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Project	Rate-regulated Activities		
Paper topic	Cover note and summary of the model		

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Purpose of this meeting

1. In its December 2016 meeting, the Board considered an overview of staff's proposals for a new accounting model for rate-regulated activities. In this meeting we begin presenting our more detailed analysis to establish the scope of the model and its recognition criteria.

2. We present the following papers in this meeting:

   (a) Agenda Paper 9 *Cover note and summary of the model*—that is this paper, which presents some background information relevant to the session together with the planned next steps. The appendix reproduces the high level summary of the new accounting model, which was included in Agenda Paper 9 *Cover note and summary of the model* presented to the Board in its December 2016 meeting, updated for refinements included in the papers presented in this meeting.

   (b) Agenda Paper 9A *The model's general approach*—this paper summarises the objective, underlying principle and general approach of the model.

   (c) Agenda Paper 9B *Scope of the model*—this paper analyses criteria for the scope of the model.

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(d) Agenda Paper 9C *Recognition of regulatory assets and regulatory liabilities*—this paper analyses criteria for recognising regulatory assets and regulatory liabilities using the model.

(e) Agenda Paper 9D *Illustrative examples*—this paper analyses several examples to illustrate the application of the recognition criteria described in Agenda Paper 9C to a common range of regulatory adjustments.

Overview

3. The Discussion Paper *Reporting the Financial Effects of Rate Regulation* (the DP), published in September 2014, discussed various forms of rate regulation. These ranged from light-touch 'market regulation' to more pervasive 'defined rate regulation'.

4. Market regulation typically applies when competition in a market is insufficient to protect customers from suppliers making excessive profit. The rate regulator's intervention is usually restricted to imposing a cap on the price that can be charged for the specified goods or services. However, the rate regulator does not establish the total amount of revenue or profit that an entity can earn.

5. In contrast, the rate-setting framework for defined rate regulation establishes a 'revenue requirement' (sometimes called 'allowable revenue' or 'authorised revenue'), which is the total consideration that the entity is entitled to bill customers in exchange for carrying out specified rate-regulated. The rate regulation includes an adjustment mechanism that 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.

6. The majority of stakeholders that responded to the DP and subsequent outreach activities suggested that:

   (a) Market regulation restricts prices in a similar way to effective competitive forces and so does not create any specific rights or obligations that would need to be accounted for differently from those of entities that are not subject to such rate regulation.

(b) Defined rate regulation creates identifiable rights and obligations that are distinguishable from those of entities that are not subject to such rate regulation. Consequently, this type of rate regulation should be the focus of the Board's project to develop an accounting model because the distinguishable rights and obligations may not be faithfully represented by the existing predominant treatment in IFRS financial statements.

7. Supporters of developing a model to recognise regulatory assets and regulatory liabilities have long argued that, without recognising such assets and liabilities, the entity's performance is distorted by the rate regulator's intervention in the imposition of performance obligations on the entity and the timing of cash flows from the customer base. Opponents of developing such a model have questioned whether such regulatory assets and regulatory liabilities would meet the asset and liability definitions in the *Conceptual Framework*.

8. In addition, the feedback we received on the DP and from subsequent outreach events, together with extensive consultation with the Accounting Standards Advisory Forum (ASAF) has been clear that an accounting model developed to improve the financial reporting for the distinguishable rights and obligations created by defined rate regulation should:

(a) recognise as regulatory assets and regulatory liabilities only those regulatory adjustments that are consistent with the definitions of assets and liabilities in the *Conceptual Framework*;

(b) use the principles of IFRS 15 *Revenue from Contracts with Customers* to provide a principle-based framework for recognising regulatory adjustments; and.

(c) provide transparent and understandable information about the effects of the rate regulator's intervention on the entity's financial position, performance and cash flows.

9. In an education session at its December 2016 meeting, the Board discussed an overview of the model that we are developing. The summary presented in Agenda Paper 9 for that meeting is reproduced in the appendix of this paper.

Next steps

10. Staff will seek decisions from the Board in future meetings as we develop the model in more detail. We will update the summary in the appendix as the Board makes tentative decisions about the model.

11. We will also ask the Board in a future meeting whether the next consultation document for the project should take the form of a second Discussion Paper or an Exposure Draft.

Future issues to consider

12. 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*.

Appendix A: Summary of proposed model

This Appendix reproduces the summary that was presented to the Board in Agenda Paper 9 *Cover note and summary of the model* for the December 2016 meeting. Items that have been amended to reflect refinements contained in the papers presented at the February 2017 meeting are highlighted by shading.

Features of the basic model	Basis for proposals
Objective To inform users of financial statements about the nature, amount, timing and uncertainty of 'regulatory performance adjustments' and cash flows arising from a regulatory agreement between the entity and a rate regulator.	The rate regulator, through the regulatory agreement, imposes obligations on the entity to transfer specified goods and services to the entity's customers, the rate regulator or other designated parties. The rate regulator determines the amount and timing of the compensation/funding the entity is entitled to in exchange for performance of these regulatory obligations, ie the rate regulator determines the payment schedule for the period(s) covered by the regulatory agreement. The rate regulator uses the customer-base as a vehicle for transferring the agreed compensation/funding to the entity.
Core principle The core principle of the model is that an entity recognises 'regulatory performance adjustments' to depict the transfer of rate-regulated goods or services to the customer base in an amount that reflects the compensation to which the entity expects to be entitled in exchange for those goods or services.	The regulatory agreement establishes the entity's right and obligation to exchange resources with the **customer-base**. [1] At the start of the regulatory agreement, both parties, the entity and the customer-base, have equally unperformed under the agreement and so the regulatory agreement is executory. The payment schedule established by the regulatory agreement often does not reflect the work performed at each payment date and so leads to some amounts being received by the entity,

[1] The 'customer-base' is a notion that underpins the effectiveness of defined rate regulation and is used by the rate regulator when establishing the rate to be charged by the entity (see paragraphs 16-20 of Agenda Paper 9A *The model's general approach*, February 2017 for more details).

<table>
<tr><th>Features of the basic model</th><th>Basis for proposals</th></tr>
<tr><td>The model supplements, but does not override, other IFRS Standards. Consequently, all other IFRS Standards are applied first to the entity’s transactions, other events and conditions, including IFRS 15 Revenue from Contracts with Customers.

The model focuses on the effects of the rate regulation by capturing, through the recognition of assets and liabilities in the statement of financial position, the rights and obligations created by the rate regulator’s intervention in the setting of the rate chargeable to customers.</td><td>from the customer-base, in arrears and some being received in advance of the entity satisfying its related regulatory obligations. Consequently, as one party performs in a way that is disproportionate to the other, the agreement ceases to be executory and an asset or liability is recognised to reflect this difference in performance. Recognising these assets and liabilities gives rise to a corresponding entry in the income statement.

The accumulation of these corresponding income statement items reflects the net timing difference between the entity’s performance of its regulatory obligations and the funding of that performance by the customer-base. An asset represents the entity’s right to be compensated for past performance of regulatory obligations. A liability represents the entity’s obligation to satisfy specified regulatory obligations for which no further compensation, or reduced compensation, is receivable from the customer-base because some compensation has already been received.</td></tr>
<tr><td>Scope

The model is applied only to the regulatory adjustments that require:
• the entity to carry out activities that are subject to a formal regulatory pricing (ie rate-setting) framework that is binding on both the entity and the rate regulator; and;
• a regulatory pricing framework to include a rate-setting mechanism that:
  o establishes how the regulated rate is calculated;
  o identifies how the rate reflects the satisfaction of the entity’s regulatory obligations; and
  o adjusts the future regulated rate for the effects of imbalances in performance between the entity and its customer-base.</td><td>The revenue recognised in accordance with IFRS 15 is recognised and measured at P x Q, where:
- P is the regulated rate per unit agreed by the rate regulator; and
- Q is the quantity of goods/service delivered by the entity to individual customers during the period.

Any differences between the quantity delivered and the quantity billed to customers will be recognised in accordance with IFRS 15 as a contract asset/ receivable, or as a contract liability/ payable, as applicable.

This model recognises a regulatory asset or regulatory liability if the rate-setting mechanism is sufficiently clear that the regulated rate for a future period will be adjusted to reflect amounts that:
• are included in the regulated rate (P) for the current period but do not relate to the goods/services delivered by the entity to individual customers in the period; and/or
• are excluded from the regulated rate (P) for the current period but relate to</td></tr>
</table>

Features of the basic model	Basis for proposals
	the goods/services delivered by the entity to individual customers in the period. There are three main types of regulatory adjustment: • Estimation adjustments; • Bonus/ penalty adjustments; and • Performance timing difference adjustments.[2]
Recognition An entity recognises a regulatory asset or regulatory liability only when: • the regulatory adjustment represents a right or obligation arising from the extent to which the performance of the entity exceeds, or has been exceeded by, the performance of the customer base, ie the extent to which the regulatory agreement is no longer executory; • the resulting regulatory asset or regulatory liability has not already been recognised as an asset or a liability by applying other IFRS Standards, and • it is highly probable that a significant reversal in the amount of cumulative compensation recognised will not occur.	The model recognises, as a regulatory asset or regulatory liability, amounts included in the revenue recognised using IFRS 15 that relate to: (a) variances between estimated and actual amounts (estimation adjustments); (b) the application of regulatory bonuses/ penalties; and/ or (c) the satisfaction, or partial satisfaction, of the entity's obligations in another period (performance timing difference adjustments). The model does not intend to capture the adjustments to the future regulated rate that relate to future transactions, events or conditions. Such adjustments reflect the future operations of the business and affect the fair value of the business, including its goodwill. Although the fair value of the business may be relevant to users of the IFRS financial statements, valuing the business is not the objective of the model.

[2] See paragraphs 26-37 of December 2016 Agenda Paper 9A *Overview of the core features of the model* for a description and example of each type of adjustment.

<table>
<tr><th>Features of the basic model</th><th>Basis for proposals</th></tr>
<tr><td>The entity recognises a regulatory asset for:
regulatory estimation adjustments that arise from variances between actual amounts and estimated amounts used in the rate-setting mechanism and for which a rate increase is included, or expected to be included, in a future period; and
regulatory bonus adjustments and performance timing differences that originate from the performance of a regulatory obligation in a period before the entity is entitled to charge the customer for that performance.
The entity recognises a regulatory liability for:
regulatory estimation adjustments that arise from variances between actual amounts and estimated amounts used in the rate-setting mechanism and for which a rate decrease is included, or expected to be included, in a future period; and
regulatory penalty adjustments and performance timing differences that originate from the entitlement of the entity to charge the customer for the performance of a regulatory obligation in a period before the entity has performed that regulatory obligation.</td><td></td></tr>
<tr><td>Derecognition
The entity derecognises a regulatory asset or regulatory liability as the originating regulatory adjustment reverses through the rate charged to the customer-base.
The entity derecognises a regulatory asset as it becomes entitled to charge the customers for the regulatory</td><td>The model requires derecognition of regulatory assets and regulatory liabilities as the originating differences reverse through amounts charged to the customer-base.
Amounts that are no longer expected to be reversed through the rate charged to the customer-base will be adjusted through subsequent measurement or impairment of the related regulatory asset or regulatory liability.</td></tr>
</table>

Features of the basic model	Basis for proposals
obligations to which the asset relates. • The entity derecognises a regulatory liability as it fulfils the regulatory obligation to which it relates or refunds the amounts previously charged to the customer-base.	
Initial measurement The model uses an allocated transaction price approach to measure regulatory assets, regulatory liabilities and the corresponding income statement adjustments. If the regulated rate includes a financing component, the model adjusts the carrying amounts of recognised regulatory assets/ liabilities to reflect the time value of money. A regulatory asset is initially measured at the amount agreed, or expected to be agreed, by the rate regulator that can be charged to the customer-base in future periods in respect of that regulatory adjustment. A regulatory liability is initially measured at the amount already charged to the customer-base which the regulator has agreed, or is expected to agree, should reduce the rate to be charged to the customer-base in future periods in respect of that regulatory adjustment.	To be within scope of the model, the regulatory agreement must include a rate-setting mechanism that identifies the basis of the rate calculation in terms of the entity's regulatory obligations. This mechanism facilitates the allocation of the amounts to be charged to the customer-base to the different regulatory obligations established by the regulatory agreement. The regulatory asset reflects the entity's right to recover the compensation/ funding that it is entitled to in exchange for having already satisfied, or partially satisfied, its regulatory obligations. The regulatory liability reflects the entity's obligation to either deliver goods or services without consideration being received in exchange (because the consideration has already been received), or to return to the customer-base amounts already received.
Subsequent measurement and impairment The entity will adjust the measurement of a recognised regulatory asset for changes in the rate agreed by, or expected to be agreed by, the rate regulator. The entity will adjust the measurement of a recognised regulatory liability for changes in the expected cost of fulfilling the respective regulatory obligations, except to the extent that the regulator has	The recovery of a regulatory asset is dependent on continued sales of the regulated goods or services. The risk that a regulatory asset will not be recovered because of a fall in demand is usually transferred away from the entity to the customer-base. This means that, if demand falls, the entity is still entitled to recover its regulatory assets and the regulated rate is increased to enable it to do so. In rare circumstances, significant or persistent falls in the level of demand or changes in the regulatory environment could result in the rate regulator taking action to reduce the recoverable amount of a regulatory asset. In such circumstances, the

Features of the basic model	Basis for proposals
agreed a corresponding adjustment to a future rate.	entity applies judgement to assess whether the carrying amount of a recognised regulatory asset is expected to be recovered through amounts to be charged to the customer-base. If not, the regulatory asset is written down to its recoverable amount and an impairment loss is recognised. The entity assesses whether the pre-funding for which a regulatory liability has been recognised is sufficient to cover the expected costs to fulfil the related regulatory obligations. If not, the entity increases the carrying amount of the regulatory liability to reflect the excess costs expected to be incurred.
Presentation The entity presents the regulatory assets recognised separately in the Statement of Financial Position from the other assets recognised in accordance with other IFRS Standards. The entity presents the regulatory liabilities recognised separately in the Statement of Financial Position from the other liabilities recognised in accordance with other IFRS Standards. The entity presents in profit or loss [or other comprehensive income] the net movement recognised in the period on its regulatory assets and regulatory liabilities. This net movement is presented separately from the IFRS 15 revenue line item.	The model applies a 'supplementary' approach to presentation similar to that used in IFRS 14. This allows a user to better understand the effects of rate regulation on the timing of the entity's cash flows.
Disclosure objective An entity discloses information that enables users to assess: (a) the nature of, and the risks associated with, the rate regulation that establishes the price(s) that the entity can charge customers for the goods or services it provides; and (b) the effects of that rate regulation on its financial position, financial performance and cash flows.	Users of financial statements need information about the entity's operating risks and the risk that changes in the rate-regulatory environment could change the timing and certainty of the entity's cash flows. An understanding of each class of regulatory asset and regulatory liability is considered important because that can provide information about the nature of the rate regulation and the potential timing of related cash flows.

Features of the basic model	Basis for proposals
The entity provides sufficient disaggregation of the increases or decreases in the entity's regulatory assets and regulatory liabilities to enable a user to understand the principal sources of the regulatory assets and regulatory liabilities and to distinguish origination of timing differences from their reversal. The disclosure objective could be met by providing a reconciliation of opening to closing regulatory assets and regulatory liabilities recognised.	
Definitions The model includes definitions of: - customer-base - regulator - regulatory adjustment - regulatory asset - regulatory liability - regulatory obligation	Terms that are specific to the model will need to be defined. The list included here may not be complete. The accompanying Agenda Paper 9A contains brief descriptions of what is intended by these terms but the staff will ask the Board to consider more precise terminology in a future meeting.[3]

[3] This overview of the model was originally included in the Cover note for the December 2016 Board meeting, which was accompanied by December 2016 Agenda Paper 9A *Overview of the core features of the model*.