
Project	<i>Rate-regulated Activities</i>
Topic	Staff summary and questions for the Board

Purpose of this agenda paper

1. This paper provides a staff summary of the analysis performed to assist the Board in answering the **key issue** of whether regulatory assets and regulatory liabilities exist in accordance with the current *Framework for the Preparation and Presentation of Financial Statements* (Framework) and consistent with current other IFRSs. This paper also requests the Board to answer questions and provide the staff with additional guidance on how to proceed with this project.
2. This paper should be read in conjunction with the other agenda papers 11–11H of the July 2010 Board meeting to assist the Board in its deliberations of the *Rate-regulated Activities* project.
3. The staff notes the material size of regulatory assets and liabilities that have been recognised by entities in jurisdictions permitted to do so using their national GAAP. The staff acknowledges the objectives of regulators to protect customers from short-term price-shocks through the use of smoothed rates for essential services. The staff also acknowledges the regulator’s fiduciary responsibility to minimise overall rates charged to customers while allowing a fair return for the entities that provide services determined to be essential to the public accomplished through the regulator’s balancing of the interests of both customers and equity holders.
4. This paper includes:
 - (a) a summary of information on the project to date;

This paper has been prepared by the technical staff of the IFRS Foundation for discussion at a public meeting of the IASB.

The views expressed in this paper are those of the staff preparing the paper. They do not purport to represent the views of any individual members of the IASB.

Comments made in relation to the application of an IFRS do not purport to be acceptable or unacceptable application of that IFRS—only the IFRS Interpretations Committee or the IASB can make such a determination.

The tentative decisions made by the IASB at its public meetings are reported in *IASB Update*. Official pronouncements of the IASB, including Discussion Papers, Exposure Drafts, IFRSs and Interpretations are published only after it has completed its full due process, including appropriate public consultation and formal voting procedures.

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- (b) a layout of the two views on recognising regulatory assets and liabilities; and
- (c) questions for the Board.

Information on the project to date

Exposure draft comment letters

5. As a result of the exposure draft published in July 2009, the Board received 155 comment letters. At its February 2010 meeting, the Board discussed a summary analysis of these comment letters and potential paths forward. That analysis of comment letters noted extremely strong support for the recognition of regulatory assets and liabilities coming from the North American utility industry. The analysis also noted mixed support from the rest of the world and from all non-utility industry entities (national standard setters, national accountancy bodies, international accounting firms, non-utility companies, etc.).
6. Below is a summarized version of the analysis included in the [February 2010 Board Paper 7](#)¹:

	North America	Rest of the World	Total	Agree	Disagree	Neither
Non-utilities	14	44	58	25	28	5
Utility Industry	78	19	97	91	6	-
Total	92	63	155	116	34	5
Agree	87	29	116			
Disagree	5	29	34			
Neither	-	5	5			

¹ http://www.ifrs.org/NR/rdonlyres/C0072CF3-0E60-4EB1-9852-264AC8D1DCA5/0/RAA0210b07_Revised5Feb2010.pdf

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Additional research and analysis

7. As a result of the February 2010 meeting, the Board requested the staff to perform additional research and analysis on the key issue of the appropriateness of the recognition of regulatory assets and liabilities. In preparing for this meeting, the staff has performed a detailed analysis including:
- (a) an analysis of the regulatory environments (Paper 11B);
 - (b) an analysis of scope (ie unit of account) (Paper 11C);
 - (c) a comparison of RRA project to current IFRSs (Paper 11D);
 - (d) a comparison of RRA project to other current IASB projects (Paper 11E);
 - (e) an summary of the results of outreach efforts (Paper 11F);
 - (f) an analysis of scope (required application of RRA to non-utility entities (Paper 11G); and
 - (g) a summary of other project matters (Paper 11H).
8. Detailed information on each of these areas is available at the referenced agenda paper to this July 2010 Board meeting.

Staff findings

9. The results of each aspect of the additional research and analysis did not provide a clear direction for this project. That is, all aspects of the staff's efforts resulted in some information that is supportive and some information that is not supportive of the recognition of regulatory assets and liabilities.
10. The amounts being considered by the Board for potential recognition as regulatory assets or liabilities are a result of the time delay that is required by the regulations. The time delay is caused by differences between the period in which a cost is included in rates (and therefore received by the entity to recover actual costs) and the period in which the underlying goods and services are provided. This is a result of the use of estimated costs to deliver the goods and services that are captured in and reimbursed through current period rates being different from the actual costs to deliver the goods and services. Any difference between the estimated and actual costs is incorporated into the aggregate rate

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charged to customers in a future period and the time delay relates only to that portion of the rates that provides for recovery of the prior period difference.

11. This delay is for practical purposes and provides the following benefits:
 - (a) It protects the customer from price shocks, for example when there are spikes in market prices for the fuel used to generate electricity or when an entity expects significant environmental clean-up obligations.
 - (b) It provides time for the entity to gather the necessary information, and analyse the actual costs against expected costs, to identify which costs should result in an adjustment to rates.
 - (c) It provides time for the regulator (and in some cases, the public) to scrutinise the price adjustment to ensure that the interests of the customer are taken into account.

12. Regulations require that the price adjustment is included in the aggregate future rate charged to all customers (or sometimes identified customer classes) receiving the goods and services in the future period. That is, the price adjustment is applied to the aggregate customer base that purchases goods and services in the future period. Goods and services that are price regulated tend to be considered 'essential' goods and services, the patterns of consumption for many customers is generally consistent from period to period, and the regulator is acting on behalf of the aggregate customer base. All of these factors reduce the importance of backwards tracing of individual/ specific customer volumes in any particular period.

13. In the staff's opinion, the most difficult aspect the Board will need to consider in this RRA project is the determination of whether the entity has 'control' over incremental future economic benefits that have been created as a result of current period costs. Factors to be considered in this determination include:
 - (a) the concept of the aggregate customer base;
 - (b) the concept of the delimited service area over a captive customer base;
and
 - (c) the individual transaction level (or higher) unit of account.

Two views

14. In the staff's opinion, the additional research and analysis does not point exclusively towards a single answer to assist the Board in determining whether to change existing IFRS requirements based on the proposals included in the exposure draft. However, consistent with all projects, individual Board members give greater weight to some factors than others. The staff does believe that the detailed analysis provided in these Papers 11-11H of the July 2010 Board meeting will assist the Board in concluding in the appropriateness of the recognition of regulatory assets and liabilities in financial statements prepared in accordance with IFRSs.
15. To assist the Board in coming to a conclusion on this aspect of the project, the staff has provided two views including supporting rationale for each view.

View 1 – recognition of regulatory assets and liabilities

16. If the Board concludes that the recognition of regulatory assets and liabilities is appropriate, the staff believes that a 'cost-plus aggregate contract' approach focusing on the delivery of goods and services to the aggregate customer base is appropriate. That is, the time delay required by regulations between incurring the unanticipated costs of the current period goods and services sold (not already included in current period rates) and invoicing the aggregate customers in a future period for this unanticipated variance is reflected as a regulatory asset or liability as at current period end. The asset represents the unanticipated revenue for goods and services provided to the aggregate customers in the current period, but not yet billed in full to the aggregate customers. The liability represents billings made for goods and services in the current period in excess of the 'specific costs an entity incurs in providing the regulated goods or services and to earn a specified return' permitted by the regulations (ie unanticipated billings in excess of what is required by regulations). If there was no time delay and the actual cost of the current period goods and services sold were reflected immediately in the current period rates, there would be no regulatory asset or liability to recognise.
17. The rationale for the 'cost-plus aggregate contract' approach is as follows:

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Controlled by the entity

- (a) Regulations created by the regulator and entered into by the entity are similar to a contract between the 'aggregate customer base' (with the regulator acting on their behalf) and the entity.
- (b) Regulations result in 'a restraint of trade agreement' (IAS 38.14) which results in the entity having effective control over the future economic benefits associated with the aggregate customer base that is in the entity's jurisdiction.
- (c) The aggregate customer base is a 'captive customer' of the entity because of the nature of the goods and services provided, method of delivery and receipt of delivery. That is, the aggregate customers cannot easily move the location of receipt of the goods and services and are often precluded from purchasing goods and services from other providers due to the regulations.

Past events

- (d) The regulations create a cause-and-effect relationship between the incurring of certain costs and an adjustment to the rates. The recognition of regulatory assets and liabilities would be determined at the level of the individual cost transaction that has this cause-and-effect relationship with the rates of the goods and services delivered. Consequently, recognition of a regulatory asset would be required in situations where regulations result in the creation of a new/ enhanced future economic benefit to the entity that did not previously exist, and vice versa for regulatory liabilities.
- (e) Regulations (ie deemed contract) that exist addressing the interaction between the entity and the aggregate customer base are consistent with a 'cost plus contract' whereby the customer will pay the entity for all costs incurred in providing the goods and services plus a specified return.
- (f) In the current period, the customer purchased goods and services and the entity sent out an 'interim progress billing' based on beginning of period expected costs.

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Future economic benefits

- (g) Any variance that exists between the beginning of period expected costs and the actual costs incurred in providing the goods or services that have already been delivered is deemed an ‘unbilled receivable’ or a ‘customer prepayment’. The regulations require that the aggregate customer base will pay any unbilled receivable balance in a future period.
 - (h) The process of receiving these new directly observable increases in the rates charged (ie new/ enhanced future economic benefits) or decreases in the rates charged (ie new/ expanded future obligations or decreased future economic benefit) includes an addition to or subtraction from, respectively, the rate required by the regulations for the future period goods and services. This practical accommodation is accomplished when the invoice billed for the purchase of goods and services next period is increased or decreased to provide recovery of or return of the new future economic benefit or new obligation, respectively.
18. This rationale has the result that entities meeting the above requirements would recognise in revenue in the current period, the total anticipated future economic benefit that results from the delivery of goods and services in the current period. Likewise, all costs incurred in the current period would continue to be recognised in the current period in accordance with other applicable IFRSs, for example as property, plant and equipment, intangible assets, inventory or operating expenses. Therefore, the accounting for the costs of providing the regulated goods and services is consistent with the costs of providing non-regulated goods and services. It is the effect of the regulations on the rates (ie sales prices) that is under consideration, rather than the costs incurred to provide those goods and services.
19. Regulatory assets do not meet the definition of a ‘financial asset’ as defined in IAS 32. Based on the above rationale, regulatory assets do meet the definition of an intangible asset; however, in the staff’s opinion, the realisation of the economic benefits of regulatory assets is similar to financial assets. That is, most intangible assets are used in an entity’s operations to assist and indirectly result in cash inflows to the entity. Whereas the economic benefits of regulatory

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assets and economic detriments of regulatory liabilities are realised through the invoicing of customers and the receipt of increased or decreased cash inflows, respectively.

20. The specific measurement and presentation of regulatory assets and liabilities are items for consideration at future Board meetings.

View 2 – disclosure only (ie no recognition of regulatory assets and liabilities)

21. If the Board concludes that the recognition of regulatory assets and liabilities is not appropriate, the staff recommends it is appropriate to require disclosures explaining the impact of regulations on the entity. The staff believes that this approach is supported by the following rationale:

Controlled by the entity

- (a) Regulations created by the regulator and entered into by the entity provide for a smoothing of rates to current period customers and prevent the entity from exerting inappropriate pressure on the rates charged to customers for goods and services deemed essential by the regulator. The regulators actions cover all customers in the aggregate customer base, but the regulations do not oblige any individual customer to purchase goods and services from the entity.
- (b) Regulations do not result in the regulator being financially responsible for the costs or partial costs of any goods and services provided to customers.
- (c) Regulations do not require individual customers to pay any additional amounts that are not determined and disclosed in the rate stated in a period in which the goods and services are provided. Any excess costs incurred in the current period are contingent on future events outside the entity's control (whether or not the individual customer elects to purchase additional goods and services in a future period at an increased rate) and not 'contingent assets' in which there is uncertainty about past events. Therefore, this potential future right should be recognised in the future period when the additional goods and services are delivered.

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Past events

- (d) The regulatory process is complicated, is impacted directly or indirectly by political influences, continues to evolve away from a pure ‘cost-of-service’ model, and typically does not provide a direct linkage to all specific past events that determine the single aggregate rate charged to customers (ie there is no ‘one-to-one’ link between a cost incurred and an identical, separately identifiable, rate adjustment). Unless all individual transactions have a direct linkage that impacts future rates, then some portion of the rate calculation is subject to subjective influence (ie negotiations with the regulator) with the result that the entire aggregate single rate charged for goods and services is subject to be influenced.

Future economic benefits

- (e) If any individual customer or the aggregate customers made the decision, for any reason, to not purchase goods and services in a future period, the entity will not obtain any increased future cash inflows from, or be required to receive reduced cash inflows from (or provide cash outflows to), any individual customer or the aggregate customers.
 - (f) Similarly, the rate charged for the delivery of goods and services in a future period is simply the rate applicable for that period.
 - (g) The rate setting process in many jurisdictions that currently classify themselves as ‘cost-of-service’ is a prospective only rate determination whereby the impacts of past events is precluded from being adjusted and is only used in assisting the determination of future rates.
 - (h) Additionally, continuing and accelerating changes in the regulatory environment provide evidence that uncertainty exists in future economic benefits of any specific past transaction. Regulators are continuing to introduce incentive based targets in the rate calculation.
22. The above rationale has the result that entities with activities subject to rate regulation would not recognise regulatory assets and liabilities. Instead, entities would be required to recognise revenue for the current period goods and services based only on regulated rates related to the delivery of goods and services in the

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current period. The rates determined for a future period would be applicable to the goods and services delivered in that future period and will be recognised as revenue in that same future period of delivery. Likewise, all costs incurred in the current period would continue to be recognised in the current period in accordance with other applicable IFRSs, for example as property, plant and equipment, intangible assets, inventory or operating expenses. The accounting for the costs of providing the regulated goods and services is therefore consistent with the costs of providing non-regulated goods and services.

23. Regulatory assets and liabilities do not meet the definition of a ‘financial asset’ or ‘financial liability’ as defined in IAS 32. Similarly, entities do not have the ability to control the individual (or aggregate) customer to make payments for any amounts not included in the stated current period rate, therefore, the definitions of an intangible asset as defined in IAS 38 and a liability as defined in IAS 37 are not satisfied.
24. The specific disclosure requirements will be considered at future Board meetings.

Questions for the Board

25. The staff notes the fine balance between the two views and requests the Board answer the following questions and provide the staff with guidance on how to proceed with this project.

Question 1 – Recognition or disclosure only

Does the Board conclude that regulatory assets and regulatory liabilities exist in accordance with the *Framework for the Preparation and Presentation of Financial Statements* and consistent with current other IFRSs?

Question 2 – Interim standard

Does the Board believe the staff should perform work on an interim standard permitting the recognition of regulatory assets and regulatory liabilities in financial statements prepared in accordance with IFRSs as detailed in Paper 11H?

Question 3 – Project timeline

Does the Board agree with the current estimated timeline provided in Paper 11H? That is, finalisation and issue of an RRA standard by H2 2011?

What next steps does the Board request the staff to take?