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STAFF PAPER

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

1. The purpose of this paper is to set out the staff's analysis and recommendations for the scope of the recognition and measurement model we are developing for defined rate regulation (the model).
2. At a future meeting, we will ask the Board whether, for disclosure purposes only, it wishes to extend the scope of the resulting IFRS Standard to require disclosures about other forms of rate regulation.

Summary of the staff's recommendation

3. We recommend the model should apply to defined rate regulation, defined as follows:

   Defined rate regulation is established through a formal **regulatory framework** that:

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

   (b) establishes a **basis for setting the rate** that includes a **rate-adjustment mechanism** that creates, and subsequently reverses, **rights** and **obligations** arising from **timing differences** when the

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regulated rate in one period includes amounts related to specified activities the entity carries out in a different period.

4. We think the above features of defined rate regulation are both necessary and sufficient for the origination of regulatory assets and regulatory liabilities.

Structure of the paper

5. This paper is structured as follows:

   (a) defined rate regulation (paragraphs 6–7);

   (b) scope of the model (paragraphs 8–32); and

   (c) recommendation (paragraph 33)

Defined rate regulation

6. Defined rate regulation is the subject matter of the accounting model we are developing. Several features of defined rate regulation support its overall effectiveness (see Agenda Paper 9A and paragraph 26(a)).

7. The analysis on the scope of the model focuses on identifying which of the features of defined rate regulation are both necessary and sufficient for the origination of regulatory assets and regulatory liabilities (see paragraphs 8–32).

Scope of the model

8. 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:

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

   (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);

   (c) includes, as part of the basis for setting the regulated rate, a rate-adjustment mechanism that creates and reverses timing differences

when the regulated rate in one period includes amounts related to specified activities the entity carries out in a different period; and

(d) imposes limitations on entry into an industry (and on exit from it).

Binding on both the entity and the regulator

9. The regulatory framework in which defined rate regulation is applied typically consists of:

   (a) legislation;

   (b) regulations or regulatory agreement (see paragraph 10); and

   (c) regulatory decisions, and subsequent court rulings on those decisions that interpret the legislation and the regulations (see paragraph 11).

10. 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 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.

11. Regulatory decisions and subsequent court rulings on those decisions provide evidence about the clarity and enforceability of terms in the legislation or in the regulatory agreement. Such decisions and rulings also provide evidence of the level of development, stability and predictability of the regulatory framework. The evidence provided contributes to assessments of the extent of any uncertainty about the existence and measurement of the regulatory assets and regulatory liabilities created by the timing differences arising from the operation of the rate-adjustment mechanism (see Agenda Paper 9C).

12. The binding terms in the regulatory agreement support the following aspects within the asset and liability definitions according to the forthcoming revised *Conceptual Framework for Financial Reporting* (revised *Conceptual Framework*):

    (a) Control of the right (in the case of assets)—by giving an entity enforceable rights that are specific to the entity.

(b) No practical ability to avoid the obligation (in the case of liabilities)—by imposing on the entity enforceable obligations that are specific to the entity.

13. We think that the existence of terms that bind both the regulator and the entity is a necessary feature for the origination of regulatory assets and regulatory liabilities and hence should be included in the criteria that establish the scope of the model.[1]

14. That criterion means that activities subject only to 'self-regulation' would not be included in the scope of the model (ie an entity cannot create enforceable rights and obligations with itself). Some entities may need to exercise judgement to assess whether the process for setting and enforcing the rates is subject to:

(a) the entity's internal governance mechanism that binds neither the entity nor the regulator; or

(b) sufficient external oversight and/or approval through statute or regulation that creates terms binding both the entity and the regulator.

The staff do not intend to develop any guidance on how entities should assess such circumstances.

Basis for setting the regulated rate

15. The existence of a basis for setting the rate within the regulatory agreement is a necessary feature for activities to be subject to rate regulation. However, on its own, it may not be a sufficient feature to differentiate defined rate regulation from other types of rate regulation.

16. In some cases, the existence of a basis for setting the rate affects only the rate per unit that an entity is permitted to charge for its goods or services. In these cases, the regulatory intervention is limited to establishing a cap price but the entity's management is then free to manage the business in order to maximise its

[1] The Board discussed this matter at its February 2018 meeting. Agenda Paper 9A addressed whether the regulatory rights and regulatory obligations arising from the rate-adjustment mechanism met the definitions of assets and liabilities in the revised *Conceptual Framework*. The paper can be found at: http://www.ifrs.org/-/media/feature/meetings/2018/february/iasb/ap9a-rate-regulated-activities.pdf

profitability. We have labelled this type of rate regulation as 'general price regulation'.

17. In general price regulation, the establishment of a cap price does not give entities any rights or obligations that would result in the recognition of assets or liabilities. This is mainly because there are no specific past events that can be linked to an entity's right to charge up to a cap or specific past events that can be linked to the entity's obligation not to charge above a cap. In other words, in general price regulation, there is no direct cause-and-effect relationship between the entity's past transactions or other past events and the entity's present right to charge a higher rate, or present obligation to charge a lower rate, for goods or services to be delivered to customers in the future.

18. Consequently, on its own, the basis for setting the rate is necessary but is not a sufficient feature for the origination of regulatory assets and regulatory liabilities.

Rate-adjustment mechanism

19. Agenda Paper 9A describes how the operation of the rate-adjustment mechanism creates timing differences between:

    (a) when an entity fulfils service requirements established by the regulatory agreement; and

    (b) when it includes the related compensation in the rate(s).

20. As a result, the rate-adjustment mechanism creates:

    (a) present rights to charge a rate increased by a specified amount[2] as a result of past events; and

    (b) present obligations to provide goods or services at a rate reduced by a specified amount[2] as a result of past events.

[2] The 'specified amount' is calculated using the rate formula, which identifies the monetary amount of the timing differences created by the regulatory agreement.

21. Agenda Paper 9A describes how the operation of the rate-adjustment mechanism creates an entity's right or obligation to adjust rate(s) to reflect the origination and/or reversal of timing differences as established in the regulatory agreement.

22. The inclusion of a rate-adjustment mechanism that creates a direct cause-and-effect relationship between the entity's **past** transactions or other events and the rate the entity will charge for goods or services delivered to customers in the **future** is a necessary feature for the origination of regulatory assets and regulatory liabilities. Consequently, this feature should be included in the criteria that establish the scope of the model.

Limitations on entry and on exit

23. Defined rate regulation is typically 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 many cases, limitations on effective competition for supply arise from the existence of natural monopolies. Paragraph 3.8 of the Discussion Paper *Reporting the Financial Effects of Rate Regulation* (the Discussion Paper) described this matter as follows (**emphasis added**):

> 3.8 Rate regulation is generally introduced when markets do not support effective competition. For example, a **natural monopoly** can develop when it is most efficient for the service to be provided by a single entity. This tends to be the case in **industries that are capital-intensive** and **require significant investment in infrastructure assets**. This, together with **physical constraints** on constructing and placing the infrastructure assets, creates **high barriers to entry**. Examples of industries with natural monopolies include public utilities such as water services, railways and electricity transmission.

24. However, other factors may lead governments to impose defined rate regulation. Some of these factors are described in paragraph 3.9 of the Discussion Paper (**emphasis added**):

> 3.9 In other cases, there may be no natural monopoly, but the government imposes rate regulation to **improve the quality, continuity, reliability and safety of the goods or services** and to ensure that the **service provision is not discriminatory** among various groups of customers. This often occurs when the goods or services that are rate-regulated are considered to be 'essential' in nature.[3]

25. During the research carried out in this project we have learned that, in some cases, entities may be able to supply goods or services only if they have been granted an explicit licence directed at protecting suppliers' financial viability by limiting entry into the industry by other suppliers. However, in some other cases, regulators may have among their goals a goal of encouraging competition. This is illustrated by paragraph 4.41 of the Discussion Paper:

> 4.41 Defined rate regulation could be applied to a situation in which there is more than one supplier if the demand for the rate-regulated goods or services exceeds the production and supply capacity of a single entity or because the rate regulator is looking to spread the risk of interruptions to the supply. Consequently, the rate regulator may need to lower barriers to competition in order to permit other entities to fulfil the necessary demand. […]

26. Respondents to the Discussion Paper[4] and members of the Consultative Group for Rate Regulation at their last meeting in October 2017[5] also commented on this feature in discussing the scope of the model. Their main comments were as follows:

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[3] Paragraph 3.10 of the Discussion Paper acknowledges that the term 'essential' is hard to define because of variations between jurisdictions.

[4] Agenda Paper 9 discussed at the February 2015 Board meeting includes an analysis of responses received to the Discussion Paper. That paper can be found at: http://www.ifrs.org/-/media/feature/meetings/2015/february/iasb/rate-regulated-activities/ap09-rate-regulated-activities.pdf.

[5] Agenda Paper 9A discussed at the December 2017 Board meeting includes a summary of the information received from the Consultative Group for Rate Regulation. That paper can be found at: http://www.ifrs.org/-/media/feature/meetings/2017/december/international-accounting-standards-board/ap09a-rra.pdf.

(a) general agreement that this feature typically supports the effectiveness of defined rate regulation (ie it contributes to fulfilling the objectives of defined rate regulation of ensuring an entity's financial viability by reducing demand risk and supporting stability, predictability and affordability of prices to customers);

(b) as a mandatory scoping criterion, this feature (limitations on entry and exit) would be subjective and unclear. There could be significant operational difficulties in applying this feature as a criterion, which may lead to possible diversity of interpretation and of accounting outcomes. The following example illustrates a situation in which entities may reach divergent conclusions.

Entity A is the largest entity in the power generating market of region X, ensuring the stability of supply of power in that market. Entity A is subject to rate regulation that employs a rate-adjustment mechanism of the type described in paragraphs 19–22. There is no explicit or regulator-imposed limitation on entry into the market. However, the economies of scale of the rate-regulated entity, and its role in ensuring the stability of the power supply in the market, supports the application of defined rate regulation on that entity.

There are several smaller power generating entities that supply power to cover demand peaks. The rates charged by those entities are subject to supply contracts, rather than being subject to defined rate regulation. In this situation where smaller entities may freely enter the market, some may reach different conclusions about whether a criterion based on limitations on entry would exclude Entity A from the scope of the model.

(c) a limitation on entry into a market does not determine whether a regulatory right or regulatory obligation exists (ie whether a regulatory asset or regulatory liability is originated). Instead, a limitation on entry increases the probability that the regulatory right will produce economic benefits that flow to the entity. This feature

should affect the measurement of the right, but does not affect whether it exists.

27. We generally agree with the comments received from both the respondents to the Discussion Paper and the members of the Consultative Group. We do not think a limitation on entry into a market is necessary for the origination of regulatory assets and regulatory liabilities. For the origination of regulatory assets and regulatory liabilities, it is necessary and sufficient only that entities entering the industry and the regulator are bound by the terms of a regulatory agreement. In addition, that regulatory agreement needs to establish a basis for setting the rate and that basis needs to include a rate-adjustment mechanism that creates timing differences between when an entity fulfils service requirements and when it includes the related compensation in the rate(s).

28. Limitations on exit from a market may not be essential for the obligation to provide goods or services at a lower rate to be unavoidable. This is because the regulatory agreement already gives the entity an unconditional obligation to provide goods or services in the future at a lower rate than it would have been able to charge had it not already received economic benefits that provided compensation for them. Consequently, the staff conclude that a limitation on exit from a market is not a necessary condition for the origination of a regulatory liability.

Other features of defined rate regulation

29. The description of defined rate regulation in paragraph 8 has been refined from the description outlined in the Discussion Paper. Many respondents to the Discussion Paper suggested that, when defining the scope, it would be better to distinguish ‘mandatory criteria’ from ‘supporting conditions or indicators’. Our analysis above identifies the ‘mandatory criteria’ that we consider would be the necessary and sufficient features of defined rate regulation for the origination of regulatory assets and regulatory liabilities (ie the features to be included in the description of the scope). Our conclusions are consistent with the main comments from respondents to the Discussion Paper.

30. For completeness, we highlight below the features outlined in paragraph 4.4 (a)–(c) of the Discussion Paper and explain why we do not recommend that they are included in the scope criteria for the model:

> 4.4 […] Defined rate regulation involves a regulatory pricing (ie rate-setting) framework that includes all of the following:
>
> (a) it applies in situations in which customers have little or no choice but to purchase the goods or services from the rate-regulated entity because:
>
> (i) there is no effective competition to supply; and
>
> (ii) the rate-regulated goods or services are essential to customers (such as clean water or electricity).
>
> (b) it establishes parameters to maintain the availability and quality of the supply of the rate-regulated goods or services and other rate-regulated activities of the entity.
>
> (c) it establishes parameters for rates (sometimes referred to as prices or tariffs) that provide regulatory protections that:
>
> (i) support greater stability of prices for customers; and
>
> (ii) support the financial viability of the rate-regulated entity.

31. In the staff's view, the features in paragraph 4.4(a) of the Discussion Paper are not necessary features for the origination of regulatory assets and regulatory liabilities. Our reasons for this conclusion are similar to the ones provided for the case of limitations on entry into an industry (and on exit from it)—see paragraph 26.

32. The features in paragraph 4.4(b)–(c) of the Discussion Paper influence the design of the rate formula and affect its ultimate effectiveness in achieving the objectives of defined rate regulation but, in the staff's view, are not necessary as separate criteria for determining the scope of the model. This is because:

(a) the feature requiring the establishment of parameters to maintain the availability and quality of the supply (4.4(b)) is redundant because it is

inherent in the criterion in paragraph 3(b)—the rate formula must create a direct cause-and-effect relationship between the goods or services delivered by the entity and the rate(s) charged to customers in order to identify the timing differences that create the regulatory assets and regulatory liabilities being accounted for by the model; and

(b) the feature requiring regulatory protections (4.4(c)) reflects the objectives of defined rate regulation embodied in the design of the basis for setting the rate. However, it is the binding terms of the regulatory agreement that determine whether regulatory rights and regulatory obligations are created, rather than the objectives behind the agreement. In addition, subjectivity would be involved in assessing whether a rate formula provides protections that support price stability and an entity's financial viability. This subjectivity may cause significant operational difficulties in applying this feature as a scope criterion, which may inadvertently lead to possible diversity of interpretation and outcomes.

Recommendation

33. On the basis of our analysis, the staff recommend using the following definition of defined rate regulation:[6]

'Defined rate regulation' is a form of economic regulation established through a formal regulatory framework that:

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

(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); and~~

~~(c)~~ that includes~~, as part of the basis for setting the regulated rate,~~ a rate-adjustment mechanism that creates, and subsequently reverses, rights

6 The description of defined rate regulation links to the description in paragraph 8 with new text underlined and deleted text struck through.

and obligations arising from timing differences when the regulated rate in one period includes amounts related to specified activities the entity carries out in a different period.; and

(d) imposes limitations on entry into an industry (and on exit from it).

Questions for the Board

Scope of the model
Do Board members agree with the staff recommendation in paragraph 33 on the features of defined rate regulation that are both necessary and sufficient to define what is included in the scope of the model?