STAFF PAPER

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Project	**Rate-regulated Activities**		
Paper topic	Reporting the Financial Effects of Rate Regulation		
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Purpose

1. On 17 September 2014, the IASB published the Discussion Paper *Reporting the Financial Effects of Rate Regulation*. The Discussion Paper focuses on a specified type of rate regulation, which, for convenience, is called '*defined rate regulation*'. This focus is designed to provide a consistent fact pattern on which to discuss how best to reflect the financial effects of rate regulation in IFRS financial statements.

2. This paper outlines the main features of defined rate regulation. Focusing on these features, we would like to get CMAC members' feedback on:

   (a) what information about the financial effects of defined rate regulation is most relevant to users of IFRS financial statements in making investing and lending decisions; and

   (b) how that information could best be presented in an entity's annual report.

Background

3. Many governments regulate the supply and pricing of particular types of activity by entities. These 'rate-regulated activities' usually involve providing goods or services that are considered in that jurisdiction to be essential to customers, including transport services, some types of insurance policies, and utilities such as gas, electricity and water.

4. Some forms of rate regulation (called *market regulation* in the Discussion Paper) establish a cap on the rate per unit that the entity is permitted to charge to customers for its rate-regulated goods or services. However, the entity's management is then free to manage the business in order to maximise its profitability.

5. In contrast, defined rate regulation has a more significant effect on the entity's financial results. The rate regulator not only regulates the rate per unit to be charged to customers for the rate-regulated goods or services, but also regulates the activities that the entity must perform. This heavily influences the investment that the entity makes in the assets that are required to carry out those activities.

6. Defined rate regulation balances the needs of the customers to purchase essential goods or services at a reasonable price with the needs of the entity to attract capital and remain financially viable. Consequently, defined rate regulation is designed to ensure that the rate-regulated entity recovers a determinable amount of consideration (the *revenue requirement*) in exchange for the rate-regulated activities that it performs. In addition, the rate regulation establishes, through the rate per unit chargeable to customers, the time at which the entity can bill customers for that consideration.

7. As a result, the time at which particular costs or income are recognised in the regulated rate per unit is deferred or accelerated in order to reduce rate volatility for customers. This results in differences between the time at which particular costs or income are recognised for regulatory purposes and when those costs or income are recognised in the statement of profit or loss in IFRS financial statements. These differences are tracked in 'regulatory deferral accounts'.

8. Most existing IFRS preparers do not recognise regulatory deferral account balances in their financial statements.[1] However, they ask whether the financial effects of rate regulation would be better reflected by recognising such balances

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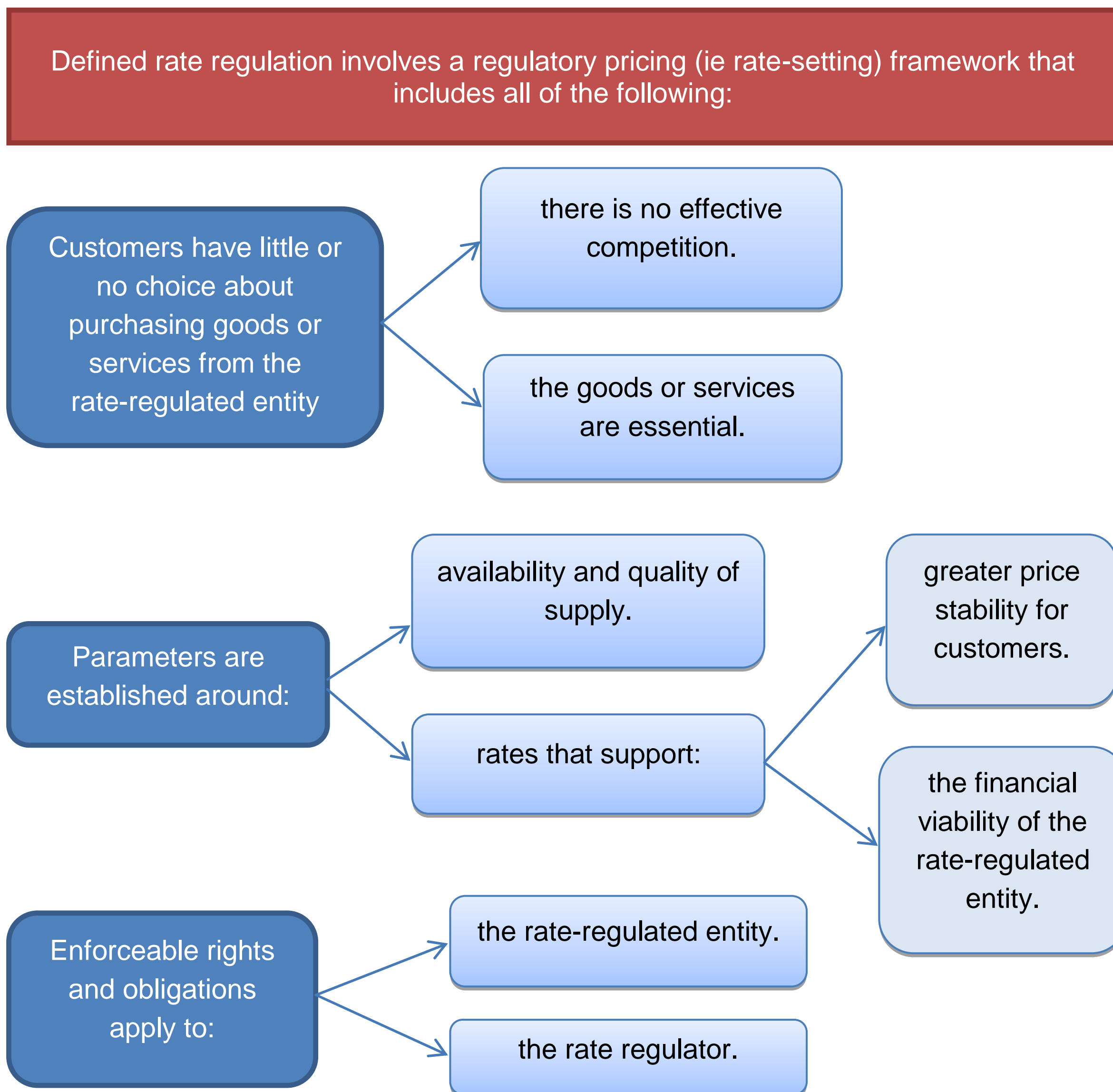
[1] In January 2014, the IASB issued IFRS 14 *Regulatory Deferral Accounts*, which permits specified first-time adopters of IFRS to 'grandfather' their existing recognition and measurement accounting policies for these accounts. IFRS 14 requires the recognised balances, and the net movements in them, to be presented separately from assets, liabilities, income and expenses recognised in the statements of financial position, profit or loss and other comprehensive income.

in the statement of financial position. This, they suggest, would allow them to more faithfully report the financial effects of the activities that they have performed in the period. Because of the rate-setting mechanisms used in defined rate regulation, these effects are not faithfully represented in the amounts that they have billed to customers in the same period, using the regulated rate per unit.

Overview of the features of defined rate regulation



9. The rate-setting framework for defined rate regulation establishes:

   (a) a ‘revenue requirement’ (sometimes called ‘allowable revenue’ or ‘authorised revenue’): this is the total consideration to which the entity is entitled in exchange for carrying out specified rate-regulated activities over a period of time; and

   (b) a regulated rate, or rates, per unit that the entity charges to customers for delivering the rate-regulated goods or services during the regulatory period.

10. This can result in differences between the time at which the entity carries out its rate-regulated activities and when it can bill customers for the activities performed. Further differences can arise because the revenue requirement is initially only an estimate, but is then revised to reflect actual events and transactions.

11. As a result, the mechanism used to calculate the regulated rate(s) includes a regulatory adjustment mechanism, which is designed to reverse specified differences between the amount of the revenue requirement accrued to date and the amounts billed to customers. This regulatory adjustment mechanism seeks to ensure that the rate-regulated entity earns no more and no less than the amount of the revenue requirement and any related profit or return to which it is entitled. The regulatory adjustment to the rate also seeks to reflect the time value of money when increases or decreases in the rate are deferred.

12. Defined rate regulation applies when there is no effective competition to the rate-regulated entity’s supply of the rate-regulated goods or services and demand for those goods or services is predictable and relatively stable. The high level of predictability of the timing and probability of future sales enables the rate regulator to use the adjustment to the price charged for future sales as a practical, low-cost and reliable mechanism for the entity to recover the amount of any under-billing or reverse the amount of any over-billing.

What information about defined rate regulation is relevant to investors and lenders?

13. The IASB has heard that investors, lenders and analysts generally consider that entities that are subject to high levels of rate regulation, including the type that we have termed ‘defined rate regulation’, hold the view that a key consideration is the effectiveness of the regulatory framework in which a rate-regulated entity operates. The effectiveness of the regulatory framework encompasses:

    (a) the ‘reasonableness’ of the rate regulation (ie how effective it is at balancing the needs of the customers and the entity);

    (b) the predictability and stability of the framework;

    (c) the transparency and efficiency of the rate-setting procedures;

    (d) the regulators’ strength and independence; and

    (e) the quality of the relationship between the rate regulator and the entity.

14. In addition to the general effectiveness of the regulatory framework, analysts also give significant consideration to the more specific ability of the rate-regulated entity to recover its costs in a timely manner and to earn the return established by the rate regulation. This involves an assessment of the statutory or regulatory mechanisms and protections that have been put in place with the aim of ensuring full and timely recovery of ‘approved’ revenues. Such mechanisms and protections are considered to include:

    (a) predictable rate-review outcomes, based on transparent and objective rate-setting formulae and procedures;

    (b) automatic annual (or more frequent) rate adjustments to allow a more timely pass-through of certain types of costs to customers;

    (c) timely automatic triggers or mechanisms to initiate a rate review for volatile or unexpected events or cost/revenue differences;

    (d) pre-approval of capital investment programmes and timely recovery of investment cash flows through rates; and

    (e) a stable, compensatory rate of return in cash that is sufficiently insulated from political intervention.

15. We would like to get CMAC members' feedback on what qualitative and quantitative disclosures would provide users of the financial statements with relevant information that would help them to:

(a) better understand the relationship between the results reported to the rate regulator and the results reported in financial statements prepared in accordance with general IFRS requirements;

(b) distinguish variability in performance that is adjusted through the rate-regulatory mechanism from variability for which there is no regulatory adjustment; and

(c) more readily predict the amount, timing and certainty of future cash flows related to the entity's rate-regulated activities.

Questions for CMAC members:

(1) What information about the entity's rate-regulated activities and the rate-regulatory environment do you think preparers of financial statements need to include in their financial statements or accompanying documents such as management commentary?

(2) How do you think that information would be used by investors and lenders in making investment and lending decisions?

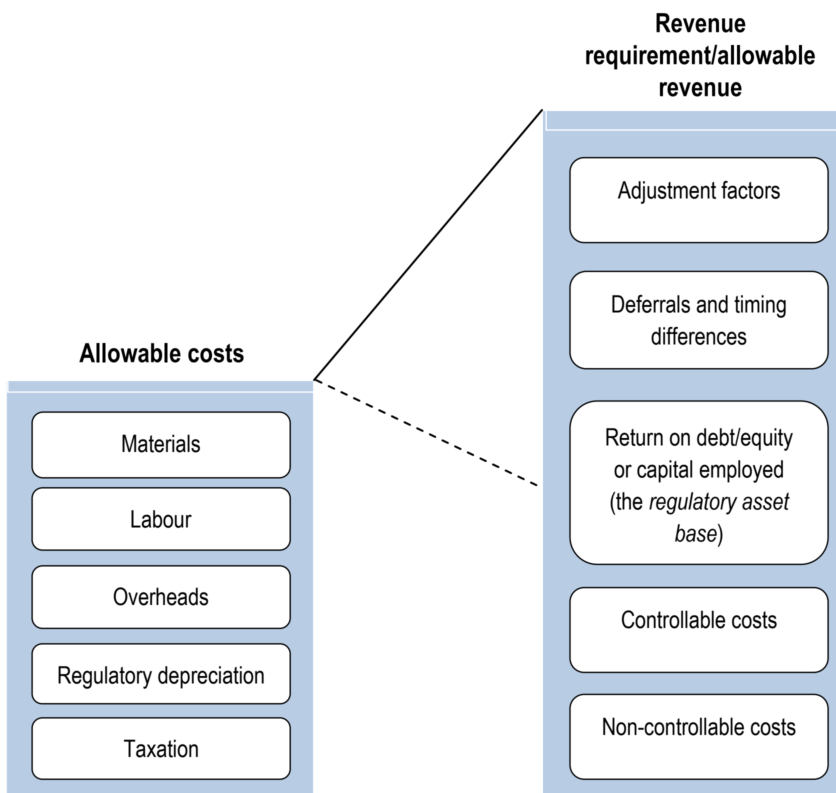
(3) Do you think it is preferable to include regulatory deferral account balances in the statements of financial position, profit or loss and other comprehensive income with supporting note disclosures, or would it be acceptable to merely include the information in:

(i) the note disclosures; or

(ii) the management commentary?

Appendix: how are the revenue requirement and the regulated rate per unit calculated?

A1. The starting point for calculating the revenue requirement is usually to identify the estimated costs (the allowable costs) of the activities that the entity is obliged to perform in accordance with the regulatory agreement. Once the types of allowable costs are identified, the rate regulator then determines what amounts of these costs are appropriate to pass on to customers and are therefore taken into account in calculating the revenue requirement.



A2. Non-controllable costs commonly include items such as fuel costs or raw material costs. The entity has little or no control over these costs and so they are commonly included at the amount incurred when calculating the revenue requirement. Controllable costs, on the other hand, can be managed by the entity. Consequently, rate regulators look at these costs in considering whether, within the regulatory agreement, the entity should be incentivised to manage them.

A3. The revenue requirement incorporates an amount that represents the target rate of return on the capital employed in the rate-regulated business. The capital employed includes the regulatory carrying amount of the property, plant and equipment used by the entity in the rate-regulated business. This regulatory carrying amount (commonly called the *regulatory asset base* or RAB) may, for a number of reasons, differ from the carrying amount determined in accordance with the requirements of IFRS. For example:

(a) the RAB may include some indirect overheads that, in accordance with IFRS, are recognised as expenses as they are incurred.

(b) the RAB may include an imputed cost of borrowing and/or an imputed cost of equity. This contrasts with the IFRS carrying amount, which includes only the directly attributable borrowing costs incurred.

(c) the RAB may be adjusted for inflation or some other price index. (When such an inflation adjustment is applied to the RAB, the allowed rate of return is typically set at a lower rate than in situations in which there is no such inflationary adjustment. This is because, in the latter case, the higher rate of return, in effect, compensates the entity for the absence of the inflationary adjustment.)

(d) the rate of regulatory depreciation may differ from that used for IFRS reporting purposes because the rate regulator may require depreciation of the RAB over a designated 'payback' period, instead of using the useful economic life of the asset, as required by IFRS.

A4. Once the allowable costs have been identified, the rate regulator determines the revenue requirement. The rate regulation provides a framework for this, which requires the rate regulator to establish the revenue requirement at a level that provides the supplier with a 'fair and reasonable' profit or rate of return. What is considered fair and reasonable is a matter of judgement and is sometimes subject to negotiation between the supplier and the rate regulator.

A5. However, the rate regulator does not have full discretion over what amounts to include in the revenue requirement. The need for defined rate regulation to balance the needs of the customers to purchase essential goods or services at a

reasonable price with the needs of the entity to attract capital and remain financially viable constrains regulatory judgement and discretion. This is important for maintaining confidence in the predictability and enforceability of the rights and obligations arising from the rate regulation. In addition, in some jurisdictions, the supplier can challenge the rate regulator's decision in the courts.

A6. The volume of regulated goods or services expected to be delivered to customers during the regulatory period is estimated when identifying the amount of the variable allowable costs to be included in the revenue requirement. The total revenue requirement is divided by this estimated volume to identify the rate per unit that the entity needs to charge customers in order to recover the revenue requirement during the regulatory period.

A7. This potential rate per unit will then be assessed to identify whether it represents a rate that is considered acceptable in accordance with the objectives of the rate regulation. If the potential rate per unit is considered to be too high for customers to afford in the regulatory period to which it relates, then the rate regulator needs to identify how to reduce the rate to an acceptable level, without jeopardising the financial viability of the entity.

A8. In some cases, the obligations of the entity could be reduced in order to reduce the costs that the entity needs to incur. This would result in a commensurate reduction in the revenue requirement to reflect the reduced obligations of the entity.

A9. Alternatively, the rate regulator could defer recovery of some of the revenue requirement until future regulatory periods. In such cases, the deferred amount is carried forward in a regulatory deferral account. The balance on the account is allocated to the revenue requirement in one or more future periods, usually on a straight-line basis. Commonly, the rate regulator compensates the entity for the time value of money in such cases and determines the interest rate to be applied.

A10. The revenue requirement and the fixed price or rate per unit established for a regulatory period are necessarily based on estimated amounts. However, the

actual revenue requirement that the entity is entitled to charge to customers is an adjustable amount, because it will reflect actual transactions and events, which may differ from the estimates used. Consequently, some differences arise between the revenue requirement and the actual amounts billed to the customers during the period. The rate to be charged in future periods is, therefore, adjusted to reverse these differences. As a result, the revenue requirement for the next regulatory period may include some deferrals and other differences that arose in earlier periods.