

STAFF PAPER

February 2017

IASB Meeting

Project	Rate-regulated Activities		
Paper topic	Scope of the model		
CONTACT(S)	Jane Pike	jpike@ifrs.org	+44 (0)20 7246 6925
	Michael Stewart	mstewart@ifrs.org	+44 (0)20 7246 6922

This paper has been prepared for discussion at a public meeting of the International Accounting Standards Board (the Board) and does not represent the views of the Board or any individual member of the Board. Comments on the application of IFRS® Standards do not purport to set out acceptable or unacceptable application of IFRS Standards. Technical decisions are made in public and reported in IASB® Update.

Purpose of the paper

1. This paper analyses criteria for the scope of the accounting model being developed to more faithfully represent the financial effects of **defined rate regulation**. It asks the Board whether it agrees with our analysis.

Summary of conclusions of the staff's analysis

2. Our analysis suggests that the model include scope criteria that require:
 - (a) 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;
 - (b) a regulatory pricing framework to include a rate-setting mechanism that:
 - (i) establishes how the regulated rate is calculated;
 - (ii) identifies how the rate reflects the satisfaction of the entity's regulatory obligations; and

- (iii) adjusts the future regulated rate for the effects of imbalances in performance between the entity and its customer-base.¹

Overview

- 3. This paper contains the following information:
 - (a) Background (paragraphs 4-7);
 - (b) Staff analysis (paragraphs 8-21):
 - (i) A formal regulatory pricing (ie rate-setting) framework (paragraphs 8-13);
 - (ii) Features of the rate-setting mechanism (paragraphs 14-17); and
 - (iii) Other features of defined rate regulation (paragraphs 18-21).
 - (c) Questions for the Board; and
 - (d) Appendix: Extract from IFRS 14: Definitions

Background

- 4. The Discussion Paper *Reporting the Financial Effects of Rate Regulation* (the DP), published in September 2014, discussed a form of rate regulation termed ‘defined rate regulation’. Paragraph 4.4 of the DP summarised the distinguishing features of defined rate regulation as follows:

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

¹ This feature links directly to the core principle of the model—see paragraph 8.

(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.

5. In addition, paragraph 4.5 of the DP noted:

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.

6. The majority of stakeholders that responded to the DP and subsequent outreach activities suggested that defined rate regulation creates identifiable rights and obligations that are distinguishable from those of entities that are not subject to such rate regulation. The stakeholders supported the development of an accounting model to improve the way that such rights and obligations are reported in IFRS financial statements.

7. Most of the stakeholders that supported the development of the model agreed that the distinguishing features of defined rate regulations described in the DP are important factors to consider when identifying which entities may have activities that fall within the scope of a model. However, many of them suggested that any scope criteria developed for the model should focus on the enforceable rights and obligations created by the rate regulation. They suggested that the other features could be included as ‘indicators’ but should not be used as scope criteria. This is because they considered the features to be subjective and difficult to apply in practice as threshold criteria.

Staff analysis

A formal regulatory pricing (ie rate-setting) framework

8. 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 funding/compensation to which the entity expects to be entitled in exchange for those goods or services.² The model is based on the notion that, at inception, the regulatory agreement is executory. A regulatory asset or regulatory liability is created to the extent that one party to the agreement performs to a greater extent than the other.
9. In our view, the application of this principle relies upon the entity having entered into a regulatory agreement that gives rights to the entity to receive compensation from the customer base and establishes obligations on the entity to transfer, within specified performance levels, goods or services to the customer base in exchange. The application of the model also relies on the regulatory agreement creating rights and obligations for the entity that are distinguishable from those of an entity that is not subject to rate regulation.
10. Without a regulatory agreement and associated pricing framework, the entity could be free to negotiate the terms and conditions of its individual contracts with customers. This could enable the modification of both the price and the performance specifications for the goods or services, which could benefit some

² See Agenda Paper 9A *The model’s general approach*.

customers but be detrimental to others. Such discrimination between customers is contrary to the conditions that are typically imposed in a defined rate regulation environment. It is, however, common in a competitive environment, especially one in which there is limited supply of highly desirable goods or services for which there is strong demand. In our view, if an entity is able to modify the price and the performance specifications for its goods or services, the entity's rights and obligations in such a situation would not be sufficiently distinguishable from those of an entity that is not subject to defined rate regulation and would not, therefore, justify applying the model.

11. Consequently, we think the model should include a scope criterion that requires 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. We think that including such a criterion provides a clear and reasonable hurdle for the identification of entities within the model's scope.
12. Including such a criterion also addresses a concern expressed by many stakeholders that entities with monopolistic features that promise to 'self-regulate' but are not subject to formal rate regulation may try to apply the model by analogy. This may arise when, for example, the entity fears that regulatory intervention may be imposed because there is a strong demand for highly desirable goods or services that are supplied by the entity and there is weak competition from other suppliers. Including a scope criterion that includes a formal rate-setting framework would mean that 'self-regulating' entities would be excluded from the model's scope.
13. To include a requirement that the entity carries out activities that are subject to a formal regulatory pricing (ie rate-setting) framework requires us to define what is meant by a 'rate regulator', because it is the rate regulator that establishes the rate-setting framework. Paragraph 5(a) of IFRS 14 *Regulatory Deferral Accounts* includes a similar scope criterion to that being recommended. That paragraph requires an entity to 'conduct rate-regulated activities'. IFRS 14 contains definitions of 'rate-regulated activities', 'rate regulation', and 'rate regulator'. We recommend that the definitions of these terms are carried forward into the model. The definitions are reproduced in Appendix A.

Features of the rate-setting mechanism

14. In some forms of rate regulation, the regulatory agreement does not establish rights and obligations that create an executory contract between the entity and a customer-base. For example, ‘market regulation’ effectively restricts (caps) prices in a similar way to effective competition but does not create any specific rights or performance obligations for the entity.³
15. Consequently, we think that the model should include scope criteria that would exclude entities subject merely to market regulation. Instead, it ought to include criteria that link to the core principle of the model (see paragraph 8). This means that the regulatory agreement needs to provide a clear link between the entity’s right to charge the customer base a determinable amount and the obligations that the entity must satisfy in exchange for that amount.
16. As a result, we suggest that the model includes further scope criteria establishing that the formal regulatory framework must include a rate-setting mechanism that:
 - (a) establishes how the regulated rate is calculated;
 - (b) identifies how the rate reflects the satisfaction of the entity’s regulatory obligations; and
 - (c) adjusts the future regulated rate for the effects of imbalances in performance between the entity and its customer-base.
17. We think that inclusion of criteria establishing essential features of the rate-setting mechanism helps to reinforce the principle of the model, ie the regulatory assets and regulatory liabilities to be recognised reflect the imbalance in performance between the entity and the customer-base.

Other features of defined rate regulation

18. So far, we have dealt explicitly with the distinguishing features listed in paragraph 4 that deal with the need for there to be a regulatory pricing framework that creates enforceable rights and obligations on the entity and the rate regulator. The feature in paragraph 4(b) addressing parameters to maintain the availability

³ See paragraphs 4 and 6(a) of Agenda Paper 9 *Cover note and summary of the model*.

and quality of the supply is implicitly included in our consideration of the obligations imposed on the entity through the regulatory agreement.

19. In our view, the other features of defined rate regulation described in paragraph 4 are indicative of the existence of defined rate regulation, but they are not necessary to create the rights and obligations that we consider are essential to the scope of the model (see paragraphs 8-17). This is because the other features, particularly the one in paragraph 4(a) that customers have little or no choice but to purchase the goods or services from the entity, describe the sort of environment in which a government is likely to impose defined rate regulation. In circumstances in which the features exist, an entity would need to consider the rate regulation to which it is subject in detail to assess whether it is within the scope of the model.
20. In addition, we think that the existence of the other features contributes to the effectiveness and enforceability of the rate regulation. Effectiveness of the rate regulation also has a role in the recoverability of regulatory assets and settlement of regulatory liabilities. This is because it strongly influences the ability of the rate regulator to predict:
 - (a) the level of demand for the rate-regulated goods and services; and
 - (b) the strength of the customer base and its ability to provide the entity with the compensation to which it is entitled in exchange for the entity satisfying its regulatory obligations.
21. Consequently, we think that it would be helpful to include in the model a brief description of the features, why they are likely to create an environment in which rate regulation within the scope of the model is likely to exist, and how they support the effectiveness of the rate regulation. This guidance could be used as a reference both when considering whether:
 - (a) the rate regulation to which an entity is subject is likely to be within the scope of the model; and
 - (b) any resulting regulatory adjustment is recoverable (see Agenda Paper 9C *Recognition of regulatory assets and regulatory liabilities* for further discussion).

Questions for the Board

Questions for the Board

1. Paragraphs 11 and 16 suggests that the model include scope criteria that require:
 - (a) 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**, using definitions contained in IFRS 14 (see the appendix of this paper); and;
 - (b) a regulatory pricing framework to include a rate-setting mechanism that:
 - (i) establishes how the regulated rate is calculated;
 - (ii) identifies how the rate reflects the satisfaction of the entity's regulatory obligations; and
 - (iii) adjusts the future regulated rate for the effects of imbalances in performance between the entity and its customer-base.

Do you agree? If yes, why; if not, why not?

2. Paragraph 19 suggests that the 'other' features of defined rate regulation described in paragraph 4 are indicative of the existence of defined rate regulation, but they are not necessary to create the rights and obligations that we consider are essential to the scope of the model.

Do you agree? If yes, why; if not, why not?

Appendix: Extract from IFRS 14 *Regulatory Deferral Accounts: Definitions*

A1. Paragraph 5(a) of IFRS 14 requires an entity within its scope to ‘conduct rate-regulated activities’. IFRS 14 contains definitions of ‘rate-regulated activities’, ‘rate regulation’, and ‘rate regulator’ that we recommend are carried forward into the model. The definitions are:

rate-regulated activities An entity’s activities that are subject to **rate regulation**.

rate regulation A framework for establishing the prices that can be charged to customers for goods or services and that framework is subject to oversight and/or approval by a **rate regulator**.

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.