

STAFF PAPER

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Project	Rate-regulated Activities		
Paper topic	Research project: Request for information		
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Purpose of the paper

1. The purpose of this paper is to request permission to publish, as an optional due process step in the Rate-regulated Activities research project, a Request for Information (RFI) to help more clearly define the scope of the project.

Introduction

2. Many commentators acknowledge that rate regulation has an economic impact on the timing and amount of revenue that can be earned by a rate-regulated entity and that the impact can be either positive or negative. There has been much debate about whether this impact can or should be recognised in IFRS financial statements.
3. There is currently a great deal of uncertainty as to whether the regulatory impact can be recognised as either assets or liabilities in accordance with the IFRS *Conceptual Framework* and existing Standards. Some commentators suggest that, even if not supported by the *Conceptual Framework* definitions, the impact should still be recognised in order to provide users of financial statements with relevant information about the regulatory environment within which the entity operates. Other commentators suggest that in such cases, users' needs would be better met through disclosure only, instead of through a departure from the *Conceptual Framework*.

4. The aim of the Rate-regulated Activities research project is to develop a Discussion Paper (DP) to consider whether rate regulation creates assets or liabilities, in addition to those already recognised in accordance with IFRS for non-rate-regulated activities. If so, the project will consider how such assets and liabilities should be accounted for, and whether (or how) IFRSs should consequently be amended. Alternatively, if the research conclusion is that rate regulation typically does not create assets or liabilities, the project will also consider how best to reflect any unique features of rate regulation in IFRS financial statements.

Background

5. In December 2012, the IASB agreed the range of issues that the DP should address (reproduced in Appendix A to this paper for convenience). The first of these issues is intended to identify what we mean by ‘rate regulation’, and what distinct rights, obligations and other distinguishing features are common to different types of rate regulation.
6. We are seeking permission to consult broadly with constituents at an early stage of the project to help us to more clearly identify what types of rate regulation exist and what industries rate regulation affects. We are conscious of relevant comments, related to identifying the project’s scope, that were made in response to both the 2011 Agenda Consultation and the previous Exposure Draft, *Rate-regulated Activities*, that was issued in July 2009 (the 2009 ED). Consequently, we think that the information that might be gathered in response to an RFI will provide a more structured and focused basis for carrying out the analysis of the other issues that have been identified as needing to be addressed in the DP.

2011 Agenda Consultation and 2009 ED

7. Many respondents to the 2011 Agenda Consultation¹ suggested that the IASB should carry out more focused research in the earlier stages of the agenda-setting process to provide evidence about the need for any changes to financial reporting. Many think that adequate initial research will halt the start/postpone/restart cycle of standard-setting that can result from the problem having been poorly defined in the first place.
8. We agree with these comments. The previous Rate-regulated Activities project was suspended in September 2010, without the IASB reaching a consensus on how the project should progress or how that lack of consensus could be resolved. We hope that a more comprehensive fact-finding process at this stage will help establish a clearer scope and direction for this project.
9. The 2009 ED was described as addressing rate-regulated activities in general. However, some comments received in response to the 2009 ED noted that the scope was too narrowly focused on achieving a particular objective for a narrow range of constituents, because it seemed to be directed towards a particular form of utilities-industry rate regulation in North America. Respondents expressed concern that this narrow scope did not cater for the various forms of industry regulation, and therefore could cause confusion and diversity in practice amongst entities subject to other types of rate regulation.
10. We think that an RFI will help us to address the feedback from both the 2011 Agenda Consultation and the 2009 ED. The RFI will be subject to our formal comment letter process, which is a good source of detailed input from a wide range of constituents, and is conducted in a transparent way.
11. This will give constituents an opportunity, at an early stage, to inform us about the features of rate regulation that we need to consider in developing the DP. This, in turn, will help to inform us as to what constituents understand by ‘rate regulation’, and give us an early indication of what types of activities or transactions they think need to be reflected in financial statements. This input will help us to more

¹ More details about the comments received from the 2011 Agenda Consultation and the IASB’s responses to those comments can be found in the Feedback Statement: *Agenda Consultation 2011* available at <http://www.ifrs.org/Current-Projects/IASB-Projects/IASB-agenda-consultation/Documents/Feedback-Statement-Agenda-Consultation-Dec-2012.pdf>.

appropriately define the scope of the Rate-regulated Activities project in order to avoid unforeseen or unintended consequences of focusing on any particular set of circumstances.

Form of the RFI

12. At this stage, we are looking for factual evidence to help establish the scope of the project. We are not looking to address whether rate regulation creates assets and liabilities as defined in the IFRS *Conceptual Framework*, and nor are we seeking opinions as to how the impact of rate regulation should be reflected in financial statements. We are looking to identify the broad, common characteristics of rate regulation to form a basis for a more widespread discussion on what the types of rate regulation are, and what types of industries are subject to rate regulation.
13. On this basis, tentative questions for the RFI would be:
 - (a) what are the objectives of the rate regulation and how do they influence the interaction between the rate regulator, the rate-regulated entity and the customers;
 - (b) how are these objectives reflected in the nature of the rate-setting mechanism, ie to what extent:
 - (i) is it designed to give the rate-regulated entity (and its owners) a 'fair rate of return' or is the focus more on reducing the cost to customers;
 - (ii) is the focus on minimising the cost to customers or are there incentives to meet other targets (eg efficiency; service levels; infrastructure investment; increased supply capacity or reliability; use of alternative resources or reduction in customer demand/usage);
 - (iii) does the regulation fix the price per unit or does it provide some flexibility for the entity to set prices (eg through price ranges or caps, based on either unit prices or total revenue or total profitability);
 - (c) what sort of rights or obligations does the regulation create;

- (i) does the entity have an exclusive right to operate in the market;
 - (ii) is the entity's right to operate in the market established by licence and if so, can the licence be revoked, renewed or transferred;
 - (iii) how is competition excluded or encouraged;
 - (iv) can the entity choose to stop providing goods/services that are subject to rate regulation and, if so, how is this achieved;
- (d) how are those rights enforced or obligations settled;
- (i) does the rate regulation provide for retrospective recovery or reimbursement of under- or over-recoveries of allowable costs through cash payments to or from parties outside the entity (eg individual customers or groups of customers, the rate regulator or the government);
 - (ii) are the rights and obligations separable from the business;
 - (iii) what happens to the rights or obligations when there is a change of ownership of the business?
14. The questions in the RFI will be worded in a neutral tone and will be set at a high level, focusing on identifying different features of rate-regulated environments.
15. The RFI will emphasise that we are currently seeking only a high-level overview of rate regulation that is currently in force and that we are stressing the importance of providing evidence and examples, rather than views and opinions. We can then use this information to select sources of rate regulation to research in more detail to help us gather sufficient evidence to form the basis of the Discussion Paper. Consequently, we will also include a question to find out whether respondents would be willing to provide further information if requested.
16. We will also include a question to elicit information about the respondents' financial reporting environment (IFRS; non-IFRS; recent adopter), and whether/how the impact of rate regulation is currently recognised in financial statements.

Comment period

17. The RFI is an additional, optional step in our research project for Rate-regulated Activities and is intended to provide input to the development of the DP. The DP will provide a further opportunity for comment in due course.
18. We are seeking high level, factual information that is narrow in scope and that we think should be readily available. Consequently, we recommend that the RFI should be published with a 60-day comment period, in accordance with the revised Due Process Handbook (as approved by the Trustees at their meeting in January 2013).

Questions for the IASB

1. Do you grant us permission to publish an RFI on rate-regulation in accordance with the guidance in paragraphs 12-16?
2. Do you agree to allow a 60-day comment period for responses?

Appendix:

- A1. In December 2012, the IASB agreed the following range of issues that the Discussion Paper should address.
1. What do we mean by “rate regulation” and should we define it?
 - (a) What are the features of rate regulation that differentiate rate-regulated activities from non-rate-regulated activities, ie what specific rights and obligations does the rate regulation convey to or impose on the rate-regulated entity?
 - (b) Do the different forms of rate regulation (such as cost-of-service, incentive-based, price-cap, hybrid, etc) create different rights and obligations?
 - (c) Are the differentiating features of rate regulation specific to the industry in which it applies or to the form of regulation?
 - (d) What are the processes in place to recover the costs or to eliminate the excess profit?
 2. What should be the scope of guidance on Rate-regulated Activities?
 - (a) Should it apply to all entities that have activities subject to rate regulation or should any specified industries be explicitly excluded or included?
 - (b) Should its application be restricted to entities or business segments that are fully rate-regulated or should it apply to the specific activities within the entity or segment that are subject to rate regulation?
 - (c) Should it be limited to cost-of-service rate regulation (as it was in the 2009 ED)?
 - (d) How much regulation should the entity or activities be subject to?
 3. What characteristics of the rights and obligations created by rate regulations meet the definitions of assets and liabilities in the IFRS Conceptual Framework?
 - (a) What are the current definitions and recognition criteria in the Conceptual Framework?
 - (b) What are the working definitions being developed in the Conceptual Framework DP and how does this affect the analysis?
 - (c) What features (ie what rights and obligations) would need to be present in a particular regulatory regime in order to identify what assets and liabilities can be recognised?
 - (d) How does the analysis of this issue interact with other similar issues such as emissions trading and other conceptually difficulty topics?

- (e) How do we define 'the customer', ie what is the unit of account?
4. If the rights and obligations created by particular rate regulations do meet the definitions of assets and liabilities, what type of asset, liability or combination of assets and liabilities are created?
- (a) If a separately identifiable asset or liability is created, is it:
- (i) a financial asset or financial liability?
 - (ii) an intangible asset?
 - (iii) any other type of asset or liability, eg a deferred cost asset, an unbilled receivable asset, or a deferred income liability?
- (b) If an asset or liability is created that is not separately identifiable as an individual item, is it an integral or separable component of a broader asset (eg part of the cost of an item of plant or equipment or part of the value of an operating licence)?
5. For any assets or liabilities identified, what are the relative advantages and disadvantages of alternative accounting models for recognition and measurement?
- (a) What recognition criteria are required, eg should probability of economic inflows/outflows be a recognition hurdle or part of the measurement basis? (This issue will be influenced by the Conceptual Framework project. The 2009 ED did not contain any recognition criteria, relying instead on the scope definition.)
- (b) Should the regulatory item be measured at historical cost or using a current value model?
- (i) Should the subsequent measurement be on the same basis as initial measurement?
 - (ii) If the regulatory item is to be measured using a current value model, what discount rate should be used, eg the rate determined as allowable by the rate regulator?
- (c) Consider the approach to derecognition when the regulatory system changes or is discontinued.
6. Does IFRS already include appropriate accounting models for recognition and measurement that can be applied to any regulatory assets or regulatory liabilities identified?
- (a) If so, can the appropriate models be applied without changing existing requirements, eg by providing application guidance?

- (b) If not, should the existing guidance be modified to deal with the particular features of rate regulation, eg to match the accounting model determined by the rate regulator?
7. How should any regulatory assets and regulatory liabilities recognised be presented in the financial statements?
- (a) In which line items in the statement of profit or loss and other comprehensive income for the period should the changes in the value of the assets and liabilities recognised be presented?
 - (b) If a regulatory asset or regulatory liability is identified as a component of a broader asset (see paragraph 13(b)), should it be presented within the broader item or as a separate item?
 - (c) Are there any other presentation approaches that could be used (especially if the outcome is that the regulatory items are not assets or liabilities)?
8. What disclosures are needed to help users understand the impact of rate regulation on the financial position, performance and cash flows of the rate-regulated entity?
- (a) Should reconciliations be provided between the IFRS amounts and those used for rate regulation purposes?
 - (b) Should the assumptions made by management about the outcomes of regulatory reviews, expected future rate level, expected rate or timing of recovery of any regulatory items recognised be disclosed?
 - (c) What level of detail should be disclosed about the type of rate regulation that the entity is subject to and the extent of the rate-regulated activities?
 - (d) If relevant regulatory information is publicly available elsewhere, eg directly from the rate regulator, does it (or a summary of it) need to be included in the financial statements or can it be cross-referred to instead?
9. If the conclusion is that rate regulation does not create additional assets and liabilities to be recognised, what information about the rate regulation needs to be presented, and how should this be done?