IFRS

STAFF PAPER

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IASB Meeting—education session

Project	**Rate-regulated Activities**		
Paper topic	Summary of the model's approach		

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Purpose of this education session

1. The purpose of this education session is to help clarify the description of the underlying basis for the development of a new accounting model to more faithfully represent financial effects of defined rate regulation. We are not asking the Board to make decisions about the model in this meeting. Instead, the paper asks the Board whether the description of the basis for our analysis is clear and whether it has any questions that could provide further clarity.

2. This paper contains:

   (a) Background (paragraphs 3-6);

   (b) A summary of:

      (i) the characteristics of the rate regulation that is referred to in this project as '**defined rate regulation**' (paragraphs 7-10);

      (ii) the relationship between the rights and obligations created by the regulatory agreement and those included in contracts with customers (paragraphs 11-16); and

      (iii) the underlying principle and general approach of a new accounting model designed to more faithfully represent financial effects of defined rate regulation (paragraphs 17-21);

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(c) Further information to support the summary (paragraphs 22-48);

(d) Proposed next steps (paragraphs 49-50);

(e) Questions for the Board (paragraph 51); and

(f) Appendix: [Draft] summary of feedback from the meeting with the Capital Markets Advisory Committee, held on 16 March 2017.

Background

3. In February 2017, the Board considered Agenda Paper 9A *The model's general approach*, which described the principles and general approach of an accounting model being developed for rate-regulated activities. That paper described the regulatory agreement as an executory contract between the entity and the 'customer base', being the past, present and future customers collectively. It also described a regulatory asset or regulatory liability as arising from an imbalance in performance between the entity and the customer base.

4. This description was influenced by feedback received on the Discussion Paper *Reporting the Financial Effects of Rate Regulation* and subsequent outreach. The feedback included requests to use principles for the model that are consistent with those in IFRS 15 *Revenue from Contracts with Customers*.

5. Some Board members suggested that introducing the notion of the customer base was complex and unnecessary. Some also suggested that describing regulatory assets and regulatory liabilities as arising from an imbalance in performance between the entity and the customer base was confusing. This confusion meant that other papers presented in the February Board meeting were not fully discussed. Those papers covered scope and recognition.

6. Although we have changed the description of the basis for the model to improve clarity, we consider the summary description presented in this paper to be consistent with the underlying basis presented in February's Board meeting. Consequently, we do not anticipate the outcome of the examples presented in Agenda Paper 9D *Illustrative Examples*, February 2017, to change as a result of the revised description presented in this paper.

Summary

Characteristics of 'defined rate regulation'

7. Regulation is broadly defined as the imposition of rules by government, backed by the use of penalties that are intended specifically to modify the economic behaviour of individuals and firms in the private sector. Economic regulations intervene directly in market decisions such as pricing, competition, market entry, or exit.[1]

8. In this project, we have been using 'defined rate regulation' as a label for a form of economic regulation established through a formal regulatory framework, which:

   (a) is binding on both the entity and the rate regulator;

   (b) imposes limitations on entry into an industry (and on exit from it);

   (c) establishes minimum service levels or other service requirements;

   (d) establishes the rate chargeable by an entity to its customers for the transfer of specified goods and/ or services; and

   (e) includes a rate adjustment mechanism that determines the amount of profit or profit margin the entity is entitled to retain. Such adjustments relate to:

      (i) the correction of past estimation variances; or

      (ii) the origination or reversal of temporary differences arising when the regulated rate in one period includes amounts relating to required activities carried out by the entity in a different period (see paragraphs 14-15).

9. Defined rate regulation is commonly used for services that governments consider essential for a reasonable quality of life for its citizens, such as the provision of clean and waste water services, electricity, some transport and communication services. Defined rate regulation generally is introduced when there are significant barriers to competition for supply because the provision of the services requires significant investment in infrastructure assets and networks and/ or there

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1 See Organization for Economic Cooperation and Development (OECD) Glossary of Statistical Terms.

are physical and other barriers to the creation of more than one infrastructure network.

10. The regulatory agreement between the rate regulator and the entity imposes regulatory requirements on the entity. These regulatory requirements are not restricted to the delivery of goods or services to customers during the current period. Instead, they include service requirements for more than one period and may also include other requirements relating to government-imposed social or environmental policies. The regulatory agreement also establishes the entity's entitlement to be compensated in exchange for satisfying its regulatory requirements. In defined rate regulation, the rate regulator uses the regulated rate as a mechanism to:

    (a) deliver to the entity the compensation to which it is entitled;

    (b) improve the stability and predictability of pricing for customers; and

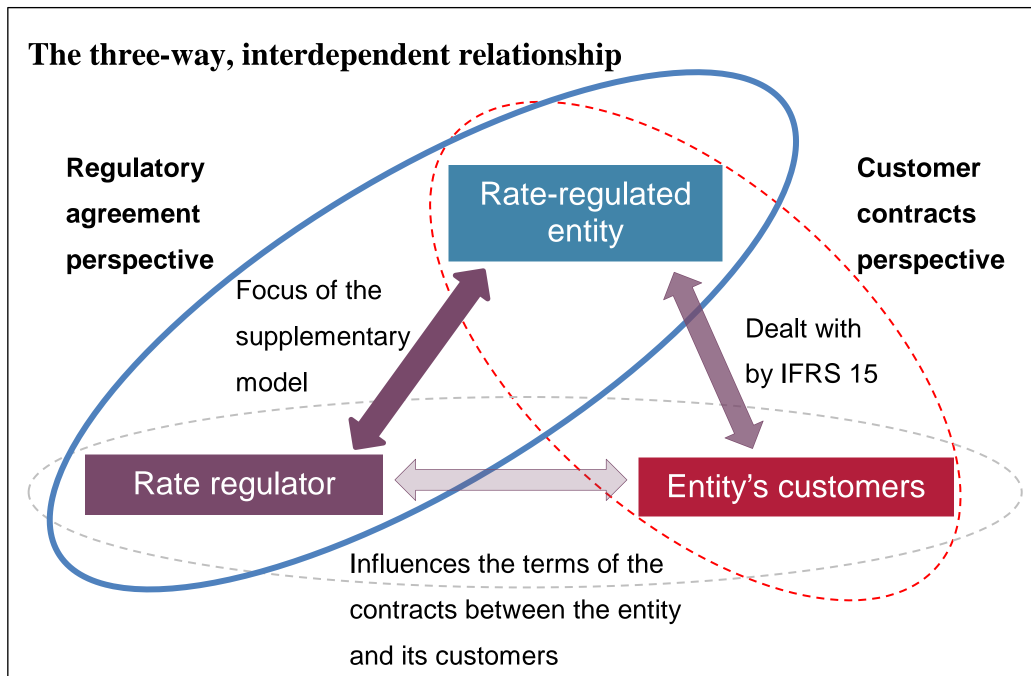
    (c) spread the cost of services across different classes of existing and future customers.

The regulatory agreement—customer vs entity perspective

11. In addition to establishing the entity's regulatory requirements and entitlement to compensation, the regulatory agreement also determines the terms and conditions of the contracts between the entity and its individual customers to achieve the aims of the mechanism described in paragraph 10. The rate regulator looks from two different perspectives to achieve these aims when establishing the regulated rate(s) to be charged to customers:

    (a) the customer contracts perspective; and

    (b) the regulatory agreement perspective.



12. From the customer contracts perspective, the rate regulator:

    (a) specifies a regulated rate chargeable to customers that is 'fixed' for goods and services supplied during a period; and

    (b) describes this regulated rate as relating wholly to the goods or services received by individual customers during the same period.

13. Consequently, from the customer contracts perspective, the entity satisfies its performance obligations by delivering goods or services in a specified period at a specified price (the regulated rate). The individual customers are obliged to pay, and the entity is entitled to receive, the amount billed in exchange for those goods or services, priced using the regulated rate.

14. However, from the regulatory agreement perspective, the rate regulator:

    (a) specifies that the regulated rate used in the individual contracts with customers is an estimated, not a fixed, price because the rate regulator will adjust the future rate to reflect allowable or chargeable estimation variances arising in the period;[2] and

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[2] Not all variances between estimated amounts and actual amounts will be reflected in the rate adjustment mechanism. In this paper, we refer to 'allowable estimation variances' to identify those amounts that the rate-setting mechanism will include in the rate calculation to increase the regulated future rate. Similarly, we refer to 'chargeable estimation variances' to identify those amounts that the rate-setting mechanism will include in the rate calculation to decrease the regulated future rate.

(b) determines what amounts included in the regulated rate relate to the various activities that the entity carries out to satisfy the regulatory requirements established by the regulatory agreement. The regulated rate described in paragraph 13 may, therefore, include amounts that reflect the delivery of goods or services to customers in past and/ or future periods.

15. From the entity's perspective, the terms and conditions of the regulatory agreement create rights and obligations for the entity that supplement the rights and obligations established for the entity's relationship with individual customers in their contracts with the entity. This is because the regulatory agreement:

(a) gives the entity a right to increase a future rate if:

(i) an allowable estimation variance has arisen; or

(ii) the entity has satisfied, or partially satisfied, a regulatory requirement but the rate regulator has not yet included in the regulated rate an allowable amount relating to that requirement; and

(b) imposes on the entity an obligation to reduce a future rate if:

(i) a chargeable estimation variance has arisen; or

(ii) the rate regulator has included in the current regulated rate an allowable amount relating to a regulatory requirement that has yet to be satisfied.

16. The supplementary rights described in paragraph 15(a) will be settled by customers paying the increased regulated rate for future goods or services. The supplementary obligations described in paragraph 15(b) will be fulfilled by the entity transferring goods or services at the reduced regulated rate.

Principle and general approach of the model

17. IFRS 15 *Revenue from Contracts with Customers* is the applicable IFRS Standard to account for the entity's contracts with individual customers (see paragraphs 12-13). This project focuses on the entity's regulatory agreement with the rate regulator, viewed from the entity's perspective (see paragraphs 14-16).

18. The principle of the model is to recognise the supplementary rights and supplementary obligations arising from the regulatory agreement that are created when the satisfaction of a regulatory requirement, or the transfer of goods or services to customers, establishes a right or obligation to charge a higher or lower regulated rate in a future period.

19. The model results in the primary financial statements presenting information that reflects the nature and amount (and perhaps timing) of adjustments to the regulated future rate and related cash flows.

    (a) The statement of financial position reports the rights to increase, and obligations to decrease, the regulated rate for future periods described in paragraph 15.

    (b) The statement(s) of financial performance report(s) **temporary** differences between the amount of profit to date that the entity is entitled to retain when viewed from the regulatory agreement perspective and the amount of profit when viewed from the customer contracts perspective. As described in paragraph 14, such temporary differences arise when:

        (i) variances between actual and estimated amounts will be corrected through an adjustment to the future rate; or

        (ii) the regulated rate charged to customers during one period includes an amount relating to a regulatory requirement that the entity satisfies in a different period.

20. The model supplements existing IFRS Standards. This means that a regulatory asset or regulatory liability will be recognised using the model only to reflect the supplementary rights and obligations outlined in paragraph 15. Consequently, a rate-regulated entity will apply the requirements of other IFRS Standards, without amendment, before applying the model. This includes applying the requirements of IFRS 15 to depict the rights and obligations contained in contracts with individual customers (from the customer contract perspective).

21. We suggest that the model should be contained in a separate IFRS Standard to replace IFRS 14 *Regulatory Deferral Accounts*.[3] This will emphasise the supplementary nature of the model and eliminate the risk of unintended consequences for those entities that do not have activities that are subject to defined rate regulation.

Further information to support the summary

The regulatory agreement

22. The model focuses on reflecting the entity's rights and obligations created by a regulatory agreement that is binding on both the entity and the rate regulator. The regulatory agreement may take the form of a contractual licensing agreement signed by both parties. Alternatively, it may be imposed through statute.

23. The regulatory agreement identifies what goods or services are subject to the rate regulation. It also establishes quality, safety or other performance specifications for them. Such performance specifications commonly require the entity to deliver the specified goods or services continuously or *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 the rate-regulated goods or services to customers without disruption to supply.

24. In addition, the regulatory agreement may also impose social or environmental requirements on the entity, for which the rate regulator promises that the entity will be entitled to compensation through the regulated rate chargeable to customers.

25. The rate regulator establishes, usually in consultation with the entity, the necessary capital expenditure and operating expenditure that the entity is expected to incur over a specified period to satisfy its regulatory requirements. Such

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[3] IFRS 14 is a temporary IFRS Standard that permits first-time adopters to continue to recognise amounts related to rate regulation in accordance with their previous GAAP requirements when they adopt IFRS Standards. However, to enhance comparability with entities that already apply IFRS Standards and do not recognise such amounts, IFRS 14 requires that the effect of rate regulation must be presented separately from other items.

budgets and forecasts will be based on expected levels of demand for the regulated goods or services, together with targeted performance levels.

26. Having determined the expected costs to the entity of satisfying its regulatory requirements, the rate regulator establishes how much compensation the entity is entitled to in exchange. The rate regulator also establishes the payment schedule for the entity’s reporting period(s) covered by the regulatory agreement, and that schedule determines the regulated rate. As noted in paragraph 10, in setting the regulated rate, the rate regulator typically looks to improve the stability and predictability of pricing for both customers and the entity by spreading the cost of services across various classes of existing and future customers.

27. As a result, the entity may, through the regulatory agreement, be:

    (a) required to carry out activities in a future period for which it has already billed customers (through the regulated rate) in the current (or past) period; and/ or

    (b) entitled to bill customers (through the regulated rate) in a future period for activities it has already carried out, as required by the regulatory agreement.

Estimation adjustments

28. As noted in paragraph 14, the regulated rate is an estimated price, not a fixed price, when viewed from the perspective of the entity in the light of the regulatory agreement. Estimation adjustments can arise due to variances between actual and estimated costs or between actual and estimated quantities or both. The rate-setting mechanism prevents the entity from making corrections to the regulated rate immediately. Instead, the regulated rate is adjusted in a later period or periods.

29. When the rate-setting mechanism adjusts the regulated rate for specified variances between estimated and actual amounts, the regulatory agreement operates in a

similar way to a cost-plus contract.[4] From the perspective of the entity, the original regulated rate is a preliminary transaction price, which is adjusted to reflect the actual costs that are specified in the regulatory agreement as being reimbursable.

Example—input price estimation adjustment

30. Entity W is a water utility company and is subject to defined rate regulation. The rate-setting mechanism allows Entity W to recover the actual input cost incurred for chemicals used in treating waste water. As a result, the entity tracks any variances from the estimated input cost included in the current rate calculation. Any variance is included in a future regulated rate calculation.

31. The rate regulator anticipates that the input cost for the water treatment chemicals will be CU30,000 for the year ended 31 December 20X1.[5] This amount is included in the rate calculation and is billed to customers during 20X1. However, the input cost actually incurred was CU32,000, resulting in an allowable variance of CU2,000. During 20X2, the input cost actually incurred is CU30,000.

32. Without the proposed model, Entity W recognises a 'loss' of CU2,000 in 20X1 but then recognises a 'profit' of CU2,000 in the next year when the increased rate is billed to customers.

33. Using the model, the entity will, at 31 December 20X1, recognise a regulatory asset of CU2,000, together with a rate adjustment (a regulatory credit adjustment) in profit or loss.[6] This rate adjustment and related asset reflect Entity W's right to bill customers (through the regulated rate) in a future period an additional amount for goods and services delivered during 20X1. The regulatory asset and the related profit or loss rate adjustment reverse in the next year when the increased rate is billed to customers.

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4 Paragraph 3 of IAS 11 *Construction Contracts* defines a cost plus contract as 'a construction contract in which the contractor is reimbursed for allowable or otherwise defined costs, plus a percentage of these costs or a fixed fee'.

5 In this Staff Paper, currency amounts are denominated in 'currency units' (CU).

6 At a future Board meeting, staff will bring a paper to discuss how any rate adjustment in profit or loss should be described and presented.

34. Entity W records the following at 31 December:

Year to 31 December 20X1	**CU**
Existing IFRS Standards	
Revenue (amounts billed)	30,000
Operating expenses	(32,000)
Loss	(2,000)
Proposed model	
Revenue (amounts billed)	30,000
Rate adjustment: amounts to be billed in future periods for goods or services delivered in the current period	2,000
Operating expenses	(32,000)
Profit	0
Regulatory asset	2,000

Year to 31 December 20X2	**CU**
Existing IFRS Standards	
Revenue (amounts billed)	32,000
Operating expenses	(30,000)
Profit	2,000
Proposed model	
Revenue (amounts billed)	32,000
Rate adjustment: amounts billed in the current period for goods or services delivered in the prior period	(2,000)
Operating expenses	(30,000)
Profit	0
Regulatory asset	0

Estimation adjustments—bonus or penalty

35. As well as adjusting the regulated rate to reflect variance corrections between estimated and actual costs or quantities, the regulatory agreement may also adjust the original estimated rate to reflect a penalty or bonus if the entity fails or exceeds specified targets. In such cases, the estimated rate assumes that the entity will achieve a minimum service level target. If the entity fails to meet the target, the entity will suffer a penalty. If the entity exceeds the target, it will earn a

bonus. The rate-setting mechanism reduces or increases the regulated rate to deliver the penalty or bonus.

36. In essence, failing to meet a service level target is an unauthorised price increase: instead of charging a specified price for a specified level of service, the entity charges the same price for a lower level of service. The penalty is a mechanism that obliges the entity to pay back the amount overcharged.

Example—penalty estimation adjustment

37. The regulatory agreement includes a target for water quality. The regulated rate set for the year-ended 31 December 20X1 assumes that Entity W will meet, but not exceed the quality target. The regulatory agreement specifies that Entity W is entitled to a bonus of CU20,000 if it exceeds the quality target, or will suffer a penalty of CU24,000 if it fails to meet the target. The bonus or penalty will be applied through an increase or reduction of the regulated rate in the next year.

38. During 20X1, Entity W failed to meet its water quality target and suffered a penalty of CU24,000. In addition, the rate regulator decided that, because of the severity of the contamination and related disruption to customers, Entity W would have to pay CU15,000 cash back to the customers affected. During 20X2, Entity W met the water quality target.

39. Without the proposed model, Entity W recognises only the obligation to pay cash back. As a result, Entity W recognises, in 20X1, CU24,000 in profit that it is not entitled to retain and then recognises a 'loss' of CU24,000 in the next year when the reduced rate is billed to customers.

40. Using the model, Entity W also recognises a regulatory liability for the penalty, together with a rate adjustment (a regulatory debit adjustment) in profit or loss to reflect that it failed to deliver to customers the required quality of water during 20X1. The regulatory liability and the related profit or loss rate adjustment reverse in the next year when the reduced rate is billed to customers.

41. Entity W records the following at 31 December 20X1:

Year to 31 December 20X1	**CU**
Existing IFRS Standards	
Revenue (amounts billed)	xx
Operating expenses: penalty to pay cash back	(15,000)
Loss	(15,000)
Proposed model	
Revenue (amounts billed)	xx
Operating expenses: compensation to customers	(15,000)
Rate adjustment: penalty for delivering a lower level of service than has been billed for during the period.	(24,000)
Profit	(39,000)
Regulatory liability	(24,000)

Year to 31 December 20X2	**CU**
Existing IFRS Standards	
Revenue (amounts billed reduced by penalty)	(24,000)
Operating expenses	(xx)
Loss	(24,000)
Proposed model	
Revenue (amounts billed reduced by penalty)	(24,000)
Operating expenses	(xx)
Rate adjustment: reversing penalty applied in prior period for delivering a lower level of service than was billed for during that period.	(24,000)
Profit	0
Regulatory liability	0

Temporary adjustments

42. As noted in paragraph 10, the rate regulator aims to improve the stability and predictability of pricing for customers and to spread the cost of services across various classes of existing and future customers. As a result, the rate regulator uses the regulated rate to determine when the entity bills customers amounts relating to activities that the entity is required to carry out to satisfy its regulatory requirements. This means that, from the perspective of the entity and its regulatory agreement, the timetable for when amounts are included in the

regulated rate and are billed to customers may differ from the timetable for when the entity actually carries out the specified activities.

Example—temporary adjustment

43. For the four-year period 1 January 20X1 through 31 December 20X4, Entity W is required to carry out an agreed programme of maintenance on the network of pipes supplying water to customers' premises and removing waste water from those premises. The estimated cost of the agreed work is CU200,000.

44. Entity W can choose when, during the four-year period, to carry out the work. The rate regulator decides that the cost will be spread evenly for customers through the regulated rate in each of the four years, 20X1-20X4. As a result, Entity W receives CU50,000 each year through the amounts billed to customers for the delivery of water services.

45. During the three years 20X1-20X3, Entity W does not carry out any of the agreed maintenance work on the network of pipes. Instead, the entity completes all of the agreed works during 20X4. The work costs CU200,000.

46. Without the proposed model, Entity W recognises a profit of CU50,000 for each of the three years 20X1-20X4 but then recognises a loss of CU150,000 in 20X4.

47. Using the model, Entity W will recognise a regulatory liability of CU50,000 at 31 December 20X1, together with a related rate adjustment (a regulatory debit adjustment) in profit or loss. During each year 20X2 and 20X3, Entity W will increase the carrying amount of its regulatory liability by CU50,000 each year because the entity has collected that further amount from customers but has not yet satisfied the requirement to carry out the agreed maintenance work. During 20X4, Entity W carries out the agreed maintenance work. This settles the regulatory liability, which is, therefore, derecognised by the end of 20X4.

48. Entity W records the following at 31 December:

Each year to 31 December 20X1, 20X2 and 20X3	CU
Existing IFRS Standards	
Revenue (amounts billed)	50,000
Operating expenses	(—)
Profit	50,000
Proposed model	
Revenue (amounts billed)	50,000
Rate adjustment: amounts billed in the period for work to be performed in future periods.	(50,000)
Operating expenses	(—)
Profit	0
Regulatory liability	50,000

Year to 31 December 20X4	CU
Existing IFRS Standards	
Revenue (amounts billed)	50,000
Operating expenses	(200,000)
Loss	(150,000)
Proposed model	
Revenue (amounts billed)	50,000
Rate adjustment: amounts billed in prior periods for work performed in this period.	150,000
Operating expenses	(200,000)
Profit	0
Regulatory liability	0

Proposed next steps

49. We will revisit the analysis in the papers presented in the February Board meeting on scope and recognition. The revised papers will reflect the clarified description of the basis for the model. We will also reconsider our recommendation to include a 'recoverability hurdle' within the recognition criteria. Instead of that recommendation, we will consider recoverability in the wider context of uncertainty and its effect on recognition and measurement.

50. We expect to bring papers for further Board discussions on the following topics:

(a) Measurement, impairment and derecognition;

(b) Presentation and disclosure;

(c) Interaction with other IFRS Standards, including IFRS 3 *Business Combinations* and IFRIC 12 *Service Concession Arrangements*;

(d) Assessment of the model's consistency with the [revised] *Conceptual Framework*;

(e) Comparison with Topic 980 *Regulated Operations* (Topic 980) in the FASB Accounting Standards Codification®; and

(f) Transition and withdrawal of IFRS 14 *Regulatory Deferral Accounts*.

Questions for the Board

51. We do not ask the Board to make decisions about the model at this meeting.

Questions for the Board
Do you consider the revised summary of the basis for the model is clear? Do you have any questions about the basis for the model that need to be clarified before we bring papers to future Board meetings asking for decisions about the mechanics of the model? Are there furthers topics that you would like us to bring to future Board meetings, in addition to those listed in paragraphs 49-50

Appendix-[Draft] summary of feedback from the meeting with the Capital Markets Advisory Committee (CMAC) held on 16 March 2017.

A1. CMAC members discussed examples in which application of the model would result in the recognition of regulatory assets and regulatory liabilities. The following paragraphs reproduce the draft notes of the meeting, which have yet to be reviewed and ratified by CMAC members.

> The purpose of the session was to obtain the CMAC members' views on the usefulness of recognising regulatory assets and regulatory liabilities for understanding the financial position, performance and expected cash flows of an entity subject to defined rate regulation. Agenda Paper 4 provides three examples in which a regulatory asset or regulatory liability could be recognised using an accounting model being developed by the Board.[7]
>
> The resulting discussion highlighted the following points:
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> - CMAC members had mixed views on the usefulness of recognising regulatory assets and regulatory liabilities:
>   - some CMAC members, particularly those that track investments in rate regulated industries, felt strongly that regulatory assets and regulatory liabilities should be recognised in the primary financial statements. They suggested that failing to do so could be misleading when the collection of cash from customers through the regulated rate in the current period includes amounts relating to expenses to be incurred in future periods, or vice versa;
>   - other CMAC members suggested that providing the information through disclosures, without recognition in the primary financial statements, would be a better approach because of the level of judgement involved in many issues regarding the rate regulation, including recoverability uncertainty, measurement

[7] The three examples discussed by CMAC members are similar to those presented in this paper.

uncertainty and possible problems in constraining the scope of the model.

- many CMAC members acknowledged the importance of understanding the nature of the rate regulation, how any adjustment to the regulated rate reflects past versus future events, and the level of uncertainty about the effectiveness of the rate regulation, particularly for the recoverability of any regulatory assets arising.
  - some CMAC members noted that many items in the primary financial statements require much judgement but it is better to apply that judgement in the primary financial statements and provide accompanying disclosures describing the judgements and estimates used;
  - other CMAC members again preferred a disclosure-only approach.

Next steps

The Board will consider the CMAC discussion and advice as it develops the proposed accounting model.