IFRS

STAFF PAPER

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Consultative Group for Rate Regulation Meeting

Project	**Rate-regulated Activities**		
Paper topic	Scope of the model		
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Purpose of the paper

1. We ask Consultative Group members whether the description of 'defined rate regulation' being used by the Board in its discussions is sufficiently clear to enable entities to identify whether they have activities within the scope of the model. This information will inform the Board's decisions about which characteristics of defined rate regulation are considered necessary and sufficient to establish the scope of the model.

Summary of the Board's discussions so far

2. 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'. Appendix A reproduces paragraphs 4.4-4.5 of the DP, which summarise the characteristics used to describe defined rate regulation in the DP.

3. The majority of respondents to the DP, and participants in subsequent outreach, agreed that the characteristics of defined rate regulation described in the DP are

important to consider when identifying which regulatory agreements should fall within the scope of a model. Some questioned whether all the characteristics are necessary to define the scope of the model. The scope of the model will determine which regulatory rate adjustments give rise to rights or obligations that could be recognised as regulatory assets and regulatory liabilities.[1]

4. Subsequent discussions with the Board have focused on the enforceable rights and enforceable obligations created by 'defined rate regulation', using the following description of defined rate regulation:

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**;[2]

(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[3] differences when the regulated rate in one period includes amounts related to specified activities the entity carries out in a different period.

5. In the following paragraphs we consider the characteristics of defined rate regulation, both those listed in paragraph 4 and others described in the DP (see Appendix A). We outline the staff's preliminary analysis of whether each is **necessary** for establishing the scope of the model. In a future meeting, the Board will consider what characteristics are necessary and which characteristics, if not all of them, are collectively **sufficient** to determine the scope of the model.

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1 See paragraphs 7 and 8 of agenda paper AP4 for examples of the activities that would be within the scope of the model.

2 IFRS 14 *Regulatory Deferral Accounts* contains a definition of 'rate regulator'. The Board has not yet discussed whether this definition should be retained or amended.

3 We have not yet discussed with the Board whether the more appropriate term is 'temporary' or 'timing'.

Staff analysis

Characteristics contained in the description of defined rate regulation (see paragraph 4)

Binding on both the entity and the rate regulator (paragraph 4(a))

6. The model focuses on reflecting the entity's rights and obligations created by a regulatory agreement that binds 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.

7. Whatever form the regulatory agreement takes, it is important that its terms bind both parties in order for those terms to have a discernible effect on the economics of the regulatory agreement. Terms that bind neither party have no commercial substance.[4] Consequently, we consider this characteristic to be necessary to establish the scope of the model.

*Establishes a basis for setting the rate chargeable **and** includes a rate-adjustment mechanism (paragraphs 4(b) and 4(c))*

8. We consider together these two characteristics, ie the defined rate regulation (i) establishes a basis for setting the regulated rate and (ii) includes a mechanism that creates and reverses temporary differences. The rate-adjustment mechanism can exist only as part of the basis for setting the regulated rate.

9. The rate-adjustment mechanism affects the amount and **timing** of rate adjustments. As discussed in agenda paper 4 (AP4), it is this mechanism that creates the right or obligation for the entity to charge an adjusted regulated rate for delivery of goods or services in the future. That adjusted regulated rate differs from the rate the entity would otherwise charge for those goods or services.

10. The need to explore the development of an accounting model for defined rate regulation arises from the rights or obligations created by the rate-adjustment

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4 The guidance supporting the asset and liability definitions in the Conceptual Framework ED highlights the importance of commercial substance and the need for contractual terms to have a discernible effect on the economics of a contract. Terms that bind neither party have no commercial substance and should be disregarded (paragraph 4.55 of the Conceptual Framework ED).

mechanism mentioned in paragraph 4(c). Consequently, we consider the rate-adjustment mechanism to be a necessary characteristic of defined rate regulation.

Minimum service levels or other service requirements (paragraph 4(b))

11. If the regulatory agreement did not specify minimum service levels or other service requirements, the entity might be able to reduce service levels to nullify the effect of a future reduction in the regulated rate. Arguably, this characteristic is not a separate characteristic, but is an aspect of the characteristic that refers to specifying a basis for setting the regulated rate.

Limitations on entry into an industry (and exit from it) (paragraph 4)

12. The staff consider that limitations on entry into, and on exit from, an industry may not be necessary for the existence of regulatory assets or regulatory liabilities. The amounts identified through the rate-adjustment mechanism are specific to the entity that is subject to that mechanism. Consequently, the right to charge a higher rate resulting from the rate-adjustment mechanism is a right that is specific to the entity. Limitations on entry into an industry are not necessary to the existence of such a right. It is necessary only that entities entering the industry are subject to the basis for setting the regulated rate.

13. A limit on entry into the industry increases the probability that the right to increase future regulated rates will produce economic benefits that flow to the entity. However, the level of the probability of an inflow of economic benefits does not determine whether the right exists. Nevertheless, the level of that probability may affect decisions about whether it is appropriate to recognise the right as an asset in the statement of financial position, and about how to measure the right.

14. Limitations on exit from an industry may not be necessary for the obligation to charge a lower regulated rate to be unavoidable. For example, if the economic consequences of exiting from a market are significantly more adverse than staying in the market and charging the lower regulated rate, the entity may not have the practical ability to avoid the obligation.

Other characteristics mentioned in the DP (see Appendix A)

15. In addition to the characteristics contained in the description of defined rate regulation in paragraph 4, Appendix A refers to three other characteristics contained in the DP's description of defined rate regulation:

    (a) customers have little or no choice but to purchase the goods or services from the rate-regulated entity (paragraph A1);

    (b) parameters for rates provide regulatory protections (paragraph A1); and

    (c) the rate-setting mechanism establishes a 'revenue requirement' and a regulated rate, or rates, per unit (paragraph A2).

16. The staff's preliminary analysis suggests that the characteristic listed in paragraph 15(a) increases the probability that the right to increase future prices will produce economic benefits that flow to the entity and the characteristics listed in paragraphs 15(b)-15(c) are common aspects of the design of the basis for setting the regulated rate chargeable by the entity to its customers. The staff's analysis suggests they are not separate characteristics that are necessary for defining the scope of the model.

Questions for Consultative Group members

Scope issues
We ask Consultative Group members whether the description of 'defined rate regulation' being used by the Board in its discussions is sufficiently clear to enable entities to identify whether they have activities within the scope of the model. This information will inform the Board's decisions about which characteristics of defined rate regulation are considered necessary and sufficient to establish the scope of the model.

17. When gathering and reporting the information we are seeking, Consultative Group members may find it helpful to consider the following questions:

(a) If the Board was to use the description of defined rate regulation in paragraph 4 to determine the scope of the model, do you think the description is sufficiently clear for entities to assess which of their activities would be within the scope of the model?

(b) What factors do you think the Board should consider in establishing the scope of defined rate regulation?

(c) Comparing the scope described in paragraph 4 to that of any local GAAP requirements for rate-regulated activities with which you are familiar, how do you think the population of entities captured by the model's scope would differ?

Appendix A: Extract from Discussion Paper: *Reporting the Financial Effects of Rate Regulation*

A1. 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 characteristics of defined rate regulation as follows:

> Defined rate regulation involves a regulatory pricing (ie rate-setting) framework that includes all of the following:
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> (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:
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> (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:
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> (i) support greater stability of prices for customers; and
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> (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.

A2. 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.

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

A3. 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 expect to be 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.