IFRS® Foundation

CMAC meeting

March 2018

Agenda paper 5

Rate-regulated Activities

The views expressed in this presentation are those of the presenter, not necessarily those of the International Accounting Standards Board (the Board) or IFRS Foundation.

Objectives of the meeting

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To seek CMAC members' views on:

- the usefulness of an initial set of information being considered for an accounting model being developed for rate-regulated activities;
- whether entities should be required to provide all the information arising from that initial set in their financial statements; and
- whether there are any other information needs the staff should consider while developing the model.

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The Board is currently developing an accounting model for companies that carry out rate-regulated activities. The model could result in companies recognising regulatory assets and regulatory liabilities to depict rights and obligations arising from the regulatory agreement between the company and the rate regulator.

At the CMAC meeting in March 2017, we presented three examples in which a regulatory asset or regulatory liability could be recognised using the model being developed. We asked CMAC members to comment on the usefulness of recognising such amounts for understanding the financial position, performance and expected cash flows of the company. See Agenda Paper discussed at that meeting at: http://www.ifrs.org/-/media/feature/meetings/2017/march/cmac/ap3-rate-regulated-activities.pdf and slide 8.

Since March 2017, we have had educational discussions with the Board that considered aspects of the model such as recognition and measurement. During 2018 we aim to gather tentative decisions from the Board on the main aspects of the model so that we can compile them in the next consultation document that we expect to publish in 2019.

We would like to use this meeting to seek CMAC members' views on a preliminary set of disclosures we are considering for the model. We will consult CMAC again once the features of the model have been further confirmed with the Board.

Questions

- Can you please comment on:
  - (a) using the disclosure objective in IFRS 14 as a reference for developing the disclosure objective for the model (slide 11);
  - (b) usefulness of the preliminary set of disclosure requirements identified for the accounting model being developed for rate-regulated activities (slides 12-22);
  - (c) whether any of the disclosure requirements identified in slides 12-16 should not be required to be provided within the financial statements.
- Are there are any other information needs the staff should consider while developing the model? How would investors use these additional pieces of information?

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Content

Before starting... a brief reminder

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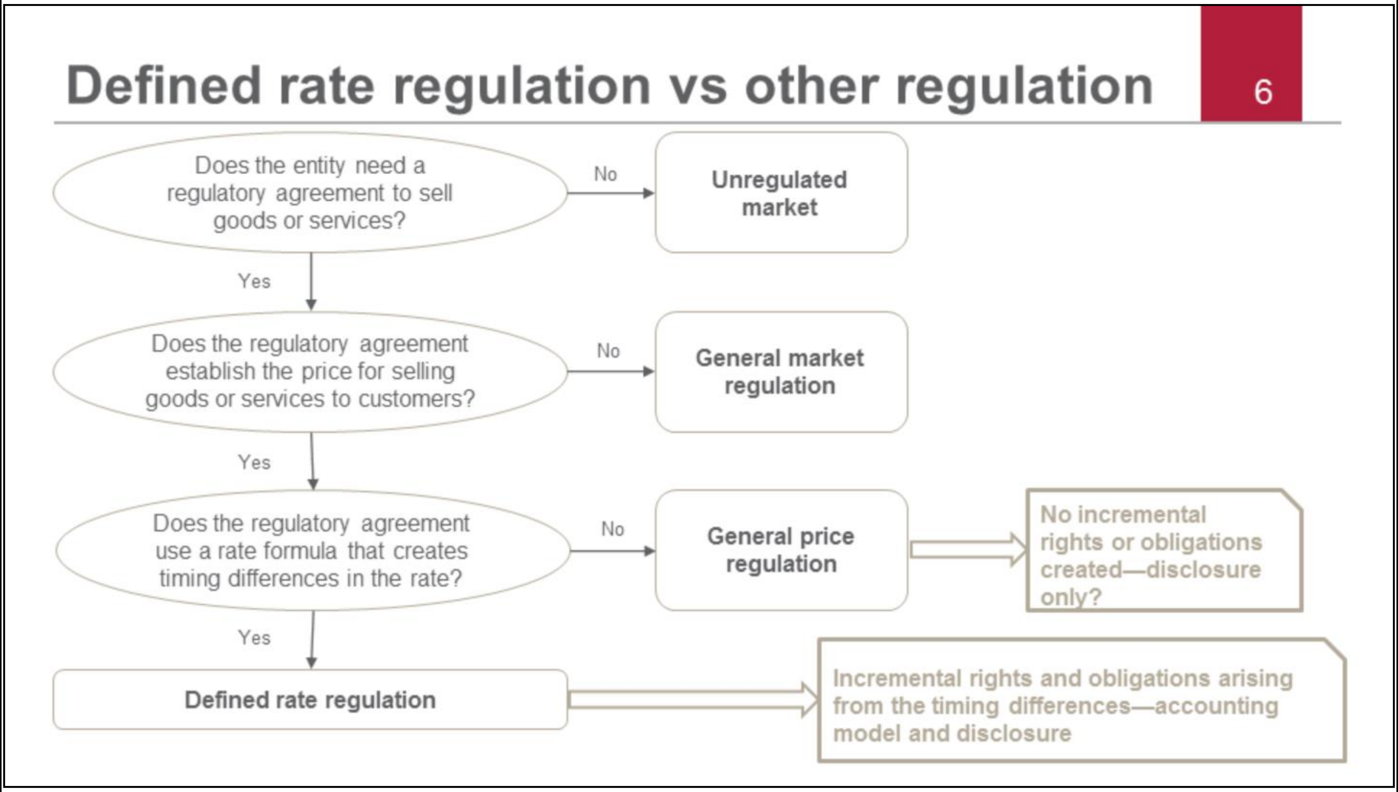
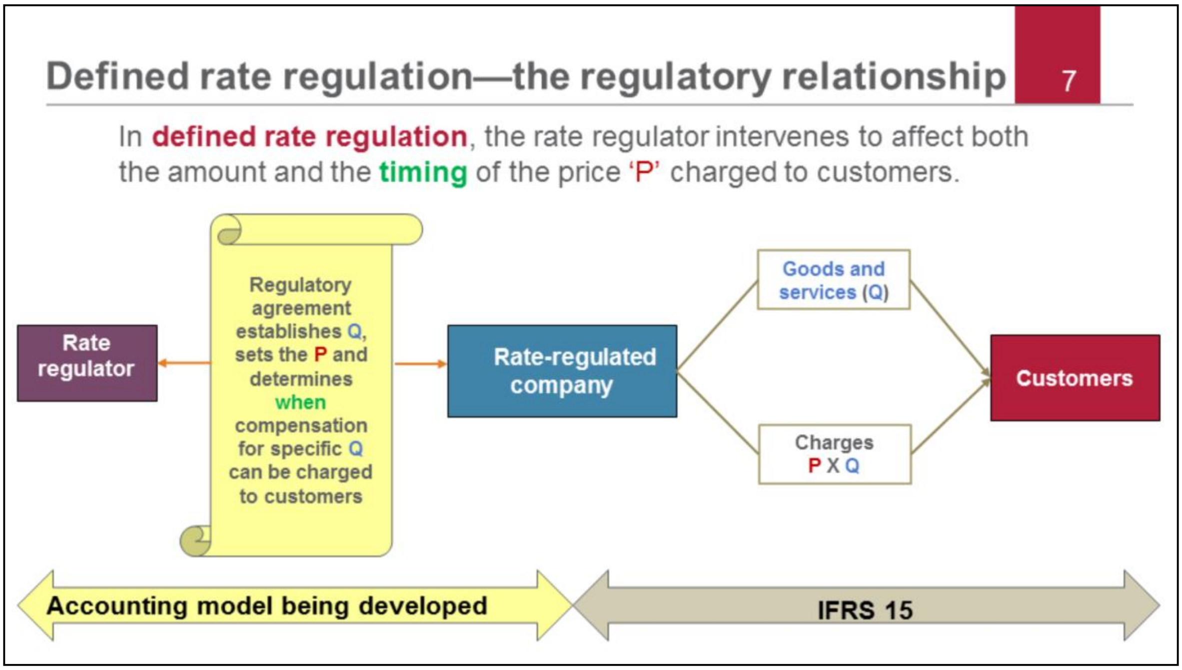


Many governments regulate the supply and pricing of particular types of goods and services by companies. These 'rate-regulated activities' usually involve providing goods and services that are considered in that jurisdiction to be essential to customers. This slide aims to identify what differentiates activities subject to defined rate regulation from unregulated activities or activities subject to other types of regulations. This project is mainly about what we refer to as defined rate regulation.

General price regulation typically applies when competition in a market is insufficient to protect customers from suppliers making excessive levels of 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. Consequently, an entity operating within a price-regulated market is exposed to both input price risk and demand risk.

In contrast, defined rate regulation establishes the total amount of revenue that an entity can charge in exchange for fulfilling the service requirements established in the regulatory agreement. Defined rate regulation uses a 'rate adjustment mechanism' to give the company some protection against both input price risk and demand risk so that the amount of revenue or profit specified in the regulatory agreement can be billed by the company to customers. As explained in the following slides, the model being developed focuses primarily on the timing differences created by the application of this rate adjustment mechanism.



This slide illustrates the following relationships:

a) the relationship between the rate-regulated companies and their customers (right hand side of the slide); and
b) the relationship between the rate regulator and the rate-regulated companies (left hand side of the slide)

<u>Right hand side of the slide</u>

Looking at the customer contracts in isolation, we observe a simple price (P) x quantity (Q) relationship. The company satisfies its direct customer performance obligations by delivering goods or services (Q) in a specified period at a specified price (the regulated rate, P). When the company delivers, the individual customers are obliged to pay, and the company is entitled to receive, the amount charged (P x Q). The amount charged using this P x Q relationship is recognised as revenue in accordance with IFRS 15 *Revenue from Contracts with Customers*.

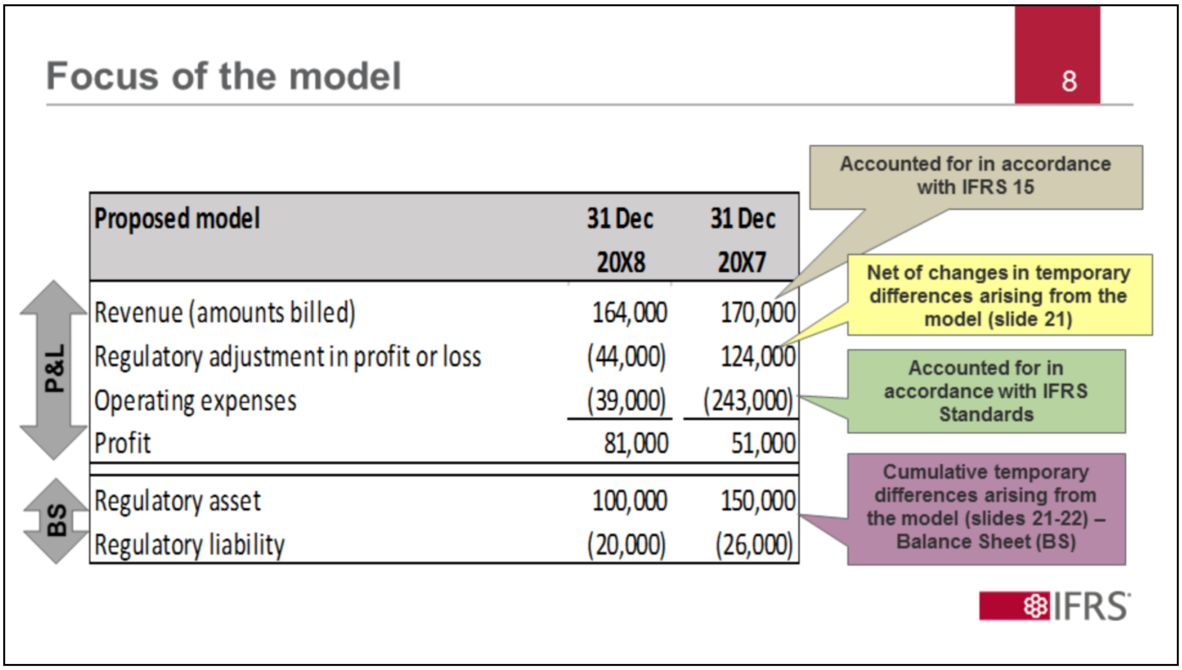
<u>Left hand side of the slide</u>

The rate-regulated company must also comply with the regulatory agreement. The regulatory agreement establishes the service requirements the company is obliged to fulfil (usually related to the quality, quantity and availability of supply). The regulatory agreement also sets out the rate formula that determines **how much compensation** the company is entitled to include in the regulated rate **in exchange** for **fulfilling its service requirements** (ie the **allowable revenue**). The rate formula approved by the rate regulator also determines **when** the company can include the allowable revenue in the rate charged to customers. This can result in **timing differences** between when the company fulfils its service requirements and when it includes the related compensation in the rate(s).

<u>What is the accounting model trying to address?</u>

As can be inferred from the above paragraphs, reporting revenue and related expenses in accordance with IFRS 15 and other IFRS Standards, using only the customer-contract P x Q relationship, does not give a complete picture of the effects of defined rate regulation on a company's financial performance during the period or its financial position at the end of the period. This is because, when looking from the perspective of the regulatory agreement, some of those effects are reported in **a different period** than the transactions or other events that created them.

One of the main challenges in this project is how to give investors information about those timing differences, and about their effect on the companies' profit margins.



Proposed model	31 Dec 20X8	31 Dec 20X7
Revenue (amounts billed)	164,000	170,000
Regulatory adjustment in profit or loss	(44,000)	124,000
Operating expenses	(39,000)	(243,000)
Profit	81,000	51,000
Regulatory asset	100,000	150,000
Regulatory liability	(20,000)	(26,000)

This slide provides an extract that illustrates summarised profit or loss and balance sheet statements. The aim is to show how movements on the regulatory asset and regulatory liability balances result in adjustments in profit or loss that reflect the origination and/or reversal of timing differences. Please note that the Board has not yet discussed aspects of the model dealing with presentation. We will discuss with CMAC members aspects of presentation in a future meeting.

- **Regulatory assets** arise when a company has fulfilled service requirements in a period (T=1) but compensation for these service requirements is not included in the rate (P) for T=1. As a result, the company's profit or loss for T=1 includes the expenses it incurred but it does not include the associated revenue.

The adjustment that the model suggests in T=1 is to increase net income (regulatory adjustment line item) in profit or loss by creating a regulatory asset in the balance sheet. Subsequent to T=1, that adjustment is reversed as the company includes the compensation for the service requirements already fulfilled in the rate(s). The reversal of the adjustment would be reflected as a reduction of net income (regulatory adjustment line item) in profit or loss and as a decrease of the regulatory asset booked in the balance sheet.

- **Regulatory liabilities** arise when a company has received compensation through the rate for service requirements it has not yet fulfilled. As a result, the company's profit or loss for the period in which it has received compensation (T=1) includes revenue for service requirements not yet fulfilled.

The adjustment that the model suggests in T=1 is to decrease net income (regulatory adjustment line item) in profit or loss by creating a regulatory liability in the balance sheet. Subsequent to T=1, the reversal of the adjustment would be reflected as an increase in net income (regulatory adjustment line item) in profit or loss as the company fulfils the service requirements and incurs corresponding expenses and as a decrease of the regulatory liability booked in the balance sheet.

[Please note that in the explanations of regulatory assets and regulatory liabilities above, period T=1 would refer to the period 20X7 in this slide].

Thinking about information needs

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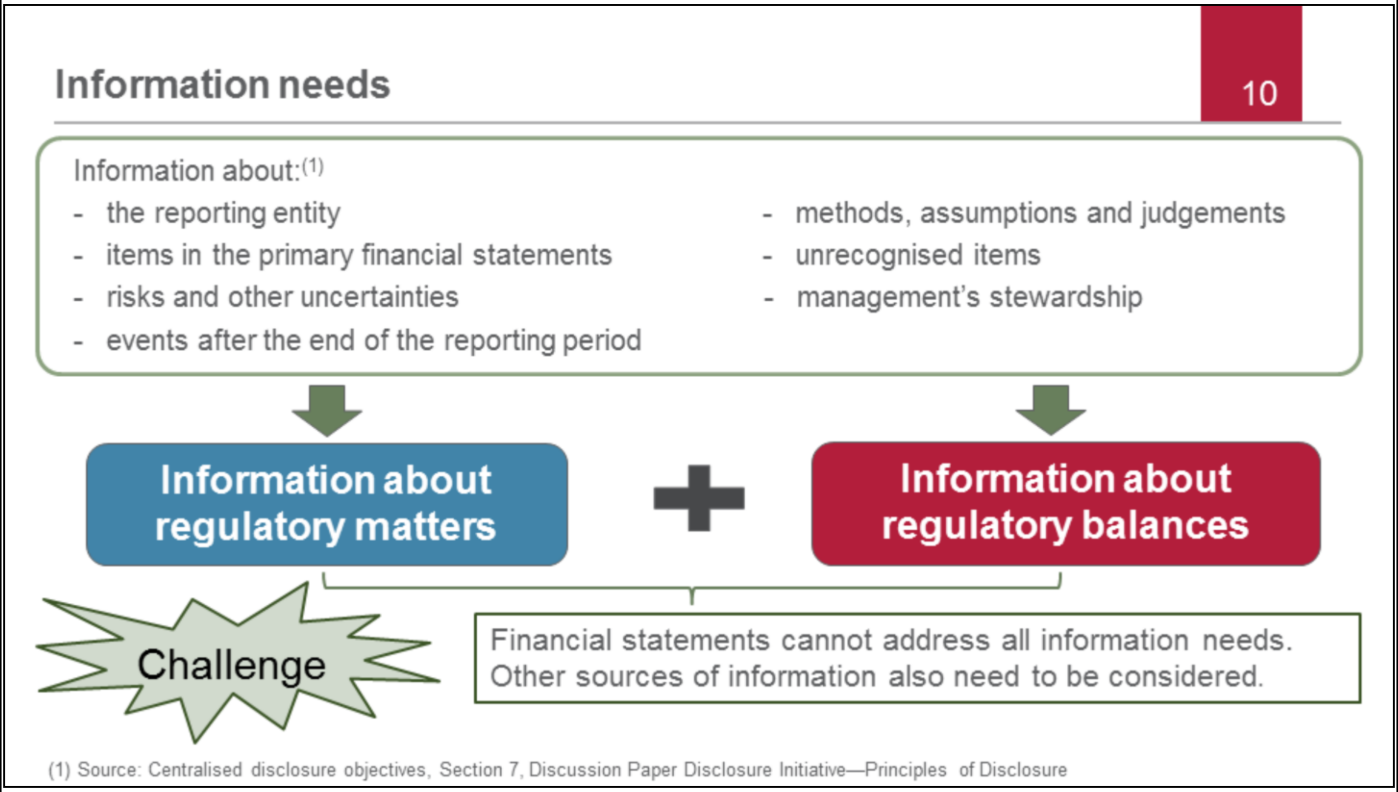


The Board normally develops disclosure objectives or requirements in IFRS Standards by focusing on the various types of information that are useful to the users of the financial statements about the classes of assets or liabilities that are within the scope of the particular Standard. This would be for us an overarching framework. The main items of this framework are included in the green rectangle at the top of the slide.

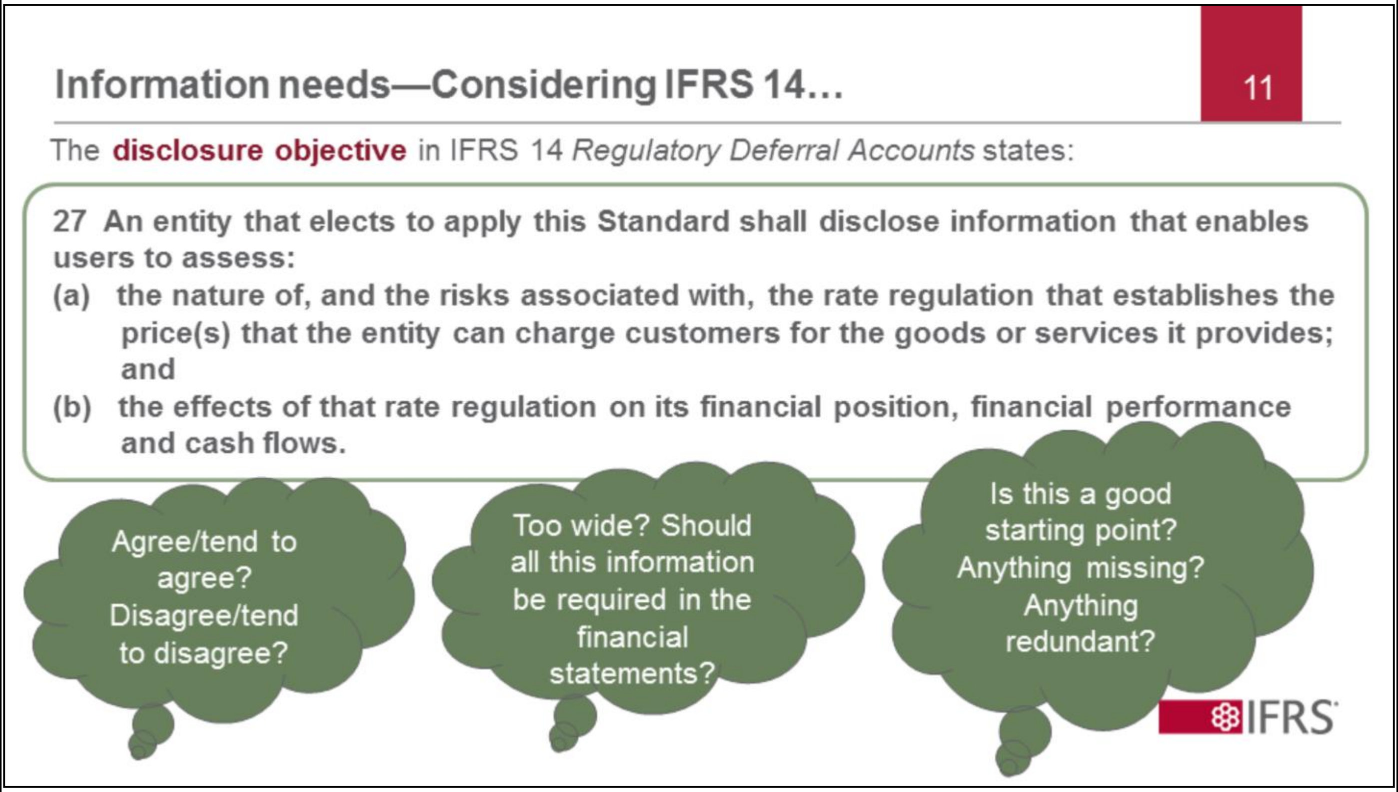
Starting from this overarching framework of types of information we think the resulting information that could be useful for users could be categorised in two main blocks:

a) Information about regulatory matters; and
b) Information about regulatory balances

Slide 11 includes the disclosure objective in IFRS 14 *Regulatory Deferral Accounts*. IFRS 14 is a temporary IFRS Standard that permits first-time adopters to continue to recognise amounts related to rate regulation in accordance with their previous GAAP requirements when they adopt IFRS Standards.

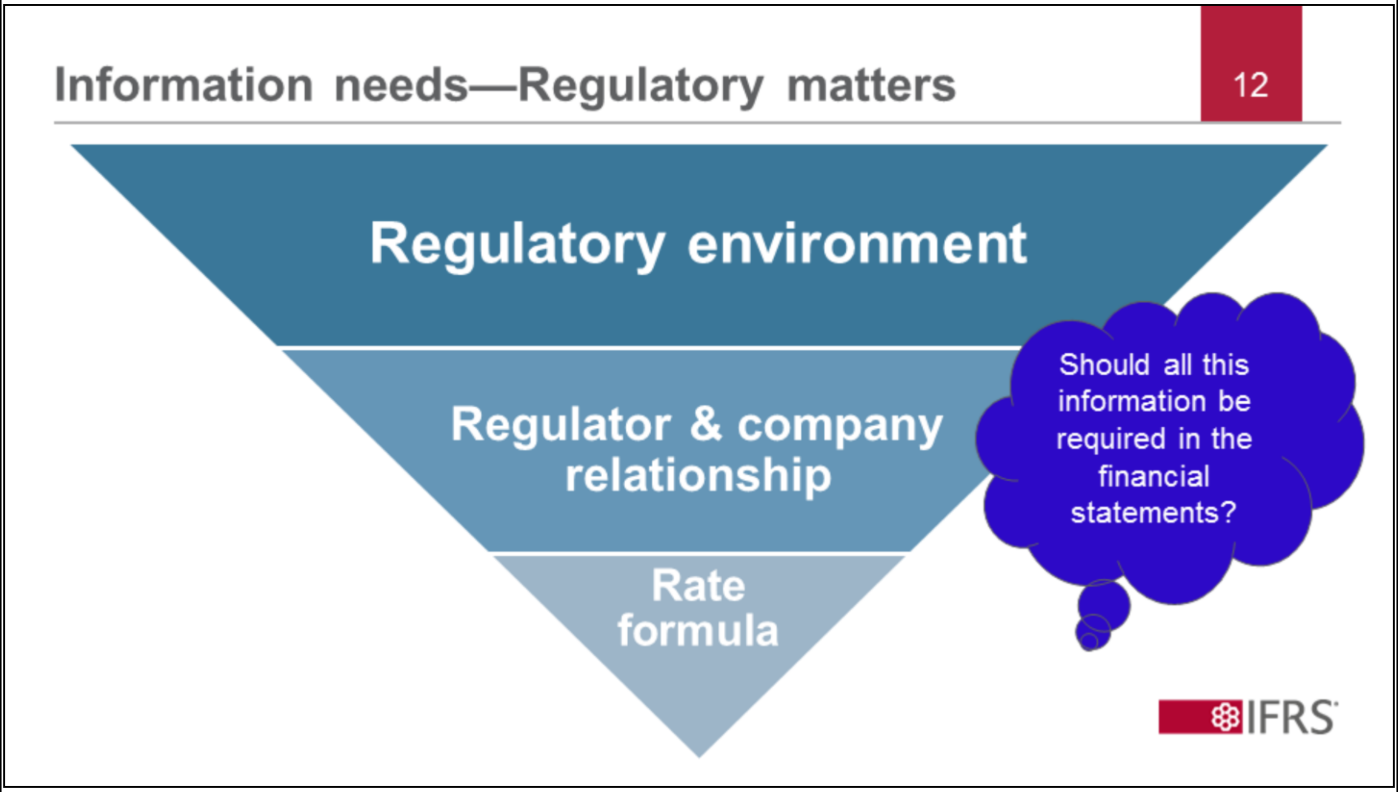
The slides that follow include possible disclosure requirements dealing with the two blocks of information mentioned above.

When developing the disclosure requirements for the model, we need to consider that general purpose financial reports do not and cannot provide all of the information that existing and potential investors, lenders and other creditors need. Consequently, we will need to assess what information companies should be required to provide in their financial statements. In this respect, it is worth highlighting that IFRS 14 states that disclosures arising from some of its requirements maybe given in the financial statements or incorporated by cross-reference from the financial statements to other statements within the annual report such as management commentary or risk report.



The objective of this slide is to ask CMAC members whether they consider the current disclosure objective in IFRS 14 is too wide or whether it could be a good reference for us when developing disclosure requirements for the model we are developing.

The disclosure objective in IFRS 14 could be seen as being too broad because it could result in companies disclosing information about the general environment in which it operates, rather than focusing on the amounts being accounted for in the financial statements. Consequently, we will need to assess what information should be required in the financial statements and what information investors could obtain from other sources (for example, general economic conditions and expectations, political events and political climate, and industry and company outlooks).

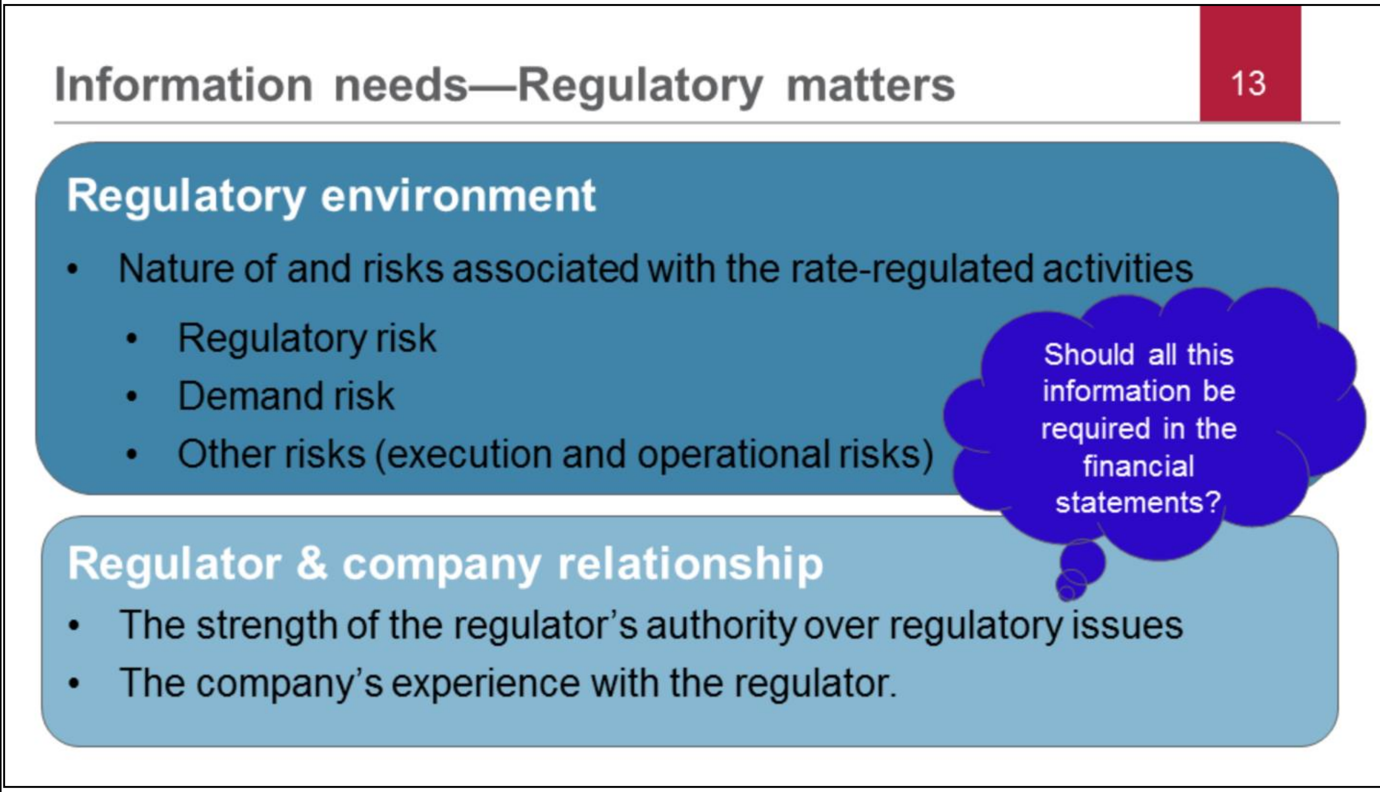


For the purposes of structuring the information relating to regulatory matters, we have identified the following three main blocks of information:

- Regulatory environment
- The relationship between the rate regulator and the rate-regulated company
- Rate setting basis and formula

The following slides provide examples of information relating to each of these blocks. Please note that these three blocks are interrelated and that some pieces of information could be included in more than one block.

As mentioned in slide 11, we will need to assess what information should be required in the financial statements and what information investors could obtain from other sources (for example, general economic conditions and expectations, political events and political climate, and industry and company outlooks).



The features of the **regulatory framework and the overall economic environment** can have a distinct effect on the risks that rate-regulated companies face compared to companies carrying out unregulated activities. The information arising from the aspects included in this slide can help investors assess the overall stability of a rate-regulated company's business and revenue profiles. We understand credit rating agencies take this information into account in their rating methodologies.

We would like to understand CMAC members' views on what information they would expect to be provided in the financial statements and what information investors could obtain elsewhere, such as in the company's management commentary, the rate regulator's website or other industry commentaries.

Illustrative examples—Regulatory matters (1)

14

The regulatory framework

The regulatory framework governing the company's activities as a transmission systems operator in Country A is formed by the Electricity Act amended on day/month/year by the X package of European directives. Additional details on the amendments to the Electricity Act can be found in Note Z.

The electricity market in Country A is regulated by Regulator X. Regulator X is the independent national regulator that monitors and controls the electricity market in Country A. Its powers include:

(a) approving the contractual terms of the regulated activities of the company;
(b) defining and monitoring the rates;
(c) ensuring non-discriminatory customers' access to the goods and services delivered;
(d) certifying the fulfilment of service requirements as specified in the regulatory agreement;
(e) […]

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We are using extracts from real life disclosures included in the financial statements of companies that are currently using IFRS 14 or local GAAP.

Examples of disclosures in slides 14, 16, 19-22 are being used as a tool to provide an indication of the type of information that could result from the initial set of disclosure requirements in slides 12, 13, 15, 17 and 18.

We are not asking CMAC members to comment specifically on the disclosures provided as examples.

Information needs—Regulatory matters

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Rate formula

- Nature/description of the rate-setting process
- Description of the rate formula, including main components, period that it covers and any updates carried out
- Rate of return approved by the regulator on the assets used to carry out the rate-regulated activities (regulatory asset base)

What specific information would be particularly useful to investors?

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The information arising from the aspects of the rate formula could help investors assess the stability of the regulated business and its cash flow generation.

We are interested in understanding what specific information relating to the rate formula would be particularly useful for investors.

Please note the rate formula determines **how much compensation** the company is entitled to include in the regulated rate in exchange for fulfilling its service requirements (ie the allowable revenue). The rate formula approved by the rate regulator also determines **when** the company can include the allowable revenue in the rate charged to customers. See slide 7.

Illustrative examples—Regulatory matters (2)

16

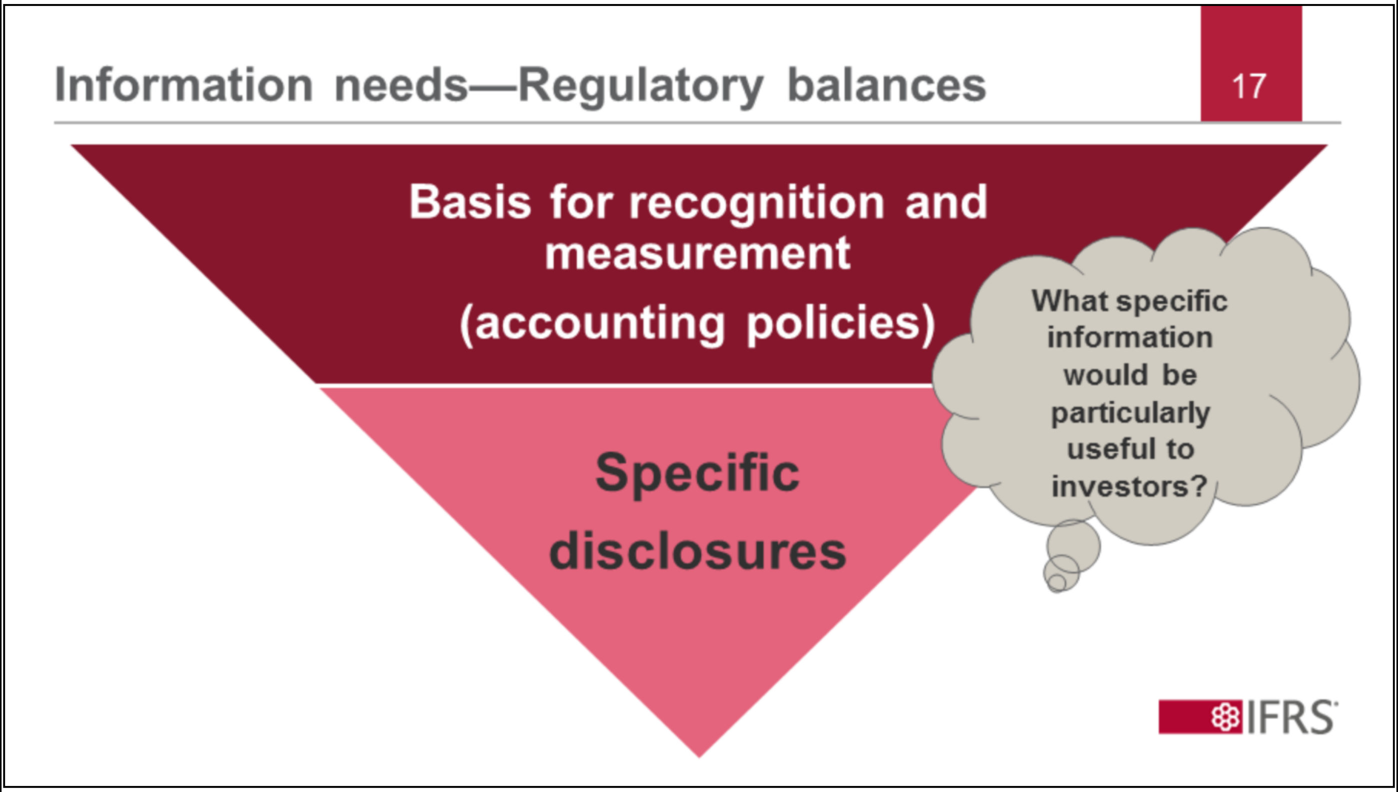
The rate formula

The regulated rates charged to our customers for use of the grids are approved in advance by Regulator X. The rate setting established by Regulator X provides the framework of approved rate(s) for five-year periods, unless specific circumstances convene differently. 2X15 was the first year of the current five-year regulatory period.

The rate is based on budgeted costs, less a number of specified items. The costs considered include the estimated approved return on the invested capital and forecasted amounts of controllable and non-controllable costs.

Non-controllable costs are costs over which the company has no direct control. These costs consist of depreciation, taxes [etc]. Controllable costs are costs over which the company has direct control and are subject to incentive regulation. Any savings with respect to the allowed budgeted controllable costs impacts positively the company's net profit by 35% of the amount.

For the current regulatory period (2X15-2X20), Regulator X has set the return on equity at X% for investments made before 2X05 and to Y% for investments made since 2X05, considering a capital structure of 40:60 (equity:debt). The main inputs used by Regulator X when deriving these returns are detailed in Note Z.



In relation to disclosures relating to the resulting regulatory assets and regulatory liabilities arising from the regulatory agreement and recognised by applying the model, we have identified two main blocks of information:

- Basis for recognition and measurement of the regulatory assets and regulatory liabilities
- Specific disclosure requirements that would enable investors to understand the composition of these items, changes in the balances during the year, the maturity profile of these items as well as other specific information such as unrecognised regulatory items.

We are interested in understanding what information relating to these blocks of information would be particularly useful for investors.

Information needs—Regulatory balances

18

Specific disclosures

- **For each type of rate-regulated activity and for each class of regulatory item within that type of activity:**

a) ***Description***—**how have the items arisen, are they explicitly included in the rate formula or is there uncertainty about their approval**

b) ***Roll-forward*** **of the carrying amounts and** ***maturity analysis***

c) ***Items*** **that are** ***no longer fully recoverable or reversible*** **or that have been** ***disallowed*** **by the regulator and the underlying reasons**

d) ***Rate of return*** **used by regulator to compensate or charge for the time lag between the transaction or other event that originates a rate adjustment and the inclusion of that rate adjustment in the amounts billed to customers**

- **Unrecognised regulatory items (for example, when recognition threshold is not met)**

This slide includes an initial set of specific disclosure requirements that we have identified so far. As the model develops further this initial set will be modified accordingly. Please note that some of these disclosure requirements are currently required by IFRS 14. On the basis of the feedback received from some stakeholders, the quality of disclosures provided by some entities has improved with the application of IFRS 14.

As the slide shows, disclosure requirements (a)-(d) should be provided on the basis of each type of rate-regulated activity in which a company may operate (eg gas distribution, electricity distribution). Please let us know if we should consider other ways in which companies could disaggregate information about the regulatory items in their financial statements.

Illustrative examples—Regulatory balances (1)

19

Basis for recognition

Utility XYZ recognises regulatory assets and regulatory liabilities when their future recovery or settlement is assessed to be probable. This assessment includes consideration of:

(i) existence of explicit requirements or guidance in legislation or regulation;
(ii) direct precedents such as Utility XYZ's past experience with the rate regulator in similar circumstances;
(iii) indirect precedents—such as the experience of other entities regulated by the same rate regulator or the decisions of other rate regulators in similar circumstances; and
(iv) advice from legal or experienced advisors.

Utility XYZ assesses whether the regulatory assets and regulatory liabilities continue to meet the criteria for probable future recovery or settlement at each year-end and when regulatory or other events occur.

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Illustrative examples—Regulatory balances (2)

Uncertainties

Utility UVW monitors and assesses periodically the risks and uncertainties related to the regulatory assets and regulatory liabilities recognised. If Utility UVW considers that it is no longer likely that regulator R will be taking into account the net carrying amounts of regulatory assets or regulatory liabilities when setting future rates, Utility UVW recognises these amounts in profit or loss for the period when such a conclusion is reached.

Unrecognised regulatory items

Utility UVW incurred CU9,736 of costs relating to the repair and maintenance of the network pipelines in Region A. Regulator MNO is currently reviewing whether the activities performed during that work were prudently carried out in accordance with Safe and Security Legislation OPQ. As a result of the uncertainty surrounding the outcome of this review, Utility UVW has not recognised CU1,000 of that amount as a regulatory asset in its consolidated statement of financial position.

Illustrative examples—Regulatory balances—Roll-forward (3)

Regulatory assets *Gas distribution*	**20X7**	**Balances arising in the period**	**Recovery / Reversal**	**20X8**
Maintenance of network pipes	150,000		(50,000)	100,000
Total	**150,000**	**-**	**(50,000)**	**100,000**

See slide 8

Regulatory liabilities *Gas distribution*	**20X7**	**Balances arising in the period**	**Recovery / Reversal**	**20X8**
Penalty adjustment	(24,000)		8,000	(16,000)
Gas cost variance	(2,000)	(4,000)	2,000	(4,000)
Total	**(26,000)**	**(4,000)**	**10,000**	**(20,000)**

See slide 8

Regulatory adjustment in profit or loss	
Regulatory liabilities arising in the period	(4,000)
Recovery of regulatory assets	(50,000)
Reversal of regulatory liabilities	10,000
Regulatory adjustment in profit or loss	**(44,000)**

See slide 8

IFRS

This slide illustrates the roll-forward of the regulatory asset and regulatory liability in slide 8. It also provides a breakdown of the regulatory adjustment line item in profit or loss showing originations of new timing differences and recovery/reversal of previous timing differences.

Illustrative examples—Regulatory balances—Maturity analysis (4)

22

Maturity of regulatory assets	Total	1 year	1-3 years	more than 3 years
Gas distribution				
Maintenance of network pipes	100,000	50,000	50,000	-
Total See slide 8	**100,000**	**50,000**	**50,000**	**-**

Maturity of regulatory liabilities	Total	1 year	1-3 years	more than 3 years
Gas distribution				
Penalty adjustment	16,000	8,000	8,000	-
Gas cost variance	4,000	4,000	-	-
Total See slide 8	**20,000**	**12,000**	**8,000**	**-**

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This slide illustrates the maturity analysis of the regulatory asset and regulatory liability shown in slide 8.

Questions

Questions

- Can you please comment on:
  - (a) using the disclosure objective in IFRS 14 as a reference for developing the disclosure objective for the model (slide 11);
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