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Project	Rate-regulated Activities		
Paper topic	Principles of the model: a summary		
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Purpose of this paper

1. The purpose of this paper is to provide:
   (a) some background as to why the Board is developing an accounting model (the model) for regulatory assets and regulatory liabilities arising when an entity subject to defined rate regulation supplies goods and services; and
   (b) a summary of the principles underlying the model.

Structure of the paper

2. This paper is structured as follows:
   (a) Defined rate regulation—background (paragraphs 3–15)
   (b) The problem we are trying to solve (paragraphs 16–18);
   (c) Purpose of the model (paragraphs 19–20);
   (d) The model's core principle (paragraphs 21–24);
   (e) Scope principles (paragraphs 25–26);
   (f) Unit of account (paragraphs 27–30);

(g) Recognition principles (paragraphs 31–32);

(h) Measurement principles (paragraphs 33–37);

(i) Presentation principles (paragraphs 38–42); and

(j) Disclosure principles (paragraphs 43–46).

Defined rate regulation—background

3. In defined rate regulation, the regulatory framework establishes a **binding regulatory agreement** through which:

   (a) the entity has a right to:

      (i) supply specified goods or services; and

      (ii) charge for those goods or services a rate(s) that is designed to compensate the entity for the goods or services it supplies to customers with the aim of making it viable for the entity to fulfil specified requirements for quality, quantity and availability of supply of the goods or services;

   and in exchange

   (b) the entity is obliged to:

      (i) fulfil the specified requirements for supplying goods or services; and

      (ii) accept the basis established in the regulatory agreement for setting rates.[1]

4. The regulatory agreement establishes the **total allowed compensation** that the entity is entitled to charge to customers for the goods or services supplied during the period. The total allowed compensation is an amount that typically consists of the following components (see paragraphs 22–24(b)):

   (a) specified 'allowable' expenses incurred; and

   (b) a target profit, which may incorporate one or more of:

[1] An entity's ability to challenge through the courts the regulator's interpretation of the regulatory agreement does not negate the entity's obligation to accept the basis established by the regulatory agreement.

(i) an interest rate or return rate applied to a base specified by the regulatory agreement;[2]

(ii) margins on allowable costs; and

(iii) incentive rewards (bonuses) or penalties.

5. The target return rate is a key source of income for entities subject to defined rate regulation.[3] This component of the target profit is typically aimed to support the entity's ongoing rate-regulated activities, including incentivising continuous investment and protecting the entity's financial viability.

6. The regulatory agreement not only establishes the **total allowed compensation** for the goods or services supplied during a period but also determines **when** (ie in which periods) that total allowed compensation is included in the rate(s) charged to customers.

7. Typically, the regulatory agreement aims to charge customers the total allowed compensation for goods or services supplied during the **same** period in which the entity supplies those goods or services. However, in some cases, the regulatory agreement includes some of the total allowed compensation in the rate(s) charged to customers in a **different** period, causing timing differences that will be 'trued-up' later. This may occur either:

(a) because the rate calculation uses estimated amounts (paragraphs 10–11); or

(b) because the regulatory agreement creates other timing differences (paragraph 12).

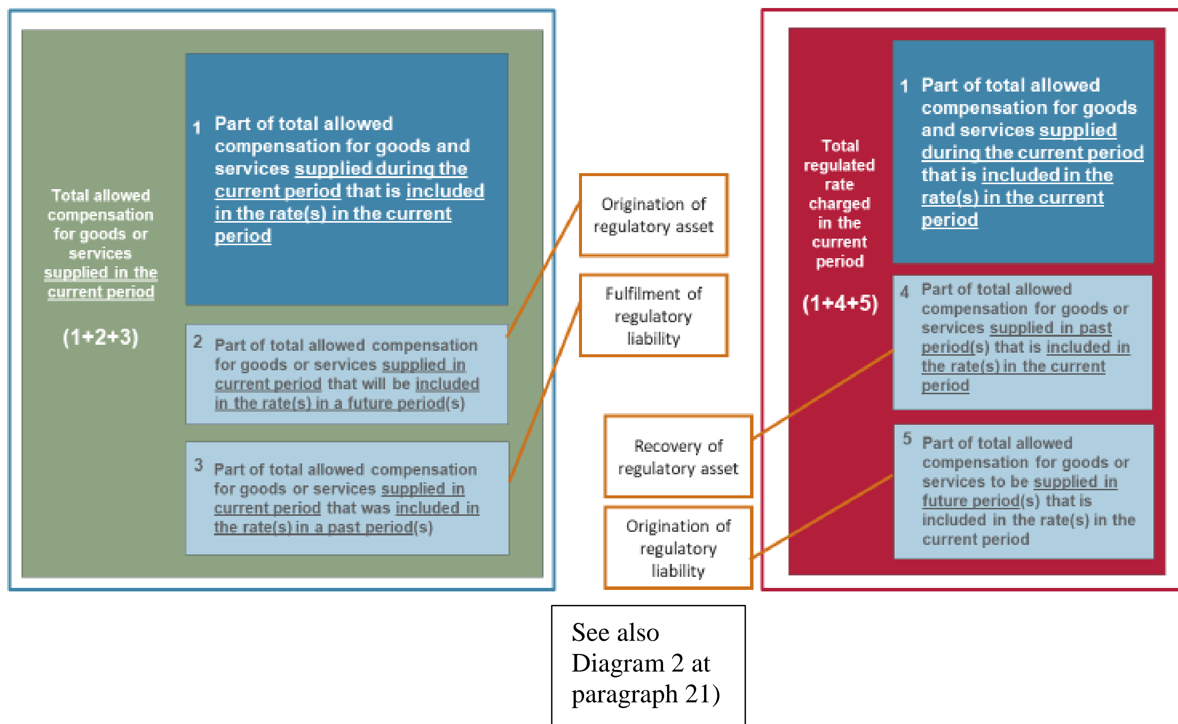
8. Because of these timing differences, the total amount charged to customers during the current period using the rate determined for the period differs from the total

[2] The base is typically based on regulatory carrying amounts—reflecting amounts invested in the regulated business in, for example, property, plant and equipment—but may differ from the carrying amounts of those items determined using IFRS Standards.

[3] In its document *'Financeability and financing the asset base – a discussion paper'* published in 2010, Ofwat, the regulator of the water sector in England and Wales, showed that 'return on capital' represented approximately 26.8 per cent of the revenue requirement for 2010-2015.

allowed compensation for the goods or services supplied during the period, as shown in Diagram 1.

Diagram 1



9. The determination of **when** all or part of the total allowed compensation is included in the rate(s), with the resulting timing differences that will be trued-up later, is an important feature that distinguishes ‘defined rate regulation’ from other forms of rate regulation.

Timing differences caused by estimation variances

10. The rate charged to customers reflects many estimated amounts and is typically fixed for the duration of a specified period to help achieve regulatory objectives of price stability and price predictability for customers. The regulatory agreement establishes which variances between estimated and actual amounts used in the rate calculation are at the risk of the entity and which are at the risk of customers. Variances at the risk of the entity do not create rights or obligations for the entity to adjust the future rate(s) charged to customers.

11. In contrast, for variances between estimated and actual amounts used in the rate calculation that are at the risk of customers, the total allowed compensation is

subsequently 'trued-up' by adding allowable variances to, and deducting chargeable variances from, future rate calculation(s). Consequently, the variances that exist at the end of an entity's reporting period create rights or obligations for the entity to adjust the future rate(s) charged to customers as a result of the goods or services already supplied.

Other timing differences

12. In addition to estimation variances, the regulatory agreement may create other differences (both positive and negative) between the time when an entity supplies goods or services to customers and the time when the entity is able to exercise its right to include in the rate(s) charged to customers some or all of the related total allowed compensation for those goods or services. Such timing differences are typically created to help achieve regulatory objectives, including price stability and price predictability for customers (eg by decelerating cash inflows to the entity) or financial viability for the entity (eg by accelerating cash inflows to the entity).

Common causes of timing differences

13. Commonly, timing differences arise when:
    - (a) allowable expenses have been incurred when supplying goods or services to customers, but the related total allowed compensation is spread through the rate(s) charged to customers over several periods;
    - (b) the rate charged to customers includes an amount designed to pre-fund allowable expenses that have not yet been incurred and relate to the future supply of goods or services to customers;
    - (c) the entity is subject to performance incentives and has (has not) achieved specified performance targets for a specified period that rewards/ (penalises) the entity with a bonus/(penalty) amount that will be added to/ (deducted from) the rate(s) in future period(s); or
    - (d) the regulatory agreement uses different principles than those used by IFRS Standards to define when allowable expenses are 'incurred' for

the supply of goods or services to customers—typically this arises when allowable expenses are incurred as the entity supplies goods or services to customers and the entity recognises in its IFRS financial statements the expense and the resulting liability, but the regulatory agreement does not include the allowable expenses in the rate(s) charged to customers until the entity pays cash to fulfil the liability.

Rights and obligations arising when goods or services are supplied

14. When, during the current reporting period, an entity subject to defined rate regulation supplies regulated goods or services to customers, the entity obtains one or more of the following:

    (a) a present right to charge customers in the current period at the rate established to be charged to customers for the goods or services supplied during the same period;

    (b) a present right to add an amount to the rate(s) to be charged to customers in future periods because some or all of the total allowed compensation for the goods or services already supplied exceeds the amount already charged to customers; and

    (c) a present obligation to deduct an amount from the rate(s) to be charged to customers in future periods because some or all of the total allowed compensation for the goods or services already supplied is lower than the amount already charged to customers.

15. It is important to understand that neither estimation variances nor other timing differences affect the rights or obligations of customers who have received goods or services from the entity during the period in exchange for the regulated rate(s) set for that period. Instead, the estimation variances and other timing differences create for the entity a present right to add an amount to, or a present obligation to deduct an amount from, the future rate(s) for the goods or services already supplied.

The problem we are trying to solve—unrecognised present rights and present obligations

16. IFRS 15 *Revenue from Contracts with Customers* provides users of financial statements with relevant information that faithfully represents the entity's right described in paragraph 14(a), ie the right to charge customers at the regulated rate(s) established for the current period in exchange for the goods or services supplied to customers during the same period. This right is incorporated in the entity's contracts with individual customers.

17. However, IFRS 15 does not provide information about the entity's right described in paragraph 14(b) or obligation described in paragraph 14(c). These rights and obligations arise through the regulatory agreement, rather than through the contracts with customers, and so are incremental to those reported using IFRS 15. These incremental rights and obligations require the entity to add amounts to or deduct amounts from the future rate(s) charged to customers because amounts already charged to customers do not fully reflect the total allowed compensation to which the entity is entitled in exchange for the goods or services it has already supplied. Although the adjustments to the future rate(s) will give rise to incremental future cash flows, the right or obligation to make that adjustment does not give the entity the right to receive cash or obligation to pay cash. Consequently, the incremental rights and obligations are not financial instruments and so are not within the scope of IFRS 9 *Financial Instruments*.

18. Not recognising these incremental rights as assets and incremental obligations as liabilities gives users of financial statements incomplete information about an entity's financial position and financial performance and may create artificial volatility in the entity's statement(s) of financial performance that could mask any real volatility. For example, an entity may recognise an expense for wasted materials in the current period and, during the same period, charge a rate to customers that includes an amount that pre-funds future allowable expenses. If the regulatory agreement disallows the current period expense because the cost of the wasted materials was avoidable, the disallowed expense will not be passed on to customers. However, the financial effect of the disallowed expense in the current period is masked by the pre-funding amount of future allowable expenses in the rate charged to customers in the current period. Consequently, without

information about the incremental rights and obligations mentioned in paragraph 14(b)–14(c), users of IFRS financial statements find it difficult:

(a) to understand the reported financial performance of entities subject to defined rate regulation;

(b) to compare the reported financial performance of such entities (ie to compare between different reporting periods for an entity and between different entities in the same reporting period); and

(c) to assess the effects of those incremental rights and obligations on the entity's prospects for future cash flows arising from the future rate(s) to be charged to customers.

Purpose of the model

19. The purpose of the model being developed is to **supplement** the information provided by IFRS 15 and other IFRS Standards by reflecting, in the current period, the incremental rights and obligations identified in paragraphs 14(b)–14(c) to 'true-up' the total allowed compensation for the goods or services supplied during the period by adding amounts to, or deducting amounts from, the future rate(s).

20. Having this additional information will help users of financial statements:

(a) to understand and assess an entity's reported financial performance, and

(b) to assess the amounts, timing and uncertainty of (prospects for) its future cash flows.

The model's core principle

21. The core principle of the model is that an entity recognises:

(a) as an asset (**regulatory asset**): the entity's present right to add an amount to the future rate(s) to be charged to customers because the total

allowed compensation for the goods or services already supplied exceeds the amount already charged to customers (paragraph 14(b));[4]

(b) as a liability (**regulatory liability**): the entity's present obligation to deduct an amount from the future rate(s) to be charged to customers because the total allowed compensation for the goods or services already supplied is lower than the amount already charged to customers (paragraph 14(c)); and

(c) as regulatory **income** or **regulatory expense**, the movement between opening and closing carrying amounts of regulatory assets and regulatory liabilities. The movement reflects the origination and subsequent reversal (ie recovery or fulfilment) of regulatory assets and regulatory liabilities during the period (see Diagram 1 at paragraph 8), plus other changes, for example changes in estimated cash flows.

Diagram 2

<table>
<tr><th>Activity period</th><th>Charging period</th><th>Rights and obligations</th><th>Effect on financial performance</th><th>Effect on financial position</th></tr>
<tr><td rowspan="2">Current period</td><td>Future period(s)</td><td>Entity has right to charge customers in the future for goods or services it supplied in the current period</td><td rowspan="2">Regulatory income</td><td>Recognise regulatory asset for right to add an amount to the rate because of goods or services already supplied</td></tr>
<tr><td>Previous period(s)</td><td>Entity charged customers in the past for goods or services it supplied in the current period</td><td>Derecognise regulatory liability because obligation is fulfilled by deduction from the rate charged in the current period</td></tr>
<tr><td>Previous period(s)</td><td rowspan="2">Current period</td><td>Entity charged customers in the current period for goods or services it supplied in a past period(s)</td><td rowspan="2">Regulatory expense</td><td>Derecognise regulatory asset because it is recovered by addition to the rate charged in the current period</td></tr>
<tr><td>Future period(s)</td><td>Entity charged customers in the current period for goods or services it will supply in a future period(s)</td><td>Recognise regulatory liability for obligation to deduct an amount from the rate because of amounts already charged</td></tr>
</table>

[4] The definitions of regulatory assets and regulatory liabilities have been revised from definitions previously discussed with the Board (see AP9A discussed at the December 2018 Board meeting and additional details in AP9B *Scope and recognition principles*).

Identifying the total allowed compensation for goods or services already supplied

22. As noted in paragraph 6, the regulatory agreement specifies the basis for determining the **amount** of the total allowed compensation for the goods or services supplied by the entity and also determines the period(s) **when** that total allowed compensation is included in the rate(s) charged to customers. The total allowed compensation typically consists of the following components (see paragraph 4):

    (a) specified 'allowable' expenses incurred; and

    (b) a target profit, which may consist of one or more of the following: interest or a return on a base amount, a margin on allowable expenses and an incentive bonus or penalty.

23. For many allowable expenses, such as costs of raw materials used in production, it is clear whether those expenses relate to goods or services already supplied rather than to goods or services to be supplied in the future. Consequently, it is also clear what the effect of those expenses on the total allowed compensation (allowable expenses plus related margin and/ or incentive) for the goods or services already supplied.

24. However, other allowable expenses may be attributable to the supply of goods or services only indirectly. The fact that the regulatory agreement treats the expenses as allowable establishes that they relate to goods or services supplied in **some** period.[5] In such cases, an entity needs to determine whether an allowable expense is part of the total allowed compensation for goods or services **already** supplied or is part of the total allowed compensation for goods and services to be supplied in the **future**. The model applies the judgements made in applying IFRS Standards to establish to **which** period that part of the total allowed compensation relates, which supports consistency of application and minimises the amount of judgement needed. For example:

[5] Expenses that are **not** determined to be incurred in supporting the supply of those goods or services or that have not been incurred in a prudent manner (eg avoidable expenses) are typically disallowed by the regulatory agreement and so are not passed on to customers through the rate(s).

(a) IAS 16 *Property, Plant and Equipment* identifies acceptable methods for allocating the depreciable amount of an item of PPE over its useful economic life. The resulting depreciation expense recognised is intended to depict the cost of the portion of the PPE consumed during the current period, and the carrying amount of the PPE is intended to depict the cost of the unconsumed portion of the PPE. The model treats the cost of the portion of the PPE consumed in the current period as relating to goods or services supplied in that period, and the carrying amount of the PPE as relating to goods or services to be supplied in future periods.

(b) IAS 16 and IAS 2 *Inventories* identify what types of overheads are included in the initial cost of an asset. In a manner similar to the treatment of depreciation, the model treats allowable overheads that are included in the carrying amount of an asset, such as PPE or inventory, as relating to the **future supply** of goods or services, irrespective of the period in which those overheads are included in the rate(s) charged to customers. On the other hand, for allowable overheads that are recognised using IFRS requirements as an expense in the current period, the model treats those overheads as relating to goods or services supplied in that period.

Scope principle

25. The model requires the incremental rights and incremental obligations that are recognised as regulatory assets and regulatory liabilities to be enforceable through a binding regulatory agreement. The Board tentatively decided that the model should define defined rate regulation as a type of rate 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** 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.

26. This scope establishes that the basis for setting the rate gives rise to rights and obligations that are enforceable. Consequently, these conditions are both necessary and sufficient to bring regulatory assets and regulatory liabilities into existence. However, in assessing our refined description of the background to the model, we conclude that the description of the scope would benefit from being updated. In paragraphs 2–7 of Agenda Paper 9B *Scope and recognition principles*, we discuss proposed changes to improve the specificity and clarity of the scope principle described in paragraph 25 and conclude that those clarifications retain the intended meaning of the original description.

Unit of account

27. Paragraphs 4.48–4.55 of the *Conceptual Framework* provides guidance to help select a unit of account. That guidance acknowledges that different units of account may be appropriate for different purposes.

28. The Board tentatively decided in February 2018 that the model will use as its unit of account the individual timing differences that create the incremental rights and obligations arising from the regulatory agreement. At the time the Board made this tentative decision, it was focusing on the general approach of the model, rather than detailed requirements. In particular, the Board was considering whether to focus on the incremental rights and incremental obligations now described in paragraphs 14(b)–14(c) (ie the rights and obligations now defined as regulatory assets or regulatory liabilities) or to also recognise other rights and obligations established by the regulatory agreement, perhaps as a single intangible asset.

29. In developing the model and refining our description of it, we have identified that:

    (a) the model does not account for timing differences—it accounts for the incremental rights and incremental obligations that come into existence as a result of timing differences; and

(b) groups of incremental rights and incremental obligations can have similar characteristics and risks, with similar implications for the prospects of future cash flows; and

(c) since February 2018, the Board has tentatively decided that it may be appropriate to group items with similar characteristics, risks and expiry patterns for measurement, presentation and disclosure (see Agenda Paper 9D *Tentative decisions made to date* for further details).

30. We consider that identifying the individual timing differences is still important to identify what incremental rights and incremental obligations arise (ie exist) as a result of those timing differences. However, we suggest that the model does not describe the unit of account as 'individual timing differences'. Instead, we consider the Board's tentative decisions that identify what unit of account is most appropriate for applying the specific requirements for measurement, presentation and disclosure are consistent with the *Conceptual Framework* and with the general principles of the model.

Recognition principles

31. The model requires the recognition of regulatory assets or regulatory liabilities if it is more likely than not that they exist—the model sets a symmetrical threshold in cases of existence uncertainty.

32. The model does not set any recognition thresholds relating to low probability of an inflow or outflow of economic benefits or high measurement uncertainty. The model considers those aspects in measurement rather than recognition. See further details in Agenda Paper 9B *Scope and recognition principles* and Agenda Paper 9C *Measurement principles*.

Measurement principles

33. As highlighted in paragraphs 21(a)–21(b), an entity using the model would recognise:

(a) a regulatory asset reflecting the entity's present right to add an amount to the future rate(s) charged to customers because the total allowed

compensation for the goods or services already supplied exceeds the amount already charged to customers; and

(b) a regulatory liability reflecting the entity's present obligation to deduct an amount from the future rate(s) charged to customers because the total allowed compensation for the goods or services already supplied is lower than the amount already charged to customers.

34. The nature of regulatory assets and regulatory liabilities do not fit neatly into any of the defined categories of assets and liabilities accounted for using IFRS Standards. Although the right to add an amount to or obligation to deduct and amount from the future (rate) to be charged to customers gives rise to incremental cash flows, the right or obligation is not a right to receive cash or obligation to pay cash (paragraph 17). The model reflects the unique nature of regulatory assets and regulatory liabilities by using a cash-flow-based measurement technique that would require an entity to:

(a) estimate the future cash flows arising from regulatory assets or regulatory liabilities, updating those estimates if changes occur; and

(b) discount the estimated future cash flows, keeping the discount rate established at initial recognition unchanged, unless the regulatory agreement changes the future cash flows by changing the interest rate or return rate.

35. We plan to ask the Board to decide whether to describe this measurement technique as applying a modified historical cost basis or applying a modified current value basis—see Agenda Paper 9C *Measurement principles* for further discussion.

Identifying the discount rate

36. Once an entity has estimated the amount and timing of the future cash flows arising from a regulatory asset or regulatory liability, the entity would then consider the effects of the time value of money and risks inherent in the cash flows for the period between the when the regulatory asset (or regulatory liability) arises and when it is recovered (or fulfilled) through subsequent inclusion

(deduction) in determining future rate(s) charged to customers. The model's principles in this area are as follows:

(a) discounting of the estimated future cash flows is not required if the effects of the time value of money and risks inherent in the estimated cash flows are not significant.

(b) the interest rate or return rate is recognised over time unless there is an identifiable transaction or event that causes some or all of it to be recognised at a point in time.

(c) for regulatory assets, the interest rate or return rate provided by the regulatory agreement should at least compensate the entity for the time value of money and risks inherent in the estimated future cash flows. If the regulatory interest rate or return rate does not provide adequate compensation, the entity will not fully recover the regulatory asset and so should recognise an expense for the partial disallowance immediately.

37. Agenda Paper 9C *Measurement principles* includes additional details on the measurement of regulatory assets and regulatory liabilities.

Presentation principles

38. As noted in paragraph 19, the purpose of the model is to provide financial information that supplements the information provided by other IFRS Standards, including IFRS 15, by recognising the incremental rights and obligations that, as identified in paragraphs 14(b)–14(c), 'true-up' the total allowed compensation for the goods or services supplied during the period by adding amounts to, or deducting amounts from, the future rate(s). Consequently, the model uses a 'supplementary approach'. This means that existing IFRS Standards are to be applied first and, subsequently, the model will be applied to recognise the incremental rights and incremental obligations arising from the timing differences.

Statement of financial position

39. The model requires regulatory assets and regulatory liabilities to be presented in the statement of financial position in separate line items beyond the line items required by IAS 1 *Presentation of Financial Statements* because the nature of regulatory assets and regulatory liabilities do not fit neatly into any of the defined categories of assets and liabilities accounted for using existing IFRS Standards.

Statement(s) of financial performance

40. Regulatory assets and regulatory liabilities arise when an entity supplies goods or services in one period but some amounts relating to those goods or services are charged to customers through the rate and, are consequently, recognised and presented as revenue, in a different period. Consequently, the model requires the net movement between opening and closing balances of regulatory assets and regulatory liabilities to be presented as a regulatory income/ (regulatory expense) line item immediately below the revenue line items presented by applying IAS 1.

41. The model requires an entity's compensation/ charge arising from regulatory interest or regulatory return (see paragraph 4(b)) to be presented within the regulatory income/ (regulatory expense) line item, rather than with financing. This is because this compensation/ charge is intended to achieve the regulatory objectives (see paragraph 5).

42. Some regulatory income or regulatory expense arises when income or expense is recognised in other comprehensive income (OCI). There could be two approaches to such regulatory income or expense, and the Staff will ask the Board at a future meeting to choose between them:

    (a) approach 1, tentatively decided by the Board in November 2018—present it in profit or loss immediately below revenue, like all other regulatory income and regulatory expense; or

    (b) approach 2—present it in OCI so that the regulatory income or regulatory expense and the underlying income or expense are both presented outside profit or loss.

Disclosure principles

43. The model identifies an overall disclosure objective, supported by more granular specific disclosure objectives and disclosure requirements supporting the specific disclosure objectives. A similar approach is being developed in the Targeted Standards-level Review of Disclosure project. (Agenda Paper 9D sets out all the Board's tentative decisions and includes the disclosure objectives and disclosure requirements that the Board tentatively agreed in November 2018.)

44. The overall disclosure objective does not focus on reporting all effects of defined rate regulation but is instead linked tightly with the purpose of the model, ie to recognise regulatory assets, regulatory liabilities and movements in their balances. Consequently, the overall disclosure objective of the model focuses on providing financial information that will help users of financial statements to understand how the origination and subsequent recovery/ fulfilment of regulatory assets and regulatory liabilities has affected the entity's financial performance and financial position.

45. The specific disclosure objectives focus on the following areas:

    (a) financial performance;

    (b) amount, timing and uncertainty of future cash flows from regulatory assets and regulatory liabilities; and

    (c) changes in the carrying amounts of regulatory assets and regulatory liabilities.

46. We have not identified a need for the Board to change its tentative decisions made to date about disclosure requirements as a result of the refinement of the description of the model. We may need, however, to provide more guidance about the application of those requirements, which we plan to discuss with the Board at a future meeting.

Questions for the Board

Question for the Board
1. Do Board members have any questions or comments on the description of the model's principles as described in this paper?