

STAFF PAPER

Accounting Standards Advisory Forum

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Project	Rate-regulated Activities: Research project		
Paper topic	Developing the Discussion Paper		
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Purpose of the paper

1. The purpose of this paper is to:
 - (a) provide a reminder of the plans for the contents of the Discussion Paper;
 - (b) summarise progress on addressing the issues to be included in the Discussion Paper; and
 - (c) provide the IASB with an opportunity to assess the progress of the project.

Introduction

2. Rate regulation is widespread and significantly affects the economic environment of rate-regulated entities. Some national GAAPs provide specific guidance on this matter, but there is no equivalent guidance in IFRS.
3. The objective of the Rate-regulated Activities research project is to develop a Discussion Paper 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 also consider how such assets

and liabilities should be accounted for, and whether (or how) IFRS should consequently be amended.

4. In December 2012, the IASB decided to address a variety of issues in the Discussion Paper. These are summarised below, with more detail provided in Appendix A.
- (a) What are the features of rate regulation that differentiate rate-regulated activities from non-rate-regulated activities?
 - (b) What rights and obligations created by rate regulation, if any, meet the definitions of assets and liabilities in the *Conceptual Framework for Financial Reporting* (the ‘*Conceptual Framework*’), in addition to the assets and liabilities already recognised in accordance with IFRS for non-rate-regulated activities?
 - (c) 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?
 - (d) If any of the rights and obligations created by rate regulation do meet the definitions of assets and liabilities and require recognition, what type of asset, liability, or combination of assets and liabilities is created?
 - (e) For any assets or liabilities identified, what are the relative advantages and disadvantages of alternative accounting models for recognition and measurement?
 - (f) Does IFRS already include appropriate accounting models that can be applied to any regulatory assets or regulatory liabilities identified?
 - (g) How should any regulatory assets or regulatory liabilities recognised be presented in the financial statements?
 - (h) What disclosures are needed to help users understand the impact of rate regulation on the financial position, performance and cash flows on the rate-regulated entity?
 - (i) What should be the scope of any guidance on rate-regulated activities?

5. In March 2013, the IASB published the Request for Information (RfI) *Rate Regulation*. The objective of the RfI was to gather high level overviews of the types of rate regulation that are currently in force in order to provide factual evidence and examples that are being used to help to develop the Discussion Paper.
6. The RfI asked five groups of questions under the following headings:
 - (a) the regulated industry and why it should be considered;
 - (b) the objectives of the rate regulation;
 - (c) the rights and obligations established by the rate regulation;
 - (d) the enforcement of rights and obligations; and
 - (e) the recovery or reversal of cost and income variances.
7. In April 2013, the IASB established a Rate-regulated Activities Consultative Group (the ‘Consultative Group’) to help in its project on rate regulation by providing a variety of expert perspectives, including those of preparers, auditors and users of financial statements, and regulators. The Consultative Group consists of senior professionals with extensive practical experience in the operation of a variety of rate-regulatory schemes. The Consultative Group met in July 2013 and November 2013 and has provided input to the staff to support the research and analysis performed to date.

Progress on addressing the issues

8. The issues listed in paragraph 4 are closely interrelated and so cannot be dealt with in a strict sequential order. To date, the IASB has discussed aspects of issues (a)-(d) in the meetings between July 2013 and November 2013. The discussions involve an iterative process to help refine the focus of the discussions in order to identify alternative views and approaches to the different aspects of rate regulation.

IASB discussions to date

9. In July 2013, the IASB discussed a staff summary of the responses to the RfI (Agenda Paper AP9 *Request for Information response summary*). The IASB was not asked to make any formal decisions at this meeting but gave feedback to the staff to help focus the use of the information obtained from the RfI responses. This feedback, together with input from the Consultative Group discussion on the RFI response summary, contributed to the staff analysis of features that are considered to distinguish rate-regulated activities from other commercial activities that are not subject to rate regulation. This analysis was presented to the IASB in September 2013.
10. In September 2013, the IASB discussed the staff's analysis of the common distinguishing features of rate-regulated activities under the general heading of "Scope issues" (Agenda Papers AP9B-9B(iii)). The analysis identified that:
 - (a) There is a wide variety of types of rate regulation that can be categorised into two broad types:
 - (i) cost-based (commonly referred to as cost-of-service or cost-plus regulation); and
 - (ii) incentive-based (sometimes referred to as price-cap or revenue-cap regulation).
 - (b) Almost all schemes identified from the responses to the RfI and other research contain elements of both types of rate regulation. Consequently, describing a particular rate-regulatory framework as cost-based or incentive-based is confusing and potentially misleading.
 - (c) There are a number of features that are common to rate regulation, no matter whether it is cost-based or incentive-based. Consequently, describing rate regulation within the context of these features may be more useful than focusing on cost-based or incentive-based rate regulation.
11. As a result of the discussion in September 2013, the IASB tentatively decided that the distinguishing features identified should form the basis of the next stage of the analysis as to whether the features create rights and obligations that could meet the definitions of asset and liability in the *Conceptual Framework*.

12. In October 2013, the IASB discussed the staff's analysis of the rights and obligation created by the distinguishing features discussed in September 2013 (AP9A *Features of rate regulation*). The analysis noted that some of the rights and obligations are not unique to rate regulation and arise from the 'licence' (whether from the terms of an explicit licence or from the terms set out in the rate regulation) to operate as a rate-regulated entity.
13. Consequently, the IASB also considered whether the next step in the staff's analysis should:
 - (a) focus on the 'package' of rights and obligations contained within the licence as a single item; or
 - (b) disaggregate the rights and obligations contained within the licence (AP9B *Unit of account*).
14. The IASB noted that, within the previous Rate-regulated Activities project, it had discussed the possible accounting treatment for a 'package' of rights and obligations contained within the licence as a single item, being an intangible asset (AP12A *Analysis of intangible assets*, September 2010). At that time, the IASB did not reach a conclusion on this issue.
15. Consequently, the IASB tentatively decided that the next step in the staff's analysis should disaggregate the rights and obligations contained within the licence and focus on a 'primary' distinguishing feature of rate regulation. This primary feature was described as a 'true-up adjustment' in what was termed a 'dual-element adjustment rate-setting mechanism'.
16. In November 2013, the staff presented an analysis of the rights and obligations attached to the true-up adjustment in the dual-element adjustment rate-setting mechanism within the context of the IFRS definitions of assets and liabilities (AP9 *Preliminary Analysis of asset and liability definitions*). Although the analysis took into consideration the existing *Conceptual Framework*, it relied more on the proposed changes to the definitions and the accompanying guidance contained in the Discussion Paper *A Review of the Conceptual Framework for Financial Reporting*, issued in July 2013. The IASB was not asked to make any decisions about the staff's analysis but was asked to provide comments on the

strengths and weaknesses of the analysis and whether alternative approaches should be developed.

17. Just before the November 2013 IASB meeting, the Consultative Group discussed the October 2013 analysis of the rights and obligations arising from the distinguishing features of rate regulation (*AP9A Features of rate regulation*). The comments received from the Consultative Group members were not reflected in the analysis presented to the IASB in November 2013 because the Consultative Group met after the papers for the IASB meeting had been published. However, before discussing the asset and liability analysis, the IASB were told that some members of the Consultative Group had expressed concerns that:
 - (a) the descriptions of the true-up adjustment and the dual-element adjustment rate-setting mechanism need further refinement; and
 - (b) the analysis of whether rate regulation might create assets and liabilities should not focus narrowly on the rate-setting mechanism, but should also place more emphasis on other features, such as the existence of a near-exclusive supplier and the legally enforceable rights and obligations set out in the rate-regulatory framework.
18. The IASB acknowledged the comments made by the Consultative Group, but agreed to discuss the asset and liability analysis as it was drafted in order to progress the project and give the staff input on further analysis needed. Views expressed by members of the IASB were mixed:
 - (a) some supported the staff's preliminary view that some aspects of rate regulation that involve a true-up adjustment can create additional assets and liabilities as defined in the *Conceptual Framework*;
 - (b) some expressed limited support for the staff's preliminary view but disagreed with, or were not convinced by, parts of the analysis; and
 - (c) some disagreed with the staff's preliminary view.
19. One IASB member asked the staff to consider the forthcoming IFRS 15 *Revenue from Contracts with Customers* and to provide an alternative analysis as to whether aspects of that [draft] Standard could be applied to the rights and obligations arising from the distinguishing features of rate regulation.

20. Following the November 2013 IASB meeting, the staff also discussed:
- (a) October 2013 Agenda Paper 9A *Features of rate regulation* with the Rate-regulated Activities Working Group of the European Financial Reporting Advisory Group (EFRAG); and
 - (b) a combination of October 2013 Agenda Paper 9A *Features of rate regulation* and November 2013 Agenda Paper 9 *Preliminary Analysis of asset and liability definitions* with the IASB's Accounting Standards Advisory Forum (ASAF).
21. The outcome of these discussions was similar to those with the IASB and the Consultative Group. In particular, the staff were asked to provide a more refined description of the distinguishing features of rate regulation and to consider the issue from a performance reporting perspective, instead of focusing primarily on the asset and liability definitions.

Issues addressed so far

22. The IASB discussions to date have been focused on aspects of the first three issues to be addressed in the Discussion Paper (these are listed in paragraph 4 and in Appendix A). These issues are:
- (a) What are the features of rate regulation that differentiate rate-regulated activities from non-rate-regulated activities?
 - (b) What rights and obligations created by rate regulation, if any, meet the definitions of assets and liabilities in the *Conceptual Framework for Financial Reporting* (the *Conceptual Framework*), in addition to the assets and liabilities already recognised in accordance with IFRS for non-rate-regulated activities?
 - (c) What should be the scope of any guidance on rate-regulated activities?
23. The discussions have also provided input into the second three issues, which are:
- (a) If any of the rights and obligations created by rate regulation do meet the definitions of assets and liabilities, what type of asset, liability, or combination of assets and liabilities are created?

- (b) For any assets or liabilities identified, what are the relative advantages and disadvantages of alternative accounting models for recognition and measurement?
 - (c) Does IFRS already include appropriate accounting models that can be applied to any regulatory assets or regulatory liabilities identified?
24. The IASB has not yet been asked to conclude on whether rate regulation creates assets and liabilities in addition to those recognised in accordance with IFRS for non-rate-regulated activities, because the issues discussed so far are closely interrelated and further discussions are needed to develop any preliminary views on them. However, the IASB has made a number of tentative decisions related to the development of the Discussion Paper.

Summary of tentative decisions taken to date

25. The Discussion Paper should briefly outline the wide variety of rate regulation seen in practice, but should acknowledge that not all types of rate regulation need to be addressed in the project. This is because some types apply in competitive markets and are not considered to create economic conditions that are sufficiently different from those found in competitive environments.
26. The Discussion Paper will focus primarily on the types of rate regulation that contain features that are claimed to create special economic conditions that we have been told are not faithfully represented by the current IFRS established practice. However, the IASB has still to discuss several aspects of these features in order to identify the potential scope of any guidance that may be developed for rate regulation.
27. The Discussion Paper should look to identify a principle-based approach that could be applicable to a variety of industries and rate-regulatory schemes. Consequently, we should focus on the nature of the rate regulation and the legally enforceable rights that support the recovery of “allowable amounts”. (Previously, we were focusing on the recovery of allowable costs but now our analysis is moving to focus on “allowable revenue”-see ASAF Agenda Papers 3C-3E/ IASB Agenda Papers 9B-AP9D that will be discussed in this meeting.)

28. We have identified a number of distinguishing features that should be described in the Discussion Paper, but discussions are still ongoing as to how essential each feature is. The features that are emerging as being most relevant are those that are found in formal regulatory pricing frameworks that:
- (a) apply in situations in which there is little or no competition;
 - (b) establish parameters for rates (sometimes referred to as prices or tariffs) that provide regulatory protections that:
 - (i) support greater stability and affordability of prices for customers; and
 - (ii) support the financial viability of the rate-regulated entity;
 - (c) establish parameters to maintain the quality and availability of the supply of the rate-regulated goods or services; and
 - (d) create rights and obligations that are legally enforceable and binding on the rate-regulated entity and on the ‘rate regulator’.
29. We identified a number of other features that are commonly found in these types of rate regulation but that may be considered to be ‘supporting’ features, instead of ‘essential’ features. The Discussion Paper will include a description of the various features and invite comments on the relative importance of each of them.
30. We outlined some of the rights and obligations arising from the distinguishing features of rate regulation. The Discussion Paper will include a summary of these and will acknowledge that some of them are similar to the rights and obligations that are found in some types of licensing agreements. Consequently, the Discussion Paper will include a discussion about accounting for the rate-regulatory agreement as a single intangible asset, namely the licence. However, this approach was considered in the previous Rate-regulated Activities project but the IASB did not reach agreement on how to progress the approach. At this time, the IASB has made a tentative decision to focus on alternative approaches to consider in the Discussion Paper.
31. We considered focusing on a particular ‘balancing’ or ‘true-up’ adjustment that is common to many rate-regulatory mechanisms. We analysed this adjustment mechanism against the revised definitions of assets and liabilities proposed in the

Discussion Paper *A Review of the Conceptual Framework for Financial Reporting*. This resulted in mixed views as to whether assets or liabilities are created in addition to those that are already recognised in accordance with IFRS for non-rate-regulated activities.

32. The IASB tentatively agreed that the next step is for the staff to refine the description of rate regulation and to provide an analysis from a performance reporting perspective. In particular, this analysis should consider the principles and accounting model being developed in the forthcoming IFRS 15 *Revenue from Contracts with Customers*.
33. The Discussion Paper should also include an analysis as to whether, if rate regulation does create a ‘regulatory asset’ for the entity, a corresponding liability is created for another party.

Discussions at this meeting

34. At this meeting, we present the next steps in our analysis. Consequently, at this meeting, we will present the following papers for the IASB to consider:
- (a) ASAF Agenda Paper 3C (IASB Agenda Paper 9B) *A revised description of the distinguishing features of rate regulation*;
 - (b) ASAF Agenda Paper 3D (IASB Agenda Paper 9C) *Calculating the allowed revenue*; and
 - (c) ASAF Agenda Paper 3E (IASB Agenda Paper 9D) *A revenue recognition approach to rate regulation*.
35. We will bring further papers to future meetings that will:
- (a) continue to develop the analysis of the distinguishing features of rate regulation and whether they create assets and liabilities that are not already accounted for in accordance with IFRS;
 - (b) consider presentation and disclosure issues; and
 - (c) consider the interaction of rate regulation with IFRIC 12 *Service Concession Arrangements*.

Questions for the IASB

Is the IASB content with the staff’s description of the project so far? In

particular:

- (a) Does the IASB have any suggestions to change the proposed contents of the Discussion Paper?
- (b) Does the IASB wish to revisit, at this time, any of the tentative decisions made so far?

Appendix A: Issues to be addressed in the Discussion Paper

- A1. 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 upon, 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?
- A2. What characteristics of the rights and obligations created by rate regulation, if any meet the definitions of assets and liabilities in the IFRS *Conceptual Framework*?
- (a) What are the working definitions being developed in the *Conceptual Framework* project and how does this affect the analysis?
 - (b) 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?
 - (c) How does the analysis of this issue interact with other similar issues such as emissions trading and other conceptually difficult topics?
 - (d) How do we define ‘the customer’?
 - (e) What is the unit of account?
- A3. 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?

- A4. If the rights and obligations created by particular rate regulations do meet the definitions of assets and liabilities and require recognition, what type of asset, liability or combination of assets and liabilities is 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)?
- A5. 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 the 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) What should be the approach to derecognition when the regulatory system changes or is discontinued?

- A6. 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?
- A7. 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)?
- A8. 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 submitted to the rate regulator for rate regulation purposes?
 - (b) Should the assumptions made by management about the outcomes of regulatory reviews, expected future rate level, and 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-referenced to instead?

A9. 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 in order to be within the scope?