

STAFF PAPER

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Project	Rate-regulated Activities		
Paper topic	The regulatory agreement period		
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Purpose of this paper

1. The purpose of this paper is to analyse how the accounting model for regulatory assets and regulatory liabilities (the model) would be applied if the term of the regulatory agreement is, may be, shorter than the period over which timing differences would reverse.
2. The paper provides analysis as to how the model's principles would be applied in such scenarios but does not contain any recommendations or ask the Board to make any decisions.

Structure of this paper

3. This paper is structured as follows:
 - (a) Background (paragraphs 4-10);
 - (b) Analysis in respect of:
 - (i) The Conceptual Framework for Financial Reporting (paragraphs 11-19);
 - (ii) Precedents in other IFRS Standards[®] (paragraphs 20-31);

- (c) Application of the model’s principles (paragraphs 32-35);
- (d) Illustrative examples of application of the model’s principles (paragraphs 36-37);
- (e) Disclosure considerations (paragraph 38); and
- (f) Interaction with IFRIC 12 *Service Concession Arrangements* (paragraphs 39-42).

Background

4. Regulatory agreements may take a variety of forms. The Board is developing a model to be applied by entities that are subject to **defined rate regulation**.
5. Defined rate regulation has been defined in this project as regulation established through a formal regulatory framework that:
 - (a) is **binding** on both the entity and the regulator; and
 - (b) establishes a **basis for setting the rate** that gives rise to rights to add amounts to, and obligations to deduct amounts from, future rate(s) because of goods or services already supplied or because of amounts already charged to customers. That basis gives rise to those rights and obligations by determining when (ie in which periods) the total allowed compensation for specified goods or services supplied is included in the rate(s) charged to customers.
6. The need for the regulatory framework to be *binding on both the entity and the regulator* has not been explored in further detail since the Board’s tentative decisions on the scope of the model in March 2018.
7. However, during recent meetings, Board members have asked how an entity should apply the model to situations where the regulatory agreement is set to expire and must be renewed, or to situations where the regulatory agreement can be terminated by one party giving notice to the other. Specifically, Board members have questioned whether, and if so how, an entity should account for regulatory assets that would be recovered (or regulatory liabilities that would be fulfilled) through the rates charged to customers over a period beyond the current term of the agreement.

8. This paper will explore these questions in detail. The staff will consider in drafting whether to provide application guidance for applying the model in these cases.

2013 Request for Information

9. In 2013 the IASB issued a Request for Information (RFI) as an early step in the rate-regulated activities research project. Responses to the RFI provided a number of insights as to the typical forms of regulation and regulatory agreements.
10. Some of the salient points from these responses for the topic at hand included the following¹ (emphasis added):
- 28. Typically, entities that are subject to rate regulation have a monopoly or near monopoly right to operate in a pre-determined geographical service territory. The monopoly right may be:
 - (a) explicit - for example, the right may be defined by an exclusive licence agreement with the rate regulatory or other licensing body, or through a service concession arrangement (which may or may not be within the scope of IFRIC 12 Service Concession Arrangements) [...] or through legislation/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).
 - 29. [...] The length of time that the explicit right is granted for varies widely. It is typically granted for a medium- or long-term period (for example, five to 30 years). Renewal is sometimes open to competition but is more typically automatic, as long as the entity can demonstrate compliance with the terms of the licence.
 - 33. The consensus of respondents is 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. In most cases, this inability to cease operations is explicit in the

¹ Quoted from the [Request for information response summary](#) presented to the Board in July 2013.

licence, rate regulation or legislation. Where there is no explicit obligation to continue to operate, the common understanding is that there is an implicit obligation and the rate regulator or other government controlled body would step-in to ensure continuity of supply if necessary.

Analysis

The Conceptual Framework for Financial Reporting

11. The *Conceptual Framework for Financial Reporting (Conceptual Framework)* provides guidance and examples which are pertinent to the issue at hand. A selection of the most relevant guidance from the *Conceptual Framework* has been extracted below and has been analysed and applied in the table at the end of this section. Throughout this section, emphasis had been added to quoted text with an underline where appropriate. Circled numbers have been added to indicate particular wording from the *Conceptual Framework* that then forms a basis for some of the further analysis provided in paragraph 19.
12. The *Conceptual Framework* defines an asset as ‘a present economic resource controlled by the entity as a result of past events.’ An economic resource ‘is a right that has the potential to produce economic benefits.’² In contrast, a liability is ‘a present obligation of the entity to transfer an economic resource as a result of past events.’³
13. Regarding the definition of an asset, paragraph 4.7 of the *Conceptual Framework* states that:

Many rights are established by contract, legislation or similar means ① [...] however, an entity might also obtain rights in other ways, for example: [...] through an obligation of another party that arises because that other party has no practical ability to act in a manner inconsistent with its customary practices, published policies or specific statements [...] ②
14. Similarly, paragraphs 4.31-4.34 state that for a liability:

² Paragraphs 4.3-4.4 of the *Conceptual Framework for Financial Reporting (Conceptual Framework)*

³ Paragraph 4.26 of the *Conceptual Framework*

Many obligations are established by contract, legislation or similar means and are legally enforceable by the party (or parties) to whom they are owed. ❶ Obligations can also arise, however, from an entity’s customary practices, published policies or specific statements if the entity has no practical ability to act in a manner inconsistent with those practices, policies or statements. The obligation that arises in such situations is sometimes referred to as a ‘constructive obligation’. ❸

In some situations, an entity’s duty or responsibility to transfer an economic resource is conditional on a particular future action that the entity itself may take. Such actions could include operating a particular business or operating in a particular market on a specified future date, or exercising particular options within a contract. In such situations, the entity has an obligation if it has no practical ability to avoid taking that action.

A conclusion that it is appropriate to prepare an entity’s financial statements on a going concern basis also implies a conclusion that the entity has no practical ability to avoid a transfer that could be avoided only by liquidating the entity or by ceasing to trade. ❸

The factors used to assess whether an entity has the practical ability to avoid transferring an economic resource may depend on the nature of the entity’s duty or responsibility. For example, in some cases, an entity may have no practical ability to avoid a transfer if any action that it could take to avoid the transfer would have economic consequences significantly more adverse than the transfer itself. ❸

However, neither an intention to make a transfer, nor a high likelihood of a transfer, is sufficient reason for concluding that the entity has no practical ability to avoid a transfer. ❹

15. In respect of the existence of a right, paragraph 4.13 states that:

In some cases, it is uncertain whether a right exists. For example, an entity and another party might dispute whether the entity has a right to receive an economic resource from that other party. Until that existence uncertainty is resolved—for example, by a court ruling—it is uncertain whether the entity has a right and, consequently, whether an asset exists [...] ❺

16. Likewise, for a liability, paragraph 4.35 states:

In some cases, it is uncertain whether an obligation exists. For example, if another party is seeking compensation for an entity’s alleged act of wrongdoing, it might be

uncertain whether the act occurred, whether the entity committed it or how the law applies. Until that existence uncertainty is resolved—for example, by a court ruling—it is uncertain whether the entity has an obligation to the party seeking compensation and, consequently, whether a liability exists [...] ⑤

17. In respect of the obligation to transfer an economic resource inherent in the definition of a liability, paragraph 4.37 of the *Conceptual Framework* states:

To satisfy this criterion, the obligation must have the potential to require the entity to transfer an economic resource to another party (or parties). For that potential to exist, it does not need to be certain, or even likely, that the entity will be required to transfer an economic resource—the transfer may, for example, be required only if a specified uncertain future event occurs. It is only necessary that the obligation already exists and that, in at least one circumstance, it would require the entity to transfer an economic resource. ⑥

18. The *Conceptual Framework* also contains guidance on the substance of contractual rights and obligations. Paragraphs 4.59-4.61 indicate:

The terms of a contract create rights and obligations for an entity that is a party to that contract. To represent those rights and obligations faithfully, financial statements report their substance [...]. In some cases, the substance of the rights and obligations is clear from the legal form of the contract. [...]

All terms in a contract—whether explicit or implicit—are considered unless they have no substance. Implicit terms could include, for example, obligations imposed by statute [...]. Terms that have no substance are disregarded. A term has no substance if it has no discernible effect on the economics of the contract. Terms that have no substance could include, for example: terms that bind neither party; or rights, including options, that the holder will not have the practical ability to exercise in any circumstances. ④

19. In situations where the regulatory agreement is set to expire and must be renewed in the near term, or the regulatory agreement can be terminated by one party giving notice, the staff consider that these principles from the *Conceptual Framework* would help determine whether the regulated entity has a present, enforceable right or obligation and thus whether it should recognise a regulatory asset or regulatory liability. Specifically:

1	<p>Rights and obligations are most commonly established by legally enforceable contracts.</p> <p>However, in some circumstances the right to add an amount to the rates charged to customers in the period beyond the current term of the regulatory agreement (or within the current term of an agreement with a cancellation option) may also arise if the regulator (or the entity) has no practical ability to act in a manner inconsistent with its customary practices or statements.</p>
2	<p>This could be the case for instance where the regulator can cancel the regulatory agreement but has no practical ability to exercise such a cancellation option because this would cause the regulator to breach legislation, customary practices, or specific statements it has made. For example, if the regulator is bound by legislation, or has publicly committed, to the provision of stable and affordable supply of an essential good or service to the local population, and the exercise of the cancellation option would violate this aim (eg because securing an alternate supplier of the regulated good or service without significant cost or disruption would not be possible), then an entity may conclude that the cancellation option is not substantive.</p>
3	<p>Likewise, an entity may not have a practical ability to avoid the fulfilment of a regulatory liability, if any action that it could take to avoid the fulfilment would have economic consequences significantly more adverse than the fulfilment itself—for example, if doing so would mean it would have to abandon the regulatory agreement and liquidate the business or cease trading.</p>
4	<p>In either situation 2 or 3, an entity may conclude that the cancellation terms of the agreement have no substance and should be disregarded—resulting in the conclusion that the regulatory agreement is binding despite the presence of such a cancellation option.</p>

<p>5</p>	<p>There may also be uncertainty about whether the entity and/or the regulator can enforce a right to terminate the regulatory agreement, whether they have the practical ability to exercise that right, the period of notice that must be given, or other factors—ie, there may be uncertainty about whether such terms are substantive. In these situations, it may be uncertain whether the regulatory agreement conveys <i>enforceable</i> rights or obligations beyond the first possible termination date, and thus whether a regulatory asset or liability exists. In some cases, this uncertainty may only be resolved subsequently, for example by subsequent court ruling or arbitration.</p> <p>In such a situation, the entity would look to the recognition principles of the model, which address existence uncertainty and indicate that an entity should recognise a regulatory asset or regulatory liability if it is ‘more likely than not’ that they exist.</p>
<p>6</p>	<p>Finally, an entity must analyse the specific facts and circumstances of its situation to determine whether the terms of the regulatory agreement are substantive and thus result in enforceable rights or obligations. In reaching this conclusion, it will generally not be appropriate to merely consider on its own the <i>likelihood</i> that a term or clause in the agreement will be exercised by, for example, considering past practice.</p> <p>For example, an entity may have a regulatory liability that it would be required to fulfil only if the regulator exercises a renewal option. The renewal option results in the <i>potential</i> to require the entity to transfer an economic resource (assuming the entity does not have the right to prevent the regulator from exercising that option). It does not need to be certain, or even likely, that the entity will ultimately be <i>required</i> to transfer an economic resource—it is only necessary that the obligation already exists and that, in at least one circumstance, it would require the entity to transfer an economic resource. Thus, if the renewal option is substantive, it does not matter whether the regulator is likely to exercise the renewal option—the entity has no practical ability to avoid fulfilling the regulatory liability.</p>

Precedents in other IFRS Standards ®

20. The concepts in the *Conceptual Framework* explored above are integrated throughout other IFRS Standards. In preparing our analysis, staff also considered other standards that address similar situations with contract renewals—the results of this research are presented below:

IFRS 17 Insurance Contracts

21. IFRS 17 expresses the above concepts in its definition of a contract and discussion of the ‘contract boundary’.
22. Paragraph 2 of that standard provides the definition of an insurance contract and indicates that, in applying IFRS 17, an entity ‘shall consider its substantive rights and obligations, whether they arise from a contract, law or regulation.’
23. Paragraphs 34-35 of IFRS 17 states that (emphasis added):
- Cash flows are within the boundary of an insurance contract if they arise from substantive rights and obligations that exist during the reporting period in which the entity can compel the policyholder to pay the premiums or in which the entity has a substantive obligation to provide the policyholder with services [...] An entity shall not recognise as a liability or as an asset any amounts relating to expected premiums or expected claims outside the boundary of the insurance contract. Such amounts relate to future insurance contracts.
24. Paragraphs B62-63 of IFRS 17 discuss the application of this concept in greater detail, stating (emphasis added):
- Many insurance contracts have features that enable policyholders to take actions that change the amount, timing, nature or uncertainty of the amounts they will receive. Such features include renewal options, surrender options, conversion options and options to stop paying premiums while still receiving benefits under the contracts. The measurement of a group of insurance contracts shall reflect, on an expected value basis, the entity’s current estimates of how the policyholders in the group will exercise the options available, and the risk adjustment for non-financial risk shall reflect the entity’s current estimates of how the actual behaviour of the policyholders

may differ from the expected behaviour [...] When an issuer of an insurance contract is required by the contract to renew or otherwise continue the contract, it shall apply paragraph 34 to assess whether premiums and related cash flows that arise from the renewed contract are within the boundary of the original contract.

25. Paragraph B64 of the standard discusses the need for the entity to have a ‘practical ability’ to set a price at a renewal date that fully reflects the risks in the contract in order for it to conclude that the *substantive obligation to provide the policyholder with services* has ceased. This is aligned with the discussion of the practical abilities of the entity or the regulator in the table in paragraph 19.
26. Finally, the Exposure Draft *Amendments to IFRS 17*, published for comment in June 2019, would permit an entity to allocate a portion of insurance acquisition cash flows recognised as an asset to insurance contracts that *are expected to result from renewal* of the insurance contracts in the initial group.

IFRS 16 Leases

27. IFRS 16 indicates that an entity includes any period covered by an extension option in determining the lease term if it is *reasonably certain* to exercise that option. In assessing whether it is reasonably certain to do so, an entity considers all relevant facts and circumstances that create an *economic incentive* for the lessee to exercise, or not to exercise, the option, including any expected changes in facts and circumstances from the commencement date until the exercise date of the option.
28. A series of factors for entities to consider in making this determination are provided in paragraphs B37-B40 of the Application Guidance to IFRS 16.

IAS 38 Intangible Assets

29. Paragraph 94 of IAS 38 states:

[...] If the contractual or other legal rights are conveyed for a limited term that can be renewed, the useful life of the intangible asset shall include the renewal period(s) only if there is evidence to support renewal by the entity without significant cost [...]
30. Paragraph 96 of IAS 38 goes on to illustrate some factors for entities to consider in making this determination.

IFRS 15 Revenue from Contracts with Customers

31. IFRS 15 provides two pertinent examples:
- (a) costs to fulfil a contract—paragraph 95 of IFRS 15 permits entities to recognise an asset for costs incurred to fulfil a contract even where those costs only relate in whole or in part to an *anticipated contract* that the entity can specifically identify (for example, costs related to services to be provided under renewal of an existing contract); and
 - (b) allocation of the transaction price—the standard also provides a practical alternative for entities to view a contract with renewal options as a contract for its expected term (ie including the expected renewal periods) rather than as a contract with a series of options each with a stand-alone selling price that is required to be estimated separately.⁴

Application of the model’s principles

32. In summary, in applying the model, an entity would need to consider not only the legal form, but also the economic substance of the terms of the regulatory agreement, in determining the period for which the agreement is binding and thus gives rise to enforceable rights or obligations which would result in the recognition of regulatory assets or regulatory liabilities (the ‘**regulatory agreement boundary**’).
33. If items are due to be recovered or fulfilled outside of the regulatory agreement boundary, then they are **not enforceable** and thus **would not be recognised** as regulatory assets or regulatory liabilities.
34. In determining the regulatory agreement boundary, an entity would consider factors such as:
- (a) the existing term of the regulatory agreement;
 - (b) the presence of any renewal or cancellation options;
 - (c) clarity and ease with which the process for invoking the renewal or cancellation options could be exercised;

⁴ Paragraphs BC391-395 of the Basis for Conclusions on IFRS 15 *Revenue from Contracts with Customers*

- (d) penalties or make-whole clauses payable upon exercise of a cancellation option; and
 - (e) other facts and circumstances specific to the arrangement which could impact the analysis (eg the presence of competition to provide the regulated goods or services and barriers to entry or exit).
35. If an entity concludes that the supply of goods or services in the current period or a past period may ultimately lead to an adjustment to the regulated rate in a future period beyond the boundary of the regulatory agreement, no regulatory asset or regulatory liability exists. The entity would then apply IAS 37 *Provisions, Contingent Liabilities and Contingent Assets* to determine whether any contingent asset or contingent liability exists, and if so, how to account for it. The staff will consider in drafting whether any guidance is needed on this point.

Illustrative examples of application of the model's principles

36. The following illustrative examples help to illustrate how the model's principles would be applied in practice.
37. Assume the following fact pattern which is common to all scenarios below:

Entity A supplies electricity transmission services to a municipality under a regulatory agreement with Regulator B. A significant storm occurs in year X after which Entity A incurs costs to restore service and repair damaged infrastructure. The regulatory agreement typically permits recovery of such costs in the years (X+3) through (X+5) after they have been incurred, in order to avoid short-term rate shocks for customers.

Scenario 1
<p><i>Fact pattern</i></p> <p>The regulatory agreement is due for renewal at the end of year X+2. The entity has been successful in renewing the agreement many times in the past. Renewal would result in Entity A continuing to provide the regulated services for a further ten year period. Although the regulator could select another operator, doing so at this point (ie with only two years until the renewal date) would leave insufficient time to complete the replacement without a critical interruption to supply.</p>

Application of principles to fact pattern:

The regulatory agreement must be renewed in order for Entity A to continue as the supplier of the regulated services after X+2. However, the facts and circumstances surrounding the renewal, coupled with the entity's success in obtaining renewals in past, lead the entity to conclude that the option for the regulator to select another supplier is not substantive and should be disregarded. This leads to the conclusion that the regulatory agreement boundary is beyond the renewal date and that it has an enforceable right to recover the storm damage costs—thus, it recognises a regulatory asset in accordance with the model's recognition and measurement principles.

Scenario 2*Fact pattern*

The regulatory agreement continues indefinitely but can be cancelled by either party at any time. However, neither party has the practical ability to exercise the cancellation option as the entity relies solely on this operation to continue as a going concern, and the costs and disruption associated with finding an alternate supplier mean that the regulator has no practical ability to exercise the option before X+5 (given the significant level of capital investment required and physical constraints that apply to putting the necessary infrastructure in place).

Application of principles to fact pattern:

Entity A concludes, on the basis of the facts and circumstances, that the cancellation option is not substantive and should be disregarded. This leads to the conclusion that the regulatory agreement boundary is not impacted by this option. Accordingly, the entity concludes that it has an enforceable right to recover the storm damage costs and recognises a regulatory asset in accordance with the model's recognition and measurement principles.

Scenario 3*Fact pattern*

The regulatory agreement continues indefinitely but can be cancelled by either party by giving two years' notice to the other party; however, there is uncertainty about how the notice process would operate and the mechanism for termination and resulting transitional provisions.

Application of principles to fact pattern:

In this case there is uncertainty regarding the notice process and resulting termination provisions. This uncertainty gives rise to a lack of clarity as to whether this term of the regulatory agreement is substantive and thus exactly where the regulatory agreement boundary lies. In such situations, it is uncertain whether Entity A has enforceable rights or obligations extending beyond the two year notice period (ie whether the rights or obligations beyond that period *exist*). Accordingly, the entity would look to the recognition principles of the model, which address instances of existence uncertainty and indicate that an entity should recognise a regulatory asset or regulatory liability if it is 'more likely than not' that the regulatory asset or regulatory liability exists. If Entity A concludes it is 'more likely than not' that the cancellation option is not substantive, then it would recognise a regulatory asset for the recovery of the storm repair costs in years X+3 through X+5.

Scenario 4*Fact pattern*

The regulatory agreement continues indefinitely but can be cancelled at the option of the regulator if Entity A fails to provide a high quality of service. The regulator would be required to provide one year's notice to Entity A and no compensation would be provided for unrecovered regulatory assets or regulatory liabilities. There is a high degree of competition for the provision of the regulated services such that the regulator could easily award the regulatory agreement to a competitor of Entity A.

Application of principles to fact pattern:

In this case, Entity A concludes that the regulator's cancellation option is substantive and therefore that the regulatory agreement boundary exists at the end of the notice period (ie X+1). Accordingly, Entity A determines that it does not have an enforceable right to recover the storm damage costs and thus it does not recognise a regulatory asset. The entity considers disclosing this fact if that information is material.

Scenario 5*Fact pattern*

The regulatory agreement continues indefinitely but can be cancelled by the regulator by providing two years' notice if Entity A fails to provide a baseline level of service. If exercised, the terms of the regulatory agreement require Entity A to be 'made whole' for any amounts unrecovered at the date of the cancellation.

Application of principles to fact pattern:

Entity A will need to consider the specific facts and circumstances of the situation. Given the 'make whole' provision, Entity A would recognise a regulatory asset and measure it by estimating all the cash flows that would result either from subsequent inclusion in rates charged to customers or from cash 'make whole' payments from the regulator. Unless there is a material difference between the cash flows that would result from those two methods of recovery, Entity A would not need to consider the probability of the regulator exercising the cancellation option. If a material difference would result between the cash flows from those two methods of recovery, the entity would apply either the 'expected value' method or the 'most likely amount' method in estimating the future cash flows.

If the regulator exercises the option, this will change the regulatory agreement boundary—at such point any amounts to be received beyond the regulatory agreement boundary (as a cash 'make whole' payment rather than through the rates charged to customers) would be recognised as a receivable (with a corresponding

derecognition of the regulatory asset following an update to the estimated cash flows to exclude amounts beyond the regulatory agreement boundary).

Disclosure considerations

38. In order to meet the general disclosure objectives of the model, which were set out in [Agenda Paper 9D presented to the Board in November 2018](#), an entity would need to consider disclosing:
- (a) any significant judgments which were necessary in determining the regulatory agreement boundary and thus in determining whether enforceable rights or obligations exist; and
 - (b) amounts which may be added to or deducted from the future rates charged to customers **but have not been recognised** as regulatory assets or regulatory liabilities because the addition or deduction would occur beyond the regulatory agreement boundary.

Interaction with IFRIC 12 *Service Concession Arrangements*

39. Lastly, staff also considered entities which may be subject to both a service concession arrangement within the scope of IFRIC 12 *Service Concession Arrangements* and to defined rate regulation.
40. Unlike most entities subject to defined rate regulation, those also subject to a service concession arrangement are party to an agreement which generally has an explicit duration and where control of any significant residual interest in the related infrastructure at the end of the concession term is maintained by the grantor. Therefore, the issues contemplated in this paper regarding contract renewals may be encountered more frequently by such entities than by other entities with rate-regulated activities that are not party to service concession arrangements.
41. An entity subject to a service concession arrangement may also be within the scope of the accounting model for regulatory assets and regulated liabilities if the arrangement

regulates the rates that the entity can charge for it to recover its investment in the associated infrastructure in a manner consistent with the scope requirements set out in paragraph 5(b). In such a situation, an entity first applies IFRIC 12 without modification and then applies the accounting model for regulatory assets and regulatory liabilities (consistent with the model being a *supplementary* model).

42. An entity in such a situation would assess the terms of the regulatory agreement in accordance with the guidance set out in this paper to determine the boundary of the arrangement and the impact on its enforceable rights and obligations.

Question for the Board

The regulatory agreement period

1. Does the Board have any comments on the staff's analysis as set out in this paper?