STAFF PAPER

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Prepared for the Global Preparers Forum Meeting

Project	**Conceptual Framework**		
Paper topic	Rate regulation: Assets and liabilities		
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Purpose of the discussion

1. The purpose of the discussion in this session of the meeting will be:

   (a) to explain one of the issues that the IASB is seeking to address in its Rate-regulated Activities project, and

   (b) to seek Global Preparers Forum (GPF) members' views on the interaction of this with the suggested definitions of asset and liability in the Discussion Paper *A Review of the Conceptual Framework for Financial Reporting*, published July 2013 (the *Conceptual Framework* Discussion Paper).

2. We would like you to consider the examples set out in paragraphs 10–12 in order to test the suggested definitions of asset and liability (which are reproduced in the Appendix of this paper) and specifically the meaning of the terms 'present economic resource' and 'present obligation'. It is unclear whether the entity can have a present economic resource or present obligation while any requirement to transfer economic resources to or from the entity remains conditional on the entity's future actions. In the context of these discussions about rate regulation, these future actions primarily involve selling the rate-regulated goods or services in future periods.

3. In this paper, we set out some brief background information about rate regulation, together with some examples about the impact of rate regulation, in order to facilitate a broad discussion about the nature of assets and liabilities and how they

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are defined in the *Conceptual Framework for Financial Reporting* (the *Conceptual Framework*). This is not intended to lead to a detailed debate about the nature of rate regulation and how such regulation should be accounted for. Instead, it is intended to explore how the suggested *Conceptual Framework* definitions of asset and liability might be applied in practice.

Background

4. Rate regulation is a framework for establishing the prices that can be charged to customers in exchange for specified goods or services (the rate-regulated goods or services). Rate regulation is widespread and significantly affects the economic environment of rate-regulated entities. Some national generally accepted accounting principles (GAAPs) provide specific guidance on this matter, but there is no equivalent guidance in IFRS.

5. The objective of the IASB's Rate-regulated Activities project is to develop a Discussion Paper to consider whether some types of rate regulation create 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.

6. A rate-regulated entity is obliged to carry out a number of activities through a legally enforceable 'regulatory agreement'. One such activity is the supply of the rate-regulated goods or services to the end-users (ie the customers). This single activity usually provides all of the consideration that the entity is entitled to earn in exchange for all the various rate-regulated activities that it performs. This can create timing differences between the required activities being performed and the consideration being billable to the customers. Some argue that these timing differences represent assets and liabilities, which will be collectible or payable through the billings for future sales of the rate-regulated goods or services. However, others argue that the timing differences should not be recognised as assets and liabilities, in part because the recovery/settlement of the amounts is conditional on the rate-regulated entity making future sales. The established IFRS

practice is that these timing differences are not recognised as assets or liabilities in IFRS financial statements.

7. For the purpose of this meeting, we set out some basic assumptions about the particular type of rate-regulated environment that we are focusing on in the project. The assumptions are somewhat simplified but are designed to support the series of short examples set out in paragraphs 10–12. The assumptions represent what we understand to be the distinguishing features of the type of rate regulation that we are focusing on currently. We have been told that these distinguishing features create special economic conditions that are currently not represented faithfully by the established IFRS practice.

8. For each of the examples, we are interested in the views of GPF members as to whether the terms of the rate regulation create an asset or liability.

Basic assumptions to apply to the examples

9. Please consider each example as a separate entity (ie the examples are not cumulative). In all examples:

   (a) the rate regulation protects the entity's right to be the exclusive supplier of essential goods or services (for example, electricity transmission services) to customers, competition is prohibited;

   (b) the supplier cannot withdraw from the market and is obliged to transmit electricity in accordance with the terms and conditions of their exclusive supply licence (the regulatory agreement);

   (c) demand is inelastic and very predictable;

   (d) the rate regulation is designed to provide a high level of assurance that the supplier will achieve a determinable amount of revenue (the allowable revenue), which will at least allow recovery of 'allowable costs' plus a profit margin;

   (e) there is a mechanism to identify any under- or over-recovery of allowable revenue and the rate regulation requires that the future rate (ie price per unit) charged to customers for the supply of electricity transmission

services is automatically adjusted for any under- or over-recovery of allowable revenue identified in earlier periods;

(f) the regulated rate charged to customers is fixed for a 12-month period: changes to the rate are applicable from 1 January each year; and

(g) the actual costs and volume of sales is as anticipated in the regulated rate, except for the items described in the examples (ie there are no variances, other than those specified in the examples).

Questions for GPF members

Assets and liabilities
1. For each of the examples in paragraphs 10–12, do you think that the supplier has an asset or liability at the end of year 20X1? If possible, please support your view by reference to the definitions in the *Conceptual Framework*.
2. Thinking about your own industry or business environment, could you reach the same conclusions if the supplier was not subject to rate regulation but instead was able to establish its own prices?

Examples

Variances from expected costs

Example 1

10. The rate regulation entitles the electricity transmission services supplier to recover the actual costs of some designated inputs (ie allowable input costs). If the allowable input costs are higher or lower than the amount reflected in the regulated rate, the rate for the next period is automatically increased or decreased to eliminate the variance through sales in the following year. Does the supplier have an asset/ liability in the following cases?

(a) Allowable input costs were CU500[1] higher than expected during 20X1 and so the price per unit for sales in 20X2 is automatically increased in order to recover this amount;

(b) Allowable input costs were CU300 lower than expected during 20X1 and so the price per unit for sales in 20X2 is automatically reduced in order to reverse this amount.

Performance penalty/ bonus

Example 2

11. The rate regulation contains an incentive to encourage the supplier to improve its quality of service to customers. The supplier is required by the rate regulator to carry out a customer satisfaction survey in December 20X1. If the satisfaction rating meets the target set by the rate regulator, the rate per unit set for 20X2 is automatically increased in order to provide a ‘bonus’. If the supplier fails to meet the target, the rate is reduced by the same amount per unit in order to impose a penalty. The total amount of the bonus or penalty is expected to be CU120, taking into account the inelastic demand and the predictability of sales volumes. Does the supplier have an asset/ liability in the following cases?

    (a) The results of the survey show that the supplier met the performance target and will increase the rate charged to customers for sales during 20X2;

    (b) The results of the survey show that the entity failed to satisfy the performance target and will reduce the rate charged to customers for sales during 20X2.

Storm damage repair

Example 3

12. If a storm causes damage to the electricity transmission network such that it results in a ‘power outage’ (ie a break in the transmission system), the rate regulation entitles the electricity transmission services supplier to recover the actual costs incurred to repair the storm damage in order to reconnect the transmission supply as quickly as possible. In some cases, the rate regulation

[1] In this Staff Paper, monetary amounts are denominated in ‘currency units’ (CU).

entitles the supplier to recover those costs only in arrears (ie the supplier must suffer the cost and then the rate is adjusted to compensate the supplier through later sales). In other cases, the rate regulation entitles the supplier to anticipate storm damage costs and reflects expected future costs in the rate charged to customers for current sales. In such cases, a 'balancing' adjustment is made once actual costs have been incurred (this enables the supplier to build up a 'cash buffer' to assist with cash flow when the storm damage occurs). Consequently, if the actual costs are lower than the amounts 'collected' in advance, the future rate is reduced to reverse the 'over-recovery'. Similarly, if the actual costs are higher, the future rate is increased. Does the supplier have an asset/ liability in the following cases (for the purpose of this example, please ignore the time value of money)?

(a) Entity X is subject to rate regulation that entitles the supplier to recover storm damage costs in arrears. A major storm happened during 20X1 and, consequently, the supplier (Entity X) suffered unplanned storm damage repair costs of CU60. The rate set for 20X2 and 20X3 is automatically increased in order to recover one half (ie CU30) of this cost through sales made during each year, 20X2 and 20X3.

(b) Entity Y is subject to rate regulation that entitles the supplier to anticipate future storm damage costs in current rates. At the start of 20X1, the supplier (Entity Y) and the rate regulator both anticipate that the next severe storm will occur in the supplier's service area during 20X4, which is expected to result in storm damage repair costs of CU40. The rate to be charged to customers is set in order to collect one quarter of this anticipated cost each year from 1 January 20X1 through 31 December 20X4. Consequently, during 20X1, Entity Y includes charges of CU10 (ie CU40 ÷ 4 years) in bills for electricity transmission services delivered to customers. No storm damage costs were incurred during 20X1.

Appendix

A1. The definitions of asset and liability in the existing *Conceptual Framework* are reproduced below, together with the working definitions contained in the *Conceptual Framework* Discussion Paper.

	Existing definitions (paragraph 4.4 of the CF)	**Suggested definitions** (paragraph 2.11 of the DP)
Asset (of an entity)	a resource controlled by the entity as a result of past events and from which future economic benefits are expected to flow to the entity.	a present economic resource controlled by the entity as a result of past events.
Liability (of an entity)	a present obligation of the entity arising from past events, the settlement of which is expected to result in an outflow from the entity of resources embodying economic benefits.	a present obligation of the entity to transfer an economic resource as a result of past events.
Economic resource	[no existing definition]	a right, or other source of value, that is capable of producing economic benefits.
Control	[no existing definition]	An entity controls an economic resource if it has the present ability to direct the use of the economic resource so as to obtain the economic benefits that flow from it. (paragraph 3.23 of the DP)