STAFF PAPER

July 2017

IASB Meeting

Project	**Rate-regulated Activities**
Paper topic	Developing the model—control and matching

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Purpose of this paper

1. The purpose of this paper is to continue to develop the underlying basis for a new accounting model (the model) for rate-regulated activities.

2. In its June 2017 meeting, the Board tentatively agreed with an analysis that concluded that the right or obligation created by the rate-adjustment mechanism set out in a regulatory agreement established by defined rate regulation meets the definition of an **asset** or a **liability**, as those terms are expected to be defined in the forthcoming revised *Conceptual Framework for Financial Reporting* (the revised *Conceptual Framework*).[1]

3. However, at that meeting some Board members asked for further analysis to show:

   (a) how the concept of control within the definition of an asset applies to the right created by the rate-adjustment mechanism, and

[1] Some proposals in the Exposure Draft *Conceptual Framework for Financial Reporting* (the Conceptual Framework ED) have been updated for the Board's tentative decisions in subsequent discussions. Throughout this paper, all references to the Conceptual Framework ED are to those updated proposals. For ease of reference, paragraph numbers in footnotes refer to the location of the original proposals in the Conceptual Framework ED.

(b) why the model is not merely trying to apply a ‘matching principle’ that entities could analogise to without being subject to defined rate regulation.

4. This paper further clarifies the analysis and responds to the requests for further analysis.

5. This paper contains:

(a) Background

(i) Defined rate regulation (paragraphs 6-16); and

(ii) The Board’s tentative decisions to date (paragraphs 17-18).

(b) Staff analysis (paragraphs 19-34):

(i) Control of the economic resource (paragraphs 20-26); and

(ii) Matching (paragraphs 27-31).

(c) Conclusions (paragraphs 32-34);

(d) Question for the Board (paragraph 35); and

(e) Appendix A—illustrative example.

Background

Defined rate regulation

6. The following paragraphs summarise the description of defined rate regulation presented to the Board in Agenda Paper 9A *Update of the Board’s discussion* June 2017, refining the description to reflect the discussion during that meeting.

7. Regulation is broadly defined as the imposition of rules by government, backed by the use of penalties that are intended specifically to modify the economic behaviour of individuals and firms in the private sector. Economic regulations intervene directly in market decisions such as pricing, competition, market entry, or exit.[2]

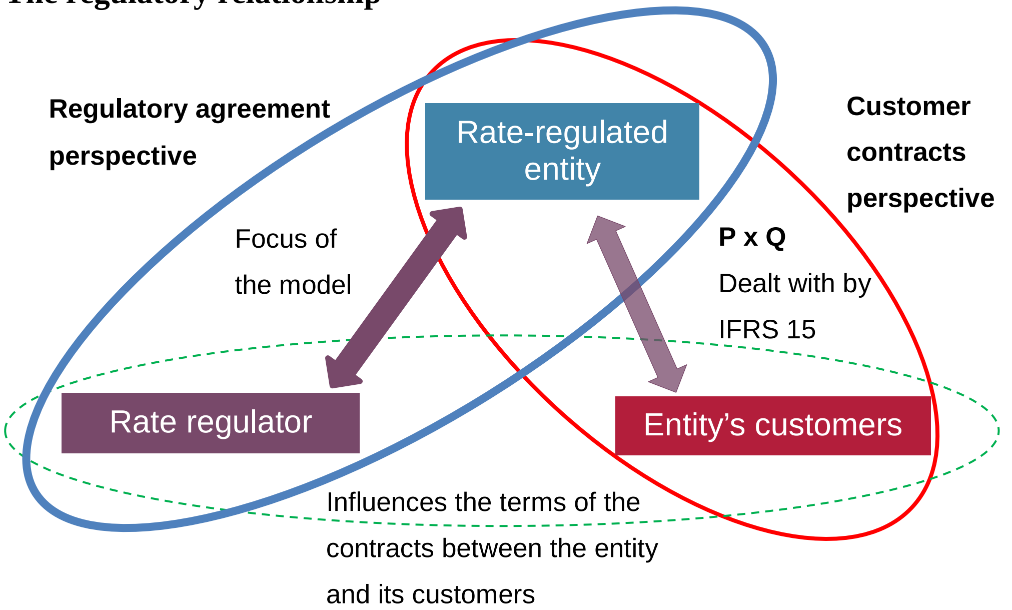
[2] See Organization for Economic Cooperation and Development (OECD) Glossary of Statistical Terms.

8. In this project, we have been using 'defined rate regulation' as a label for a form of economic regulation established through a formal regulatory framework that imposes limitations on entry into an industry (and on exit from it) and that:

   (a) is binding on both the entity and the rate regulator; and

   (b) establishes a basis for setting the regulated rate chargeable by the entity to its customers (P) for the transfer of specified goods and/ or services that comply with minimum quality levels or other service requirements (Q).

The regulatory relationship



9. In some forms of economic regulation, such as market regulation, the primary purpose of the regulator's intervention is to act as a proxy for efficient competition to protect customers from excessive profit-taking by the suppliers.[3] Such regulatory intervention typically uses a rate-setting methodology that caps the prices that suppliers can charge customers at a level that enables an efficient supplier to make a profit commensurate with risk.

[3] 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 price cap is rarely based on the specific costs that any individual supplier incurs but, instead, the price cap is based on benchmark costs (see paragraphs 3.30-3.33 of the Discussion Paper *Reporting the Effects of Rate Regulation*, published in September 2014).

10. However, as previously discussed with the Board, defined rate regulation generally is introduced for services that governments consider essential for a reasonable quality of life for its citizens and for which there are significant barriers to effective competition for supply. In such cases, the objectives of the rate regulator go beyond acting as a proxy for a competitive market. The rate regulator's objectives include ensuring that the regulated goods or services are of appropriate quality and are accessible, available and affordable to the public. In addition, the rate regulator may also require the entity to carry out other activities relating to government-imposed social or environmental policies, and which may not relate directly to the delivery of goods or services to customers. We use the term 'regulatory requirements' to cover both service requirements related to the delivery of goods or services to customers and other requirements related to other government-imposed policies.

11. As a consequence of the wider objectives in defined rate regulation, the rate-setting methodology used by a rate regulator in defined rate regulation are not merely designed to cap the prices that suppliers can charge customers during the period. In addition, the rate-setting methodology uses a rate-adjustment mechanism to:

    (a) improve the stability and predictability of pricing for customers; and

    (b) spread the cost of the regulatory requirements across different classes and generations of existing and future customers.

12. The rate-setting methodology used in defined rate regulation is established by law. It is typically set out in legislation or in a contractual licensing agreement signed by both the rate regulator and the rate-regulated entity. The methodology typically specifies the following two components of the regulated rate (P):

    (a) a 'current period' rate component that comprises the estimated amounts that are intended to compensate the entity for satisfying regulatory requirements **during** the current period;[4] and

[4] We used the term 'base component' in the description given in Agenda Paper 9A Update of the Board's discussions presented in the Board's June 2017 meeting but use a more descriptive term here.

(b) a ‘temporary difference’ rate component that adjusts the current and /or a future regulated rate according to a **rate-adjustment mechanism** to reflect **temporary differences** that arise when the regulated rate in one period includes amounts related to specified activities the entity carries out in a different period.

13. The current period component of the rate may be considered to be equivalent to the amount that the rate regulator perceives to be a fair and reasonable amount that enables an efficient supplier to make a profit commensurate with risk, if the entity satisfies all regulatory requirements in the same period as it supplies the regulated goods or services. The rate-adjustment mechanism is used to enable the rate regulator to achieve the additional objectives of improving price stability and predictability and of spreading costs across different classes and generations of existing and future customers (see paragraph 11).

14. The temporary difference component reflects temporary differences that arise when:

(a) there are differences between actual and estimated amounts used in the calculation of the current period rate component (estimation variances) **and** the rate-adjustment mechanism requires those estimation variances to be ‘corrected’ through the regulated rate to be charged in future periods (‘allowable estimation variances’ and ‘chargeable estimation variance’);[5]

(b) the entity fully or partially fulfils a regulatory requirement but the related compensation amount has not yet been included in the regulatory rate for the current period; or

(c) the regulated rate for the current period includes a compensation amount relating to a regulatory requirement that has yet to be fulfilled.

[5] Not all variances between estimated amounts and actual amounts will result in adjustments to a future regulated rate. We refer to ‘allowable estimation variances’ to identify those amounts that the rate-setting mechanism will include in the rate calculation to increase the regulated future rate. Similarly, we refer to ‘chargeable estimation variances’ to identify those amounts that the rate-setting mechanism will include in the rate calculation to decrease the regulated future rate.

15. At the end of a reporting period, the rate-adjustment mechanism in the legally binding regulatory agreement gives the entity:

    (a) a **right** to charge customers a **favourable** rate in a future period in exchange for goods or services delivered in that period); or

    (b) an **obligation** to charge customers an **unfavourable** rate in a future period in exchange for goods or services delivered in that period).[6]

16. There is a direct cause-and-effect relationship between the entity's **past** satisfaction of regulatory requirements and the entity's right to charge a favourable rate, or obligation to charge an unfavourable rate, for goods or services delivered to customers in a future period. This is because the calculation of the rate adjustment determines the extent to which the rate is favourable or unfavourable to the entity.

The Board's tentative decisions to date

17. The regulatory agreement establishes a range of rights and obligations for the entity that encompass many aspects of the entity's rate-regulated business and how it operates. This combination of rights and obligations, if considered as a single unit of account, might be seen as constituting an intangible asset. Measuring the value of that intangible asset, and any changes in that value, may incorporate changes in the value of the business and internally generated goodwill. Such changes in value would, by their nature, include amounts that relate to future cash flows, transactions and events, including the associated profit of those future transactions. Consequently, in February 2017, the Board tentatively decided not to develop an intangible asset model to account for the regulatory agreement as a whole.[7]

18. Instead, the Board tentatively decided to develop a model that focuses on a defined narrow subset of rights and obligations arising from the rate-adjustment mechanism contained in the regulatory agreement. In addition, the Board

[6] The rights/obligations arising from the rate-adjustment mechanism are consumed/fulfilled as the entity includes the rate increase/decrease in a future regulated rate that is charged to customers on the future delivery of goods or services.

[7] See paragraphs 24-26 of Board Agenda Paper 9A *Update of the Board's discussions*, June 2017, for a summary of reasons why the Board discarded an intangible asset model approach.

tentatively decided that an entity will apply the requirements of other IFRS Standards before applying the requirements of the model. Consequently, the model is **not** aiming to account for:

(a) the regulatory agreement as a whole (including the right to make future sales, priced at the 'current period component');

(b) the customer relationships affected by the regulatory agreement;

(c) other rights or obligations created by the regulatory agreement, (ie other than those created by the past events captured by the rate-adjustment mechanism);

(d) existing or future receivables from or payables to customers, (recognised using IFRS 9 *Financial Instruments*); or

(e) contract assets or contract liabilities (recognised using IFRS 15 *Revenue from Contracts with Customers*).

Staff analysis

19. The model is being developed to account for the defined narrow subset of rights and obligations arising from the rate-adjustment mechanism; ie an entity's **right** to charge customers a **favourable** rate, or an **obligation** to charge customers an **unfavourable** rate, in a future period. That right or obligation has arisen because of a **past** transaction or event and is established by law through a regulatory agreement that is binding on both the entity and the rate regulator (paragraphs 15-16). The following paragraphs consider how the concept of control within the definition of an asset applies to the right to charge a favourable rate.

Control of the economic resource

20. The Conceptual Framework ED defines an asset as 'a present **economic resource controlled** by the entity as a result of **past** events'.

21. In the Conceptual Framework ED, the Board proposed guidance on three aspects of the definition of an asset:

(a) **Rights—**the Conceptual Framework ED provides examples of **rights** that constitute **economic resources**. The examples include the right to exchange economic resources with another party on favourable terms.[8]

(b) **Potential to produce economic benefits—**the Conceptual Framework ED confirms that for a right (ie an economic resource) to have the potential to produce economic benefits, it need not be certain, or even likely, that the right will produce economic benefits. It is only necessary that the right already **exists** and that there is at least one circumstance in which it would produce economic benefits beyond those available to all other parties. In addition, the Conceptual Framework ED confirms that, although an economic resource derives its value from its existing potential to produce future economic benefits, the economic resource is the **existing right**, not the future economic benefits.[9]

(c) **Control** of the right (ie the economic resource)—the Conceptual Framework ED makes it clear that, for an entity to control an economic resource, the entity must have the right to deploy that resource in its activities and the economic benefits from that resource must flow to the entity (either directly or indirectly) rather than to another party. This aspect of control does not imply that the entity can ensure that the resource will produce economic benefits in all circumstances. Instead, it means that if the resource produces economic benefits, the entity is the party that will receive them.[10]

22. Based on the description in paragraphs 12-16, we conclude that the right to charge the favourable rate satisfies the first two aspects of the definition of an asset:

(a) a right (ie economic resource) exists, established in law, to charge a favourable rate to customers as a direct result of a past transaction or event, and

[8] Paragraph 4.8 of the Conceptual Framework ED.

[9] Paragraphs 4.13 and 4.15 of the Conceptual Framework ED.

[10] Paragraph 4.21 of the Conceptual Framework ED.

(b) the right has the potential to produce economic benefits.

23. The remaining aspect of the definition of an asset to consider is control. The economic resource the model seeks to account for is the right to exchange economic resources with customers on terms that are favourable to the entity. The regulatory agreement entitles the entity to deploy that right (ie economic resource) in its business. The favourable rate is specific to the entity and, consequently, it is the entity that will benefit from any economic benefits that flow from the right to charge that rate, not another party.

24. For the economic resource to exist, it is not necessary that the entity can control whether customers will continue to buy the regulated goods or services in the future. This is because, although an economic resource derives its value from its existing potential to produce future economic benefits, the economic benefit is the existing right, not the future economic benefits.[11] The degree of certainty about the volume of future sales affects the **measurement** of the economic benefits expected to flow to the entity. It might also affect decisions about whether it is appropriate to recognise the economic resource as an asset, but it does not affect the **existence** of the economic resource itself.

25. Consequently, we conclude that the entity's right to charge a higher, favourable, regulated rate arising from the rate-adjustment mechanism does meet all three aspects of the definition of an asset, as that term is expected to be defined in the revised *Conceptual Framework*.

26. Having established that the asset exists, we need to consider whether to recognise the asset in the statement of financial position. Agenda Paper 9B for this meeting considers the recognition criteria in the revised *Conceptual Framework* and considers the effects of uncertainty on recognition.

Matching

27. The Conceptual Framework ED states that the recognition of assets or liabilities arising from transactions or other events may result in the simultaneous recognition of both income and related expenses. For example, the sale of goods

[11] Paragraph 4.15 of the Conceptual Framework ED.

for cash results in the recognition of both income (from the recognition of one asset—the cash) and expenses (from the derecognition of another asset—the goods that were sold). The simultaneous recognition of income and related expenses is sometimes referred to as the **matching** of costs with income. The concepts in the *Conceptual Framework* lead to such matching when it arises from the recognition of changes in assets and liabilities. However, these concepts do not allow the recognition in the statement of financial position of items that do not meet the definition of assets or liabilities.[12]

28. We note that, in some cases, the financial effects of transactions between customers and an entity subject to defined rate regulation may seem to be similar to the financial effects of transactions between customers and an entity conducting activities in a competitive market. For example, an entity in a competitive market may aim to set the price(s) it charges customers for its goods or services at a level designed to enable it to make a profit commensurate with risk. However, the entity does not have a binding right or obligation to adjust its price if, for example, it incurs costs that are higher or lower than the costs that would result in that profit. In addition, in a competitive market, the ability to increase prices is available to all other suppliers in the market and is not specific to the past transactions or events of the entity so there is no right that meets the definition of an asset. Similarly, price constraints due to market conditions or other factors do not create an obligation to decrease prices and so there is no obligation that meets the definition of a liability.

29. Consequently, although the activities subject to defined rate regulation and those operating in a competitive market may seem to be operationally very similar, the legally binding terms of the agreements between the parties confer very different rights and obligations relating to those activities.

30. Many of the responses to the Discussion Paper *Reporting the Financial Effects of Rate Regulation* and other outreach activities suggest that the rights and obligations arising from the rate-adjustment mechanism have a discernible effect on the entity's financial position, financial performance and cash flows. They also suggest that failing to recognise the entity's right or obligation arising from

[12] Paragraph 5.8 of the Conceptual Framework ED.

the rate-adjustment mechanism could be misleading, particularly when reviewing the entity's performance. Instead, recognising an entity's right to charge customers a favourable rate, or an obligation to charge customers an unfavourable rate, would give useful information to the users of financial statements about the entity's current financial performance and financial position, and help identify the effect of the rate adjustment mechanism on the entity's future cash flows.

31. Consequently, the model recognises the entity's rights and obligations arising from the rate-adjustment mechanism as assets and liabilities in the statement of financial position. Changes in those rights and obligations are recognised in the statement of profit or loss in the period in which the changes occur. This may result in the simultaneous recognition of income and related expenses—sometimes referred to as matching (see Appendix A for a simplified example).

Conclusions

32. As described in paragraph 16, the effects of the rate-adjustment mechanism are specific to the rate-regulated entity and so the right to charge a favourable rate designed to compensate the entity for the past satisfaction of its regulatory requirements is available only to the entity, not to all other parties. In other markets, an ability to increase the price charged to customers is available to all parties and need not relate directly to past transactions of the individual participants in that market. Consequently, in the absence of the rate-setting mechanism in a binding regulatory agreement, the ability to increase the price does not meet the definition of an asset.

33. If the Board subsequently confirms its tentative decision to restrict the scope of the model to the rights and obligations arising from the rate-adjustment mechanism, other entities that do not have those rights and obligations will not be eligible to apply the model either directly or by analogy. Even though the transactions carried out by entities in a competitive market may seem operationally similar to transactions carried out by entities subject to defined rate regulation, the rights and obligations relating to those transactions are very different.

34. The proposed scope of the model is intended to provide users of financial statements with useful information about a rate-regulated entity's rights and obligations arising from the rate-adjustment mechanism. Those rights and obligations can be separately identified and, in many cases, can be measured with a high level of certainty.[13] Recognising changes in those rights and obligations in the period in which the changes occur may result in the simultaneous recognition of income and related expenses, but this is a consequence of applying the model, not a driver for it.

Question for the Board

35. We are not making recommendations at this stage so are not asking Board members for decisions. Instead, we are seeking tentative views to help build the analysis for a future discussions.

Question for the Board
1. Do Board members have any comments or clarifying questions on issues discussed in this paper?

[13] See Agenda Paper 9B for a discussion of the effects of uncertainty on the recognition of regulatory assets and liabilities.

Appendix A—illustrative example: recognising changes in an entity's rights and obligations arising from the rate-adjustment mechanism

A1. The following example reproduces Example 1 from the Board Agenda Paper 9B *Rate adjustment examples*, June 2017, in which further illustrative examples of the application of the model are provided.

Example 1—input price variance

A2. The regulatory agreement gives Entity W the right to charge a regulated rate intended to recover the actual input cost incurred for chemicals used in treating waste water. Entity W includes any estimation variance arising in the regulated rate for the next year.

A3. The estimated input cost for each year 20X1-20X3 is CU30,000. During 20X1, the actual input cost of the chemicals is CU2,000 higher than estimated. This creates an allowable variance of CU2,000, which is included in the rate charged to customers during 20X2. No further input cost variances arise during the three-year period.

Originating right and its reversal

A4. The right to charge an extra CU2,000 in 20X2 arises only because the rate-adjustment mechanism specifies that the input cost variance arising in 20X1 is added to the rate charged in 20X2. This creates a right, arising from the regulatory agreement and from the input cost variance, which has the potential to produce economic benefits for Entity W. The economic benefit arises because, as a result of past transactions, the entity has a right to charge a regulated rate that enables Entity W to transfer goods or services to customers during 20X2 on terms that are favourable to the entity: ie at a higher price than it would otherwise have charged in the absence of the rate-adjustment mechanism and of the input cost variance in 20X1.

A5. Entity W cannot control whether its customers will buy water services in the future. However, the definition of an asset does not require that the right to charge a favourable rate will produce economic benefits in all circumstances. Instead, the definition of an asset merely requires that the entity has the right and, in addition, that any economic benefits arising from that right flow to the entity (either directly or indirectly) rather than to another party. The regulatory agreement grants Entity W the right to supply water services in Country X and to charge the favourable regulated rate for those services. The same rights are not available to all other parties. Consequently, we conclude that this right meets the definition of an asset and should be recognised by Entity W in its IFRS financial statements.

A6. During 20X2, Entity W bills customers using the higher regulated rate and recognises another asset—cash or a receivable. Assuming Entity W sells sufficient services during 20X2 to recover the CU2,000 from customers, it will not have the right, at the end of 20X2, to continue to transfer goods or services at a favourable rate. As a result, the entity no longer has a regulatory asset at 31 December 20X2.

Applying the model

A7. Without the proposed model, Entity W recognises a ‘loss’ of CU2,000 in 20X1 but then recognises a ‘profit’ of CU2,000 in 20X2 when the increased rate is billed to customers.

A8. Using the model, the entity will, at 31 December 20X1, recognise a regulatory asset of CU2,000, together with the related regulated rate adjustment income in profit or loss.[14] During 20X2, Entity W includes the CU2,000 in its bills to customers and receives cash or recognises a receivable. Entity W also recognises a related regulated rate adjustment expense in profit or loss for the period to reflect the fact the amount of revenue recognised in 20X2 using IFRS 15 includes CU2,000 that was already recognised as regulated rate adjustment income in 20X1.

[14] At a future Board meeting, the staff will bring a paper to discuss how any rate adjustment in profit or loss should be described and presented.

A9. Entity W records the following at 31 December:

Year to 31 December	20X1 CU000	20X2 CU000	20X3 CU000
Existing IFRS Standards			
Revenue (amounts billed)	30	32	30
Operating expenses	(32)	(30)	(30)
Profit/ (Loss)	(2)	2	0
Proposed model			
Revenue (amounts billed)	30	32	30
Regulated rate adjustment: income/ (expense)	2	(2)	0
Operating expenses	(32)	(30)	(30)
Profit/ (Loss)	0	0	0
Regulatory (liability)/ asset	2	0	0