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**International
Accounting Standards
Board**

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Note: The observer note is based on the staff paper prepared for the IFRIC. Paragraph numbers correspond to paragraph numbers used in the IFRIC paper. However, because the observer note is less detailed, some paragraph numbers are not used.

INFORMATION FOR OBSERVERS

IFRIC meeting: November 2008, London

Project: Regulatory assets and liabilities – Background (Agenda Paper 6A)

Introduction

1 As background to making its recommendation on the IFRIC agenda decision, the staff made some preliminary background information researches that are summarised in this paper. This paper provides information about :

- (a) Rate regulations;
- (b) Accounting standards and financial reporting practices; and
- (c) Alternative views under IFRS.

- 2 In section (c)—Alternative views under IFRS, the staff report the views they are aware of. The staff’s own views are set out in agenda paper 6 for this meeting.
- 3 The appendix to this paper lists the documents the staff provided as attachments to previous agenda papers.

Rate regulations

- 4 The staff noted that the Canadian Institute of Chartered Accountants (CICA) issued a research report on ‘Financial Reporting by Rate-regulated Enterprises’. This research report gives interesting information about rate regulations in Canada and accounting practices in Canada and the US. The staff also looked at annual reports of large utilities in Europe that thoroughly describe the different rate regulations in Europe. Although what follows is mainly based on the research report issued by the CICA, the staff did not find any major differences with rate regulations in Europe.
- 5 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.
- 6 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.
- 7 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.
- 8 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.
 - 9 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.
 - 10 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

- 11 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.
- 12 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.

13 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.

14 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

15 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.

16 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.

17 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

18 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.

19 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.

20 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.

21 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

22 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.

- 23 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.
- 24 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.
- 25 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.
- 26 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.

27 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

28 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.

29 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.

Accounting standards and financial reporting practices

30 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 has enquired of various National Standard Setters and is not aware of one other than the US that issued an accounting standard or an interpretation on a similar issue. International Financial Reporting Standards do not specifically address this issue but divergence does not seem to be significant in practice at present.

Standards and practices in the United States

31 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.

32 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.

33 SFAS 71 provides guidance on preparing general purpose financial statements for most public utilities. Certain other companies with regulated operations 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.

34 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.

35 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.

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

- 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;

- the regulated rates must be designed to recover the specific entity's costs of providing the regulated services or products;
- 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.

Entities currently reporting in IFRS

- 37 IFRS do not specifically address this issue but divergence does not seem to be significant in practice at present.
- 38 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 that arises in a few regulatory regimes.
- 39 The staff also have examples of entities that report in both US GAAP and IFRS that concluded that regulatory assets and liabilities did not fulfil the recognition criteria for assets and liabilities under IFRSs.

Alternative views under IFRS

Overall comments

40 IFRSs do not specifically address the issue of regulatory assets and liabilities. In this context, the *EU round table on consistent application of IFRS* held a meeting in October 2007 and identified divergence of views on how IFRSs should apply to regulatory assets and liabilities. On the other hand, the IFRIC received twelve letters¹ from some regulators, utilities and analysts based in the United States and Canada that all support the recognition of regulatory assets and liabilities.

41 It seems that there is also divergence of views among analysts. Some of those the staff have met are of the view that recognising regulatory assets and liabilities does not help to predict future cash flows. Rather, the rate-regulated entity should disclose information about the effects of the regulation on the regulated asset base (RAB) and on the future cash flows. Other analysts commented that they find the recognition of regulatory assets and liabilities helpful. For example one analyst stated in a letter to the IFRIC that *‘The recognition by these utilities of regulatory assets and liabilities allows them to properly reflect the decisions and actions of their regulator in their financial statements. I believe that not recognizing these balances in the financial statements would result in financial information that is incomplete and does not represent the economic environment in which these companies operate. Consequently, if these companies do not recognize rate regulated assets and liabilities in their financial statements, I believe this regulatory information will be provided or disclosed outside of the financial statements, resulting in an increased complexity and increased use of “non-GAAP measures” to more accurately communicate the financial results.’*

¹ These letters were attached in Appendix 1 to agenda paper 5 presented at the September IFRIC meeting

Whether rate regulation creates an asset? If so, what is the nature of this asset?

Regulatory assets are intangible assets

42 Some believe that an intangible asset may be recognised as a result of rate regulation (**View 1A**).

- **Identifiable.** Paragraph 12 of IAS 38 states that ‘an asset meets the identifiability criterion in the definition of an intangible asset when it is separable [...] or arises from contractual or other legal rights, regardless of whether those rights are transferable or separable from the entity or from other rights and obligations.’ Regulatory assets may not be separable from the existing licence but they clearly arise from contractual or legal rights and provide the entity with additional rights as a result of the rate regulation.
- **Control.** Paragraph 13 of IAS 38 states that ‘the capacity of an entity to control the future economic benefits from an intangible asset would normally stem from legal rights that are enforceable in a court of law.’ In some circumstances, a regulator may allow a utility to increase prices in the future in order to compensate for all, or part of, excess costs incurred. That decision is enforceable and gives the utility a contractual right or other legal right to charge users a higher price. Therefore, it can be argued that, in that case, the utility would control the regulatory asset.
- **Future economic benefits.** Paragraph 22 of IAS 38 states that ‘an entity shall assess the probability of expected future economic benefits using reasonable and supportable assumptions that represent management's best estimate of the set of economic conditions that will exist over the useful life of the asset.’ The probability that future economic benefits attributable to the regulatory asset will flow to the entity depends on users using the service, that is, the

demand risk. A utility would normally be in a position to assess such a probability in the same way as it does so for the existing licence.

43 Supporters of View 1A also believe it is possible to draw an analogy with IFRIC 12 *Service Concession Arrangements*. IFRIC 12 requires the recognition of an intangible asset for an entity's right to charge the public to use infrastructure.

44 Some believe that an intangible asset cannot be recognised as a result of a rate regulation (**View 2A**). They argue that:

- the rate agreement does not give rise to the recognition of an intangible asset as it does not change the nature of the existing licence;
- the regulator may sometimes reverse a previous decision or its decision may be challenged or overturned by the government;
- the utility does not have control over the recoverability of the future economic benefits because it does not control whether the customers will use the service. Will the future demand be sufficient to recover the asset recognised? Can the utility's customer choose an alternative product or supplier? (Although it should be noted that these questions seem to be the reason for the third criterion in SFAS 71).

IAS 32 Financial Instruments: Presentation

- 45 Paragraph 11(c) of IAS 32 defines a financial asset as ‘a contractual right to receive cash or another financial asset from another entity’.
- 46 In most cases, the regulator grants the utility the permission to add an additional charge per unit to *future* billings to customers but would not permit the utility to charge identifiable existing customers through a retroactive pricing adjustment. Therefore there would be no contractual arrangements designed to ensure that the utility has a *present* right to receive cash from individual customers.

Whether rate regulation creates a liability? If so, what is the nature of this liability?

- 47 Attached to the letter submitted to the IFRIC in January 2008 is a paper discussing whether rate regulation creates a liability in accordance with IAS 18, IAS 32 or IAS 37 (see Appendix 1 to agenda paper 7A presented at the May 2008 IFRIC meeting). In the discussion that follows, the staff only highlight the main arguments in favour or against recognition of regulatory liabilities.

IAS 32 Financial Instruments: Presentation

- 48 A common view is that, in most cases, the agreement with the regulator that requires the return of excess profit to customers would usually not meet the definition of a financial liability because the utility has no present obligation to pay cash either to the regulator or to individual existing customers.
- 49 Only in a few cases, a financial liability would be recognised. In pages 5 and 6 of the paper attached to the submission, it is noted that ‘*in some arrangements, the regulator may have the power to require the company to pay cash to the regulator if revenues exceed a defined amount, or if the company’s return exceeds a defined*

level. In such cases, the company may have a financial liability due to the regulator. Even if the usual practice is for the regulator to direct the company to re-invest excess proceeds, or re-set prices, the company will have a financial liability if the regulator has the power to require the company to deliver cash. In other arrangements, the company may be obliged to rebate cash to individual customers, such that a financial liability exists as a result of an explicit or implicit inclusion of the requirements in the regulation into the terms of the contract with each customer.'

IAS 37 Provisions, Contingent Liabilities and Contingent Assets

- 50 Some believe that an obligation may be recognised in accordance with IAS 37 as a result of rate regulation (**View 1B**). Paragraph 20 of IAS 37 states that ‘An obligation always involves another party to whom the obligation is owed. 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.’ Supporters of this view argue that a past event has taken place: the excess charge to customer, as a result of the difference between the budgeted cost and revenues and the actual amounts. This past event, based on the contractual arrangement with the regulator, gives rise to a present obligation to return the gain to present and future customers, ie ‘the public at large’. *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.* [letter from the Edison Electric Institute]
- 51 Some believe that an obligation cannot be recognised in accordance with IAS 37 as a result of rate regulation (**View 2B**). They 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. This view was also the view held by the UK Accounting Standards Board when the latter issued FRS 12 *Provisions, Contingent Liabilities and Contingent Assets*. Appendix VII *Development to the FRS* states:

- 16 By basing the recognition of a provision on the existence of a present obligation, the FRS rules out the recognition of any provision made simply to allocate results over more than one period or otherwise to smooth the results reported. For example, in a regulated industry the results achieved in the current period may cause the pricing structure in the next period to be adjusted, eg the higher the profits in this year the lower the prices permitted for next year. There is no justification under the FRS for a provision to be recognised in such circumstances. The purpose of such a provision would be to transfer some of the current year's profit to the following year, which would suffer from lower prices because of the current year's profits. However, there is no present obligation that requires the transfer of economic benefits to settle it and nothing to justify recognition of a provision.

Appendix: list of documents distributed to the IFRIC

May 2008 IFRIC meeting

- Appendix 1 to AP 7A: Submission
- Appendix 2 to AP 7A: Extract from the August 2005 IFRIC Update

September 2008 IFRIC meeting

- Appendix 1 to AP 5: Letters received by the IFRIC after the May IFRIC meeting
- Appendix 2 to AP 5: Agenda Paper 6 for the March 2008 Meeting of National Standard Setters