Project ***Rate-regulated Activities***

Topic **Analysis of scope (unit of account)**

Purpose of this agenda paper

1. This paper provides the Board an analysis of the unit of account at which this project should be applied to determine the recognition of regulatory assets and liabilities.

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.

Background

3. Numerous comment letters received on the RRA ED noting that the scope of the project was 'unclear'. This included a request for clarification of the term 'operating activities'. Many constituents believe the scope of the project should be expanded while others believe the scope should be narrowed.

4. The RRA ED states, in part:

> **3 An entity shall apply this [draft] IFRS to its operating activities that meet the following criteria:**
>
> **(a) an authorised body (the regulator) establishes the price the entity must charge its customers for the goods or services the entity provides, and that price binds the customers; and**
>
> **(b) the price established by regulation (the rate) is designed to recover the specific costs the entity incurs in providing the regulated goods or services and to earn a specified return (cost-of-service regulation). The specified return could be a**

minimum or range and need not be a fixed or guaranteed return.

4 If regulation establishes different rates for different categories, such as different classes of customers or volumes purchased, the related operating activities of an entity are within the scope of this [draft] IFRS provided that the regulator approves the definition and the rate for each of those categories and that all customers of the same category are bound by the same rate.

5 An entity shall determine at the end of each reporting period whether its operating activities meet the criteria in paragraph 3.

6 Some regulation determines rates based on targeted or assumed costs, for example industry averages, rather than the actual costs incurred or expected to be incurred by the entity. Activities regulated in this way are not within the scope of this [draft] IFRS.

7 This [draft] IFRS does not apply to financial assets and financial liabilities, as defined in IAS 32 *Financial Instruments*: *Presentation*.

BC13 The exposure draft does not address an entity's accounting for reporting to regulators (regulatory accounting). Regulators may require a regulated entity to maintain its accounts in a form that permits the regulator to obtain the information needed for regulatory purposes. The exposure draft would neither limit a regulator's actions nor endorse them. Regulators' actions are based on many considerations. The exposure draft specifies how an entity reports the effects of rate regulation in its financial statements prepared in accordance with IFRSs.

BC14 In the past, rate regulation tended to be applied to an entire entity. With acquisitions, diversification and deregulation, rate regulation may now be applied to only a portion of an entity's activities. In some cases, an entity may have both regulated and non-regulated activities. In others, the entity may be permitted to negotiate rates individually with some customers. The exposure draft applies only to the activities of an entity that meet the two criteria set out in paragraph 3 of the draft IFRS.

Constituent comments

5. The staff has held numerous discussions with preparers, national standard setters, international accounting firms and various investor/ analysts to discuss the unit of account at which this project should be applied (reporting entity, cash-generating unit, transaction, etc.). These discussions included reviewing the specific regulatory frameworks and procedures applied in several regulatory jurisdictions around the world.

6. Appendix A to this paper provides comments received from seven different national standard setters primarily focused on the scope of this RRA project, but also addressing other aspects of this project. Paper 11F *Results of outreach efforts* of the July 2010 Board meeting includes a broader range of comments received from constituents.

Unit of account analysis

7. Through the discussions with constituents and other research and analysis performed by the staff the issue of scope of this RRA project has emerged as one of the key issues. The issue of scope involves the interaction of the unit of account of application of this RRA project and the various forms regulatory mechanisms in all jurisdictions around the world (that continue to evolve). This paper provides an analysis of the unit of account to apply the requirements of the RRA project. Paper 11B *Analysis of regulatory environments* of the July 2010 Board meeting provides analysis of the common regulatory mechanisms in use around the world.

8. The RRA ED noted that 'an entity shall apply this [draft] IFRS to its operating activities that meet the following criteria…" The RRA ED did not provide additional guidance as to the meaning of 'operating activities'. Numerous comments were received requesting clarification on the scope of the RRA project. The three obvious units of account for consideration include:

   (a) reporting entity;

   (b) cash-generating unit; and

   (c) individual transaction.

Reporting entity

9. Entities with regulated activities frequently have both regulated and unregulated activities. The regulated activities are often covered by different forms of regulation and each jurisdiction often applies its regulations to different components of the entity's activities. These regulatory variations have a varying impact on the economics of the entity.

10. Application of the RRA project at the reporting entity level would attempt to capture the valuation of the entire reporting entity at each reporting period. Draft paragraph OB7 of the Board's soon to be issued Chapter 1 *The Objective of General Purpose Financial Reporting* of the *Conceptual Framework for Financial Reporting* states (emphasis added):

> General purpose financial reports are <u>not designed to show the value of a reporting entity</u>; but are likely to help existing and potential equity investors, lenders and other creditors who wish to estimate the value of the reporting entity.

11. Based on the above, in the staff's opinion, application of the RRA project at the reporting entity level (ie 1 unit of account for the entire entity) does not appear in line with the current (or soon to be issued) *Framework*.

Cash-generating unit

12. The RRA ED states that this project should be applied to 'operating activities' that are subject to rate regulation. Paragraphs 17-20 of the RRA ED on the issue of 'recoverability' specifies that if regulatory assets when taken as a whole may not be recoverable it is an indication that the cash-generating unit in which the regulatory assets and regulatory liabilities are included may be impaired and the cash-generating unit shall test for impairment in accordance with IAS 36 *Impairment of Assets*. Paragraph BC54 of the RRA ED states, in part, that 'The Board concluded that this treatment is appropriate because regulatory assets and regulatory liabilities do not generate cash inflows that are largely independent from other assets of the entity.'

13. Application of the RRA project at the CGU level would be consistent with the notion of an 'aggregate customer base' and the notion that all of the assets within the CGU including the regulatory assets and liabilities do not generate largely independent cash flows. However, the link between past transactions and future benefits is not usually direct at the CGU level. That is, often regulations specify a direct link between past events and future economic benefits for some transactions with the remaining transactions aggregated into one amount for negotiation between the entity and the regulator. Unless all individual transactions in a CGU have a direct linkage that impacts future rates, then some portion of the rate calculation is subject to subjective influence with

the result that the entire aggregate single rate charged for goods and services is able to be influenced.

14. For example, assume that in a prior period an entity was permitted to charge CU45 per unit and actual costs to provide that unit was CU55. This results in excess costs of CU10. For this example, assume that CU8 of the excess costs relating to raw material/ supply prices for which there is an automatic 'pass-through' of costs (ie deferral and variance account) will be included in future rates for recovery. The remaining CU2 that is a current period expense, but not incorporated into the current period rates, is absorbed by the entity (with the result that the entity will have a lower profitability in the current period).

15. Assume in the current period that same entity is required to charge CU53 per unit in the current period with that rate comprised of the following:

    (a) CU8 for the pass-through account to recover the excess costs incurred in the prior period;

    (b) CU45 for all other costs associated with the sale of the goods or services in the current period (made up of 45 individual costs at CU 1 for each individual cost).

16. In this example, the entity has some costs associated with a pass-through account (CU8) and other costs are not directly eligible for reimbursement of excess variances (CU2). Therefore, in the prior period the entity is required to absorb CU2 of actual costs. Additionally, in the current period, the entity estimates that the underlying cost of providing the current period goods and services is CU46, a CU1 increase in estimated costs over the prior period; however, given the increase in the aggregate rate per unit paid by the customer from CU45 to CU53, the regulator does not permit the entire increase in the current period rates up to CU54 (CU46 + CU8). Rather, the regulator instructs the entity to defer the remaining CU1 of estimated current period costs that are not directly associated with a pass-through account to a future period.

17. The costs that are not directly associated with a pass-through account are incorporated into the comprehensive regulatory review and determination of one net rate per unit of good or service for which the regulatory process is complex and time consuming with most rate orders determining rates on a prospective

basis (often with a statutory requirement that precludes retrospective rate making or adjustments to prior rates).

18. If some portion of the aggregate rate is subject to alteration (disallowance, partial allowance, deferral, etc) by the regulator, then an argument can be made that all components of the aggregate rate are subject to alteration. This can be seen in the above example where pass-through accounts do not exist for all transactions. In the example above, as a result of the economic and political environment in the jurisdiction and the time of the regulatory review, the regulator has required the entity to exclude the amount of CU1 of current period estimated costs and defer those costs to a future period. That CU1 of deferred estimated costs will be reviewed as part of an aggregate rate case review to determine the potential ability of the amount being permitted into a future rate increase.

Individual transaction

19. The concept of an asset in paragraphs 49 and 53-59 of the *Framework* requires, among other things, the incurrence of a past event. The linkage between the past event and the future expected benefits expected to flow to the entity is most easily evidenced at the individual transaction level.

20. Whether an entity is considered to be 'cost-of-service' or 'incentive based' almost all entities around the world that are subject to rate regulation have some component of their aggregate rate that is a 'direct pass through' cost where the linkage between the past event and the future expected benefit for that individual transaction is clear. These type of pass-through accounts vary across regulatory jurisdictions and are not limited to but often include, gas commodity price change pass-through variance accounts or electricity market price pass-through variance accounts. Many regulators require a relatively short time period of recovery of these types of costs that the regulator believes the entity's management does not have the ability to influence.

21. Additionally pass-through accounts can include items some consider to be more subjective in nature and include: income tax rate change variance accounts, pension costs deferral accounts, storm damage recovery deferral accounts, etc. Pass-through accounts can also include deferral accounts for amounts incurred

currently and authorized by the regulator to be carried forward for review at a future regulatory proceeding and recovery in a period(s) for which rates have not yet been set.

22. However, as noted above in the analysis of the 'cash-generating unit' unit of account, unless all components of an aggregate rate have this direct link, then an argument can be made that all components of the aggregate rate are subject to alteration.

23. Additionally, the individual transaction unit of account appears to contradict the concept that regulatory assets and liabilities are created as a result of the regulations that bind the 'aggregate customer base' and therefore the aggregate transactions between the entity and its customers. A past event with an individual customer does not equate to a future economic benefit will be received from that same individual customer. The aggregate customer base concept requires the use of a deemed contract in the form of the regulations or statutes at the aggregate customer base.

Staff opinions on the unit of account

24. In the staff's opinion, application of the RRA project at the reporting entity level does not appear in line with the current (or soon to be issued) *Framework*. Additionally, it does not appear to be consistent with the application of many rate regulations in the world today that apply direct pass through recovery for specified costs and require other costs to be included in a comprehensive rate case with the final outcome being determined simultaneously with hundreds of other costs.

25. In the staff's opinion, application of the RRA project at the cash-generating unit level would provide a better linkage between the underlying assets that are creating the benefit and the future benefits expected to flow to the entity. The cash-generating unit level also does not appear unreasonable when using the aggregate customer base through which past events occur and future benefits are received. However, many constituents have pointed out that use of the aggregate customer base is not appropriate because as at any reporting date, an entity is unable to specify from which customer the future benefits will be received.

26. In the staff's opinion, application of the RRA project at the individual transaction level provides the most direct linkage between the past event and the expected future benefit. In the staff's opinion, if the Board determines that the recognition of regulatory assets and liabilities is appropriate, the individual transaction level provides the best support for the creation of rights and obligations of the entity. Although, as stated earlier this may still require use of the aggregate customer base concept and if any portion of the aggregate rate is determined to be subjective, an argument can be made that the entire rate is subjective.

Staff recommendation

27. As noted in numerous comment letters and heard through many of the staff's outreach efforts, the issue of determining an appropriate scope is critical to the success of the RRA project and at the same time extremely difficult to appropriately capture. This task is made more difficult given the differences in regulatory procedures in the over 100 jurisdictions that require or permit application of IFRSs.

28. As noted above, each of the three unit of account levels analysed by the staff (reporting entity, cash-generating unit, individual transaction) have their benefits and drawbacks. However, in the staff's opinion, a unit of account at the individual transaction level is most closely aligned with the *Framework*, current IFRSs and other current IASB projects.

Appendix A – Selected constituent comments

A1. National Standard Setter 1

> It is believed that all three concepts mentioned above [reporting entity, cash-generating unit, individual transaction], may give problems in practice.
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> We think this is a difficult question to answer because it could then have an impact on consolidation principles. For example for entities to which the ED could apply might end up having different results. For example in the petroleum distributor sector one group has a subsidiary which meets the ED requirements. The group financial statements including this subsidiary would not meet the requirements which implies any rate regulated asset/liability would be reversed on consolidation. In another company in the same industry the retail part of the group is not a separate subsidiary and this company does not meet the ED requirements for a rate regulated asset/liability. This can result in the financial statements of companies which contain some similar business (i.e. first company has retail operations [with refining in a separate company] while the other company has both retail and refining operations) not having comparable results. The normal consolidation principle is to prepare results as if the barriers between the various companies don't exist and so whether the ED applies should be considered from that aspect. If the suggestion is that this does not have to apply (i.e. consider the application of the ED from either the entity or component of an entity approach) then instead of the financial statements reflecting business activity it could result in entities artificially altering their groups to determine whether the ED applies or not (or might change this from year to year depending on whether they wish it to apply or not).
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> Another suggestion is that the statement should rather look at the economic elements of the regulatory model that is subject to rate regulation. For example in our electricity utility's case the latest model developed by the regulator is to focus on certain areas of the cost of the company. For example the primary energy costs to generate electricity. Instead of focussing on all costs, the regulator will then determine the over or under recovery on the generation's primary energy cost.

A2. National Standard Setter 2

> We support the scope of the ED. However, we think that should be clarified if entities that operate in a regulated industry in which the rates are based on industry average costs and hold almost the totality of market share, could fall within the scope of this standard. In this case, the specific costs incurred by the entity approximate the industry average costs.
>
> It should also be clarified if regulations in which the rate is determined by the regulator in part recovering the specific costs incurred by the entity and the other part of the rate is based on targeted costs or industry average costs could fall within the scope of the proposed Standard. Based on a literal interpretation, it would seem that such systems do not fall within the scope of the standard in question. However, if they did, it would be still necessary to clarify whether the recognition of regulatory assets must be limited only to the part that covers the specific costs incurred.

A3. National Standard Setter 3

> The participants [of a national standard setter] of this discussion criticised that the scope of the ED does not cover a lot of entities and issues of the complex [country] regulatory system.
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> I will also make some remarks on utility entities, because companies in this line of business are not in the scope of the ED in [country].
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> Until 2009 there was a cost-based form of regulation of utility entities in [country]. Nowadays there is an incentive regulation. The regulator determinates a *revenue-cap* every year. If there are changes of the consumer price index or of non-influenceable cost components there is an adaption of the *revenue-cap* to the 1st January of the legal year. Incentive regulation is not within the scope of the Exposure Draft. In particular revenue-caps are not conform with paragraph 3 (b) of the ED. Furthermore, revenue-limits are regulated by revenue-caps, not prices as claimed by paragraph 3 (a).

A4. National Standard Setter 4

> We are of the view that rate regulation does not of itself create assets and liabilities as defined in the *Framework for the Preparation and Presentation of Financial Statements*. In deciding not to add to its agenda a project on rate-regulated activities, the IFRIC noted that the recognition criteria in SFAS 71 *Accounting for the Effects of Certain types of Regulation* were not fully consistent with the recognition criteria in International Financial Reporting Standards (IFRSs) and would require the recognition of assets under certain circumstances which would not meet the recognition criteria of relevant IFRSs. Given that is the case, we do not understand why this project did not start with a discussion paper analysing the technical basis of the project. Without a sound conceptual base, we believe there is no justification for overriding the principles in other IFRSs in the case of rate-regulation.
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> For those who have been applying IFRSs for some time, there is no issue that requires a specific standard. Specifically the IFRIC tentative agenda decision published in November 2008 recorded that although rate regulation is widespread and significantly affects the economic environment of regulated industries, divergence does not seem to be significant in practice. This view was supported by the [national standard setter] who wrote to the IASB Chairman early in the life of the rate-regulated project.
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> We question whether the IASB's Exposure Draft indeed meets the needs of the majority of constituents of the IASB as it is limited to a specific form of rate-regulation designed to recover the specific costs the entity incurs in providing the regulated goods or services and to earn a specified return. We are concerned that the proposals in the Exposure Draft will result in regulated entities being able to recognise assets and liabilities that unregulated entities are prohibited from recognising (such as internally generated intangible assets, research and development, indirect overheads and the imputed cost of equity capital used in financing the construction of property, plant and equipment). This inconsistency with other IFRSs results in economically similar transactions being treated differently and will lead to a lack of comparability: within a regulated entity over time; among

different regulatory entities; and between regulated and unregulated entities. In addition, regulators in different jurisdictions may take different approaches to regulated activities and vary their approach over time creating further inconsistency.

We are of the view that the IASB should not proceed with a standard on rate-regulated activities. If the IASB proceeds to issue a standard based on the Exposure Draft, we do not agree with the proposed scope for the following reasons:

i. Recovery of specific costs implies the application of a smoothing mechanism by implying deferral of costs in order to match those costs with future revenue.

ii. It is illogical to limit the application of the proposals to entity specific costs. Why not apply the proposals to industry regulated prices? For example, why not develop a standard that also addresses industry wide regulation such as the general regulation of the taxi industry in [country] whereby a regulator sets prices for the industry as a whole, not prices to be charged based on cost of individual entities operating within the taxi industry.

iii. Arguably, by capturing entities whose prices are set by an 'authorised body' the proposed scope is too broad. All governing bodies can determine prices that bind customers, especially where the entity is some type of monopoly position. As such certain activities of many entities may fall within the proposed scope.

We are concerned that the Exposure Draft appears to be directed towards the form of rate-regulation in North America and does not cater for the various forms of industry regulation and therefore could cause diversity in practice amongst entities subject to regulation. To fall within the scope of the Exposure Draft it is required that a regulator establish a price that the regulated entity **must** then charge to customers. In [country] and [country] however, often regulators set price caps or acceptable price ranges. As such regulated entities are still free to charge whatever price they consider appropriate provided the price charged does not exceed the price cap or provided the price charged falls within the acceptable price range. Because these entities are not required to charge their customers a specific price it appears that these entities will not fall within the scope of the Exposure Draft. Thus, even though these entities are subject to regulation which will have much the same effect on their activities as would the more prescriptive regulation envisaged in the Exposure Draft, these entities may not be entitled to recognise a regulatory asset or be required to recognise a regulatory liability.

Entities, other than utility entities, are subject to forms of regulation and could potentially fall within the scope of the IASB's Exposure Draft. We can see how, for example, some of the activities of our government insurer (the [name of entity]) or even professional bodies established under statute (such as the [country accounting body]), could potentially fall within the scope of the Exposure Draft. In addition, we are concerned that, through the hierarchy in IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors*, the proposals in the Exposure Draft could by analogy be applied to a wide variety of similar situations and result in

many entities deferring expenditure that should be recognised as an expense.

Based on the above, we find it hard to answer your specific questions. They are predicated on the assumption that some form of recognition of assets arising from rate-regulation is appropriate. Our starting point is that a specific form of rate-regulation does not, in and of itself, create a basis for asset recognition that warrants a specific standard.

A5. National Standard Setter 5

We don't believe that it would be right to have a rate-regulated entity, which has half of its activities regulated and in scope (due to ROR nature) and half of its activities not in scope, for the whole entity not to be in scope. The unit of account should allow for entities that are part regulated or have part of their activities regulated to have that part/portion within the standard. Therefore the standard could be applied to that portion of an entity's activities that are rate regulated and meet the criteria in 3 (a)/(b).

A standard on rate regulation could cover all rate-regulated entities and include paragraph 3 (a) and (b) as recognition criteria. This is because some of the disclosures proposed would be useful for users even if the rate-regulated entity wasn't regulated on a rate of return basis.

A6. National Standard Setter 6

We disagree with respondents who suggest the scope be broadened to include all entities with prices subject to approval by a regulator, and recognition criteria be introduced to then restrict the recognition of regulatory assets or liabilities to activities with a direct link to past events. We acknowledge the political attraction to rewriting the scope section of the proposed standard to make it more inclusive and satisfy those who argue for recognition criteria. However, in our view, doing so produces the same outcome as the existing proposals, with an extra step. We think this reduces the clarity of the proposals.

A7. National Standard Setter 7

Given the strength of feeling in the [national standard setter]’s response to last year’s ED on RRA [objecting to the recognition of regulatory assets and liabilities], I am afraid we are not in a position to answer your questions on the clarification of the scope, as we do not think that any guidance is necessary (although I accept that other jurisdictions take a different view).