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STAFF PAPER

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Project	**Rate-regulated Activities**		
Paper topic	Update of the Board's discussions		
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Purpose of this paper

1. The purpose of this paper is to provide an update of the Board's discussions during its meetings in April-July 2017. The Board discussed the underlying basis for a new accounting model (the model) being developed for rate-regulated activities.

Structure of this paper

2. The structure of this paper is as follows:

   (a) Background—defined rate regulation (paragraphs 3-14);

   (b) The Board's tentative decisions to date (paragraphs 15-18);

   (c) Next steps (paragraphs 19-21);

   (d) Discussions with the Board—building the model (Appendix A);

   (e) Definitions of asset and liability (Appendix B);

   (f) Discarding an intangible asset approach (Appendix C); and

(g) Summary of feedback and comments received from Request for Information, Discussion Paper and outreach activities (Appendix D).

Background—defined rate regulation

3. In its February 2017 meeting, the Board tentatively decided that the staff should continue to develop the model, focusing on the rights and obligations arising from the rate-adjustment mechanism specified in the regulatory agreement. Those rights and obligations need to be considered in the context of the rate-regulated environment, ie in the context of 'defined rate regulation'. The following paragraphs summarise the description of defined rate regulation that forms the basis of our analysis, and which continues to be refined through continued discussions with the Board.

4. 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]

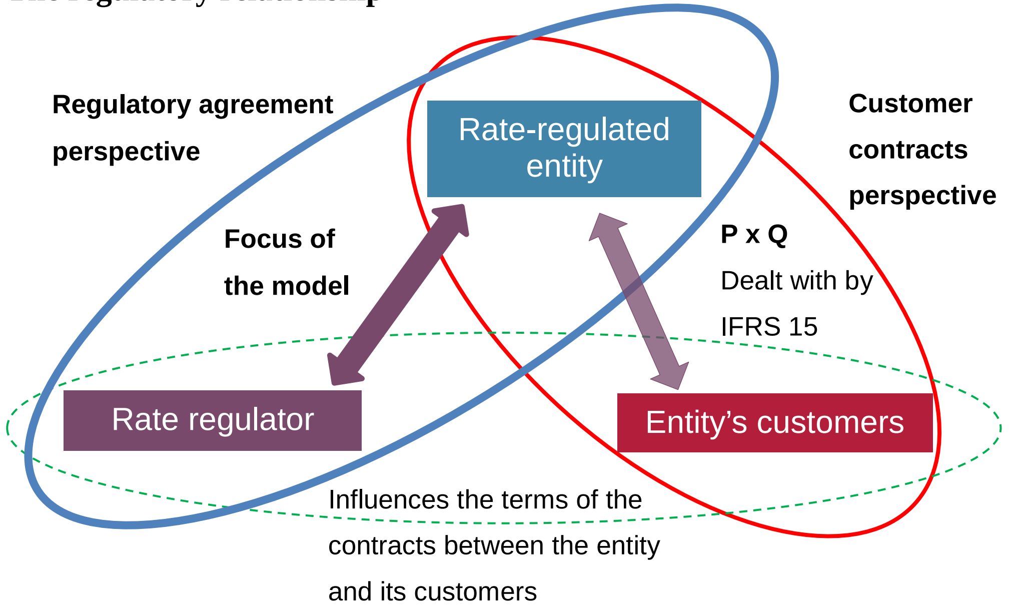
5. In this project, we have been using 'defined rate regulation' as a label for a form of economic regulation established through a formal regulatory framework that imposes limitations on entry into an industry (and on exit from it) and that:

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

   (b) establishes a basis for setting the regulated rate chargeable by the entity to its customers (P) for the transfer of specified goods and/ or services that comply with minimum quality levels or other service requirements (Q). The basis for setting the rate includes a rate-adjustment mechanism that originates, and subsequently reverses, temporary differences that arise when the regulated rate in one period includes amounts intended to compensate the entity for specified activities the entity carries out in a different period.

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

The regulatory relationship



6. In some forms of economic regulation, such as market regulation, the primary purpose of the regulator's intervention is to act as a proxy for efficient competition to protect customers from excessive profit-taking by the suppliers.[2] Such regulatory intervention typically uses a rate-setting methodology that caps the prices that suppliers can charge customers at a level that enables an efficient supplier to make a profit commensurate with risk.

7. However, as previously discussed with the Board, defined rate regulation generally is introduced for services that governments consider essential for a reasonable quality of life for their citizens and for which there are significant barriers to effective competition for supply. In such cases, the objectives of the rate regulator go beyond acting as a proxy for a competitive market. The rate regulator's objectives include ensuring that the regulated goods or services are of appropriate quality and are accessible, available and affordable to the public. In addition, the rate regulator may also require the entity to carry out other activities relating to government-imposed social or environmental policies, and which may not relate directly to the delivery of goods or services to customers. We use the

[2] Market regulation is a term that is often used to indicate an incentive-based regulation, which often takes the form of a 'price cap' that applies to all suppliers in a competitive market. The price cap is rarely based on the specific costs that any individual supplier incurs but, instead, the price cap is based on benchmark costs (see paragraphs 3.30-3.33 of the Discussion Paper *Reporting the Effects of Rate Regulation*, published in September 2014).

term ‘regulatory requirements’ to cover both service requirements related to the delivery of goods or services to customers and other requirements related to other government-imposed policies.

8. As a consequence of the wider objectives in defined rate regulation, the rate-setting methodology used by a rate regulator in defined rate regulation is not merely designed to cap the prices that suppliers can charge customers during a specified period. In addition, the rate-setting methodology uses a rate-adjustment mechanism to:

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

    (b) spread the cost of the regulatory requirements across different classes and generations of existing and future customers.

9. The rate-setting methodology used in defined rate regulation is established by law. It is typically set out in legislation or in a contractual licensing agreement signed by both the rate regulator and the rate-regulated entity. The methodology typically specifies the following two components of the regulated rate (P):

    (a) a ‘current period’ rate component that comprises the estimated amounts that are intended to compensate the entity for satisfying regulatory requirements **during** the current period;[3] and

    (b) a ‘temporary difference’ rate component that adjusts the current and /or a future regulated rate according to a **rate-adjustment mechanism** to reflect **temporary differences** that arise when the regulated rate in one period includes amounts related to specified activities the entity carries out in a different period.

10. The current period component of the rate may be considered to be equivalent to the amount that the rate regulator perceives to be a fair and reasonable amount that enables an efficient supplier to make a profit commensurate with risk, if the entity satisfies all regulatory requirements in the same period as it supplies the regulated goods or services. The rate-adjustment mechanism is used to enable the rate regulator to achieve the additional objectives of improving price stability and

[3] We used the term ‘base component’ in the description given in Agenda Paper 9A Update of the Board’s discussions presented in the Board’s June 2017 meeting but use a more descriptive term here.

predictability and of spreading costs across different classes and generations of existing and future customers (see paragraph 8).

11. The temporary difference component reflects temporary differences that arise when:

(a) there are differences between actual and estimated amounts used in the calculation of the current period rate component (estimation variances) **and** the rate-adjustment mechanism requires those estimation variances to be ‘corrected’ through the regulated rate to be charged in future periods (‘allowable estimation variances’ and ‘chargeable estimation variances’);[4]

(b) the entity fully or partially fulfils a regulatory requirement but the related compensation amount has not yet been included in the regulatory rate for the current period; or

(c) the regulated rate for the current period includes a compensation amount relating to a regulatory requirement that has yet to be fulfilled.

12. At the end of a reporting period, the rate-adjustment mechanism in the legally binding regulatory agreement gives the entity:

(a) a **right** to charge customers a **favourable** rate in a future period in exchange for goods or services delivered in that period (ie a higher rate than would have otherwise been determined by the rate regulator as the ‘current period’ charge for the goods or services delivered in the future period); or

(b) an **obligation** to charge customers an **unfavourable** rate in a future period in exchange for goods or services delivered in that period (ie a lower rate than would have otherwise been determined by the rate

[4] Not all variances between estimated amounts and actual amounts will result in adjustments to a future regulated rate. We refer to ‘allowable estimation variances’ to identify those amounts that the rate-setting mechanism will include in the rate calculation to increase the future regulated 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 future regulated rate.

regulator as the 'current period' charge for the goods or services delivered in the future period).[5]

13. There is a direct cause-and-effect relationship between the entity's **past** satisfaction of regulatory requirements and the entity's **present** right to charge a higher/ favourable rate, or obligation to charge a lower/ unfavourable rate, for goods or services delivered to customers in a future period. This is because the calculation of the rate adjustment determines the extent to which the rate is favourable or unfavourable to the entity.

14. Our analysis suggests that it is the rate-adjustment mechanism in the regulatory agreement that creates rights and obligations for the entity in addition to the rights and obligations arising from the individual contracts between the entity and its customers. Consequently, it is only the rights and obligations created by the rate-adjustment mechanism that the model aims to account for by recognising regulatory assets and regulatory liabilities.

The Board's tentative decisions to date

15. The regulatory agreement establishes a range of rights and obligations for the entity that encompass many aspects of the entity's rate-regulated business and how it operates. This combination of rights and obligations, if considered as a single unit of account, might be seen as constituting an intangible asset. Measuring the value of that intangible asset, and any changes in that value, may incorporate changes in the value of the business and internally generated goodwill. Such changes in value would, by their nature, include amounts that relate to future cash flows, transactions and events, including the associated profit of those future transactions. Consequently, in February 2017, the Board tentatively decided not to develop an intangible asset model to account for the regulatory agreement as a whole.[6] Instead, the Board tentatively decided to

[5] 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.

[6] See Appendix C for a summary of reasons why the Board discarded an intangible asset model approach.

develop a model that focuses on a defined narrow subset of rights and obligations arising from the rate-adjustment mechanism contained in the regulatory agreement.

16. The Board also tentatively decided that an entity will apply the requirements of other IFRS Standards, including IFRS 15 *Revenue from Contracts with Customers*, before applying the model. Consequently, the model aims to account only for the rights and obligations arising from the rate-adjustment mechanism that are not already covered by other IFRS Standards. In making this tentative decision, the Board identified that IFRS 15 presents information about the entity's contracts with customers, which provides useful information to users of financial statements. Presenting regulatory assets, regulatory liabilities and the related income or expense adjustments to profit or loss separately from the amounts recognised using IFRS 15 provides users of financial statements with additional relevant information. The information provided by the model is intended to represent faithfully how the rate-adjustment mechanism in the regulatory agreement affects the entity's financial position, financial performance and future cash flows.

17. As a result of the Board's tentative decision to apply other IFRS Standards before applying the model, the Board also tentatively decided to develop the model through a separate Standard to replace IFRS 14 *Regulatory Deferral Accounts*. Consequently, we are not proposing to amend IFRS 15 to reflect the existence of the regulatory assets or liabilities. Nor are we proposing to amend IAS 38 *Intangible Assets* to reflect any rights or obligations arising from the regulatory agreement that go beyond the regulatory assets and regulatory liabilities arising from the rate-adjustment mechanism.

18. Consequently, the model is **not** aiming to account for:

    (a) the regulatory agreement as a whole (including the right to make future sales priced at the 'current period rate component');

    (b) the customer relationships affected by the regulatory agreement;

    (c) other rights or obligations created by the regulatory agreement, (ie other than those created by the past events captured by the rate-adjustment mechanism);

(d) existing or future receivables from or payables to customers, (recognised using IFRS 9 *Financial Instruments*); or

(e) contract assets or contract liabilities (recognised using IFRS 15).

Discussions with the Board—next steps

19. Appendix A summarises the aspects of the model that have been discussed in a series of education sessions with the Board in its April-July 2017 meetings. Staff are using those discussions to refine and further develop the model. So far, Board discussions have covered aspects of:

(a) the objective, principles and general approach of the model;

(b) scope;

(c) an analysis of the rights and obligations arising from the rate-adjustment mechanism and the definitions of assets and liabilities, as those terms are expected to be defined in the forthcoming revised *Conceptual Framework for Financial Reporting* (revised *Conceptual Framework*);

(d) recognition and reversal of regulatory assets and regulatory liabilities in conditions of certainty;

(e) recognition of regulatory assets and regulatory liabilities in conditions of uncertainty; and

(f) measurement of regulatory assets (this meeting—September 2017).

20. In the remaining Board meetings in 2017 we expect to discuss the following:

When	**Items**
Q4 2017	Further measurement issues, including measurement of regulatory liabilities. Presentation and disclosure. Consolidation of discussions held so far and follow up on outstanding matters from previous discussions. Interaction of the model with the requirements of IFRIC 12 *Service Concession Arrangements*.

Q4 2017 (continued)	High-level comparison with *FASB Accounting Standards Codification*® Topic 980 *Regulated Operations*. Decide on the form of the next consultation document—DP or ED.

21. We also expect to discuss the project with the following consultative bodies before the end of 2017:

Rate-regulated Activities—Consultative discussions of the model

ASAF September and December 2017	Aim to provide updates on Board discussions and ask ASAF members to highlight areas needing more clarity.
IASB Consultative Group for Rate Regulation October 2017	Aim to provide updates on Board discussions and ask Consultative Group members to highlight possible practical application issues and areas needing more clarity.

Appendix A: Discussions with the Board—building the model

1. This Appendix summarises the aspects of the model discussed with the Board during its February and April-July 2017 meetings. The Board is considering aspects of each feature of the model through a series of education sessions to build an overview of how the features work together. The Board will then make decisions about proposals for the model to be included in either a second Discussion Paper or an Exposure Draft. Consequently, the descriptions in this summary may be subject to change as the Board refines and further develops the model.

Features of the model	Board discussions
Objective The objective of the model is to inform users of financial statements about the nature, amount, timing and uncertainty of 'regulatory rate adjustments' and related cash flows arising from a regulatory agreement between an entity and a rate regulator.	The Board considered the feedback received on the Discussion Paper *Reporting the Financial Effects of Rate Regulation* (Discussion Paper), published in September 2014.[7] Many respondents to that Discussion Paper suggested that the combination of rights and obligations created by defined rate regulation creates unique or distinguishable economic conditions that are not faithfully represented by the current predominant practice in IFRS financial statements. In developing the model, the Board is seeking to provide useful information so that investors can compare the effects of rate regulation on the financial position, performance and cash flows of companies with significant rate-regulated activities.

[7] See Appendix D for a summary of the feedback.

Features of the model	**Board discussions**
Core principle (February, April-May) The core principle of the model is that an entity recognises 'regulatory rate adjustments' to reflect **temporary differences** that arise when the regulated rate in one period includes amounts related to specified activities the entity carries out in a different period **and** those differences will be reversed through the operation of a **rate-adjustment mechanism**.	The Board discussed how the regulatory agreement creates a package of rights and obligations for the entity that encompass many aspects of the entity's rate-regulated business and how it operates. This combination of rights and obligations, if considered as a single unit of account, might be seen as constituting an intangible asset. Measuring the value of that intangible asset, and any changes in that value, may incorporate changes in the value of the business and internally generated goodwill that are prohibited from being recognised using existing IFRS Standards. Such changes in value would, by their nature, include amounts that relate to future cash flows, transactions and events, including the associated profit of those future transactions. Consequently, the Board tentatively decided not to develop an intangible asset model to account for the regulatory agreement as a whole.[8] Instead, it tentatively decided that the model should focus on recognising the 'supplementary' rights and obligations arising from a regulatory agreement. Those supplementary rights or obligations are created when: • the entity fully or partially fulfils a regulatory requirement that has not yet been reflected in the regulatory rate billed to customers and the regulatory agreement gives the entity a right to charge a higher regulated rate for goods or services delivered in a future period than would have otherwise been determined by the rate regulator; or • the amount already billed to customers relates to a regulatory requirement that the entity has yet to fulfil and the regulatory agreement obliges the entity to charge a lower regulated rate for goods or services delivered in a future period than would have otherwise been determined by the rate regulator.
Supplementary approach (February, April-May) The model supplements, but does not override, other IFRS Standards. Consequently, all other IFRS Standards are applied first to the entity's	The Board identified that the entity's rights and obligations created by the regulatory agreement and those created by its contracts with individual customers, while being complementary, are distinct and subject to different risks. Consequently, reporting the relationship between them separately would provide more relevant information to users of financial statements because separate reporting:

[8] See Appendix C for further details.

Features of the model	Board discussions
transactions, events and conditions, including IFRS 15 *Revenue from Contracts with Customers*.	• enhances comparability of financial reporting across entities that are subject to different levels of rate regulation; and • is more transparent in enabling users of financial statements to more clearly identify the recognised effects of the rate regulation. Consequently, the Board tentatively decided that an entity will apply the requirements of other IFRS Standards before applying the model. As a result, the model is being developed to enable the Board to introduce it within the scope of a separate IFRS Standard, without making substantive amendments to other IFRS Standards.[9] This significantly reduces the risk of confusion and unintended consequences on the application of other IFRS Standards for entities outside the scope of the model. Such unintended consequences could include inappropriate analogies to the model being drawn by entities that are not subject to defined rate regulation.
Scope (February) The model is being developed to be applied only to activities subject to 'defined rate regulation' established through a formal regulatory framework that imposes limitations on entry into an industry (and on exit from it) and that: • is binding on both the entity and the rate regulator; • establishes a basis for setting the regulated rate chargeable by the entity to its customers (P) for the transfer of specified goods and/ or services that comply with minimum quality levels or other service requirements (Q); and	The Board discussed how a combination of the characteristics of 'defined rate regulation' could create rights and obligations for an entity that are distinguishable from those of an entity that is not subject to defined rate regulation.[10] The Board focused on the presence of a binding tripartite agreement in the rate-regulated environment between the entity, the rate regulator and the entity's customers. Through this regulatory agreement, an entity has an enforceable right or obligation, arising as a direct result of past events, to charge a higher or lower regulated rate than would have otherwise been determined by the rate regulator as the charge for the goods or services delivered in the future period. Consequently, the Board tentatively decided to continue developing the model by focusing on the supplementary rights and obligations arising from the rate-adjustment mechanism that are enforceable on the entity and the rate regulator.

[9] This is consistent with the approach used in IFRS 14 R*egulatory Deferral Accounts*.

[10] See Appendix B for a summary of the characteristics and their interaction with the definitions of assets and liabilities, as those terms are expected to be defined in the forthcoming revised *Conceptual Framework for Financial Reporting*.

Features of the model	Board discussions
• uses a rate-adjustment mechanism to create and reverse temporary differences that arise when the regulated rate in one period includes amounts related to specified activities the entity carries out in a different period.	In a future meeting, the Board will consider what combination of the characteristics of defined rate regulation, if not all of them, is necessary and sufficient to determine the scope of the model.
Recognition (June-July) In developing recognition criteria for the model, the Board are considering the criteria that are expected to be set in the forthcoming revised *Conceptual Framework for Financial Reporting* (revised *Conceptual Framework*).[11]	The Board discussed examples illustrating how the model would recognise a regulatory asset or regulatory liability when the regulatory agreement is sufficiently clear about how the rate charged to customers is calculated and about what amounts are included in the rate-adjustment mechanism. In such cases, the criteria for recognition in the revised *Conceptual Framework* will be met. The Board also discussed three types of uncertainty that could affect the recognition of regulatory assets and regulatory liabilities—existence uncertainty, outcome uncertainty and measurement uncertainty. Some Board members indicated an initial preference for using a 'probable' threshold for the recognition of both regulatory assets and regulatory liabilities. The Board will consider this again after it discusses measurement.
Derecognition (June) The model is being developed to recognise regulatory assets and regulatory liabilities that reflect **temporary differences** that arise when the regulated rate in one period includes amounts related to specified activities the entity carries out in a different period **and** those	The Board discussed examples illustrating how the model would derecognise a regulatory asset or regulatory liability when the regulatory agreement is sufficiently clear about how the rate charged to customers is calculated and about what amounts are included in the rate-adjustment mechanism. In such cases, the entity: • derecognises a regulatory asset as it charges customers the higher rate to which the asset relates; or • derecognises a regulatory liability as it fulfils the regulatory requirements to which amounts previously charged to the customers relate.

11 Some proposals in the Exposure Draft *Conceptual Framework for Financial Reporting* (the Conceptual Framework ED) have been updated for the Board's tentative decisions in subsequent discussions. Throughout this paper, all references to the revised *Conceptual Framework* are to those updated proposals.

Features of the model	Board discussions
differences will be reversed through the operation of a **rate-adjustment mechanism**. Consequently, the model derecognises a regulatory asset or regulatory liability as the originating regulatory adjustment reverses.	The Board will, in a future meeting, discuss how to account for amounts previously recognised that are no longer expected to be reversed through the rate charged to customers.
Measurement (September) The Board is discussing measurement in its September 2017 meeting.	In the illustrative examples used to discuss recognition and derecognition, the regulatory assets and regulatory liabilities were measured at the amount of the originating temporary difference, ie: • for a regulatory asset—the amount of the costs incurred when the entity fully or partially fulfils a regulatory requirement but the related compensation amount has not yet been included in the regulatory rate billed to customers; and • for a regulatory liability—the amount already billed to customers that relates to a regulatory requirement that has yet to be fulfilled. In its September 2017 meeting, the Board will begin to explore factors to consider when selecting a measurement basis for regulatory assets. In a future meeting, the Board will discuss further measurement issues for regulatory assets as well as measurement issues relating to regulatory liabilities.
Presentation The illustrative examples used in developing the model to date have presented regulatory assets and regulatory liabilities separately in the Statement of Financial Position from the other assets and liabilities recognised in accordance with other IFRS Standards. The illustrative examples have also presented in profit or loss the movement recognised in the period on its regulatory assets and regulatory	The Board has not yet discussed presentation. The illustrative examples discussed by the Board have presented separately the regulatory assets, regulatory liabilities and the movement on those assets and liabilities recognised in the period. This has been done to illustrate the effects of applying the model after other IFRS Standards, ie using the supplementary approach. The Board will discuss presentation in a future meeting.

Features of the model	Board discussions
liabilities. This net movement is presented separately from the IFRS 15 revenue line item.	
Disclosure objective Paragraph 27 of IFRS 14 *Regulatory Deferral Accounts* has the following disclosure objective: 'An entity that elects to apply this Standard shall disclose 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.'	The Board has not yet discussed disclosure when developing the model. However, the Board discussed disclosure requirements when developing IFRS 14. Stakeholders that responded to the Discussion Paper *Reporting the Financial Effects of Rate Regulation*, published in September 2014, expressed strong support to use the disclosure requirements in IFRS 14 as a basis for any disclosure requirements that may be developed as a result of this project.[12] The Board will discuss disclosure requirements in a future meeting.
Transition The Board will discuss transition after proposals for the model are more fully developed.	

[12] See Appendix D for a summary of feedback and comments received from the Discussion Paper and outreach activities.

Appendix B: Definitions of asset and liability

1. As discussed in the May and July 2017 Board meetings, any entity has a right to establish the price that it will charge to its customers in exchange for the goods or services it transfers to those customers during the period. In the absence of defined rate regulation, this price is assumed to reflect the price that the entity would receive in an orderly transaction with willing customers. This assumption suggests that although each party to the transaction may perceive a net benefit in the exchange, the terms of the exchange are balanced, ie the exchange of resources is made on terms that are neither favourable nor unfavourable. The contract to exchange goods or services at this price is an executory contract until:

   (a) either the entity transfers goods or services; or

   (b) customers pay for goods or services in advance.

   Consequently, the entity would not recognise an asset or a liability in advance of an exchange taking place.[13]

2. During the May and July 2017 Board meetings we also considered the interaction between the definitions of assets and liabilities and the characteristics of defined rate regulation. We concluded that a combination of those characteristics suggested that the rights and obligations created by the rate-adjustment mechanism are assets and liabilities, as those terms are expected to be defined in the forthcoming revised *Conceptual Framework for Financial Reporting*.[14] We have not expressed an opinion about whether **all** of the characteristics of defined rate regulation listed in the following table are necessary for the creation of regulatory assets and regulatory

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[13] An exception to this outcome would arise if the entity entered into a non-cancellable contract with a customer and the price agreed for the exchange were to make the contract onerous. In such a case, a liability would be recognised using IAS 37 *Provisions, Contingent Liabilities and Contingent Assets*.

[14] When referring to the definitions of assets and liabilities throughout this paper, we have used the proposals in the Exposure Draft *Conceptual Framework for Financial Reporting* (the Conceptual Framework ED), updated when applicable for the Board's tentative decisions in subsequent discussions.

liabilities. The Board will, in forthcoming meetings, discuss what combination of characteristics, if not all of them, is necessary and sufficient to determine the scope of the model.

3. The table below provides a high level overview of the links between the definitions of assets and liabilities in the Conceptual Framework ED and the characteristics of defined rate regulation that were discussed at the May and July 2017 Board meetings.

Conceptual Framework	**Characteristics of defined rate regulation**
Binding terms The guidance supporting the asset and liability definitions 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).	***Binding terms*** The regulatory agreement may take the form of a contractual licensing agreement or may be imposed through statute. Regardless of its form, the terms of the regulatory agreement bind both the entity and the rate regulator. Those binding terms establish rights and obligations for the entity that have commercial substance because they clearly have a discernible effect on the economics of the regulatory agreement.
Asset definition An asset is a present economic resource **controlled** by the entity as a result of **past events**. An economic resource is a **right** that has the potential to produce economic benefits.	***Mechanism for setting the regulated rate (P)*** Defined rate regulation establishes a basis for setting the regulated rate (ie a rate-setting mechanism) chargeable by an entity to its customers for the transfer of specified goods and/ or services. The rate-setting mechanism includes a rate-adjustment mechanism that creates temporary differences when the regulated rate in one period includes amounts relating to required activities carried out by the entity in a different period.

Conceptual Framework	**Characteristics of defined rate regulation**
Guidance • An entity must have **a right** that has the **potential to produce economic benefits** for the entity beyond those available to all other parties. • An entity **controls** an economic resource if it has the right to deploy the economic resource in its activities and if, in addition, any economic benefits from that resource flow to the entity (either directly or indirectly) rather than to another party. Control does not imply that the entity can ensure that the resource will produce economic benefits in all circumstances.	We consider that: (a) a rate-setting mechanism is a characteristic (ie characteristic A) that differentiates market regulation[15] and defined rate regulation from normal competitive markets; and (b) a rate-adjustment mechanism is a characteristic (ie characteristic B) that differentiates defined rate regulation from both market regulation and normal competitive markets. In normal competitive markets, the mere right to set prices and increase prices does not have the potential to produce economic benefits beyond those available to all other parties. Similarly, mere price constraints due to market conditions or other factors do not create an obligation to decrease prices and so there is no obligation that meets the definition of a liability. Although characteristic A is necessary to create regulatory assets and liabilities, it is not sufficient. Characteristic B is necessary to ensure that an entity has the right or obligation to adjust a future regulated rate to reflect the origination and/or reversal of temporary differences created by the rate-

[15] 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. Consequently, the regulation does not include a 'rate-adjustment mechanism' that determines the amount of profit or profit margin that an entity can earn.

Conceptual Framework	Characteristics of defined rate regulation
Liability definition A liability is a **present obligation** of the entity to transfer an economic resource as a result of **past events**. *Guidance* • An entity must have an **obligation** to transfer an economic resource. Obligations to transfer an economic resource **need not result in a direct outflow of cash.** For example, such an obligation can exist if the obligation requires an exchange of economic resources with another party on unfavourable terms or if it requires the provision of services. • The obligation must be a present obligation that exists as a result of **past events**. An entity has a present obligation that exists as a result of past	adjustment mechanism.[16] The rate-adjustment mechanism is designed to give the entity additional compensation for the **past fulfilment** of agreed regulatory requirements, or to transfer an excess of compensation that the entity has **already** received. As a result, the rate-adjustment mechanism creates rights to charge an increased regulated rate or obligations to charge a decreased regulated rate for the delivery of future goods or services. A right arises from the rate-adjustment mechanism if the entity has already partially or fully fulfilled a regulatory requirement **(past event)** but the current regulated rate does not yet reflect the compensation that the entity is entitled to in exchange. Even though the entity cannot compel its customers to buy the regulated goods or services, the entity's right to charge an increased future regulated rate has the potential to produce for the entity an inflow of economic benefits that are not available to other parties. That right will be consumed as the entity includes the rate increase in future regulated rates and will lead to an inflow of economic benefits if customers pay the increased future regulated rate for the future delivery of goods or services.

[16] June 2017 Board Agenda Paper 9B *Rate adjustment examples* contains five numerical examples that illustrate how the rate-adjustment mechanism creates rights and obligations that the model seeks to recognise as regulatory assets and regulatory liabilities. In addition, the examples also illustrate how the model could derecognise these regulatory assets and regulatory liabilities as the rights are consumed and the obligations are fulfilled.

Conceptual Framework	**Characteristics of defined rate regulation**
events only if the entity has already received economic benefits, or conducted activities, that will or may require it to transfer an economic resource that it would not otherwise have had to transfer. A present obligation can exist at the end of the reporting period even if the transfer of economic benefits cannot be enforced until some point in the future. • An obligation may be expressed as being conditional on a particular future action that might be taken by the entity, such as conducting particular activities. The entity has an obligation if it has **no practical ability to avoid taking that action**. • If an entity is preparing its financial statements on a going concern basis, it has no practical ability to avoid a transfer of economic benefits if the only way to avoid the transfer is by liquidating the entity or ceasing trading.	An obligation arises from the rate-adjustment mechanism if the entity has already received economic benefits through billings to customers **(past event)** that will require it to supply regulated goods or services at a reduced future regulated rate (ie to transfer an economic resource by charging a reduced regulated rate for that supply). The entity has **no practical ability to avoid** making that transfer because of the binding terms of the regulatory agreement. ***Other characteristics*** ***Limitations on entry into an industry (and exit from it)*** We consider that limitations on entry into, and on exit from, an industry may not be essential 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 price 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 rate-adjustment mechanism.

Conceptual Framework	**Characteristics of defined rate regulation**
	A limit on entry into the industry enhances the probability that the right will produce economic benefits that flow to the entity. However, the probability of an inflow of economic benefits affects the measurement of the right, not its existence. Limitations on exit from an industry may not be essential for the obligation to charge a lower regulated rate to be unavoidable. The economic consequences of exiting from a market may be significantly more adverse than the transfer of the economic resources itself. ***Minimum quality levels or other service requirements*** Arguably, this characteristic is not a separate characteristic, but is part of the rate-setting mechanism because without it an entity could charge the regulated rate for a lower level of service.

Appendix C—Discarding an intangible asset approach

1. The regulatory agreement establishes a range of rights and obligations for the entity that encompass many aspects of the entity's rate-regulated business and how it is operated. This combination of rights and obligations might be seen as constituting an intangible asset. However, we consider that the resulting intangible asset, if considered as a single unit of account, forms part of, but is not separable from, the business as a whole or goodwill. This is because the regulatory agreement has a pervasive effect on the value of the entity's rate-regulated business.

2. The Discussion Paper *Reporting the Financial Effects of Rate Regulation* (Discussion Paper) published in September 2014 highlighted some problems with using the requirements of IAS 38 *Intangible Assets* to reflect the rights and obligations arising from the regulatory agreement.[17] Consequently, the Discussion Paper suggested that developing an 'intangible asset model' for rate regulation would involve developing requirements different from those contained in IAS 38. The problems with using the requirements of IAS 38 include the following:

    (a) Some entities would be prohibited from recognising an intangible asset for the regulatory agreement because IAS 38 does not allow the initial recognition of intangible assets at amounts other than cost (paragraphs 21, 24 and 76 of IAS 38). This means that many rate-regulated entities would not recognise a regulatory intangible asset because many such entities do not pay a fee to acquire or renew a regulatory agreement.

    (b) Most, if not all, entities would be prohibited from recognising the rights and obligations highlighted in paragraph 12 as changes in the fair value of any intangible asset. This is because IAS 38 permits an entity to subsequently measure an intangible asset at fair value only if its fair value can be measured by reference to an active market (see paragraphs 75–78 of IAS 38).

[17] See paragraphs 5.35–5.46 of the Discussion Paper.

(c) The rights and obligations highlighted in paragraph 12 arise because of the rate-adjustment mechanism specified in the regulatory agreement. Any costs incurred by the entity that relate to the creation of such rights and obligations are unlikely to satisfy the requirements of IAS 38 to be classed as costs 'incurred subsequently to add to, replace part of, or service' any original intangible asset recognised (see paragraphs 18 and 20–23 of IAS 38).

3. Few respondents to the Discussion Paper expressed support for developing an intangible asset model, for both conceptual and practical reasons.[18] The reasons, identified through the responses to the Discussion Paper and through subsequent outreach, for not developing an intangible asset model include:

(a) Changes in the value of the regulatory agreement intangible asset may incorporate changes in the value of the business and internally generated goodwill. Such changes in value would, by their nature, include amounts that relate to future cash flows, transactions and events, including the associated profit of those future transactions. This would involve a significant level of measurement uncertainty in respect of future transactions and events.

(b) Recognising changes to the overall value of an intangible asset would not communicate the timing of reversals in the temporary differences arising from rate-adjustment mechanism. This information is important to help users of financial statements predict the effects of the regulatory adjustment on the timing of cash flows.

(c) If the net effect of the rights and obligations arising from the regulatory agreement described in paragraph 12 is isolated and treated as a separate regulatory intangible asset, it is not clear how the net effect meets the definition of an intangible asset, particularly when the net effect results in a credit balance (ie a net regulatory liability).

(d) Developing a new intangible asset model for rate regulation could cause unintended consequences for the accounting for other intangibles assets

[18] See paragraphs 52–56 of Agenda Paper 9 presented to the Board in February 2015.

and may create a conflict or confusion with the intangible asset model existing within IFRIC 12 *Service Concession Arrangements*.

Appendix D: Summary of feedback and comments received from Request for Information, Discussion Paper and outreach activities

1. We have conducted extensive research during this project to identify the characteristics of defined rate regulation and understand how the rate-setting and rate-adjustment mechanisms work in practice. We have worked with members of ASAF and with the Board's Consultative Group for Rate Regulation to develop and confirm the descriptions of defined rate regulation used in papers presented to the Board and to ASAF. We have also conducted two formal public consultations, together with formal and informal outreach with different types of stakeholders in many countries. We summarise below the main messages received that are pertinent to our description of defined rate regulation and our approach to developing the model to account for the rights and obligations arising from the rate-adjustment mechanism.

Feedback received from Request for Information

2. The Board received 79 comment letters responding to its Request for Information (RFI) *Rate Regulation*, published in March 2013. The objective of the RFI was to gather high-level overviews of types of rate regulation in force to provide factual evidence and examples that would be used to help to determine the scope of a Discussion Paper.

3. The responses to the RFI are summarised in Agenda Paper 9 presented to the Board in its July 2013 meeting. The responses came from 25 countries and described aspects of rate regulation in 37 countries. The distribution of responses by type and region of respondent is summarised as follows:

Distribution of responses by type	**Per cent %**
Preparers	51
Preparer representative bodies	13
Standard-setting bodies [incl. endorsement advice bodies]	12
Rate regulators	12
Accountancy firms/ bodies	9
Others	3
Total	**100**

Distribution of responses by region	**Per cent %**
Asia	13
Europe	42
Latin America	10
North America	21
Others	14
Total	**100**

4. All of the respondents that commented on the scope of the project welcomed the Board's intention to investigate a wide variety of rate regulatory schemes. They cautioned the Board against developing rule-based guidance applicable to only certain types of schemes. This is consistent with many of the responses to the Exposure Draft *Rate-regulated Activities* (the 2009 ED), published in July 2009. The 2009 ED focused on a specific type of rate regulation (commonly known as 'cost-of-service' or 'return-on-base-rate' regulation).

5. The responses to the RFI identified two general types of rate regulation:

   (a) Cost-based (commonly known as 'cost-of-service' or 'return-on-base-rate' regulation);[19] and

   (b) Incentive-based (including price-cap or revenue-cap regulation).

6. However, these two types reflect two extremes of a range of rate regulation. Few, if any, schemes fall neatly into either extreme and the analysis of the responses highlighted that the high-level terminology commonly used when describing rate regulation can be misleading. Consequently, a new term, 'defined rate regulation', was developed to capture the common characteristics of almost all of the schemes described.

7. Even though the objectives of rate-regulatory schemes can vary widely, the following objectives appeared to be common to most schemes described in the responses:

   (a) to protect the interests of consumers by:

      (i) controlling the price charged to customers (a 'fair and reasonable rate'); and

      (ii) providing rate stability;

[19] See Agenda Paper 9 discussed at the July 2013 Board meeting.

(b) to maintain the (public) service; and

(c) to provide investors with a 'fair rate of return'.

8. As part of the rate regulator's objective to maintain the public service, defined rate regulation typically imposes significant obligations on the supplier. Common obligations include:

(a) services must be provided to consumers on a non-discriminatory basis;[20]

(b) defined minimum service levels must be achieved;

(c) specified levels of investment in infrastructure capacity and reliability must be achieved; and

(d) emissions and other environmental targets must be met, which may include participation in conservation programmes or investment in the use of cleaner or more sustainable energy or material sources.

9. In exchange for these obligations, the regulation typically provides entities with a right, in law, to have the opportunity to recover their costs and earn a fair rate of return. Consequently, the rate-setting mechanism set by the rate regulator must provide a reasonable assurance that the supplier will recover its costs and earn a fair return, although it does not guarantee recovery.

10. Without exception, the rate-setting mechanisms described in the responses to the RFI use estimated amounts to establish the rate to be charged for the future supply of the goods/services that are subject to the rate regulation. Although the rate-setting mechanisms vary widely, almost all respondents to the RFI noted that variance/deferral accounts are used to record differences between the estimated and actual amounts for certain pre-defined types of income or expenditure.

11. The use of variance/deferral accounts (ie the rate-adjustment mechanism) is considered by many of the respondents to increase the assurance that the rate-regulated entity is able to recover the tracked costs (or 'refund' any excess recovery).

[20] This usually means that network access and connection to the network cannot be refused or that services must be provided to certain classes of consumers at the regulated rate, irrespective of the cost of providing services to that particular class of consumer, for example, those in remote or rural areas.

Comments received from the Discussion Paper and outreach activities

12. The Board received 113 comment letters in response to its Discussion Paper *Reporting the Financial Effects of Rate Regulation* (the Discussion Paper), published in September 2014. The Discussion Paper described the common features of 'defined type of rate regulation', which contains a combination of cost-based and incentive-based mechanism (ie a 'hybrid' type of rate regulation). The Discussion Paper explored which of the common features of defined rate regulation, if any, create a combination of rights and obligations that is distinguishable from the rights and obligations arising from activities that are not rate-regulated. The Discussion Paper also:
    (a) sought to identify what information about the economic and financial effects of rate regulation is most relevant to users of financial statements; and
    (b) explored several possible approaches that the Board could consider when deciding how best to report the financial effects of rate regulation.

13. Agenda Paper 9 for the February 2015 Board meeting summarises the responses to the Discussion Paper and the external consultation and formal outreach activities conducted around the Discussion Paper. The distribution of responses by type and region of respondent is summarised as follows:

Respondent type	Africa	Asia-Oceania	Europe	North America	Latin America	Global	Total
Accountancy Body	3	5	3	-	-	1	**12**
Accounting Firm	-	-	-	1	-	6	**7**
Academic	-	-	-	4	-	-	**4**
Securities Regulator	-	2	1	2	1	1	**7**
Standard Setter	-	9	10	1	2	-	**22**
User	-	1	2	2	-	-	**5**
Sub-total Non-Rate-Regulated	**3**	**17**	**16**	**10**	**3**	**8**	**57**
Rate Regulator	-	-	-	3	1	-	**4**
Preparer (Representative Body)	-	2	4	2	2	2	**12**
Preparer (Transportation)	-	1	5	1	-	-	**7**
Preparer (Utilities)	-	8	8	14	3	-	**33**
Sub-total Rate-Regulated	**0**	**11**	**17**	**20**	**6**	**2**	**56**
Total	**3**	**28**	**33**	**30**	**9**	**10**	**113**

14. The main comments received were as follows:

    (a) Many respondents agreed that the Discussion Paper provides a good description of the distinguishing characteristics of a wide range of rate-regulatory schemes that exist in practice. Most agreed that the incentive-based type of rate regulation described as 'market rate regulation' in the Discussion Paper does not create sufficiently distinctive combination of rights and obligations to support developing specific accounting requirements. However, many suggested that information about this type of rate regulation should be included in any disclosure requirements developed as a result of this project.

    (b) Most respondents agreed that the description of the hybrid-type of rate regulation, termed 'defined rate regulation' in the Discussion Paper, appropriately captures the common characteristics of a wide variety of rate-regulatory schemes found in practice, together with the rights and obligations created by the schemes. Consequently, there was strong support for using this as the basis for ongoing discussions about how best to report the financial effects of rate regulation.

    (c) Many respondents suggested that the combination of rights and obligations created by defined rate regulation creates unique or distinguishable economic conditions that are not faithfully represented by the current predominant practice in IFRS financial statements. As a result, we heard that users of financial statements need to rely on non-GAAP information obtained from a variety of sources outside the audited financial statements, which they were concerned typically lacks comparability. Although some users are content with this situation, others would prefer to obtain the information in a more accessible and comparable format within audited IFRS financial statements. However, there was limited support for the Board to develop disclosure-only requirements.

    (d) There was strong support for developing principle-based, specific accounting requirements that will lead to the recognition of at least some regulatory deferral account balances in IFRS financial statements.

The strongest support was for an approach based on the **principles** contained in IFRS 15 *Revenue from Contracts with Customers*, focusing on the entity's rights and obligations relating to the customers as a whole (the customer-base), instead of individual customers. This is most likely to result in adjustments to the timing of recognition of a combination of revenue and costs. Several respondents noted that the rate-setting mechanism focuses primarily on determining the amount of consideration to which the entity is entitled. Consequently, it seems logical to focus any accounting requirements on revenue recognition. Several respondents noted, in addition, that the deferral of cost recognition is not incompatible with the principles of IFRS 15. Using IFRS 15, an entity recognises particular contract costs as an asset if specified conditions are met (paragraphs 91-98 of IFRS 15).

(e) There was strong support for the amounts recognised to be identified separately within the financial statements. Views were mixed about whether the amounts should be disclosed separately only in the notes to the financial statements or also in the statement of financial position and income statement.

(f) There was very little support for an intangible asset approach. Most of the opponents of this approach who gave reasons for their view agreed with the disadvantages outlined in the Discussion Paper (see Appendix C).

(g) There was strong support to use the disclosure requirements in IFRS 14 *Regulatory Deferral Accounts* as a basis for any disclosure requirements that may be developed as a result of this project.