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International Accounting Standards Board

INFORMATION FOR OBSERVERS

Board Meeting:	**February 2009, London**
Project:	**Rate-regulated Activities**
Subject:	**Defining the Scope of the Project (Agenda paper 9)**

Introduction

1. At the December 2008 Board meeting, the Board decided to add to its agenda a project on rate-regulated activities. The issue is whether entities with such activities could or should recognise an asset or a liability as a result of rate regulation imposed by regulatory bodies or governments. For background information, please refer to agenda paper 12 for that meeting.

Objective of this meeting

2. The objective of this meeting is to define the scope of the project. For that purpose, this agenda paper:

   (a) proposes a scope for the project;

(b) suggests scope exclusions;

(c) provides illustrative examples of the application of the proposed scope;

(d) compares the proposed scope with that of SFAS 71 *Accounting for the Effects of Certain Types of Regulation*.

3. The staff will ask the Board in paragraphs 52-55 of the paper whether it agrees with the proposed scope. We think that scope issues relate to whether the definitions of assets or liabilities are met. Therefore we do not intend to discuss recognition, measurement and disclosure issues at this meeting.

What type of rate regulation should be within the scope?

4. We think the project should address rate regulation that can create assets or liabilities (other than financial assets and liabilities—see paragraph 33 of this paper). Therefore, we suggest that the project should address situations in which an entity operates rate-regulated activities that meet the following criteria:

    (a) the entity's rates for regulated goods or services delivered to its customers are established by or are 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; [criterion 1] and

    (b) the rate regulation takes the form of a *cost-of-service regulation*. [criterion 2]

5. If only some of an entity's activities are regulated and meet these criteria, we think that a Standard on rate-regulated activities should be applied to only that portion of the entity's activities.

6. We also think that, when assessing whether an entity operates rate-regulated activities within the scope of the project, the entity should consider all the surrounding terms imposed by law or regulation as well as the specific agreements with its customers.

Setting the criteria

Criterion 1: The rate-setting mechanism

7. We think that the project should be limited to rate-regulated activities in which the rates are established by or are subject to approval by an independent, third-party regulator. We note that this independence increases the assurance that rights and obligations created by rate regulation actually exist and are enforceable.

8. In agenda paper 12 for the December 2008 Board meeting, we argued that in such circumstances, the regulator acts *on behalf of the customers* who individually

have no bargaining power with the entity. Agreements between a rate-regulated entity and its customers cannot be understood without reference to the regulation in place. Therefore, such agreements are different from agreements between an entity and its customers in a non-regulated environment. By contrast, an entity whose governing body unilaterally imposes restrictions on its own rates would not qualify.

9. However, in some circumstances, the governing body of the rate-regulated entity has been given the authority by statute or contract to establish rates to be charged for goods or services. If the Board agrees with the proposed scope, the staff will develop application guidance on whether the governing body of the rate-regulated entity is independent for the Board to consider at a later meeting.

Criterion 2: Cost-of-service regulation

10. This second criterion would limit the scope of the project to cost-of-service regulation, ie rate regulation that, in our view, can create a regulatory asset or liability. For this criterion to be workable, we acknowledge that the term 'cost-of-service regulation' needs to be defined and we suggest the following definition:

> *Cost-of-service regulation* is regulation in which the rates are designed to recover the specific entity's costs of providing the regulated goods or services and to earn a specified return. The rate-setting mechanism is such that any return lower than that specified is recovered from customers by increasing future rates and any excess return is returned to customers by decreasing future rates.

11. We think that this definition, to some extent, is similar to the definition of a cost plus contract in IAS 11: '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.' From the perspective of the regulated entity, 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. The regulator acts on behalf of the customers to

identify which costs are allowable. We note that the US FASB took a similar view when developing SFAS 71 (see paragraph 71 of that Standard).

12. With the above definition of cost-of-service regulation, we clearly intend to exclude regulation that only has a mechanism for setting rates with no 'guarantee' that the entity will recover its costs plus a specified return.

Why the definitions of an asset or a liability would be met for rate regulation within the proposed scope?

Asset Definition

13. 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.

14. 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 future economic benefits because it does not control whether the customers will use the service. We disagree with this view 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.

15. The conceptual framework project team thinks 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.

16. For example, 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. We note that this conclusion is reflected in accounting for customer relationship intangible assets in business combinations.

17. 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.

18. We think that, under a cost-of-service regulation, the entity's enforceable right by regulation to recover its costs plus a specified return meets the definition of an asset. The adjustment of future rates is only a mechanism to implement that right. The probability of future economic benefits is actually a recognition criterion. We note that the criterion in paragraph 5(c) of SFAS 71 provides interesting guidance on assessing whether the future economic benefits are probable:

> 'In view of the demand for the regulated services or products and the level of competition, direct and indirect, it is reasonable to assume that rates set at levels that will recover the enterprise's costs <u>can be charged to and collected from customers</u>. This criterion requires consideration of anticipated changes in levels of demand or competition during <u>the recovery period</u> for any capitalized costs.' [emphasis added]

19. We acknowledge that there may be situations in which, although a regulatory system falls within the proposed scope, the recognition criteria are not met. For example, the environment in which the entity operates a rate-regulated activity may change rapidly as a result of the introduction of alternative goods or services, increasing competition or deregulation. We intend to bring a paper on recognition issues at a later meeting.

Liability Definition

20. 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.

21. 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 decreased rate will, in effect, be billed. Therefore, the obligation is not a present obligation but a contingent liability that depends on the future sales.

22. We 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. Obligations link the entity with what it has to do because obligations are enforceable against the entity by legal or equivalent means.

23. We believe that, in accordance with both the current *Framework* and the recent decisions taken by the IASB during phase B of the project on the conceptual framework, a cost-of-service regulation creates a regulatory liability when an entity has excess returns that it is obliged to return to its customers by decreasing future rates.

Assets and liabilities

24. In considering whether the existence of rate regulation can result in the recognition of assets and liabilities, we 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.

25. We 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.

26. This is another reason why the staff proposes to include only cost-of-service regulation within the scope of the project. With such regulation it is clear that regulatory assets and liabilities result from past events. The entity has already incurred costs, received revenues or earned more or less than the specified return that results in the adjustment to future rates.

27. We 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.

Interaction with IFRIC 12 *Service Concession Arrangements*

28. IFRIC 12 provides guidance on determining the nature of the asset received (an intangible or a financial asset) by the operator in exchange for the acquisition or construction of the infrastructure used in the service concession. We 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.' However, the IFRIC did not consider the effects of a future change of rates imposed by regulation.

29. Some 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.

30. First, we 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 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 change of future rates by regulation. Rather, we think a change of future rates caused by a cost-of-service regulation triggers recognition of a separate intangible asset, ie the so-called 'regulatory' assets.

31. Overall, we think that an entity having an arrangement within the scope of IFRIC 12 would have to consider whether its rate-regulated activities fall within the proposed scope of this project. If it does, the entity would apply both IFRIC 12 and the Standard on rate-regulated activities. We also think that the approach developed in this paper is consistent with the intangible asset model in IFRIC 12.

What type of rate regulation should be excluded from the scope?

32. As mentioned earlier in the paper, the project would not address regulation that only has a mechanism for setting rates with no 'guarantee' that the entity will recover its costs plus a specified return. Under such regulation, an obligation may arise as a result of an onerous contract but in this case IAS 37 would apply. Similarly, forms of regulation that are based on targeted or assumed costs rather

than the specific costs actually incurred by the entity would not be within the scope.

33. Also, the project would not address situations in which the definition of a financial asset or financial liability is met in accordance with IAS 32 *Financial Instruments: Presentation*, for example, when the entity has a contractual right to receive cash from an identifiable customer or a contractual obligation to deliver cash to an identifiable customer. In that case, we think the entity should apply IAS 32 and IAS 39 *Financial Instruments: Recognition and Measurement*.

Examples of the application of the proposed scope

34. The following examples illustrate various types of regulatory regimes for which we believe the application of the scope definition is quite straightforward.

Example 1

35. The company operates under a cost of service regulation with a determinable variable return. The performance incentive mechanism allows it to keep 25% of the amount by which the actual return exceeds the target return allowed by the regulator (referred to as ‘overearnings’). The regulator requires the customers’ share of the overearnings (75%) to be returned to them in the form of rate reductions over 3 years commencing in the fiscal year following its approval of the determination of such overearnings. If the company earns less than the return allowed by the regulator, it is permitted to increase rates in the following 3 years to recover 50% of the difference. In both cases, 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.

36. We think that this form of rate regulation falls within the proposed scope. In this case, the entity has a right to recover 50% of the lower return achieved and similarly an obligation to return to its customers 75% of the overearnings. Consequently, the entity should account for both the right and the obligation.

Example 2

37. 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 the commodity delivered, natural gas in this case. Assume a gas company charges its customers two rates – one for the cost of energy and another for the costs of distribution. It is this separation that permits customers to obtain their energy from suppliers other than the distributor.

38. The company determines the difference between the revenue received at the rate charged and the purchase rate of the commodity each month. This difference is then recovered from or returned to 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 of the accumulated adjustments from the previous 11 months). Because the customers are required to pay the actual cost of energy supplied, the company's view is that in the absence of rate regulation these amounts would simply be recognised as customer receivables/payables.

39. We agree with this conclusion. In the absence of rate regulation, the company would be entitled to bill each customer the difference between the price it charged and its cost for the gas the customer used last month on the next month's bill. Because an identifiable amount would be due from an individual customer based on that customer's prior usage, a financial rather than regulatory asset or liability would exist. In this example, we conclude that, any difference between price and cost creates assets or liabilities that are not financial assets or liabilities (the counterparty is the customer base not an individual customer) and therefore this form of regulation falls within the proposed scope.

Example 3

40. A regulator may allow an increase in rates over a three-year period if the rate-regulated entity undertakes a customer education programme in the current period. That is, the regulator identifies costs that it will permit to be recovered once they are incurred.

41. We note that, in this example, the right to increase future rates does not arise from costs already incurred for providing the regulated goods or services but from the future performance of an education programme. We think that this rate regulation would also falls within the proposed scope. The entity would recognise the right to increase future rates when the education programme has been performed.

Example 4

42. Paragraph 58 of SFAS 71 states 'For example, consider a regulated enterprise that incurs costs to repair damage caused by a major storm. If the regulator approves recovery of the costs through rates over some future period or is expected to do so, the rate action of the regulator creates a new asset that offsets the reduction in the damaged asset. The enterprise has probable future economic benefits—the additional revenue that will result from including the cost in allowable costs for rate-making purposes. The future benefits are obtained or controlled by the enterprise as a result of a past event—incurring the cost that results in the rate order.'

43. We support this analysis and we believe that the nature of the costs incurred to be recovered does not really matter as the past event is the incurrence of specific allowed costs. In this example from SFAS 71, we are aware that the expectation to recover the costs as opposed to a formal approval by the regulator may cause problems in practice and we intend to come back on that issue at a later meeting.

Example 5

44. At the direction of its regulator a gas utility pays rebates to customers to help cover the cost of converting their furnaces to natural gas if they sign a service contract with the company. These amounts are usually deferred and then amortised over the periods covered by the contracts (generally five years).

45. We do not believe that these grants fall within the proposed scope even though the regulator requires the entity to offer the rebates to its customers. They are more in the nature of customer/contract acquisition costs and the treatment is in accordance with IFRSs for similar costs.

Comparison with the scope of SFAS 71

46. We note that 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.

47. Paragraph 5 of SFAS 71 'applies to general-purpose external financial statements of an enterprise that has regulated operations that meet all of the following criteria:

   a. The enterprise's rates for regulated services or products provided to its customers are established by or are 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.

   b. The regulated rates are designed to recover the specific enterprise's costs of providing the regulated services or products.

   c. In view of the demand for the regulated services or products and the level of competition, direct and indirect, it is reasonable to assume that rates set at levels that will recover the enterprise's costs can be charged to and collected from customers. This criterion requires consideration of anticipated changes in levels of demand or competition during the recovery period for any capitalized costs.'

48. Paragraph 7 of SFAS 71 states that 'Authoritative accounting pronouncements that apply to enterprises in general also apply to regulated enterprises. However, enterprises subject to this Statement shall apply it instead of any conflicting provisions of standards in other authoritative pronouncements.' For example:

   - Foot note number 4 of that SFAS 71 explains that 'a regulator might authorize a regulated enterprise to incur a major research and development cost because the cost is expected to benefit future customers. The regulator might also direct that cost to be capitalized and amortized as an allowable cost over the period of expected benefit. If the criteria of paragraph 9 of this Statement were met, the enterprise would capitalize that cost even though FASB Statement No. 2, *Accounting for Research and Development Costs*, requires such costs to be charged to income currently. Statement 2 would still apply to accounting for other research and development costs of the regulated enterprise, as would the disclosure requirements of Statement 2.'

- Paragraph 15 of SFAS 71 states that 'In some cases, a regulator requires an enterprise subject to its authority to capitalize, as part of the cost of plant and equipment, the cost of financing construction as financed partially by borrowings and partially by equity … After the construction is completed, the resulting capitalized cost is the basis for depreciation and unrecovered investment for ratemaking purposes. In such cases, the amounts capitalized for rate-making purposes as part of the cost of acquiring the assets shall be capitalized for financial reporting purposes instead of the amount of interest that would be capitalized in accordance with FASB Statement *No. 34, Capitalization of Interest Cost*.'

We believe that both regulations described above fall within the proposed scope of the project on rate-regulated activities and that similar exemptions are not needed under IFRSs. This is because, an entity applying IFRSs should apply all IFRSs and when an IFRS specifically applies to a transaction, the entity should apply that IFRS for that transaction.

49. Paragraph 8 of SFAS 71 states that 'This Statement does not apply to accounting for price controls that are imposed by governmental action in times of emergency, high inflation, or other unusual conditions.' This is because, as explained in paragraph 70 of SFAS 71, 'Price controls imposed in periods of unusual conditions are not expected to be applied consistently over an extended period. Indeed, their duration usually is limited by statute. In that environment, assurance of future benefits cannot be provided by probable future actions of the price control regulator because that regulator may not exist at a given future date.' We think that such an exclusion is not needed because, like the criterion in paragraph 5(c) of SFAS 71, it relates to recognition issues.

50. The last sentence of paragraph 8 of SFAS 71 states that 'Nor does it cover accounting for contracts in general. However, if the terms of a contract between

an enterprise and its customer are subject to regulation and the criteria of paragraph 5 are met with respect to that contract, this Statement shall apply.' This is because, as explained in paragraph 71 of SFAS 71, 'The economic effects of cost reimbursement contracts are in some respects similar to the economic effects of the type of regulation addressed by this Statement. However, most contracts tend to be relatively short-term, whereas regulation of enterprises covered by this Statement is expected to continue beyond the foreseeable future. The Board noted that other authoritative literature addresses contract accounting and concluded that it should exclude the general issue of contract accounting from the scope of this Statement.' We don't think that the proposed scope for a Standard on rate-regulated activities would create an overlap with IAS 11 because IAS 11 does not involve an independent regulator.

51. We acknowledge that the proposed scope is slightly different from that of SFAS 71 (two criteria instead of three) but we do not expect that this difference would result in different accounting treatments because we intend to cover the third criterion as a recognition criterion rather than a scope requirement.

Questions to the Board

52. Do you agree with the proposed scope set out in paragraphs 4-6 and 10 of this paper as well as the scope exclusions suggested in paragraphs 32-33? If not, which particular inclusions/exclusions do you think are problematic?

53. If you agree, do you have any comments on the staff analysis of whether the definitions of an asset or a liability are met in paragraphs 13-27 of this paper?

54. Do you think the examples set out in paragraphs 35-45 of this paper are useful? Do you have other examples that you would like the staff to consider?

55. Do you agree with the staff that the proposed scope and more generally the direction of the project is consistent with SFAS 71?