IFRS

STAFF PAPER

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IASB® meeting

Project	Rate-regulated Activities	
Paper topic	Scope—Determining whether a regulatory agreement is within the scope of the proposed model	
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Objective

1. This paper analyses and makes recommendations about:

   (a) specific aspects of the scope proposals in the Exposure Draft *Regulatory Assets and Regulatory Liabilities* (Exposure Draft) dealing with the conditions for a regulatory asset or a regulatory liability to exist.

   (b) some of the concerns raised by respondents on the difficulty of determining whether a regulatory agreement is within the scope of the Exposure Draft in specific circumstances.

2. At future IASB meetings, we will discuss other concerns within the scope workstream. Agenda Paper 9A of this meeting sets out the scope topics for redeliberation and the sequence in which they are discussed.

Summary of staff recommendations

3. The staff recommend the IASB:

   (a) reconfirms:

      (i) the proposal to require an entity to apply the final Standard to all its regulatory assets and regulatory liabilities.

(ii) the proposal that the final Standard should apply to all regulatory agreements and not only to those that have a particular legal form.

(iii) the proposed conditions for a regulatory asset or a regulatory liability to exist.

(b) does not explicitly specify in the final Standard which regulatory schemes would be within or outside its scope.

(c) clarifies in the final Standard that:

(i) a regulatory agreement may encompass enforceable rights and enforceable obligations to adjust the regulated rate beyond the current regulatory period.

(ii) regulatory agreements that create asymmetric rights and obligations—for example, a regulatory agreement that gives rise to only regulatory liabilities—are within the scope of the requirements.

(iii) regulatory assets and regulatory liabilities may arise from a regulatory agreement that originates differences in timing when a specified regulatory threshold is met—for example, cap and floor schemes.

(iv) a regulated rate need not be determined using an entity's specific costs for the entity to be within the scope of the final Standard.

Structure of the paper

4. This paper is structured as follows:

(a) proposals in the Exposure Draft (paragraphs 6–9);

(b) summary of comments received (paragraphs 10–12); and

(c) staff analysis (paragraphs 13–55).

5. The Appendix sets out the features of 'defined rate regulation' as described in the Discussion Paper *Reporting the Financial Effects of Rate Regulation* (Discussion Paper).

Proposals in the Exposure Draft

6. Paragraph 3 of the Exposure Draft proposes that an entity applies the [draft] Standard to all its regulatory assets and regulatory liabilities. The Exposure Draft does not restrict the scope to regulatory agreements with a particular legal form, or that have particular features.

7. Paragraph 6 of the Exposure Draft specifies that a regulatory asset or a regulatory liability can exist only if:

   (a) an entity is party to a regulatory agreement;

   (b) the regulatory agreement determines the regulated rate the entity charges for the goods or services it supplies to customers; and

   (c) part of the total allowed compensation for goods or services supplied in one period is charged to customers through the regulated rates for goods or services supplied in a different period (that is, differences in timing arise).

8. Paragraphs 20–23 of the Exposure Draft deal with rights and obligations that are not regulatory assets or regulatory liabilities. In particular, paragraph 21 of the Exposure Draft says that:

   (a) a regulatory asset permits an entity to increase future regulated rates only because of goods or services already supplied; and

   (b) a regulatory liability obliges an entity to decrease future regulated rates only because of amounts already included in revenue.

9. A right to increase future regulated rates, or an obligation to decrease them, for any other reason is not a regulatory asset or a regulatory liability.

Summary of comments received

10. Many respondents said the proposed scope may be broader than intended. Many respondents also said that the scope proposals are not sufficiently clear to help them determine whether a regulatory agreement, arrangement or activity is in the scope of the Exposure Draft.

11. According to the feedback, factors that contributed to these concerns include:

    (a) exclusion of some of the features of 'defined rate regulation' as described in the Discussion Paper in the conditions for a regulatory asset or a regulatory liability to exist.[1]

    (b) difficulty in identifying the rights and obligations that may constitute a regulatory agreement.

    (c) uncertainty about whether particular features may cause a regulatory agreement to be within, or outside, the scope of the proposals.

12. These respondents recommended the IASB:

    (a) restrict the scope of the final Standard. For example, the final Standard may include certain features of 'defined rate regulation' as additional conditions for a regulatory asset or a regulatory liability to exist.

    (b) clarify the regulatory agreements that would be affected, or that would not be affected, by the final Standard. For example, the final Standard could include more guidance and examples, including the types of regulatory schemes that would be outside the scope of the final Standard.

Staff analysis

13. The analysis is structured as follows:

    (a) confirming the conditions for regulatory assets or regulatory liabilities to exist in paragraph 6 of the Exposure Draft (paragraphs 14–23);

    (b) legal form of a regulatory agreement (paragraphs 24–29);

    (c) what constitutes a regulatory agreement (paragraphs 30–35);

    (d) determining which regulatory schemes would be within or outside the scope (paragraphs 36–40); and

    (e) particular features of a regulatory agreement (paragraphs 41–55).

[1] Paragraph BC82 of the Basis for Conclusions on the Exposure Draft.

Confirming the conditions for regulatory assets or regulatory liabilities to exist

14. The Exposure Draft proposes to require that an entity applies the final Standard to all its regulatory assets and regulatory liabilities. Respondents broadly supported this scope proposal, subject to specific scope exclusions they recommended for arrangements that would be within the scope of IFRS 9 *Financial Instruments* and IFRS 17 *Insurance Contracts*.

15. A few respondents identified a few advantages in focusing the scope of the proposals on the creation of regulatory assets and regulatory liabilities:

    (a) it is an efficient approach as it ensures the inclusion of different types of regulatory schemes without needing to identify and define them; and

    (b) it helps avoid sector specific accounting.

16. We agree with these respondents and therefore recommend that the IASB includes this scope proposal in the final Standard.[2] We will discuss the possibility of introducing specific scope exclusions in the final Standard at future IASB meetings (see Agenda Paper 9A discussed at this IASB meeting).

Remaining features of 'defined rate regulation'

17. The Exposure Draft specifies three conditions for a regulatory asset or a regulatory liability to exist. Out of these three conditions, two are also features of 'defined rate regulation' (see Appendix). The remaining features of 'defined rate regulation' are:

    (a) customers have little or no choice but to purchase the goods or services from the rate-regulated entity, because there is no effective competition to supply and the rate-regulated goods or services are essential to customers;

    (b) the regulatory pricing framework (that is, rate-setting) establishes parameters to maintain the availability of the supply of the rate-regulated goods or services; and

[2] The population of regulatory assets and regulatory liabilities to be accounted for applying the final Standard may change, depending on the IASB's future redeliberations on certain aspects of the proposed model, such as the total allowed compensation. Nevertheless, these redeliberations are not expected to require reconsideration of the conditions for a regulatory asset or a regulatory liability to exist in paragraph 6 of the Exposure Draft.

(c) the regulatory pricing framework establishes parameters for rates to provide regulatory protections that support greater stability of prices for customers and support the rate-regulated entity's financial viability.

18. The IASB decided that these remaining features may be present in many rate-regulatory schemes, but are not necessary for a regulatory asset or a regulatory liability to exist. In addition, the IASB:

(a) did not think that setting a narrower scope by including some or all of the remaining features of 'defined rate regulation' would produce more useful information about the effects of regulatory assets and regulatory liabilities; and

(b) considered that assessing whether the remaining features of 'defined rate regulation' are present would be difficult and highly subjective.

19. A few respondents raised concerns about the IASB's decision to exclude the remaining features of 'defined rate regulation' from the conditions for a regulatory asset or a regulatory liability to exist. According to these respondents, the proposed conditions may bring into the scope of the final Standard certain arrangements and activities that the IASB did not intend to include in the scope. These respondents, however, did not provide specific examples of such arrangements and activities. A few national-standard setters in Europe and Asia-Oceania said that:

(a) including the feature of 'defined rate regulation' in paragraph 17(a) as an additional condition in the scope of the final Standard; or

(b) narrowing the scope of the final Standard by requiring a high probability of the regulated rate increasing or decreasing in the future and sufficient demand for goods or services to enable the recovery of regulatory asset or fulfilment of regulatory liability through adjustments to future regulated rates;

may have the benefit of restricting the scope to only those regulatory assets and regulatory liabilities that are subject to little measurement uncertainty, resulting in information that is useful for predicting future cash flows.

20. However, a few national standard-setters in Europe and Latin America expressed support for the proposed conditions for a regulatory asset or a regulatory liability to exist, for reasons similar to those described in paragraph 18.

21. The staff agree with the respondents in paragraph 20 and with the IASB's view in paragraph 18 for not adding the remaining features of 'defined rate regulation' as part of the conditions for a regulatory asset and a regulatory liability to exist.

22. In addition, the staff agree with the rationale in paragraph BC83 of the Basis for Conclusions that:

    (a) the feature of 'defined rate regulation' in paragraph 17(a) would increase the probability that the regulatory assets or regulatory liabilities in the scope of the Standard would ultimately result in inflows or outflows of cash. However, that feature does not determine whether a regulatory asset or a regulatory liability exists. We think the measurement uncertainty that regulatory assets or regulatory liabilities would typically be subject to is unlikely to be so significant that it would justify the loss of information that would result from a narrower scope. In addition:

        (i) the proposed model factors outcome and measurement uncertainties in the measurement of regulatory assets and regulatory liabilities; and

        (ii) the proposed requirement in paragraph 80(d) of the Exposure Draft to disclose an explanation of how risks and uncertainties affect the recovery of regulatory assets or fulfilment of regulatory liabilities would provide information about outcome and measurement uncertainties.

    (b) the features of 'defined rate regulation' in paragraphs 17(b) and 17(c) influence the determination of the rate and affect its ultimate effectiveness in achieving the regulatory objectives, but do not determine whether a regulatory asset or a regulatory liability exists.

23. Overall, the staff think that the scope of the final Standard should not be narrowed by including the remaining features of 'defined rate regulation'. The staff recommend the IASB carries into the final Standard the conditions for a regulatory asset or a regulatory liability to exist in paragraph 6 of the Exposure Draft.

Legal form of a regulatory agreement

24. Most respondents agreed that the proposed requirements should apply to all regulatory agreements and not only to those that have a particular legal form. A few respondents commented that given the various regulatory schemes and jurisdictions affected, it is preferable to leave this aspect of the proposals broad.

25. The staff agree with the feedback from respondents that it is preferable to leave this aspect of the scope proposals broad, given the diverse rate-regulatory schemes across jurisdictions and industries. Applying the proposed model to diverse rate-regulatory schemes would have the benefit of providing useful information about the effects of regulatory assets and regulatory liabilities arising from these schemes in the financial statements.

26. The staff continue to think that specifying the legal form of regulatory agreement is unnecessary, if the IASB retains the proposal that the rights and obligations created by the regulatory agreement must be enforceable.

27. A representative body of European banks expressed concerns about the proposal that a regulatory agreement may take various forms. In their view, the combination of this proposal and the proposal to not define the term 'regulator' may result in agreements, such as master service agreements or intercompany agreements, creating regulatory assets and regulatory liabilities for an entity with itself or with other entities under common control. This respondent thought that the final Standard should explicitly specify the legal form of a regulatory agreement, and that a regulator is necessary for a regulatory asset or a regulatory liability to exist.

28. The staff think the respondent's concerns mainly relate to the proposal that a regulator is not required for a regulatory asset or a regulatory liability to exist. Agenda Paper 9C of this meeting discusses those concerns.

29. Therefore, the staff think that the final Standard should apply to all regulatory agreements and not only to those that have a particular legal form.

What constitutes a regulatory agreement

30. Some respondents said that it may be difficult to identify the rights and obligations that may constitute a regulatory agreement. A few respondents asked whether a regulatory agreement:

    (a) needs to be a standalone arrangement (for example, a contractual licencing agreement), or whether it can refer to rights and obligations specified by legislation or regulations (that is, rights and obligations subsumed within a regulatory framework).

    (b) refers to the broader regulatory framework that entitles an entity to charge a regulated rate (for example, a contractual licencing agreement or a regulatory framework established by law), or whether it refers to the regulatory period (that is, the period over which the regulated rate is required to be applied).

31. The feedback, however, provides very few examples of situations in which it is unclear whether a set of rights and obligations constitute a regulatory agreement applying the proposals. Those situations mainly relate to:

    (a) uncertainties about whether the final Standard would scope in some agreements (for example, intercompany agreements). These uncertainties relate to the lack of clarity on whether a regulator is required for a regulatory asset or a regulatory liability to exist. Agenda Paper 9C of this meeting discusses these uncertainties.

    (b) the difficulty of determining whether the rights and obligations to adjust future regulated rates are enforceable. We will analyse enforceability matters when redeliberating the proposed requirements for recognition and measurement (see Agenda Paper 9A discussed at this IASB meeting).

32. The staff think that the Exposure Draft is sufficiently clear that the set of enforceable rights and enforceable obligations that determine a regulated rate can be established in standalone arrangements (such as contractual licensing agreements or service concession arrangements), or can be specified by statute, legislation or regulations (paragraph 8 of the Exposure Draft).

33. The staff also think that the proposed definition of a regulatory agreement would not limit the set of enforceable rights and enforceable obligations to only those that would result in adjustments to the regulated rates charged within the current regulatory period. Instead, that definition would also encompass those enforceable rights and enforceable obligations that arise from a broader regulatory framework that entitles an entity to charge a regulated rate beyond the current regulatory period.

34. Some regulatory agreements give rise to enforceable rights and enforceable obligations that result in adjustments to future regulated rates beyond the current regulatory period. For example, a regulatory agreement may allow pension costs to adjust future regulated rates only when cash is paid in future regulatory periods. We think that the financial statements should reflect enforceable rights and enforceable obligations to adjust future regulated rates, even if the adjustments are made to regulated rates beyond the current regulatory period.

35. Therefore, we recommend the IASB clarifies that a regulatory agreement can encompass enforceable rights and enforceable obligations to adjust regulated rates beyond the current regulatory period.

Determining which regulatory schemes would be within or outside the scope

36. A few respondents said that the final Standard could explicitly specify which regulatory schemes would be within or outside the scope. As an example, respondents cited the final Standard could explicitly specify that a regulatory agreement that places a cap on the price that an entity can charge customers (price cap regulation) does not give rise to any regulatory asset or regulatory liability.

37. The staff think that it is unnecessary for the final Standard to specify that a particular regulatory scheme, such as a price cap regulation, does not give rise to any regulatory asset or regulatory liability for the reasons in paragraphs 38–39.

38. The scope proposals are clear that for a regulatory asset or regulatory liability to exist a difference in timing needs to arise (paragraph 6(c) of the Exposure Draft). Consequently, only regulatory schemes in which the basis for setting the rate gives rise to differences in timing are able to create regulatory assets or regulatory liabilities. A price cap regulation that only prohibits an entity from charging a price

above the regulated cap does not give rise to differences in timing. However, we think it is unnecessary for the final Standard to state this.

39. Furthermore, regulatory schemes are diverse and, in some cases, regulatory agreements sharing the same label may give rise to different sets of rights and obligations. If the final Standard specified that price cap regulation does not give rise to any regulatory asset or regulatory liability, there is a risk that a regulatory scheme labelled 'price cap' that causes differences in timing to arise may be excluded from the scope of the final Standard.

40. Therefore, we recommend the IASB does not explicitly specify in the final Standard which regulatory schemes would be within or outside its scope.

Particular features of a regulatory agreement

41. Some respondents cited particular features of regulatory agreements that create uncertainty about whether such regulatory agreements would be in the scope of the proposals:

    (a) an agreement that originates either regulatory assets or regulatory liabilities, but not both. For example, a regulatory agreement that creates an obligation to deduct over-recoveries from future regulated rates, but not a right to add under-recoveries to future regulated rates (asymmetric rights and obligations).

    (b) an agreement under which an entity has discretion or flexibility to set the rate charged to customers, but deviations from a specified regulatory threshold, such as a cap and/or floor, originate amounts that need to be adjusted in future rates.

    (c) a regulatory agreement that determines a regulated rate on the basis of the industry's average costs, instead of an entity's specific costs.

42. The analysis of particular features of regulatory agreements is structured as follows:

    (a) asymmetric rights and obligations (paragraphs 43–44);

    (b) regulatory schemes involving cap and/or floor (paragraphs 45–50); and

    (c) non-entity specific cost inputs (paragraphs 51–55).

Asymmetric rights and obligations

43. In some cases, regulatory agreements may create differences in timing that may give rise to only rights to add an amount in future regulated rates (regulatory assets) or only obligations to deduct an amount from future regulated rates (regulatory liabilities), but not both. In this section we are referring to such a case as a regulatory agreement that gives rise to asymmetric rights and obligations.

44. The scope proposals do not require that a regulatory agreement creates both regulatory assets and regulatory liabilities. This means that the Exposure Draft includes within its scope regulatory agreements that create asymmetric rights and obligations. In such cases, the proposed model would be applied to any right or obligation that meets the definition of a regulatory asset or a regulatory liability. Nevertheless, we recommend the IASB clarifies this matter in the final Standard.

Regulatory schemes involving cap and/or floor

45. Some respondents shared features of cap and floor schemes and recommended the final Standard clarify whether cap and floor schemes that give rise to differences in timing are within the scope.

46. Cap and floor schemes generally constrain the returns an entity can make over a specified period. For example, if:

    (a) amounts charged are *above* a specified revenue cap determined by the regulatory agreement, an entity has an obligation to deduct that difference from rates to be charged in the future; and/or

    (b) amounts charged are *below* a specified revenue floor determined by the regulatory agreement, the entity has a right to increase rates in the future to recover that difference.

47. A few respondents asked whether such cap and floor schemes would be in the scope of the final Standard. The uncertainty arises mainly because paragraph 6(b) of the Exposure Draft states that 'the regulatory agreement *determines the regulated rate* the entity charges'. These respondents argue that in cap and floor schemes the entity has discretion or flexibility to set the rate, provided the rate is set within the bounds of the regulated cap and floor thresholds.

48. The Exposure Draft referred to regulatory assets and regulatory liabilities arising from regulatory agreements that *determine* an entity's *regulated rate* in a manner that causes differences in timing to arise. The staff think that the final Standard should also apply to regulatory assets and regulatory liabilities arising from regulatory agreements that provide some flexibility to the entity for determining the rate but include regulatory thresholds that cause differences in timing to arise.

49. In the case of cap and floor schemes of the type described in paragraph 46, the regulatory agreement originates differences in timing by requiring an entity to adjust future rates for deviations above the revenue cap or below the revenue floor. Scoping out regulatory agreements that create differences in timing when certain regulatory thresholds are met would result in a loss of useful information about the effects of those regulatory assets and regulatory liabilities.

50. Therefore, the staff recommend the IASB clarifies in the final Standard that regulatory assets and regulatory liabilities may arise from a regulatory agreement that originates differences in timing when a specified regulatory threshold is met (for example, cap and floor schemes).

Non-entity specific cost inputs

51. In some cases, regulatory agreements may determine the regulated rate using input costs other than an entity's specific costs, for example, the average costs of a group of industry peers (benchmarked costs). A regulatory agreement may establish that any differences between the entity's actual costs and the benchmarked costs are fully or partially shared between the entity and its customers. This appears to be a common feature of some incentive-based regulatory schemes.

52. A few respondents asked whether such regulatory agreements would be in the scope of the final Standard. One of these respondents said that the scope proposals, along with the recognition and measurement proposals, suggest that a one-to-one relationship needs to exist between total allowed compensation and an entity's actual costs.

53. The Exposure Draft does not restrict regulatory assets or regulatory liabilities to those arising when the regulated rate has been determined by considering an entity's own

costs. This means that the Exposure Draft does not scope out regulatory assets or regulatory liabilities created by regulatory agreements in which the regulated rate is determined using benchmarked costs (that is, costs that are not specific to the entity). If such regulatory agreements give rise to differences in timing, these agreements can create rights and obligations that meet the definitions of regulatory assets and regulatory liabilities. What determines whether a regulatory scheme is in the scope of the proposals is its ability to give rise to differences in timing. In agreements such as those described in paragraph 51, differences in timing may arise, for example, if the regulatory agreement requires an entity to share with customers the differences between its actual costs and the benchmarked costs by adjusting future regulated rates.

54. Conversely, no differences in timing would arise if the regulatory agreement does not require the entity to adjust future regulated rates for the differences between its actual costs and the benchmarked costs. In such cases, the effect of those gains or losses would form part of the entity's financial performance in the period they arise.

55. We recommend the IASB clarifies in the final Standard that the regulated rate does not need to be determined using an entity's costs for the entity to be within the scope of the final Standard. In other words, regulatory agreements that determine the rate on a basis different from the entity's costs would be within the scope of the final Standard if those regulatory agreements give rise to differences in timing.

Questions for the IASB

1. Does the IASB agree with the staff recommendations to reconfirm:
   (a) the proposal to require an entity to apply the final Standard to all its regulatory assets and regulatory liabilities (paragraphs 14–16).
   (b) the proposal that the final Standard should apply to all regulatory agreements and not only to those that have a particular legal form (paragraphs 24–29).
   (c) the proposed conditions for a regulatory asset or a regulatory liability to exist in paragraph 6 of the Exposure Draft (paragraphs 17–23).

2. Does the IASB agree not to explicitly specify in the final Standard which regulatory schemes would be within or outside its scope (paragraphs 36–40)?

3. Does the IASB agree with the staff recommendations to clarify in the final Standard that:

   (a) a regulatory agreement may encompass enforceable rights and enforceable obligations to adjust the regulated rates beyond the current regulatory period (paragraphs 33–35).

   (b) regulatory agreements that create asymmetric rights and obligations—for example, a regulatory agreement that gives rise to only regulatory liabilities—are within the scope of the requirements (paragraphs 43–44).

   (c) regulatory assets and regulatory liabilities may arise from a regulatory agreement that originates differences in timing when a specified regulatory threshold is met—for example, cap and floor schemes (paragraphs 45–50).

   (d) a regulated rate need not be determined using an entity's specific costs for the entity to be within the scope of the final Standard (paragraphs 51–55).

Appendix—Features of defined rate regulation

A1. The Discussion Paper *Reporting the Financial Effects of Rate Regulation* identified common features of a variety of rate-regulatory schemes around the world. These features were thought likely to create a combination of rights and obligations that would support the recognition of assets or liabilities. The Discussion Paper used the term 'defined rate regulation' to capture these common features.

A2. The Discussion Paper described 'defined rate regulation' as involving a regulatory pricing (rate-setting) framework or basis that:

(a) 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) 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) establishes parameters for regulated rates to provide regulatory protections that:

(i) support stability of prices for customers; and

(ii) support the financial viability of the rate-regulated entity.

(d) creates rights and obligations that are enforceable on the rate-regulated entity and on the regulator.

A3. The table shows the features of 'defined rate regulation' that were included in the proposed conditions for a regulatory asset or regulatory liability to exist (paragraph 6 of the Exposure Draft) and those features that were excluded:

Features of 'defined rate regulation' in the Discussion Paper	
Included in the proposed conditions (paragraph 6 of the Exposure Draft)	**Excluded from the proposed conditions**
Part of feature (c)—the regulatory pricing framework establishes parameters for regulated rates. This is included in paragraph 6(b) in the Exposure Draft, that is, the regulatory agreement determines the regulated rate.	Part of feature (c)—the regulatory pricing framework establishes parameters for rates to provide regulatory protections that support greater stability of prices for customers and support the rate-regulated entity's financial viability.
Part of feature (b)—the regulatory pricing framework establishes parameters to maintain the *quality* of the supply of the rate-regulated goods or services. This is included in paragraph 6(b) of the Exposure Draft as the regulated rate will typically also specify a minimum quality for the goods or services to be supplied.	Part of feature (b)—the regulatory pricing framework establishes parameters to maintain the *availability* of the supply of the rate-regulated goods or services.

Features of 'defined rate regulation' in the Discussion Paper	
Included in the proposed conditions (paragraph 6 of the Exposure Draft)	**Excluded from the proposed conditions**
Feature (d)—the regulation creates rights and obligations that are enforceable. This is included in paragraph 6(a) of the Exposure Draft as 'regulatory agreement' is defined as a set of enforceable rights and obligations.	-
-	Feature (a)—customers have little or no choice but to purchase the goods or services from the rate-regulated entity, because there is no effective competition to supply and the rate-regulated goods or services are essential to customers.