Project ***Rate-regulated Activities***

Topic **Additional analysis of regulatory liabilities**

Purpose of this agenda paper

1. This paper provides additional analysis of regulatory liabilities in the context of the Board's *Rate-regulated Activities* (RRA) project. This analysis is prepared based on directions provided by the Board at its July 2010 meeting deliberating the RRA project.
2. This paper includes the following sections:
   - (a) Analysis of regulatory liabilities:
     - (i) Overview and relationship to regulatory assets,
     - (ii) Liabilities in general,
     - (iii) Emissions Trading Schemes; and
     - (iv) Other relevant matters; and
   - (b) Staff summary and recommendations.

Analysis of regulatory liabilities

Overview and relationship to regulatory assets

3. The staff notes that a regulatory asset in the context of the RRA project is 'created' as a result of the entity incurring costs in excess of its anticipated costs (or selling less goods and services than anticipated) to determine the current period rates charged to customers for the sale of goods and services. Similarly,

This paper has been prepared by the technical staff of the IFRS Foundation for discussion at a public meeting of the IASB.

The views expressed in this paper are those of the staff preparing the paper. They do not purport to represent the views of any individual members of the IASB.

Comments made in relation to the application of an IFRS do not purport to be acceptable or unacceptable application of that IFRS—only the IFRS Interpretations Committee or the IASB can make such a determination.

The tentative decisions made by the IASB at its public meetings are reported in IASB *Update*. Official pronouncements of the IASB, including Discussion Papers, Exposure Drafts, IFRSs and Interpretations are published only after it has completed its full due process, including appropriate public consultation and formal voting procedures.

a regulatory liability is 'created' as a result of the entity incurring costs less than its anticipated costs (or selling more goods and services than anticipated) to determine the current period rates charged to customers for the sale of goods and services.

4. The staff agrees with the international accounting firm publication on IFRSs in the Energy, Utilities & Mining industries that states, in part [emphasis added]:

> **Future price decreases**
>
> Price regulation can also lead to the requirement from a regulator for a utility entity to reduce its prices in a future period. A decrease in prices seldom leads to the recognition of a liability, as it does not constitute a refund of past amounts collected. The benefit of reduced prices is only received by customers if they continue to purchase the commodity. This is not sufficient to cause the recognition of a liability. It might be appropriate to recognise a liability if the entity was obliged to repay cash to the customers (or perhaps to the government) or if the reduction in prices was so significant that it represented an onerous contract. An obligation to pay cash to customers or the government would be recognised as a financial liability. An onerous contract would be recognised as a provision. It is extremely rare that the recognition of a liability under IAS 39 or IAS 37 *Provisions, Contingent Liabilities and Contingent Assets* is met in the context of price regulation because the customer must purchase future services or commodity to receive the benefits.
>
> The IFRIC has considered the topic of regulatory assets and liabilities twice; once when dealing with service concessions and a second time in response to a question about whether FAS 71 could be applied under IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors*. The IFRIC concluded on both occasions that the recognition criteria in FAS 71 were not fully consistent with IFRS and that any assets or liabilities recognised in relation to rate-regulated utilities needed to meet the normal recognition criteria in the IFRS standards.

5. The Appendix A to the September 2010 Board Paper 12A provides the complete excerpt related to the accounting for regulatory assets and liabilities in the context of IFRSs from the above noted international accounting firm publication.

Liabilities in general

6. Paragraph AG12 in the Application Guidance to IAS 32 *Financial Instruments: Presentation* states:

> Liabilities or assets that are not contractual (such as income taxes that are created as a result of statutory requirements imposed by governments) are not financial liabilities or financial assets. Accounting for income taxes is dealt with in IAS 12. Similarly, constructive obligations, as defined in IAS 37 *Provisions, Contingent Liabilities and Contingent Assets*, do not arise from contracts and are not financial liabilities.

7. Paragraph 11 of IAS 32 provides the definition of a financial liability:

> **A *financial liability* is any liability that is:**
>
> **(a) a contractual obligation:**
>
> **(i) to deliver cash or another financial asset to another entity; or**
>
> **(ii) to exchange financial assets or financial liabilities with another entity under conditions that are potentially unfavourable to the entity; or**
>
> **(b) a contract that will or may be settled in the entity's own equity instruments and is:**
>
> **(i) …**

8. Future price decreases imposed by a regulator do not result in the entity being obligated to pay cash or other financial assets. Rather, a regulatory liability results in a decreased rate charged for the sale of goods and services in a future period and will thus lead to a lower profit margin being earned in that period. Therefore, regulatory liabilities do not meet the definition of a financial liability.

9. IAS 37 *Provisions, Contingent Liabilities and Contingent Assets* provides guidance for general liabilities that do not meet the definition of a financial liability. IAS 37 states [emphasis added]:

> **Relationship between provisions and contingent liabilities**
>
> 12 In a general sense, all provisions are contingent because they are uncertain in timing or amount. However, within this Standard the term 'contingent' is used for liabilities and assets that are not recognised because their <u>existence will be confirmed only by the occurrence or nonoccurrence of one or more uncertain future events not wholly within the control of the entity</u>. In addition, the term 'contingent liability' is used for liabilities that do not meet the recognition criteria.
>
> 13 This Standard distinguishes between:
>
> (a) provisions – which are recognised as liabilities (assuming that a reliable estimate can be made) because they are present obligations and it is probable that an outflow of resources embodying economic benefits will be required to settle the obligations; and
>
> (b) contingent liabilities – which are not recognised as liabilities because they are either:
>
> (i) possible obligations, as it has yet to be confirmed whether the entity has a present obligation that could lead to an outflow of resources embodying economic benefits; or

(ii) present obligations that do not meet the recognition criteria in this Standard (because either it is not probable that an outflow of resources embodying economic benefits will be required to settle the obligation, or a sufficiently reliable estimate of the amount of the obligation cannot be made).

10. Paragraph 14 of IAS 37 states [emphasis added]:

> **Provisions**
>
> **A provision shall be recognised when:**
>
> **(a) an entity has a <u>present obligation</u> (legal or constructive) as a result of a past event;**
>
> **(b) it is probable that an outflow of resources embodying economic benefits will be required to settle the obligation; and**
>
> **(c) a reliable estimate can be made of the amount of the obligation.**
>
> **<u>If these conditions are not met, no provision shall be recognised</u>.**

11. In providing guidance on the concept of the 'past event' the gives rise to a present obligation, paragraph 19 of IAS 37 states [emphasis added]:

> It is only those obligations arising from past events <u>existing independently of an entity's future actions</u> (ie the future conduct of its business) that are recognised as provisions. Examples of such obligations are penalties or cleanup costs for unlawful environmental damage, both of which would lead to an outflow of resources embodying economic benefits in settlement regardless of the future actions of the entity. Similarly, an entity recognises a provision for the decommissioning costs of an oil installation or a nuclear power station to the extent that the entity is obliged to rectify damage already caused. In contrast, because of commercial pressures or legal requirements, an entity may intend or need to carry out expenditure to operate in a particular way in the future (for example, by fitting smoke filters in a certain type of factory). <u>Because the entity can avoid the future expenditure by its future actions, for example by changing its method of operation, it has no present obligation for that future expenditure and no provision is recognised.</u>

12. The rationale included in the paragraph BC52 of the Basis for Conclusions to IFRIC 12 *Service Concession Arrangements* notes that '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…' Similarly, in the staff's opinion, IAS 37 also does not take into consideration whether the future contingent event that may (or may not) occur in the future is highly probable of occurring. The point is that a high probability of a future event occurring (eg the sale in 2011 of electricity to

customers in the City of London) is not sufficient to recognise the impact of that contingent future event in the current period (ie 2010).

13. In the staff's opinion, regulatory liabilities are contingent as the term is used in IAS 37 because the future rate decrease required by the regulator will only have an economic impact on the entity if customers purchase goods and services in a future period. Therefore, consistent with paragraph 27 of IAS 37, 'An entity shall not recognise a contingent liability.'

Emissions Trading Schemes

14. The Board (jointly with the FASB) has an active project *Emissions Trading Schemes* (ETS) to consider comprehensive guidance for entities participating in an ETS. This includes consideration of the appropriate accounting treatment by an entity when it receives (through third-party purchase or receipt from a government or regulator for no monetary consideration) and disposes of (through sale or return to the plan administrator) ETS allowances. In the staff's opinion, there are some similarities between RRA and ETS that include the government/ regulatory involvement. However, in the staff's opinion the facts and circumstances in the RRA and ETS projects are quite different and those differences may result in the Board reaching differing conclusions as a result of the differing fact patterns between these two projects.

15. One of the key questions in ETS, in a cap and trade scheme, is whether and when a liability should be recognised. In particular, focusing on the situation when an entity receives ETS allowances from the scheme administrator (ie regulator) for no consideration. (The September 2010 Board Paper 12A includes a discussion of the key features of these allowances and how they compare to regulatory assets.)

16. In answering the key question the Boards have considered whether the receipt of ETS allowances (for no monetary consideration) is an obligating event, and thus whether the entity has a present obligation and therefore whether a liability should be recognised. Although, the ETS project is still in its early stages, at its March 2009 meeting, the Board tentatively decided that an entity is presently obligated when it receives allowances from the scheme administrator for no monetary consideration. However, there has been no consensus on the nature of

and rationale for the present obligation. The ETS project staff are proposing to discuss the issue with both the IASB and the FASB in their joint September 2010 meeting.

17. Conversely in RRA, an entity determines rates to be charged in a period and it is only if the actual results of operations vary from the estimates used to determine the current period rates does the entity have a 'regulatory asset' or 'regulatory liability'. Additionally, regulatory assets and liabilities are typically not separable (ie cannot be sold or traded). Paragraph 19 of IAS 37 confirms that an entity shall not recognise a liability if the entity can avoid the future expenditure by its future actions. While there is a high likelihood that the entity will sell goods and services in a future period and if it does it will charge a rate less than the rate charged in the current period, IAS 37 does not look at the likelihood of the entity taking future actions. IAS 37 only looks at whether those future actions can be avoided.

Other relevant matters

Going concern

18. The staff believes it is in appropriate to say that an entity is implicitly obligated to operate in a future period or the entity will not be a going concern. This argument is not specific to entities that are subject to rate-regulation. If relevant, this argument would be applicable (and required) for all entities.

Outflow of resources

19. The staff notes that paragraph 14 of IAS 37 requires that for a provision to be recognised it must include, among other things, that 'it is probable that an outflow of resources embodying economic benefits will be required to settle the obligation'. This is consistent with the definition of a liability in paragraph 49 of the *Framework*. There is no discussion that a decrease in an inflow of future economic benefits (ie the rates charged for the sale of goods and services in a future period) that will occur in a future period is a liability.

20. Paragraphs 66–69 of IAS 37 provide guidance on onerous contracts. IAS 37 states:

> 68 This Standard defines onerous contract as a contract in which the unavoidable costs of meeting the obligations under the contract exceed the economic benefits expected to be received under it. The unavoidable costs under a contract reflect the least net cost of exiting from the contract, which is the lower of the cost of fulfilling it and any compensation or penalties arising from failure to fulfil it.
>
> 69 Before a separate provision for an onerous contract is established, an entity recognizes any impairment loss that has occurred on assets dedicated to that contract (see IAS 36).

21. The rationale proposed in the RRA project that the regulations (ie regulatory compact) can be seen as an implicit 'contract' between the entity and regulator who is acting on behalf of the aggregate customer base. If this rationale is similarly applied when determining whether a regulatory liability should be recognised, as required by paragraph 68 of IAS 37, an entity would first need to determine that the 'contract' is onerous. Then as required by paragraph 69 of IAS 37, the entity would need to impair any previously recognised regulatory assets prior to the recognition of a regulatory liability since those regulatory assets arise only as a result of the 'contract' and therefore are dedicated to that 'contract'.

Staff summary and recommendations

22. In the staff's opinion, regulatory liabilities do not meet definition of a financial liability. Regulatory liabilities also do not meet the definition of a provision as specified in IAS 37.

23. The characteristic that this represents is a reduction in a future inflow of economic benefits which, in the staff's opinion, is a change in the value of an existing license (whether or not recognised). Additionally, a reduction in a future inflow of economic benefits is not a liability in accordance with paragraph 49 of the *Framework*. Only an outflow of resources embodying economic benefits is a liability.

24. The staff believes that an attempt to examine provisions that exist in different industries through differing industry specific vantage points may result in inconsistent accounting treatments for provisions. Some constituents may consider the different accounting treatments for the same type of asset to be industry specific guidance that the Board has long stated its desire to avoid.

Therefore, the staff recommends that the specific fact pattern of an entity with activities that are subject to rate-regulation be analysed as part of the Board's *Phase B: Elements and Recognition* of its *Conceptual Framework* project.