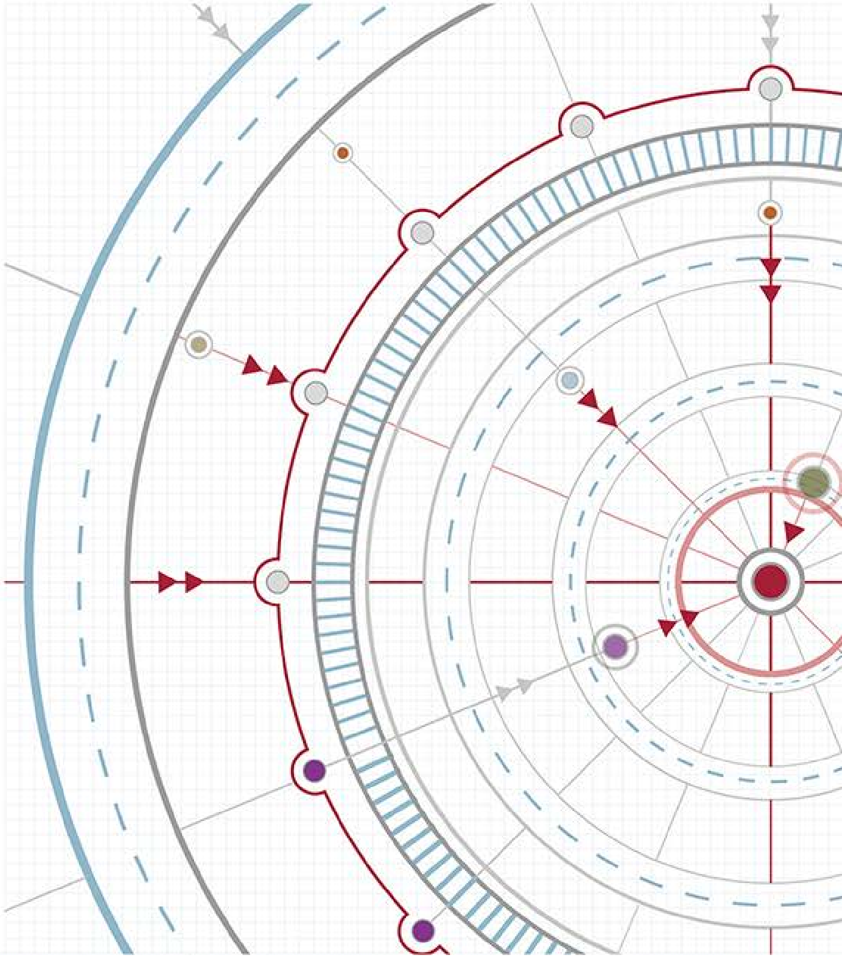
IFRS® Foundation

AP 9E



IASB Meeting—May 2019

Rate-regulated Activities: principles of the model—how the description has evolved

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

Purpose of this document

This slide deck outlines the principles of the accounting model being developed to recognise regulatory assets and regulatory liabilities arsing when an entity supplies goods or services subject to defined rate regulation.

The purpose of this document is to supplement the contents of Agenda Papers 9A-9C being presented by staff at the May 2019 Board meeting.

This document also shows how the wording used in these papers to describe the principles of the model has evolved, to aid understanding and clarity, from the wording used in papers presented to the Board in its December 2018 meeting.

Background information—defined rate regulation

Rate-regulated entity

Rate regulator

Both entity and rate regulator are bound by a **regulatory agreement** through which . . .

The entity has a **right** to

Supply specified rate-regulated goods or services

Charge for those goods or services a rate designed to make it viable for the entity to fulfil specified service requirements for the supply of those goods or services

The entity has an **obligation** to

Fulfil the specified service requirements for quality, quantity and availability of the supply of goods and services

Accept the basis established in the regulatory agreement for setting rates

Comparison to December 2018 AP9A—incremental rights and obligations

Previous description of the model referred to:

- regulatory assets and regulatory liabilities—incremental rights and obligations resulting from **regulatory timing differences** that will affect the future rate(s) charged to customers
- **regulatory timing differences**—timing differences that arise through the operation of the rate-adjustment mechanism when an entity fulfils service requirements in a **different period** than the period in which those service requirements are charged to customers through the regulated rate

Refinements to the description:

- elimination of reference to **rate-adjustment mechanism**
- clearer definition of when an entity **fulfils service requirements**—ie when the entity supplies goods or services, rather than when it carries out other activities such as constructing infrastructure assets
- clearer description about when timing differences arise—ie when the '**total allowed compensation**' for goods or services already supplied exceeds or is lower than the amount already charged

See paras 6-12, December 2018 AP9A

Incremental rights and obligations reported by the model

When, in the current period, the entity supplies goods or services, it obtains one or more of the following:

Financial asset

the present right to charge customers in current period the regulated rate for goods or services supplied in the same (current) period—a trade receivable)

Regulatory asset

the present right **to add an amount to the rate(s)** to be charged to customers in future periods because the **total allowed compensation** for ***the goods or services already supplied*** **exceeds** the amount already charged to customers

Regulatory liability

the present obligation **to deduct an amount from the rate(s)** to be charged to customers in future periods because the **total allowed compensation** for ***the goods or services already supplied*** **is lower than** the amount already charged to customers

Incorporated into current contracts with customers—reported using IFRS15 *Revenue from Contracts with Customers*

Arise from the regulatory agreement—are incremental to the rights reported using IFRS 15 and are outside the scope of IFRS 9 *Financial Instruments*. These **incremental rights and obligations** are (typically) not currently reported.

Purpose of the model is to supplement the information provided by IFRS 15 by recognising, in the current period, regulatory assets and regulatory liabilities

Comparison to December 2018 AP9A—definitions of regulatory asset/ liability

Previous description of definitions of regulatory asset and regulatory liability:

- Regulatory asset—a present regulatory right to charge a rate **increased by an amount** as a result of **past events**
- Regulatory liability—a present regulatory obligation **to provide goods or services** at a rate **reduced by an amount** as a result of **past events**

Refinements to the description:

- clearer definition of **past event** that gives rise to an incremental right or incremental obligation—ie when goods or services are supplied in the period
- clarification of how the **amount** of the timing difference is determined—ie the difference between right to the '**total allowed compensation**' and the amount already charged to customers
- Clarification of the obligation—to deduct an amount from the future rate(s), rather than to provide goods or services

See para 15, December 2018 AP9A

Regulatory assets and regulatory liabilities

Regulatory asset

the present right **to add an amount to the rate(s)** to be charged to customers in future periods because the **total allowed compensation** for ***the goods or services already supplied*** **exceeds** the amount already charged to customers

Clearer about what **amount**

Regulatory liability

the present obligation **to deduct an amount from the rate(s)** to be charged to customers in future periods because the **total allowed compensation** for ***the goods or services already supplied*** **is lower than** the amount already charged to customers

Clearer about what **obligation**

Clearer about what ***event***

Unclear about what *event*

Previous definitions

Regulatory asset

The present regulatory right

- to charge a rate increased by an amount
- as a result of past events.

Regulatory liability

The present regulatory obligation

- to provide goods or services
- at a rate reduced by an amount
- as a result of past events.

Unclear about what obligation

Unclear about what amount

Comparison to December 2018 AP9A—determining the ‘total allowed compensation’

Previous description of regulatory timing differences referred to:

- some effects of some transactions or other events are reported as income or expense in a different period than the period in which other effects of the same transaction or event are reported—some felt this suggested a ‘**matching**’ focus

Refinements to the description:

- clarification of how the **amount** of the timing difference is determined—ie the difference between the right to the ‘**total allowed compensation**’ and the amount already charged to customers—helps focus on rights and obligations arising

See para 12, December 2018 AP9A

Total allowed compensation—amount

Total allowed compensation—the amount an entity is entitled to charge customers for goods or services supplied during the period

- Allowable expenses
  - Directly attributable to goods or services delivered
  - Indirectly attributable to goods or services delivered
- Target profit
  - Interest or return on base amount (*time related*)
  - Margins on costs
  - Incentive rewards (bonuses) and penalties

The fact that the regulatory agreement treats the expenses as **allowable** establishes that they relate to goods or services supplied in **some** period—apply judgements used in applying IFRS Standards to establish **which** period

Total allowed compensation—timing

<u>Total allowed compensation</u>—the amount an entity is entitled to charge customers for goods or services supplied during the period

Typically, total allowed compensation is included in the same period the goods or services are supplied but some **timing differences** may arise

Estimation variances

- At the entity's risk—no resulting adjustment to future rate(s)
- At the customers' risk—true-up through future rate(s)

Other timing differences

- Allowable expenses incurred and 'spread' through future rate(s)
- Pre-funding in current rate for future allowable expenses
- Different principles for defining 'incurred'

Measurement

Measurement—
a cash-flow-based measurement technique

<u>Board's tentative decision</u>—apply a cash-flow-based-measurement technique

Estimate future cash flows:
- estimate using 'most likely amount' or 'expected value' (depending on facts and circumstances)
- update estimates if changes occur

Discount the estimated cash flows:
- keep the discount rate established at initial recognition **<u>unless</u>** the regulatory agreement changes the cash flows by changing the interest rate or return rate

Allowable expenses

Interest or return on base amount (*time related*)

Margins on costs

Incentive rewards (bonuses) and penalties

Types of regulatory assets/ liabilities

Treated as part of the regulatory capital base (RCB)—capex

- long-term
- blended return rate
- includes equity return component, typically based on WACC

Treated as operating items—opex

- short- or medium-term
- blended return rate
- excludes equity return component, typically close to corporate borrowing rates or entity's incremental borrowing rate

Similar in nature so considered together (**see slides 15 and 17**)

Related to expenses payable/ (income receivable) in the future that will be added to/ (deducted from) future rate(s) when cash is paid/ (received)

- regulatory agreement treats the amount of cash paid as the allowable expense/ (cash received as the chargeable income) so no regulatory interest or return rate is needed

Considered separately from capex/ opex items (**see slide 16**)

Comparison to December 2018 AP9B *Discount Rate*—assessing the discount rate

Previous description of discount rate recommendations:

- created complexity by recommending different requirements for regulatory assets treated as part of the RCB and for regulatory assets treated as operating items
- did not distinguish between measurement principles and measurement mechanics and so did not distinguish recommendations that:
  - were consistent with the measurement principles and so were 'core' to the cash-flow-based measurement technique
  - were exceptions to the measurement principles—the previous description did not clearly explain the reasons for such exceptions

Refinements to the description:

- clarify measurement principles
- reduce complexity by considering regulatory assets treated as part of the RCB and those treated as operating items as a single category
- clarify recommended exceptions to the measurement principles
- provide separate discussion on regulatory liabilities

Measurement principles—regulatory assets (capex and opex)

Does the interest rate or return rate established by the regulatory agreement adequately compensate the entity for the time value of money and risks inherent in the cash flows between the origination of a regulatory asset and its recovery through the rate(s) charged to customers?

Yes

Does the regulatory interest rate or return rate provide compensation in excess of the time value of money and risks inherent in the cash flows?

No

Recognise interest or return income over time

Yes

Does the excess compensation relate to an identifiable transaction or event?

No → **Recognise interest or return income over time**

Yes

Recognise excess compensation in identified period

No

- **Discount using a rate that compensates for time value and inherent risks**
- **Recognise partial disallowance immediately**
- **Unwind discount over time**

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Recommended exception to the measurement principles

Related to expenses payable/ (income receivable) in the future that will be added to/ (deducted from) future rate(s) when cash is paid/ (received)

- regulatory agreement treats the amount of cash paid as the allowable expense/ (cash received as the chargeable income) so no regulatory interest or return rate is needed

<u>Staff recommendation (December 2018)</u>

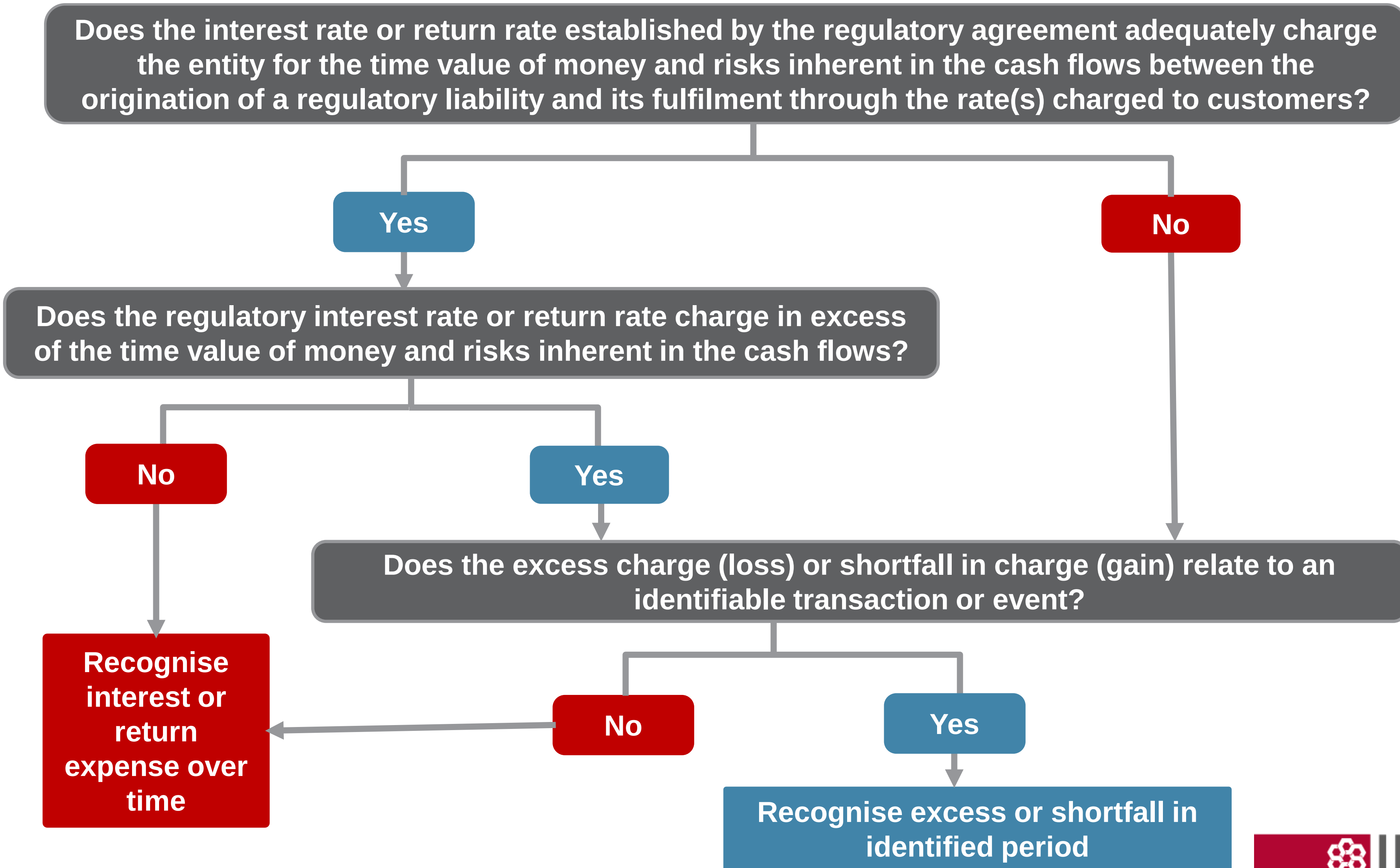
- Measure the regulatory asset/ liability at the same amount as the related liability or asset[1]

Reasons for recommended exception

- would provide the most users with the most relevant and understandable information;
- is consistent with the discussion of measurement inconsistencies in paragraph 6.58 of the *Conceptual Framework*; and
- is consistent with an exception that already exists in IFRS 3 Business Combinations (for indemnification assets).

1. If the regulatory asset is subject to additional risks that do not affect the related liability, the measurement of the regulatory asset may need to be adjusted to reflect those additional risks (see paragraph 60 in Agenda Paper 9B for the Board's December 2018 meeting).

Measurement principles—regulatory liabilities



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