STAFF PAPER

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World Standard-setters Meeting

Project	**Rate-Regulated Activities**
Paper topic	**Common features of rate regulation**

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Purpose of the paper

1. The purpose of this paper is to support discussion at the World Standard-setters meeting about what rights and obligations are established by the common features of rate regulation. These features have been identified through the responses to the IASB's Request for Information *Rate Regulation*, published in March 2013.

Background

2. In October 2012, the IASB decided to restart a project on Rate-regulated Activities. The initial aim of the project is to develop a Discussion Paper (the planned DP) in order to provide the opportunity for a broader debate on the circumstances in which rate regulation can (or should) result in the recognition of assets and liabilities, as defined in the IFRS *Conceptual Framework for Financial Reporting* (the *Conceptual Framework*).[1]

3. The IASB's previous Rate-regulated Activities project resulted in the publication, in July 2009, of the Exposure Draft *Rate-regulated Activities* (the 2009 ED). The 2009 ED proposed that regulatory balances derived from a specific type of rate regulation (cost-of-service regulation) should be recognised as assets and liabilities in IFRS financial statements. However, the project was suspended in

[1] The existing definitions of assets and liabilities and other guidance in the *Conceptual Framework* may be subject to revision, as proposed in the Discussion Paper *A Review of the Conceptual Framework for Financial Reporting*, published in July 2013 (the *Conceptual Framework* DP).

September 2010 and, consequently, the proposals in the 2009 were not finalised because:

(a) respondents to the ED and the members of the IASB at that time, expressed very strongly-held but divergent views about the proposals; and

(b) the IASB could not, in the time available, find a way to resolve those divergent views.

4. The vast majority of the responses to the 2009 ED received from entities in the utilities industry and from North American respondents agreed with the proposals to recognise ‘regulatory balances’ as assets and liabilities. The responses received from non-utilities industry respondents and from the rest of the world were split, with approximately half agreeing with the proposals and the other half disagreeing.[2]

What’s changed since the previous project was suspended

5. Since September 2010, there have been two significant developments:

(a) in March 2013, the IASB issued the Request for Information *Rate Regulation* (the RfI). We have been able to use the information gathered in response to that RfI to understand more clearly the common features of rate regulation; and

(b) since September 2010, the IASB has debated numerous conceptual issues in a variety of projects. The discussions have contributed to the IASB’s current understanding of the *Conceptual Framework*, which has informed the contents of the Discussion Paper *A Review of the Conceptual Framework for Financial Reporting* (the *Conceptual Framework* DP).

6. In developing the planned DP on rate-regulated activities, the IASB will investigate what rights and obligations are established by the common features of rate regulation. This will then form the basis of discussions as to whether those rights and obligations should result in the recognition of assets and liabilities in accordance with the *Conceptual Framework*.

[2] See Appendices C-E to IASB Agenda Paper 7: *Summary comment letter analysis*, February 2010 for details

Common features of rate regulation

7. The following common features of rate regulation are those that the IASB staff consider are most likely to distinguish rate-regulated activities from general commercial activities and have the biggest impact on the amounts, timing and certainty of cash flows and ‘regulated earnings’. The features described in this paragraph are simplified to aid this discussion but are not unrealistic:

   (a) there must be a ‘rate regulator’, whose role and authority is established in legislation or other formal regulations;

   (b) the rate regulator must establish rates both in the interests of the customers and to ensure the overall financial viability of the rate-regulated entity, which both grants rights and imposes obligations on the entity;

   (c) the rate regulation gives the entity an exclusive or near-exclusive right (either in the form of a licence or some other regulatory action) to supply the rate-regulated good or service (eg electricity) to customers in the market, and competition is restricted;

   (d) the rate-regulated good or service is considered ‘essential’ or near essential, resulting in relatively inelastic and, consequently, very predictable demand because customers have little or no choice but to buy the good or service from the entity;

   (e) the rate regulator imposes obligations on the supplier:

      (i) to control the prices charged; and

      (ii) to protect the quality and availability of the supply of the essential goods and services;

   (f) the entity cannot withdraw from the market and must supply the essential good or service in accordance with current terms and conditions of the rate-regulatory framework;

   (g) the rate regulator may have the ability, perhaps only in limited circumstances, to transfer the exclusive right to operate to another entity, or the entity may, with the prior approval of the rate regulator, transfer its exclusive right to operate to another entity. In either situation, the same rights and obligations transfer to the incoming entity;

(h) the rate regulation requires that the mechanism for setting the future rate charged to customers reflects an 'automatic' adjustment to the rate if the revenue billed to customers is lower than, or in excess of, the amount permitted by the rate regulation;

(i) the formula for setting the rate comprises of at least two distinct and identifiable components:

   (i) an amount based on the 'allowed' costs for the period, permitted margin and the predicted sales volumes for the next 'regulatory period' (this is the price (or rate) for the goods/services supplied during the future period until the rate is next reset); and

   (ii) the adjustment made to the rate for amounts based on past performance (including variances from expected costs, permitted revenues and any bonuses/penalties for meeting or failing to meet incentive targets);

(j) the rate regulation does not permit the rate regulator to disallow or otherwise amend the amount of the adjustment that is based on past performance, as long as the entity has complied with the requirements of the rate regulation. However, the rate regulator may have some flexibility to determine the time period over which the adjustment applies and whether interest is earned/charged on the remaining balance.

Appendix: Definitions of assets and liabilities

For convenience, the existing and proposed *Conceptual Framework* definitions[3] of assets and liabilities are reproduced below:

	Existing definitions	Proposed definition
Asset (of an entity)	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 present economic resource controlled by the entity as a result of past events.
Liability (of an entity)	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.	a present obligation of the entity to transfer an economic resource as a result of past events.
Economic resource	[no existing definition]	a right, or other source of value, that is capable of producing economic benefits.
Control	[no existing definition]	An entity controls an economic resource if it has the present ability to direct the use of the economic resource so as to obtain the economic benefits that flow from it.

[3] The table of definitions is contained in paragraph 2.11 of the *Conceptual Framework* DP (except for 'control', which is defined in DP paragraph 3.23)