

STAFF PAPER

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IASB Meeting

Project	Rate-regulated Activities		
Paper topic	Restarting the project		
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Introduction

1. In response to the Agenda Consultation feedback, the IASB, in its May 2012 meeting, supported giving priority to developing a proposal for a standards-level project for Rate-regulated Activities.
2. In order to understand the issues, the need for guidance, and the challenges that we face, the staff have analysed the feedback received in the Agenda Consultation and we have reviewed the Rate-regulated Activities project that was undertaken in 2008-2010. We have developed our preliminary views on how to proceed and are seeking input on this from the IASB in advance of consulting with the IFRS Advisory Council in October 2012.
3. This paper proposes that the project should focus on developing a Discussion Paper on rate-regulated activities to assess whether the IASB should develop an IFRS (or amend existing IFRSs). The staff assessment is that we should aim to publish a Discussion Paper in the fourth quarter of 2013. The Agenda Consultation process highlighted that constituents are aware that developing an IFRS, if that is the appropriate course of action, will take time. Consequently, the IASB has also received requests for an interim IFRS to be published for use until a more comprehensive solution is developed.
4. This Agenda Paper 15 covers the following areas:
 - (a) Background
 - (i) Financial reporting issues to be addressed;

- (ii) The previous Rate-regulated Activities project; and
 - (iii) Why we are restarting the project.
- (b) Summary of staff recommendations
 - (i) development of a Discussion Paper (DP);
 - (ii) requests for an interim IFRS.
- (c) Basis for the staff recommendations
 - (i) development of a Discussion Paper (DP);
 - (ii) alternatives for an interim IFRS.

Background

Financial reporting issues to be addressed

5. In many jurisdictions, rate regulation is imposed when an entity has a monopoly or a dominant market position that gives it excessive market power, particularly over ‘essential’ goods or services, such as water, electricity and other utilities. In such situations, there is a lack of competition to constrain the prices that the entity can charge. To compensate, governments impose rate regulation through a ‘regulatory authority’ that aims to set ‘just and reasonable rates’. Generally, the rate-regulated entity is not allowed to charge prices other than those approved by the regulator. The regulator can increase the rate to allow the entity to recover particular “allowable” costs or lower the rate to eliminate excess profits. Such rate changes are usually applied prospectively and so there is usually a ‘time lag’, eg an entity may incur higher than expected costs of raw materials in the current period but cannot increase prices to reflect this until later periods.
6. Most commentators acknowledge that rate regulation has an economic impact on the timing and amount of revenue of the rate-regulated entity and that the impact can be either positive or negative. In some jurisdictions, this impact is recognised in the financial statements of rate-regulated entities as a regulatory asset (a right to charge higher prices in the future) or as a regulatory liability (an obligation to reduce prices in the future).

7. However, some argue that the right or obligation to charge higher or lower prices in the future is not a sufficiently differentiating feature of rate regulation and so regulatory assets and regulatory liabilities should not be recognised. (To challenge this, it would be useful to compare the economic situation of a rate-regulated entity with a comparable entity in a competitive market that has the ability to increase future selling prices when, for example, the price of its raw materials has increased. That increased future selling price could be set at a level that both maintains margins in the future and also recoups past margin reductions caused by the time lag between the increase in raw materials prices and the increase in selling price. This fact pattern results in the same cash-flow pattern as the comparable rate-regulated entity, but the application of the opposing views to recognise a regulatory asset or not would be represented very differently in the financial statements.)
8. Such differing views were not resolved in past discussions about the key issues relating to the accounting for rate regulation. These key issues are:
- (a) do regulatory assets and regulatory liabilities exist (ie do they meet the definitions of assets and liabilities in the *Conceptual Framework*¹);
 - (b) if so, should they be recognised in accordance with the *Conceptual Framework*; and
 - (c) if so, is their recognition consistent with other IFRSs?

The previous Rate-regulated Activities project

9. The IASB has previously undertaken a project to identify whether, and if so, how, an entity should reflect, in its general purpose IFRS financial statements, the impact that rate regulation has on its activities. An Exposure Draft (ED) *Rate-regulated Activities* was published in July 2009 to try to resolve this issue. This ED proposed that there are circumstances in which regulatory assets or regulatory liabilities should be recognised.

¹ The previous discussions focused on the *Framework for the Preparation and Presentation of Financial Statements*, part of which has now been superseded by the revised (and renamed) *Conceptual Framework for Financial Reporting*. However, the definitions of “elements”, including assets and liabilities, are unchanged in the current version of the *Framework*.

10. Respondents to the ED, as well as IASB members, expressed very divergent, and often strongly-held, views relating to the key issues above. The views expressed by preparers and users very strongly reflected their existing financial reporting, eg almost all of the respondents from Canada and the USA expressed strong support for the recognition of regulatory assets and regulatory liabilities (which would be consistent with their current treatment). However, respondents from other jurisdictions expressed equally strong opposition against their recognition because it would reduce the existing comparability between rate-regulated and non-rate-regulated entities.
11. Little common ground was identified between the opposing views. Consequently, the project was subsequently suspended in September 2010 pending the outcome of the Agenda Consultation.

Why are we restarting the project?

12. The research carried out during the previous project concluded that no significant divergence existed in practice in jurisdictions applying IFRSs: entities generally do not recognise regulatory assets or regulatory liabilities. However, advocates of the ability to recognise regulatory assets and regulatory liabilities continue to discuss the ability to recognise these assets and liabilities in accordance with current IFRSs, particularly in those jurisdictions that have recently adopted or are considering adopting IFRSs as their primary basis for financial reporting.
13. Many respondents to the Agenda Consultation noted that rate regulation is common in many jurisdictions. It is clear, however, that there are many different types of rate regulation and there are many variations within each type. Although the regulatory effect on future prices might be similar, the differences between rate regulation regimes lead to different rights and obligations for the rate-regulated entity. Some jurisdictions have financial reporting requirements that they believe are appropriate for their particular rate regulations. This ensures that the requirements are consistent within that jurisdiction.
14. The July 2009 ED proposed that regulatory assets or regulatory liabilities should be recognised only if an entity's activities are subject to "cost-of-service" rate regulation (see paragraph 24). However, the previous project did not include a

broad debate about what types of rights and obligations in differing regulatory regimes might support the recognition of assets and liabilities. This contributed to the uncertainty as to what features of any particular regulatory regime may create rights and obligations that would support the recognition of some elements of what, in some jurisdictions, are currently broadly described as regulatory assets or regulatory liabilities.

15. The absence of such a debate means that, even if a regulated entity carries out a detailed analysis of each regulatory regime to which it is subject, it may still be uncertain as to whether it can recognise a regulatory asset or regulatory liability. We therefore believe that it is important that the project should be restarted to assist preparers in making this assessment in a consistent and cost-efficient way.
16. In addition, the lack of explicit guidance in IFRSs is seen by some to be barrier to adoption of IFRSs in some jurisdictions. In particular in Canada², where some rate-regulated entities in the utilities sector are transitioning to IFRSs but others are switching to US GAAP and still others are retaining pre-changeover Canadian GAAP. Clearer requirements for rate-regulated activities will also benefit other jurisdictions looking to converge with, or adopt, IFRS, such as India.
17. Consequently, we are restarting the project to try to identify, and more clearly articulate:
 - (a) what features of rate regulation differentiate rate-regulated activities from non-rate-regulated activities;
 - (b) do such differentiating features give rise to rights and obligations that meet the definitions of assets and liabilities in the IFRS *Conceptual Framework*;
 - (c) if so, should they be recognised in accordance with the *Conceptual Framework*; and
 - (d) if they are to be recognised, how should they be accounted for?

² The Canadian Accounting Standards Board (AcSB) decided to extend the deferral of the mandatory IFRS changeover date for entities with qualifying rate-regulated activities by one year to January 1, 2013, in light of recent discussions of the IASB's future agenda. Those discussions suggest an increased possibility that the IASB may:

- address rate-regulated activities as part of its future agenda; and
- develop interim guidance in the meantime that, in effect, would allow the continuation of accounting practices in accordance with pre-changeover standards in Part V of the Handbook.

The deferral of the mandatory changeover date for an additional year will permit the AcSB to consider the actions it might take should the IASB add to its agenda a project on the effects of rate regulation.

Summary of staff recommendations

Development of a Discussion Paper (DP)

18. The staff recommend that the rate-regulated activities project should focus on developing a Discussion Paper as a matter of urgency, using the existing research and the work that will be done on the *Elements* chapter of the *Conceptual Framework* project.
19. The DP would help us to:
 - (a) confirm our preliminary understanding of users' information needs with respect to rate regulation;
 - (b) determine the scope of a future IFRS (if it is decided that an IFRS is needed);
 - (c) identify, across a range of common regulatory regimes, the differentiating features of rate regulation, ie the nature of the rights and obligations that could give rise to recognised assets and liabilities;
 - (d) identify the broad accounting model (or models) that should be applied in any future IFRS, including recognition and measurement; and
 - (e) identify the main disclosure needs.
20. We believe that a comprehensive DP exploring the key issues can be developed before the end of 2013, subject to the interaction with the *Conceptual Framework* project. However, further guidance, in whatever form it may take (eg a *Rate-regulated Activities* IFRS, amendments to other IFRSs or a conclusion that no specific requirements need to be developed), will need to be the subject of our normal due process steps. This means that a final resolution might not be available before 2016.

Requests for an interim IFRS

21. Some comments received in response to the Agenda Consultation and the related outreach activities requested that some guidance should be provided more quickly in the form of an interim IFRS. This request for urgency comes predominantly from Canada, where the current lack of guidance is creating diversity in practice

(see paragraph 16). Consequently, the staff set out some options for such an interim IFRS and some benefits and disadvantages of each one (see paragraphs 31-44). The options identified are:

- (a) disclosure-only requirements;
- (b) IFRS 6-style ‘grandfathering’ of existing accounting policies, with some restraints;
- (c) use of national GAAP; or
- (d) specified accounting requirements.

22. The staff understand the requests for an interim IFRS. However, research to date indicates that, in jurisdictions that are using IFRSs (including those that have recently transitioned to IFRSs), regulatory assets and regulatory assets are not generally recognised and there is little diversity in practice. We therefore believe that any interim IFRS (other than a disclosure-only IFRS) should be targeted at first-time adopters only.

Basis for the staff recommendations

23. Although much research was done in the previous project, more detailed research is still needed to better understand users’ information needs and to determine the scope of the project, as well as to identify possible solutions that could be applied.
24. The previous project had started to identify a wide diversity of regulatory regimes. These range from cost-based (cost-of-service) regimes that focus on allowing the rate-regulated entity to recover particular “allowable” costs, plus a reasonable return on those costs, through to incentive-based (price-cap) regimes that aim to encourage the rate-regulated entity to maximise efficiency to reduce costs and thereby reduce prices charged to end-users. In practice, many rate regulators use a combination of the two types of regimes. Although the different regimes often lead to a similar impact on the rates that an entity can charge its customers, the differences in the regime can lead to different rights and obligations for the entity.
25. The previous ED was aimed only at cost-of-service regimes, but many respondents noted that such a narrow scope would not provide a satisfactory solution for the majority of rate-regulated regimes, which increasingly include at

least some element of incentive-based requirements. Some respondents to the ED were also confused by the measurement method proposed, which was a net present value approach. Some argued that a cost accumulation measurement approach is more compatible with cost-of-service rate-regulation, and that a current-value or future-cash-flow approach was more compatible with incentive-based rate regulation.

26. As a result of the feedback received in the previous project, later discussions in the 2010 IASB meetings started to focus on the more detailed features of different rate-regulation regimes, to identify separate rights and obligations created by the rate-regulation. Some of these rights and obligations may support the recognition of some types of assets and liabilities that are currently recognised in accordance with existing IFRSs. Changes to the rates chargeable under rate regulation may result in separate rights or obligations or may represent a change in value of existing rights or obligations. Further analysis of the different rights and obligations could help to more clearly articulate whether they do meet the definition of an asset or liability within the *Conceptual Framework* or not.

Development of a Discussion Paper (DP)

27. As previously noted, very divergent, and often strongly held, views exist as to whether or not regulatory assets or regulatory liabilities exist and should be recognised in the Statement of Financial Position. Little common ground was identified between respondents to the July 2009 ED and between IASB members with strongly opposing views.
28. The ED started from the premise that regulatory assets and liabilities should be recognised. It explained the rationale for this and asked questions about the appropriateness of the recognition criteria proposed in that ED. However, the responses received suggested that a more fundamental discussion was needed first about whether this was the right starting point. The responses therefore suggested that a broader debate was needed first, before a Standard could be developed.
29. Consequently, we believe that a Discussion Paper (DP) is an important step in developing proposals for rate-regulated activities. A DP would enable these views to be compared and analysed in a balanced way to build an acceptance of

the basis for the IASB's eventual conclusions on this project. A DP would also be able to explore whether existing regulatory assets and regulatory liabilities can be analysed to identify at a finer level the features necessary in a regulatory regime to give rise to the rights and obligations that support the recognition of assets and liabilities.

30. In addition, the key technical issues for the *Rate-regulated Activities* project are closely interlinked with the definitions of assets and liabilities in the *Conceptual Framework*. We understand that the *Conceptual Framework* project will also soon be restarted and the staff involved with the two projects will work closely together to ensure a consistent approach is adopted. In particular, a DP for *Rate-regulated Activities* could test the definitions of assets and liabilities being developed in the *Conceptual Framework* project. If we decided not to develop a DP and instead go straight to an Exposure Draft, we would need to use the current *Conceptual Framework*. This is likely to expose us to criticism because stakeholders would understandably want to know whether the proposals would be consistent with the new *Conceptual Framework*.

Alternatives for an interim IFRS

31. The staff do not believe that the key issues can be resolved quickly because of the reasons given above in paragraphs 27-30 discussing the development of a DP. We expect that the additional research required can be completed expeditiously but the divergence of views will require more time to reconcile. We believe that an ambitious but realistic target for the publication of a DP is late Q3/early Q4 2013. Even if the comments received on the DP turn out to identify a reasonable level of consensus on a way forward, the staff would not expect to issue a final standard until 2016 because of the cross-cutting nature of the issues.
32. As noted in paragraphs 12-16, the lack of guidance on rate-regulated activities continues to create uncertainty and is contributing to diversity in practice, particularly in Canada. We have therefore considered requests to act more urgently to develop an interim IFRS to reduce uncertainty for first-time adopters of IFRSs in the shorter term. The timing for such an interim IFRS would depend on its style. The diversion of resources required to produce an interim IFRS

would also, to some extent, push back the timing of development of the DP. The remainder of this paper sets out some alternatives for the IASB to consider if it believes that more urgent action is needed.

A disclosure-only IFRS

33. A disclosure-only IFRS would provide users with more transparent and relevant information to enable them to better understand the potential impact of rate regulation on the activities of an entity. The scope of any such IFRS could be wide and capture a range of different rate regulations. In Canada, entities subject to rate regulation already provide detailed information in accordance with local requirements.
34. These requirements are similar to those proposed in the July 2009 ED. We believe that many of these disclosures would provide relevant information for users of existing IFRS financial statements and could help to increase understanding of the types of rate regulation and the impact on the reported financial performance and position of the reporting entity.
35. An interim, disclosure-only IFRS is expected to have a bigger impact on existing IFRS preparers, because there are currently no specific disclosure requirements within IFRS for the impact of rate-regulated activities. In addition, we believe that regulatory assets or regulatory liabilities are generally not currently recognised in jurisdictions that have already adopted IFRS.
36. An exposure draft (ED) of such an interim IFRS could be developed quickly, with limited resources. We understand that the Canadian disclosure requirements work well in practice and so could be used as a strong starting-point for developing an ED.

An IFRS 6-style 'grandfathering' option

37. Paragraphs 10-12 of IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors* specify a hierarchy of criteria that an entity should use in developing an accounting policy if no IFRS applies specifically to an item. IFRS 6 provides an exemption from part of that hierarchy, but limits the exemption's impact by

identifying expenditures to be included in, or excluded from, exploration and evaluation assets and requiring all such assets to be assessed for impairment.

38. The purpose of this exemption was to allow an entity adopting IFRSs to continue to apply its existing accounting policy for the exploration for, and evaluation of, mineral resources, subject to some limited improvements. This avoided disruption to users (eg lack of continuity of trend data) and preparers (eg systems changes).
39. Entities applying IFRS 6 are required to provide disclosures that identify and explain the amounts in an entity's financial statements arising from the exploration for, and evaluation of, mineral resources. These disclosures help users of those financial statements to better understand the timing, amount and certainty of future cash flows from any exploration and evaluation assets that are recognised. An IFRS 6-style interim IFRS for *Rate-regulated Activities* could require disclosures that help users in the same way.
40. Developing an IFRS 6-style interim IFRS for rate regulated activities would assist rate-regulated entities to adopt IFRSs in Canada and other jurisdictions that have not yet adopted IFRSs. However, this 'grandfathering' of existing practices would not address the diversity of practices currently used in those countries (eg in Canada, we understand that there are currently five different frameworks being applied by rate-regulated utility companies).
41. However, it would give the IASB an opportunity to require limited improvements to accounting policies to isolate the impact of rate regulation into a separate regulatory asset or regulatory liability and require all other assets and liabilities to follow existing IFRSs. This would require many entities to make changes to their existing accounting policies because they currently recognise some of the the regulatory impact within other assets or liabilities (eg many entities currently capitalise regulatory costs into property, plant and equipment that would not be permitted to be capitalised in accordance with IAS 16 *Property, Plant and Equipment*).
42. This solution would be more advantageous to first-time adopters than to existing preparers, because it allows a continuation of existing practices, except perhaps for some reclassification of amounts into 'regulatory assets' or 'regulatory

liabilities' from other assets and liabilities. However, it is also likely to raise new uncertainties about whether existing IFRS preparers could or could not recognise 'regulatory assets' or 'regulatory liabilities'.

A national-GAAP 'grandfathering' option

43. The IASB has previously considered whether, as an interim solution, to require an entity to continue to follow its national accounting requirements (ie national GAAP) in accounting for insurance and for the exploration for, and evaluation of, mineral resources to prevent the selection of accounting policies that do not form a comprehensive basis of accounting. In each case, the IASB decided against this course of action because defining national GAAP would have posed problems. This would also apply for rate-regulated activities. Further definitional problems could arise in the case of rate-regulated activities, because some entities do not apply the national GAAP of their own country. For example, some non-US entities with rate-regulated activities, including some Canadian utility entities, apply US GAAP. In addition, we understand that some utility entities in Canada apply more localised, provincial requirements.

An interim IFRS with specified accounting requirements

44. Some participants in the Agenda Consultation Round-table discussions held earlier in 2012 suggested developing an interim IFRS based on the requirements of a particular existing national GAAP relating to rate-regulated activities. Several countries currently have requirements to recognise regulatory assets and regulatory liabilities, such as the USA, Canada and India. Developing an interim IFRS based on a particular country's existing requirements would have the advantage of better comparability across entities using that interim IFRS. However, this has a number of disadvantages, including:
- (a) the scope of the interim IFRS would need to be carefully defined, which would require consideration not only of the different types of rate regulation that it would apply to, but also whether it would apply only to those rate-regulated entities that currently recognise regulatory assets

or regulatory liabilities in accordance with their current GAAP or whether it should also apply to existing IFRS preparers;

- (b) substantial IASB member and staff time would be required to analyse and evaluate the existing requirements in different jurisdictions, to identify whether a particular one is considered more appropriate than another when compared to the current IFRS *Conceptual Framework* or IAS 8 hierarchy for selecting an accounting policy. This work would be used as part of the development of the DP but may be seen as pre-empting the outcome of the more comprehensive *Rate-regulated Activities* project and would significantly delay the completion of that project; and
- (c) for those entities that are not currently using the methodology selected, a change in accounting policies would be required that might be followed by another change, once the IASB's standards-level project on rate-regulated activities is completed.

Questions for the IASB

Question 1: Discussion Paper

Do you agree that the staff should begin work on a Discussion Paper on *Rate-regulated Activities*?

Question 2: Interim IFRS approaches

- (a) Do you agree that the staff have appropriately identified the interim options available and do you have any initial preference for any particular option?
- (b) Are there any other issues for which we should seek input from the Advisory Council?