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Discussion Paper DP/2014/2

Reporting the Financial Effects of Rate Regulation

Comments to be received by 15 January 2015

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Discussion Paper DP/2014/2 *Reporting the Financial Effects of Rate Regulation* is published by the International Accounting Standards Board (IASB) for comment only. Comments on the Discussion Paper need to be received by **15 January 2015** and should be submitted in writing to the address below or electronically via our website www.ifrs.org using the 'Comment on a proposal' page.

All responses will be put on the public record and posted on our website unless the respondent requests confidentiality. Requests for confidentiality will not normally be granted unless supported by a good reason, such as commercial confidence.

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Summary

Why is the Discussion Paper being published?

The International Accounting Standards Board (IASB) is publishing this Discussion Paper to consult a wide range of stakeholders about:

(a) what features, if any, distinguish the economic environment in which some rate-regulated entities operate; and

(b) whether those features would best be reflected in general purpose financial statements by modifying the requirements of International Financial Reporting Standards (IFRS) in any way.

This Discussion Paper does not include any specific accounting proposals. Instead, it considers the characteristics of rate-regulated activities and assesses how best to report these characteristics in a relevant and representationally faithful way in IFRS financial statements.

Rate regulation is widespread and some forms of rate regulation can significantly affect the economic environment of rate-regulated entities. The rate regulation may affect not only the amount of revenue and profit that a rate-regulated entity can earn, but also the timing of the cash flows associated with the entity's rate-regulated activities. The timing may be affected because, when establishing the rate to be charged to customers, the rate regulator attributes some costs (or income) to a period other than the period in which those costs (or income) would normally be recognised in profit or loss for financial reporting purposes. Consequently, differences arise between amounts recognised as assets, liabilities, income and expense using regulatory accounting requirements compared to the amounts recognised using accounting policies established in accordance with IFRS.

Before IFRS 14 *Regulatory Deferral Accounts* was issued in January 2014, there was no specific guidance in IFRS that permits adjustments to be made to the accounting policies established in accordance with the general requirements of IFRS when the regulatory accounting requirements conflict with them.[1] As a result, the established practice of almost all rate-regulated entities that are not eligible to apply IFRS 14 is not to recognise, as assets or liabilities in IFRS financial statements, the balances (commonly called 'regulatory deferral account balances') that arise when a rate-regulated entity recognises amounts of costs or income in a different period for regulatory purposes. This has given rise to debate as to whether this established practice faithfully represents the financial effects of some types of rate regulation.

This established practice reflects two factors:

(a) in some cases, the amounts recognised within property, plant and equipment, intangible assets and inventories for regulatory purposes differ from those recognised in accordance with the requirements of the relevant Standards.

(b) in other cases, there is a disagreement over whether the amounts identified as separate regulatory deferral account balances meet the definitions of assets and liabilities in the IFRS *Conceptual Framework for Financial Reporting* (the '*Conceptual*

1 IFRS 14 is available only to specified entities that adopt IFRS after IFRS 14 was issued and does not affect existing IFRS preparers (see paragraphs 1.9–1.10).

Framework'). Some of the disagreement arises because different assumptions are made about the underlying fact patterns, even though the rate regulation being considered is assumed to be of the same 'type'. This has created confusion in the conceptual debate and has been a barrier to identifying a common understanding of the economic environments in which rate-regulated entities operate and how they might differ from the economic environments of comparable entities that are not subject to rate regulation.

Consequently, the IASB is seeking input from a wide variety of stakeholders in order to develop a common starting point for a more focused discussion about the accounting for rate-regulated activities.

What does this Discussion Paper include?

The following paragraphs summarise each Section of this Discussion Paper.

Section 1—Introduction

Section 1:

(a) provides some background to the Rate-regulated Activities project;

(b) describes the objectives of the project;

(c) describes the IASB's approach to developing this Discussion Paper; and

(d) explains what information the IASB is seeking from stakeholders through this Discussion Paper and how it will be used in future work on the Rate-regulated Activities project.

Section 2—Providing useful information about rate regulation

Section 2 outlines the main messages that the IASB has heard about the types of information that users of general purpose financial statements find helpful in making decisions about providing resources to a rate-regulated entity. Some of this information is currently provided voluntarily in IFRS financial statements or, more commonly, in another document, such as the management commentary that accompanies the financial statements.

Section 3—What is rate regulation?

Section 3 provides background on what rate regulation is, how different economic conditions lead to different types of rate regulation, and why most types of rate regulation contain elements of both cost recovery and incentive approaches. It also highlights that, for the purpose of this Discussion Paper, the IASB is focusing on a group of features of a number of types of rate regulation that is considered to be most likely to create a combination of rights and obligations that is distinguishable from the rights and obligations arising from other activities that are not rate-regulated. The purpose of focusing on this group of features is to provide a consistent fact pattern on which to discuss how best to reflect the financial effects of rate regulation in IFRS financial statements. For ease of reference, the type of rate regulation that contains all of these features has been given a title of 'defined rate regulation'.

Section 4—Defined rate regulation

Section 4 addresses the following topics:

(a) an overview of the features of defined rate regulation, how the regulated rate is established and how the regulated rate is subsequently adjusted to reflect past events and transactions;

(b) a more detailed description of the features of defined rate regulation; and

(c) consideration of whether the features of defined rate regulation create a combination of rights and obligations for which specific accounting requirements should be developed.

Section 5—Alternative financial reporting approaches

Section 5 discusses different views about whether regulatory deferral account balances meet the definitions of an asset and a liability in the *Conceptual Framework*. In addition, the Section outlines other possible approaches that the IASB could consider when deciding how best to reflect the financial effects of defined rate regulation in IFRS financial statements. It indicates the identified advantages and disadvantages of each of the following possible approaches:

(a) recognising the package of rights and obligations established by the regulatory agreement as an intangible asset, that is, a licence—paragraphs 5.35–5.46 consider whether the IASB should explore an approach that would involve amending IAS 38 *Intangible Assets* to recognise some aspects of the rate-setting process in changes to the carrying amount of the regulatory licence, or components of the licence;

(b) reporting using regulatory accounting requirements—paragraphs 5.47–5.51 consider whether the IASB should explore an approach that would involve providing an exemption to the general requirements of IFRS to enable rate-regulated entities to apply regulatory accounting requirements that would otherwise conflict with IFRS;

(c) developing specific IFRS requirements to defer/accelerate the recognition of costs and/or revenue—paragraphs 5.52–5.90 consider whether the IASB should explore an approach that would involve developing accounting requirements to defer or accelerate costs, revenue or a combination of costs and revenue; and

(d) prohibiting the recognition of regulatory deferral account balances—paragraphs 5.90–5.109 discuss why this approach may be appropriate and considers whether the IASB should develop disclosure-only requirements.

Section 6—Presentation and disclosure requirements in IFRS 14

Section 6 provides a brief summary of the presentation and disclosure requirements in IFRS 14 and some background about their development. The IASB is seeking more feedback about the usefulness of these requirements to users of IFRS financial statements. If the IASB decides to develop a long-term solution to replace IFRS 14, the current requirements will inform the proposals for that solution but should not be considered as prejudging decisions about any subsequent requirements that may be developed.

Section 7—Other issues

Section 7 highlights some of the issues that the IASB, after considering the feedback obtained from this Discussion Paper, may need to consider if it decides to develop any specific accounting requirements for rate-regulated activities. The issues are not addressed in this Discussion Paper but are included to encourage further feedback on some of the features of defined rate regulation and to help stakeholders to understand the issues that the IASB may need to consider in due course.

What are the next steps in this project?

Any views expressed in this Discussion Paper are preliminary and subject to change. The IASB will consider the comments received on this Discussion Paper before deciding whether or not to develop an Exposure Draft on reporting the financial effects of rate regulation.

Invitation to comment

The IASB invites comments on all matters in this Discussion Paper and, in particular, on the questions set out at the end of each Section.

Comments are most helpful if they:

(a) respond to the questions as stated;

(b) indicate the specific paragraph or paragraphs to which the comments relate;

(c) contain a clear rationale; and

(d) describe any alternatives that the IASB should consider, if applicable.

Respondents need not comment on all of the questions and are encouraged to comment on any additional matters.

The IASB will consider all comments received in writing by **15 January 2015**.

The IASB is seeking to test the description of defined rate regulation to ensure that it captures a suitable range of activities. If your organisation is subject to some form of rate regulation, would you be willing to take part in a survey or field test to help map the description of defined rate regulation against the details of the rate regulation to which your organisation is subject? If so, please provide the project team with contact details by emailing RateRegulation@ifrs.org. Responses will be treated in confidence and individual responses will not be identified in the summarised results presented publicly.

Questions for respondents

Question 1

(a) What information about the entity's rate-regulated activities and the rate-regulatory environment do you think preparers of financial statements need to include in their financial statements or accompanying documents such as management commentary?

Please specify what information should be provided in:

(i) the statement of financial position;

(ii) the statement(s) of profit or loss and other comprehensive income;

(iii) the statement of cash flows;

(iv) the note disclosures; or

(v) the management commentary.

(b) How do you think that information would be used by investors and lenders in making investment and lending decisions?

Question 2

Are you familiar with using financial statements that recognise regulatory deferral account balances as regulatory assets or regulatory liabilities, for example, in accordance with US generally accepted accounting principles (GAAP) or other local GAAP or in accordance with IFRS 14? If so, what problems, if any, does the recognition of such balances cause users of financial statements when evaluating investment or lending decisions in rate-regulated entities that recognise such balances compared to:

(a) non-rate-regulated entities; and

(b) rate-regulated entities that do not recognise such balances?

Question 3

Do you agree that, to progress this project, the IASB should focus on a defined type of rate regulation (see Section 4) in order to provide a common starting point for a more focused discussion about whether rate regulation creates a combination of rights and obligations for which specific accounting guidance or requirements might need to be developed (see paragraphs 3.6–3.7)? If not, how do you suggest that the IASB should address the diversity in the types of rate regulation summarised in Section 3?

Question 4

Paragraph 2.11 notes that the IASB has not received requests for it to develop special accounting requirements for the form of limited or 'market' rate regulation that is used to supplement the inefficient competitive forces in the market (see paragraphs 3.30–3.33).

(a) Do you agree that this type of rate regulation does not create a significantly different economic environment and, therefore, does not require any specific accounting requirements to be developed? If not, why not?

(b) If you agree that this type of rate regulation does not require any specific accounting requirements, do you think that the IASB should, alternatively, consider developing specific disclosure requirements? If so, what would you propose and why?

Question 5
Paragraphs 4.4–4.6 summarise the key features of defined rate regulation. These features have been the focus of the IASB's exploration of whether defined rate regulation creates a combination of rights and obligations for which specific accounting guidance or requirements might be developed in order to provide relevant information to users of general purpose financial statements.
(a) Do you think that the description of defined rate regulation captures an appropriate population of rate-regulatory schemes within its scope? If so, why? If not, why not?
(b) Do you think that any of the features described should be modified in order to include or exclude particular types of rate-regulatory schemes or rate-regulated activities included within the scope of defined rate regulation? Please specify and give reasons to support any modifications to the features that you suggest, with particular reference to why the features may or may not give rise to circumstances that result in particular information needs for users of the financial statements.
(c) Are there any additional features that you think should be included to establish the scope of defined rate regulation or would you omit any of the features described? Please specify and give reasons to support any features that you would add or omit.

Question 6
Paragraphs 4.62–4.72 contain an analysis of the rights and obligations that arise from the features of defined rate regulation.
(a) Are there any additional rights or obligations that you think the IASB should consider? Please specify and give reasons.
(b) Do you think that the IASB should develop specific accounting guidance or requirements to account for the combination of rights and obligations described? Why or why not?

Question 7
Section 5 outlines a number of possible approaches that the IASB could consider developing further, depending on the feedback received from this Discussion Paper. It highlights some advantages and disadvantages of each approach. (a) Which approach, if any, do you think would best portray the financial effects of defined rate regulation in IFRS financial statements and is most likely to provide the information that investors and lenders consider is most relevant to help them make their investing and lending decisions? Please give reasons for your answer? (b) Is there any other approach that the IASB should consider? If so, please specify and explain how such an approach could provide investors and lenders with relevant information about the financial effects of rate regulation. (c) Are there any additional advantages or disadvantages that the IASB should consider before it decides whether to develop any of these approaches further? If so, please describe them. If commenting on the asset/liability approach, please specify, if it is relevant, whether your comments reflect the existing definitions of an asset and a liability in the *Conceptual Framework* or the proposed definitions suggested in the *Conceptual Framework* Discussion Paper, published in July 2013.

Question 8
Does your organisation carry out activities that are subject to defined rate regulation? If so, what operational issues should the IASB consider if it decides to develop any specific accounting guidance or requirements?

Question 9
If, after considering the feedback from this Discussion Paper and the *Conceptual Framework* project, the IASB decides to prohibit the recognition of regulatory deferral account balances in IFRS financial statements, do you think that the IASB should consider developing specific disclosure-only requirements? If not, why not? If so, please specify what type of information you think would be relevant to investors and lenders in making their investing or lending decisions and why.

Question 10

Sections 2 and 6 discuss some of the information needs of users of general purpose financial statements. The IASB will seek to balance the needs of users of financial statements for information about the financial effects of rate regulation on an entity's operations with concerns about obscuring the understandability of financial statements and the high preparation costs that can result from lengthy disclosures (see paragraph 2.27).

(a) If the IASB decides to develop specific accounting requirements for all entities that are subject to defined rate regulation, to what extent do you think the requirements of IFRS 14 meet the information needs of investors and lenders? Is there any additional information that you think should be required? If so, please specify and explain how investors or lenders are likely to use that information.

(b) Do you think that any of the disclosure requirements of IFRS 14 could be omitted or modified in order to reduce the cost of compliance with the requirements, without omitting information that helps users of financial statements to make informed investing or lending decisions? If so, please specify and explain the reasons for your answer.

Question 11

IFRS 14 requires any regulatory deferral account balances that have been recognised to be presented separately from the assets and liabilities recognised in the statement of financial position in accordance with other Standards. Similarly, the net movements in regulatory deferral account balances are required to be presented separately from the items of income and expense recognised in the statement(s) of profit or loss and other comprehensive income.

If the IASB develops specific accounting requirements that would apply to both existing IFRS preparers and first-time adopters of IFRS, and those requirements resulted in the recognition of regulatory balances in the statement of financial position, what advantages or disadvantages do you envisage if the separate presentation required by IFRS 14 was to be applied?

Question 12
Section 4 describes the distinguishing features of defined rate regulation. This description is intended to provide a common starting point for a more focused discussion about whether this type of rate regulation creates a combination of rights and obligations for which specific accounting guidance or requirements should be developed. Paragraph 4.73 suggests that the existence of a rate regulator whose role and authority is established in legislation or other formal regulations is an important feature of defined rate regulation. Do you think that this is a necessary condition in order to create enforceable rights or obligations, or do you think that co-operatives or similar entities, which operate under self-imposed rate regulation with the same features as defined rate regulation (see paragraphs 7.6–7.9), should also be included within defined rate regulation? If not, why not? If so, do you think that such co-operatives should be included within the scope of defined rate regulation only if they are subject to formal oversight from a government department or other authorised body?

Question 13
Paragraphs 7.11–7.22 highlight some of the issues that the IASB may consider if it continues to progress this project. Do you have any comments or suggestions on these or any other issues that may or may not have been raised in this Discussion Paper that you think the IASB should consider if it decides to develop proposals for any specific accounting requirements for rate-regulated activities?

How to comment

Comments should be submitted using one of the following methods.

Electronically (our preferred method)	Visit the 'Comment on a proposal page', which can be found at: go.ifrs.org/comment
Email	Email comments can be sent to: commentletters@ifrs.org
Postal	IFRS Foundation 30 Cannon Street London EC4M 6XH United Kingdom

All comments will be on the public record and posted on our website unless confidentiality is requested. Such requests will not normally be granted unless supported by good reason, for example, commercial confidence. Please see our website for details on this and how we use your personal data.

Section 1—Introduction

1.1 This Section:

(a) provides some background to the Rate-regulated Activities project (see paragraphs 1.2–1.10);

(b) describes the objectives of the project (see paragraphs 1.11–1.15);

(c) describes the IASB's approach to developing this Discussion Paper (see paragraphs 1.16–1.21); and

(d) explains what information the IASB is seeking from stakeholders through this Discussion Paper and how it will be used in future work on the Rate-regulated Activities project (see paragraphs 1.22–1.24).

Background

1.2 Many governments regulate the supply and pricing of particular types of activity by entities. These activities usually involve providing goods or services that are considered in that jurisdiction to be essential to customers, including transport services, some types of insurance policies, and utilities such as gas, electricity and water. These regulations are often designed to allow the suppliers to recover specified costs and to earn a specified amount of consideration through the rates (that is, the prices or tariffs) they charge to customers. However, rate regulation is also designed to protect the interests of customers. As a result, the rate regulator may allow the entity to recover specified costs by increasing rates charged to customers, but may spread the rate increase over a period of time to dampen rate fluctuations for customers. The rate regulator may also provide a financing return to the entity as compensation for the deferral. The rate-regulated entities, for regulatory purposes, usually keep track of these deferred and other specified amounts (see paragraphs 2.18–2.19) in separate regulatory deferral accounts until they are recovered through future sales of the regulated goods or services.

1.3 Except for IFRS 14 (see paragraph 1.9), there is no specific guidance in IFRS about how to account for the balances in these regulatory deferral accounts. However, some national accounting standards permit or require the balances to be recognised as assets and liabilities in specified circumstances, depending on the type of rate regulation in force. In some cases, these regulatory deferral account balances are incorporated into the carrying amount of items such as property, plant and equipment and intangible assets. In other cases, the balances are recognised as separate items, which are often referred to as 'regulatory assets' and 'regulatory liabilities'. When recognised, this changes the timing of when these amounts are recognised in profit or loss in financial statements when compared to the timing that would normally apply in accordance with the local generally accepted accounting principles (GAAP) for entities that are not subject to rate regulation.

1.4 In June 2005, the IFRS Interpretations Committee (the 'Interpretations Committee') received a request about the application of the specific guidance contained in the US Standard SFAS 71 *Accounting for the Effects of Certain Types of*

Regulation.[2] The request asked whether, in accordance with the hierarchy in paragraphs 10–12 of IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors*, an entity could apply SFAS 71 when selecting an accounting policy in the absence of specific guidance in IFRS.

1.5 The Interpretations Committee concluded that the recognition criteria in SFAS 71 were not fully consistent with the recognition criteria in IFRS. Applying the guidance in SFAS 71 would result in the recognition of regulatory deferral account balances under certain circumstances that would not meet the recognition criteria of relevant Standards. Further details about this Interpretations Committee conclusion and the outcome of other requests to the IASB and the Interpretations Committee are included in Appendix A.

1.6 Since 2005, an established IFRS practice has developed, with the result that almost all entities eliminate regulatory deferral account balances when adopting IFRS and do not recognise such balances in IFRS financial statements. This practice acknowledges the conflicts between some of the accounting requirements of SFAS 71, and national GAAPs that are based on that Standard, and those of Standards such as IAS 16 *Property, Plant and Equipment* that were highlighted in the Interpretations Committee's conclusion in 2005.

1.7 Despite the established practice, there remains uncertainty about whether or not regulatory deferral account balances meet the definitions of assets and liabilities in the IFRS *Conceptual Framework for Financial Reporting* (the '*Conceptual Framework*') and, therefore, whether IFRS guidance should be changed to require their recognition in IFRS financial statements. The IASB began, but discontinued, an earlier Rate-regulated Activities project (see Appendix A). Strongly held but diverse views were formed as that project developed and many complex accounting issues were raised. At that time, the IASB was unable to develop a clear direction to help it resolve the issues but has continued to receive requests to resolve them.

1.8 As a result of its 2011 Agenda Consultation process,[3] the IASB decided, in September 2012, to start a new comprehensive research project on rate-regulated activities to investigate the issues that stakeholders had raised previously. In December 2012, the IASB acknowledged that the established IFRS practice, together with the lack of explicit guidance in IFRS about rate regulation, could be a significant barrier to the adoption of IFRS for entities with significant regulatory deferral account balances.

1.9 Consequently, in January 2014, the IASB issued IFRS 14 *Regulatory Deferral Accounts*. IFRS 14 is intended as a temporary measure to reduce the significant barrier to the adoption of IFRS that is mentioned in paragraph 1.8. It is available only to specified entities that adopt IFRS after IFRS 14 was issued and does not affect existing IFRS preparers. Using IFRS 14, the specified first-time adopters are able to continue to apply their previous GAAP recognition and measurement

2 The guidance in SFAS 71, together with subsequent amendments and related guidance, has now been incorporated into Topic 980 *Regulated Operations* in the Financial Accounting Standards Board's (FASB), *Accounting Standards Codification*®.

3 In July 2011, the IASB published a formal *Request for Views* document to provide a channel for formal public input on the broad aspects of its agenda-setting process.

policies for regulatory deferral account balances, although the presentation and disclosure requirements may differ from their previous GAAP.

1.10 In developing IFRS 14, the IASB did not express any view about whether or not the regulatory deferral account balances meet the definitions of assets and liabilities in the *Conceptual Framework*. Instead, the IASB continued with its research project on rate-regulated activities.

Objectives of the IASB's Rate-regulated Activities research project

1.11 The objectives of the research project include identifying:

(a) what information about the economic effects of rate regulation is most relevant to users of financial statements in making investment and lending decisions;

(b) which features of rate regulation have the biggest effect on the amount, timing and certainty of revenue, profit and cash flows; and

(c) whether and, if so, how IFRS should be amended to provide relevant information in IFRS financial statements about the rate regulation to which the entity is subject.

Scope and approach of this Discussion Paper in defining rate regulation

1.12 An early step in the process to develop this Discussion Paper was to identify the range of rate-regulatory schemes that should be considered in this project. In March 2013, the IASB published a Request for Information *Rate Regulation* (the 'RFI'). This consultation asked stakeholders to provide overviews of the types of rate regulation that they considered relevant to the project to help the IASB identify the common features of such schemes.

1.13 The responses to the RFI highlight that there is a wide variety of rate-regulatory frameworks and schemes. Although the frameworks described were categorised into two broad types (cost-of-service regulation and incentive-based regulation), almost all schemes described contain elements of both types. The IASB noted that applying the common terms 'rate regulation' and 'rate-regulated activity' to varying fact patterns has made it difficult to develop a consensus on accounting principles, because the rights and obligations created by different types of rate regulation vary widely.

1.14 Consequently, in order to provide a common focus for a technical discussion, the IASB has decided to focus, in this Discussion Paper, on a generic type of rate regulation that the responses to the RFI suggest is reasonably representative of the type of rate regulation that stakeholders consider relevant for this project. This Discussion Paper calls this generic type of rate regulation 'defined rate regulation' to avoid the existing terminology that has proved confusing to date. Defined rate regulation applies when customers have little or no choice but to purchase the rate-regulated goods or services from the entity. The rate regulation is designed to ensure that the rate-regulated entity recovers a determinable amount of consideration (the 'revenue requirement') in exchange for the rate-regulated activities that it performs. In addition, the rate regulation establishes, through the rate per unit chargeable to customers, the time at which the entity can bill customers for that consideration. Section 4 discusses the features of defined rate regulation and the rights and obligations arising from them.

1.15 The IASB has tentatively decided to focus on defined rate regulation because it is considered to be most likely to create a combination of rights and obligations that is distinguishable from the rights and obligations arising from other activities. Consequently, in the IASB's preliminary view, defined rate regulation is considered to provide the clearest case for discussing whether the IASB should provide guidance for rate-regulated activities. However, this tentative description of defined rate regulation is not intended to define permanently the scope of the project.

Development of this Discussion Paper

1.16 In developing this Discussion Paper the IASB has drawn on its discussions about rate-regulated activities—both in the previous and current Rate-regulated Activities projects. This Discussion Paper also draws on the IASB's discussions about other projects that have involved consideration of the definitions of assets and liabilities and the interaction with reporting performance, such as revenue recognition.

1.17 The IASB is currently reviewing and updating its *Conceptual Framework*.[4] This review includes consideration of the definitions of assets and liabilities.[5] Because the definitions of assets and liabilities are a central aspect of the Rate-regulated Activities project, the outcome of the Rate-regulated Activities project will be influenced by the outcome of the *Conceptual Framework* project.

Consultative groups

1.18 The IASB has established a Rate-regulated Activities Consultative Group to provide a variety of expert perspectives, including those of users of financial statements, preparers, auditors and rate regulators. This Discussion Paper has benefited from the input of this group, particularly in relation to the descriptions of rate regulation and how a wide variety of rate-regulatory schemes operate.

1.19 In addition, the IASB has received some input from the Accounting Standards Advisory Forum (ASAF), particularly in relation to the definitions of assets and liabilities and the interaction with the *Conceptual Framework* and other Standards. The ASAF is an advisory group to the IASB, consisting of national standard-setters and regional bodies involved with accounting standard-setting. For more information about the ASAF, please refer to http://go.ifrs.org/ASAF.

1.20 The IASB plans to continue to work with the consultative group and the ASAF when considering the responses to this Discussion Paper.

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4 The IASB published, in July 2013, the Discussion Paper *A Review of the Conceptual Framework for Financial Reporting* (the '*Conceptual Framework* Discussion Paper'). The deadline for comments was 14 January 2014. The IASB is currently considering the responses received with a view to publishing an Exposure Draft of proposed changes to the existing *Conceptual Framework* later in 2014.

5 See paragraph 3.2 of the *Conceptual Framework* Discussion Paper.

Preliminary views

1.21 The IASB has not reached preliminary views on all of the issues discussed in this Discussion Paper. Furthermore, the IASB may change its preliminary views because of comments received on this Discussion Paper.

Feedback being sought and next steps

1.22 The Rate-regulated Activities project is part of the IASB's active research programme. The IASB has decided to seek input from a wide variety of stakeholders about its analysis of the information obtained through the responses to the RFI and other research conducted to date before it considers whether to develop accounting guidance or requirements for rate-regulated activities. This is because the IASB wants not only to confirm its understanding of the economic environment in which rate-regulated entities operate, but also to confirm whether the description of defined rate regulation can provide a common starting point for a more focused discussion about the accounting for rate-regulated activities.

1.23 Consequently, the IASB is seeking input from stakeholders to:

(a) identify what information about the financial effects of rate regulation is most relevant to users of financial statements in making investment and lending decisions;

(b) confirm whether the description of defined rate regulation appropriately identifies the type of rate regulation that has the biggest effect on the amount, timing and certainty of revenue, profit and cash flows; and

(c) provide the IASB with insight into the advantages or disadvantages of some possible approaches to providing relevant information about the financial effects of rate regulation.

1.24 The feedback received from this Discussion Paper and related outreach activities is expected to provide the IASB with a foundation for reaching a conclusion that can be broadly supported by a wide range of stakeholders about whether or not to develop an accounting model for rate-regulated activities. Following consideration of the responses to this Discussion Paper, the IASB will assess whether to add the project to its active standard-setting agenda.

Section 2—Providing useful information about rate regulation

2.1 This Section outlines the main messages that the IASB has heard about the types of information that users of general purpose financial statements find helpful in making decisions about providing resources to a rate-regulated entity. Some of this information is currently provided voluntarily in IFRS financial statements or, more commonly, in another document, such as the management commentary that accompanies the financial statements.

2.2 IFRS 14 introduced some presentation and disclosure requirements for those entities that are eligible and elect to apply it. The IASB has been clear that IFRS 14 is a temporary Standard, and that the conclusions reached in developing that Standard do not necessarily reflect the decisions that the IASB will reach on this project. The IASB will monitor feedback received from users and preparers on the appropriateness of the information presented once practice has begun to develop. Section 6 provides a summary of the IFRS 14 requirements and some background about their development.

Introduction

2.3 The objective of general purpose financial reporting is to provide financial information about the reporting entity that is useful to existing and potential investors, lenders and other creditors in making decisions about providing resources to the entity. Those decisions involve buying, selling or holding equity and debt instruments, and providing or settling loans and other forms of credit.[6]

2.4 Decisions by existing and potential investors about buying, selling or holding equity and debt instruments depend on the returns that they expect from an investment in those instruments. Similarly, decisions by existing and potential lenders and other creditors about providing or settling loans and other forms of credit depend on the principal and interest payments or other returns that they expect. Investors', lenders' and other creditors' expectations about returns depend on their assessment of the amount, timing and uncertainty of (the prospects for) future net cash inflows to the entity.[7]

2.5 To assess an entity's prospects for future net cash inflows, existing and potential investors, lenders and other creditors need information about the resources of the entity, claims against the entity, and how efficiently and effectively the entity's management and governing board have discharged their responsibilities to use the entity's resources.[8]

2.6 As part of the research for this project, the IASB is investigating what effect rate regulation has on the amount, timing and certainty of future cash inflows to the entity and how this influences the returns expected by existing and potential investors, lenders and other creditors.

2.7 The IASB will use the responses to this Discussion Paper to consider whether users of IFRS financial statements would be provided with more relevant

6 See paragraph OB2 of the *Conceptual Framework*.

7 See paragraph OB3 of the *Conceptual Framework*.

8 See paragraph OB4 of the *Conceptual Framework*.

information about the effects of rate regulation on the financial position, financial performance and cash flows of rate-regulated entities if IFRS was amended to provide specified accounting requirements for specified types of rate-regulated activities. This Discussion Paper focuses on the needs of the primary users of financial statements.[9] However, other users may also find general purpose financial statements useful. In particular, the IASB has been told that some rate regulators use general purpose financial statements as a source of information for regulatory purposes.

2.8 During the Rate-regulated Activities project that was carried out in 2009–2010, the IASB staff gathered input that is relevant to the current research about the information needs of users of financial statements. This information was obtained through meetings, calls and correspondence from investors, lenders and analysts, utility preparers and trade organisations, international networks of accounting firms, national standard-setters, securities regulators and utilities regulators. This information has helped the IASB to understand users' needs and has been supplemented during the current research, primarily through discussions with members of our Consultative Group and other interested parties. Methodologies used by credit-rating agencies when assessing entities in rate-regulated utility industries have also been considered.

2.9 This Section and Section 6 outline the main messages that the IASB has identified from this research. The IASB is seeking input from stakeholders, particularly investors and lenders (ie the primary users) to help it assess whether the main types of information that are helpful to users of financial statements have been appropriately identified. The IASB will use the input to consider whether it is feasible to present that information within IFRS financial statements and, if so, how best to present it.

Does rate regulation have an impact on the amount, timing and certainty of cash flows?

2.10 Rate regulation is a mechanism by which a rate regulator (often a government body) imposes a control over the rates that can be charged to customers for goods or services. In some cases, this directly affects only the rate per unit that the entity is permitted to charge for its rate-regulated goods or services. However, the entity's management is then free to manage the business in order to maximise its profitability.

2.11 This type of rate regulation, described as 'market regulation' in Section 3 (see paragraphs 3.30–3.33), is often used when there are few suppliers in a market and competition between suppliers is not strong enough to sufficiently constrain the maximum price that all suppliers can charge. In this situation, the rate regulator imposes a price cap that applies to all suppliers in the market. This encourages the suppliers to seek to increase profitability by reducing costs or increasing the volume of sales made. The IASB has been told that, in these cases, the actions of management usually have a much greater influence than

9 Primary users are existing and potential investors, lenders and other creditors who cannot require reporting entities to provide information directly to them and must rely on general purpose financial statements for much of the financial information that they need (see paragraph OB5 of the *Conceptual Framework*).

the rate regulator over the total amount of revenue and profit for the period, and the associated cash flows. Consequently, the IASB has not had requests to develop any specific accounting or disclosure requirements for this type of rate regulation.

2.12 In contrast, defined rate regulation (see paragraph 1.14) has a more significant effect. This type of rate regulation typically applies when there is a single supplier of 'essential' goods or services. In such cases, the rate regulator acts not only in the interests of customers but also seeks to protect the financial viability of the supplier. This need to balance the interests of the customers and the supplier results in the rate regulator intervening in many aspects of the supplier's operations. Consequently, the rate regulator not only regulates the rate per unit to be charged to customers for the rate-regulated goods or services, but also regulates the activities that the entity must perform and regulates the quality and profitability of those activities (see Section 4 for more details).

2.13 The regulatory agreement establishes the total amount of consideration (commonly called the 'revenue requirement', 'allowable revenue' or 'authorised revenue') to which the entity is entitled in exchange for all of its rate-regulated activities. This revenue requirement reflects a targeted rate of return, which is established in the defined rate regulation. The entity is not paid directly by the rate regulator or the government for carrying out these activities. Instead, it receives consideration for these activities through the amounts billed to customers.

2.14 The regulatory agreement identifies the rate (or range of rates) per unit that the entity charges to customers during the next 'regulatory period' (ie the period until the next rate-setting determination or agreement). This rate is typically fixed for the duration of the regulatory period, or, when adjustment is permitted, the circumstances are predetermined or prescribed. The rate is based on estimates related to the volume of rate-regulated goods or services expected to be delivered to customers during the same regulatory period. This rate-setting mechanism establishes how much revenue will be billed (that is, invoiced) to customers during the period.

2.15 In addition to affecting the amount of revenue and profit that an entity is able to earn, defined rate regulation can also affect the period(s) in which the revenue is billed to customers. This is because, when establishing the rate per unit to be charged to customers, the rate regulator considers many factors, including rate volatility, financial stability of the entity, fairness between current and future customers (sometimes referred to as 'intergenerational equity'), affordability of prices and other government policies.

2.16 This means that, for rate-setting purposes, the rate regulator attributes some costs (or income) to a period that is different from the period in which those costs (or income) would normally be recognised in profit or loss in accordance with financial reporting standards. This creates some differences between the profit that an entity reports to the rate regulator through its regulatory financial reports and the profit reported in its general purpose financial statements prepared in accordance with IFRS. These differences are typically tracked by the entity, for regulatory purposes, in separate 'regulatory deferral accounts' until they are reversed through billings to customers in future periods.

2.17 A brief description of some examples of common differences has been included here to provide some context for the discussion that follows about the information needs of users of financial statements. Further examples are described in Section 5 and Appendix B.

2.18 Many differences relate to variances that arise between the estimates used by the rate regulator in establishing the rate for the next regulatory period and the actual results that arise from transactions and events that occur during that period. These variances arise for a variety of reasons, such as differences in the volumes of rate-regulated goods or services delivered, or differences in the price of raw materials, or because unpredictable events have occurred. For example, a major storm could damage electricity transmission or distribution lines, resulting in increased repair costs for the transmission or distribution entity, which will subsequently be recovered from customers through increased rates in the future.

2.19 Other differences arise because of differences between the IFRS requirements for measuring assets such as property, plant and equipment and the equivalent rate-regulatory requirements. For example, IAS 16 requires an entity to include in the initial costs of the asset only those costs that are directly attributable to bringing the item of property, plant and equipment to the location and condition necessary for it to be capable of operating in the manner intended by management. Indirect costs will, for IFRS purposes, be recognised immediately in profit or loss when incurred. In some cases, the entity will, for rate-regulatory purposes, include indirect overheads in the initial cost of the asset. This increases the regulatory carrying amount of the asset. The inclusion of indirect overheads in the cost of the asset delays the recognition of those indirect costs in profit or loss for regulatory purposes because, instead of being recognised as an immediate expense, they are recognised as an expense through the depreciation of the asset over several periods.

2.20 Before trying to identify what information about rate regulation is relevant to users of financial statements, it is important to highlight that differences between amounts recognised in profit or loss in accordance with IFRS and those recognised for regulatory purposes may arise for reasons other than timing. For example, an entity may incur some costs that the rate regulator determines are inappropriate for the entity to pass on to customers. When setting the rate to be charged to customers, the rate regulator disallows such costs in the rate calculation. The costs will be recognised as incurred in the general purpose financial statements in accordance with normal IFRS requirements. The costs will also be recognised as incurred in the regulatory financial statements but will not be included in the calculation of the revenue requirement.

What information about defined rate regulation is most relevant to users of financial statements?

2.21 We have heard that users of financial statements need information about the effect of rate regulation when it affects both the price that is charged to customers and the management and profitability of the business. Consequently, the remainder of Section 2 focuses on defined rate regulation and explores the type of information that we understand is most relevant to allow users of financial statements to understand the effect of defined rate regulation on the management of a rate-regulated entity's business and on the amount, timing and certainty of revenue, profit and cash flows.

2.22 The providers of capital to entities that are subject to defined rate regulation understand that the rate regulation is designed to balance the interests of both the supplier (ie the rate-regulated entity) and its customers (see paragraphs 4.4–4.7). This means that, when establishing the rate to be charged, the rate regulator seeks to ensure that the supplier is financially viable and can attract the levels of investment necessary to maintain the targeted volume and quality of supply. As a result, the providers of both debt and equity capital to the supplier need confidence that the rate regulation will enable the entity to recover its appropriate costs and to generate sufficient returns to cover its cost of capital. In addition, the providers of capital must have confidence in the entity's ability to collect the cash generated from the rate-regulated activities in order to repay borrowings and to pay interest and dividends.

2.23 However, in addition to supporting the financial viability of the entity, the rate regulator seeks to ensure that the regulated rate per unit charged is relatively stable for customers. In order to reduce volatility in the rate and to spread the impact of any significant rate changes, the rate regulator may specify the timing of when the entity can bill customers for the rate-regulated activities it has performed or is required to perform in the future. The specified timing is reflected in the calculation of the regulated rate per unit. As a result, the entity's cash inflows from its customers tend to be smoothed by the actions of the rate regulator. This creates differences between the amount of revenue that the entity can bill to customers during the period, and the amount of consideration to which the entity is entitled in accordance with the revenue requirement in exchange for the rate-regulated activities performed in the period. In such circumstances, the calculation of the regulated rate per unit typically incorporates an interest adjustment to reflect the time value of money. The interest adjustment is designed to ensure that the entity is still able to earn its targeted regulatory rate of return in accordance with the rate regulation.

2.24 The differences between the amounts billed and the amount of the revenue requirement can be either positive or negative. In some periods, originations and reversals of differences may offset each other; while, in other periods, they may create gains or losses that subsequently reverse through the rate-regulatory mechanism. Some suggest that without adjustments being made to recognise these differences as assets and liabilities in IFRS financial statements, the results reported in accordance with IFRS can appear artificially volatile, because defined rate regulation ultimately brings cumulative profitability back to the targeted rate.

2.25 The IASB has heard that users of financial statements particularly value information that helps them to distinguish variability in performance that is adjusted through the rate-regulatory mechanism from variability for which the mechanism provides no adjustment. This information is needed to help them to understand the effect of the rate regulation on the revenue, profit and related cash flows of the entity, and to assess how reliable the rate regulation is in ensuring that the entity can earn its targeted returns through its billings to customers.

2.26 In developing the disclosure requirements in IFRS 14 (see Section 6), the IASB staff observed that some IFRS preparers who do not recognise regulatory deferral account balances in their IFRS financial statements provided, voluntarily, both quantitative and qualitative disclosures in the management commentary that accompanies the financial statements. In some cases, more detailed information about the rate regulation was contained in documents provided to investors and analysts to explain the results.

Questions for respondents

2.27 The IASB has not developed proposals regarding what information should be presented in IFRS financial statements as a result of this project. Section 6 outlines the presentation and disclosure requirements of IFRS 14 in order to solicit more feedback about their usefulness to users of IFRS financial statements. The presentation and disclosure requirements in IFRS 14 may not capture all of the information that is used by investors, lenders, analysts and rate regulators. However, a balance needs to be achieved between the needs of users for information about the financial effects of rate regulation on an entity's operations with concerns about obscuring the understandability of financial statements and high preparation costs that can result from excessive disclosures.

2.28 Consequently, this Discussion Paper is seeking feedback from interested parties, in particular users of financial statements, to inform the IASB's consideration about how best to reflect information about rate regulation in IFRS financial statements. In particular, the IASB is seeking input from investors, lenders and analysts about why the information is valuable and how they might use it.

Question 1

(a) What information about the entity's rate-regulated activities and the rate-regulatory environment do you think preparers of financial statements need to include in their financial statements or accompanying documents such as management commentary?

Please specify what information should be provided in:

(i) the statement of financial position;

(ii) the statement(s) of profit or loss and other comprehensive income;

(iii) the statement of cash flows;

(iv) the note disclosures; or

(v) the management commentary.

(b) How do you think that information would be used by investors and lenders in making investment and lending decisions?

Question 2
Are you familiar with using financial statements that recognise regulatory deferral account balances as regulatory assets or regulatory liabilities, for example, in accordance with US GAAP or other local GAAP or in accordance with IFRS 14? If so, what problems, if any, does the recognition of such balances cause users of financial statements when evaluating investment or lending decisions in rate-regulated entities that recognise such balances compared to: (a) non-rate-regulated entities; and (b) rate-regulated entities that do not recognise such balances?

Section 3—What is rate regulation?

3.1 This Section deals with the following topics:

(a) background information about rate regulation; including an introduction to 'defined rate regulation', why rate regulation exists and what objectives it aims to achieve (see paragraphs 3.2–3.20); and

(b) categories of rate regulation, including cost-based, incentive-based and hybrid types (see paragraphs 3.21–3.37).

Background

3.2 The RFI (see paragraph 1.12) defined rate regulation as 'the mechanism by which a rate regulator imposes a control over the setting of prices that can be charged to customers for services or products'. This consultation asked stakeholders to provide high level overviews of the types of rate regulation that they considered relevant to the project to help the IASB identify both the range of approaches and the common features of such schemes.

3.3 This Section sets out a general description of some common categories of rate regulation, together with a brief description of why these categories exist. This is intended to provide some general background about rate regulation and its objectives before specifying, in Section 4, a generic type of rate regulation that was identified from the responses to the RFI and is named 'defined rate regulation'.

Focusing the discussion—defining rate regulation

3.4 A major objective of the IASB's Rate-regulated Activities project is to identify whether rate regulation sufficiently changes the financial position, performance and cash flows of rate-regulated entities to support modifying the general requirements of IFRS that apply to the entities. In particular, the IASB is seeking to determine whether rate regulation creates distinguishable rights and obligations that support recognition of 'regulatory assets' or 'regulatory liabilities' in addition to the assets and liabilities already recognised in accordance with IFRS for non-rate-regulated activities. If so, the nature of any regulatory asset or regulatory liability would need to be identified in order to assess how best to reflect it in IFRS financial statements.

3.5 The IASB has heard a variety of views from stakeholders about both the existence and the nature of many regulatory assets and regulatory liabilities. Some commentators have a strongly held view that rate regulation creates assets and liabilities that should be recognised for IFRS financial reporting purposes, but others have an equally strong view that it does not. Many of the views expressed are based on a particular rate-regulatory scheme with which the commentator is familiar. However, as discussed later in this Section, there is a wide variety of rate-regulatory schemes and the terminology used to describe them can be confusing because almost all are hybrid schemes. This means that the distinguishing rights and obligations created by rate regulation have not, so far, been clearly identified in previous IASB standard-setting efforts.

3.6 Consequently, as noted in paragraph 1.14, the IASB has tentatively decided to focus its analysis initially on a generic type of rate regulation that this Discussion Paper calls defined rate regulation. This type of rate regulation balances the needs of the customers to purchase essential goods or services at a reasonable price with the needs of the entity to attract capital and remain financially viable. It is seen in situations in which the customers have little or no choice but to purchase the goods or services from the rate-regulated entity. The rate regulation is designed to ensure that the rate-regulated entity recovers a determinable amount of consideration (the 'revenue requirement') in exchange for the rate-regulated activities that it performs. In addition, the rate regulation establishes, through the rate per unit chargeable to customers, the time at which the entity can bill customers for that consideration.

3.7 Section 4 describes the features of defined rate regulation. This provides a common starting point for a more focused discussion about whether that form of rate regulation creates a combination of rights and obligations for which the general requirements of IFRS should be modified. Section 5 outlines a number of possible approaches to developing an accounting model if the feedback provided in response to this Discussion Paper suggests that is appropriate.

Why does rate regulation exist?

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.

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.

3.10 The term 'essential' is hard to define because of variations between jurisdictions. Essential goods or services tend to be those considered to be essential to modern life so that, for moral or social reasons, the government considers that their universal provision should be guaranteed.[10] The widespread provision of essential goods or services in developed countries often includes gas, electricity and water services, transport, telecommunication and postal services, healthcare, education and others (see paragraph 4.31). Such services are still commonly provided by local or national government, but provision through public or private entities is becoming increasingly significant in many countries.

10 Other terms may be used to describe essential goods or services, such as 'public services' or 'services of general interest' or 'services of a general economic interest'. For example, the types of essential goods or services considered in this Discussion Paper may be included in the categories 'services of general interest' or 'services of a general economic interest' using terminology that is widely accepted in the European Union (White Paper on services of general interest, COM(2004)374, 12.5.2004).

3.11 The strength or extent of any rate regulation imposed usually reflects the relationship between the levels of supply and demand for the goods or services and the level of competition that exists in the market for those goods or services. Generally, the more restricted the availability and/or level of competition, the more prescriptive the rate regulation.

3.12 For example, in some environments, there is a plentiful supply of the essential goods or services from a large number of competitive suppliers. In such cases, the government may choose not to apply any rate regulation, because the competitive market forces sufficiently protect customers in terms of pricing and the quality and availability of supply. This unregulated, competitive market approach is becoming increasingly common for some types of services, such as electricity generation and supply (but not transmission) and telecommunications. As a result, such services are becoming deregulated when the levels of competition become effective.

3.13 In many environments, there is a reasonable supply of the essential goods or services but competition is restricted because there are few suppliers. In such cases, the government may choose to apply limited rate regulation, which is designed to supplement the existing competitive constraints on pricing when the level of competition is considered insufficient to protect customers. This type of rate regulation typically applies a price-cap restriction to all competitors in the market (see paragraphs 3.30–3.33) but does not involve establishing protections for service quality or for the financial viability of the suppliers.

3.14 In other environments, there may be a limited supply of the essential goods or services and only one supplier. In such cases, the government is more likely to impose extensive rate regulation. The rate regulation protects the financial viability of the supplier but also supports the interests of customers by incorporating requirements relating to the quantity and quality of supply in addition to pricing restrictions (see paragraph 2.12). This type of rate regulation, called defined rate regulation in this Discussion Paper, is discussed in Section 4.

Objectives of rate regulation

3.15 The form that the rate regulation takes reflects the objectives of the rate regulator, which are usually established by government. Although there is a perception that rate regulation is designed primarily to protect customers by keeping the price of the rate-regulated goods or services as low as possible, this is not always the case. For example, a low price may lead to low service standards, which may not be acceptable. Consequently, the rate regulator may protect customers by establishing higher minimum service standards, which results in higher prices for customers. In addition, when the supply of the essential goods or services is limited, and particularly when there is only one supplier, the rate regulator normally seeks to ensure that the rate regulation also provides an economically sustainable outcome for the supplier of those goods or services.

3.16 As indicated in paragraph 3.8, rate regulation is common in industries that are capital-intensive and require significant investment in long-life infrastructure assets. If investors are faced with the prospect of not recovering their risk-adjusted cost of capital, this would discourage investment in new capacity (this applies to equity as well as debt capital). Lack of investment in the infrastructure could lead to a reduction in quality, or even shortages in the supply, of the rate-regulated goods or services. Because these goods or services are considered to be essential, such failings would imply that the type of rate regulation would not serve the interests of the customers.

3.17 For that reason, the providers of both debt and equity capital need confidence that the regulatory approach will enable the full recovery of the rate-regulated entity's reasonable costs over the full operational life of an asset, including the original acquisition cost of the asset and the cost of the capital employed. In this context, 'reasonable costs' does not necessarily equate to the entity operating in such a way that it achieves maximum productivity with minimum wasted effort or expense. Instead, it reflects the level of efficiency that the rate regulator establishes to be reasonable, within the context of balancing the need to protect the financial viability of the entity at the same time as maintaining or improving the service standards provided to customers.

3.18 For example, in some industries, particularly utilities such as water services, that were previously government-owned, the entity may have inherited old and inefficient infrastructure assets that take time and investment to improve. In such cases, the rate regulator establishes a phased programme for improving efficiency over time. This programme shares the costs of the inefficiencies of the inherited infrastructure between the customers and the entity until the infrastructure can be renewed and improved in accordance with the efficiency improvement programme.

3.19 The increased use of incentives in rate regulation is reflected in the responses to the RFI, which also indicate a global trend moving toward more non-financial as well as financial objectives. Many of these objectives focus on improving service levels, or achieving other government targets, including those created by social, economic and environmental policies. Common objectives include:

(a) improvements in the quality and efficiency of service;

(b) increased customer satisfaction;

(c) increases in supply capacity and reliability;

(d) achievement of environmental goals/reductions in polluting emissions;

(e) development of innovative technologies/use of alternative resources;

(f) encouragement of competition; and

(g) decreases (or increases) in customer demand or usage.

3.20 This increasingly complex combination of objectives is leading to a trend away from cost-based rate regulation towards rate-regulatory schemes that are increasingly incentive-based.

Categories of rate regulation

3.21 The responses to the RFI described two general categories of rate regulation:

(a) cost-based (commonly known as 'cost-of-service' or 'return-on-base-rate' regulation); and

(b) incentive-based (including price-cap or revenue-cap regulation).

3.22 However, these two categories describe two ends of a broad range of rate regulation. At one end of the range, the formula used to calculate the rate is focused on the entity's actual input costs, with a 'balancing adjustment' mechanism to ensure that actual input costs are recovered. At the other end of the range, the formula used to calculate the rate is focused on targeted outputs, with little or no 'true-up' or balancing adjustment to actual results.

Cost-of-service or return-on-base-rate

3.23 In this type of rate-regulatory scheme, the rate is intended to ensure that the rate-regulated entity recovers all of its 'allowable costs', plus a 'fair and reasonable' rate of return on its capital investment. Allowable costs are those that the rate regulator agrees are reasonably incurred for the purpose of carrying out the specified rate-regulated activities. The restriction of allowable costs to those that are reasonably incurred is designed to ensure that customers do not pay for avoidable waste or other inefficiencies.

3.24 Terms such as 'reasonably incurred' and 'fair and reasonable' or other terms with similar meaning are common in rate regulation. This provides the rate regulator with some flexibility in establishing the rate to be charged to customers, and often leads to negotiations between the entity and the rate regulator. These negotiations typically involve some compromise by both parties in order to reach an agreement but it does not mean that the rate regulator has a free choice as to which costs to allow or disallow or what rate of return to permit. Commonly, the rate regulation provides a formula for calculating the regulated rate, which includes guidance about the types of costs or other items that will be taken into account within the rate formula. This limits regulatory discretion and provides predictability about the outcome of rate-regulatory interventions, which helps to attract both debt and equity capital investment.

3.25 In a typical cost-of-service or return-on-base-rate type of scheme, the formula used to calculate the rate is focused on the entity's actual input costs. The regulated rate is typically determined in advance of the period over which the rate applies, and is based on forecasts and assumptions. The actual costs and volumes differ from those forecasts and assumptions. A cost-based rate formula uses a balancing adjustment mechanism to adjust for variances between estimated and actual results. The balancing adjustment mechanism is, in effect, an acknowledgement that the original rate determination is 'provisional' (ie the rate is subject to revision). Such a cost-based formula is typically designed to ensure that the entity recovers:

(a) the specific operating costs of providing the regulated goods/service;

(b) the specific capital costs of the assets used to provide the regulated goods/service; and

(c) a specified rate of return on the entity's capital investment.

3.26 Cost-of-service rate regulation in its traditional or 'pure' form is becoming less common. Many of the schemes described as cost-of-service also include some incentive-based elements and, therefore, would be better described as hybrid schemes (see paragraphs 3.34–3.37). Consequently, the IASB is considering, in this project, a wider range of schemes than just cost-of-service schemes.

Incentive-based

3.27 At the other end of the range, the formula used to calculate rates charged to customers is based on targeted outputs, with no balancing adjustment to reconcile back to actual results. Such schemes set targets in order to provide an incentive to the rate-regulated entity to maximise efficiency by allowing the entity to retain any profits above the target level. In contrast, the entity suffers the downside of any inefficiency or under-recovery of costs.

3.28 An incentive-based formula typically:

(a) uses 'benchmark' or target costs, revenue and return rates as a starting point for setting the initial rate.

(b) adjusts the target input measures for inflation and for a variety of output-based objectives, with incentives or penalties applied through the rate formula.

(c) does not adjust the approved rate to recover or reverse past variances between actual and estimated amounts. However, past experiences can influence expectations about future cost levels, which are then used to establish future prices.

3.29 In contrast to pure cost-of-service rate regulation, which seems to be becoming less typical, schemes at the end of the incentive-based range of rate regulation can be found in practice. Such schemes typically apply when there is some competition to supply the rate-regulated goods or services but some limited rate regulation is needed to supplement the competitive forces in the market. Paragraphs 3.30–3.33 provide further details about this type of rate regulation, which, for convenience, is named 'market regulation'.

Market regulation

3.30 Market regulation is a term that is often used to indicate an incentive-based regulation, which often takes the form of a 'price cap' that applies to all suppliers in a competitive market. The rate regulator establishes a maximum level for the price per unit that all suppliers in the market can charge customers for the goods or services (ie a price cap) but does not set a 'floor' for that price.

3.31 The price cap established by the rate regulator is rarely based on the specific costs that any individual supplier incurs in providing the rate-regulated goods or services but, instead, the price cap is based on benchmark costs. Consequently, although this type of rate regulation provides some protection for customers in the form of a capped price per unit, it does not provide assurance to the entities in the market that they will be able to recover their costs or make a reasonable return on the goods or services that are sold subject to the rate regulation. Examples of such regulation include the capping of prices that:

(a) banks in some jurisdictions can charge for processing credit card transactions; and

(b) telecommunications providers in some jurisdictions can charge for mobile telephone ‘roaming’ services.

3.32 Using this market regulation, the rate regulator does not restrict the total amount of revenue or profit that an entity can earn during the ‘regulatory period’ (ie the period over which the restricted price is required to be applied). Consequently, an entity may be able to increase profitability by reducing costs. In addition, the entity may gain a competitive advantage by reducing its selling price below the cap in order to gain market share and increase the volume of sales. This could result in the entity earning a higher amount of revenue, which would provide a greater contribution to fixed costs and, therefore, result in the entity earning a higher profit.

3.33 When market regulation has (or has the potential to have) a negative impact on the availability and quality of service, the rate regulator may increase the level of regulatory intervention. In some cases, the rate regulator may impose a minimum price per unit (ie a price floor) in addition to the price cap, in order to support competition. Alternatively, the rate regulator may impose service conditions on the suppliers in order to maintain the quality and availability of supply. In such cases, the rate regulation is not purely market regulation. Instead, it typically incorporates a mixture of cost-based and incentive-based mechanisms, which is commonly referred to as hybrid rate regulation.

Hybrid rate regulation

3.34 In the responses to the RFI, almost all of the schemes described as cost-of-service contained some incentive mechanisms and almost all schemes described as incentive-based incorporated some cost-recovery mechanisms.

3.35 For example, some schemes described as cost-of-service included incentive-based elements, such as the use of benchmark costs, instead of the entity’s specific costs, industry average weighted average cost of capital or market return rates instead of the entity’s specific debt/equity mix or actual cost of capital and incentive/penalty adjustments to the rate for other (usually non-financial or output-based) objectives.

3.36 In contrast, the more detailed descriptions of some schemes described as incentive-based included references to the use of variance or deferral accounts for some specified costs, which provide the basis for a balancing adjustment to reconcile the entity’s variances between actual and estimated costs through the approved rate in the same way as in the traditional cost-of-service schemes.

3.37 The balance between the cost-based and incentive-based elements is often dependent on the local circumstances, and may change over time to reflect changes in the local circumstances. For example, if industry capacity is constrained and new capacity is required, the rate regulator might add some capacity expansion incentives into the price-setting mechanism. In contrast, if there is surplus capacity, the rate regulator may place more emphasis on operational cost efficiencies or capacity reductions.

Questions for respondents

3.38 The IASB has not received requests to develop specific accounting requirements for pure incentive-based types of schemes, such as market regulation. In its previous Rate-regulated Activities project (see paragraph 1.7), the IASB considered only cost-of-service schemes. However, in response to requests to consider a wider range of schemes, the IASB is currently focusing on not only cost-of-service schemes but also a type of hybrid rate regulation, which this Discussion Paper calls defined rate regulation (see Section 4).

Question 3
Do you agree that, to progress this project, the IASB should focus on a defined type of rate regulation (see Section 4) in order to provide a common starting point for a more focused discussion about whether rate regulation creates a combination of rights and obligations for which specific accounting guidance or requirements might need to be developed (see paragraphs 3.6–3.7)? If not, how do you suggest that the IASB should address the diversity in the types of rate regulation summarised in Section 3?

Question 4
Paragraph 2.11 notes that the IASB has not received requests for it to develop special accounting requirements for the form of limited or 'market' rate regulation that is used to supplement the inefficient competitive forces in the market (see paragraphs 3.30–3.33). (a) Do you agree that this type of rate regulation does not create a significantly different economic environment and, therefore, does not require any specific accounting requirements to be developed? If not, why not? (b) If you agree that this type of rate regulation does not require any specific accounting requirements, do you think that the IASB should, alternatively, consider developing specific disclosure requirements? If so, what would you propose and why?

Section 4—Defined rate regulation

4.1 This Section addresses the following topics:

(a) an overview of the features of defined rate regulation, how the regulated rate is established and how the regulated rate is subsequently adjusted to reflect past events and transactions (see paragraphs 4.2–4.29);

(b) a more detailed description of the features of defined rate regulation (see paragraphs 4.30–4.61); and

(c) consideration of whether the features of defined rate regulation create a combination of rights and obligations for which specific accounting requirements should be developed (see paragraphs 4.62–4.79).

What is defined rate regulation?

4.2 Defined rate regulation incorporates a number of features that are common to a wide variety of rate-regulatory schemes around the world. These features were identified from the types of schemes that respondents to the RFI suggested give rise to a combination of rights and obligations that create economic conditions that are distinguishable from those found in environments that are not rate-regulated. Some suggest that this combination of rights and obligations creates specific assets and liabilities for which accounting requirements should be developed.

4.3 This Section sets out the features of defined rate regulation, together with a brief analysis of the rights and obligations associated with them. The IASB is seeking input from stakeholders about whether these features appropriately describe rate-regulatory schemes that exist. In addition, the IASB is seeking input about whether the features create a combination of rights and obligations for which it should consider developing specific accounting guidance or requirements.

Defined rate regulation—an overview

4.4 Defined rate regulation balances the needs of the customers to purchase essential goods or services at a reasonable price with the needs of the entity to attract capital and remain financially viable. 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.

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

4.5 The rate-setting framework for defined rate regulation establishes:

(a) a 'revenue requirement' (sometimes called 'allowable revenue' or 'authorised revenue'): this is the total consideration to which the entity is entitled in exchange for carrying out specified rate-regulated activities over a period of time; and

(b) a regulated rate, or rates, per unit that the entity charges to customers for delivering the rate-regulated goods or services during the regulatory period.

4.6 For defined rate regulation, the mechanism used to calculate the regulated rate(s) includes a regulatory adjustment mechanism to reverse specified differences between the amount of the revenue requirement accrued to date and the amounts billed to customers. This regulatory adjustment mechanism seeks to ensure that the rate-regulated entity earns no more and no less than the amount of the revenue requirement and any related profit or return to which it is entitled. The regulatory adjustment to the rate also seeks to reflect the time value of money when increases or decreases in the rate are deferred.

4.7 Consequently, some suggest that defined rate regulation creates a combination of rights and obligations that supports the recognition of the entity's right to recover, or obligation to reverse, the specified differences as assets or liabilities in the statement of financial position. The remainder of this Section outlines the features of defined rate regulation and the combination of rights and obligations that relate to the rate-regulatory mechanism.

Regulatory agreements—the terms of service

4.8 Situations in which the customer has little or no choice but to purchase essential goods or services from a single supplier commonly lead to a government considering regulatory intervention. This could be set out in an explicit licence or in legislative rate regulation or a combination of the two. The resulting terms of service establish the activities that are the subject of the rate regulation, and whether the entity can carry on activities that are outside the rate regulation.

4.9 The rate-regulated activities that the entity is required to perform are both directly and indirectly related to providing the goods or services that are billed to the customers. The indirect activities may involve satisfying related government objectives such as changes to the infrastructure network (for example, expansion, contraction, renewal or upgrading) and/or achieving other environmental, social or economic policies.

4.10 In some cases, the government may provide the entity with funding to carry out some of these activities. This may involve a separate contractual arrangement by which the entity bills the government for the work done. Alternatively, it may take the form of a government grant or tax relief, etc. Situations in which funding is provided in part by government could meet the definition of defined rate regulation. However, this Discussion Paper focuses on the situations in which all of the funding is provided by customers (see paragraph 4.29). In such cases, the rate-setting mechanism incorporates all of the relevant consideration for these activities into the formula that is used to calculate the rate per unit that is to be charged when the rate-regulated goods or services are delivered to customers. Consequently, the timing of billing this consideration to customers is more closely linked to the timing of delivery of the rate-regulated goods or services than to the timing of performance of the overall rate-regulated activities.

4.11 In addition, defined rate regulation provides some regulatory protections to the supplier. These include barriers to competition and an entitlement to recover its revenue requirement from customers. The rate-setting process uses a balancing adjustment mechanism that is intended to adjust future rates to recover any shortfalls in amounts billed to customers and to reverse amounts over-billed.

The rate-setting mechanism

4.12 The rate-setting mechanism identifies the revenue requirement; that is the total consideration to which the entity is entitled in exchange for carrying out the required rate-regulated activities over a specified period of time, in accordance with the agreed terms of service. The revenue requirement is typically linked, in defined rate regulation, to an amount of allowable profit or a specified rate of return on capital invested. However, the incentive mechanisms within defined rate regulation may permit an entity to under-perform or over-perform when compared to the target profit or rate of return. Consequently, the main focus of the rate-setting mechanism is establishing the revenue requirement, instead of a profit amount.

4.13 Initially, the revenue requirement is based on estimated amounts. The estimated amount of the revenue requirement is divided by the estimated quantity of the rate-regulated goods or services expected to be delivered to establish the rate or price, or a range of rates, per unit to be charged to customers for the duration of the regulatory period. The regulatory period is the time between regulatory rate determinations or agreements. This period differs in different rate-regulatory schemes. In many schemes it has a one-year duration but is commonly three to five years or may be longer. This rate per unit is designed to provide the entity with a billing mechanism that is intended to result in the recovery of the revenue requirement, including any related allowable profit or return for the period.

4.14 Although the volume and type of goods or services to be provided can often be reliably estimated, the actual output varies according to a number of factors, including the occurrence or non-occurrence of contingent events that are outside the control of the rate-regulated entity, such as a severe storm or flooding. Consequently, differences may arise between:

(a) the billable revenue: that is the amount of revenue that the entity bills (invoices) to customers, using the established rate per unit, in exchange for the actual quantity of rate-regulated goods or services delivered in the period; and

(b) the revenue requirement: that is the amount of consideration to which the entity is entitled in exchange for carrying out the required rate-regulated activities during the period, including those both directly and indirectly related to delivering the rate-regulated goods or services.

4.15 In addition, intentional differences are sometimes created by the rate regulator. This typically occurs when the rate regulator decides to reduce price volatility. In such circumstances, the rate regulator will, when establishing the rate, spread a large price change over time. This spreading may affect more than one regulatory period and commonly affects more than one interim or annual period for financial reporting purposes.

4.16 In defined rate regulation, the rate-regulatory framework contains a mechanism that is designed to reverse these differences. The inclusion of such a regulatory adjustment mechanism acknowledges that, in effect, the original regulatory rate determination is provisional, that is, it is subject to some form of adjustment to actual amounts. When the time value of money is relevant, the regulatory agreement compensates the entity by applying interest to any price increase that is deferred, or charges the entity by applying interest to any price reduction that is deferred. The regulatory adjustment mechanism seeks to ensure that the rate-regulated entity earns no more and no less than the amount of the revenue requirement and any related profit or return to which it is entitled during the regulatory period.

4.17 However, the regulatory adjustment mechanism may not be a full one-for-one balancing adjustment. This is because, for efficiency and cost-benefit considerations, defined rate regulation allows some differences to 'flow through' and affect the entity's profit, without adjustment. Often, these unadjusted differences would not be significant in relation to the overall level of costs incurred or the amount of the revenue requirement. In some cases, especially when the regulatory period covers several years, the defined rate regulation may include a rate-review 'trigger'. This trigger allows the entity to seek a rate increase, or the rate regulator (or customers) can seek a rate decrease, when events or transactions deviate significantly from those used to estimate the revenue requirement. This trigger mechanism helps to keep unadjusted differences to an acceptable level (see paragraph B31).

4.18 In other cases, particular types of differences are designed to flow through the entity's profit or loss, because they relate to incentives within the rate regulation, which may be material in amount.

4.19 Some suggest that these unadjusted flow-through amounts do not require any special accounting requirements to be developed for them. This is because these unadjusted differences are not subject to a regulatory adjustment mechanism and so should flow through the entity's profit or loss account in accordance with the accounting policies developed using the general requirements of IFRS. This would be consistent with amounts that are not subject to any rate regulation.

4.20 The remainder of this analysis focuses on the aspects of the rate-setting mechanism that make regulatory adjustments to the rate to be charged to customers in order to adjust differences that arise between the estimated revenue requirement and the actual amounts billed to customers using the regulated rate per unit. This focus is consistent with the feedback from users of financial statements, who are interested in receiving information that helps them to distinguish variability in performance that is adjusted through the rate-regulatory mechanism from variability for which the mechanism provides no regulatory adjustment (see paragraph 2.25).

How does defined rate regulation adjust for differences between the revenue requirement and billed revenue?

4.21 The most common method used to recover or reverse the amount of a difference is to adjust the price for future sales to seek to eliminate the difference over a period of time. The length of time usually depends on a number of factors, including the size of the difference, the ability of customers to absorb a price increase, the ability of the entity to fund price reductions, etc.

4.22 In defined rate regulation, it is usually assumed that the rate regulator is able to use the adjustment to the price charged for future sales as a practical, low-cost and reliable mechanism for the entity to recover the amount of any under-billing or reverse the amount of any over-billing. This is because the customer has little or no choice but to purchase the rate-regulated goods or services from the entity.

4.23 The restriction of customer choice makes demand relatively inelastic and contributes to a high level of predictability of the timing and probability of future sales. This does not mean that there needs to be a stable level of demand. It generally means that any changes in expected volumes are within a range that is narrow enough to allow the rate regulator to achieve the objective of providing the regulatory protections to both the rate-regulated entity and its customers.

4.24 Consequently, some suggest that a distinguishing feature of defined rate regulation is the regulatory adjustment mechanism for recovering or reversing a significant proportion of any under-billings or over-billings; that is the differences between the amount of revenue billable to customers during the period and the amount of consideration to which the entity is entitled in exchange for the rate-regulated activities performed to date in accordance with the revenue requirement.

4.25 If the rate regulator can no longer predict the volume of demand for the rate-regulated goods or services within a manageable range of outcomes, the type of rate regulation, in particular, the rate-setting mechanism, would be expected to change to reflect this. In such cases, other mechanisms would be used to reverse revenue requirement differences or to protect customers and/or the rate-regulated entity. These other mechanisms might involve cash flows between the entity and the rate regulator or other government body, instead of relying solely on customers buying the rate-regulated goods or services in the future. In service concession arrangements, mechanisms involving cash flows between the entity (the operator) and the rate regulator (the grantor) may be more common than in defined rate-regulated agreements. Although the terms and conditions of some service concession arrangements are similar to those seen in defined rate regulation, the accounting for such arrangements already is addressed within IFRS in IFRIC 12 *Service Concession Arrangements*. Consequently, such arrangements are outside the scope of this Discussion Paper but the IASB may need to consider the interaction with IFRIC 12 in due course (see Section 7).

Other forms of adjusting revenue requirement mismatches

4.26 In a few cases, the differences between billable revenue and the revenue requirement are settled directly with the rate regulator. This means that the entity pays cash to, or receives cash from, the rate regulator or other designated body, depending on whether the entity has billed more, or less, revenue to customers than the actual revenue requirement that relates to the activities it has completed during the regulatory period, in accordance with the terms of service.

4.27 In a few other cases, the entity issues additional bills or credit notes to specific customers or groups of customers that have purchased the rate-regulated goods or services from the entity in the past. The amounts billed or credited equal the value of the differences and are allocated to the customers in proportion to their past purchases during the regulatory period.

4.28 This form of retrospective correction of differences with customers is rare because it contradicts the objective of protecting customers from the immediate effects of price volatility. In the rare situations in which the difference is settled through retrospective billing adjustments, or directly in cash with the rate regulator or other government body, the amounts receivable, or payable, are generally accepted to be financial assets, or financial liabilities, that are within the scope of IFRS 9 *Financial Instruments*.[11] Consequently, no specific accounting problems arise in these cases.

4.29 In other cases, the rate regulator may use other methods to change the cash flows of the entity to recover or reverse the differences. For example, government grants or subsidies, levies or taxation could be used. However, the use of such indirect methods to ensure that the entity earns no more or no less than the revenue requirement adds complexity to the analysis. Consequently, this Discussion Paper focuses on the situations in which adjustments to future rates charged to customers are used as the mechanism to recover or reverse differences. If, as a result of the feedback from this Discussion Paper, the IASB decides to develop proposals for guidance or requirements for rate-regulated activities, the interaction with other settlement methods will need to be considered (see Section 7).

The distinguishing features of defined rate regulation

4.30 Paragraphs 4.4–4.6 outline the features of the type of regulatory framework that this Discussion Paper calls defined rate regulation. The following paragraphs provide a summary of these features. This is followed by a summary of the typical rights and obligations associated with them.

11 For entities that do not yet apply IFRS 9, any reference to IFRS 9 should be read as a reference to IAS 39 *Financial Instruments: Recognition and Measurement*.

Essential goods or services

4.31 Defined rate regulation is imposed on a supplier when the goods or services supplied are considered to be essential (see paragraph 3.9). The types of industries identified in the responses to the RFI that commonly fall within the scope of what is described in this Discussion Paper as 'defined rate regulation' are varied but fall into the following broad categories:

(a) energy (including electricity, gas, oil/petroleum, heating);

(b) water and sanitation;

(c) public transport (including trains, buses, taxis, toll roads, air traffic control, port and airport services);

(d) telecommunications;

(e) postal services;

(f) insurance; and

(g) other (including fertilisers, health services, cemeteries).

4.32 Although the industry categories seem quite different in nature, each is considered to provide goods or services that are considered to be essential in a particular jurisdiction. How essential the goods or services are considered to be often reflects the level of availability compared to demand, the level of industrial development and the culture of the local environment.

4.33 In some jurisdictions, goods or services that are considered to be essential in nature are not subject to rate regulation, because there is sufficient natural competition in supply to negate the need for such regulation. In some cases, rate regulation has been removed because changes in technology have reduced natural barriers to competition, for example, in telecommunications.

4.34 In some cases, changes in regulatory approaches have encouraged competition. For example, in the electricity and gas industries, vertical integration of the supply stages from extraction/generation through transport/transmission and distribution to retail supply to the end user is increasingly being broken down into distinct stages. Different levels of rate regulation may then apply to the different stages. When competition is possible, commonly at the extraction/generation and retail supply stages, deregulation has sometimes occurred or a simple price cap or market regulation applies (see paragraphs 3.30–3.33). However, the transportation/transmission and distribution stages often operate as a monopoly because of the high levels of infrastructure investment required, together with the physical limitations of installing alternative transportation/transmission and distribution lines. Consequently, defined rate regulation commonly applies to these stages.

No effective competition to supply

4.35 Typically, the entities that are subject to defined rate regulation have an exclusive right to operate in a predetermined geographical service territory. The exclusive right may be:

(a) explicit—for example, the right may be defined by an exclusive licence agreement or contract with the rate regulator or other licensing body, or through legislation or other regulation; or

(b) implicit—for example, there may be significant barriers to entry (a natural monopoly) due to, for example, the high level of capital investment required or because of physical constraints that apply to putting the necessary infrastructure in place (for example, accessing private land in order to lay a pipeline).

4.36 Some suggest that any specified accounting model for rate-regulated activities should be limited to those entities that have *no* competition for the supply of the rate-regulated goods or services. Others suggest that requiring such a strict criterion would significantly limit the types of rate-regulated activities that would be within the scope of any accounting guidance or requirements for rate-regulated activities that might be developed by the IASB. They suggest further that such a limited scope would result in a different accounting treatment for similar transactions, even when the financial effects of the rate regulation that apply are comparable.

4.37 Consequently, the IASB is seeking input from stakeholders specifically about parameters that could be applied to situations in which there is limited competition but the outcome of the rate regulation produces a comparable economic environment to that in which there is no competition. In particular, the IASB is seeking feedback on the following scenarios:

(a) the entity is the exclusive supplier of a good or service, but customers could choose to use an alternative to that good or service (paragraphs 4.38–4.39); and

(b) the entity is not the exclusive supplier of a good or service but may be considered to be an essential supplier (paragraphs 4.40–4.42).

Alternative good or service

4.38 In some situations, an entity is subject to rate regulation that displays the features of defined rate regulation, except that the customers may have an opportunity to use a different good or service as an alternative to the one provided by the rate-regulated entity. For example, the entity, in a designated territory, may be the exclusive distributor of natural gas, which is used by customers as the primary energy source to fuel the heating and cooking systems in their homes. However, customers could use alternative energy sources such as electricity or oil. In another example, the rate-regulated entity may operate a toll road or vehicle ferry service between two locations. Customers could use alternative routes to travel between the locations instead of using the toll road or the ferry.

4.39 If customers have a relatively free choice between the alternative goods or services, then it is questionable whether the entity is able to ensure that it can recover its revenue requirement from customers. However, it may not be viable for customers to use the alternative good or service because of cost or other restraints. For example, customers that use gas to heat their homes and cook may be restricted from switching to using electricity for heating and cooking because the cost of switching is prohibitive. For the toll road or vehicle ferry service, customers may be able to drive along an alternative route but, again, the disadvantages of using the alternative route may be such that very few customers would choose to do so.

Essential but not exclusive supplier

4.40 In some situations, an entity will be subject to rate regulation that displays the features of defined rate regulation, except that there may be two or more rate-regulated entities supplying the rate-regulated goods or services. For example, in a geographical territory, there may need to be two or more entities that generate electricity in order to satisfy demand from the population and avoid power cuts or shortages. Each generator may use the same fuel to power its plant or the rate regulator may require different generators to use different sources of fuel, for example, a mixture of coal, hydro, solar and nuclear power.

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. In these circumstances, although there is no exclusive supplier, each supplier may be considered to be an essential supplier.

4.42 Consequently, in such cases, the rate regulator seeks to ensure the financial viability of each supplier and, therefore, such essential suppliers would have equivalent rights and obligations to the exclusive suppliers that are subject to defined rate regulation.

Maintaining the availability and quality of the supply

4.43 In defined rate regulation, the rate regulator balances the needs of the customers with the needs of the supplier. Consequently, as a counterbalance to the lack of effective competition against the entity's right to supply the essential goods or services, defined rate regulation imposes significant obligations on the rate-regulated entity that would not usually be present in an efficiently competitive market. This reflects a common objective of defined rate regulation, which is to maintain the availability and quality of the supply of the essential goods or services. This is because shortages in the supply, or reductions in quality, could have an adverse effect on customers.

4.44 Common obligations include:

(a) the goods or services must be provided to customers on a non-discriminatory basis;

(b) defined minimum service levels, for example:

  (i) emissions and other environmental targets must be met; or

  (ii) specified levels of investment in infrastructure capacity and reliability must be achieved.

(c) rate-regulated operations cannot cease, be restructured or transferred without the approval of the rate regulator.

Providing goods or services on a non-discriminatory basis

4.45 The obligation to provide the rate-regulated goods or services on a non-discriminatory basis usually means that network access and connection to the network cannot be refused, or that services must be provided to certain classes of customers at the regulated rate, irrespective of the cost of providing services to that particular class of customer, for example, those in remote or rural areas.

4.46 However, providing the rate-regulated goods or services on a non-discriminatory basis does not necessarily mean that the entity must provide the goods or services to all customers at the same price. In some cases, the rate regulator permits or requires the entity to charge a different price to different groups of customers. For example, the rate regulator may require the entity to charge a lower rate to customers in financial difficulties. In some cases, a rate-regulated entity may be required by the rate regulator to continue to deliver the rate-regulated goods or services to customers that fail to pay for the goods or services that they have received.

Achieving the defined minimum service level

4.47 Defined rate regulation establishes the minimum service level that the supplier is obliged to deliver. This establishes parameters for the volume and quality of the goods or services, and the timing and location of delivery. It may also establish what assets should be constructed or purchased in order to produce or deliver the rate-regulated goods or services. The terms of service also establish what other activities the entity needs to perform that are subject to rate regulation, and whether the entity is permitted to carry on other activities that are outside the regulation.

4.48 Some forms of cost-based rate regulation were perceived to encourage inefficient behaviour, because they allowed suppliers to recover costs of, and earn a rate of return on, all of the investment in infrastructure capacity. In some cases, this could result in capacity that is not needed in order to meet current or projected demand. This increases the allowable returns of the entity, which results in customers paying higher rates unnecessarily because they are paying for unused capacity. This is not in the interests of customers if it rewards entities for inefficient behaviour. Conversely, in some forms of incentive-based rate regulation, serious shortages in supply could occur, because the allowable rate of return is not sufficient to encourage the supplier to invest in additional infrastructure to meet increasing demand or to maintain quality levels.

4.49 In defined rate regulation, the rate regulator acts to balance the needs of the customers with those of the supplier and with other (government) objectives, such as reducing the environmental impact of producing the rate-regulated goods or services. Consequently, in defined rate regulation, the rate regulator and the supplier usually try to anticipate the expected level of demand for the rate-regulated goods or services and take action to ensure that the demand is manageable and can be satisfied within the rate-regulatory and government objectives. This means that the rate regulator can require the supplier to make specified levels of investment in the infrastructure that is needed to supply the rate-regulated goods or services at the volumes and quality required. The rate regulator uses the rate-setting mechanism to ensure that the supplier complies with these obligations and receives a reasonable amount of consideration in exchange for that compliance.

4.50 In some cases, the rate regulator uses the supplier to influence consumer behaviour in order to help manage demand. For example, an obligation to meet emissions or other environmental targets may include participation in conservation programmes or investment in cleaner or more sustainable energy or material sources. This can result in the entity having to encourage customers to reduce their level of purchases of the rate-regulated goods or services or having to produce the rate-regulated goods or services using more expensive materials and/or methods.

4.51 For example, the rate regulator may set the rate to reflect the objective of reducing consumption by charging a higher price per unit to customers. Such higher prices contribute to the recovery of the higher production charges, or may be required to be used to fund other regulated activities of the supplier. In some cases, they are paid to the government by the supplier in the form of higher taxes or levies.

Continuing operations

4.52 In many cases, the regulatory agreement is clear that the rate-regulated entity cannot cease, suspend, restructure or transfer operations (and the rights and obligations attached to those operations) without the approval of the rate regulator. The responses to the RFI suggest that, when there is no explicit obligation to continue to operate, the common understanding is that there is an implicit obligation. This is because the rate regulator or other government-controlled body is expected to step in to ensure the continuity of supply if necessary. Consequently, some suggest that the explicit or implicit obligation to continue to operate is a distinguishing feature of defined rate regulation. Entities that are not subject to defined rate regulation can choose to cease operating or otherwise withdraw from disadvantageous markets or activities in order to reinvest in more advantageous markets, or can divest in order to return debt and equity capital to lenders and investors.

4.53 In addition, the rights and obligations created by the rate regulation are rarely separable from the rate-regulated business. Because of the essential nature of the rate-regulated goods or services, it is in the interest of the customers to ensure the continued operation of the supplier's rate-regulated business to secure the availability of supply. If the rate regulator gives approval for the rate-regulated business to be transferred to another operator, the existing rights and obligations transfer to the new operator unchanged, including those related to the rate-setting mechanism. Consequently, the price agreed to transfer the business usually reflects the expectation that the balances that arose from regulatory differences between the amount of revenue billed to customers and the amount of consideration accrued will be recovered/reversed through the rates established for future sales made by the incoming supplier.

Establishing the rate to be charged to customers

4.54 In exchange for the obligations placed on the supplier, defined rate regulation provides the rate-regulated entity with a right to recover the revenue requirement. In establishing the revenue requirement and the regulated rate per unit, the rate regulator not only has to ensure that customers receive value for money, but also that the long-term financial and economic sustainability of the rate-regulated entity is maintained.

4.55 Rates that are below the level required to ensure an economically sustainable outcome for the rate-regulated entity would not be in the best interests of the entity's customers (assuming an acceptable level of cost and technical efficiency by the entity). This is because, if equity investors in the rate-regulated entity are faced with the prospect of not recovering their risk-adjusted cost of capital over the life cycle of the assets in which they have invested, or lenders risk not recovering their principal and interest, it would discourage any investment in new capacity for these typically long-life infrastructure industries.

4.56 For that reason, one of the key objectives of effective defined rate regulation is to attract capital. In order to achieve this, the providers of capital need confidence that the rate regulation will enable the full recovery, through the prices of the rate-regulated goods or services provided to customers, of the entity's reasonable costs over the operational life of the assets.

4.57 Consequently, in defined rate regulation, the entity will track specified amounts, including differences between the revenue requirement and the amounts billed to customers, in designated regulatory deferral accounts. The rate-setting mechanism incorporates the balances in these accounts into the calculation of the future rate to be charged to customers. This provides a process for the rate-regulated entity to recover, or reverse, the tracked amounts through future bills to customers.

Recovery or reversal of regulatory deferral account balances

4.58 Defined rate regulation uses a prospective adjustment to the rate charged for the future sales of the rate-regulated goods or services to recover or reverse regulatory deferral account balances. The mechanisms used for this adjustment vary but include the following:

(a) an adjustment to the allowed rate of return on capital employed throughout the next regulatory period (ie until the next rate-setting procedure resets the rate);

(b) an adjustment to the regulatory carrying amount of assets (ie the amount of capital employed, to which the allowed rate of return is applied);

(c) an adjustment to the approved rate throughout the next regulatory period; or

(d) a temporary adjustment to the approved rate for a specified period (sometimes referred to as a 'rate-rider' or 'rate-tracker', which is sometimes highlighted to customers as a separate element of the rate).

4.59 In some cases, the adjustment to the future rate is automatic (ie explicitly included in the rate formula). In other cases, the adjustment cannot be made until it has been specifically approved by the rate regulator.

4.60 In many cases, the rate-setting mechanism allows the entity, the rate regulator or customers to request a rate review before the end of the normal regulatory period. This is sometimes called a rate reset or trigger clause. This mechanism can be invoked when the differences between the revenue requirement and the actual amounts billed to customers are larger than expected or when actual demand is not expected to allow for full recovery/reversal of approved amounts and the rate is no longer considered reasonable by one or more of the parties that can request a review. Sometimes, the rate review is automatically triggered when variances exceed a pre-determined limit or 'corridor', which may occur because of a cumulative shift in the trend or because of a major, unexpected event, such as a severe storm.

4.61 Appendix B sets out further details about how the revenue requirement is estimated and how differences between the revenue requirement and the actual amounts billed to customers are adjusted.

Does defined rate regulation create a distinguishable combination of rights and obligations?

4.62 As noted in paragraph 4.4, defined rate regulation applies in situations in which customers have little or no choice but to purchase the goods or services from the rate-regulated entity. This is because the rate-regulated goods or services are considered essential to customers and the rate-regulated entity has no effective competition against its right to supply those essential goods or services. Consequently, defined rate regulation establishes both rights and obligations for the rate-regulated entity, which are designed to balance the needs of the customers with the needs of the entity to attract capital and remain financially viable.

4.63 In the remainder of this Section, we consider the rights and obligations associated with the features of defined rate regulation and consider whether any of the rights or obligations, or a combination of those rights and obligations, suggest that the IASB should develop specific accounting guidance or requirements for rate-regulated activities.

Exclusive right to supply essential goods or services

4.64 Not all 'essential' goods or services are subject to defined rate regulation in every jurisdiction. This is because, in some jurisdictions, there may be a plentiful supply of the essential goods or services, together with competition among suppliers. In such cases, defined rate regulation is unnecessary (see paragraph 3.12). Consequently, it seems reasonable to conclude that the essential nature of the goods or services supplied does not, in itself, create any specific rights or obligations for the suppliers, nor any specific needs for information for users of financial statements.

4.65 The right of an entity, granted through a licence or similar agreement that restricts competition, to be the exclusive supplier of particular goods or services in a defined service territory is common. Such rights are found in licensing agreements for items such as films, video recordings, plays, manuscripts, patents and copyrights and many other items.

4.66 Such licensing agreements provide the licence holder with an opportunity to earn revenue in exchange for delivering the licensed goods or services. However, the right to be the exclusive supplier of the licensed goods or services does not, in the absence of contractual arrangements designed to ensure that the licence holder receives a minimum amount of revenue or income, give the licence holder a contractual right to receive cash. This is true even if receipt of the cash is highly probable, because the demand for the licensed goods or services is inelastic and highly predictable. Consequently, the licence holder's asset is the licence, which would be classified as an intangible asset within the scope of IAS 38 *Intangible Assets*. The licence would not be classified as a financial asset. This is confirmed in paragraph AG10 of IAS 32 *Financial Instruments: Presentation*:[12]

> Physical assets (such as inventories, property, plant and equipment), leased assets and intangible assets (such as patents and trademarks) are not financial assets. Control of such physical and intangible assets creates an opportunity to generate an inflow of cash or another financial asset, but it does not give rise to a present right to receive cash or another financial asset.

4.67 Because IAS 38 already addresses licences that provide an exclusive right to supply, this suggests that the right of the rate-regulated entity to be the sole supplier of the goods or services does not, in itself, create special rights or obligations for which specific accounting guidance should be developed.

4.68 Paragraphs 4.64–4.67 suggest that, individually, the essential nature of the rate-regulated goods or services and the lack of effective competition do not appear to create distinguishable rights or obligations for which specific accounting guidance is needed. However, some suggest that the combination of these features is important to support both the existence and the enforceability of the entity's right to recover its revenue requirement (see paragraphs 4.22–4.24).

Obligations to achieve the defined minimum service level

4.69 Some obligations imposed by defined rate regulation could be considered to be unique and may, therefore, distinguish rate-regulated activities from general commercial activities that are not subject to defined rate regulation. These obligations include:

(a) the requirement for the entity to supply the rate-regulated goods or services to customers on a non-discriminatory basis, as directed by the rate regulator (see paragraphs 4.45–4.46);

(b) the requirement for the entity to provide the rate-regulated goods or services in accordance with the minimum service levels and at the regulated price, as established by the rate regulation (see paragraphs 4.47–4.51); and

12 See paragraph BC48 of IFRIC 12 for similar comments.

(c) the inability of the entity to cease, suspend, restructure or transfer operations (and the rights and obligations attached to those operations) without the approval of the rate regulator (see paragraphs 4.52–4.53).

4.70 Other obligations contained in the regulatory agreement may require the entity to meet specified emissions or other environmental targets, or may include obligations for maintaining health and safety or employment-related or consumer protection standards. For example, in the electricity industry, entities that generate electricity are commonly subject to many regulations about the volume of greenhouse gases and other pollutants that can be emitted. Many governments are imposing restrictions on coal-fired or oil-fired generating plants and are instead requiring electricity generators to use more sustainable sources of energy, such as hydroelectric or solar power. Similar restrictions are being imposed on electricity generators and other entities that currently emit greenhouse gases and other pollutants, but that are not subject to defined rate regulation.

4.71 Consequently, it seems reasonable to conclude that such obligations do not create a special environment for which specific accounting requirements need to be developed for rate-regulated entities. This is because these regulatory obligations can be found in many competitive environments and, therefore, are not exclusive to entities that are subject to defined rate regulation.

Right to recover the revenue requirement

4.72 To compensate the entity for such rate-regulated obligations, and to prevent the obligations from becoming onerous, the rate regulation also grants rights to the entity. Some suggest that the most distinguishable feature of defined rate regulation is the entity's right to recover the revenue requirement, using the rate-setting mechanism to adjust for under-billings or over-billings over time. This right ensures that the entity (and its capital providers) can rely on the rate regulation to recover its reasonable costs over the operational life of the assets that are used in providing the rate-regulated goods or services (see paragraph 4.57). However, defined rate regulation also ensures that the entity has a right to recover only the amount of its revenue requirement. Defined rate regulation seeks to do this by prohibiting the entity from retaining any excess amounts billed to customers. Consequently, the rate-setting mechanism is an important aspect of the effectiveness of the defined rate regulation in ensuring that the entity recovers no more and no less than its revenue requirement.

Enforcement of rights and obligations

4.73 Some suggest that the existence of a rate regulator whose role and authority is established in legislation or other formal regulations is an important feature to consider when analysing what rights and obligations established by the rate regulation are enforceable. This is because, in order for there to be a substantive right or obligation, there has to be an enforcement mechanism outside the entity. For example, a management decision to commit to a particular course of action can, without any external interaction, be changed or reversed by the entity. This reasoning is consistent with IAS 37 *Provisions, Contingent Liabilities and Contingent Assets*. Paragraphs 72–77 of IAS 37 discuss restructuring provisions and make it clear that a management or board decision to restructure does not give rise to a constructive obligation until the entity has raised a valid expectation in those affected that it will carry out the restructuring.

4.74 The rights and obligations of the rate-regulated entity, the rate regulator and the customers are usually enforced through the application of the terms and conditions set out in the rate regulations, legislation, licence, etc. In order to function effectively and to achieve the defined regulatory objective of ensuring an economically sustainable outcome for the rate-regulated entity and reasonable rates for customers, the rate regulation and detailed rate-setting mechanism need to be sufficiently predictable and enforceable.

4.75 If the rate-regulated entity fails to satisfy any of its obligations established in the regulatory agreement or terms of service, the rate regulator has various sanctions built into the rate regulation. These include:

(a) imposing fines or penalties;

(b) reducing the future rate to be charged to customers; or

(c) withdrawing the entity's operating licence and forcing the transfer of the rate-regulated business, including the infrastructure and other supporting assets, to another entity or to a government body.

4.76 In order to balance the rate regulator's ability to enforce the entity's obligations, the entity is able to enforce its right to recover the revenue requirement. Although the determination of the revenue requirement and the recovery or reversal of some differences between the revenue requirement and amounts billed to customers requires regulatory approval before the entity can change the rate charged to customers, the rate regulator does not have complete discretion over what is or is not allowable. The criteria upon which the rate regulator determines the future rate are established within the regulatory agreement. The rate regulator must apply the criteria in a reasonable way, which balances the needs of the customers with those of the entity.

4.77 To help ensure that the criteria are applied fairly, there are several steps involved in establishing the revenue requirement and the rate or range of rates per unit to be charged to customers for the next regulatory period. Some of these steps may be open to public comment. An important aspect of the entity's right to recover the revenue requirement is that the entity typically has a legal right to challenge the decisions of the rate regulator to ensure that the rate regulation is applied reasonably. In some cases, customers (sometimes through a designated representative body) can also challenge the rate regulator's decisions. This right to challenge is typically focused on the application of the rate-setting mechanism because, although the rate-setting mechanism establishes a formula for calculating the regulated rate, some judgement is usually required to apply the formula. This judgement applies to issues such as what costs are reasonably incurred, what rate of return is reasonable and whether qualitative targets have been achieved.

4.78 However, clear legislation and regulatory policies, including the right to challenge the rate regulator's decisions, function as a limit to regulatory judgement and discretion. This is important for maintaining confidence in the predictability and enforceability of the rights and obligations arising from the rate regulation.

4.79 The finalised regulatory agreement (sometimes called a 'rate ruling') is binding on both the entity and the rate regulator. It confirms the entity's obligations for the next regulatory period, together with the amount of revenue that the entity is entitled to charge to customers in exchange for satisfying those obligations. In addition, the agreement distinguishes between the amount of revenue that can be billed to customers using the current regulatory rate per unit and any amount of the revenue requirement that will be carried forward as part of a future rate adjustment.

Questions for respondents

4.80 This Section describes a number of features that are common to a wide variety of rate-regulatory schemes around the world, which have been identified from responses to the RFI. Some suggest that the combination of rights and obligations that are created by these features create economic conditions that support developing specific accounting guidance or requirements.

Question 5

Paragraphs 4.4–4.6 summarise the key features of defined rate regulation. These features have been the focus of the IASB's exploration of whether defined rate regulation creates a combination of rights and obligations for which specific accounting guidance or requirements might be developed in order to provide relevant information to users of general purpose financial statements.

(a) Do you think that the description of defined rate regulation captures an appropriate population of rate-regulatory schemes within its scope? If so, why? If not, why not?

(b) Do you think that any of the features described should be modified in order to include or exclude particular types of rate-regulatory schemes or rate-regulated activities included within the scope of defined rate regulation? Please specify and give reasons to support any modifications to the features that you suggest, with particular reference to why the features may or may not give rise to circumstances that result in particular information needs for users of the financial statements.

(c) Are there any additional features that you think should be included to establish the scope of defined rate regulation or would you omit any of the features described? Please specify and give reasons to support any features that you would add or omit.

Question 6
Paragraphs 4.62–4.72 contain an analysis of the rights and obligations that arise from the features of defined rate regulation. (a) Are there any additional rights or obligations that you think the IASB should consider? Please specify and give reasons. (b) Do you think that the IASB should develop specific accounting guidance or requirements to account for the combination of rights and obligations described? Why or why not?

Section 5—Alternative financial reporting approaches

5.1 This Section provides background information about why the IASB is exploring whether or not it should modify IFRS in order to reflect the possible financial effects of rate regulation. Paragraphs 5.10–5.31 discuss different views about whether regulatory deferral account balances meet the definitions of an asset and a liability in the *Conceptual Framework*. This Section also outlines other possible approaches that the IASB could consider when deciding how best to reflect the financial effects of defined rate regulation in IFRS financial statements. It indicates the identified advantages and disadvantages of each of the following possible approaches:

(a) recognising the package of rights and obligations established by the regulatory agreement as an intangible asset;

(b) reporting using the regulatory accounting requirements;

(c) developing specific IFRS requirements to defer/accelerate the recognition of costs and/or revenue; and

(d) prohibiting the recognition of regulatory deferral account balances in IFRS financial statements.

Background

5.2 Section 2 discussed the information that helps users of general purpose financial statements to understand the rate-regulatory environment and its impact on the financial position and performance of a rate-regulated entity. Paragraph 2.25 highlighted that users of financial statements look for information that helps them to:

(a) better understand the rate-regulatory factors that affect the amount, timing and certainty of the revenue, profit and cash flows related to an entity's rate-regulated activities;

(b) better understand the relationship between the results reported to the rate regulator and the results reported in financial statements in accordance with general IFRS requirements; and

(c) distinguish between variability in performance that is adjusted through the rate-regulatory mechanism from variability for which there is no regulatory adjustment.

5.3 In defined rate regulation (described in Section 4), the regulatory agreement established between the rate regulator and the entity sets out the range of activities that will be performed by the entity during each regulatory period. These activities include the delivery of the rate-regulated goods or services to customers, together with a range of other activities that directly or indirectly support the delivery of those goods or services or that support other objectives of the rate regulator (see paragraph 4.9). The regulatory agreement also establishes the mechanism for determining:

(a) the amount of the 'revenue requirement'; that is, the consideration that the entity is entitled to in exchange for performing those activities (see paragraph 4.12); and

(b) the billing process; this determines when the consideration will be billed to customers (see paragraph 4.13).

5.4 The revenue requirement is initially based on estimates but is subsequently adjusted based on actual transactions and events during the period. The rate-setting mechanism is designed to ensure that specified differences between the estimated revenue requirement and the adjusted revenue requirement will be billed to individual customers. This is done by adjusting the future rate chargeable to customers for the rate-regulated goods or services that are delivered in future periods.

5.5 Those who do not support modifying IFRS requirements for rate-regulated activities suggest that a rate-regulated entity should recognise revenue for the goods or services that it transfers to individual customers during the period by using the regulated rate per unit multiplied by the quantity of units delivered in the period. They suggest that the timing of recognition for that revenue should match the timing of delivery of those goods or services, because the delivery is the entity's only direct revenue-generating activity. This direct revenue-generating activity should be accounted for in accordance with the IFRS requirements for revenue recognition applicable to the contractual agreement between the entity and the individual customers.[13] In addition, costs should be recognised as incurred in accordance with the general requirements of IFRS. This approach is consistent with the established IFRS practice for most rate-regulated entities.

5.6 The reason why the IASB is carrying out its comprehensive Rate-regulated Activities project is because some are of the view that particular aspects of rate regulation create a special combination of rights and obligations that may be more faithfully represented by modifying the established IFRS practice. As noted in paragraph 5.3, defined rate regulation not only establishes how much consideration an entity is entitled to, but also determines when the entity can bill customers for that consideration. Those who support reconsidering the current practice and IFRS requirements for rate-regulated activities suggest that the performance of a rate-regulated entity should reflect the effects of the transactions and events that have occurred in the period, even if the entity is prevented from billing customers for those effects until future periods.

5.7 The main focus of the earlier debates has been the accounting treatment of the regulatory deferral account balances. Previous discussions have tended to focus on whether the entity's right to increase the future rate, or obligation to reduce the future rate, is sufficient to support the recognition of the regulatory deferral account balances as assets and liabilities, in accordance with IFRS. One of the difficulties with that approach is that it has tended to focus on the use of future sales to recover or reverse the regulatory deferral account balances, instead of looking at what transactions or events have resulted in the creation of those balances. This focus on the future sales and rate adjustments has resulted in divergent views, which are outlined in paragraphs 5.10–5.31.

13 The revenue recognition requirements applicable to the contractual agreement between the entity and the individual customers are contained in IFRS 15 *Revenue from Contracts with Customers* (see paragraphs 7.15–7.17).

5.8 In addition, the IASB is currently revising the *Conceptual Framework* and is in the process of redeliberating the preliminary views expressed in the Discussion Paper *A Review of the Conceptual Framework for Financial Reporting* (the '*Conceptual Framework* Discussion Paper'). The IASB's tentative decisions made to date suggest that the definitions of assets and liabilities, and the supporting guidance about their meaning, are likely to change from the current *Conceptual Framework*, along the lines of the changes proposed in the *Conceptual Framework* Discussion Paper. However, at the time of writing this Discussion Paper, it is not clear how significant the impact of these changes may be.

5.9 Consequently, the IASB has not formed a preliminary view on whether regulatory deferral account balances meet either the current or proposed revised *Conceptual Framework* definitions of an asset and a liability. It will use the input received from the responses to this Discussion Paper and the *Conceptual Framework* project to help it assess whether to develop any specific accounting guidance or requirements for rate-regulated activities. In the meantime, this Section explores not only whether regulatory deferral account balances meet the asset/liability definitions but also some other possible approaches that the IASB may consider in due course.

The asset and liability debate

5.10 Many of those who do not support recognising 'regulatory assets' and 'regulatory liabilities' have argued that the right to increase or the obligation to decrease the rate chargeable for future sales does not create a present resource/right or a present obligation for the entity. Instead, they suggest that the right or obligation to recover or reverse regulatory deferral account balances by adjusting the future rate constitutes a possible future asset or possible future liability that is conditional on future sales being made. As such, the regulatory deferral account balances would be classified as contingent assets or contingent liabilities because, although they may arise from past events and transactions, their existence as assets and liabilities will only be confirmed by the occurrence of a sufficient volume of future sales.

5.11 The accounting treatment for contingent assets and contingent liabilities is set out in IAS 37. In accordance with IAS 37, neither contingent liabilities nor contingent assets are recognised (see paragraphs 27 and 31 of IAS 37), but they may require disclosure, depending on the probability of an outflow or inflow of economic benefits (see paragraphs 28 and 34 of IAS 37).

5.12 However, those who support recognising regulatory deferral account balances as regulatory assets and regulatory liabilities disagree with the view that these are contingent amounts. The regulatory deferral account balances constitute differences between the amount of consideration to which the entity is entitled in exchange for performing its rate-regulated activities and the amount of revenue billed to customers (see paragraphs 5.3–5.4). Consequently some suggest that the entity has a present right to recover, or an obligation to refund, amounts that have been under-billed or over-billed.

5.13 The following paragraphs discuss these two views.

Conceptual Framework definitions of assets and liabilities

5.14 The *Conceptual Framework* currently defines an asset as 'a resource controlled by the entity as a result of past events and from which future economic benefits are expected to flow to the entity'. A liability is currently defined in the *Conceptual Framework* as 'a present obligation of the entity arising from past events, the settlement of which is expected to result in an outflow from the entity of resources embodying economic benefits'.

5.15 The *Conceptual Framework* Discussion Paper suggested modifying the definitions so that an asset is 'a present economic resource controlled by the entity as a result of a past event' and a liability is 'a present obligation of the entity to transfer an economic resource as a result of past events'. The addition of the term 'present' to the definition of an asset makes explicit a notion that was already implicit in the existing definition. In addition, it emphasises that the accounting is for the past transaction or other event that brought the resource under the entity's control or imposed the obligation on the entity. It also emphasises the parallel between the definitions of 'asset' and 'liability'.[14] The proposed deletion of the existing reference in each definition to the probability of a flow of economic benefits is intended to refocus the definitions on the existence of the resource (asset) or obligation (liability) instead of on the probability of any resultant cash flows.

5.16 Additional guidance is contained in the *Conceptual Framework* Discussion Paper on the definitions of an asset and a liability. In particular, there is guidance about the entity having 'control' over the resource instead of the resulting cash flows.[15] There is also additional guidance about the entity having a 'present obligation'.[16] This takes into consideration, in the assessment of the existence of a present obligation, the role of future actions or events that are outside the entity's control and those that depend on the entity's future actions. Although this additional guidance focuses on the distinction between a present obligation and a conditional obligation, it is also relevant when considering whether an entity has a present resource or a conditional resource.[17]

Control

5.17 Some suggest that an entity that is subject to defined rate regulation should recognise regulatory deferral account debit balances (that is, amounts of the revenue requirement not yet billed to customers) as assets in IFRS financial statements. This is, they suggest, because the entity controls the resource (that is, its right to recover the regulatory deferral account balance in accordance with the rate regulation), because it has an exclusive right to provide the rate-regulated goods or services, at the regulated rate, within the defined territory. Consequently, it is the entity, and no other party, that receives the economic benefits generated from the future delivery of the rate-regulated goods or services at the higher regulated price.

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14 See paragraphs 2.13 and 2.16 of the *Conceptual Framework* Discussion Paper.

15 See paragraphs 3.16–3.32 of the *Conceptual Framework* Discussion Paper.

16 See paragraphs 3.63–3.69 of the *Conceptual Framework* Discussion Paper.

17 See paragraphs 3.70–3.97 of the *Conceptual Framework* Discussion Paper.

5.18 To support this view, they refer to paragraph 3.27 of the *Conceptual Framework* Discussion Paper, which notes that: 'For an entity to control an economic resource, the economic benefits arising from the resource must flow to the entity (either directly or indirectly) rather than to another party'. The same paragraph goes on to suggest that: 'This requirement does not imply that the entity can ensure that the resource will generate economic benefits in all circumstances. Instead it means that, if the resource generates economic benefits, the entity is the party that will receive them'.

5.19 This concept that control does not require certainty that the resource will generate economic benefits is not new. For example, IAS 2 *Inventories* has established that inventories are assets. This is true even though the entity cannot control whether existing or potential customers will buy the inventory items. Instead, the entity recognises the inventories based on the expectation that there will be future sales to customers, even if those customers have not been identified yet. Some suggest that, for an entity that is subject to defined rate regulation, the probability of future sales is higher than for many entities holding inventories, because the customers have little or no choice but to purchase the essential rate-regulated goods or services from the entity (see paragraph 4.4). Consequently, they suggest that recovery of the regulatory deferral account balance is, therefore, highly probable and supports recognition of the balance as an asset.

5.20 Some who do not support recognising regulatory deferral account debit balances as assets in IFRS financial statements suggest that the entity's right to recover the balance by increasing the rates at which it sells goods or services in the future is not analogous to recognising inventories as assets. They suggest that the resource that is recognised as an inventory asset is not a right to make a future sale but is instead the physical item of inventory. The probability of selling the inventory in the future is reflected in the measurement of the inventory recognised. In contrast, many regulatory deferral account debit balances do not represent the cost of physical items that are held by the entity. Instead, many such balances represent costs incurred in providing services that have already been transferred to customers and, therefore, are not controlled by the entity.

Present or conditional obligation to transfer an economic resource

5.21 In defined rate regulation, many regulatory deferral account balances arise from differences between the revenue requirement and the revenue billed to customers using the regulated rate. For rate-regulatory purposes, a credit balance arising in a regulatory deferral account represents the excess revenue billed to customers over the amount of consideration to which the entity is entitled in exchange for its rate-regulated activities performed to date. The entity is obliged to reverse the excess that has been billed to customers by reducing the rate that is charged for the delivery of rate-regulated goods or services in future periods.

5.22 In this situation, the regulatory deferral account credit balance has arisen from past events and transactions. However, those who do not support recognising such balances as liabilities question whether the past events create a present obligation to transfer an economic resource. In defined rate regulation, the entity is not required to refund the customers who have been over-billed, or to make a payment to the rate regulator or other designated body. Instead, the past over-billing is reversed by reducing the rate that is charged for future sales. Consequently, some do not see the reversal of the regulatory deferral account credit balance as a present obligation, because the reversal depends on the entity's own future actions; that is, it depends on the entity making sales to customers in the future.

5.23 This question as to whether a past event creates a present or a conditional obligation has been a source of difficulty for the IASB when addressing other issues. In the *Conceptual Framework* Discussion Paper, the IASB has acknowledged that, when trying to determine whether a liability exists in other situations, it has encountered difficulties in practice because:

> it is unclear whether those past events are *sufficient* to create a present obligation to transfer an economic resource if such a transfer remains conditional on future events that have not occurred, or on further actions that the entity has not taken, by the reporting date.[18]

5.24 Paragraphs 3.68–3.97 of the *Conceptual Framework* Discussion Paper discuss the IASB's thinking on this issue. Three views were discussed (see paragraphs 5.25–5.27).

5.25 The IASB has tentatively rejected the view (described as View 1 in the *Conceptual Framework* Discussion Paper) that an obligation must be strictly unconditional. It does not think that an entity should omit from its financial statements liabilities that have arisen from past events and that the entity has no practical ability to avoid. Doing so would exclude relevant information about the inevitable future costs of the entity's past actions.[19]

5.26 The *Conceptual Framework* Discussion Paper presents two further views (View 2 and View 3) as alternatives to View 1.[20] When the *Conceptual Framework* Discussion Paper was published, the IASB had not reached a preliminary view on whether the definition of a liability:

(a) should include only those liabilities that the entity has no practical ability to avoid (View 2); or

(b) should also include conditional obligations that the entity might be able to avoid through its future actions but that have nevertheless arisen as a result of past events (View 3).

5.27 During the IASB's redeliberations, it tentatively decided that an entity has a present obligation to transfer an economic resource as a result of past events if both:[21]

(a) the entity has no practical ability to avoid the transfer; and

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18 See paragraph 3.67 of the *Conceptual Framework* Discussion Paper.

19 See paragraph 3.96 of the *Conceptual Framework* Discussion Paper.

20 These alternative views are discussed in paragraphs 3.77–3.89 in the *Conceptual Framework* Discussion Paper.

21 This tentative decision was reported in *IASB Update*, July 2014.

(b) the amount of the transfer is determined by reference to benefits that the entity has received, or activities that it has conducted, in the past.

5.28 In defined rate regulation, the entity is required to continue to provide the rate-regulated goods or services on demand at the reduced rate per unit. Customers have little or no choice but to purchase the rate-regulated goods or services from the entity because of the essential nature of the goods or services. As a result, some suggest that the entity has no practical ability to avoid reversing the regulatory deferral account credit balance by providing the rate-regulated goods or services at the reduced rate per unit (View 2).

5.29 In addition, a regulatory deferral account credit balance arises from past performance (including amounts over-billed as a result of variances from expected costs and permitted revenues and/or penalties for failing to meet incentive targets). Consequently, the amount of the balance has arisen as a result of past transactions and events and is determined by reference to benefits that the entity has received, or activities that it has conducted, in the past (View 3).

5.30 Those who do not support recognising such regulatory deferral account balances as liabilities further suggest that although the entity may have an obligation to reverse the balance by reducing the price charged to customers for future sales, this does not involve the transfer of an economic resource. Instead, the entity will earn a lower profit for its future sales.

5.31 A counter-argument is that the entity has, in effect, been overpaid for the rate-regulated goods or services that it has delivered to date. Those who support recognising regulatory deferral account credit balances as liabilities suggest that this overpayment is, for rate-regulatory purposes, similar to a prepayment for the goods or services to be delivered in the future. An amount received in advance is recognised as a liability in accordance with other Standards, even though the entity has no obligation to return the cash already received. For example, paragraph 106 of IFRS 15 *Revenue from Contracts with Customers* notes that a contract liability is an entity's obligation to transfer goods or services for which the entity has received consideration (or is due consideration). This acknowledges that the entity has an obligation to transfer an economic resource, although that economic resource is not cash or another financial asset. This is highlighted in paragraph AG11 of IAS 32, which states:

> Assets (such as prepaid expenses) for which the future economic benefit is the receipt of goods or services, rather than the right to receive cash or another financial asset, are not financial assets. Similarly, items such as deferred revenue and most warranty obligations are not financial liabilities *because the outflow of economic benefits associated with them is the delivery of goods and services* rather than a contractual obligation to pay cash or another financial asset. [Emphasis added.]

Other possible financial reporting approaches

5.32 The previous asset/liability debate has focused on whether regulatory deferral account balances should be recognised as assets or liabilities. In exploring other possible approaches to reporting the effects of defined rate regulation in IFRS financial statements, this Section also considers how regulatory deferral account balances arise, and whether this additional consideration could help to clarify some of the issues that have not yet been resolved in the asset/liability debate. The descriptions are high level and do not propose detailed requirements. This is because, before developing accounting proposals, the IASB wishes to confirm its understanding of the economic and financial effects of rate regulation. At this time, the IASB has not formed a preference for any approach. This is because the primary objective of this Discussion Paper is to identify a common starting point for a more focused discussion about the accounting for rate-regulated activities (see paragraph 1.22).

5.33 In addition, the IASB is seeking input from stakeholders, particularly investors and lenders, about any specific information that they may seek about the effects of defined rate regulation. In particular, the IASB wants to find out whether any of the possible approaches explored here has the potential to deliver more relevant information, in IFRS financial statements, about the financial effects of rate regulation than is currently available. This Section outlines some of the logic behind the approaches, together with some of their possible advantages and disadvantages. This summary should not be considered to be a comprehensive review of all possible approaches. They are described here to stimulate discussion and to assist stakeholders in providing the IASB with the input it is seeking.

5.34 In summary, the possible approaches described in this Section include:

(a) recognising the package of rights and obligations created by defined rate regulation as a single asset, namely the ‘regulatory licence’. In this approach, the regulatory licence would be classified as an intangible asset. In order to more fully reflect changes in the balance of rights and obligations and, therefore, the changing value of this intangible asset, the IASB would need to consider amending the existing requirements of IAS 38.

(b) adopting the accounting requirements established by the rate regulation in the general purpose IFRS financial statements of the rate-regulated entity. In order to apply this approach, the IASB would need to consider an exemption from applying existing IFRS for such entities in order to allow rate-regulated entities to present some aspects of their ‘regulatory financial statements’ as their general purpose financial statements.

(c) recognising the impact of the rate regulation through specific IFRS requirements. This approach would require the IASB to consider how to amend existing IFRS to directly reflect the differences arising between the revenue requirement and the amounts billed to customers. Possible ways of modifying IFRS requirements include deferring/accelerating the recognition of:

    (i) costs;

    (ii) revenue; or

    (iii) a combination of costs and revenue.

(d) prohibiting the recognition of regulatory deferral account balances. This approach would effectively retain the current established IFRS practice for existing IFRS preparers (that is, preparers that do not apply IFRS 14).

The established IFRS practice is not to recognise regulatory deferral account balances, nor to apply an accounting treatment that differs from the normal IFRS requirements that are applied by entities that are not subject to rate regulation. If the IASB was to decide to adopt this approach, it may consider whether or not to develop disclosure-only requirements.

Recognising the package of rights and obligations as an intangible asset

5.35 Some who do not support developing specific IFRS requirements to recognise regulatory deferral account balances suggest that the regulatory licence is similar to other exclusive operating licences seen in other commercial environments; these licences are accounted for in accordance with IAS 38 (see paragraphs 4.65–4.67 and 5.103–5.107). However, others suggest that there is a feature of regulatory licences that distinguishes them from other operating licences. This feature is the periodic rate-review process, which establishes, for each regulatory period, the obligations that the entity must fulfil during the period and the amount of revenue that the entity is entitled to earn in exchange for satisfying those obligations. Those who hold this view suggest that, in effect, this process modifies or renews the terms and conditions of the licence at intervals throughout its term.

5.36 Consequently, it is necessary to consider whether the existing requirements of IAS 38 should be amended in order to reflect the outcome of the rate-setting determinations. This could either be done using a form of component accounting or a revaluation model.

A component of the regulatory licence or other agreement

5.37 IAS 16 sets out requirements for accounting for the separate components of a tangible asset that have different useful lives. Some suggest that a similar component approach could be used to account for the timing and other differences that create regulatory deferral account balances. This could result in each originating difference being recognised as a separate component of the regulatory licence. These recognised components would then be amortised over the rate-regulatory adjustment period.

5.38 However, the component approach that is currently applicable to tangible assets is likely to need modification if it was applied to the regulatory agreement. Paragraphs 12–13 of IAS 16 note that subsequent expenditure required to replace the original component must meet the general recognition criteria for capitalisation. Although IAS 38 does not contain such explicit references to componentisation, it does contain similar requirements for the capitalisation of subsequent expenditure incurred to 'add to, replace part of or service' the original asset.

5.39 A difficulty in applying a component approach to the regulatory licence is that the regulatory deferral account balances do not necessarily represent amounts expended in order to add to, replace or service the original licence. Instead, such balances arise as a result of the application of the terms of the licence and the rate-setting mechanism. They are taken into account in establishing the rate to be applied during future regulatory periods but do not, in themselves, represent the costs of acquiring, renewing or modifying the terms of the licence.

5.40 In addition, the regulatory deferral account balances can be both positive (an increase in prices) or negative (a decrease in prices). An asset component approach using a cost and amortisation model does not seem suited to reflecting the originating differences that can be negative as well as positive.

Revaluing the regulatory licence or other agreement

5.41 An alternative to recognising the regulatory deferral account balances as components of the cost of the regulatory licence could be to modify IAS 38 to permit the revaluation of the regulatory licence or components of it. This could enable an entity to reflect negative as well as positive movements in the value of the licence, which may result from obligations to reduce the future rate as well as from the right to increase the future rate.

5.42 The existing requirements in IAS 38 provide an option to measure intangible assets at fair value. However, when the revaluation option is applied, the fair value of an intangible asset is determined by reference to an active market (see paragraph 75 of IAS 38). For entities that are subject to defined rate regulation, there is no active market, as defined in IAS 38, for the licence. The licence grants the entity the exclusive right to supply the rate-regulated goods or services in the specified geographical territory and does not permit the entity to transfer the licence to another entity without the prior approval of the rate regulator. Consequently, the IASB would need to amend IAS 38 to permit or require revaluation of the regulatory licence, or a component of it, in the absence of an active market. However, such a revaluation approach raises a number of practical difficulties, which may outweigh the potential benefits of this approach.

5.43 The regulatory agreement contains a wide range of rights and obligations that encompass many aspects of the entity's rate-regulated business and how it is operated. Changes in the value of the regulatory licence may incorporate changes in the value of internally generated goodwill, because the value of the licence is so closely related to the value of the rate-regulated business as a whole (see paragraph 4.53). For example, changes in value can arise from changes in the population in the licence territory, changes in weather conditions, consumption patterns, etc. In addition, the value of the licence can be influenced by how much flexibility the regulatory agreement provides to management to enable them to create positive differences between the amount of profit that is determined by the rate regulation and the amount that the entity can earn through any incentive elements.

5.44 Recognising such overall changes in value could obscure those that arise from the elements of the regulatory licence that result in the creation of regulatory deferral account balances. As an alternative, the IASB could consider requiring recognition only of the changes in the current value of the licence that arise from the entity's right to increase, or obligation to decrease, the future rate to eliminate regulatory deferral account balances. However, identifying the impact on the value of the regulatory licence resulting from each rate determination separately from other changes in value of the business could be complex.

5.45 In addition, IAS 38 currently requires changes in the fair value of an intangible asset to be recognised through other comprehensive income. Some regulatory deferral account balances relate to items that are recognised in profit or loss, while others relate to items recognised in other comprehensive income. If the components of the regulatory licence that relate to the rate-setting mechanism and the reversal of regulatory deferral account balances are to be revalued, some suggest that, to avoid creating accounting mismatches, the existing requirement to recognise all changes in the fair value of the licence through other comprehensive income would need to be amended to permit some changes in value to be recognised through profit or loss. However, this could create complexity in separating the overall change in fair value of the regulatory licence into those changes in value that should be recognised in profit or loss and those that should be recognised through other comprehensive income.

5.46 At this time, the IASB has not dismissed the possibility of amending IAS 38 as discussed in paragraphs 5.35–5.45. However, the potential complexity and associated costs of applying such modified requirements to the regulatory licence, or components of it, raise questions about whether the benefits of such an approach would outweigh the costs. In particular, the IASB would need to consider whether revaluing the regulatory licence would provide users with sufficiently transparent and understandable information about the impact of the rate regulation and the variability that is adjusted through the rate-setting mechanism, as distinct from the variability that flows directly through to the profit or loss of the entity.

Reporting using regulatory accounting requirements

5.47 Another possible approach for reporting the effects of defined rate regulation is to permit (or require) the accounting prescribed by the rate regulator to be used in general purpose IFRS financial statements. This would require an exception to allow or require the accounting policies required by the rate regulation to override those established in accordance with the general requirements of IFRS.

5.48 Rate regulators often prescribe the accounting requirements that a rate-regulated entity must follow for regulatory accounting purposes. In some cases, the rate regulation contains a detailed uniform system of accounts, which prescribes the accounting requirements for all costs and income that are subject to the rate regulation. In other cases, the rate regulation will, as a starting point, rely on the principles and requirements that are embodied in the GAAP applied in the jurisdiction by entities that are not subject to rate regulation. The rate regulator then makes changes to address the treatment of particular costs or income. These changes override the general GAAP and become embedded within the regulatory accounting requirements.

5.49 Some who support using regulatory accounting requirements in general purpose financial statements argue that it is onerous to require a rate-regulated entity to prepare financial statements on two bases: one for the rate regulator using regulatory accounting requirements and another for general purpose financial reporting. Consequently, they suggest that allowing entities subject to defined rate regulation to prepare their IFRS financial statements using the regulatory accounting requirements would be less onerous and might save costs for rate-regulated entities.

5.50 However, there are several arguments against such an approach:

(a) although defined rate regulation has a number of common characteristics and features, the details of the rate-setting mechanism and related regulatory accounting requirements differ from jurisdiction to jurisdiction, from rate regulator to rate regulator, and even between entities that report to the same rate regulator. The use of a variety of requirements would reduce the comparability of the financial statements of rate-regulated entities. This would reduce the relevance of information provided to investors and lenders.

(b) many rate-regulated entities have activities in different locations that are subject to defined rate regulation. The regulatory accounting requirements for similar items may differ, depending on the details of the rate regulation in each location. Applying different regulatory accounting requirements to similar transactions and events is contrary to the enhancing characteristic of comparability in IFRS financial reporting, which would add complexity and reduce the transparency of information for users of financial statements.[22]

(c) in line items for which there are specific regulatory accounting requirements, it may be difficult to distinguish the effect of the rate regulation on those items from the effect of general market conditions and management decisions.

(d) the objective of general purpose financial statements is different from the objective of regulatory accounting requirements. The objective of the former is to provide financial information about the entity that is useful to existing and potential investors and lenders in making decisions about providing resources to the entity (see paragraph 2.3). The objective of regulatory accounting is to support the rate-setting mechanism employed by the rate regulator to balance the needs of customers with the financial viability of the rate-regulated entity and, in some cases, to help achieve the government's social, environmental or fiscal policies. If the general purpose financial statements were to be replaced by those prepared using the regulatory accounting policies, there is a risk that investors and lenders could lose information that is relevant to their decision-making needs.

5.51 In addition, the argument that preparing financial statements on two bases is onerous could be applied equally to many entities when the financial statements required for tax or other compliance purposes differ from general purpose financial statements. The objectives of general purpose financial statements and such special purpose financial statements are different. In the case of income tax, the temporary differences that arise from differences between the IFRS

22 See paragraphs QC20–QC25 of the *Conceptual Framework*.

accounting treatment and the tax treatment for particular items are reflected through the accounting for deferred tax in accordance with IAS 12 *Income Taxes*.

Developing specific IFRS requirements to defer/accelerate the recognition of costs and/or revenue

5.52 Generally, the underlying business activities of rate-regulated entities are similar to those of other entities that manufacture goods or provide services. This suggests that the underlying business activities are accounted for in the same way as they are by similar entities that are not subject to rate regulation. If specific accounting requirements are to be developed for rate-regulated activities, then it seems logical that the tailored requirements focus on those that are needed to reflect the financial effects of the rate regulation. This is the approach that has been applied commonly in local GAAPs, including US GAAP.

5.53 Paragraphs 5.62–5.90 discuss various approaches to developing specific IFRS requirements in order to reflect the financial effects of rate regulation in the financial statements. The discussion reflects, to some extent, the range of approaches that are taken by those rate regulators who rely on the general requirements of the GAAP applicable to the entity in its local jurisdiction as a starting point for the regulatory accounting requirements.

5.54 The possible modifications to IFRS outlined in paragraphs 5.64–5.91 consider using information that should already be available to an entity that is subject to defined rate regulation. Before outlining the possible modifications, the following paragraphs make general comments about some advantages and disadvantages to the general approach of developing specific IFRS requirements to defer/accelerate the recognition of costs and/or revenue.

5.55 A disadvantage to developing specific IFRS requirements is the added complexity that would be created in dealing with the interactions between the regulatory requirements and the general IFRS requirements. Section 7 discusses some of the issues identified to date and IFRS 14 identifies others. For example, in many cases, rate regulation has different requirements than IAS 16 for the costs that an entity includes as part of the carrying amount of self-constructed property, plant and equipment. Any specific IFRS requirements that might be developed would need to address these differences. This could involve modifying IAS 16 to reflect the regulatory requirements, or overlaying separate requirements so that IAS 16 is still applied and the regulatory differences are treated as separate items. Retaining the general IAS 16 requirements and identifying the regulatory differences separately could provide greater transparency and more information to users of the financial statements, because it would enhance comparability with entities that are not subject to defined rate regulation.

5.56 Although the latter approach has been adopted in IFRS 14 (see Section 6), IFRS 14 is a temporary Standard that is not intended to prejudge the outcome of the research project. Consequently, the requirements of IFRS 14 should not be seen as an indicator of any specific requirements that may be developed as a result of this project.

5.57 There are advantages to developing specific IFRS requirements for reporting the financial effects of defined rate regulation, instead of relying on the regulatory accounting requirements. Financial statements prepared in accordance with IFRS are widely accepted as providing high quality, transparent and comparable information, based on clearly articulated principles. Retaining general IFRS requirements as the starting point, and using the principles of IFRS to identify the extent to which the general requirements of IFRS are modified to reflect the consequences of rate regulation, would help to maintain the quality, transparency and comparability of the information provided in general purpose financial statements.

5.58 Paragraphs 5.62–5.90 explore three approaches to modifying general IFRS requirements. Each approach would need to incorporate presentation and disclosure requirements to ensure that the effects of rate regulation are faithfully reported in a transparent and understandable way. Section 6 considers the presentation and disclosure requirements of IFRS 14 as a starting point for the discussion of this issue. The three possible approaches to modifying IFRS requirements that have been identified to date are:

(a) deferring/accelerating the recognition of costs—this approach reflects the traditional 'cost-based' nature of rate regulation in several jurisdictions. Amounts billed or billable to customers during the accounting period using the regulated rate per unit are recognised as revenue. The recognition of incurred costs is deferred, or expected costs are accelerated, in profit or loss to match their recognition for regulatory purposes.

(b) deferring/accelerating the recognition of revenue—using this approach, entities report costs in the period in which they are incurred, in accordance with the general requirements of IFRS. Amounts billed or billable to customers during the accounting period using the regulated rate per unit are recognised initially as revenue. An adjustment to revenue is also recognised to reflect the future compensatory adjustment to the rate chargeable to customers.

(c) deferring/accelerating the recognition of a combination of costs and revenue—this approach would defer/accelerate costs for some items, such as the capitalisation of costs related to property, plant and equipment, but defer/accelerate revenue for other items, such as storm damage repairs and incentive bonuses/penalties.

5.59 The three possible approaches contained here are intended to provide a starting point for consideration but do not necessarily indicate the nature of the IASB's future discussions.

5.60 Before describing the possible approaches, it is important to remember that the IASB is focusing on the type of defined rate regulation that has been described in Section 4 and Appendix B. In defined rate regulation, there is a regulatory agreement that establishes the amount of the revenue requirement; that is, the consideration to which the entity is entitled in exchange for performing the required rate-regulated activities (see paragraphs 4.12–4.16). Differences arise during the regulatory period between the revenue requirement and the amount of revenue that is billed to customers. Revenue requirement shortfalls will be recovered by increasing the future rate; excess revenue billed will be reversed by reducing the future rate. The rate regulator uses the rate-setting mechanism to dampen rate volatility for customers and to determine the period(s) over which specified differences will be reversed through future billings. This can result in the entity having to temporarily suffer some volatility in cash flows by deferring rate changes. The rate regulation compensates the entity for delays in its ability to increase the rate that it can charge to customers, or imposes a finance cost on the entity when the rate regulation delays a rate reduction.

5.61 Those who support developing specific accounting requirements for rate-regulated activities suggest that this would help users to distinguish between variability in performance that is adjusted through the rate regulation from variability in performance for which there is no rate-regulatory adjustment.

Deferring/accelerating the recognition of costs

5.62 This approach would change the timing of when incurred costs are recognised through profit or loss. For many regulatory adjustments that focus on cost recovery, adjusting the timing of when costs are recognised in general purpose financial statements is likely to follow most closely the approach required by the rate regulator. Consequently, some consider this approach to be relatively simple and cost-effective to apply and to faithfully represent the effects of the rate regulator's intervention on the entity's ability to recover costs and the allowable profit through the adjustments to the revenue requirement and regulated rate.

5.63 For example, defined rate regulation commonly contains requirements for the nature and amount of costs that can be capitalised as part of the regulatory carrying amount of property, plant and equipment. Although the rate regulation may start with requirements similar to those in IAS 16 for capitalising costs, rate-regulatory adjustments may then be required for the initial regulatory carrying amount of the asset. For example, the rate regulation may allow the entity to capitalise some indirect overheads that would be recognised as an expense as incurred, in accordance with IAS 16. This delays when those indirect overheads are recognised as costs for rate-regulatory purposes, because they would be recognised in the regulatory profit or loss account over time through the regulatory depreciation of the asset, instead of being recognised immediately in profit or loss in accordance with IAS 16. In addition, the rate regulation may require the regulatory carrying amount of the asset to be depreciated over a shorter or longer period than the useful life of the asset. This creates a further difference between the regulatory carrying amount and the carrying amount that would be determined in accordance with IAS 16.

5.64 The regulatory asset carrying amount is important for rate-regulatory purposes, because it is typically used to calculate the return that an entity is entitled to earn on its investment in assets used in its rate-regulated activities. This allowable return is used by the rate regulator to establish the revenue requirement during the regulatory period, that is, the total amount of revenue that the entity is entitled to earn during the period, in accordance with the rate regulation.

5.65 Those who support deferring costs in such circumstances suggest that reflecting the regulatory adjustments to the carrying amount of the asset in the general purpose financial statements provides users of those statements with relevant information. It could enable users of IFRS financial statements to more easily identify and predict the effect of the regulatory requirements on the amount and timing of the entity's revenue, profit and related cash flows. This is because the revenue requirement includes, as a starting point for the estimated amount, the regulatory carrying amount of an asset multiplied by the regulatory rate of return.

5.66 However, critics of this approach suggest that it relies too heavily on a 'matching' principle and that it artificially smooths the results of the entity over time. Others suggest that it lacks transparency and can be misleading because it results in some costs being reported in profit or loss later than when they are incurred.

5.67 A common example that demonstrates the criticism about transparency relates to the costs incurred by electricity transmission or distribution suppliers for repairing damage to the supply network to reinstate the power supply following power outages due to a storm.

5.68 Adverse weather conditions, such as a storm, could disrupt electricity transmission or distribution services by damaging power lines or substations. Commonly, the regulatory agreement requires the entity to repair the storm damage to restore the service as quickly as possible. In exchange, the entity is entitled to consideration, which may be limited to the repair costs actually incurred. This consideration is billed to customers in future periods when it is incorporated into the rate per unit through the rate-setting mechanism. However, the adjustment to the rate per unit typically occurs months after the costs have been incurred and is often designed to spread the cost to customers over several years in order to avoid a 'rate shock', which could result in hardship for some customers.

5.69 For regulatory purposes, the entity initially recognises the allowable repair costs as a regulatory asset, instead of recognising them as expenses in profit or loss. The regulatory asset is then depreciated over the periods when it is recovered through the adjusted rate per unit billable to customers for the rate-regulated goods or services delivered. This approach allows the storm damage repair costs to be recognised in the same periods as the related billed revenue. However, not recognising the repair costs in the general purpose financial statements in the period that they are incurred lacks transparency, because it does not faithfully represent the activities that have been performed during the period.

5.70 Another disadvantage of a cost deferral/acceleration approach is that it does not reflect the changing nature of rate regulation in many jurisdictions. As described in Sections 3–4, defined rate-regulatory schemes combine elements of actual cost recovery, together with more incentive-based elements. Increasingly, the regulatory adjustments involve rewarding (or penalising) entities for good (or poor) performance. The amount of consideration that the rate-regulated entity is entitled to earn as a reward (or is required to forfeit as a penalty) is not always directly related to the amount of costs incurred by the entity. In these situations, a cost deferral/acceleration approach is unlikely to faithfully represent the financial effects of the defined rate regulation.

Deferring/accelerating the recognition of revenue

5.71 This approach would seek to reflect the amount of consideration to which the entity is entitled in exchange for the activities actually performed in the period, in accordance with the rate regulation, instead of focusing on the amount that is billed to customers during the period. The latter amount reflects the price per unit multiplied by the number of units of the rate-regulated goods or services that are delivered. Deferring/accelerating the recognition of some of the revenue billed to customers to instead reflect the amount of the revenue requirement that relates to the activities actually performed in the period would, some suggest, faithfully represent the impact of the rate regulator's intervention on the amount and timing of revenue, which is established through the rate-setting mechanism.

5.72 To demonstrate how a revenue adjustment approach could work, it is applied in this paragraph to the storm damage example described in paragraphs 5.67–5.69. The defined rate regulation entitles the entity to receive a determinable amount of consideration in exchange for the work performed to re-establish the services after a storm. An additional amount of revenue is recognised in profit or loss during the period in which the storm damage is repaired, and the actual storm damage costs are recognised in profit or loss when they are incurred (unless they are included in the cost of another asset in accordance with other Standards). This revenue adjustment reflects the amount of consideration related to the repair activities performed in the period, which the entity will be able to recover, through the rate-setting mechanism, in bills sent to customers in future periods.

5.73 In this case, the revenue adjustment approach allows users of the financial statements to see, more readily than using the cost deferral approach, the impact of the rate-regulatory adjustment, because it provides greater transparency and comparability with similar entities that are not subject to defined rate regulation. This is because the actual storm damage costs are recognised when they are incurred, in the same way as they would be in the absence of rate regulation. As long as the related revenue adjustment is clearly identified through specific presentation or disclosure requirements, the users of financial statements would see how the rate regulation compensates the entity for the activities that it performs in accordance with the rate regulation. Disclosure requirements could provide additional information, such as the amount of any costs that will not be compensated through a price adjustment (ie any disallowed costs), whether the entity is entitled to earn a markup on the costs incurred, what period(s) the recovery of the consideration is expected to be spread over and whether the entity will be compensated for the time value of money during any deferral period.

5.74 Some suggest that deferring or accelerating the recognition of revenue would also better reflect regulatory adjustments that are not directly related to the recovery of incurred costs, but instead involve rewarding (or penalising) entities for good (or poor) performance. This reward or penalty is determined based on the performance of the entity during a specified period and is reflected through a temporary adjustment to the rate per unit that is charged for the regulated goods or services delivered in a future period.

5.75 Those who support a revenue adjustment approach suggest that reflecting the reward (or penalty) in the same period in which the performance target is met (or not) provides relevant information about the performance of the entity during the period. The regulatory adjustment to the rate per unit is directly attributable to the performance of the measurement period and, therefore, should be reflected in the same period.

5.76 However, some regulatory adjustments relate to the performance of activities that result in changes to the infrastructure or other assets that the entity uses in its rate-regulated operations, instead of activities that relate directly to the transfer of goods or services to customers. These assets would typically be classified as property, plant and equipment or intangible assets, which would normally be recognised in the statement of financial position of the entity and be accounted for in accordance with IAS 16 or IAS 38. Some suggest that deferring or accelerating the recognition of costs, or a combination of costs and revenue, may be more appropriate in these circumstances.

Deferring/accelerating the recognition of a combination of costs and revenue

5.77 Paragraphs 5.62–5.76 discuss some advantages and disadvantages of deferring or accelerating the recognition of either costs or revenue. Consequently, if the IASB develops any specific accounting requirements for rate-regulated activities, a possible approach would be to combine aspects of both the cost and revenue approaches. Although this may add complexity to any model developed, it might alleviate some of the complexities of trying to apply a single model to the different aspects of defined rate regulation.

5.78 For example, deferring or accelerating the recognition of revenue may be useful to account for performance bonuses or penalties and for differences created by variances between the estimated revenue requirement and the adjusted revenue requirement that relate to input cost or volume variances or to activities such as repairing storm damage. This approach would result in the actual costs incurred that relate to the identifiable rate-regulated activities being recognised in profit or loss in the period during which they are incurred (see paragraphs 5.72–5.75). This may provide users of financial statements with relevant and representationally faithful information about the activities performed during the period. Disclosures could then provide information about when the entity expects the accrued or deferred revenue to be recovered or reversed through future billings.

5.79 In contrast to deferring/accelerating the recognition of revenue, deferring/accelerating the recognition of costs may be preferable for reflecting differences in the requirements for capitalising the costs of assets such as property, plant and equipment (see paragraphs 5.63–5.65).

5.80 Some who support modifying the existing IAS 16 requirements to reflect the amounts determined for regulatory purposes suggest that an item of property, plant and equipment meets the definition of an asset in the *Conceptual Framework*. The issue then ceases to be about recognition but instead relates to how that item is measured on initial recognition and subsequently. Using the regulatory requirements to identify which costs are included or excluded from the initial measurement of the asset could more closely align the IFRS carrying amount of an asset with the regulatory carrying amount, to which the regulatory rate of return is applied. This may provide users of financial statements with relevant information to help them better understand the basis of the revenue requirement and the effect of capital expenditure on the investors' rate of return.

5.81 In some cases, the rate regulator approves an increase in the regulated rate charged to customers in anticipation of the entity acquiring or constructing property, plant and equipment. Some suggest that, in such cases, revenue should be deferred until the asset is brought into use. The IASB, if it decides to develop IFRS requirements using a combination of cost and revenue deferral/acceleration, would need to establish guidance about whether to adjust the carrying amount of the rate-regulated assets or to recognise a separate asset or liability reflecting the deferred/accelerated amounts.

Adjustments to the revenue requirement related to the acquisition or construction of rate-regulated tangible assets

5.82 Entities that are not subject to defined rate regulation determine when they invest in new or replacement assets and whether they finance the acquisition or construction by using cash made available from retained earnings, or issuing either debt or equity capital or a combination of each of those.

5.83 In defined rate regulation, the rate regulator may influence when the entity acquires or constructs new or replacement property, plant and equipment and infrastructure assets to provide the quantity and quality of goods or services determined by the regulatory agreement. The rate regulation will also determine when the entity will be able to recover the costs of acquiring or constructing the asset, which may influence how management decide to finance the acquisition or construction. The rate regulator may approve the related increase in the rate in order to recover the cost (and allowed rate of return on the cost):

(a) in arrears—the revenue requirement is increased when the asset is brought into use to include an amount of regulatory depreciation, that is, depreciation based on the regulatory carrying amount of the asset (see paragraphs 5.84–5.86); or

(b) partially in advance with the remainder in arrears—the revenue requirement is increased before the asset is acquired or constructed, with the subsequent regulatory depreciation amount being reduced to reflect the amounts recovered in advance (see paragraphs 5.87–5.90).

Adjusting the revenue requirement in arrears

5.84 When establishing the revenue requirement, the rate regulator typically reflects the cost of property, plant and equipment by incorporating an amount of depreciation of the regulatory carrying amount of the assets. This recognises that the entity has invested in acquiring or constructing the assets needed to carry out the rate-regulated activities and that the cost of the assets should be recoverable, together with a reasonable rate of return, through the amount of revenue billed to customers in exchange for the future goods or services delivered.

5.85 Paragraph 5.63 describes why the regulatory carrying amount of the asset may differ from the carrying amount determined in accordance with IAS 16. This has resulted in some suggestions that the general requirements of IFRS should be amended so that the carrying amount of the asset for regulatory purposes can be reported for IFRS purposes by deferring or accelerating the recognition of costs. For example, in constructing an item of property, plant and equipment, the entity may incur some costs that would not be capitalised in accordance with IAS 16 or IAS 23 *Borrowing Costs*. Such costs would be recognised as an expense as incurred in accordance with the general requirements of IFRS. The rate regulator may determine that the costs should be recovered from customers through future billings. However, the rate regulator may decide to defer the recovery by including the costs in the regulatory carrying amount of the asset instead of treating them as operating costs. As a result, the entity earns the regulatory rate of return on those costs. This compensates the entity for the delay in recovering them from customers.

5.86 A cost deferral approach would, in effect, treat such costs as capital costs, in the same way as the rate regulation does. Consequently, the costs would not be recognised as an expense in the period in which they are incurred. Instead, the costs would be recognised in profit or loss as part of a higher deprecation charge. Arguments against this approach are outlined in paragraphs 5.99–5.102.

Adjusting the revenue requirement in advance

5.87 The rate regulator sometimes increases the regulated rate per unit in anticipation of the entity investing funds in assets. Some suggest that the entity should defer recognising revenue for the amount of the selling price of the goods or services delivered to individual customers in the current period that relates to the future asset acquisition or construction. Instead, the cost of the asset is an investment in the entity's own assets and the related revenue should be deferred until the asset is put into use in generating future goods or services that are delivered to customers. At that time, the rate regulator makes an adjustment to reduce the amount of the depreciation expense to be included in the calculation of the regulated rate to be charged in later periods. This is because the entity has already recovered part of the cost of its investment in the asset prior to that asset being put into use. The revenue deferred as a result of this approach would subsequently be recognised in profit or loss to compensate for the adjustment that the rate regulator makes to the revenue requirement to restrict the regulatory depreciation adjustment. The depreciation of the asset would be recognised in profit or loss in accordance with IAS 16.

5.88 A counter-argument against deferring the amount of revenue recognised before or during the acquisition or construction of the asset would be that many non-rate-regulated entities finance the construction of property, plant and equipment from cash made available from retained earnings. There is generally no disagreement that the amounts billed to customers for the delivery of goods or services, which build up the cash needed to fund the construction, should be recognised as revenue in the period when it is billed.

5.89 However, a difference between rate-regulated and non-rate-regulated entities is that the decision to invest in property, plant and equipment by a rate-regulated entity is usually influenced by the rate regulator. The rate-regulatory agreement establishes the entity's obligations to acquire or construct the assets and the revenue requirement establishes the entity's right to consideration for satisfying those obligations. Consequently, if the planned construction is cancelled before completion, the rate regulator reduces the revenue requirement of future periods to 'refund' the amounts previously collected but not used for the intended purpose.

5.90 The IASB has not yet considered this issue in sufficient detail to propose a recommended approach. It is highlighted here to promote discussion about which of the approaches to account for defined rate regulation would result in the most relevant information if the IASB decides to pursue any of them.

Prohibiting the recognition of regulatory deferral account balances

5.91 The IASB may conclude, after considering the feedback from this Discussion Paper and from the *Conceptual Framework* project, that regulatory deferral account balances should not be recognised in IFRS financial statements. No specific IFRS requirements would be developed for recognising and measuring such balances or for deferring or accelerating the recognition of income or costs in order to reflect when income or costs are recognised for rate-setting purposes. This would effectively retain the existing predominant IFRS practice and, therefore, few, if any, regulatory deferral account balances would be recognised.

5.92 Some who do not support recognising regulatory deferral account balances in general purpose financial statements note that all entities use a framework for establishing the price that they charge to customers. They believe that the involvement of a rate regulator in establishing a pricing framework does not provide compelling support for changing the timing of recognition of costs and revenue from the timing that would otherwise be reported in accordance with general IFRS requirements.

5.93 The remainder of this Section sets out a number of arguments that suggest that the IASB should not develop any specific accounting requirements for defined rate-regulated activities. However, the IASB could consider whether to supplement this approach with some specific disclosure requirements.

Cost recognition

5.94 Those who do not support modifying IFRS requirements to recognise regulatory deferral account balances suggest that failing to recognise specified costs, such as storm damage costs (see paragraphs 5.68–5.69), as expenses in the period in which they were incurred would not only lack transparency but could be misleading. Defined rate regulation does not change when the costs of repairing the storm damage were incurred. Instead, the rate regulation affects when the entity can recover those costs by increasing the price that it charges for the goods or services that it sells in the future. Consequently, some think that defined rate regulation should not change the timing of recognition of costs in the statement(s) of profit or loss and other comprehensive income.

Revenue recognition

5.95 Some who do not support modifying IFRS requirements note that rate regulation is typically designed to act as a substitute for competition in situations in which there are insufficient competitive forces to protect customers from exploitative prices. They therefore suggest that rate regulation does not have a significant distinguishable economic impact when compared to the economic effects of a competitive market. As a result, the rate regulation does not, in itself, support a different approach to recognising assets and liabilities or revenue and costs from that required by existing IFRS.

5.96 In a competitive market, all entities have, subject to market forces, the ability to increase or decrease the price charged for the future supply of goods or services. Some view the various rate-setting mechanisms used by rate regulators to be similar to those used by unregulated entities in a competitive market. Although the rate regulation may create a ‘right’ to increase future prices or an ‘obligation’ to decrease future prices, they believe that this is economically no different from an unregulated entity’s ability to increase, or need to decrease, future prices. This is because the rate regulation does not legally entitle the rate-regulated entity to collect the cash flows related to the higher price from the rate regulator or other designated party. Instead, the rate-regulated entity only becomes unconditionally entitled to collect the related cash flows when it delivers additional goods in the future, for which it can bill customers at the higher price. Similarly, a required reduction in the regulated price does not oblige the entity to pay the ‘regulatory refund’ to the rate regulator or other designated party. Instead, the rate-regulated entity is only obliged to provide the regulated goods or services to customers at the reduced price in the future.

5.97 Consequently, some suggest that the entity’s revenue should be recognised when the rate-regulated goods or services are delivered to customers, using the regulated rate per unit that is applicable at the time that the goods or services are delivered. This approach, some suggest, is consistent with the approach applied in IFRS 15, and also with the approach used previously in IAS 18 *Revenue*. IFRS 15 requires revenue to be recognised when (or as) the entity satisfies a performance obligation. A performance obligation is a ‘promise in a contract with a customer to transfer [goods or services] to the customer’.

5.98 The focus in IFRS 15 is on the contract between the entity and the individual customers to whom it delivers the goods or services in exchange for consideration. For an entity subject to defined rate regulation, the entity’s only source of consideration/revenue is the customers that purchase the rate-regulated goods or services. Consequently, the entity’s only ‘revenue-generating’ activity appears to be the delivery of the rate-regulated goods or services to its customers. This means that revenue should be recognised using the regulated rate per unit when those goods or services are transferred to customers (Section 7 discusses further the interaction of rate regulation with IFRS 15).

Measuring property, plant and equipment

5.99 Some who do not support modifying the requirements of IFRS accept that rate regulation can affect the value of individual assets or the value of the entity's overall rate-regulated operations. However, they suggest that existing IFRS is sufficient to deal with this in the same way as for entities that are not subject to rate regulation.

5.100 For example, an entity may own a machine that is used in its rate-regulated operations and is, therefore, subject to rate regulation for rate-setting purposes. In defined rate regulation, the revenue requirement is designed to ensure that the entity recovers the original acquisition or construction cost of the asset as well as the cost of the capital invested in it (see paragraph 4.56). The rate regulator determines how to measure the carrying amount of the asset for this purpose, which may result in the regulatory carrying amount being higher or lower than the IAS 16 carrying amount (see paragraph 5.63). The revenue requirement and resulting rate per unit are then calculated by applying the permitted rate of return to the regulatory carrying amount.

5.101 Some suggest that reporting the regulatory carrying amount of the machine may be more useful to users of the financial statements than the IAS 16 carrying amount, because this would help users to better predict future revenue cash flows by multiplying the regulatory rate of return by the regulatory carrying amount. A counter to this argument is that the objective of IAS 16 is different. It is to provide users of financial statements with information about an entity's investment in its property, plant and equipment (see paragraph 1 of IAS 16) and this does not require the asset's recoverable amount to be reported. Instead, IAS 16 requires an entity to recognise and measure property, plant and equipment at cost less any accumulated depreciation and impairment, unless the entity chooses to apply the revaluation model.

5.102 Although the rate regulator may use a different carrying amount to calculate the revenue requirement, this does not change the cost of the asset but instead affects the timing of the recovery of the asset's cost and may affect its recoverable amount. If the recoverable amount is less than the IAS 16 carrying amount, then the entity will recognise an impairment loss in accordance with IAS 36 *Impairment of Assets*. If the recoverable amount is higher than the IAS 16 historical cost carrying amount, the IAS 16 revaluation model is available to the entity. Assets that are subject to defined rate regulation may be considered as a class of assets for this purpose. However, the measurement requirements of the revaluation model may not result in the same carrying amount as the regulatory requirements.

Recognising the regulatory licence as an intangible asset

5.103 Some who do not support modifying IFRS requirements for rate-regulated activities suggest that the package of rights and obligations arising from rate regulation is similar to that contained in operating licences that are not subject to defined rate regulation. Such operating licences, which are common in other commercial environments and also contain a package of rights and obligations, are generally identified as the 'unit of account' for accounting purposes. This single resource is then usually accounted for as an intangible asset, in accordance with IAS 38.[23] Some suggest that a regulatory licence or agreement should be accounted for in the same way and that no special IFRS accounting requirements are necessary. (A contrary view has been discussed in paragraphs 5.35–5.46, which considered modifying IAS 38.)

5.104 In the IASB's preliminary view, if the entity has paid directly for a distinct regulatory licence, the licence would meet the definition of, and recognition criteria for, a separately acquired intangible asset, in accordance with IAS 38.

5.105 However, the direct cost to acquire or renew the licence or other agreement to supply the rate-regulated goods or services is typically insignificant and may be nil. This is because the cost of the licence is rarely intended to reflect its value. Typically, any cost of the licence is passed on to customers through the regulated rate established for the rate-regulated goods or services. This means that, in some cases, the rate regulator keeps costs to customers low by forgoing recovery of the administrative costs incurred in issuing or renewing the licence, or by seeking only an amount intended to reimburse the rate regulator for such costs.

5.106 If the cost of the licence to the rate-regulated entity is nil, then the entity would, in effect, not recognise the intangible asset. If there is a cost, then the licence is recognised initially at that cost. However, if the regulatory licence is acquired free of charge, or for nominal consideration, by way of a government grant, the entity could choose to recognise both the licence and the grant initially at fair value, as permitted by IAS 20 *Accounting for Government Grants and Disclosure of Government Assistance*.

5.107 Whether the entity recognises the regulatory licence initially at cost or at fair value, it would be prohibited from revaluing the licence to reflect changes in its value, because the revaluation model in IAS 38 would not be available. That model requires the existence of an active market (see paragraph 5.42). Such a market, as defined in IAS 38, would not exist for rate-regulatory licences or other agreements establishing the rights and obligations associated with rate-regulated activities. However, this is again similar to other operating licences granted in other commercial environments.

Disclosure-only requirements

5.108 Although those who do not support modifying the requirements of IFRS for rate-regulated activities suggest that rate regulation does not create a sufficiently distinguishable economic environment to support developing specific IFRS requirements, they accept that some additional disclosure requirements may be appropriate in some circumstances. This may be the case, for example, if the rate regulation restricts the entity's ability to react to changing circumstances in a timely manner. This typically applies when the rate regulation permits rate changes to be applied only at predetermined intervals, and those intervals are substantially longer than would apply in a competitive environment. For example, there is a global price increase, which is

23 An intangible asset is defined in IAS 38 as 'an identifiable non-monetary asset without physical substance'.

expected to apply for the foreseeable future, of 10 per cent per barrel for oil that is used by an entity to generate electricity in an oil-fired power plant. The entity is subject to defined rate regulation.

5.109 In an unregulated, competitive market, the increase in fuel input costs would be quickly reflected through an increase in the price of electricity generated by all competitors. However, the defined rate regulation delays the increase being reflected for, say, one year but when the change occurs, prices are expected to rise by more than 10 per cent. This is because the excess input costs incurred in the period before the increase in the regulated price takes effect are reflected in the revised price, in addition to the underlying 10 per cent increase that is expected to remain for the foreseeable future. Consequently, the profit in the initial year is reduced because of the cost increase, but this reduction is compensated for by higher profit in the following year when the increased price charged to customers compensates the entity. Arguably, disclosures about the delay in recovery and the ultimate right to increase prices to recover past costs would help users of the financial statements to understand the effects of the rate regulation on future cash flows.

Questions for respondents

5.110 This Section has outlined a number of possible approaches to providing relevant information to users of financial statements about the effects of defined rate regulation. These approaches range from making no changes to the general requirements of IFRS, through disclosure-only requirements and narrow-scope modifications to IAS 38, to more widespread changes to the general requirements of IFRS. Such widespread changes could affect the reporting of several line items in the statement of financial position and the statement(s) of profit or loss and other comprehensive income.

5.111 At this time, the IASB has not made any tentative decisions about which approach(es), if any, it prefers. Instead, the IASB is seeking feedback from stakeholders about the advantages and disadvantages of the approaches and whether there are any other approaches it should consider.

5.112 This feedback will then be considered, together with the feedback received on the other issues considered in this Discussion Paper, in order to determine the next steps for the Rate-regulated Activities project.

Question 7
Section 5 outlines a number of possible approaches that the IASB could consider developing further, depending on the feedback received from this Discussion Paper. It highlights some advantages and disadvantages of each approach. (a) Which approach, if any, do you think would best portray the financial effects of defined rate regulation in IFRS financial statements and is most likely to provide the information that investors and lenders consider is most relevant to help them make their investing and lending decisions? Please give reasons for your answer? (b) Is there any other approach that the IASB should consider? If so, please specify and explain how such an approach could provide investors and lenders with relevant information about the financial effects of rate regulation. (c) Are there any additional advantages or disadvantages that the IASB should consider before it decides whether to develop any of these approaches further? If so, please describe them. If commenting on the asset/liability approach, please specify, if it is relevant, whether your comments reflect the existing definitions of an asset and a liability in the *Conceptual Framework* or the proposed definitions suggested in the *Conceptual Framework* Discussion Paper, published in July 2013.

Question 8
Does your organisation carry out activities that are subject to defined rate regulation? If so, what operational issues should the IASB consider if it decides to develop any specific accounting guidance or requirements?

Question 9
If, after considering the feedback from this Discussion Paper and the *Conceptual Framework* project, the IASB decides to prohibit the recognition of regulatory deferral account balances in IFRS financial statements, do you think that the IASB should consider developing specific disclosure-only requirements? If not, why not? If so, please specify what type of information you think would be relevant to investors and lenders in making their investing or lending decisions and why.

Section 6—Presentation and disclosure requirements in IFRS 14

6.1 This Section provides a summary of the IFRS 14 presentation and disclosure requirements and some background about their development in order to seek more feedback about their usefulness to users of IFRS financial statements. If the IASB decides to develop a long-term solution to replace IFRS 14, the current requirements will inform the proposals for that solution but should not be considered as prejudging decisions about any subsequent requirements that may be developed.

6.2 The requirements in IFRS 14 are set out in three categories:

(a) the presentation of amounts recognised in the statements of financial position, profit or loss and other comprehensive income;

(b) disclosures about the activities that are subject to rate regulation; and

(c) disclosures about the amounts recognised in the statements of financial position, profit or loss and other comprehensive income.

Presentation of amounts recognised in the statements of financial position, profit or loss and other comprehensive income

6.3 Section 1 noted that the IASB did not, in developing IFRS 14, express any preliminary view about whether or not the regulatory deferral account balances that are recognised in accordance with that Standard meet the definitions of assets and liabilities in the *Conceptual Framework* (see paragraph 1.10). Consequently, IFRS 14 requires an entity applying that Standard to isolate the effect of recognising regulatory deferral account balances by presenting the totals of all such balances, and the movements within them, as separate line items in the statements of financial position (after subtotals for total assets and total liabilities), and profit or loss and other comprehensive income (see paragraphs 20–26 of IFRS 14).

6.4 In the statement of financial position, the total of all regulatory deferral account debit balances and the total of all regulatory deferral account credit balances are isolated and distinguished, by the use of subtotals, from the assets and liabilities that are presented in accordance with other Standards. The subtotals are drawn before the regulatory deferral account balances are presented (see paragraphs 20–21 of IFRS 14).

6.5 In the statement(s) of profit or loss and other comprehensive income, the net movements recognised in the amounts of regulatory deferral accounts are presented as separate line items. The amount presented in profit or loss is isolated from the profit or loss recognised in accordance with other Standards by the use of a subtotal, which is drawn before the net movement in regulatory deferral account balances.

6.6 In addition, IFRS 14 requires some disaggregation of information about the regulatory deferral account balances recognised and net movements in them, including information about any related amounts of deferred taxation, discontinued operations, disposal groups and earnings per share (EPS).

6.7 The separate presentation of regulatory deferral account amounts is required in order to address the potential reduction in comparability that was perceived to be created by making IFRS 14 available, on an elective basis, to a limited group of entities. IFRS 14 is not available to first-time adopters of IFRS that do not recognise regulatory deferral account balances in accordance with their previous GAAP, nor to any existing IFRS preparers. These entities are not permitted to change their existing accounting policies in order to start to recognise such balances.

6.8 In developing IFRS 14, the IASB concluded that presenting the regulatory deferral account balances and net movements separately would provide more useful information about the regulatory environment (see paragraph BC45 of IFRS 14).

6.9 In the statement of financial position, perhaps the biggest impact of this separate presentation relates to property, plant and equipment. In some jurisdictions, the local GAAP permits or requires the entity to report the rate-regulatory carrying amount of the property, plant and equipment in general purpose financial statements, instead of the amount that would otherwise be reported in accordance with the local GAAP by entities that are not subject to rate regulation. In paragraph 2.19, we identified one difference between the regulatory carrying amount and the IAS 16 carrying amount, which was the inclusion in the regulatory carrying amount of some indirect costs that would be immediately recognised as an expense in accordance with IAS 16.

6.10 Another common difference relates to the amount of finance costs that are capitalised in the regulatory carrying amount compared to those capitalised in the IAS 16 carrying amount, which is determined in accordance with IAS 23. IAS 23 includes only those borrowing costs that are directly attributable to the acquisition, construction or production of a qualifying asset to be capitalised as part of the cost of the asset. IAS 23 does not permit an actual or imputed cost of equity to be capitalised.

6.11 In contrast, the regulatory carrying amount in some jurisdictions includes an 'allowance for funds used during construction' (AFUDC), which typically differs from the amount capitalised in accordance with IAS 23. This is because the AFUDC reflects an imputed cost of capital, which may include an imputed cost of equity and an actual or imputed cost of borrowing. When an imputed cost of borrowing is used, this is usually established by the rate regulator. The entity's actual borrowing rate may be higher or lower than this rate.

6.12 Another possible difference between the regulatory carrying amount and the IAS 16 carrying amount arises when the rate regulation applies an inflation adjustment or price index to the regulatory carrying amount. This practice varies between rate-regulatory schemes. When an inflation adjustment is applied to the regulatory carrying amount of property, plant and equipment, the allowed rate of return is typically set at a lower rate than in situations in which there is no such inflationary adjustment. This is because, in the latter case, the higher rate of return, in effect, compensates the entity for the absence of the inflationary adjustment.

6.13 In accordance with IFRS 14, an entity applies the requirements of IAS 16 to present, in the statement of financial position, the property, plant and equipment carrying amount, with any differences between this amount and the regulatory carrying amount reported as a separate regulatory deferral account balance. At this time, the IASB has not decided whether this separate presentation of the IAS 16 carrying amount and the regulatory differences should continue if the IASB decides to amend IFRS as a result of this Rate-regulated Activities project. This is an issue on which the IASB is particularly interested in receiving feedback.

6.14 An advantage of retaining the separate presentation is that this may more clearly identify what adjustments the rate regulation requires. This could enhance comparability between rate-regulated entities, because the underlying property, plant and equipment carrying amounts will be calculated on a consistent basis, with the amount of the regulatory adjustment clearly identified as a separate item.

6.15 However, separating the regulatory carrying amount into the IAS 16 carrying amount and a separate regulatory balance may be more costly for a rate-regulated entity and may be less clear for users of financial statements, who may prefer to see the regulatory carrying amount as a single item. Typically, it is this regulatory carrying amount to which the rate regulator applies the regulatory rate of return that is used to calculate the revenue requirement and the rate per unit charged to customers. Consequently, it provides relevant information for investors, lenders and analysts to help them to predict future revenue, profit and cash flows of the entity.

Disclosures about the activities that are subject to rate regulation and the amounts recognised in the statements of financial position, profit or loss and other comprehensive income

6.16 In developing the disclosure requirements in IFRS 14, the IASB staff considered the disclosure requirements in some local GAAPs, together with the disclosures provided by some entities that applied that GAAP. In addition, the staff considered disclosures provided in management commentaries that accompany financial statements and information contained in documents provided to investors and analysts to explain the annual results. For IFRS preparers in particular, this sometimes involves the extensive use of non-GAAP measures and disclosures in the financial statements, including 'pro-forma' statements of income and financial position that include regulatory balances. The IASB staff also considered the information used by some credit analysts in their publicly available methodology documents. Our observations from this research are summarised in paragraphs 6.17–6.21. These observations informed the disclosure requirements of IFRS 14 that are outlined in paragraphs 6.22–6.25.

6.17 Investors, lenders and analysts generally consider that entities that are subject to high levels of rate regulation, including the type that we have termed 'defined rate regulation', are not primarily subject to influence from market forces. Consequently, they are not generally compared directly with competitive entities in similar or other industry sectors. Instead, the effectiveness of the regulatory framework in which a rate-regulated entity operates is a key consideration. The effectiveness of the regulatory framework encompasses:

(a) the 'reasonableness' of the rate regulation (ie how effective it is at balancing the needs of the customers and the entity);

(b) the predictability and stability of the framework;

(c) the transparency and efficiency of the rate-setting procedures;

(d) the regulators' strength and independence; and

(e) the quality of the relationship between the rate regulator and the entity.

6.18 In addition to the general effectiveness of the regulatory framework, analysts also give significant consideration to the more specific ability of the rate-regulated entity to recover its costs in a timely manner and to earn the return established by the rate regulation. This involves an assessment of the statutory or regulatory mechanisms and protections in place to ensure full and timely recovery of 'approved' revenues. Such mechanisms and protections are considered to include:

(a) predictable rate-review outcomes, based on transparent and objective rate-setting formulae and procedures;

(b) automatic annual (or more frequent) rate adjustments to allow a more timely pass-through of certain types of costs to customers;

(c) timely automatic triggers or mechanisms to initiate a rate review for volatile or unexpected events or cost/revenue differences;

(d) pre-approval of capital investment programmes and timely recovery of investment cash flows through rates; and

(e) a stable, compensatory rate of return in cash that is sufficiently insulated from political intervention.

6.19 In some jurisdictions, the documentation relating to the rate-setting process is publicly available. Consequently, investors, lenders and analysts have access not only to the details of the rate-setting framework but also to the entity's rate application and the rate-regulator's determination of the rate. In such cases, interested parties, for example, customer representatives, are usually able to comment on the rate application and may be represented in public hearings that are held before the rate regulator makes the final rate determination.

6.20 However, the level of publicly available information varies across jurisdictions. When there is less publicly available information, users of financial statements have to rely more on the entity itself to provide relevant information to assist them in their investing or lending decisions.

6.21 In jurisdictions in which 'regulatory assets' and 'regulatory liabilities' are currently recognised in accordance with local GAAP in general purpose financial statements, users of the financial statements still request additional information. Other sources of information are used, particularly about the timing and certainty of cash flows and the reconciliation of reported earnings to the earnings permitted by the rate regulation. However, the IASB staff have also received feedback that investors, lenders, analysts and rate regulators consider the financial statements to be a valuable source of information. This is because the financial statements are usually readily available and because they present relevant information in a transparent and consistent manner. This provides a foundation from which analysis can be developed, which helps to reduce the volume of information that needs to be obtained from alternative sources. In addition, the independent audit process is generally considered to support the credibility and reliability of the information provided. This may reduce the level of compliance costs that investors, lenders and rate regulators need to incur directly in verifying the information.

6.22 IFRS 14 requires some qualitative disclosures to help users of financial statements to assess the nature of, and risks associated with, the entity's rate-regulated activities. These disclosures include:

(a) a brief description of the nature and extent of the activities that are subject to rate regulation and the nature of the rate-setting process; and

(b) information about risks and uncertainty in the future recovery or reversal of each type of regulatory deferral account balance that has been recognised.

6.23 IFRS 14 requires some disclosures about the amounts of regulatory deferral account balances that have been recognised in the financial statements. As well as the accounting policies used to recognise and measure such balances, the entity is required to disclose, for each class of regulatory deferral account balance:

(a) a reconciliation of the carrying amount at the beginning and end of the period, with movements segregated between amounts arising in the period, amounts recovered or reversed in the period and other reconciling items;

(b) the rate of return or discount used to reflect the time value of money; and

(c) the remaining periods over which the entity expects to recover or reverse the regulatory deferral account balance recognised.

6.24 The IASB concluded that the combination of the IFRS 14 presentation requirements and the qualitative and quantitative disclosure requirements provide users of the financial statements with relevant information. This information helps users to:

(a) better understand the relationship between the results reported to the rate regulator and the results reported in financial statements prepared in accordance with general IFRS requirements;

(b) distinguish variability in performance that is adjusted through the rate-regulatory mechanism from variability for which there is no regulatory adjustment; and

(c) more readily predict the amount, timing and certainty of future cash flows related to the entity's rate-regulated activities.

6.25 Respondents to the Exposure Draft *Regulatory Deferral Accounts*, which preceded IFRS 14, generally supported the proposed disclosure requirements of IFRS 14. However, it is too early to assess the effectiveness of the disclosures because IFRS 14 was issued in January 2014.

Questions for respondents

6.26 IFRS 14 permits an entity within its scope to continue to apply the recognition and measurement policies for regulatory deferral accounts that it applied in accordance with its previous GAAP before adopting IFRS for the first time. Consequently, the presentation and disclosure requirements contained in IFRS 14 are intended to compensate for the possible loss of comparability to entities not applying IFRS 14 by requiring segregated presentation of, and extensive disclosures about, the regulatory deferral account balances recognised and how they have arisen. However, if the IASB was to develop specific requirements as a result of the feedback from this Discussion Paper, those requirements would not be limited to first-time adopters of IFRS. The requirements of IFRS 14 may be a useful starting point for discussion.

Question 10

Sections 2 and 6 discuss some of the information needs of users of general purpose financial statements. The IASB will seek to balance the needs of users of financial statements for information about the financial effects of rate regulation on an entity's operations with concerns about obscuring the understandability of financial statements and the high preparation costs that can result from lengthy disclosures (see paragraph 2.27).

(a) If the IASB decides to develop specific accounting requirements for all entities that are subject to defined rate regulation, to what extent do you think the requirements of IFRS 14 meet the information needs of investors and lenders? Is there any additional information that you think should be required? If so, please specify and explain how investors or lenders are likely to use that information.

(b) Do you think that any of the disclosure requirements of IFRS 14 could be omitted or modified in order to reduce the cost of compliance with the requirements, without omitting information that helps users of financial statements to make informed investing or lending decisions? If so, please specify and explain the reasons for your answer.

Question 11
IFRS 14 requires any regulatory deferral account balances that have been recognised to be presented separately from the assets and liabilities recognised in the statement of financial position in accordance with other Standards. Similarly, the net movements in regulatory deferral account balances are required to be presented separately from the items of income and expense recognised in the statement(s) of profit or loss and other comprehensive income. If the IASB develops specific accounting requirements that would apply to both existing IFRS preparers and first-time adopters of IFRS, and those requirements resulted in the recognition of regulatory balances in the statement of financial position, what advantages or disadvantages do you envisage if the separate presentation required by IFRS 14 was to be applied?

Section 7—Other issues

7.1 This Section highlights some of the issues that the IASB, after considering the responses to this Discussion Paper, may need to consider if it decides to develop any specific accounting requirements for rate-regulated activities. In particular, it introduces some:

(a) further considerations about the distinguishing features of defined rate regulation (see paragraphs 7.6–7.9); and

(b) some possible interactions with other Standards (see paragraphs 7.11–7.22).

Introduction

7.2 In this Discussion Paper, the IASB is seeking input from stakeholders about its analysis of rate regulation and its description of defined rate regulation. This is because the IASB wants not only to confirm its understanding of the economic environment in which rate-regulated entities operate, but also to confirm whether the description of defined rate regulation can provide a common starting point for a more focused discussion about the accounting for rate-regulated activities.

7.3 The description of defined rate regulation, set out in Section 4, is focused upon the features of a regulatory pricing framework that balances the needs of customers and the rate-regulated entity, because the customers have little or no choice but to purchase the goods or services from the rate-regulated entity (see paragraph 4.4). This type of rate regulation creates rights and obligations that are enforceable on the rate-regulated entity and the rate regulator.

7.4 The IASB is seeking feedback through this Discussion Paper that will help it to identify which features of defined rate regulation might be considered as 'essential' or merely 'supportive' in delineating a distinguishable combination of rights and obligations, and whether there are other features that the IASB should take into account. A particular concern, discussed in paragraphs 7.6–7.9, is whether self-regulated entities, such as co-operatives, could be considered to be subject to 'defined rate regulation'.

7.5 In addition, this Section (see paragraphs 7.11–7.22) highlights some areas for which there is a potential interaction between the effects of defined rate regulation and existing IFRS requirements. They are outlined here to raise awareness of them and to seek input as to whether there are other potential interactions that stakeholders think should be addressed if the IASB decides to develop any specific accounting requirements for activities that are subject to defined rate regulation.

The authority of the rate regulator—co-operatives

7.6 The description of defined rate regulation, set out in Section 4, is focused upon a regulatory pricing framework that creates rights and obligations that are enforceable on the rate-regulated entity and the rate regulator. This suggests that the existence of a rate regulator whose role and authority is established in legislation or other formal regulations is an important feature (see paragraph

4.73). This raises questions about whether co-operatives that are not subject to external regulation could be considered to be subject to defined rate regulation or whether they would instead be considered to be 'self-regulated' and consequently be outside the scope of defined rate regulation.

7.7 A co-operative is 'an autonomous association of persons united voluntarily to meet their common economic, social, and cultural needs and aspirations through a jointly owned and democratically controlled enterprise'.[24] Co-operatives are formed for many reasons and can be of many types, such as worker, consumer, producer, purchasing, marketing, distributing, farming, electric, water and housing co-operatives.

7.8 Co-operatives are commonly self-regulated when it comes to setting prices for goods or services that they supply, which are usually supplied to the members of the co-operative. The IASB staff has heard that, when the goods or services being supplied by the co-operative are considered to be essential, the co-operative is commonly subject to some form of regulatory oversight. This oversight is designed to encourage or ensure that the co-operative provides those goods or services on a non-discriminatory basis and at a price that prevents excessive profit-making. For example, oversight may be exercised by a government department or other authorised body that provides loans, tax relief or other incentives to encourage the co-operative to achieve similar objectives to those often identified in defined rate-regulatory frameworks.

7.9 The IASB is seeking input about whether self-regulating entities such as co-operatives should, if the other features of defined rate regulation are present, be included within the population of entities that are subject to defined rate regulation (see Question 12).

Interactions with other Standards

7.10 The purpose of the following paragraphs is to highlight some of the issues that, in addition to those discussed in Section 5, the IASB may need to consider if, as a result of the feedback from this Discussion Paper, it decides to develop proposals for amending IFRS. It is premature to present an analysis of the issues or suggestions for their resolution at this time. They are highlighted here to raise awareness and to seek input about whether there are other interactions that the IASB should take into account in any further deliberations.

Interaction with IFRIC 12

7.11 As noted in paragraph 3(c) of IFRIC 12, a common feature of a service concession arrangement is that the '[service concession] contract sets out the initial prices to be levied by the operator and regulates price revisions over the period of the service arrangement'. This feature is confirmed within the scope criteria in paragraph 5(a) of IFRIC 12.

7.12 In some situations, the operator is guaranteed a specified or determinable level of consideration by the grantor. The entity recovers this consideration either

24 As defined by the International Co-operative Alliance (ICA), http://ica.coop/en.

directly from the grantor or through the amounts billed to the individual users of the service, with any shortfalls or excess recoveries being received from, or paid to, the grantor.

7.13 In other situations, the operator relies solely on revenue from sales of the concession service over the period of the arrangement in order to recover its costs and earn a reasonable rate of return. In such cases, the grantor may not pay the operator for any shortfalls below the targeted revenue levels. Sometimes the grantor may extend the length of the contract period to increase the probability that the operator receives the targeted level of returns over the total concession contract period.

7.14 The terms and conditions of some service concession arrangements have many similarities to those seen in defined rate regulation, particularly when the operator relies solely on sales of the concession service in order to generate sufficient revenue over the period of the arrangement to recover its costs and earn a reasonable rate of return. Consequently, the issues faced by operators in such service concession arrangements are likely to be similar to entities that are subject to defined rate regulation. However, a significant difference is that the property, plant and equipment or infrastructure assets used to provide the concession service are not recognised as assets of the operator, because the service concession arrangements within the scope of IFRIC 12 do not convey the right to control the use of the assets to the operator (see paragraph 11 of IFRIC 12).

Interaction with IFRS 15

7.15 The IASB has recently issued IFRS 15, which supersedes the requirements of IAS 11 *Construction Contracts* and IAS 18. IFRS 15 and its predecessor Standards address the accounting for revenue arising from contractual transactions between the entity and a customer. Such a transaction arises if a customer purchases the rate-regulated goods or services from the entity.

7.16 Some suggest that, because the rate regulator acts on behalf of the customers, the rate regulation may be considered to be an implied or quasi-contract between the rate-regulated entity and the collective customers (sometimes called the 'customer base'). Using this view, the entity would not only recognise revenue as it transfers the rate-regulated goods or services to individual customers (the billable revenue), but it would also recognise the amount of the consideration to which it is entitled in exchange for all the rate-regulated activities that it has performed to date (the revenue requirement). In support of this view, they suggest that, in defined rate regulation, specified differences arising between the revenue requirement and amounts billed to customers that are expected to be incorporated into the future rate(s) charged to customers could be considered to be a variable component of the consideration billed to customers. IFRS 15 restricts recognising variable consideration as revenue to the extent that it is highly probable that the consideration will not reverse (see paragraph 56 of IFRS 15). This view would support deferring the recognition of revenue, together with recognising a related liability to reflect the reversal of amounts over-billed (ie amounts above the revenue requirement that are expected to be adjusted through future rate reductions).

7.17 However, paragraph 31 of IFRS 15 requires an entity to 'recognise revenue when (or as) the entity satisfies a performance obligation by transferring a promised good or service (ie an asset) to a customer. An asset is transferred when (or as) the customer obtains control of that asset'. In defined rate regulation, many of the rate-regulated activities for which the consideration is included in the revenue requirement do not involve the transfer of goods or services to the rate regulator or to the customers, either individually or collectively. For example, the activities may involve making changes to the entity's property, plant and equipment or infrastructure assets or switching to alternative sources of energy, etc (see paragraphs 4.49–4.50). Consequently, even if the rate regulation was to be viewed as a contract between the rate-regulated entity and the collective customers, it is unclear how this would affect the recognition of revenue in accordance with IFRS 15. As a result, if the IASB decides to develop specific IFRS requirements involving the deferral or acceleration of revenue (see Section 5), it could consider whether and, if so, how the principles of IFRS 15 could be adapted to form the basis of a tailored revenue recognition model for rate-regulated activities.

Interaction with IAS 12 and IAS 20

7.18 The description of defined rate regulation in Section 4 assumed that the regulated rate could be established at such a level that it would, over time, allow the entity to recover its revenue requirement. However, in some situations, the rate required to compensate the entity for carrying out all of its required rate-regulated activities may be so high that it is not considered to be affordable by the customers. In such cases, the rate regulator needs to use alternative ways to compensate the entity (see paragraphs 4.26 and 4.29).

7.19 This may result in the rate regulator providing government grants or other subsidies to the entity or using taxation to provide additional funding to the entity. Consequently, if the IASB decides to develop specific requirements for reporting rate-regulated activities, it may need to consider how to allocate the total revenue requirement between the amounts that will be recovered through amounts billed to customers and those that will be recovered through other forms of settlement with the government or rate regulator. This may involve some interaction with the existing requirements of IAS 12 and IAS 20.

Interaction with IFRS 3 *Business Combinations*

7.20 Paragraph 10 of IFRS 3 requires that, at the acquisition date, an acquirer recognises, separately from goodwill, the assets acquired, and liabilities assumed, in a business combination. If the IASB decides to develop specific requirements for reporting rate-regulated activities, it may need to consider how to recognise and measure regulatory deferral account balances acquired or assumed in a business combination.

Interaction with IFRS 9

7.21 In some cases, the rate regulator or other designated body pays cash to the entity as consideration for the performance of specified tasks or settles revenue mismatches (both over- and under-billings) in cash. In such situations, it is generally accepted that the amounts receivable or payable will be classified as financial assets and financial liabilities within the scope of IFRS 9 (see paragraph 4.28).

7.22 However, in the more common case described in Section 4, the entity does not have a right to receive cash from, or an obligation to pay cash to, the rate regulator in order to settle revenue mismatches. Instead, the entity settles such mismatches by increasing or decreasing the rate charged to customers for future sales. Many proponents of recognising such mismatches as regulatory assets and regulatory liabilities acknowledge that the balances are unlikely to meet the definitions of financial assets and financial liabilities, because the entity does not have a present right/obligation to receive/pay cash or other financial asset.[25] Instead, they suggest that the balances are more in the nature of accrued revenue and deferred revenue, that is, amounts billed in arrears or billed in advance of performing the activities to which the revenue relates. If the IASB decides to develop specific requirements as a result of this project, the nature of any regulatory balances to be recognised would need to be established in order to identify the appropriate measurement basis for them.

Questions for respondents

7.23 This Section highlights some of the issues that the IASB, after considering the feedback obtained from this Discussion Paper, may need to consider if it decides to develop any specific accounting requirements for rate-regulated activities. The issues are not addressed in this Discussion Paper but are included to encourage further feedback on some of the features of defined rate regulation and to help stakeholders to understand the issues that the IASB may need to consider in due course.

Question 12
Section 4 describes the distinguishing features of defined rate regulation. This description is intended to provide a common starting point for a more focused discussion about whether this type of rate regulation creates a combination of rights and obligations for which specific accounting guidance or requirements should be developed. Paragraph 4.73 suggests that the existence of a rate regulator whose role and authority is established in legislation or other formal regulations is an important feature of defined rate regulation. Do you think that this is a necessary condition in order to create enforceable rights or obligations, or do you think that co-operatives or similar entities, which operate under self-imposed rate regulation with the same features as defined rate regulation (see paragraphs 7.6–7.9), should also be included within defined rate regulation? If not, why not? If so, do you think that such co-operatives should be included within the scope of defined rate regulation only if they are subject to formal oversight from a government department or other authorised body?

25 The definitions of financial asset and financial liability are set out in paragraph 11 of IAS 32, to which Appendix A of IFRS 9 refers.

Question 13
Paragraphs 7.11–7.22 highlight some of the issues that the IASB may consider if it continues to progress this project. Do you have any comments or suggestions on these or any other issues that may or may not have been raised in this Discussion Paper that you think the IASB should consider if it decides to develop proposals for any specific accounting requirements for rate-regulated activities?

Appendix A
Previous requests for IFRS guidance about rate-regulated activities

A1 The IASB and the IFRS Interpretations Committee (the 'Interpretations Committee') received several requests for guidance on whether rate-regulated entities can or should recognise, in their IFRS financial statements, a regulatory deferral account debit or credit balance as a result of price or rate regulation by regulatory bodies or governments. Some national accounting standard-setting bodies permit or require such balances to be recognised as assets and liabilities under some circumstances, depending on the type of rate regulation in force. In such cases, these regulatory deferral account balances are often referred to as 'regulatory assets' and 'regulatory liabilities'.

A2 In particular, US generally accepted accounting principles (US GAAP) have specified recognition and measurement requirements for the effect of certain types of rate regulation since at least 1962. In 1982, the US national standard-setter, the Financial Accounting Standards Board (FASB), issued SFAS 71 *Accounting for the Effects of Certain Types of Regulation*.[26] SFAS 71 formalised many of those principles. In the absence of specific national guidance, practice in many other jurisdictions followed SFAS 71. In the financial statements of rate-regulated entities that apply such guidance, regulatory deferral account balances are often incorporated into the carrying amount of items such as property, plant and equipment and intangible assets, or are recognised as separate items, similar to receivables or payables, in the financial statements. This changes the timing of when these amounts are recognised in profit or loss.

A3 In June 2005, the Interpretations Committee received a request about SFAS 71. The request asked whether, in accordance with the hierarchy in paragraphs 10–12 of IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors*, an entity could apply SFAS 71 when selecting an accounting policy in the absence of specific guidance in IFRS.

A4 The Interpretations Committee previously discussed the possible recognition of regulatory deferral account debit balances as part of its project on service concessions. As a result of its consideration at that time, the Interpretations Committee concluded that 'entities applying IFRS should recognise only assets that qualified for recognition in accordance with the IASB's *Framework for the Preparation and Presentation of Financial Statements* ... and relevant accounting standards, such as IAS 11 *Construction Contracts*, IAS 18 *Revenue*, IAS 16 *Property, Plant and Equipment* and IAS 38 *Intangible Assets*.'[27,28] In other words, the

26 The guidance in SFAS 71, together with subsequent amendments and related guidance, has now been incorporated into Topic 980 *Regulated Operations* in the FASB *Accounting Standards Codification*®.

27 In September 2010, the IASB replaced the *Framework for the Preparation and Presentation of Financial Statements* with the *Conceptual Framework for Financial Reporting*. The definitions of assets and liabilities and the criteria for recognising them in the statement of financial position were unchanged.

28 IAS 11 and IAS 18 are superseded by IFRS 15 *Revenue from Contracts with Customers*, issued in May 2014.

Interpretations Committee thought that an entity should recognise regulatory assets only to the extent that they meet the criteria to be recognised as assets in accordance with existing IFRS.

A5 The Interpretations Committee concluded that the recognition criteria in SFAS 71 were not fully consistent with the recognition criteria in IFRS.[29] Applying the guidance in SFAS 71 would result in the recognition of regulatory deferral account balances under certain circumstances that would not meet the recognition criteria of relevant Standards. Consequently, the requirements of SFAS 71 were not indicative of the requirements of IFRS. The Interpretations Committee decided not to add a project on regulatory assets to its agenda.

A6 In January 2008, the Interpretations Committee received a second request to consider whether rate-regulated entities could or should recognise a regulatory liability (or a regulatory asset) as a result of rate regulation. The Interpretations Committee again decided not to add the issue to its agenda for several reasons. Importantly, it concluded that divergence did not seem to be significant in practice for entities that were applying IFRS. The established practice of almost all entities is to eliminate regulatory deferral account balances when IFRS is adopted and not to recognise such balances in IFRS financial statements. However, the Interpretations Committee also noted that rate regulation is widespread and significantly affects the economic environment of many entities.

A7 The IASB noted the ongoing requests for guidance on this issue. It also considered the comments that had been received on the Interpretations Committee's tentative agenda decisions. Those comments pointed out that although divergence in IFRS practice did not exist, several jurisdictions whose local accounting principles permitted or required the recognition of regulatory deferral account balances would be adopting IFRS in the near future. This would increase pressure for definitive guidance on the recognition of regulatory deferral account balances as assets or liabilities.

A8 Consequently, in December 2008, the IASB added a project on rate-regulated activities to its agenda and subsequently, in July 2009, published an Exposure Draft *Rate-regulated Activities* (the '2009 Exposure Draft'). The responses to the 2009 Exposure Draft raised complex and fundamental issues. In September 2010, the IASB decided that the complex technical issues could not be resolved quickly, and discontinued that project.

29 See *IFRIC Update*, August 2005.

Appendix B
Calculating the revenue requirement and establishing the regulated rate

B1 Section 4 provides an overview of defined rate regulation. This overview includes a summary of how the rate-setting mechanism establishes the 'revenue requirement', that is, the total consideration to which the entity is entitled in exchange for carrying out the specified rate-regulated activities (see paragraphs 4.12–4.18).

B2 The purpose of this Appendix is to provide a more detailed description of a typical mechanism used in defined rate regulation to calculate the revenue requirement and how the rate-setting mechanism is used to adjust future rates for mismatches between the revenue requirement and the amount of revenue billed to customers.

B3 When possible, the regulatory agreement is designed to ensure that the revenue requirement is collected from the customers that receive the rate-regulated goods or services. In some cases, however, the rate regulator may decide that the revenue requirement exceeds the amount that customers can be expected to afford. In order to make up for the shortfall, the rate regulator may facilitate government subsidies to be paid to the entity in the form of government grants or other government assistance, including tax relief.

B4 When an entity receives part of its revenue requirement through such government actions, this will be in the scope of IAS 20 *Accounting for Government Grants and Disclosure of Government Assistance* and/or IAS 12 *Income Taxes*. However, as noted in paragraph 4.29, this adds complexity to the analysis. Consequently, this Discussion Paper focuses on the situation in which the whole revenue requirement is collected from the customers that receive the rate-regulated goods and services.

Obligations established by the regulatory agreement

B5 The rate regulation establishes the framework that the rate regulator and the entity (the parties) work within when establishing the price that is to be charged to customers for the rate-regulated goods and services. Usually, there is some negotiation between the parties to establish:

(a) what activities the entity needs to perform and what goods and/or services the entity needs to deliver during the regulatory period.

(b) the total amount of revenue that the entity is entitled to receive in exchange for the agreed performance, which incorporates an agreed estimate of the quantity of rate-regulated goods or services expected to be delivered to customers during the period. This total revenue is often termed the 'revenue requirement' or 'allowable revenue'.

B6 The regulatory period is the time during which the revenue requirement is applied, that is, the time between the effective dates of rate determinations or agreements. This period varies by rate regulation, typically between one and five years, although some are longer.

B7 The rate-regulated activities that the entity is obliged to perform during the regulatory period could include:

(a) the delivery of the rate-regulated goods and/or services to customers: this can involve targets for quality as well as quantity;

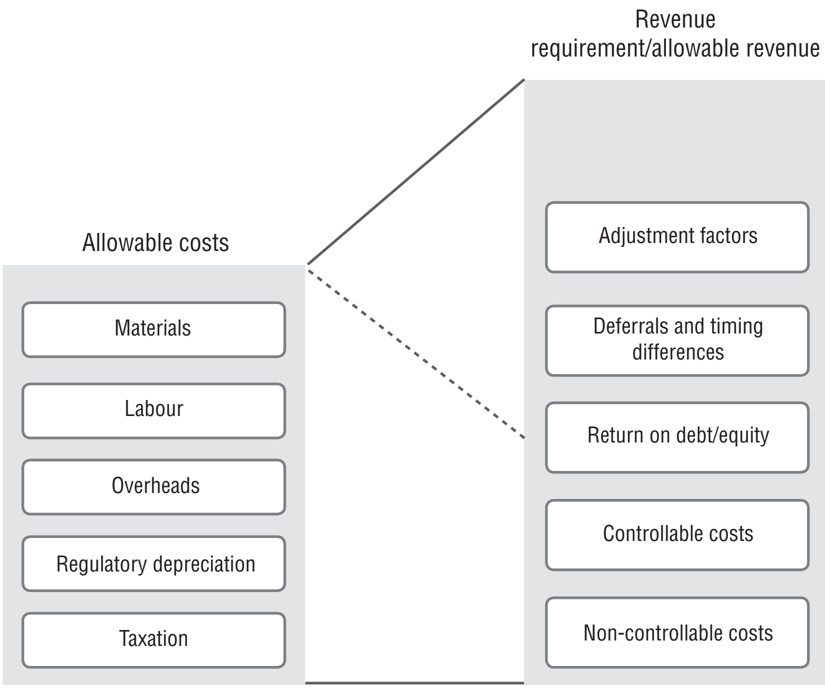
(b) making changes to the capacity of the network: this can involve renewals, additions, reductions through retirement, or upgrades;

(c) satisfying other government objectives: this can involve reducing greenhouse gases or other pollutants, switching to renewable energy sources or changing customer behaviour to manage demand; and

(d) standing ready to repair damage to the network and restore services to customers after storms or other contingent events.

How is the revenue requirement calculated?

B8 The revenue requirement is calculated based on a number of steps. The precise order of the steps may differ from those described in the following paragraphs. However, the process described contains the common features seen in a variety of schemes and is therefore intended to be considered to be representative.



Step 1: Identify allowable costs

B9 The starting point for most defined rate regulation schemes is to identify the estimated costs (the allowable costs) of the activities that the entity is obliged to perform in accordance with the regulatory agreement.

B10 This cost breakdown may be based on a combination of actual past costs for a designated period, budgeted future costs or benchmark costs (see paragraph B15), adjusted for any non-recurring or other costs that are not representative of the ongoing costs of performance for the rate-regulated entity.

B11 The type of costs that are typically included in allowable costs are:

(a) regulatory depreciation of regulated assets—the value of regulated assets (commonly referred to as the 'regulated asset base' (RAB) or 'regulated asset value' (RAV)) is depreciated over a specified time period. The amounts of the regulated assets and related depreciation are calculated based on the requirements of the regulatory agreement. The principles on which these are calculated are usually similar to the principles for measuring the IFRS carrying amount of the assets, but there may be differences in the amounts calculated. For example, the RAB may be increased for inflation; or the period over which the RAB is depreciated may be shorter than the useful economic life; or the initial cost capitalised may include indirect costs or an imputed cost of equity that would not be permitted to be capitalised by IAS 16 *Property, Plant and Equipment* or IAS 23 *Borrowing Costs*.

(b) costs of service—these can include costs of materials, labour, finance costs, variable overheads and an allowable portion of fixed overheads. Regulatory agreements commonly try to impose some discipline on an entity by allowing only those costs that are considered to be efficiently or prudently incurred. Rate regulators have different approaches to determining what is considered an efficient or prudent cost and this may be different to the actual costs incurred.

(c) taxation—in some cases, the profit earned by an entity on rate-regulated activities may be exempt from taxation. In other cases, the entity may be taxed on such profits, but the rate regulator considers the amount of taxation paid or payable to be an allowable cost for rate-regulatory purposes.

B12 Once the types of allowable costs are identified, the rate regulator then determines what amounts of these costs are appropriate to pass on to customers and, therefore, are taken into account in calculating the revenue requirement.

Step 2: Distinguish controllable and non-controllable costs and decide whether any costs should be incentivised

B13 Non-controllable costs commonly include items such as fuel costs or raw material costs. The entity has little or no control over these costs and so they are commonly included at the amount incurred when calculating the revenue requirement. Consequently, such non-controllable costs contribute to the variability of the revenue requirement that is ultimately billed to customers.

B14 Controllable costs, on the other hand, can be managed by the entity. Consequently, rate regulators look at these costs in considering whether, within the regulatory agreement, the entity should be incentivised to manage them. Rate regulators have different approaches to determine what method of incentive is appropriate.

B15 Increasingly, the regulatory agreement restricts the allowable controllable costs to a target or a 'benchmark' level. This level is often based on a hypothetical entity, because entities that are subject to defined rate regulation have no effective competition and, therefore, comparable competitors are rarely available as benchmarks. In some cases, the regulatory agreement fixes the controllable costs at this target amount and, therefore, if the entity is able to satisfy its obligations at a lower cost, it is allowed to retain the benefit. In other cases, the regulatory agreement may require the entity to 'share' some of the benefit by reducing the revenue requirement.

Step 3: Identify any revenue requirement adjustment factors

B16 Once the allowable costs have been identified, the rate regulator determines what amount of revenue is allowable. The rate regulation provides a framework for this, which often requires the rate regulator to establish the revenue requirement at a level that provides the supplier with a 'fair and reasonable' profit or rate of return. What is considered fair and reasonable is a matter of judgement and is sometimes subject to negotiation between the supplier and the rate regulator. In some jurisdictions, the supplier can challenge the rate regulator's decision in the courts.

B17 There are a number of items for which the rate regulator adjusts the allowable cost base when establishing the revenue requirement. Some of these relate directly to the allowable costs identified. These adjustments may reflect, for example, different assumptions about cost movements, quantities and required quality. Other adjustments relate directly to the amount of the revenue requirement without there being a direct link to costs, for example, adjustments related to performance incentives.

B18 Some adjustments may be applied to amend prices during a regulatory period, particularly when that period is longer than one year. The amount and timing of the adjustments will be built into the rate regulation through a regulatory formula. Other adjustments may apply only when a formal rate review occurs and, therefore, only take effect during the next regulatory period. This allows the rate regulator to consider the impact of the adjustment on the overall position of the entity and the customers and, therefore, reflect it appropriately in the revenue requirement for the next regulatory period(s).

B19 The following summarise some of the more common adjustments:

(a) return on capital—regulated assets are funded through debt or equity or a combination of both. Defined rate regulation allows an entity to earn a return on the capital invested in such regulated assets in order to cover the cost of debt (interest costs), and to provide a profit for the holders of equity in the entity. In some regulatory agreements, the rate regulator uses an imputed cost of equity, on which the entity is entitled to earn a rate of return through the revenue requirement. Consequently, the terms 'profit' and 'cost of equity capital' may have different meanings for regulatory purposes and are reflected in different ways through the revenue requirement calculation. Regulatory agreements usually set the debt/equity ratio to be used in calculating the return on capital, which may apply the actual debt/equity ratio or may set a benchmark ratio.

Similarly, some regulatory agreements use the actual interest rate(s) on the entity's borrowings but others use a benchmark interest rate as a way to incentivise the entity to borrow efficiently.

(b) performance incentives—some regulatory agreements include incentives that are designed to encourage specific actions. These incentives cover a wide variety of actions. Some relate directly to the quantity or quality of the goods or services provided to customers, such as achieving customer satisfaction targets, reducing the number of power outages, or improving the punctuality of public transport services. Other incentives may relate only indirectly to the quantity or quality of the goods or services provided to customers, such as reducing greenhouse gas emissions or using a higher proportion of renewable energy sources. Achieving performance beyond targets set out in these incentive mechanisms may increase the revenue requirement or, alternatively, failing to achieve certain minimum targets may lead to a reduction in the revenue requirement.

(c) inflation adjustments—either general or specific inflation adjustments may be made to capital costs, operating costs or both when establishing the revenue requirement. In some regulatory agreements, an inflation adjustment may be made directly to the total amount of the revenue requirement.

(d) capacity adjustments—these adjustments reflect planned changes to the volume of rate-regulated goods or services that are expected to be delivered to customers. These planned changes may involve investment in regulated assets in order to satisfy expected increases in demand. Alternatively, it could involve retirement of regulated assets to eliminate excess capacity.

(e) trackers and flow-through accounts—in some regulatory agreements, the entity is allowed to recover, during the regulatory period, the actual cost of specified items, such as raw materials or fuel. These are typically classified as non-controllable costs. In order to minimise the difference in timing between incurring these costs and recovering them, the revenue requirement is adjusted at short intervals during the regulatory period for variations in the cost (and volume) of these items.

(f) contingent events—rate-regulated goods or services are considered to be 'essential' to customers and maintaining the supply is an important aspect of the regulatory agreement. Consequently, the revenue requirement commonly includes an adjustment to ensure that the entity is compensated for the costs of restoring the supply after an adverse event such as a storm, earthquake or flood. There are two general approaches identified for dealing with contingent events:

    (i) an ex-ante adjustment: the rate regulation anticipates the event happening by including an amount in the revenue requirement that relates to the future anticipated event. This builds up a reserve, for example, a storm damage reserve, that the entity can draw on when the storm occurs. There is then a further adjustment to the revenue requirement for the difference between the reserve balance and the allowable storm damage costs. If the anticipated event does not happen within a specified time, the revenue requirement is reduced in order to maintain or reduce the level of the reserve.

(ii) an ex-post adjustment: the revenue requirement does not include any amount related to possible future or anticipated events. Instead, the formula used to calculate the revenue requirement includes an adjustment factor that is triggered when the event occurs. Consequently, when the entity incurs the costs, for example, when the storm damage is repaired, the revenue requirement is increased in order to recover the allowable storm damage costs.

B20 The revenue requirement and the fixed price or rate per unit established for a regulatory period is necessarily based on estimated amounts. However, the actual revenue requirement that the entity is entitled to charge to customers is an adjustable amount, because it will reflect actual transactions and events, which may differ from the estimates used. Consequently, some differences arise between the revenue requirement and the actual amounts billed to the customers during the period. The rate to be charged in future periods is, therefore, adjusted to reverse these differences. As a result, the revenue requirement for the next regulatory period may include some deferrals and other differences that arose in earlier periods (see paragraphs B26–B27). The rate regulator determines whether these amounts will be adjusted to reflect the time value of money. Typically, the rate regulator also determines the interest rate to be applied.

Step 4: Calculate the revenue requirement

B21 At this stage, the total potential revenue requirement for the next regulatory period can be established. The potential revenue requirement is the amount of revenue that the entity is entitled to earn in exchange for performing the activities that it is obliged to perform in accordance with the regulatory agreement, based on an expected quantity of rate-regulated goods or services to be delivered.

B22 The volume of regulated goods or services expected to be delivered to customers during the regulatory period is estimated when identifying the amount of the variable allowable costs to be included in the revenue requirement. The total revenue requirement is divided by this estimated volume to identify the rate per unit that the entity needs to charge customers in order to recover the revenue requirement during the regulatory period.

B23 This potential rate per unit will then be assessed to identify whether it represents a rate that is considered acceptable in accordance with the objectives of the rate regulation. In defined rate regulation, the objective is to balance the interests of the customers with those of the entity. Consequently, if the potential rate per unit is considered to be too high for customers to afford in the regulatory period to which it relates, then the rate regulator needs to identify how to reduce the rate to an acceptable level, without jeopardising the financial viability of the entity.

B24 In some cases, the obligations of the entity could be reduced. For example, planned expenditure to upgrade the network in order to reduce emissions could be delayed. This would reduce the costs that the entity needs to incur and would result in a commensurate reduction in the revenue requirement to reflect the reduced obligations of the entity.

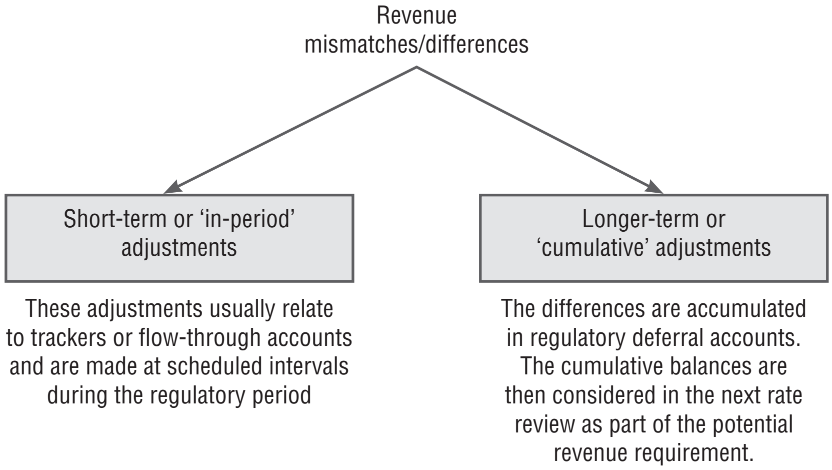
B25 Alternatively, the rate regulator could defer recovery of some of the revenue requirement until future regulatory periods. In such cases, the deferred amount is carried forward in a regulatory deferral account. The balance on the account is allocated to the revenue requirement in one or more future periods, usually on a straight-line basis. Commonly, the rate regulator compensates the entity for the time value of money in such cases.

Step 5: Establish how and when any under-recovery or over-recovery of the revenue requirement will be reversed

B26 The rate per unit is fixed during the regulatory period, based on the estimated revenue requirement. The amount of the estimated revenue requirement is, however, adjusted to reflect actual events and transactions. Consequently, a mismatch arises between the amount of billable revenue that is invoiced to customers during the regulatory period, which may incorporate one or more financial reporting periods, and the adjusted revenue requirement calculated for that period (see paragraph B20).

B27 In defined rate regulation, the entity is entitled and required to correct these revenue mismatches by adjusting the rate per unit that is charged to customers for future sales of the rate-regulated goods and services. The rate regulation establishes when the rate is changed and which future regulatory period or periods the mismatch is allocated to for inclusion as an adjustment to the revenue requirement.

B28 There are two broad approaches for the timing of rate adjustments dealing with revenue mismatches. Some rate-regulatory schemes use both approaches, depending on the source of the revenue mismatches.



B29 In-period adjustments usually relate to variable, non-controllable costs of production. They are commonly used for commodities, such as fuel costs, when the rate regulation is designed to allow the entity to pass on the input cost of the commodity to customers, often without a mark-up. The variances between the estimated input cost used to calculate the rate per unit charged to customers and the actual input cost per unit are recorded in regulatory deferral accounts (often called 'trackers' or 'flow-through accounts'). The rate per unit charged to customers is adjusted at short intervals, for example, three-monthly, throughout the regulatory period in order to pass on these variances to customers on a timely basis.

B30 Cumulative adjustments relate to other variances and timing differences or revenue mismatches. These may be smaller or less volatile than the variances captured in the in-period adjustments and, therefore, are suitable for correcting in the longer term. Alternatively, they may be very large variances, such as those caused by events such as a storm. In such cases, the rate regulator usually looks to spread the impact of these amounts on the rate in order to protect customers from 'price spikes' or significant short-term volatility. As a result, the mismatches are recorded through regulatory deferral accounts and used in the next rate review to establish the revenue requirement for the next regulatory period(s).

B31 In some rate-regulatory schemes, particularly those with multi-year regulatory periods, the rate regulation includes a rate review 'trigger' (sometimes called an 'off-ramp' clause). Such triggers are designed to ensure that if actual events or transactions deviate significantly from the estimates used to calculate the revenue requirement, a new rate-review is carried out earlier to correct for major revenue mismatches. The trigger may result in a rate review being started automatically in specified circumstances, or it can provide the supplier and/or the rate regulator with the right to have a rate review performed, again in specified circumstances.

Allocating the revenue requirement differences to regulatory periods

B32 The rate regulation often specifies the time period or periods over which cumulative differences between the revenue requirement and amounts billed to customers will be allocated to the revenue requirement. In many schemes, a 'corridor' approach is used to balance the interests of both customers and the entity and to provide greater certainty over timing issues. When a corridor approach is used, revenue mismatches follow different specified timetables for allocation and adjustment depending on whether they are inside or outside the corridor.

B33 In some cases, no adjustments are made to correct amounts that are inside the corridor. In such cases, these differences are effectively ignored for regulatory purposes. Consequently, they are unlikely to need specific accounting requirements, but instead would flow through profit or loss, unless they could be recognised as part of the cost of other assets in accordance with other Standards.

B34 The following simplified example demonstrates how a revenue mismatch is calculated and corrected. The assumptions used are as follows:

(a) the regulatory period lasts four years—from 20X3–20X6 inclusive. The latest rate review established that the revenue requirement for 20X3 is CU16,000 with an estimated sales level of 2,000 units.[30] Consequently, the rate per unit is fixed at CU8 per unit for the year.

(b) except for the quantity of units delivered to customers, all other estimates and assumptions used to calculate the revenue requirement for 20X3 were achieved and reflected in actual results.

(c) the rate per unit of CU8 includes an amount of CU3 that relates to variable costs. This means that any quantity shortfall relating to the variable amount flows through without any adjustment to the revenue requirement of future periods. The remaining CU5 relates to fixed amounts and the quantity variance related to this portion of the selling rate is recorded as a timing difference to be allocated to the revenue requirement of future periods. Consequently, the revenue timing mismatch that arises in Year 1 is calculated as the quantity shortfall multiplied by CU5 per unit.

(d) the rate regulation uses a corridor approach to allocate the revenue mismatch to the revenue requirement of future years as follows:

(i) mismatches that are less than +/- 5 per cent of the revenue requirement are carried forward to be included in the next rate review;

(ii) mismatches between +/- 5 per cent and less than 10 per cent of the revenue requirement are corrected on a straight-line basis over a two-year period beginning in Year t+2 (in which t is the year that the mismatch originated); and

30 In this Discussion Paper, currency amounts are denominated in 'currency units' (CU).

(iii) mismatches of 10 per cent or more trigger a new rate review to establish when the amount will be corrected through a revised regulated rate per unit.

Mismatch arising 20X3 (ie the first year of the four-year regulatory period)	Case A	Case B	Case C
Estimated sales quantity	2,000	2,000	2,000
'Fixed' element of the regulated rate per unit	CU5	CU5	CU5
'Fixed' element of the revenue requirement (based on quantity of 2,000 units)	CU10,000	CU10,000	CU10,000
Actual quantity delivered	1,950 units	2,150 units	1,750 units
Revenue mismatch, ie (under-)/over-recovery	(CU250)	(CU750)	(CU1,250)
Percentage (under-)/over-recovery	(2.5)%	7.5%	(12.5)%

B35 In this example, we consider three alternative outcomes to demonstrate how the timing mismatch is corrected in accordance with the corridor approach set out in the rate regulation:

Case A: the entity has under-recovered CU250, or 2.5 per cent of the revenue requirement. This amount is recorded in a regulatory deferral account to carry forward to the next rate review. There is no adjustment to the revenue requirement for the remainder of the regulatory period 20X3–20X6.

Case B: the entity has over-recovered CU750, or 7.5 per cent of the revenue requirement. This amount is allocated on a straight-line basis to the revenue requirement for the two-year period beginning in Year t+2. The mismatch occurred in 20X3, which is Year t+0. The revenue requirement calculated for each of the years 20X5 (Year t+2) and 20X6 (Year t+3) is reduced by CU375 (CU750 ÷ 2), which reduces the regulated rate per unit to be charged in those years.

Case C: the entity has under-recovered CU1,250, or 12.5 per cent of the revenue requirement. There is an off-ramp or rate review clause in the rate regulation that is triggered by this mismatch. Consequently, a new rate review will be performed during 20X4 in order to establish the revenue requirement and the regulated rate per unit to be applied for a new regulatory period, which covers the four-year period from 20X5–20X8.