IFRS

STAFF PAPER

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Project	Rate-regulated Activities		
Paper topic	Background and summary of decisions to date		
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Purpose of this paper

1. The purpose of this paper is to provide background information about the accounting model we are developing for ‘defined rate regulation’ (the model) and to summarise the Board’s tentative decisions to date.

Structure of the paper

2. This paper is structured as follows:
   (a) Defined rate regulation—basis for setting the rate (paragraphs 4–9);
   (b) Timing differences—regulatory assets and regulatory liabilities (paragraphs 10–16);
   (c) Tentative decisions about the model (paragraphs 17–18).
3. The appendix to this paper summarises all the tentative decisions made by the Board while developing the model.

Defined rate regulation—basis for setting the rate

4. The model aims to provide users of financial statements with useful information about those rights and obligations that are created by defined rate regulation and are not captured in a sufficiently useful way by existing IFRS Standards (see paragraphs 10–16).

5. Defined rate regulation is typically applied for goods or services that governments consider essential for a reasonable quality of life for their citizens and for which there are significant barriers to effective competition for supply. In such cases, the defined rate regulation typically has objectives that include **protecting customers** by:

(a) ensuring:

(i) quality, quantity and availability of supply (done through establishing service requirements in the regulatory agreement); and

(ii) stability, predictability and affordability of pricing (done through the basis for setting rates established by the regulatory agreement).

(b) supporting the rate-regulated entity's (entity) ability to fulfil the service requirements established in the regulatory agreement by **protecting the entity's financial viability** (done by ensuring the regulated rate (rate) enables the entity to obtain an adequate amount of compensation from customers in exchange for fulfilling its service requirements).

6. To achieve those objectives, there is a **binding regulatory agreement** through which:

(a) the entity has a right to:

(i) supply the rate-regulated goods or services (goods or services); and

(ii) charge a **rate(s)** for those goods or services that is designed with the aim of making it viable for the entity to fulfil the specified service requirements (see paragraphs 5(b) and 7).

and **in exchange**

(b) the entity is obliged to:

(i) fulfil specified service requirements (usually related to quality, quantity and availability of supply); and

(ii) accept the basis for setting rates established in the regulatory agreement.

7. The basis for setting rates operationalises the regulatory objectives (paragraph 5) and forms part of the binding regulatory agreement (paragraph 6). The basis for setting rates helps to support the objective of protecting an entity's financial viability by giving the entity some protection against both input price risk and demand risk. As a result, the rate formula uses a **rate-adjustment mechanism** to adjust future rates for variances between estimated and actual inputs to the rate calculation. These adjustments for variances create **timing differences** between the time when a transaction or event takes place and the time when some of the effects of that transaction or event are reflected in the rate.

8. Further timing differences may arise when the rate regulator uses the rate-adjustment mechanism to reduce the volatility of rate fluctuations, which contributes to stability, predictability and affordability of pricing for customers.

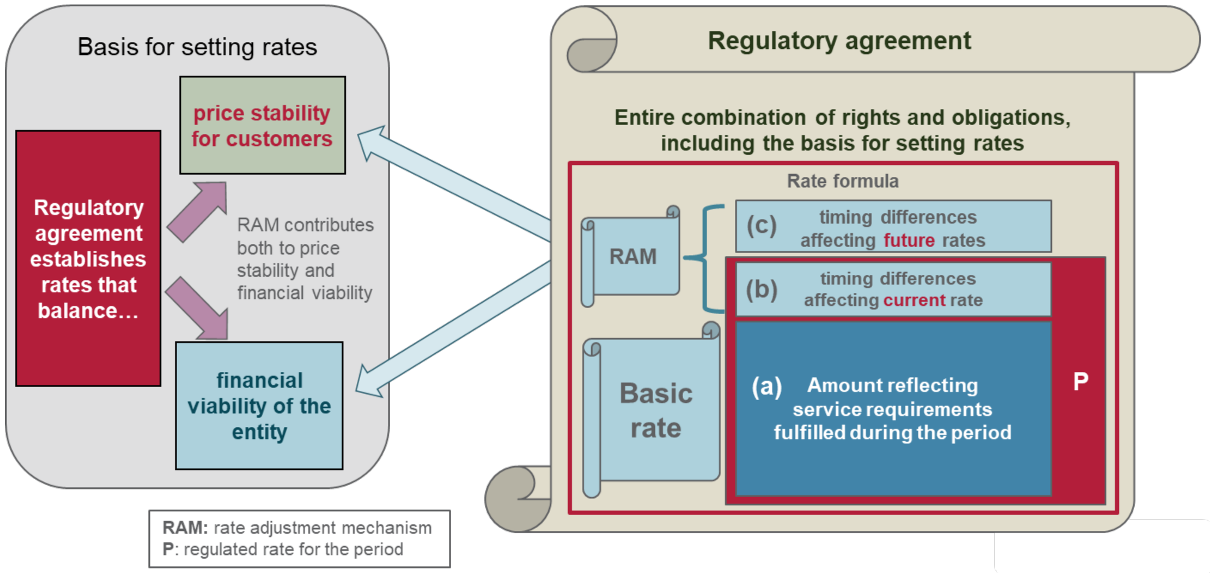
9. The regulatory agreement creates a direct and specific **cause-and-effect relationship** between the time when an entity carries out a rate-regulated activity (activity) to fulfil its service requirements and the time when amounts related to that activity are included in the rate(s) charged to customers. The direct and specific cause-and-effect relationship means that the rate formula can be used to identify (see Diagram 1):

(a) the amount of compensation included in the **current period rate** in exchange for service requirements fulfilled in the current period (**basic rate**), represented by (a) in Diagram 1;

(b) positive and negative adjustments to the **current period rate** reflecting service requirements fulfilled in earlier period(s) or to be fulfilled in later period(s), represented by (b) in Diagram 1; and

(c) positive and negative adjustments that will be made to **future period rate(s)** reflecting service requirements fulfilled in or before the current period, represented by (c) in Diagram 1.

Diagram 1



Timing differences—regulatory assets and regulatory liabilities

10. The regulated rate chargeable in the current period consists of items (a) and (b) in paragraph 9. The resulting revenue is recognised in accordance with IFRS 15 *Revenue from Contracts with Customers*.

11. Our research indicates that reporting revenue using IFRS 15 provides useful information to users of financial statements. The information both is relevant and faithfully represents what it purports to represent—the entity satisfies its customer performance obligations by delivering a quantity of goods or services (Q) in a specified period at a specified price (the regulated rate, P). When the entity delivers the goods or services, customers are obliged to pay, and the entity is entitled to receive, the amount charged (P x Q). As a result, we are not proposing to amend IFRS 15 or other existing IFRS Standards.

12. However, our research has also found that applying only existing IFRS Standards, without recognising the rights and obligations created by the timing differences highlighted in paragraphs 7–9, does not give a complete picture of the effects of defined rate regulation on an entity's financial performance during the period or its financial position at the end of the period. This is because those timing differences mean that some effects of some transactions or other events are reported as income or expenses in a different period than the period in which other

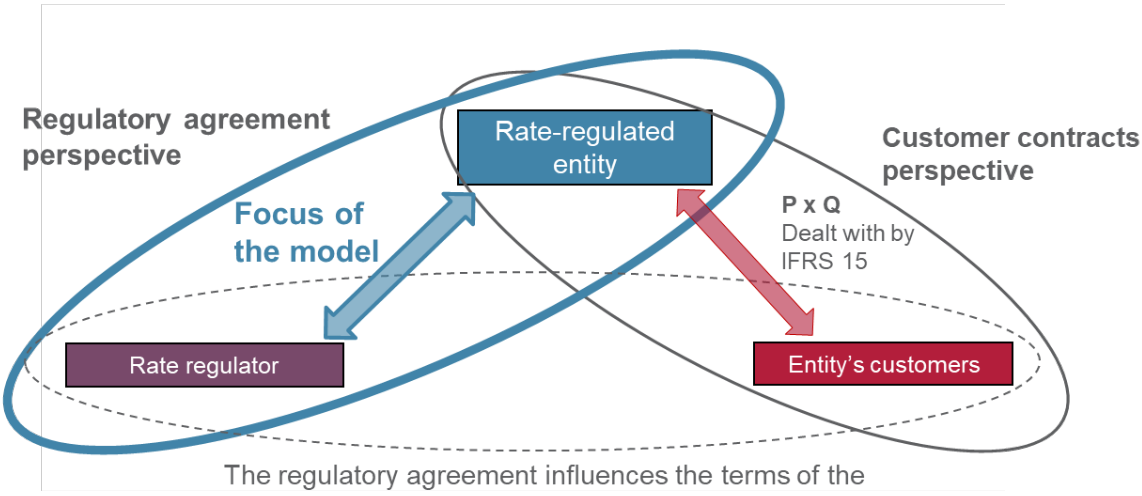
effects of the same transaction or event are reported. We refer to those timing differences as 'regulatory timing differences' and describe them as timing differences that arise through the operation of the rate-adjustment mechanism when an entity fulfils service requirements in a different period than the period in which those service requirements are charged to customers through the regulated rate.

13. Not recognising the assets or liabilities that result from the regulatory timing differences creates artificial volatility in the statement of financial performance that may mask any real economic volatility. This makes it difficult for users to assess the entity's performance for the period and the implications of that performance for the entity's ability to generate future cash inflows from its activities.

14. In developing the model, we are using a '**supplementary approach**' (see Diagram 2). This means that existing IFRS Standards, including IFRS 15, will continue to be applied without modification (ie using the customer contracts perspective in the case of IFRS 15). The model will then be applied to provide information about the effects of those regulatory timing differences (ie using the regulatory agreement perspective).

Diagram 2

In **defined rate regulation**, the regulatory agreement affects both the amount and the **timing** of the price 'P' billed to customers.



The regulatory agreement influences the terms of the contracts between the entity and its customers

15. The rights and obligations created by the regulatory timing differences are **incremental** to those reported using existing IFRS Standards and can be analysed as:

    (a) present rights to charge a rate increased by a specified amount[1] as a result of past events; and

    (b) present obligations to provide goods or services at a rate reduced by a specified amount[1] as a result of past events.

16. The supplementary approach used by the model recognises:

    (a) in the statement of **financial position**, the incremental rights and obligations resulting from existing regulatory timing differences that will affect **future** rates (paragraph 9(c)); and

    (b) in the statement of **financial performance**, the regulatory timing differences originating or reversing **during** the period (paragraph 9(b) and (c)).

Tentative decisions about the model

17. So far, the Board has reached tentative decisions on proposals for:

    (a) Scope;

    (b) Unit of account;

    (c) Recognition of regulatory assets and regulatory liabilities;

    (d) Measurement of regulatory assets and regulatory liabilities;

    (e) Presentation and disclosure objectives and requirements.

18. The Board's tentative decisions to date on the model are included in the appendix.

[1] The 'specified amount' is calculated using the rate formula, which identifies the monetary amount of the timing differences created by the regulatory agreement.

APPENDIX—summary of tentative decisions to date

A1. The following table summarises the Board's tentative decisions made while developing the model. The bolded meeting references also include a hyperlink to the Board meeting webpages.

Topic	**Tentative decisions** (extracts from IASB Update)	Comments
General approach in the model	**February 2017 (Agenda Paper 9A)** The Board examined how the principle proposed in the model, as well as its general approach, make use of principles in IFRS 15 *Revenue from Contracts with Customers* and of the Board's latest thinking in the *Conceptual Framework* project. The Board tentatively decided that the staff should continue developing the model using the general approach. However, it asked the staff to rework the analysis describing the principles supporting the approach.	The model's general approach provides financial information that supplements information provided by other IFRS Standards. This means that a rate-regulated entity will apply other IFRS Standards, including IFRS 15, without amendment, before applying the model. The supplementary approach means that, using the model, an entity will then recognise rights and obligations arising from the rate-adjustment mechanism. The Board confirmed this approach in its February 2018 meeting (see unit of account section of this table).
Scope	**March 2018 (Agenda Paper 9B)** The Board tentatively decided that the accounting model should apply to defined rate regulation established through a formal regulatory framework that: (a) is binding on both the entity and the regulator; and	This tentative decision is consistent with a previous Board decision to focus on enforceable rights and obligations discussed at the Board's **February 2017** meeting.

Topic	**Tentative decisions** (extracts from IASB Update)	**Comments**
	(b) establishes a basis for setting the rate for specified goods or services that includes a rate-adjustment mechanism. That mechanism creates, and subsequently reverses, rights and obligations caused by the regulated rate in one period including amounts related to specified activities the entity carries out in a different period.	The features of defined rate regulation described in points (a) and (b) of the tentative decision in March 2018 are both necessary and sufficient for the origination of regulatory assets and regulatory liabilities. In November 2018, the Board tentatively decided that the scope of disclosures should not be broadened to include the provision of information about the general regulatory and economic environment.
Unit of account	**February 2018 (Agenda Paper 9A)** The Board tentatively decided that: (a) the accounting model will use as its unit of account the individual timing differences that create the incremental rights and obligations arising from the regulatory agreement. (b) the present regulatory right—to charge a rate increased by an amount as a result of past events—meets the definition of an asset in the *Conceptual Framework*. (c) the present regulatory obligation—to provide goods or services at a rate reduced by an amount as a result of past events—meets the definition of a liability in the *Conceptual Framework*.	The rate-adjustment mechanism creates timing differences between: (a) the time when the entity fulfils the service requirements established in the regulatory agreement; and (b) the time when the entity includes the related compensation in the rate(s). We refer to those timing differences as '**regulatory timing differences**'. Consequently, at the end of each reporting period, the entity may have some rights and obligations that are not recognised in the entity's statement of financial position using existing IFRS Standards, even

Topic	**Tentative decisions** (extracts from IASB Update)	**Comments**
		though the transaction or other event that created them has already occurred. These outstanding rights and obligations are **incremental** to those reported using existing IFRS Standards. In November 2018, the Board tentatively decided to permit offsetting of regulatory assets and regulatory liabilities when specified conditions are met. In addition, the Board tentatively decided that an entity should present all regulatory income and regulatory expense netted as a separate line item in profit or loss, although disaggregating that item and presenting additional line items would not be prohibited (see unit of account section of this table).
Recognition of regulatory assets and regulatory liabilities	**March 2018 (Agenda Paper 9B)** The Board tentatively decided that the accounting model: (a) should require the recognition of regulatory assets or regulatory liabilities if it is more likely than not that they **exist**—the model sets a symmetrical recognition threshold in cases of **existence uncertainty**; and (b) should not set thresholds that would prevent recognition of a regulatory asset or regulatory liability for which there is:	These tentative decisions build on examples discussed at the Board's **June 2017** meeting. As a result of the Board's decision to set a recognition threshold only for existence uncertainty, an entity would reflect any outcome uncertainty—ie uncertainty about the amount or timing of an inflow or outflow—in the

Topic	**Tentative decisions** (extracts from IASB Update)	Comments
	(i) low probability of an inflow or outflow of economic benefits; or (ii) high measurement uncertainty.	measurement of the regulatory asset or regulatory liability in the statement of financial position. Uncertainty about the amount or timing of the inflow or outflow would include any uncertainty arising from demand risk or credit risk.
Measurement of regulatory assets	**May 2018 (Agenda Paper 9B)** The Board tentatively decided that the measurement of regulatory assets should reflect: (a) estimates of the future cash flows the regulatory assets will generate. These cash flows include amounts that result from: (i) the costs of assets used and operating expenses incurred; (ii) any margins on the operating expenses incurred; and (iii) any interest on the operating expenses incurred or returns on the costs of assets used. (b) discounting the estimates of future cash flows if there is a significant financing component. The Board also tentatively decided that: (a) the measurement of regulatory assets should reflect changes, if any, in the estimates of the future cash flows the regulatory assets will generate. (b) the discount rate established at initial recognition should remain unchanged during the subsequent measurement of the regulatory assets. (In its July 2018 meeting, the Board	In its May 2018 meeting, the Board discussed **whether** regulatory assets should be measured on a basis that uses: (a) a cash-flow-based measurement technique; (b) discounting when there is a significant financing component; and (c) updated estimates of future cash flows. In its July 2018 meeting, the Board discussed **how** to: (a) estimate future cash flows; (b) establish the discount rate to be used at initial recognition and subsequently; and (c) account for changes in the estimates of future cash flows.

Topic	Tentative decisions (extracts from IASB Update)	Comments
	tentatively decided the discount rate established at initial recognition should change if the interest or return rate provided by the regulatory agreement changes—see 'Changes in estimated cash flows, including changes caused by changes in the discount rate' section of this table).	In its December 2018 meeting, the Board is discussing further how to identify the discount rate to use (see Agenda Paper 9B).
	July 2018 (Agenda Papers 9B and 9D) ***Estimating future cash flows*** The Board tentatively decided that, for each regulatory asset recognised, an entity should: (a) estimate future cash flows using either the 'most likely amount' method or the 'expected value' method, depending on which method the entity concludes would better predict the amount of the cash flows arising from a particular timing difference; and (b) apply the same method consistently from the origination of the timing difference until its reversal. The Board also discussed how an entity should determine whether to consider the outcome of each timing difference separately or together with one or more other timing differences. The Board tentatively decided such determinations should be based on the approach that would better predict the amount of the resulting future cash flows.	As a result of the Board's tentative decisions in May 2018 and July 2018, the model for measuring regulatory assets and regulatory liabilities would use a cash-flow-based-measurement technique, which would reflect discounted estimates of future cash flows arising from those assets or liabilities. We plan to ask the Board to review a summary of the entire model in January 2019. That summary will include a description of the measurement technique and how uncertainties, such as credit risk and demand risk, would be reflected in the estimation of the cash flows and/ or the discount rate.

Significant financing component and discount rate

No explicit financing component

The Board tentatively decided that, if a regulatory agreement does not provide explicit compensation for the effects of time between the origination and reversal of a timing difference, an entity should use judgement to determine whether the financing component of the timing difference is significant. Such judgement should be based on the entity's facts and circumstances.

If the entity concludes the financing component is not significant, discounting the future cash flows is not required. However, if the entity concludes the financing component is significant, the entity should use a 'reasonable rate' to discount the estimated future cash flows and recognise any loss in profit or loss immediately.

Explicit financing component

The Board tentatively decided that, when a financing component is explicit, an entity should measure the regulatory asset by discounting the estimated future cash flows using the interest rate or return rate established by the regulatory agreement for those cash flows. However, that requirement would not apply where clear evidence shows that the regulatory interest rate or return rate is set at a level that provides an excess or deficit in compensation because of an identifiable event or decision. In this circumstance, an entity should recognise the excess or deficit in compensation in the period in which the identifiable event or decision occurs.

Suggestions for drafting

The Board asked the staff to develop suggestions to simplify, clarify and add guidance to the tentative decisions made at the July meeting when describing the model. In particular, the Board asked the staff to develop guidance on factors to consider when determining a 'reasonable' discount rate.

The Staff are presenting a paper in December 2018, Agenda Paper 9B *Discount rates*, recommending further guidance on how to determine the discount rate to use when applying the model's cash-flow-based-measurement technique to regulatory assets and regulatory liabilities.

Topic	**Tentative decisions** (extracts from IASB Update)	**Comments**
	Changes in estimated cash flows, including changes caused by changes in the discount rate The Board tentatively decided that the model should adopt the treatment required by IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors* to account for changes in estimated future cash flows. Consequently: (a) the effect of a change in estimated future cash flows should be recognised prospectively in profit or loss in: (i) the period of change, if the change affects only that period; or (ii) the period of change and future periods, if the change affects both; and (b) if the change gives rise to a change in a regulatory asset, the change should be recognised by adjusting the carrying amount of the related asset in the period of change. When a regulator changes the interest rate or return rate used to compensate an entity for the period between the origination and reversal of a timing difference, the Board tentatively decided that the entity should: (a) measure the outstanding regulatory asset balance using the revised interest rate or return rate to discount the estimated future cash flows; and (b) recognise any resulting change in the carrying amount of the regulatory asset in the period of change.	When the regulator changes the interest rate or return rate applicable to the estimated future cash flows, an entity would need to assess whether the revised rate is acceptable to use as a discount rate. This assessment would be similar to the assessment carried out when establishing the discount rate to use on initial recognition of the regulatory asset or regulatory liability being measured. As noted previously, in December 2018 the Board is

Topic	**Tentative decisions** (extracts from IASB Update)	Comments
	Measurement of regulatory liabilities The Board also tentatively decided that the model should apply the same measurement requirements for regulatory liabilities and regulatory assets.	discussing how to identify the discount rate to use (Agenda Paper 9B).
Presentation and Disclosure	**July 2018 (Agenda Paper 9C)** The Board started its discussions about an objective to guide the development of presentation and disclosure requirements for the model. The Board was not asked to make any decisions.	
Presentation	**November 2018 (Agenda Paper 9C)** *Statement of financial position* The Board tentatively decided that an entity should: (a) present regulatory assets and regulatory liabilities as separate line items in addition to the line items required by IAS 1 *Presentation of Financial Statements*; (b) applying IAS 1, classify regulatory assets and regulatory liabilities as current or noncurrent, except when a presentation based on liquidity is used; and (c) offset regulatory assets and regulatory liabilities only if they are expected to lead to adjustments to the same future rate(s) charged to customers and, consequently:	

Topic	**Tentative decisions** (extracts from IASB Update)	Comments
	(i) they have the same pattern and timing of reversal; (ii) they arise in the same regulatory regime; and (iii) the entity has a legally enforceable right to offset them. The Board also tentatively decided that although offsetting would be permitted when the conditions in subparagraphs (c)(i)–(iii) are met, it should not be required. *Profit or loss section of the statement(s) of financial performance* The Board tentatively decided that an entity should: (a) present all regulatory income and regulatory expense in profit or loss, and not in other comprehensive income; (b) present regulatory income and regulatory expense netted as a separate line item (regulatory income or regulatory expense line item) in addition to the line items required by IAS 1; (c) present the regulatory income or regulatory expense line item immediately below the revenue line item(s) required by IAS 1; and (d) include regulatory interest income and regulatory interest expense within the regulatory income or regulatory expense line item.	

Topic	**Tentative decisions** (extracts from IASB Update)	Comments
	The Board tentatively decided not to prohibit an entity from disaggregating the required line items and presenting additional line items or subtotals in the primary financial statements when such presentation would be relevant to an understanding of the entity's financial position and/or financial performance, as required by IAS 1.	
Disclosure	**November 2018 (Agenda Papers 9D-9E)** *Disclosure objectives* The Board tentatively decided that: (a) the overall disclosure objective for defined rate regulation should be focused on the effects that the transactions or other events that give rise to regulatory timing differences have on an entity's financial performance and financial position. The objective should not be broadened to include the provision of information about the general regulatory and economic environment; nor to include information about all the effects of defined rate regulation on the entity's financial performance, financial position and cash flows. (b) the specific disclosure objectives should focus on information to help users of financial statements:	

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	(i) to understand the effects of regulatory timing differences on the entity's financial performance by distinguishing between: (1) fluctuations in revenue and expenses compensated for through the rate-adjustment mechanism; and (2) fluctuations in revenue and expenses for which there is no such compensation; (ii) to understand and assess the amount, timing and uncertainty of (prospects for) future cash flows that will result from the entity's regulatory assets and regulatory liabilities; and (iii) to understand how the entity's financial position was affected during the period by transactions or other events that caused changes in the carrying amounts of regulatory assets and regulatory liabilities. *Disclosure requirements* The Board tentatively decided that an entity should disclose: (a) a breakdown of the regulatory income or regulatory expense line item in profit or loss into the following components: (i) originations of regulatory assets, together with qualitative and quantitative information about the reasons for their amounts;	

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	(ii) originations of regulatory liabilities, together with qualitative and quantitative information about the reasons for their amounts; (iii) recovery of regulatory assets; (iv) fulfilment of regulatory liabilities; and (v) changes in the carrying amount of regulatory assets and regulatory liabilities due to changes in estimates, together with qualitative and quantitative information about the reasons for those changes; (b) a maturity analysis of the carrying amounts of regulatory assets and of regulatory liabilities at the end of the period, and an explanation of how the future recovery of regulatory assets or the future fulfilment of regulatory liabilities is affected by risks and uncertainty; (c) the discount rate or ranges of discount rates used to discount the estimated cash flows reflected in the carrying amounts of regulatory assets and of regulatory liabilities at the end of the period and, if different, the related regulatory interest or return rate(s) approved by the regulator, together with qualitative and quantitative information about the reasons for those differences; and (d) a reconciliation of the carrying amount of regulatory assets and of regulatory liabilities from the beginning to the end of the period.	

Topic	**Tentative decisions** (extracts from IASB Update)	**Comments**
	The Board also tentatively decided that an entity should assess whether the information provided through the disclosure requirements in paragraphs a–d is sufficient to meet the overall disclosure objective. If not, the entity should disclose any additional information needed to meet that objective.	
Interactions between the model and IFRS Standards	**November 2018 (Agenda Paper 9B)** *Exceptions to the requirements of other IFRS Standards* The Board tentatively decided that the measurement requirements of IAS 36 *Impairment of Assets* and IFRS 5 *Non-current Assets Held for Sale and Discontinued Operations* should not be applied to regulatory assets and regulatory liabilities. *Guidance on applicability of other IFRS Standards* The Board tentatively decided that the model should include application guidance about its interaction with IAS 12 *Income Taxes*, similar to the application guidance in paragraph B10 of IFRS 14 *Regulatory Deferral Accounts*. However, the Board tentatively decided against including an explicit statement—similar to that made in paragraph 16 of IFRS 14 in relation to regulatory deferral items—that other IFRS Standards apply to regulatory assets, regulatory liabilities, regulatory income and	The Board also discussed aspects of the interaction between the model and IFRS 3 *Business Combinations* and asked the staff to conduct further analysis for discussion at a future meeting.

Topic	**Tentative decisions** (extracts from IASB Update)	Comments
	regulatory expense in the same way as they apply to other assets, liabilities, income and expenses. *Isolation of regulatory items through presentation and disclosure requirements* The Board tentatively decided that the model should not carry forward the presentation and disclosure requirements in IFRS 14 for an entity to isolate, using subtotals, regulatory items from the assets, liabilities and net income and expense recognised using other IFRS Standards. *Location of requirements and guidance on interactions with other IFRS Standards* The Board tentatively decided that any requirements and application guidance on interactions between the model and other IFRS Standards should be included in a future Standard on rate-regulated activities, rather than added to those other Standards.	