STAFF PAPER

May 2018

IASB Meeting

Project	**Rate-regulated Activities**		
Paper topic	Background and summary of decisions to date		

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Purpose of this paper

1. The purpose of this paper is to provide background information about the accounting model we are developing for 'defined rate regulation' (the model) and to summarise the Board's tentative decisions to date.

Structure of the paper

2. This paper is structured as follows:
   (a) Defined rate regulation—basis for setting the rate (paragraphs 4–9);
   (b) Timing differences—regulatory assets and regulatory liabilities (paragraphs 10–16);
   (c) Unit of account (paragraphs 17–18);
   (d) Scope (paragraphs 19–21);
   (e) Recognition (paragraphs 22–23); and
   (f) Next steps (paragraph 24).

3. This paper includes two appendices:
   (a) Appendix A summarises all the tentative decisions made by the Board while developing the model; and
   (b) Appendix B provides an overview of the project plan.

Defined rate regulation—basis for setting the rate

4. The model aims to provide users of financial statements with useful information about those rights and obligations that are created by defined rate regulation and are not captured in a sufficiently useful way by existing IFRS Standards (see paragraphs 10–16).

5. Defined rate regulation is typically applied for goods or 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 defined rate regulation typically has objectives that include:

   (a) **protecting customers** by ensuring:

      (i) quality, quantity and availability of supply (done through establishing service requirements in the regulatory agreement); and

      (ii) stability, predictability and affordability of pricing (done through the basis for setting rates established by the regulatory agreement).

   (b) **protecting the financial viability of the rate-regulated entity** (entity) by ensuring the regulated rate (rate) enables the entity to obtain an adequate amount of compensation from customers in exchange for fulfilling its service requirements.

6. To achieve those objectives, there is a **binding regulatory agreement** through which:

   (a) the entity has a right to:

      (i) supply the rate-regulated goods or services (goods or services); and

      (ii) charge a **rate(s)** for those goods or services that is designed such that the entity is able to fulfil the specified service requirements (see paragraphs 5(b) and 7).

   and **in exchange**

   (b) the entity is obliged to:

(i) fulfil specified service requirements (usually related to quality, quantity and availability of supply); and

(ii) accept the basis for setting rates established in the regulatory agreement.

7. The basis for setting rates operationalises the regulatory objectives (paragraph 5) and forms part of the binding regulatory agreement (paragraph 6). The basis for setting rates helps to support the objective of protecting an entity's financial viability by giving the entity some protection against both input price risk and demand risk. As a result, the rate formula uses a rate-adjustment mechanism to adjust future rates for variances between estimated and actual inputs to the rate calculation. These variance adjustments create **timing differences** between when a transaction or event takes place and when some of the effects of that transaction or event are reflected in the rate.

8. Further timing differences may be created using the rate-adjustment mechanism to reduce the volatility of rate fluctuations, which contributes to stability, predictability and affordability of pricing for customers.

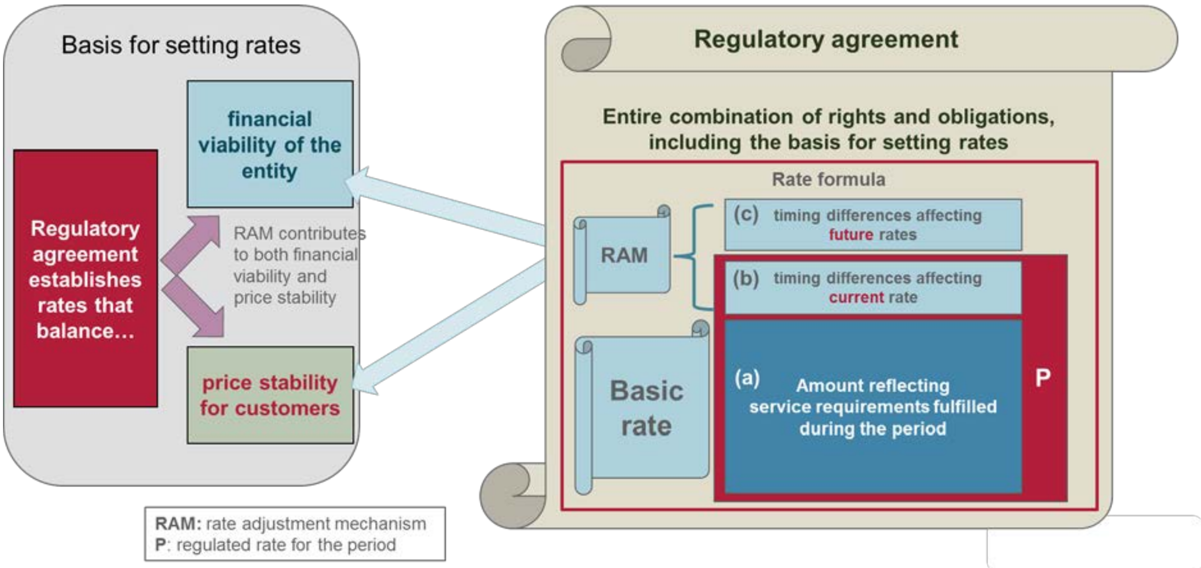
9. The regulatory agreement creates a direct and specific **cause-and-effect relationship** between when an entity carries out a rate-regulated activity (activity) to fulfil its service requirements and when amounts related to that activity are included in the rate(s) charged to customers. The direct and specific cause-and-effect relationship means that the rate formula can be used to identify (see Diagram 1):

(a) the amount of compensation included in the **current period rate** in exchange for service requirements fulfilled in the current period (ie **the basic rate**), represented by (a) in Diagram 1;

(b) positive and negative adjustments to the **current period rate** reflecting service requirements fulfilled in an earlier or later period(s), represented by (b) in Diagram 1; and

(c) positive and negative adjustments that will be made to **future period rate(s)** reflecting service requirements fulfilled in an earlier or later period(s), represented by (c) in Diagram 1.

Diagram 1



Timing differences—regulatory assets and regulatory liabilities

10. The regulated rate chargeable in the current period consists of items (a) and (b) in paragraph 9. The resulting revenue is recognised in accordance with IFRS 15 *Revenue from Contracts with Customers*.

11. Our research indicates that reporting revenue using IFRS 15 provides useful information to users of financial statements. The information is both relevant and faithfully represents what it purports to represent—the entity 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 entity delivers the goods or services, customers are obliged to pay, and the entity is entitled to receive, the amount charged (P x Q). As a result, we are not proposing to amend IFRS 15 or other existing IFRS Standards.

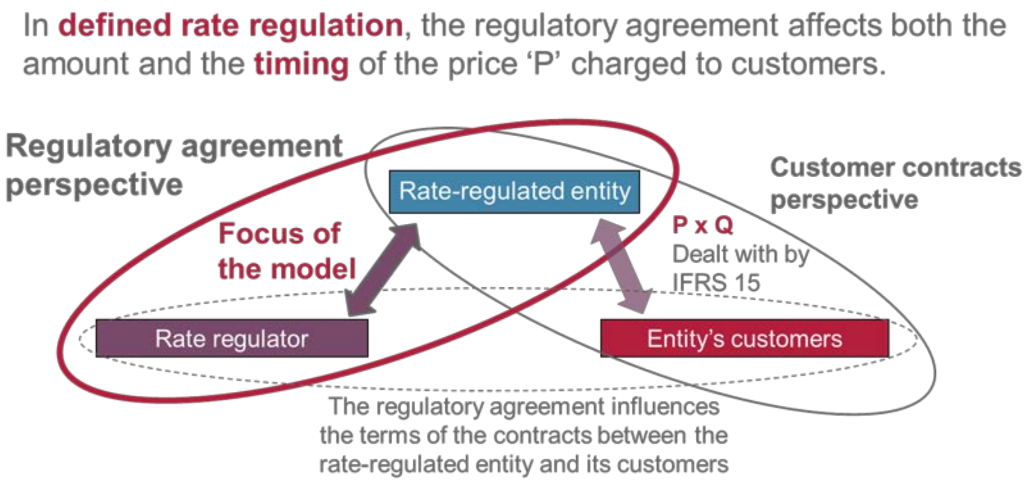
12. However, our research has also found that applying only existing IFRS Standards, without recognising the rights and obligations created by the timing differences highlighted in paragraphs 7–9, does not give a complete picture of the effects of defined rate regulation on an entity's financial performance during the period or its financial position at the end of the period. This is because those timing differences mean that the effects of some transactions or other events are reported

as income or expenses in a different period than the period in which the transaction or event takes place.

13. Not recognising the assets or liabilities that result from the timing differences creates artificial volatility in the statement of financial performance that may mask any real economic volatility. This makes it difficult for users to assess the entity's performance for the period and the effects of that performance on the entity's ability to generate future cash inflows from its activities.

14. In developing the model, we are using a '**supplementary approach**' (see Diagram 2). This means that existing IFRS Standards, including IFRS 15, will continue to be applied without modification (ie using the customer contracts perspective). The model will then be applied to provide information about the effects of those timing differences (ie using the regulatory agreement perspective).

Diagram 2



15. The rights and obligations created by the timing differences are **incremental** to those reported using existing IFRS Standards and can be characterised as:

(a) present rights to charge a rate increased by a specified amount[1] as a result of past events; and

(b) present obligations to provide goods or services at a rate reduced by a specified amount[1] as a result of past events.

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

16. The supplementary approach used by the model recognises:

    (a) in the statement of **financial position**, the incremental rights and obligations reflecting timing differences that will affect **future** rates (paragraph 9(c)); and

    (b) in the statement of **financial performance**, the timing differences originating and reversing **during** the period (paragraph 9(b) and (c)).

Unit of account

17. The model uses as its **unit of account** the **individual** timing differences arising from the operation of the rate-adjustment mechanism in the regulatory agreement. This unit of account provides users of financial statements with useful information about the expected pattern of reversal of timing differences and the timing of their effect on the entity's future cash flows.

18. For presentation and disclosure in financial statements, the Board will consider whether, and if so when, to group timing differences with similar characteristics and risks and similar reversal patterns.

Scope

19. The model applies to defined rate regulation established through a formal **regulatory framework** that:

    i. is **binding** on both the entity and the regulator; and

    ii. establishes a **basis for setting the rate** for specified goods or services that includes a **rate-adjustment mechanism**. That mechanism creates, and subsequently reverses, rights and obligations caused by the regulated rate in one period including amounts related to specified activities the entity carries out in a different period.

20. These features of defined rate regulation are both necessary and sufficient for the origination of regulatory assets and regulatory liabilities.

21. At a later meeting, the Board will discuss whether, for disclosure purposes only, it wishes to extend the scope of the resulting IFRS Standard to require disclosures about forms of rate regulation other than defined rate regulation.

Recognition

22. The model requires the recognition of regulatory assets or regulatory liabilities if it is **more likely than not** that they exist (ie the model sets a symmetrical recognition threshold in cases of existence uncertainty).

23. The model does not set thresholds that would prevent recognition of a regulatory asset or regulatory liability for which there is:

    (a) low probability of an inflow or outflow of economic benefits; or

    (b) high measurement uncertainty.

Next steps

24. The next steps in this project can be found in Appendix B.

APPENDIX A—summary of tentative decisions to date

A1. The following table summarises the Board's tentative decisions made while developing the model. The bolded meeting references also include a hyperlink to the Board meeting webpages.

Topic	**Tentative decisions** (extracts from IASB Update)	Comments
General approach in the model	**February 2017 (Agenda Paper 9A)** The Board examined how the principle proposed in the model, as well as its general approach, make use of principles in IFRS 15 *Revenue from Contracts with Customers* and of the Board's latest thinking in the *Conceptual Framework* project. The Board tentatively decided that the staff should continue developing the model using the general approach. However, it asked the staff to rework the analysis describing the principles supporting the approach.	A rate-regulated entity will apply other IFRS Standards, including IFRS 15, without amendment, before applying the model. The general approach means that, using the model, an entity will then recognise rights and obligations arising from the rate-adjustment mechanism. The Board confirmed this approach in its February 2018 meeting (see unit of account section of this table).
Scope	**March 2018 (Agenda Paper 9B)** The Board tentatively decided that the accounting model should apply to defined rate regulation 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 for specified goods or services that includes a rate-adjustment mechanism. That mechanism creates, and subsequently reverses, rights and obligations caused by the regulated rate in	This tentative decision is consistent with a previous Board's decision to focus on enforceable rights and obligations discussed at the Board's **February 2017** meeting.

Topic	**Tentative decisions** (extracts from IASB Update)	**Comments**
	one period including amounts related to specified activities the entity carries out in a different period.	
Unit of account	**February 2018 (Agenda Paper 9A)** The Board tentatively decided that: (a) the accounting model will use as its unit of account the individual timing differences that create the incremental rights and obligations arising from the regulatory agreement. (b) the present regulatory right—to charge a rate increased by an amount as a result of past events—meets the definition of an asset in the *Conceptual Framework*. (c) the present regulatory obligation—to provide goods or services at a rate reduced by an amount as a result of past events—meets the definition of a liability in the *Conceptual Framework*.	The rate-adjustment mechanism creates timing differences between: (a) when the entity fulfils the service requirements established in the regulatory agreement; and (b) when the entity includes the related compensation in the rate(s). Consequently, at the end of each reporting period, the entity may have some outstanding rights and obligations that are not recognised in the entity's statement of financial position using existing IFRS Standards, even though the transaction or other event that created them has already occurred. These outstanding rights and obligations are **incremental** to those reported using existing IFRS Standards.
Recognition of regulatory assets and	**March 2018 (Agenda Paper 9B)** The Board tentatively decided that the accounting model:	These tentative decisions build on examples discussed at the Board's **June 2017** meeting.

Topic	**Tentative decisions** (extracts from IASB Update)	Comments
regulatory liabilities	(a) should require the recognition of regulatory assets or regulatory liabilities if it is more likely than not that they exist—the model sets a symmetrical recognition threshold in cases of existence uncertainty; and (b) should not set thresholds that would prevent recognition of a regulatory asset or regulatory liability for which there is: (i) low probability of an inflow or outflow of economic benefits; or (ii) high measurement uncertainty.	

APPENDIX B–project plan

B1. The following tables provide an overview of the project plan.

	Topic	Time
Step 1	Supplementary approach	Feb 2018
Step 2	Unit of account	Feb 2018
Step 3	Asset & liability definitions	Feb 2018
Step 4	Recognition	March 2018
Step 5	Measurement	May/June 2018
Step 6	Presentation	July 2018
Step 7	US GAAP comparison	July 2018
Step 8	Discussion Paper or Exposure Draft	July 2018
Step 9	Disclosure	Sept 2018
Step 10	Interaction with other Standards	Sept 2018
Step 11	Transition, consequential amendments (depending on DP/ED decision)	Oct 2018
Step 12	Due process	Oct 2018

	Measurement	Time
Step 5.1	Conceptual Framework	May 2018
Step 5.2	Characteristics of regulatory assets	May 2018
Step 5.3	No significant financing component	May 2018
Step 5.4	Significant financing component	May 2018
Step 5.5	Description of the proposed measurement technique	May 2018
Step 5.6	Estimating expected cash flows	June 2018
Step 5.7	Identifying significant financing component	June 2018
Step 5.8	Changes in discount rate	June 2018
Step 5.9	Confirming measurement regulatory liabilities	June 2018

Discussed
Outstanding

To be discussed at this meeting
To be discussed at a future meeting