Rate Regulated Activities:
Key features and main concerns

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RATE REGULATED ACTIVITIES: PURPOSE OF THIS PRESENTATION

- ✓ During meetings in September and October the IASB discussed key Features of Rate Regulated Activities.
- ✓ IASB staff is currently asking Consultative members to assist in prioritising the features, rights and obligations related to rate regulation in order to identify whether a single feature, right or obligation, or a combination of specific features/rights/obligations is or are sufficient to distinguish rate-regulated activities from similar commercial activities.
- ✓ The purpose of this presentation is to explain our view on the issues that have been discussed by the IASB and to propose an alternative approach on Key Features and accounting implications to the current one discussed by the IASB.

RATE REGULATED ACTIVITIES : OUR VIEW ON KEY FEATURES DISCUSSED IN SEPTEMBER 2013 PAPER 9B

❖ Key features of rate regulation proposed in p.14 September 13 of Paper 9B:

Feature	Our View
(a) Exclusive right or near-exclusive right to provide the rate-regulated goods or services.	√
(b) Goods or services are considered 'essential' or near-essential, resulting in relatively inelastic demand.	? The inelasticty of demand is a relative concept, depending on the price level, excessive tariffs could lead to lower consumption in every type of goods or services.
(c) The rate regulator imposes obligations on the supplier to control the prices and to protect the quality and availability of goods or services.	√
(d) There must be a 'rate regulator', whose role and authority is established in legislation or other formal regulations.	√ ⚠ In the case of concession arrangements, the regulator and the grantor of the concession are normally the same entity and rate regulation is set in the concession arrangement.
(e) The entity may have some flexibility for charging different prices but only if the rate regulator approves the pricing structure to ensure that it is consistent with the rate-setting mechanism.	√ ⚠ See point d) above.

RATE REGULATED ACTIVITIES : KEY FEATURES, SEPTEMBER 13, PAPER 9B

Feature	Our view
(f) The rate regulation requires that the mechanism for setting the future rate charged to customers reflects an 'automatic' adjustment to the rate if the revenue billed to customers is lower than, or in excess of, the amount permitted by the rate regulation. (g) The formula for setting the rate consists of at least two distinct and identifiable components: - an amount based on the budgeted costs, permitted margin and predicted sales volumes for the next 'regulatory period' (price or rate), and - the adjustment made to the rate for amounts based on past performance.	X The scope proposed in this paper is too narrow. Why? -It is only focused on "deviations" (past performance worse or better than expected) rather than on setting "initial" regulation. Why is initial regulation excluded from the scope? -The "true up mechanism" or "automatic adjustment" is only a mechanism established in some types of regulations to reinforce the probability that costs will be recoverd with future tariffs. As is being discussed within the conceptual framework, probability is a question related to asset measurement not to asset recognitiion. -"True up mechanism" differs from different types of regulations. "Automatic adjustment through deferral accounts" is only one of them. Other examples are: 1) "right to economic and financial balance of a concesssion" that is the rigth the operator has to receive a compensation from the concession grantor due to government decisions or changes in the economic enviroment with a material impact on the economics of the concession or 2) the case of some type of regulated activities where tariffs are revised every five years, and past deviations are considered in regulation for the next regulatory period not on a retrospective basis. -The key element in rate regulated activities, is the existence of a timing difference or mismatch, between costs related to regulated activities that are recognised for financial reporting purposes as incurred, and revenue related to the regulated activity that is affected by price regulation, and is recognized, for financial reporting purpose when the underlying services are rendered (normally years after cost recognition).

RATE REGULATED ACTIVITIES: PRACTICAL EXAMPLES

To illustrate our concerns we will work with two practical examples:

- **Example A (probably included within the current scope)**

Due to the impact of a hurricane, an electricity transport company (Company A) has incurred costs to repair and refurbish the infrastructure (operating expenses, depreciation, cost of debt, taxes, etc.). All these costs are going to be recovered in the next 10 years through a special tariff set by the regulator that will be charged to the customers depending on energy consumption. Tariffs are based in a "true up mechanism" that recognizes an automatic adjustment for extra costs due to major climate effects.

*Can Company A, under current draft scope, recognize a regulatory asset as costs are incurred, taking into consideration that the future tariffs have been established to recover the current costs and a fair rate of return? **YES***

- **Example B:**

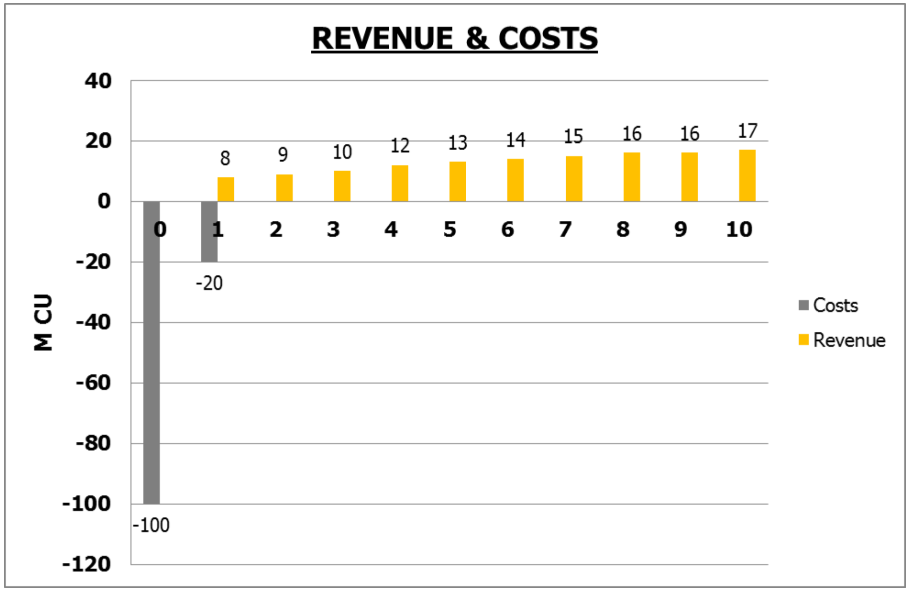
A Government has decided to refurbish and to build new lanes in an existing road, which currently is congested, through a toll road electronic system. For this purpose it signs a contract with a private company (the operator) that will build the new infrastructure and after finishing construction will incur costs (operating expenses, depreciation, cost of debt, taxes, etc.). All these costs are going to be recovered in the next 10 years by charging tariffs to the users of this infrastructure, which are fixed by the Government (operator) to protect users from the dominant position of the operator, as there is no alternative road, and to allow the operator to obtain a fair rate of return. Tariffs have not been fixed according to a "true-up" mechanism as are based not on deviations but on initial costs/investment expected for the project. In case of future deviations there is not an automatic adjustment, but a type of compensation right "right to the economic and financial balance" (for example if the government decide to build an alternative free road)

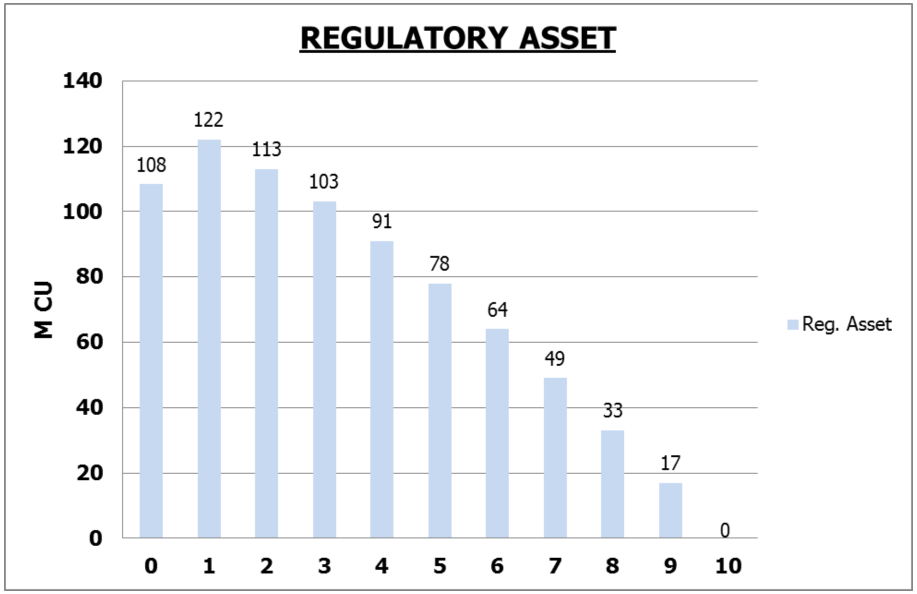
*Can Company B, under current draft scope, recognize a regulatory asset as costs are incurred, taking into consideration that the future tariffs have been established to recover the current costs and a fair rate of return? **PROBABLY NOT***

Is there any major difference between the two cases that justifies the different recognition criteria?

EXAMPLE A: ELECTRICITY TRANSPORT

	M CU
Revenue	130
Costs	-120
Profit	10
Rate of return (*)	8,3%





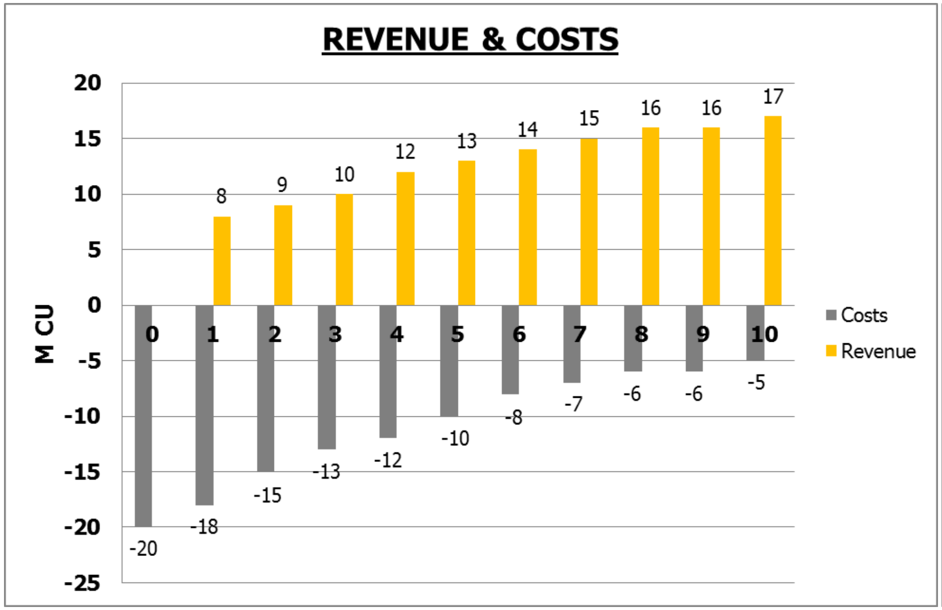
Can the company recognize an asset in year 1?

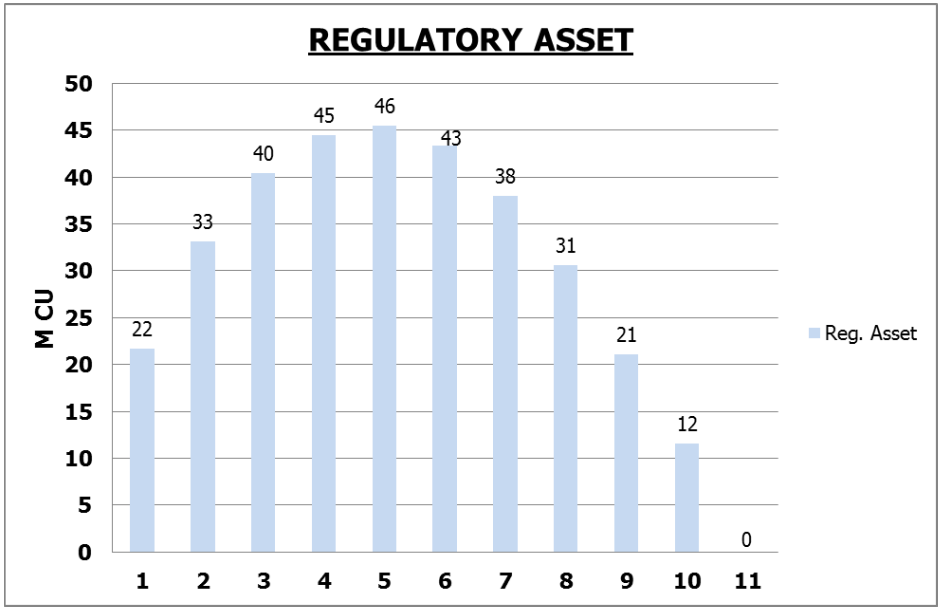
(*) Excluding time value of money

RATE REGULATED ACTIVITIES: PRACTICAL EXAMPLES ASSET RECOGNITION

EXAMPLE B: TOLL ROAD CONCESSION

	M CU
Revenue	130
Costs	-120
Profit	10
Rate of return (*)	8,3%





Can the company recognize a regulatory asset? Which will be the impact of future deviations?

(*) Excluding time value of money

RATE REGULATED ACTIVITIES: ALTERNATIVES KEY FEATURES AND DEFINITION

❖ We propose the following definition, with four key features:

- ✓ A company (regulated entities) renders or sells essential services or products (such as energy, water, transport, infrastructure…) from a monopoly or dominant position. 1
- ✓ A regulator supported by legislation or government regulations approves or determines prices that bind customers. 2
- ✓ Through price regulation, the regulator covers two main objectives:
  - It protects users from the monopoly or dominant position and establishes quality and availability controls. 3
  - It allows regulated entities to recover costs and earn a fair return. 4

Different types of rate regulations (costs vs incentive) are covered within this definition and will be in the scope of the project.

RATE REGULATED ACTIVITIES: ACCOUNTING IMPACT

- The application of current standards to "Rate Regulated Activities", implies:

  - Costs related to regulated activities (including operating expenses, depreciation, cost of debt, capital and taxes associated with investment) are recognized as incurred.

  - Revenue related to the regulated activity that is affected by price regulation, is recognized when the underlying services are rendered (normally years after cost recognition).

TIMING DIFFERENCES

RATE REGULATED ACTIVITIES: ACCOUNTING GUIDANCE NEEDED

Can a company, under a regulated activity, recognize a regulatory asset due to the tariffs that it is going to receive in the future in order to compensate current costs and obtain a fair return during the regulatory period?

We propose recognizing the asset if:

- The four key features mentioned in slide 8 are met.
- Timing differences mentioned in slide 9 exists.

Will the recognition be affected by the existence and type of true-up mechanism? NO

According to the new conceptual framework project: *probability is not an issue of recognition, but of measurement*. The regulatory asset will be measured based on the most probable expected scenario. Deviations would be considered as changes in estimates. Existence or not of "true up mechanism" will suppose lower exposure to changes but not a restriction to asset recognition.