

## STAFF PAPER

December 2017

## IASB Meeting

Project	Rate-regulated Activities		
Paper topic	Summary of information received from the Consultative Group		
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This paper has been prepared for discussion at a public meeting of International Accounting Standards Board (the Board). The views expressed in this paper do not represent the views of the Board or any individual member of the Board. Comments on the application of IFRS<sup>®</sup> Standards do not purport to set out acceptable or unacceptable application of IFRS Standards. Technical decisions are made in public and reported in IASB<sup>®</sup> *Update*.

**Purpose of the paper**

1. The purpose of this paper is to inform the Board about the key messages received from members of the Consultative Group for Rate Regulation (CGRR) at the meeting held on 26 October 2017. The paper reproduces the meeting summary prepared by IASB staff, which is available on the IFRS Foundation<sup>®</sup> website.

## STAFF PAPER

October 2017

**Consultative Group for Rate Regulation  
Meeting**

Project	Rate-regulated Activities		
Paper topic	Summary of information received from the Consultative Group		
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This note is prepared by staff of the International Accounting Standards Board (the Board), and summarises the discussion that took place with the Board's Consultative Group for Rate Regulation.

**Purpose of this paper**

1. The purpose of this paper is to provide a summary of the information received from the Consultative Group for Rate Regulation at the meeting held on 26 October 2017.<sup>1</sup> At that meeting we discussed different aspects of the new accounting model (the model) being developed for rate-regulated activities with the aim of gathering:
  - (a) Consultative Group members' views on the clarity and completeness of some of the features of the model as discussed so far with the Board;  
and
  - (b) information about the application of rate regulation, including operational aspects, to help develop some features of the model in more detail.<sup>2</sup>

<sup>1</sup> The papers discussed with the Consultative Group for Rate Regulation can be found at: <http://www.ifrs.org/news-and-events/calendar/2017/october/consultative-group-for-rate-regulation/> A full [recording of the meeting](#) is available on the IFRS Foundation® website.

<sup>2</sup> This paper incorporates comments received during the meeting and in follow up emails, including comments from members that could not attend the meeting (see Appendix).

## Structure of this paper

2. The information received from the members is summarised according to the aspects of the model they relate to:
  - (a) scope (paragraphs 3–6);
  - (b) rights and obligations (paragraphs 7–11);
  - (c) uncertainty (paragraphs 12–18);
  - (d) identifying interest rate or return rate (paragraphs 19–22); and
  - (e) presentation and disclosure (paragraphs 23–26).

## Scope

3. We asked the members whether the description of ‘defined rate regulation’ being used in the Board’s discussions is sufficiently clear to enable entities to identify whether they have activities within the scope of the model.
4. The Board has been using the following description:

**Defined rate regulation** is a form of economic regulation established through a formal regulatory framework that imposes limitations on entry into an industry (and on exit from it) and that:

- (a) is binding on both the entity and the **rate regulator**;<sup>3</sup>
- (b) establishes a basis for setting the regulated rate chargeable by an entity to its customers for the transfer of specified goods and/ or services that comply with minimum quality levels or other service requirements; and
- (c) includes, as part of the basis for setting the regulated rate, a rate-adjustment mechanism that creates and reverses temporary differences

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<sup>3</sup> IFRS 14 *Regulatory Deferral Accounts* contains the following definition of ‘rate regulator’: ‘An authorised body that is empowered by statute or regulation to establish the rate or a range of rates that bind an entity. The rate regulator may be a third-party body or a related party of the entity, including the entity’s own governing board, if that body is required by statute or regulation to set rates both in the interest of the customers and to ensure the overall financial viability of the entity’. The Board has not yet discussed whether this definition should be retained or amended.

when the regulated rate in one period includes amounts related to specified activities the entity carries out in a different period.

5. The members generally suggested that, subject to the clarification of the items described below, the description captures what they thought should be captured within the scope of the model and is sufficiently clear to enable entities to identify whether they have activities within the intended scope of the model:

(a) the phrase ‘imposes limitations on entry into an industry (and on exit from it)...’ is subjective, reduces clarity and may inadvertently exclude some entities that would otherwise meet the criteria. Members illustrated this point through an example. In that example, the stability of supply in a power generating market is being ensured mainly by the largest entity, which is rate regulated. This entity is subject to rate regulation that employs a rate-adjustment mechanism. There are several smaller entities that supply power to cover demand peaks. Those entities are not rate regulated and there is no explicit or regulator-imposed limitation on entry into the market. However, the economies of scale of the rate-regulated entity, and its role in ensuring the stability of the power supply in the market, support the effective operation of the rate regulation imposed on that entity. Members questioned whether the ability of the smaller entities to enter that market should exclude the rate-regulated entity from the scope of the model.

A member also commented that a limitation on entry does not underpin whether an asset or liability is originated but, instead, relates to measurement uncertainty and recoverability.

(b) a more explicit link to the definition of ‘rate regulator’ could help to assess whether an entity could be in the scope of the model when statute or regulation provides a framework requiring the entity’s own governing body to set rates both in the interest of the customers and to ensure the entity’s overall financial viability.

6. Members also commented that:
- (a) the description should clarify whether the intention is to capture activities (either a portion of an entity's activities or all of an entity's activities) or particular transactions;
  - (b) the use of the term 'chargeable' in bullet (b) of the description could suggest that an entity has flexibility about the rate to charge, which could create some tension with what is typically understood by rate regulation (ie the entity is bound by rates established by a rate regulator);
  - (c) the term 'temporary' was found confusing and the term 'timing' was generally preferred instead; and
  - (d) the provision of examples to illustrate activities both within and outside the scope could be helpful.

## **Rights and obligations**

7. As previously discussed with the Board, the model aims to account for the rights and obligations created by the rate-adjustment mechanism, by recognising regulatory assets and regulatory liabilities. This is because the rate-adjustment mechanism creates a direct cause-and-effect relationship between the entity's **past** transactions or other events and the entity's **present** right to charge a higher rate, or obligation to charge a lower rate, for goods or services to be delivered to customers in the **future**.<sup>4</sup>
8. With this context in mind, we asked members to provide information about how entities identify rate-adjustment amounts and how individual rate-adjustment balances are tracked through amounts billed to customers.
9. The members stated that the terms of the regulatory agreements are typically clear enough to identify most temporary differences that qualify to be included in the rate-adjustment mechanism.

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<sup>4</sup> The rights/obligations arising from the rate-adjustment mechanism are consumed/ fulfilled as the entity includes the rate increase/ decrease in a future regulated rate that is charged to customers on the future delivery of goods or services.

10. In addition, the detailed record-keeping requirements that rate-regulated entities have to fulfil enable identification and tracking of individual adjustments from origination to the unwinding through amounts billed to customers under both cost-based and incentive-based regulation.
11. Members emphasised the need for regulated entities to keep detailed records to ensure control of billings and also to enable the monitoring, supervision and audit by the rate regulators.

## **Uncertainty**

12. We asked members to provide information about the sources of uncertainty arising from the rate-adjustment mechanism and how such uncertainty is dealt with in practice, for both regulatory and financial reporting purposes, when recognising and measuring rate adjustments.
13. Members suggested that the regulatory agreement generally states clearly the items to be included in the rate-adjustment mechanism, limiting the level of uncertainty.
14. The main source of uncertainty arises from whether the rate regulator will approve rate adjustments for items or amounts that an entity did not include in the budgets/forecasts used to support a previous rate determination and for which variances from estimated amounts are not mentioned explicitly in the rate-adjustment mechanism. Part of this uncertainty relates to whether the regulator will consider that the entity incurred costs, or undertook activities, in a prudent manner.
15. When deciding whether to recognise, using IFRS 14 *Regulatory Deferral Accounts* or local GAAP, regulatory assets or regulatory liabilities that have not yet been formally approved by the rate regulator:
  - (a) entities tend to use a threshold that approval is ‘more likely than not’ or ‘probable’ (some seem to use a threshold as high as a 70-75 per cent likelihood of approval); and
  - (b) the amount recognised is usually measured as the ‘most likely’ outcome. For example, if an entity estimates that there is an 80 per cent

probability of recovering CU100, the entity recognises CU100, not CU80.<sup>5</sup>

16. Entities typically consider a hierarchy of different factors when assessing the probability that a rate adjustment will be approved by a rate regulator, including:
- (i) existence of explicit requirements or guidance in legislation or regulation;
  - (ii) direct precedents—ie the entity’s past experience with the rate regulator in similar circumstances;
  - (iii) indirect precedents—such as the experience of other entities regulated by the same rate regulator or the decisions of other rate regulators in similar circumstances; and
  - (iv) advice from legal or experienced advisors.
17. Members also emphasised that there is typically frequent communication between the entity and the rate regulator. As a result, entities can usually obtain preliminary (non-binding) views from the rate regulator to help them assess the probability of approval.
18. Members noted that another factor limiting the level of uncertainty is that many regulatory assets and regulatory liabilities are relatively short-term in nature. There are two main exceptions to this:
- (a) regulatory assets arising from long-life infrastructure costs incurred (including both costs accounted for using IAS 16 *Property, Plant and Equipment* and costs expensed); and
  - (b) regulatory assets and regulatory liabilities arising from timing differences that arise when financial reporting recognises long-term liabilities or assets for items such as asset retirement obligations, pension obligations, or deferred taxation but regulatory accounting policies do not recognise those items until the entity pays or receives the related cash (see paragraph 22).

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<sup>5</sup> In this Agenda Paper, currency amounts are denominated in ‘currency units’ (CU).

## Identifying interest rate or return rate

19. We asked members to provide information about whether, and if so how, rate regulators compensate or charge an entity for the time-lag between the transaction or other event that originates a rate adjustment and the inclusion of that rate adjustment in the amounts billed to customers.
20. Members suggested that entities are typically compensated or charged for the time-lag between the transaction or event that originates a rate adjustment and the reversal of that adjustment through amounts billed to customers. Members commented that, when calculating the rate at which the entity will be compensated or charged for the time-lag, rate regulators typically:
  - (a) establish a weighted average cost of capital (WACC) rate to be applied to both short-term and long-term qualifying regulatory assets and regulatory liabilities;
  - (b) use a ‘deemed’ or benchmark capital structure to calculate the WACC; and
  - (c) use, as an input to the debt component of the WACC calculation, the entity’s borrowing rate or a market interest rate for a financial instrument (often a low-risk bond) with a maturity period similar to the expected time-period over which the regulatory asset or regulatory liability is expected to be reversed in amounts billed to customers.
21. Members also commented that:
  - (a) rate regulators have typically established procedures or policies to update regularly the interest or rates of return. When this happens, the new rates apply to both old and new regulatory assets and regulatory liabilities;
  - (b) some short-term regulatory assets and regulatory liabilities are subject to compensation or charge based on bank borrowing rates for prime borrowers, rather than the WACC; and
  - (c) requiring entities to discount regulatory assets or regulatory liabilities using an interest or rate of return that differs from the one established

by the rate regulator would cause operational complexities which may not outweigh the benefits of any other solution. Members questioned whether such a requirement would result in relevant information and questioned what any 'day one gain or loss' arising from discounting future cash flows at a different rate would represent.

22. Members also commented that regulatory assets and regulatory liabilities may result from recognising long-term liabilities such as asset retirement obligations, pension obligations, and deferred taxation (see paragraph 18(b)). Those items are commonly reflected on a cash basis in amounts billed to customers. Consequently, the rate regulator does not need to identify a separate interest component because the entity has not yet suffered a cash outflow for which it needs to be compensated.

### **Presentation and disclosure**

23. We asked members to provide information about how feasible it is to disaggregate information about individual rate-adjustment account balances and to track when the balances are included in amounts billed to customers.
24. Members suggested that, because of the level of detail needed to comply with record-keeping requirements in regulatory agreements, it is typically feasible to:
- (a) disaggregate, in the notes, regulatory assets and regulatory liabilities presented as line items in the statement of financial position into material individual rate-adjustment account balances; and
  - (b) identify the timing of when regulatory assets and regulatory liabilities will be reflected in amounts billed to customers, enabling disaggregation of regulatory balances between current and non-current amounts.
25. Members also commented that:
- (a) presenting regulatory assets and regulatory liabilities and related movements on those items as separate line items within the statements of financial position and of financial performance was generally perceived as an improvement from the presentation requirements in

IFRS 14, which requires the line items to be separately presented below total assets, total equity and liabilities and profit for the period; and

- (b) the benefit of presenting movements in the balances of regulatory assets and regulatory liabilities as a separate line item in the statement(s) of financial performance, rather than presenting those movements within the revenue and/ or expenses lines, is unclear. Without guidance or requirements, this could result in diversity in the location and description of the line item (or items) presented and the use of sub-totals around the line item(s). Requiring reconciliations in the notes to the line item(s) in the primary financial statements could help.

- 26. A member suggested that the quality of disclosures provided by some entities has improved with the application of IFRS 14.

## APPENDIX—Consultative Group members

A1. As noted in footnote 2, this paper incorporates comments received during the meeting and in follow up emails, including comments from members that could not attend the meeting. The following Consultative Group members and official observers contributed to the information presented in the paper:

<b>NAME</b>	<b>ORGANISATION</b>	<b>Country</b>	<b>Attended</b>
Lily Ayalon	Ayalon Projects—Control and Consulting	Israel	By video
Leonardo George de Magalhães	Companhia Energética de Minas Gerais (CEMIG)	Brazil	No
Duane DesParte	Exelon Corporation	USA	In person
Dennis Deutmeyer	Ernst & Young LLP	Global (USA)	By video
Richard McCabe	RMM Management Solutions Inc	Canada	In person
Pascale Mourvillier	PAM Expertise	France	In person
Tim Murray	RBC Capital Markets / Royal Bank of Canada	Canada	In person
Michel Picard	KPMG	Global (Canada)	In person
POON Man Wah	CLP Power Hong Kong Ltd	Hong Kong	No
Michael Timar	PricewaterhouseCoopers	Global (UK)	In person
Phil Aspin	EFRAG (official observer)	Europe (UK)	By video
Bryan Craig	US Federal Energy Regulatory Commission—Office of Enforcement (official observer)	USA	In person