STAFF PAPER

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Accounting Standards Advisory Forum

Project	Rate-regulated Activities		
Paper topic	Responding to issues raised in ASAF discussions		

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Purpose of the paper

1. This paper summarises:
   (a) concerns expressed by members of the Accounting Standards Advisory Forum (ASAF) in discussions about the development of a new accounting model intended to enhance the way that the financial effects of rate regulation are presented in IFRS financial statements; and
   (b) how those concerns are addressed in the staff's preliminary proposals for the new accounting model. To help ASAF members consider these proposals, the core principles and features of the model are further outlined in Appendix A.
2. This paper asks members of ASAF whether the core principles and features of the model address their concerns about:
   (a) scope;
   (b) interactions with other IFRS Standards and the Conceptual Framework; and
   (c) segregating identifiable rate adjustments from the overall changes in value of the regulatory licence/agreement.
3. The paper focuses on an overview of the core principles and features of the model; it does not address the detailed proposals to be included in the model. The

Board will consider the detailed proposals for the model in early 2017, after considering an overview of the model in its December 2016 meeting.

Structure of the paper

4. The paper contains the following information:

   (a) Background (paragraphs 5-6);

   (b) A summary of the concerns expressed by ASAF members and how they have been addressed in the proposed new model (paragraphs 7-36);

   (c) Questions for ASAF members (paragraph 37);

   (d) Next steps (paragraphs 38-40); and

   (e) An overview of the core principles and features of the model (Appendix A).

Background

5. Since the publication of the Discussion Paper *Reporting the Financial Effects of Rate Regulation* (the DP) in September 2014, the Board has heard that the combination of rights and obligations created by the type of 'defined rate regulation' described in the DP may not always be faithfully represented by the existing predominant IFRS practice.[1][2] In line with the feedback from the DP and subsequent outreach, the staff have been developing an accounting model that would result in the recognition of at least some regulatory assets and regulatory liabilities.

6. The ASAF has contributed to the staff's exploration of the issues through its meetings in December 2014, July 2015, October 2015, April 2016 and September 2016. In providing their advice, ASAF members have highlighted the

[1] The overview of the features of 'defined rate regulation' contained in paragraphs 4.4-4.7 of the DP is reproduced in Appendix B.

[2] The existing predominant IFRS practice applies existing IFRS Standards without modification. As a result, few entities recognise regulatory assets or regulatory liabilities.

need for staff to address a number of concerns when developing the accounting model.

Concerns expressed by ASAF members

Scope

7. ASAF discussions about scope have focused on the description of ‘defined rate regulation’ contained in the DP (see Appendix B). ASAF members expressed concerns that this description is not sufficiently precise to determine the scope of an accounting model to recognise regulatory assets or regulatory liabilities. In particular, comments suggested that the scope should focus more precisely on the enforceable rights and obligations that are created by the rate regulation, with the key features described in the DP used as ‘supporting factors or indicators’.

8. In response to these concerns, the model does not focus on the general rate-regulatory regime but, instead, focuses on specified regulatory adjustments that arise through the rate-setting mechanism. To ensure that the scope of the model is tightly drawn, it focuses on specified regulatory adjustments that:

    (a) arise from identifiable timing differences between performance of the entity vs performance of customers; and

    (b) result in regulatory balances that are included, or expected to be included, by the rate regulator in establishing the rate(s) that can be charged to customers.

9. The regulatory adjustments are specified in the context of the rights and obligations contained in enforceable regulatory agreements. Those agreements need to establish a clear link between an entity’s right to a determinable amount of compensation/funding in exchange for satisfying specified regulatory obligations.

10. Staff still consider that the description of defined rate regulation used in the DP is useful when assessing the strength or enforceability of the rate regulation. We intend to incorporate the key features from the DP into the model as factors or indicators to be considered when assessing how and when regulatory balances are likely to reverse.

Interactions with other IFRS Standards and the Conceptual Framework

11. ASAF discussions highlighted that any new accounting model to recognise regulatory assets and regulatory liabilities ought to:

    (a) focus on the ‘customer-base’, instead of individual customers (paragraphs 12-14);

    (b) identify clear principles to define ‘performance’ in a rate-regulated context and to identify when revenue should be recognised for that performance. In particular, ASAF members suggested that the model should distinguish between revenue recognised in accordance with IFRS 15 *Revenue from Contracts with Customers* and any ‘regulatory revenue’ recognised, avoiding any double-counting of revenue (paragraphs 15-18);

    (c) consider the ‘balance sheet perspective’ as well as the performance perspective. This means that any model developed should reflect the definitions of, and criteria for recognising, assets and liabilities (paragraphs 19-23);

    (d) apply caution when recognising regulatory assets, particularly when dealing with longer-term items that are intended to be recovered through rates over several years (paragraphs 24-27); and

    (e) address whether the situation in which an entity is prohibited from recovering the carrying amount of an asset from customers (eg because it has already received funding through a government grant or previous billings to customers) should result in:

        (i) the asset being impaired; or

        (ii) the recognition of a regulatory adjustment (paragraphs 28-32).

The customer-base

12. The rate regulator has the power to impose a rate on customers that includes compensation/funding for the entity’s past or future satisfaction of its regulatory obligations. The rate regulator uses this power, through the rate-setting mechanism, to smooth rate changes and fluctuations, and consequently cash

flows, for individual customers. The regulator does this by imposing rate adjustments prospectively on customers as a group (ie as a single 'customer-base'), without distinguishing between old and new customers.

13. Commonly, the regulated rate shown on bills to customers does not distinguish between the different aspects of the rate calculation. From an individual customer perspective, the regulated rate is the contractual consideration payable in exchange for the goods or serviced received in the period. Consequently, the composition of the rate is not relevant to the terms of the contracts with customers.

14. Because the regulated rate may include adjustments that relate to goods or services transferred to customers in past periods, or to be transferred to customers in future periods, the customer-base may, at any point in time, have either 'underpaid' or 'overpaid' for the goods or services it has consumed in a period. If the customer-base has underpaid, the entity is not entitled, based on the terms of the contracts with individual customers, to bill individual customers retrospectively for the amount underpaid. Instead, this underpayment is included in the regulated rate chargeable to all individuals within the customer-base in the future. Similarly, if the customer-base has overpaid, the individual customers within the customer-base are not entitled to a refund or credit for a proportion of the amount overpaid. Instead, this overpayment is included in the regulated rate chargeable to all individuals within the customer-base in the future.

Principles to define 'performance' and distinguish revenue

15. To address the concerns in paragraph 11(b), the model:

(a) applies a supplementary approach; ie an entity applies other IFRS Standards, including IFRS 15, before applying the model (paragraphs A2-A3);

(b) focuses on the transfer of goods, services or other economic benefits to define performance; and

(c) distinguishes between the transfer of goods and services to customers (ie the satisfaction of performance obligations identified in contracts with individual customers) and the satisfaction of other obligations created by the regulatory agreement, which may or may not involve the delivery of goods or services to the rate regulator or other parties (paragraphs A13-A17).

16. Before applying the model, revenue is recognised when (or as) the entity satisfies performance obligations in accordance with IFRS 15. Revenue is measured using the transaction price included in the contracts with individual customers, ie the regulated rate (paragraph A13). This reflects the contractual rights and obligations between the entity and its individual customers.

17. The model then highlights the rate regulator's intervention in establishing the regulated rate. The rate regulator establishes the amount that the entity is entitled to charge the customer-base in exchange for satisfying its regulatory obligations. The rate regulator then determines when the entity can include, through the regulated rate used in bills to individual customers, the amount to be charged to the customer-base as a whole. This intervention by the rate regulator results in imbalances between the timing of performance of the entity (by satisfying its regulatory obligations) and the performance of the customer-base (by consuming the regulated goods or services or by making payments). The model recognises regulatory assets and regulatory liabilities to reflect these timing differences.

18. Staff propose that the net increase or decrease in the sum of regulatory assets and regulatory liabilities resulting from such timing differences is presented separately as a net regulatory adjustment in the statement(s) of profit or loss and other comprehensive income. To inform users of the financial statements about how the regulatory rights and obligations between the entity and the customer-base interact with the contractual rights addressed by IFRS 15, the entity discloses, in the notes, an analysis of the net adjustment showing:

(a) originations and reversals of regulatory adjustments; and

(b) the nature of those adjustments (paragraphs A14-A15).

The balance sheet perspective

19. The model focuses on the rights and obligations of the entity and the customer-base contained in the regulatory agreement (paragraphs A4-A8) in a similar way that IFRS 15 focuses on the rights and obligations of the entity and an

individual customer in a contract with a customer. The rights and obligations in the regulatory agreement result in an exchange of resources that, at the inception of the agreement, is equally unperformed. The subsequent exchange involves:

(a) the transfer by the entity of goods, services or other economic resources to customers, the rate regulator or other parties, thereby satisfying the entity's regulatory obligations; and

(b) the receipt by the entity of the compensation/funding to which it is entitled in exchange for satisfying those regulatory obligations. This compensation/funding is usually payable by the customer-base although, in some cases, the rate regulator or another party may also contribute an amount, eg through a government grant.

20. The model uses a historical cost measurement basis. It does not try to determine whether the amount of compensation/funding receivable from the customer-base represents the 'fair value' of the economic resources transferred in exchange for that amount. Consequently, there is no 'net' asset or net liability to recognise at the inception of the regulatory agreement, because the exchange of resources set out in the agreement is equally unperformed; ie it is executory.[3]

21. It could be argued that, at the inception of the regulatory agreement, the entity could apply a gross presentation approach and recognise a regulatory asset and a regulatory liability of an equal amount. The asset would represent the overall compensation/funding to which the entity is entitled; the liability would represent its wholly unfulfilled regulatory obligations.

22. However, a gross presentation is not usually used in IFRS Standards for the asset and liability arising from the combined rights and obligations contained in an executory contract. The reason for this is explained in paragraph 4.41 of the Exposure Draft *Conceptual Framework for Financial Reporting* (the *Conceptual Framework* ED), published in May 2015, which states:

> Entering into the contract [the regulatory agreement] is the activity that establishes the extent of the entity's right and

[3] Appendix A and paragraph 4.40 of the Exposure Draft *Conceptual Framework for Financial Reporting*, published in May 2015, defines an executory contract as "A contract that is equally unperformed: neither party has fulfilled any of its obligations, or both parties have fulfilled their obligations partially and to an equal extent."

> obligation to exchange economic resources. That right, and the obligation to exchange economic resources, are interdependent and cannot be separated. Hence, the combined right and obligation constitute a single asset or liability. The entity has an asset if the terms of the exchange are favourable; it has a liability if the terms are unfavourable. . . .

23. As either party performs, ie fulfils or partially fulfils its obligations, the agreement ceases to be executory to the extent that the performance of one party exceeds the performance of the other party (or parties). If the entity performs first in fulfilling its regulatory obligations, for example, by transferring goods or services to customers, that performance is the event that changes the reporting entity's right and obligation to exchange economic resources into a right to receive an economic resource (ie an asset). If the customer-base perform first, for example by paying in advance of the entity fulfilling its regulatory obligations, that performance is the event that changes the reporting entity's right and obligation to exchange economic resources into an obligation to transfer an economic resource (ie a liability).[4]

Caution when recognising regulatory assets

24. Some ASAF members advised that caution should be applied when recognising regulatory assets, particularly when dealing with longer-term items that are intended to be recovered through rates over several years.

25. In principle, there is no reason to treat regulatory liabilities and regulatory assets differently when they arise from the same rate-setting mechanism. Consequently, the criteria used to recognise and measure each regulatory adjustment identified using the model will be the same.

26. However, the longer the period over which a regulatory balance will be reversed through the regulated rate, the greater the risk that conditions may change before the balance fully reverses. The entity must therefore, when assessing whether a regulatory balance is expected to be included in establishing the future rate,

[4] See paragraph 4.42 of the *Conceptual Framework* ED.

consider the enforceability of the rate regulation through the period over which the balance is expected to be reversed (see paragraph A7).

27. The model requires the reassessment of the entity's expectations at each reporting date. The regulated balances recognised will be adjusted, if appropriate, to reflect any changes in those expectations.

No future recovery of asset carrying amounts

28. ASAF members discussed situations in which an entity is prohibited from recovering the carrying amount of an asset from customers through rates in the future. This situation arises when the entity has already been compensated for the cost of the asset, eg because it has already received funding through a government grant or previous billings to customers. Some ASAF members are concerned that there may be some overstatement of the entity's assets if the asset in point is not impaired.

29. In the case of an entity receiving a government grant, staff consider that the existing requirements of IAS 20 *Accounting for Government Grants and Disclosure of Government Assistance* adequately address this point. Paragraph 12 of IAS 20 requires:

> Governments shall be recognised in profit or loss on a systematic basis over the periods in which the entity recognises as expenses the related costs for which the grant is intended to compensate.

30. In a defined rate regulation environment, an entity is typically not permitted to recover the cost of constructing an asset through rates if the entity has already been compensated for that cost through a government grant. By applying IAS 20, the compensation received will be recognised through profit or loss on the same basis that the cost of the related asset is recognised as an expense.[5] Paragraph 24 of IAS 20 permits an entity to apply either a net presentation or gross presentation approach.

    (a) In the net presentation approach, the grant is deducted from the carrying amount of the asset.

[5] See paragraphs 12 and 15-18 of IAS 20.

(b) In the gross presentation approach, the grant is initially recognised in the balance sheet and then is recognised in profit or loss on a systematic basis, usually on the same basis as the depreciation of the asset to which it relates.

31. When the gross presentation approach of IAS 20 is applied, the inability of the entity to generate future cash inflows to recover the asset's carrying amount through the regulated rate does not require the entity to impair the asset. This is because the recoverable amount of the asset (or the cash-generating unit of which it forms a part) cannot be determined without considering the recognised balance of the related grant.[6]

32. The staff proposals for the new model apply a similar principle to IAS 20. If amount charged to customers includes an amount that prefunds the construction of an asset, the prefunded amount is recognised as a regulatory liability. It is then recognised in profit or loss on a systematic basis, usually on the same basis as the depreciation of the asset to which the prefunding relates.

Segregating amounts from the overall value of the regulatory licence/agreement.

33. Some ASAF members suggested that the combination of rights and obligations created by the regulatory agreement/licence form a single intangible asset. They questioned why we have been looking to develop a model that recognises individual regulatory assets and regulatory liabilities, instead of looking to recognise a single intangible asset. The intangible asset approach was considered in the DP.[7]

34. Staff agree that the combination of rights and obligations created by the regulatory agreement/licence form part of an intangible asset. However, we consider that the intangible asset forms a part of, but is not separable from, the business as a whole or goodwill. This is because the rights and obligations created by the type of regulatory agreement within the scope of the proposed model are pervasive throughout the business. In addition, any changes in the value of such an

[6] See paragraphs 75-76 of IAS 36 *Impairment of Assets*.

[7] Paragraphs 5.35-5.46 of the DP discussed a possible intangible asset model approach.

intangible asset would, by their nature, include amounts that relate to future cash flows, transactions and events, including the associated profit of those future transactions.

35. Recognising the value of the intangible asset, and subsequent changes in the value, would require an accounting model that would be very different from the existing requirements of IAS 38 *Intangible Assets*. It would also involve a significant level of measurement uncertainty in respect of the future transactions of the entity. Consequently, few respondents to the DP expressed support for such a model to be developed, for both conceptual and practical reasons.

36. Although the model being proposed will not capture the full extent of the financial effects of the rate regulation, staff suggest that it will improve the relevance of the financial information provided to users of financial statements. This is because, by recognising regulatory adjustments that can be identified and measured with a reasonable level of certainty, the model will capture the variability in cash flows imposed on the entity by the rate regulator as a consequence of past actions by the entity.

Questions for ASAF members

37. ASAF members are asked the following questions:

Questions for ASAF members
Do the core principles and key features of the model address ASAF members previously expressed concerns about: (a) scope; (b) interactions with other IFRS Standards and the Conceptual Framework; and (c) segregating identifiable rate adjustments from the overall changes in value of the regulatory licence/agreement? If not, what concerns have not been addressed?

Next steps

38. In an education session at the Board's December 2016 meeting, staff will present an overview of its preliminary proposals for the model. We will highlight the input received from ASAF members and other stakeholders and how that input has contributed to the development of our proposals.

39. Staff will continue to develop the core principles and features outlined in this paper and present further details of the proposals to the Board in early 2017. Staff will seek decisions from the Board about detailed proposals for the model on scope, recognition and dereocgnition, measurement, presentation and disclosure.

40. Staff will propose to the Board that the details of the proposed model, together with the Board's views on the model, are published for consultation with stakeholders in a second Discussion Paper.

Appendix A: Core principles and features of the proposed model

A1. The core objective of the proposed new model is to establish principles that an entity applies to inform users of the effects of the rate regulation on the entity's cash flows, arising from past transactions, events and conditions. To achieve that objective, the model:

(a) supplements the requirements of existing IFRS Standards, ie an entity applies other IFRS Standards before applying the new model;

(b) focuses on the rights and obligations arising from the regulatory agreement and restricts the scope of the proposed accounting to those regulatory adjustments that link, through the rate-setting mechanism, the entity's right to charge customers a determinable amount in exchange for satisfying specified regulatory obligations to the satisfaction of those obligations; and

(c) addresses the satisfaction of the entity's regulatory obligations to the customer-base separately from the satisfaction of the entity's performance obligations to individual customers (which are addressed through IFRS 15).

A 'supplementary' approach—general

A2. The new model is designed to 'supplement' the requirements of existing IFRS Standards. This means that a rate-regulated entity will recognise income, expenses, assets and liabilities in accordance with other IFRS Standards before applying the new model.

A3. The model informs users of the effects of the rate regulation on the entity's cash flows arising from past transactions, events and conditions by presenting separately:

(a) revenue recognised as (or when) the entity satisfies performance obligations contained in contracts with individual customers, using the regulated rate (ie recognised using IFRS 15); and

(b) regulatory adjustments that arise due to the origination and reversal of timing differences between:

(i) the entity’s performance (by satisfying its regulatory obligations); and

(ii) the performance of the entity’s customers (by consuming goods or services or making payments).

Focus on the rights and obligations in the regulatory agreement

A4. To be within the scope of the model, the rate regulator must have the power to bind both the entity and the customers to a rate and the rate regulation must establish:

(a) obligations that the entity must satisfy; and

(b) the entity’s right to receive from customers a determinable amount in exchange for satisfying those obligations.

A5. To link the right to receive from customers a determinable amount to the obligations to be satisfied in exchange for that amount, the regulatory agreement must include a rate-setting mechanism that:

(a) establishes how the regulated rate is calculated, which identifies the basis of the rate calculation in terms of the entity’s regulatory obligations; and

(b) an adjustment mechanism to:

(i) correct for variances from estimates;

(ii) apply bonuses and penalties; and

(iii) adjust the timing of when the entity is allowed to bill the customer-base.

A6. The model focuses on the entity’s regulatory rights and obligations by recognising only those regulatory adjustments that:

(a) reflect the rate regulator’s intervention in establishing the rate(s) to be charged to customers; and

(b) are enforceable by either the entity or the rate regulator.

A7. Enforceability of the regulatory agreement is necessary to support the existence of the rights and obligations contained in it. Enforceability also influences how and when any regulatory balance reverses and the probability that reversal will be achieved fully through the regulated rate. Users consider such probability when assessing the entity's operating risks and the timing and certainty of the entity's cash flows. The model proposes disclosure in the notes that will inform that assessment.[8]

A8. The concept of the 'customer-base' supports the probability of reversal, through the rate-setting mechanism, of any regulatory balance recognised. This is because the risk of failing to reverse regulatory balances relating to individual customers that may cease to consume the regulatory goods or services falls on the customer-base, not on the entity.

Steps in the model

A9. To achieve the core objective of the model, the entity needs to apply a number of steps to identify:

- (a) whether the regulatory agreement includes a relevant rate-setting mechanism;
- (b) what regulatory obligations are enforceable through the regulatory agreement; and
- (c) how the amount chargeable to customers relates to the satisfaction of those regulatory obligations.

A10. The entity identifies any amounts charged or chargeable to customers up to the reporting date that reflect the origination and reversal of timing differences between:

- (a) the entity's performance (by transferring goods or services to customers or other parties); and

[8] IFRS 14 *Regulatory Deferral Accounts* contains requirements for disclosures that staff propose to carry forward into the new model.

(b) the performance of the entity's customers (by consuming goods or services or making payments).

A11. Regulatory adjustments are recognised for amounts attributable to such timing differences. Some judgement may be needed in this attribution, particularly if the rate regulator applies a 'haircut' or discount to the regulated rate. This may arise when the sum of all the components of a rate application is higher than the total amount ultimately allowed to be recovered through the regulated rate. Except when an entity has observable evidence that the entire discount relates to only one or more, but not all, regulatory obligations, the entity applies judgement to allocate the discount proportionately on a systematic basis.

A12. Once the entity has completed the above steps, it is in a position to identify any regulatory adjustments to be recognised using the model.

A 'supplementary' approach—revenue

A13. The model supplements the requirements of other IFRS Standards. As a result, the entity applies IFRS 15, without modification, to recognise revenue from contracts with customers, before applying the model. This means that the entity will recognise revenue when (or as) the entity satisfies a performance obligation to customers using the contractual rate, ie the regulated rate. This means that the amount of revenue recognised (P x Q) is based on the regulated rate (P) and the quantity (Q) of goods or services transferred to individual customers during the period.

A14. The entity then recognises increases/decreases in its regulatory assets/liabilities arising from the origination or reversal of timing differences during the period. The model proposes that the entity recognises a net regulatory adjustment for the corresponding net movement in regulatory assets/liabilities. The model also proposes that the entity:

(a) presents the net regulatory adjustment separately from the revenue recognised in accordance with IFRS 15; and

(b) discloses in the notes to the financial statements an analysis and description of the timing differences included in the net adjustment.

A15. The origination and reversal of timing difference included in the net adjustment may represent:

(a) goods or services:

(i) transferred to customers in past periods; and

(ii) to be transferred to customers in future periods.

(b) goods, services or other economic benefits

(i) transferred to the rate regulator or other parties during the period;

(ii) transferred to the rate regulator or other parties in past periods; and

(iii) to be transferred to the rate regulator or other parties in future periods.

A16. The model uses a historical cost measurement basis. When the entity performs later than the customer-base, it recognises the originating timing difference as a regulatory liability. The regulatory liability is measured at the higher of the amount charged to customers and the cost expected to be incurred in fulfilling the related regulatory obligation in future periods. When the entity performs earlier than the customer-base, it recognises the originating timing difference as a regulatory asset. The regulatory asset is measured at the amount agreed, or expected to be agreed, by the regulator that can be charged to customers in future periods in respect of the regulatory obligation already performed.

A17. The entity must consider, when assessing whether a regulatory balance is expected to be included in establishing the future rate, the enforceability of the rate regulation. The assessment must consider the period over which the balance is expected to be reversed through rates and the risk that circumstances, including the enforceability of the rate regulation, may change through that period. This is particularly so for some longer-term items for which reversal of the timing difference is spread through rates over several years. At each reporting date, the entity must review, for all identified timing differences, its assessment about the reversal of the timing difference through amounts included in future rates. The regulated balances recognised will be adjusted, if appropriate, to reflect any changes due to new or revised facts and circumstances.

Regulatory obligations related to the entity's own assets

A18. A significant aspect of the entity's regulatory obligation is to be able to deliver specified goods or services to customers *on demand*. This means that the entity needs to ensure that it has the assets and infrastructure in place to ensure that it is able to transfer rate-regulated goods or services to customers without disruption to supply. This typically requires significant investment in the maintenance, replacement and enhancement of assets required to produce and/or deliver the regulated goods or services.

A19. When establishing the regulated rate, the rate regulator typically considers the programme of maintenance, replacement and enhancement of assets needed to ensure the continuity of supply. The rate regulator ensures that the entity is provided with sufficient funding for such investment activities by using the regulated rate and/or other funding sources, such as government grants. This funding might be in advance or in arrears of the investment occurring.

A20. The model proposes that, whatever method is used by the rate regulator to fund allowable maintenance, replacement and enhancement activities, the principles to be applied to the accounting treatment of the related costs and funding is the same. The following paragraphs outline the model's proposed requirements for recognising assets and liabilities arising from such activities and the related funding received/receivable.

Recognising assets from activities that maintain, repair or enhance the entity's own assets

A21. Activities that result in the entity incurring maintenance, replacement or enhancement costs do not directly transfer goods or services to customers or other parties. Instead, they maintain, generate or enhance resources of the entity (ie its own assets) that will be used in satisfying (or in continuing to satisfy) its obligations to transfer economic benefits to customers, the rate regulator or other parties in the future, ie satisfying its regulatory obligations. The model proposes that such costs be identified as 'costs incurred to fulfil a regulatory agreement'.[9]

A22. If the costs incurred in fulfilling the entity's regulatory obligations are capitalised as an asset within the scope of another IFRS Standard (for example IAS 2 *Inventories*, IAS 16 *Property, Plant and Equipment*, IAS 38 *Intangible Assets* or IFRS 15), the entity accounts for those costs in accordance with those other Standards.

A23. If, instead, the entity carries out activities that lead to it incurring costs in fulfilling a regulatory obligation that are not capitalised as an asset within the scope of another IFRS Standard, the model proposes that the entity recognises an asset from those costs if the costs:

(a) relate directly to the regulatory agreement;

(b) generate or enhance resources of the entity that will be used in satisfying (or in continuing to satisfy) regulatory obligations in the future; and

(c) are expected to be recovered through the regulated rate mechanism.

A24. Any asset recognised from the maintenance, replacement and enhancement costs incurred in fulfilling a regulatory obligation is amortised on a systematic basis that is consistent with the transfer to customers of the goods or services to which the asset relates.

Recognising liabilities from funding received/receivable for activities that maintain, repair or enhance the entity's own assets

A25. The rate regulator determines when an entity receives the funding required to carry out the investment activities that maintain, repair or enhance the entity's own assets. This funding might be in advance or in arrears of the investment occurring. The model proposes that the entity recognises a regulatory liability or regulatory asset for timing differences between the entity's performance (by satisfying its regulatory obligations) and the performance of the customer-base

[9] Paragraphs 95-104 of IFRS 15 provide requirements to account for 'costs to fulfil a contract'. The staff's proposals for the treatment of costs to fulfil a regulatory agreement apply similar principles to those IFRS 15 requirements.

and the rate regulator (by consuming the regulated goods or services or making payments).

A26. Paragraphs 28-32 outline the requirements of IAS 20 for dealing with the receipt of a government grant. The requirements reflect that the government has performed, by making a payment, earlier than the entity has performed. The entity's performance is not the construction of its own asset, but the use of that asset in satisfying its regulatory obligations.

A27. The model uses the same principles if the customer-base pays in advance of the entity using the asset to transfer the related goods or services. Consequently, the model proposes that amounts charged to customers in advance of the entity's performance are recognised as a regulatory liability. This amount is then recognised in profit or loss on a systematic basis, usually on the same basis as the depreciation of the asset to which it relates.

Appendix B

The discussion with ASAF members at meetings between December 2014 and September 2016 have focused on a type of rate regulation termed 'defined rate regulation' in the Discussion Paper *Reporting the Financial Effects of Rate Regulation* (the DP). Paragraphs 4.4-4.7 provide the following overview.

Defined rate regulation—an overview

4.4 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. Defined rate regulation involves a regulatory pricing (ie rate-setting) framework that includes all of the following:

(a) it applies in situations in which customers have little or no choice but to purchase the goods or services from the rate-regulated entity because:

(i) there is no effective competition to supply; and

(ii) the rate-regulated goods or services are essential to customers (such as clean water or electricity).

(b) it establishes parameters to maintain the availability and quality of the supply of the rate-regulated goods or services and other rate-regulated activities of the entity.

(c) it establishes parameters for rates (sometimes referred to as prices or tariffs) that provide regulatory protections that:

(i) support greater stability of prices for customers; and

(ii) support the financial viability of the rate-regulated entity.

(d) it creates rights and obligations that are enforceable on the rate-regulated entity and on the rate regulator.

4.5 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.

4.6 For defined rate regulation, the mechanism used to calculate the regulated rate(s) includes a regulatory adjustment mechanism 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.

4.7 Consequently, some suggest that defined rate regulation creates a combination of rights and obligations that supports the recognition of the entity’s right to recover, or obligation to reverse, the specified differences as assets or liabilities in the statement of financial position. The remainder of this Section outlines the features of defined rate regulation and the combination of rights and obligations that relate to the rate-regulatory mechanism.