March 2015

STAFF PAPER

Rate-regulated Activities Consultative Group

Project	**Rate-regulated Activities**		
Paper topic	Summary of the 4 March 2015 meeting		
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Purpose of this paper

1. The purpose of this paper is to provide a high level summary of the issues discussed at the 4 March 2015 meeting of the IASB's Rate-regulated Activities Consultative Group. The meeting was held in public at the IASB's offices. A recording of the meeting is available on the IFRS website at http://www.ifrs.org/Meetings/Pages/Rate-regulated-Activities-Consultative-Group-meeting-March-2015.aspx.

Introductory session

2. In the opening session, IASB member Amaro Gomes welcomed everyone to the meeting. Mr Gomes emphasised that the purpose of the day's meeting was to gain insight and information about the Group's views—not to decide on solutions. He also noted that because of time constraints, there might not be the opportunity to discuss all comments. Consequently, Group members should reach out to the staff to provide more information, if necessary. In addition, the staff will contact Group members for further information, when necessary.

Overview of feedback received

3. After a short summary of the day's planned sessions, Jane Pike provided an overview of Agenda Paper (AP) 2, which summarised the feedback received on the Discussion Paper *Reporting the Financial Effects of Rate Regulation* and the IASB's discussion of this summary paper.

4. Some members noted that they were pleasantly surprised at the level of support for recognising at least some regulatory deferral account balances, especially when compared to responses received in the previous Rate-regulated Activities project. Members think that this reflects an increased understanding of defined rate regulation.

5. Some members were concerned by the level of support for a disclosures-only approach, which they continue to feel would not be an appropriate solution, in part because this would not provide improved comparability. In line with many comments received in response to the Discussion Paper, members suggest that disclosures would not be a sufficient substitute for the recognition of regulatory balances, but could provide useful supplementary information.

6. A few members expressed a concern about comments made in the responses to the Discussion Paper about using the recognition of regulatory deferral account balances for earnings management purposes. Some members said they had rarely seen balance write-offs. One member noted that in his jurisdiction, a deferral account cannot be created by the entity unless the rate regulator allows it. Others noted that smoothing of billable amounts and related cash flows is something that occurs because of the rate regulator, not because of the actions of the rate-regulated entity. A few members commented that the maturity of the rate regulation is an important factor that should be considered when assessing the reliability of the rate regulation.

7. One member expressed a concern about the small number of comment letters received from users of financial statements. Dr Teixeira responded to say that the proportion of comment letters from users of financial statements is consistent with that of other projects. Consequently, much of our user input is obtained through other outreach activities.

8. A few members noted the importance of 'user knowledge' and the need to focus on users of financial statements that have a reasonable knowledge and understanding of the financial effects of rate regulation. It was suggested that the recognition of regulatory deferral account balances, supported by focused disclosures about the balances, could be less complex and more understandable than disclosure-only.

9. Some members noted that the suggestion made in responses to the Discussion Paper about using the customer base as the unit of account needs to be further analysed, especially within the context of IFRS 15 *Revenue from Contracts with Customers* and the *Conceptual Framework*.

User information needs

10. Natasha Dara provided a summary of AP 3 to introduce a discussion about the practicality of disclosing information about rate regulation. AP 3 summarises the suggestions for specific disclosure requirements made by respondents to the Discussion Paper.

11. Members reiterated their views, within the context of this paper, that disclosure requirements should be considered as supplementary to recognised regulatory deferral account balances, rather than in place of those balances.

12. Members warned against excessive disclosure requirements and the risk of obscuring important information through disclosures of excessive length and detail. Members also noted that much of the information listed in AP 3 is general information that any investor would like, regardless of the industry and whether the entity is rate-regulated or not. In addition, as acknowledged in the paper, members noted that much of the information, including information about the rate-regulatory mechanism and associated risk, is already provided elsewhere, for example, on the rate regulator's website or in the Management Commentary. Members also noted that investors in entities that are subject to rate regulation are generally aware of the rate-regulatory norms and do not require repetition of the information in financial statements.

13. Some members noted that it would not be feasible to provide some of the information and reconciliations that were suggested by respondents to the Discussion Paper. In some cases, this would be because the entity has operations that are subject to rate regulation in a number of jurisdictions and so the volume of information could be excessive. In other cases, the information or reconciliation may not be available or relevant, depending on circumstances.

14. Some responses to the Discussion Paper suggested that the amount of the regulatory asset base (RAB) should be disclosed, together with a reconciliation of this amount to the carrying amount of property, plant and equipment (PPE). One member noted that in US GAAP, the carrying amount of PPE is generally equivalent to the RAB amount. Others noted that this is not always the case in other jurisdictions, because the calculation of the RAB may include not only the historical cost of the PPE but could also include net working capital amounts, inflationary adjustments and other items. Some members commented that it may not always be feasible to provide reconciliations between the RAB and PPE, particularly in cases in which the entity has activities subject to several rate-regulatory schemes.

15. One member noted the importance of providing information to help users of financial statements understand and predict the effect of the rate regulation on the cash flows and revenue of the entity for the next and subsequent years. It is especially important to have information about the timing of recovery, including the remaining periods over which balances are to be recovered/reversed, and whether returns are being earned on those balances.

16. One member suggested that disclosure about the use of judgement and a probability assessment would be particularly useful to users of financial statements. Another member noted that a probability assessment could be problematic because it could involve disclosing confidential, strategic information and create problems in negotiations with rate regulators or lenders.

What is performance?

17. Ms Pike explained that a number of respondents to the Discussion Paper suggested that the principles of IFRS 15 might be used as a starting point to

develop an accounting model to account for rate-regulated activities. AP 4 outlines some of the issues that would need to be addressed if the principles of IFRS 15 were to be used in such a model, including the nature of the entity's obligations to perform different activities, whether those activities transfer goods or services to customers and the identity of 'the customer'. In particular, members emphasised the need to focus on the three-way relationship between the entity, the rate regulator and the recipients of the rate-regulated goods or services.

18. Although IFRS 15 focuses on the relationship between the entity and the recipients of the goods and services, it was noted that there is no explicit barrier to considering the three-way relationship. The more problematic issue is that IFRS 15 focuses on exchange transactions in which performance obligations are satisfied through the transfer of goods or services. Rate regulation typically identifies a revenue requirement that provides the entity with consideration for performing a variety of activities, not all of which relate directly to the transfer of goods and services to customers.

19. Many members suggested that the strongest evidence of what activities should lead to revenue recognition is the agreement with the rate regulator. Although the rate regulator does not typically pay for the activities performed, the customers who receive the rate-regulated goods or services are aware that the rate regulator will establish the rates and the terms and conditions to which the customers and the entity are bound. Paragraph 24 of IFRS 15 acknowledges that performance obligations are not limited to explicit promises in the contract. Instead, performance obligations may include implicit contractual terms, which members suggest include the requirements established by the rate regulation.

20. Members suggested that for many rate-regulated entities, performance not only involves the delivery of goods or services; performance also requires the entity to stand ready to deliver goods or services when the customer requires them. In other words, the revenue-generating performance could be viewed as the carrying out of all the activities necessary to provide continuous access to the service, which involves the activities needed to maintain the infrastructure, as well as the delivery of the service itself.

21. IASB member Mary Tokar noted that the comments made by members on this issue suggested that a possible approach would be to look at the rate regulation as the ‘customer contract’ and determine performance on the basis of the wider activities that form the basis of the ‘revenue requirement’. The relationship with the individual customers would then be regarded merely as the mechanism for collecting cash, instead of being used to determine when revenue should be recognised. Ms Tokar observed that this approach could lead to a different result than the traditional ‘cost deferral’ view adopted for the recognition of many regulatory deferral account balances in accordance with IFRS 14 or other GAAPs.

22. Members responded that any financial reporting outcome would still need to link revenue recognition to performance that has taken place in the past, ie by the reporting date. Some members noted that, in some cases, the regulated rate currently being charged to customers includes an amount that is being collected to pre-fund specified future activities. For regulatory purposes, this would be treated as deferred revenue and would be recognised as a regulatory liability until the specified activities are carried out.

23. This led to further discussion around how to define performance within the context of the overall obligations of the entity, as established by the terms and conditions of the regulatory agreement. This, members suggested, would need to involve a determination about how much to aggregate or disaggregate those obligations, to identify the timing of the recognition of revenue. For example, should performance:

    (a) include only the physical delivery of goods or services to customers; or

    (b) should it also include the performance of activities that satisfy the stand-ready obligation to maintain the network. so that customers always have access to the service on demand; or

    (c) should it also include the activities required to enhance and ‘future-proof’ the network to ensure the continuing access to, and availability of, the service?

24. One member noted the importance of paragraph 25 of IFRS 15, which highlights that performance obligations do not include activities that an entity must undertake to fulfil a contract unless those activities transfer a good or service to a

customer. In many cases, the requirements of the rate regulation and the calculation of the revenue requirement make the boundary unclear between the activities that deliver goods and services, and those that the entity must undertake to support its ability to deliver goods and services unclear. The same member suggested that identifying this boundary will be challenging, but it would be critical to the project if a model is developed based on the principles of IFRS 15.

25. Another member suggested looking at the rights and obligations of the entity at the expiry or termination of the regulatory period. The terms of any balancing or compensatory payments may help to identify what the regulator considers to be performance, for which the entity is entitled to consideration.

Types of regulatory deferral account balances

26. Ms Pike introduced AP 5, which presented a list of illustrative examples indicating how regulatory deferral account balances arise. This formed the basis of a discussion about whether the balances could be grouped into different categories and whether they relate to performance.

27. Members suggested that the key issue is not how the balances arise, but whether the entity has a right or obligation to recover or refund the amount from or to customers, the rate regulator or another designated body.

28. Members suggested that categorising balances by their nature is less relevant than categorising them according to their risk profile. This would be more helpful to users of financial statements in predicting future revenue and cash flows. Possible categories suggested include:

    (a) 'mechanical' adjustment balances that are expected to be recovered/reversed in the short term, such as 'flow-through' commodity price adjustments, which involve little judgement and are relatively easy to measure;

    (b) other adjustment balances that are expected to be recovered/reversed in the short term, but are somewhat subjective, such as bonuses for achieving qualitative performance targets; and

(c) adjustment balances that may be more readily quantifiable but are only recoverable in the longer term and may be subject to more uncertainty about recovery across multiple regulatory periods.

Interaction with IFRIC 12 *Service Concession Arrangements*

29. Ms Dara introduced the day's final session, which was an education session about the requirements of IFRIC 12. Several responses to the Discussion Paper noted the importance of considering the interaction of the project with IFRIC 12, without specifying the particular issues to focus on. IASB staff will be looking to members with experience in applying IFRIC 12 to assist in this area.

30. The scope of IFRIC 12 requires that

> the grantor controls or regulates what services the operator must provide with the infrastructure, to whom it must provide them, and at what price; . . . (paragraph 5(a) of IFRIC 12).

31. Consequently, arrangements within the scope of IFRIC 12 will be subject to some form of rate regulation. However, not all will be subject to the type of rate regulation that is the focus of this project (ie defined rate regulation).

32. Some members suggested that the IASB should focus only on defined rate regulation, because they would not want the Rate-regulated Activities project to be delayed because of widening the scope to tackle the arrangements covered by IFRIC 12. These members suggested that service concession arrangements are not sufficiently similar to activities that are subject to defined rate regulation.

33. Other members noted that, in some jurisdictions, monopolistic utilities such as water fall into the scope of IFRIC 12. They noted that the economics of these arrangements that are within the scope of IFRIC 12 seem very similar to those seen in circumstances that are outside the scope of IFRIC 12 and are subject to defined rate regulation. Consequently, they note that this is an important issue because, although the economics are similar, the accounting treatment could be very different.

34. Ms Tokar and IASB Director of Implementation Activities Michael Stewart both commented that caution should be observed in making the distinction between service concession arrangements and other rate-regulated activities. It is important to look carefully at the similarities and differences. Accounting outcomes should be similar for similar economic conditions, but we will need to be clear about determining the boundary between different arrangements that may have different accounting outcomes.

Next steps

35. The IASB staff will consider the information discussed in conjunction with the feedback on the Discussion Paper to develop papers for IASB meetings in the next few months.

36. As noted during the meeting, the staff will seek further input from the Consultative Group via email and telephone as necessary.