Project **Rate-regulated activities**

Topic **Recognition and measurement**

Introduction

Objective of this paper

1. The objective of this paper is to define the relevant recognition and measurement criteria for assets and liabilities within the scope of this project. As such, this paper:

   (a) analyses the need for recognition criteria in addition to the scope criteria the Board decided on in February and recommends that none be included in the standard;

   (b) analyses the nature of assets and liabilities recognised in accordance with this standard and concludes that they are not within the scope of IAS 39 *Financial Instruments: Recognition and Measurement*;

   (c) discusses the appropriate measurement bases for assets and liabilities recognised as a result of rate regulation (regulatory assets and liabilities) and concludes that a probability-weighted expected value is the most appropriate basis; and

   (d) identifies additional material that the staff recommends be included in the standard as application guidance.

Staff analysis

2. The standard developed as a result of this project will assume that an entity has applied all other relevant IFRSs to prepare its financial statements before considering its application. If some or all of the entity's activities are regulated, this standard is considered to determine whether additional assets or liabilities should be recognised as a result of that regulation. If the entity concludes that a regulated activity is within the scope of this standard, the next step is to

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determine whether to recognise assets and liabilities as a result of the regulation and if so, how to measure the them.

3. This paper addresses only the recognition and measurement criteria for this project. It assumes the scope criteria have been met for the regulated activity being considered for recognition and measurement.

Recognition criteria – threshold for recognition

4. Given that the entity has concluded that the scope criteria have been met for the regulated activity in question, the next step is to determine *if* regulatory assets or liabilities should be recognised.

5. The Board's most recent discussions on the *Framework* and the current definition of assets relate to present rights to future economic benefits as a result of the occurrence of past events; for liabilities, present obligations expected to result in an outflow of economic benefits arising from past events. The Board has already concluded that the form of regulation included in the scope of the project results in assets or liabilities consistent with the definitions in the *Framework*. This is because it includes specific costs/receipts that have already been incurred/received by the entity for which the entity will receive future economic benefits through reimbursement of the costs or will give up economic resources by repayment of amounts previously received by a reduction of future receipts.

6. Since the regulations govern the entity's relationship with its customer base as a whole, the entity receives the present right or obligation to receive or pay economic benefits from or to the aggregate customer base. The regulations that govern an aggregate customer base create the same pricing structure for all the entity's customers[1]. Contracts between the entity and individual customers govern the operation of those customers' accounts payable. Customers are not able to negotiate individual terms and conditions, including prices. Therefore, the staff believes the proper unit of account for regulatory assets and liabilities is at the aggregate customer level.

[1] The existence of different prices for different classes of customers is considered further in Agenda Paper 9C for this meeting.

7. The question is whether the standard should include a separate recognition criterion. SFAS No. 71 *Accounting for the Effects of Certain Types of Regulation* (FAS 71) includes a minimum threshold that must be satisfied before an asset or liability can be recognised. Paragraph 9 of FAS 71 states:

> Rate actions of a regulator can provide reasonable assurance of the existence of an asset. An enterprise shall capitalize all or part of an incurred cost that would otherwise be charged to expense if both of the following criteria are met:
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> a. It is probable that future revenue in an amount at least equal to the capitalized cost will result from inclusion of that cost in allowable costs for ratemaking purposes.
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> b. Based on available evidence, the future revenue will be provided to permit recovery of the previously incurred cost rather than to provide for expected levels of similar future costs. If the revenue will be provided through an automatic rate-adjustment clause, this criterion requires that the regulator's intent clearly be to permit recovery of the previously incurred cost.
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> If at any time the incurred cost no longer meets the above criteria, that cost shall be charged to earnings. [footnotes omitted]

8. FAS 71 is explicit that for this purpose the term 'probable' has the same meaning as is SFAS 5 *Accounting for Contingencies*. Thus, if the criterion that the asset be 'probable' of recovery is not met, FAS 71 precludes the recognition of any asset related to that cost. In IFRS the term 'highly probable' is used with similar meaning. The staff notes that both the asset and liability definitions and the recognition criteria in the *Framework* do not consider probability in this way. Rather, paragraph 85 of the *Framework* uses the notion of probability in the same sense as it is employed in other standards and defined in the *Glossary*, that is, 'more likely than not'.

9. The staff recommends that the standard not include a separate recognition criterion. In the staff's view, the scope criteria the Board has already specified are both necessary and sufficient for the recognition of regulatory assets and liabilities. Consequently, once the scope criteria have been met, assets and liabilities exist as a result of the regulation that the entity should recognise. This is because of the cause and effect relationship between an entity's costs and its rate based revenue stream. In a regulatory environment within the scope of the

project, incurring costs/receiving payments creates the right to recover the costs/obligation to return the payments from/to the aggregate customer base. This should lead to the recognition of an asset/liability because both the probability of inflow/outflow of economic benefits and the reliable measurement criteria are met.

10. The staff notes that the conclusion that all items that meet the scope criteria should be recognised is consistent with the recognition of income tax assets and liabilities as currently proposed in the exposure draft on Income Taxes. That exposure draft proposes that if there is uncertainty regarding the realisation of the asset or liability, that uncertainty is considered as part of the measurement of the asset or liability. The staff agrees with the conclusion that if an asset or liability exists, it should be recognised in the entity's financial statements.

11. The staff also notes that an important consequence of this conclusion is that the standard would not have to include additional criteria specifying when regulatory assets and liabilities should be derecognised. Failure to satisfy the scope criteria in future reporting periods would automatically result in the derecognition of all previously recognised regulatory assets and liabilities.

Question 1 – Recognition criteria – threshold for recognition
1. For the reasons outlined in the preceding paragraphs, the staff recommends that if an activity is within the scope of this standard, regulatory assets and liabilities should be recognised in the entity's financial statements and that no additional recognition criteria are necessary. Does the Board agree? If not, what recognition criteria does the Board recommend?

Recognition criteria – type of asset or liability

12. In the staff's view, the nature of regulatory assets and liabilities needs to be considered. The result of the project will be a separate standard setting out accounting requirements for the assts and liabilities within its scope. However, to the extent that those assets and liabilities are similar to others for which standards already exist in IFRS, consistency with their requirements is highly desirable.

13. The staff has concluded that in general regulatory assets (or liabilities) recognised as a result of the application of this standard are not financial instruments subject to the requirements of IAS 39 as the entity does not have the

right to request reimbursement from, or the obligation to make payments to, individual customers for fixed or determinable amounts.[2]

14. IAS 32 *Financial Instruments: Presentation* defines a financial instrument as:

> any contract that gives rise to a financial asset of one entity and a financial liability or equity instrument of another entity.

As noted earlier, regulatory assets and liabilities do not arise as a result of contracts with individual customers. Rather they are the result of actions the regulator imposes with respect to the aggregate customer base.

15. Consequently, in the staff's view, the assets that arise as a result of regulation are <u>intangible assets</u> as defined in IAS 38 *Intangible Assets*.

> An *intangible asset* is an identifiable non-monetary asset without physical substance.

A regulatory asset is created as a result of specific previously incurred costs for which the regulations governing the entity's activities permit or require the entity to increase billings in future periods to recover them.

16. The regulatory assets meet the requirements of paragraphs 9-17 of IAS 38 because they are:

    (a) identifiable – they relate to specifically incurred costs of the entity;

    (b) controlled by the entity – the entity has been granted the right to increase future billings to the aggregate customer base; and

    (c) increased future billings that will result in future economic benefits in the form of increased cash collections.

17. Applying the provisions of this standard will require the entity to determine and track the separate costs allowed to be included in future rates to be recovered/repaid due to the regulations. This tracking of the separate costs allowed by the regulator ensures that the requirement of IAS 38 that 'the cost of the asset can be measured reliably' is met.

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[2] The staff understands that in rare circumstances the regulator may direct that specific amounts be paid to or recovered from specific customers. In that case, the definition of financial instruments would be satisfied.

18. The asset is a separable intangible asset, i.e., a right to charge customers. This makes it different from the right to operate, such as in concession arrangements in accordance with IFRIC 12 *Service Concession Arrangements*. A licence gives an entity a right to do business that may or may not provide future economic benefits, but it does not necessarily give a right to cash flows as entailed by the regulator in the case of rate-regulated activities.

19. If there were no specific standard relating to regulatory liabilities, the staff believes they would be within the scope of IAS 37 *Provisions, Contingent Liabilities and Contingent Assets*. However, IAS 37 provides guidance on the accounting for liabilities for which no specific standard exists. Consequently, once the standard resulting from this project is issued, regulatory liabilities will be within its scope rather than IAS 37.

Questions 2, 3, 4 – Recognition criteria – type of asset or liability
2. The staff recommends that to the extent possible the requirements of this standard be consistent with the requirements of other standards covering similar assets and liabilities. Does the Board agree?
3. For the reasons outlined in paragraphs 13 to 18, the staff has concluded that regulatory assets meet the definition of intangible assets in IAS 38. Does the Board agree? If not, what type of asset does the Board believe is created?
4. For the reasons outlined in paragraph 19 the staff has concluded that the guidance for regulatory liabilities would otherwise be provided by IAS 37. Does the Board agree?

Specific rate-regulated assets and liabilities – what to recognize

20. Not all costs that an entity incurs are automatically recoverable from its customers. Regulators review entities' costs to ensure that they were appropriately incurred to provide the regulated service and were 'prudent'. Consequently, a cost must be *allowable* to be included in the determination of rates. Allowable costs are usually defined as actual or estimated costs for which revenue is intended to provide recovery. In cost-of-service regulation, allowable costs include interest costs and a reasonable return on shareholders' investments.

21. Two issues need to be considered:

    (a) determining whether a cost is allowable, and

    (b) the inclusion of a return on equity in the recoverable amount.

Allowable costs

22. Usually, the rate-making process is initiated by the entity preparing and filing a rate case designed to show the costs of providing service to customers. When a cost has been formally considered as part of a rate case, the regulator has provided clear evidence of its agreement on costs that are *allowable*. Such evidence can be in the form of a final rate order, setting forth findings of fact and of law, issued by the regulator to support its decisions.

23. However, in practice, costs may be incurred several periods before they are formally considered in a rate case. Consequently, staff understands that a variety of evidence is considered in determining the likelihood that particular costs will be *allowable* when they are reviewed by the regulator.

24. Evidence that could support the recovery of costs includes (in order of persuasiveness):

    (a) statutes or regulations that specifically provide for the recovery of the cost in rates and cannot be overturned by future regulatory decisions;

    (b) rate orders from the regulator specifically authorising recovery of the cost in rates;

    (c) previous rate orders from the regulator allowing recovery for substantially similar costs (precedents) for a specific entity or other entities in the same jurisdiction;

    (d) written approval from the regulator (although not a formal rate order) approving future recovery in rates;

    (e) uniform regulatory accounting guidance providing for the accounting treatment of various costs that is typically followed by the regulator in setting rates;

(f) written approval from the regulatory staff of the jurisdiction suggesting they will support rate recovery of the cost (but is not legally binding on the regulatory body that sets rates); and

(g) analysis of recoverability from internal or external legal counsel.

Recommendation and question 5 – Specific rate-regulated assets and liabilities – allowable costs
5. The staff recommends that a discussion of the evidence the entity considers in assessing whether costs will be allowed by the regulator be included as application guidance in the standard. Does the Board agree?

Is return on equity an allowable cost?

25. Most regulators allow (and often require) the costs of debt to be considered allowable costs, thus allowing the entity to be reimbursed for the specific costs of the entity's debt. This treatment would be consistent with the current provisions of IAS 23. Additionally, most regulators allow (and often require) the economic costs of equity to be considered allowable costs. The regulator generally accomplishes this by specifying a targeted debt to equity ratio to ensure both lower costs of financing through the use of both debt and equity financing and a reasonable risk (leverage) profile of the entity. Regulators then allow a reasonable weighted average cost of capital which includes both the debt and equity returns.

26. The debt costs are easy to link back to specific costs the entity has incurred. However, some may argue that the equity component of the weighted average cost of capital is not an 'incurred cost'. The staff believes two separate issues arise. The first issue is whether it is appropriate to assume that a return on investment includes a cost of equity capital. The second is whether an assumed cost of equity can be included as a regulatory asset.

27. When a non-financial asset being tested for impairment in accordance with IAS 36 *Impairment of Assets*, in the absence of an active market for the asset, both fair value and value in use must be estimated using expected future cash flows. The standard requires the discount rate applied to those expected cash flows to reflect 'current market assessments of … the risks specific to the asset

for which the future cash flow estimates have not been adjusted.' Paragraph 56 provides the following guidance:

> This rate is estimated from the rate implicit in current market transactions for similar assets or from *the weighted average cost of capital* of a listed entity that has a single asset (or a portfolio of assets) similar in terms of service potential and risks to the asst under review. [emphasis added].

28. The staff therefore believes it is clear that if a regulator did not include the cost of equity in the return permitted on regulatory assets, the asset would be impaired in accordance with IAS 36 unless it could be assumed that the risk of the asset would permit it to be financed entirely by debt. The assumed cost of 100% debt financing would also have to be considered. In the staff's view, the use of the weighted average cost of capital is meant to capture the economic return that investors would require to invest in the regulatory assets and is appropriate. The staff does not believe that this needs to be discussed in the standard itself but recommends that it be discussed in the Basis for Conclusions.

Recommendation and question 6 – Specific rate-regulated assets and liabilities –cost of capital
6. Based on the analysis in paragraphs 25-28, the staff recommends that the equity component of the weighted average cost of capital is an allowable cost and can be recognised as a regulatory asset. Does the Board agree?

Measurement criteria – <u>how</u> to measure the assets and liabilities

29. Assuming the Board agrees with the staff recommendations earlier in this paper, the final question is <u>*how*</u> should the results of the entity's activities be measured? Many of the previous recommendations are relevant to answering this question.

30. The staff noted in paragraph 12 that it would be desirable if the accounting for regulatory assets and liabilities was consistent with those for other similar assets and liabilities. The staff also concluded that regulatory assets meet the definition of intangible assets, so IAS 38 is relevant, and regulatory liabilities would otherwise be within the scope of IAS 37, so its requirements should be considered.

31. IAS 38 requires internally developed intangible assets to be recognised initially at cost. For regulatory assets, the cost will have already been incurred. The

estimation that is required is whether the cost will be allowed to be included in future rates (see paragraphs 22 to 28) and, if so, how much will be allowed. Paragraph 22 of IAS 38 states "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."

32. Consistent with this guidance in IAS 38, the staff recommends that regulatory assets should be measured, both on initial recognition and subsequently, on the basis of the probability-weighted average of all possible outcomes. Those outcomes would consider both of the factors discussed in paragraph 31.

33. The staff believes that this approach to measurement is consistent with the requirements of IAS 36 which is the standard applicable to the assessment of intangible assets for impairment. IAS 36 notes that estimations about the variability of expected future cash flows should be considered, although the effects of variability can be included either in the estimates of future cash flows or in the estimate of the discount rate. As discussed in paragraph 25, the regulator will have already set a permissible market-based weighted average cost of capital that would be used as the discount rate. Therefore, it is necessary to include the variability of the estimates in the cash flows.

34. The staff believes the standard should include indicators of impairment that are specific to regulatory assets that an entity should consider in addition to those set out in IAS 36. In addition, the standard should clarify that regulatory assets and liabilities should be included in the cash-generating unit with the relevant PP&E when testing for impairment.

35. As noted in paragraph 30, the regulatory liabilities recognised in accordance with this standard would otherwise be within the scope of IAS 37. IAS 37 requires liabilities to be measured based on the best estimate of the expenditure required to settle the obligation. Paragraphs 39 and 40 of IAS 37 provide the following guidance:

> Uncertainties surrounding the amount to be recognised as a provision are dealt with by various means according to the circumstances. Where the provision being measured involves a large population of items, the obligation is estimated by weighting all

> possible outcomes by their associated probabilities. The name for this statistical method of estimation is 'expected value'. The provision will therefore be different depending on whether the probability of a loss of a given amount is, for example, 60 per cent or 90 per cent. Where there is a continuous range of possible outcomes, and each point in that range is as likely as any other, the mid-point of the range is used.
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> Where a single obligation is being measured, the individual most likely outcome may be the best estimate of the liability. However, even in such a case, the entity considers other possible outcomes. Where other possible outcomes are either mostly higher or mostly lower than the most likely outcome, the best estimate will be a higher or lower amount. …

36. The staff recommends that regulatory liabilities also be measured on the basis of the probability-weighted average of all possible outcomes. The staff believes that this approach is not inconsistent with the current guidance in IAS 37. Moreover it is the approach that the Board proposed in the exposure draft of amendments to IAS 37 published in 2005. It is also the approach that the Board recently proposed in the exposure draft to replace IAS 12 *Income Taxes*.

37. The staff agrees with the Board's rationale set out in the Basis for Conclusions on the IAS 12 ED:

> … the Board believes that the use of a probability-weighted average of all possible outcomes, without any probability-based recognition threshold, provides more relevant information than an approach that uses a probability-based recognition threshold. No possible outcomes are ignored in the measurement.

Recommendation and question 7 – Measurement criteria – how to measure the assets and liabilities
7. Based on the analysis in paragraphs 29-37, the staff recommends that regulatory assets and liabilities be measured using the probability-weighted average of all possible outcomes? Does the Board agree? If not, how does the Board believe the regulatory assets and liabilities should be measured?

Question 8 – Other issues
8. Are there any other recognition and measurement issues the Board believes should be considered?