Tuesday 24 September 2013
The Grange City Hotel (London)

Meeting documentation

World Standard-setters Meeting

Smaller group discussions: Rate regulated activities

IFRS™

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Smaller group discussion
Rate regulated activities

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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*.

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[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)

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International Financial Reporting Standards

Rate-regulated Activities

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The views expressed in this presentation are those of the presenter, not necessarily those of the IASB or IFRS Foundation.

Agenda

- Background
- The previous IASB Rate-regulated Activities project
- The new IASB Rate-regulated Activities project
  - Overview
  - Interim proposals - ED *Regulatory Deferral Accounts*
  - Main project – Discussion Paper
    - Request for Information: *Rate Regulation*
    - Common features of rate regulation
- Project timeline and next steps
- Q&A

Rate-regulated Activities - Background (1)

- Rate regulation is a restriction in the setting of prices that can be charged to customers for (usually essential) goods or services
- Objectives of the rate regulator usually involve
  - setting 'just and reasonable rates' for consumers;
  - ensuring the financial viability of suppliers; and
  - protecting the availability and stability of supply
- Rate regulation usually requires suppliers to increase the selling price (rate) to recover 'allowable revenue', or lower the rate to eliminate 'excess' revenue
- Rate changes usually apply prospectively and are often designed to 'smooth' the impact of rate changes for customers over time

Rate-regulated Activities - Background (2)

Some national GAAPs permit or require regulatory balances to be recognised in financial statements – either as separate '**regulatory assets**' or '**regulatory liabilities**', or as part of another asset or liability balance (eg part of the cost of property, plant and equipment)

Regulatory debit balances represent deferred 'allowable' costs/revenue (the rate regulation gives the entity the right to increase future rates)

Regulatory credit balances generally represent deferred 'excess' profits/revenue (the rate regulation requires the entity to reduce future rates)

No specific guidance in IFRS

Requests for guidance

Historically, calls came from Europe for guidance

- Desire to use US GAAP to recognise regulatory balances
- IFRS Interpretations Committee decided US guidance was not fully consistent with IFRS *Conceptual Framework* and other Standards
- Predominant practice = regulatory balances not recognised in IFRS financial statements

Later, more calls came for clear guidance and greater convergence with US GAAP

- Project added to IASB Agenda in Dec 2008
- Exposure Draft *Rate-regulated Activities* published in July 2009 (the 2009 ED)

Earlier Rate-regulated Activities project

- 2009 ED proposed that regulatory balances should be recognised as assets and liabilities for certain (cost-of-service) types of rate regulation
  - Reponses split evenly between:
    - Support in principle for recognition (mainly from the utilities industry) but disagreement with the scope and measurement proposals
    - Opposition in principle from others (on the grounds that regulatory balances do not meet the IFRS definitions of assets/liabilities)
- IASB could not reach consensus on fundamental issues so suspended the project in September 2010
- Responses to 2011 Agenda Consultation recommended restarting the project to try to find a solution

The new Rate-regulated Activities project

IASB started renewed Rate-regulated Activities project in September 2012

2 distinct paths

Short-term interim solution (Exposure Draft (ED) *Regulatory Deferral Accounts* published in April 2013 – deadline for comment 4 September 2013)

Longer-term comprehensive project (starting with a research phase to develop a Discussion Paper (DP))

Interim solution: ED Regulatory Deferral Accounts

Interim solution proposes:

- to permit first-time adopters of IFRS to continue to recognise regulatory balances in accordance with their existing local GAAP (recognition and measurement)
- to require the impact of recognising regulatory balances to be isolated in order to allow direct comparison with rate-regulated entities that do not recognise regulatory balances (presentation and disclosure)

How will the proposals affect IFRS financial statements (1)

No impact on existing IFRS financial statements

No impact on cash flows

Isolated impact of recognising regulatory balances in the financial statements:

2 line items in the balance sheet:
- Regulatory debit balances – after total assets
- Regulatory credit balances – after total liabilities

1 line item in profit or loss – after profit before tax

How will the proposals affect IFRS financial statements (2)

If finalised, the Standard will lower a significant barrier to the adoption of IFRS for many entities

- will allow users to compare a greater number of rate-regulated entities across a wider range of countries
- limited scope (only first-time adopters that already recognise regulatory balances) will introduce some inconsistency in IFRS financial statements

Isolation of regulatory balances should improve comparability:

- should improve transparency of reported regulatory impact
  - regulatory amounts will no longer be incorporated within other line items in balance sheet or income statement
  - all other line items presented in accordance with IFRS

Rate-regulated Activities DP

More research is needed on the nature of different types of rate regulation

- Request for Information-*Rate Regulation* (issued in March 2013 – deadline for responses 30 May 2013)

Responses will feed into the DP:

- what information about the effects of rate regulation are most useful to users
- does rate regulation create assets/liabilities (link to restarted Conceptual Framework project)

Request for Information Rate Regulation

- Fact-finding document
  – What are the main objectives of rate regulation?
  – How does the rate-setting mechanism reflect these objectives?
  – What rights and obligations are created?
  – How are rights enforced and obligations settled?
- 79 responses, providing information from 37 countries and 8 broad industry types

What goods/services are rate regulated?

- Energy – Electricity, Gas, Oil/petroleum, Heating (generation/production, transmission/transportation, retail/supply)
- Water supply and services
- Public transport (rail, bus, taxi)
- 'Logistics' (air traffic control, port and airport services, roads)
- Insurance
- Waste and recycling services
- Postal services
- Telecommunications
- Others (fertiliser manufacture/supply, health services, cemeteries)

Objectives of rate regulation

Not a simple substitute for competition	
Main objectives	**Other objectives**

• 'just and reasonable rates'
  • low prices for consumers
  • reasonable rate of return for suppliers/investors to ensure financial viability
	• availability/reliability of supply
	• service quality
	• environmental protection
	• encourage competition

• reducing price volatility for consumers	

Scope - price-setting mechanisms

- High-level terminology can cause confusion
- Similar types of schemes may be classified differently
- Different schemes may be classified in the same category
- Many schemes use a combination of features

- Need to identify common features to define potential scope

User needs

- Transparent information about amounts, timing and certainty of cash flows
- Reconciliations between 'regulatory' earnings and earnings reported in financial statements
- Qualitative information about the rate-regulatory environment:
  - strength of rate regulation
  - relationship between rate regulator and entity
  - correlation between actual earnings and allowed (regulatory) earnings

Common features (1)

- Authority of rate regulator is established by statute
- Rates must balance interests of customers and the supplier
- Rate regulation supports monopoly supplier
  - explicit licence
  - other barriers to competition
- Supplier has obligations to maintain supply
  - "essential" goods/services
  - price inelasticity
  - low demand risk

Common features (2)

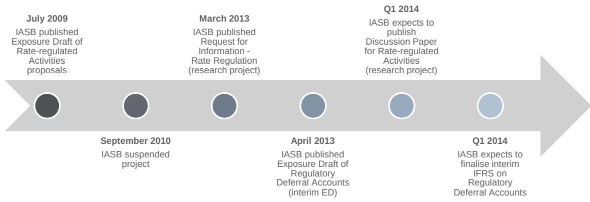
- Rate regulation establishes prices (rates)
  - limits negotiation with customers
  - prices require approval of rate regulator
- Rate-regulatory mechanism provides strong assurance about certainty of future cash flows that relate to past events
  - objective mechanism
  - 'automatic' adjustment

What we need to know from interested parties

We will need input from interested parties at various stages, including:

- reaction to the interim solution ED
  - will it achieve greater comparability and transparency?
  - will the information to be presented and disclosed be understandable and useful?
- input to the research for the DP
  - what are the common features of rate regulation?
- reaction to the DP
  - what information about the effects of rate regulation is most useful?
  - are the common features of rate regulation appropriately described and do they create the rights and obligations attached to them?

Rate-regulated activities project timeline



Where to go for more information

- Rate-regulated Activities project page on the IFRS website
  - http://www.ifrs.org/Current-Projects/IASB-Projects/Rate-regulated-activities/Pages/Rate-regulated-activities-landing.aspx

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Thank you

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