of the obligation depends on the occurrence of uncertain future events: the future sales. If a sale is made in the future period, a rebate will, in effect, be paid. Therefore, the obligation is not a present obligation but a contingent liability that depends on the future sales.

42. The staff note that during phase B of the project on the conceptual framework, the FASB and the IASB agreed that their respective definitions of a liability place too much emphasis on identifying both the specific past event and the future outflow of economic benefits, instead of focussing on the economic obligation that presently exists. An economic obligation is something that is capable of resulting in cash outflows *or reduced cash inflows*, directly or indirectly, alone or together with other economic obligations [emphasis added]. Obligations link the entity with what it has to do because obligations are enforceable against the entity by legal or equivalent means.

43. Therefore, the staff believe that, based on the latest FASB and IASB decisions, it could be argued that rate regulation creates an economic obligation when an entity is obligated to decrease its future rates according to a cost-of-service or other similar form of regulation.

Assets and liabilities

44. In considering whether the existence of rate regulation can result in the recognition of assets and liabilities, the staff believe that some constituents have focussed too much on the entity's transactions with individual customers. The essence of the argument that neither assets nor liabilities exist as a result of rate regulation is that both depend on the existence of future customer transactions that the entity cannot compel.

45. The staff note that IAS 37 specifically states that 'It is not necessary, however, to know the identity of the party to whom the obligation is owed–indeed the obligation may be to the public at large.' In the case of rate-regulated entities, any right or obligation arises in relation to a specifically identifiable group–the customer base. Therefore, although the individual members of that group may change over time, the relationship the regulator oversees is the one the entity has with the *group*. The cash flows the regulator monitors are those arising from transactions with the group as a whole.

46. The staff also note that, in some regulatory regimes, particularly those in which the customers are other businesses, the entity is assured by regulation that its costs will be recoverable from the group of entities that use the service. In the extreme, we understand that in at least one circumstance if only one customer utilised a gas pipeline in a year, all the pipeline operator's costs would be recoverable from that one customer.

c) Can an analogy with IFRIC 12 be drawn?

47. Supporters of the recognition of regulatory assets argue that the analogy with IFRIC 12 *Service Concession Arrangements* is quite straightforward.

48. The staff note that paragraph 17 of IFRIC 12 states that 'the operator shall recognise an intangible asset to the extent that it receives a right (a licence) to charge users of the public service. A right to charge users of the public service is not an unconditional right to receive cash because the amounts are contingent on the extent that the public uses the service.' Thus, the IFRIC concluded that an

unconditional right to receive future revenues from customers was not necessary for the operator to recognise an asset – the right to charge customers for the expected future usage of the infrastructure was sufficient. The staff also note that the discussion in paragraphs BC50 and BC51 suggests that the IFRIC considered contractual arrangements in which the price charged by the operator varies by regulation designed to ensure that the operator received a substantially fixed return and concluded that such arrangements would not meet the definition of a *financial* asset.

49. The staff also note paragraph BC52 states that :

> However, the IFRIC concluded that the fact that the operator's asset was low risk did not influence its classification. IAS 32 does not define financial assets by reference to the amount of risk in the return—it defines them solely by reference to the existence or absence of an unconditional contractual right to receive cash. There are other examples of licences that offer the holders of the rights predictable, low risk returns, but such licences are not regarded as giving the holder a contractual right to cash. And there are other industries in which price regulation is designed to provide the operators with substantially fixed returns—but the rights of operators in these other industries are not classified as financial assets as a result. <u>The operator's asset is a variable term licence, which would be classified as an intangible asset within the scope of IAS 38</u>. [Emphasis added]

However, in the last sentence of that paragraph, the staff's view is that the IFRIC considered the nature of the asset arising from the amount paid to construct or acquire the infrastructure and concluded that the asset the operator received – the licence – was an intangible rather than financial asset. The IFRIC did not consider the effect of a future change of prices by regulation.

50. Others argue that rate regulation does not give rise to the recognition of an intangible asset as it does not change the nature of the existing licence. First, the staff note that, in most cases, the license is not recognised as an intangible asset as it would be when it is acquired in circumstances such as IFRIC 12 or a business combination. Second, the staff's view is that the nature of the service provided under the licence may not have changed but the rates charged for that service have been altered by the regulation. The change in the amount or timing of future cash

flows arising from regulation under the license affects its fair value. Because IAS 38 generally does not permit revaluation to fair value, the carrying amount of the licence would not be altered by the effect of a future change of prices by regulation. Rather, it can be argued that, in some circumstances, the effect of a future change of prices by regulation may trigger recognition of a separate intangible asset, ie the so-called 'regulatory' assets.

51. Others also argue that the regulator may sometimes reverse a previous decision or its decision may be challenged or overturned by the government. The staff note that, in general, IFRSs account for the contractual arrangements in place at a particular time. If the terms of the arrangement subsequently change, the effects of the change are recognised in the period of the change.

52. Overall, the staff are concerned that the absence of recognition of regulatory assets and liabilities in *all* circumstances, as supported by the current practice, may not be consistent with IAS 38 and IFRIC 12. Under the intangible asset model in IFRIC 12, the operator bears the demand risk, having only a right to charge users of the public service for future use of the infrastructure. In contrast, in a cost-of-service regulation, the entity has more than a simple right to charge users: it has *a right to recover its costs plus a specified return* although that right is implemented by rate adjustments for practical reasons. Moreover, IAS 38 does not make any distinction between intangible assets arising from contractual rights and those arising from legal rights. Rate regulations are enforceable and may create legal rights and obligations that the rate-regulated entity should account for.

d) Can an analogy with a cost plus contract as defined in IAS 11 be drawn?

53. The staff note that paragraph 3 of IAS 11 defines a cost plus contract as 'a construction contract in which the contractor is reimbursed for allowable or otherwise defined costs, plus a percentage of these costs or a fixed fee.' Under a cost-of-service regulation, the allowable costs and the specified return are not

determined by the customers themselves but by the regulator acting on their behalf.

54. Therefore, the staff think that it could be argued that, from the perspective of the regulated entity, the contracts with the customers together with the cost-of-service regulation have, in substance, economic effects similar to cost plus contracts directly negotiated with customers in a non-regulated environment. In both environments (regulated or not), an entity has the same right to be reimbursed for allowable or otherwise defined costs, plus a percentage of these costs or a fixed fee.

e) Are there cross cutting issues with other standards or current projects?

Insurance contracts

55. In its Discussion Paper *Preliminary Views on Insurance Contracts*, the Board summarised its preliminary views reached in chapter 4—*Policyholder behaviour, customer relationships and acquisition costs* as follows:

> 173 The Board has reached the following preliminary views:
>
> (a) An insurer has an asset relating to its ability to derive net economic benefits from future premiums that the policyholder must pay to retain guaranteed insurability. Guaranteed insurability is a right that permits continued coverage without reconfirmation of the policyholder's risk profile and at a price that is contractually constrained.
>
> (b) The insurer should recognise that asset, and measure it in the same way as the related insurance liability (ie at current exit value).
>
> (c) That asset is part of a customer relationship, not a contractual asset. Nevertheless, the insurer should present that asset as part of the related insurance liability. The insurer need not separate that asset from the liability for recognition, measurement or presentation. (emphasis added)
>
> […]

56. The staff note that insurers cannot compel the payment of future premiums but virtually all existing models, and the Board's preliminary conclusions, would

include them either as separate contract acquisition assets or in the measurement of insurance contracts.

IAS 12 Income Taxes

57. The staff note that paragraph 5 of IAS 12 states that 'temporary differences are differences between the carrying amount of an asset or liability in the statement of financial position and its tax base.' Temporary differences may be either taxable temporary differences or deductible temporary differences. Paragraph 24 of IAS 12 states that 'a deferred tax asset shall be recognised for all deductible temporary differences to the extent that it is probable that taxable profit will be available against which the deductible temporary difference can be utilised, unless…'

58. The staff think that it could be argued that regulatory assets and liabilities and deferred tax assets and liabilities both reflect temporary differences that are expected to reverse and therefore should follow the same accounting treatment.

Section C—WHETHER THE IASB'S AGENDA CRITERIA ARE MET

59. The due process handbook for the IASB sets out five criteria to be considered in deciding whether to add a potential item to the agenda:

    (1) the relevance to users of the information involved and the reliability of information that could be provided;

    (2) existing guidance available;

    (3) the possibility of increasing convergence;

    (4) the quality of the standards to be developed; and

    (5) resource constraints.

Criterion 1: The relevance to users of the information and the reliability of information that could be provided

60. Criterion 1 considers whether a project on rate-regulated activities would address the needs of users across different jurisdictions.

International relevance and pervasiveness

61. Rate regulation is widespread and significantly affects the economic environment of rate-regulated entities. A specific standard, SFAS 71 (and subsequent modifications and interpretations), dealing with this topic exists in US GAAP. Although no similar standard exists in Canada, SFAS 71 has been widely used by analogy. Consequently, many billions of dollars of so-called 'regulatory' assets and liabilities are recognised in both countries. To the best of the staff's knowledge, no similar standard exists elsewhere either, although it appears that in many jurisdictions entities either follow the accounting prescribed by the regulator or analogise to SFAS 71.

Urgency

62. In October 2007, the European Roundtable on Consistent Application of IFRSs identified rate-regulated activities as a problematic accounting issue with significant divergence of views on how IFRSs should apply. Since, the National Standard Setters group has also discussed this question at several of its meetings. Both bodies expressed the view that either the IFRIC or the Board should address the issue.

Consequences of not taking this project on the agenda

63. Although the IFRIC did not identify significant divergence in practice, the staff are of the view that divergence may emerge in the future when new jurisdictions adopt IFRSs and will not find specific guidance addressing the issue. In the absence of authoritative guidance, the staff are concerned that uncertainty will remain as to how IFRSs should apply. It is also worth noting that although there

is currently no divergence in practice, many constituents do not appear to be satisfied with the existing accounting, leading to the issue being raised with the IFRIC for a second time.

Criterion 2: Existing guidance available

64. Criterion 2 considers whether the project will address an area on which existing guidance is insufficient.

65. The staff note that IFRSs already provide the following guidance:

- The definitions of an asset and a liability in the *Framework*;
- The intangible asset model in IAS 38 and IFRIC 12;
- The definitions of a financial asset and a financial liability in IAS 32;
- General disclosures in IAS 1.

66. However, it seems to the staff that this guidance is not sufficiently clear because many challenge the legitimacy of current practice and interpret the *Framework*, IAS 38 and IAS 37 in a different manner.

Criterion 3: The possibility of increasing convergence

67. The staff believe that a project on rate-regulated activities provides the opportunity of increasing convergence of the accounting standards in different jurisdictions, for example convergence between IFRSs and US GAAP and practice in other jurisdictions that have applied SFAS 71 by analogy, and therefore meets criterion 3.

Criterion 4: The quality of the standard to be developed

68. Criterion 4 considers the qualitative aspects of the standard that is proposed to be developed.

Developing a full standard or a "holding" standard

69. The staff are of the view that the scope is sufficiently narrow (see the proposed scope in paragraphs 25 and 26 of this paper) that the Board should first seek to develop a permanent standard on rate-regulated activities. Only a full standard that prescribes the accounting for the effects of certain rate regulation can achieve comparability.

70. As an alternative, if the Board wishes to wait for the completion of phase B of the conceptual framework project, we suggest developing a 'holding standard' similar to IFRSs 4 and 6, with the objective to:

    (a) require application of all relevant IFRSs (in some jurisdictions rate-regulated entities simply follow the accounting prescribed by the regulator rather than adopting the SFAS 71 approach);

    (b) permit entities to continue to use their existing accounting policies for the recognition and measurement of regulatory assets and liabilities; and

    (c) require disclosures about the nature of the regulation and the basis on which assets and liabilities are recognised.

Cost/benefit considerations

71. An important aspect of the quality of a new standard is the balance between the benefits of the information produced in accordance with the standard and the costs to entities of providing such information.

72. The staff's view is that the costs for entities to produce the information that would be required by a standard on rate-regulated activities would not be significant because entities that undertake such activities already bear most of these costs as part of the information required to comply with the regulation in place. They must maintain records that apply the regulatory basis to submit to the regulator.

Feasibility

73. As previously noted, many of the issues that arise in rate-regulated activities are closely related to issues in other projects. Those projects are:

    (1) *Conceptual framework.* One of the objectives of phase B of the conceptual framework project is to revise and clarify the definitions of an asset and a liability. The Boards have tentatively adopted new working definitions of an asset and a liability (see http://www.fasb.org/project/cf_phase-b.shtml). However, several issues need to be addressed to complete phase B, such as the interaction of the working definition of a liability with the Boards' joint project on financial instruments with characteristics of equity.

    (2) *Insurance contracts.* In February 2008, the Board started its review of responses to the discussion paper *Preliminary Views on Insurance Contracts*. The Board expects to publish an Exposure Draft in late 2009, with a view to publishing a final standard in 2011.

74. However, the staff believe that the tentative decisions reached by the Board on these two projects indicate that a consensus may be reached expeditiously on the narrow issue of rate-regulated activities.

Criterion 5: Resource constraints

75. Criterion 5 considers whether there are sufficient resources to undertake the rate-regulated activities project in the Board's agenda.

Availability of the Board

76. The key resource is Board time. As emphasised at the November SAC meeting, we recognise that this is an extremely scarce commodity especially in the current environment. However, we believe that it is possible to manage the project to minimise the Board time consumed.

Availability of staff

77. We think that much of the research is already complete and capacity is available in the IFRIC team that would not require the diversion of staff from MoU projects.

Availability of expertise outside the IASB

78. When considering the size of a project on rate-regulated activities, we do not think that a working group needs to be established. As described in this paper, we have already received inputs from constituents around the world. However, we think we will have to contact national standard-setters and industry associations to ensure that we have considered all relevant information. We note that many industry groups have already volunteered assistance if needed.

Staff conclusion and recommendation

79. The staff believes that a potential project on rate-regulated activities meets all agenda criteria and recommend that the project be added to the Board's technical agenda.

Section D—WHETHER A PROJECT ON RATE-REGULATED ACTIVITIES SHOULD BE ADDED

80. ***Does the Board agree to add a project on rate-regulated activities to its technical agenda? If so,***

    (a) Does the Board agree with the staff that it should first seek to develop a permanent standard?

    (b) Does the Board agree with the scope suggested by the staff in paragraphs 25 and 26 of this paper?

Section E—PROPOSED PROJECT PLAN

81. We believe that the issue is sufficiently narrow that it justifies producing an exposure draft as the first due process document.

82. ***Does the Board agree that an exposure draft should be issued as the first due process document?***

83. There are several issues for the Board to discuss before it can reach conclusions to be published as an exposure draft. At a minimum, the staff believes that publication of an ED will require the following time:

Month	Topic
February 2009	Scope of the project Discussion of the main issues
March 2009	Disclosures and cost/benefit analysis
April 2009	Consideration of the exposure draft and sweep issues
May 2009	Publication

84. ***Does the Board agree with the proposed project plan and timetable presented above?***

Appendix 1: additional background information on rate-regulated entities

85. Rate regulation is a restriction in the setting of prices that can be charged to customers for services or products. There are a number of basic regulatory processes and methodologies and, within each, there can be different applications that vary with the regulator, the entity being regulated and the circumstances faced.

86. The goal of rate regulation is to set "just and reasonable rates." Generally, rate regulation is imposed when an entity has a monopoly or a dominant market position that gives it excessive market power. In such situations, there is a lack of effective competition to constrain the prices that the entity can charge. To compensate, governments impose rate regulation.

87. In most cases, governments impose rate regulation by creating legislation setting up a regulatory authority and giving it jurisdiction to approve the rates of a specific entity or categories of entities (for example, electric distribution utilities). Entities falling within the jurisdiction of the regulatory authority are not allowed to charge prices other than those approved by the regulatory authority.

88. The norm is for a government to create a separate regulatory authority. However, a government may regulate rates through other means such as empowering the governing body of government-owned utilities to set rates in accordance with a statute.

89. In the past, rate regulation tended to be applied to an entire organisation. With acquisitions, diversification and deregulation, rate regulation may now be applied to only a portion of an organisation's operations. In some cases, an organisation may have both regulated and non-regulated operations, and the regulated operations may be subject to the authority of different regulators.

90. There is no universal method of rate regulation. The rate-setting process and the application of that process can vary from one jurisdiction to another. Within a jurisdiction, it can vary from one entity to another. In addition, rate regulation is constantly evolving.

Rate-setting Processes

91. Traditionally, regulatory authorities have convened public hearings to review the rate applications of large entities. After the entity prepares a submission setting out its proposed rates, and the support for those rates, the regulatory authority may decide to hold a hearing. After the hearing is completed, the regulatory authority makes a decision based on the submissions, the response to the written questions and the testimony given at the public hearing.

92. As an alternative to a public hearing, a regulatory authority may have a "paper hearing." The regulated entity and interveners make written submissions, submit written questions and provide written responses. Based on this written documentation, the regulatory authority makes a decision.

93. In Canada, there is currently a trend to negotiated settlements. The regulated entity and representatives of its customers negotiate allowed rates, or at least issues that affect the determination of allowed rates. Issues that cannot be settled by negotiation go to the regulator for resolution. Also, the regulator must approve any settlement.

94. The negotiation process is intended to be more informal and less adversarial than the normal regulatory process. It is expected to be less costly and offers the opportunity for better settlements. In the hearing process, the regulated entity and other interested parties put their position to the regulator, who then renders a decision based on the evidence presented. With a negotiated settlement, the regulated entity can negotiate rates with the other interested parties, which offers the opportunity for a settlement that is preferred by all parties.

Rate-setting Methodologies

95. The legislation empowering a regulatory authority usually provides little direction on how rates are to be established, except that the rates must be "just and reasonable" or a similar general statement. Usually, regulatory authorities have significant discretion in deciding the regulatory methodology that will be used in setting allowed rates and how that methodology will be applied.

96. There are a number of basic regulatory methodologies and, for each, there can be applications that vary with the regulator, the entity being regulated and the circumstances faced. In some cases, a specific rate must be charged; in other cases, a maximum limit is set on the rates.

97. In the past, the primary regulatory methodology for the major utilities was "cost-of-service" regulation, also referred to as "return-on-rate-base" regulation. Under this approach, rates are set to give the utility the opportunity to recover its costs of providing service plus a fair return. In recent years, however, there has been a trend to performance-based regulatory methodologies, such as price-cap regulation. With price-cap regulation, initial rates often reflect the cost of service, but are allowed to increase, or are required to decrease, in accordance with a formula over time.

Cost of Service / Return-on-Rate Base

98. Under cost-of-service regulation, the rates are set to provide a rate-regulated entity the opportunity to recover its costs and earn a return on its investment. The regulator establishes the revenues required to cover the expected cost of providing the regulated service, including a fair return on the investment in the regulated operations. This amount is called the "revenue requirement." The regulator then sets rates that will provide the entity with a reasonable opportunity to recover its revenue requirement.

99. Rates may be set for a short period, such as a year, or may be set until changed. In the latter case, the entity seeks new rates when existing rates will not allow it to recover its costs and earn a fair return. Alternatively, the regulator may seek a rate review when allowed rates are considered excessive. As a result, a regulated entity's actual return is usually close to its allowed return.

100. With cost-of-service regulation, there is a direct link between the costs that an entity is expected to incur and its expected revenue — rates are set to allow the entity to recover its expected costs. Although regulators may follow GAAP in determining the amount of any specific cost to be included in the cost of service, it is not always the case. Regulatory authorities may decide that additional considerations are appropriate in setting "just and reasonable" rates, for example:

- **Cost deferral**. Where certain specific costs are subject to material variation, are difficult to predict and are largely outside the control of management, a regulator may require a regulated entity to place the difference between the expected and actual amount of those costs in a deferral account. The amount in the deferral account may then be used to increase or decrease the future revenue requirement. This results in a portion of the costs (or cost savings) of one period being included in the revenue requirement of another. In some

cases, deferral balances may be refunded or recovered in a lump sum and the revenue requirement is not adjusted.

- **Rate smoothing**. To avoid rate fluctuations or to smooth out an increase in rates, a regulator may defer costs (or cost savings) with the deferred amount to be reflected in future rates.

- **Cost disallowance**. When a regulator decides that a cost was not prudently incurred, it may disallow all or part of the cost, thereby reducing (or eliminating) any future recovery of that cost.

101. When the regulated entity is in a situation of monopoly or near monopoly and demand is fairly steady, recovery at the higher rates is reasonably predictable. Therefore, in these circumstances, when a regulator decides to defer the recovery of a cost, it is assumed that the regulated entity will recover that cost.

Price Cap

102. With price-cap regulation, prices are capped, with the capped rates changing each period in accordance with a formula. In its simplest form, rates are allowed to increase by a percentage amount equal to the rate of inflation less a productivity factor. When the measure of productivity is greater than the rate of inflation, rates must be decreased.

103. The formula may include provision for what is sometimes referred to as an exogenous factor. This is an adjustment for costs or cost savings not covered by the basic formula. Generally, amounts covered by the exogenous factor must be material and outside the control of management. A common example is an unexpected change in income tax rates. If income tax rates increase, the rates of the rate-regulated entity are allowed to increase beyond what would be allowed by the formula to cover the increase in this cost. The exogenous factor recognizes the difficulty in developing a simple formula that will deal with all economic and other events.

104. The price-cap methodology may contain deferral accounts. As noted above under cost-of-service regulation, these accounts deal with specific costs that vary significantly, are difficult to predict or are largely outside the control of management. Differences between the expected and actual level of the costs are placed in a deferral account and recovered through an increase in future rates or used to reduce future rates.

105. With price-cap regulation, there are usually periodic reviews of the formula to ensure that the resulting rates are just and reasonable. The reviews may result in an adjustment to the base rates and/or the formula for increasing (decreasing) rates.

106. It has been argued that price-cap regulation breaks the link between rates and costs; rate increases are based on the price-cap formula and not on changes in the costs of the regulated entity. There is rarely a complete break, however, between rates and costs. For example:

- initial rates will often reflect the cost of service;
- the price cap formula is usually intended to reflect reasonably expected changes in costs;
- in the periodic reviews, rates will often be evaluated against the cost of service;
- the exogenous factor allows for changes in rates to reflect costs, or cost savings, not covered by the price-cap formula;
- deferral accounts result in an adjustment in rates to reflect differences between the expected and actual level of specific costs.

107. However, the main difference between cost-of-service regulation and price cap regulation is that the latter does not 'guarantee' that the regulated entity will

recover its costs and earn a specified return. Under such regulation, it may not even be certain that the utility will be viable at the prices the regulator permits.

Hybrid — Price Cap / Cost of Service

108. The hybrid methodology is a modification of the price-cap and cost-of-service methodologies. Rates are set in accordance with a price-cap formula. At the end of the year, the actual return on equity is compared to the allowed return on equity. A portion of earnings in excess of that allowed must be returned to customers through a reduction in future rates. In some cases, a portion of any earnings below that allowed is also shared with customers through an increase in future rates. The hybrid methodology increases the incentive for the utility to improve its efficiency and reduce costs to its customers, because it is allowed to retain a portion of cost savings.

109. Examples of regulation based on hybrid methodologies are the UK water regulation and many of the regulatory regimes in North America. In Belgium, the regulation of electricity transmission also seems to have recently adopted such a hybrid methodology.

Appendix 2: illustrative examples

110. The descriptions of the following 'regulatory' assets and liabilities were provided by a Canadian natural gas utility. They illustrate a variety of regulatory mechanisms that have differing effects on rates for differing goods/services.

Grants paid

111. Grants paid are mainly amounts given to customers to help cover the cost of converting their equipment to natural gas so they can sign a service contract with the company. These amounts are deferred and then amortized over the periods covered by the contracts (generally five years).

112. *Staff comment* – we do not believe that these grants should be considered assets arising from rate regulation. The company does so because the regulator requires it to offer the grants. However, they are more in the nature of customer/contract acquisition costs and the treatment is in accordance with IFRSs for similar costs.

Amounts related to energy supply

113. The regulatory rules in a number of Canadian provinces and U.S. States do not allow distributors to make a profit or loss on the supply of energy, natural gas in this case. Therefore, the company charges customers two rates – one for the cost of energy and another for the costs of transmission. It is this separation that permits customers to obtain their energy from suppliers other than the entity responsible for the transmission.

114. The company determines the difference between the revenue received at the rate charged for natural gas supplied and the purchase price of the natural gas each month. This difference is then returned to or recovered from customers beginning the next month in the form of adjustments to the rates charged for natural gas over a period of 12 months. Thus, the rate charged based on the expected cost of

natural gas to be supplied in September is adjusted for one-twelfth of any profit or loss on gas supply made in August (as well as the accumulated adjustments from the previous 11 months).

115. *Staff comment* – Because both the volume supplied and the difference between estimated and actual cost of gas are known, the company could bill each customer the actual cost differential the following month. Consequently, in the absence of rate regulation these amounts would simply be recognised as customer receivables/payables.

Amounts related to weather (temperature and wind)

116. Distribution rates are based on volumes and are approved annually. Therefore, in order to determine the rate to charge per unit for gas distributed, the company must estimate the total volume to be delivered in a year. Obviously, the volume distributed will be affected by weather, especially winter temperatures.

117. The objective of normalizing temperatures is to spread over future periods the difference between actual revenues and revenues derived from rates based on historical average temperatures. The normalisation calculation involves a regression analysis of customers' consumption based on average temperatures for the past 30 years, assuming heating starts to have an impact starting at a temperature of 13 degrees Celsius. If the actual temperature is warmer than normal, the difference will be recorded as an asset (revenues to recover from customers) and the opposite will occur if the temperature is colder than normal. The calculation is done monthly (during the heating season) from October to May.

118. The variation is determined annually and is amortized so as to be recovered in rates over five years. Because rates are set based on budgets before the annual actual is determined, the rate adjustment begins the second year after the one in which it occurs (that is, the amount determined for 2008 will affect rates beginning in January 2010). However, customers (or the company) are

compensated for the year delay in adjusting rates as the amount of the adjustment also includes interest at the company's cost of capital for that year.

119. The regulator believes that this rate stabilization account provides protection from variations in volume caused by weather (a perfect hedge) for both the company and its customers at no cost and is therefore preferable to the imperfect results that could be achieved using (costly) weather derivatives.

Amounts related to the cost of distribution

120. The company operates under a return on rate base form of regulation. The performance incentive mechanism allows it to keep 25% of the amount by which the actual return exceeds the return allowed by the regulator (referred to as 'overearnings'). The regulator requires the customers' share of the overearnings (75%) be returned to them in the form of rate reductions over 3 years commencing in the fiscal year following its approval of such overearnings. If the company earns less that the return allowed by the regulator, it is permitted to increase rates in the following 3 years to recover 50% of the difference. Once again, the amount is adjusted by interest at the company's cost of capital to compensate the party receiving the payment for the delay in recovery.

121. *Staff comment* – the permitted return is determined based on an assumed capital structure and an amount of capital determined in accordance with regulation.

Approval of deferral accounts

122. The regulator approves deferral accounts for certain expenses or variances from forecasted expenses. In essence, there is an 'approval principle' of the deferred item, but these items are still subject to a prudence review in a future hearing. Due to regulatory lag, there are many cases in which deferral account treatment is approved retroactively when a revenue requirement decision is made after the beginning of a year. In this case, it might be reasonable for a utility to use precedent to defer items that were given deferral account treatment in its last rate hearing.

123. *Staff comment* – another view is that only a formal approval by the regulator creates a right or an obligation that should be accounted for.

Appendix 3: letter received from an association of US electric companies

[Omitted from observer note]