

STAFF PAPER

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Project	Rate-regulated Activities		
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Introduction

1. This paper recommends that the scope of the [draft] interim Standard should be restricted to entities with operating activities that are subject to rate regulation by an authorised body and for which the rate-setting mechanism is based on ‘allowable costs’¹.
2. This recommended scope is wider than that of the 2009 ED so that it appropriately captures a wider variety of regulatory regimes. However, retaining the proposal that an authorised body is required to set the regulation based on some form of identifiable costs will provide some structure to the types of regimes that will be within the scope. In addition, recognition restrictions proposed in Agenda Paper 5B will prevent entities that currently do not recognise regulatory deferral account balances within financial statements from starting to do so when applying the [draft] interim Standard.

Background

3. The scope of the 2009 ED was set out as follows:

“3 An entity shall apply this [draft] IFRS to its operating activities that meet the following criteria:

¹ Allowable costs are those costs for which the regulated rate is intended to provide recovery. Such costs are normally defined within the rate regulation or by the rate regulator.

- (a) an authorised body (the regulator) establishes the price the entity must charge its customers for the goods or services the entity provides, and that price binds the customers; and
- (b) the price established by regulation (the rate) is designed to recover the specific costs the entity incurs in providing the regulated goods or services and to earn a specified return (cost-of-service regulation). The specified return could be a minimum or range and need not be a fixed or guaranteed return.”

4. The vast majority of respondents to the 2009 ED commented on the scope proposals. Many of them, when proposing changes to the scope, focused on their desired outcome of what types of regulation should be in or out of the scope rather than a core principle. Many of those comments referred to their existing practices and regulatory regimes when supporting their views (and whether regulatory deferral account balances were recognised in accordance with their jurisdictionally accepted accounting principles (local GAAP)).
5. The majority of comments related to the criterion in paragraph 3(b), ie the restriction to, and definition of, cost-of-service rate regulation. Many respondents considered this scope to be too narrow, claiming that it would exclude many of the entities currently recognising regulatory deferral account balances in their financial statements in accordance with local GAAP. The 2009 ED defined cost-of-service rate regulation as:

A form of regulation for setting an entity’s prices (rates) in which there is a cause-and-effect relationship between the specific costs the entity incurs in providing the regulated goods or services and its related revenues, as specified by the regulator.

6. The requirement for the cause-and-effect relationship to be between the **specific** costs the entity **incurs** and the related rate-regulated revenues caused the greatest concern. Increasingly, rate regulators are inclining towards more incentive-based methodologies that use intermittent rebasing to actual, average or industry

benchmarked costs. Consequently, increasing numbers of rate-regulatory regimes require a less direct link to actual costs incurred. This reduces the record-keeping requirements and the frequency of detailed rate-approval submissions, which helps to reduce the regulatory burden on rate-regulated entities (and ultimately on their customers).

7. Despite this, the accounting for regulatory purposes relating to regulatory deferral and variance account balances has generally remained unchanged within many regulatory regimes. The accounting within financial statements of those entities that are permitted or required to recognise such regulatory balances in accordance with their local GAAP has also been retained.
8. A few respondents to the 2009 ED expressed concern that the proposed scope was too broad and cited two main reasons for this:
 - (a) The 2009 ED proposals might be applied, by analogy, to entities having monopolistic features. This concern was raised within the context of entities that, in the absence of an external regulator, self-regulate on a cost-of-service basis (ie cost plus predetermined return). Entities may do this to avoid potential government intervention if they might otherwise be perceived to be abusing their monopoly position.
 - (b) The 2009 ED proposals would capture some types of entity that respondents did not believe were intended by the IASB to be within the scope. In particular, some insurance entities might have been captured by the scope for certain types of insurance policy, where legislation requires compulsory cover and prices are regulated.

Recommended scope

9. We recommend that the scope of the interim Standard should:
 - (a) retain the first criterion of the 2009 ED version; and
 - (b) relax the second criterion, to eliminate the reference to cost-of-service methodology. However, the criterion should still require some causation effect linking the deferred costs to the rate-setting mechanism, ie the costs are only deferred because they are specifically

allowed by the rate regulator to be recovered through future rates charged to customers.

10. Changing the second criterion as recommended would capture within the scope, many rate-setting mechanisms that use a formula for setting prices and that formula is intermittently rebased against costs. These types of mechanisms are often referred to as hybrid or incentive-based. Many respondents to the 2009 ED raised questions about whether these types of schemes were intended to be within the scope. Many of those respondents suggested that the intermittent rebasing of the rate formula is a form of cost-of-service regulation because it provides a link between allowable costs and the regulated rate. Regulators usually permit variances between actual costs and the estimated costs included in the original formula to be deferred and included in the next ‘rebased’ rate determination.
11. Consequently, we recommend that the scope of the 2009 ED should be amended as follows (new text is underlined and deleted text is struck through):
 - x An entity shall apply this [draft] IFRS to its operating activities that meet the following criteria:
 - (a) an authorised body (the regulator) establishes the maximum price the entity must charge its customers for the goods or services the entity provides, and that price binds the customers; and
 - (b) the price established by regulation (the rate) is designed to recover the ~~specific costs the entity incurs in~~ entity’s allowable costs of providing the regulated goods or services and to restrict the return that the entity can earn. ~~earn a specified return (cost-of-service regulation). The specified return could be a minimum or range and need not be a fixed or guaranteed return.~~
12. This scope is broadly equivalent to that used in Topic 980 *Regulated Operations*² in the *FASB Accounting Standards Codification*[®], which is reproduced in the Appendix to this agenda paper. We understand that many entities that recognise

² Topic 980 brings together the requirements formerly contained in SFAS 71 *Accounting for the Effects of Certain Types of Regulation* and subsequent related guidance and amendments.

regulatory deferral account balances in accordance with their local GAAP do so based on Topic 980 or similar guidance. Consequently, the scope criteria set out in paragraph 11 above should allow the majority of entities that currently recognise such balances to continue to do so when adopting the [draft] interim Standard for the first time.

13. The proposed scope will confirm that entities must be subject to formal rate regulation. The effect of this will be that entities with monopolistic features that are not subject to formal rate regulation cannot apply the [draft] interim Standard by analogy (see paragraph 8(a)).
14. This change to the scope would not address the concerns of those respondents to the 2009 ED that considered the scope to be so broad that it might inadvertently capture some entities that currently do not recognise regulatory deferral account balances (see paragraph 8(b)). However, these concerns will be addressed through recommendations restricting the recognition of regulatory deferral account balances contained in Agenda Paper 5B *Interim Standard: Recognition and Measurement*.

Questions for the IASB

Question: scope of the interim Standard

Do you agree with the staff's recommended scope criteria? If not, what alternative do you suggest?

Appendix: Extract from Topic 980 *Regulated Operations* in the FASB Accounting Standards Codification[®]: Scope

980-10-15-2 The guidance in the Regulated Operations Topic applies to general-purpose external financial statements of an entity that has regulated operations that meet all of the following criteria:

- a. The entity'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 entity's costs of providing the regulated services or products. This criterion is intended to be applied to the substance of the regulation, rather than its form. If an entity's regulated rates are based on the costs of a group of entities and the entity is so large in relation to the group of entities that its costs are, in essence, the group's costs, the regulation would meet this criterion for that entity.
- 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 entity'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. . . .³

³ Recoverability is considered in the context of recognition, measurement and impairment in Agenda Paper 5B *Interim Standard: Recognition and Measurement*, rather than the scope considerations in this agenda paper.