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Mr Kevin Stevenson
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Dear ~~Mr Stevenson~~ Kevin

EXPOSURE DRAFT 185 RATE-REGULATED ACTIVITIES

The Heads of Treasuries Accounting and Reporting Advisory Committee welcomes the opportunity to comment on the Australian Accounting Standard Board's Exposure Draft ED 185 *Rate-regulated Activities.*

The scope of the ED is limited to entities whose activities are subject to cost-of-service regulation. It explicitly excludes other price regulatory regimes, such as those based on targeted or assumed costs and those employing price caps. HoTARAC assumes that this means price regulation based on assumed efficient costs, rather than actual past costs or regulated prices that include inflation adjustments, would be outside the scope of this ED.

HoTARAC has significant conceptual concerns with this ED, including the following:

- HoTARAC does not think that the prospect of cost-recovery is sufficient reason for recognising a cost as an asset when it would otherwise be expensed. To do so would be a departure from the *Framework for the Preparation and Presentation of Financial Statements*;

- HoTARAC considers that, where an entity measures its property, plant and equipment at fair value or recoverable amount, the effects of price regulation may already be captured in the values of those assets;

- HoTARAC believes that there is a greater need to focus on guidance for the appropriate valuation of the property, plant and equipment assets engaged in the delivery of rate-regulated activities;

- HoTARAC doubts that a mere promise by a regulator or an anticipated action by a regulator in the circumstances described in the ED would give rise to an asset or liability. Recognising assets or liabilities in anticipation of a future action outside the control of the entity, rather than a past event, also appears to be in conflict with the Framework; and

- HoTARAC strongly opposes the ED permitting the requirements of existing Standards to be disregarded (on cost-benefit grounds) in certain circumstances. There is no conceptual basis for allowing this. The Board should not endorse convenience as a reason for non-compliance with its Accounting Standards.

The ED is ambiguous regarding the exact nature of a regulatory asset and a regulatory liability. It is therefore unclear how these items meet the definitions of asset and liability in the Framework. HoTARAC considers that the ED should clarify exactly what controlled resource and past event give rise to a regulatory asset and exactly what present obligation and past event give rise to a regulatory liability.

HoTARAC has reservations about whether a regulatory asset or regulatory liability can ever arise under the present Framework. However, if they can, HoTARAC is not convinced that it can happen prior to the sale of goods or services at the new prices approved by the regulator. Assets and liabilities do not normally arise from trading activities until delivery of the goods or services in question at the contractual (in this case, regulated) rate. The ED's proposals appear to create the ability to smooth revenue recognition, to which HoTARAC is opposed on conceptual grounds.

HoTARAC endorses the alternative views as set out after the ED's Basis for Conclusions.

Comments by HoTARAC on the questions from the ED are provided in Attachment 1.

If you have any queries regarding HoTARAC's comments, please contact Robert Williams at NSW Treasury on 02 9228 3019.

Yours sincerely

D W Challen
CHAIR
HEADS OF TREASURIES ACCOUNTING AND REPORTING ADVISORY COMMITTEE

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Encl

Contact: Amy Huxley
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ATTACHMENT 1

Response to AASB ED 185 *Rate-regulated Activities*

HoTARAC has several significant conceptual concerns with the Exposure Draft. HoTARAC is not convinced that assets or liabilities would, in fact, arise in relation to price regulation. All of HoTARAC's comments should be read subject to this concern.

Question 1

The exposure draft proposes two criteria that must be met for rate-regulated activities to be within the scope of the proposed IFRS (see paragraphs 3-7 of the draft IFRS and paragraphs BC13-BC39 of the Basis for Conclusions).

Is the scope definition appropriate? Why or why not?

HoTARAC considers that part of the scope definition is inappropriate.

Under the scope criteria in Paragraph 3, the ED would apply where a supplier must sell goods or services at a price determined by a regulator and the customers are bound by that price. However, HoTARAC notes that, while a supplier is compelled to sell to all customers at the regulated price, customers are not compelled to buy from that supplier and therefore to pay the regulated price. In response to changes in regulated prices, customers have the option to alter their consumption or, in some cases, to switch to a different supplier. Customers should not be considered to be bound by a regulated price if their purchases are optional.

HoTARAC therefore suggests that the scope criteria should indicate that the regulated price binds the supplier rather than its customers. The binding nature of the price on the customers does not appear to be an essential part of the scope and should be deleted.

HoTARAC notes that the scope of the ED is limited to entities whose activities are subject to cost-of-service regulation and that it explicitly excludes price-regulatory regimes based on targeted or assumed costs. HoTARAC believes that many price-regulated activities in Australia would be outside the scope of the ED as prices are based on recovering estimated efficient future costs rather than based on recovery of previously incurred costs.

Question 2

The exposure draft proposes no additional recognition criteria. Once an activity is within the scope of the proposed IFRS, regulatory assets and regulatory liabilities should be recognised in the entity's financial statements (see paragraphs BC40-BC42 of the Basis for Conclusions).

Is this approach appropriate? Why or why not?

HoTARAC considers the approach to be inappropriate because it blurs the distinction between matters of scope, definition and recognition. This is particularly evident from paragraph 21 that requires derecognising when the scope criteria are no longer met. Moreover, the ED does not sufficiently distinguish recognition from measurement.

Firstly, paragraph BC42 notes the Board's view that the scope criteria are both necessary and sufficient for the recognition of regulatory assets and regulatory liabilities and that assets and liabilities are recognisable if they meet the scope criteria. Despite the IASB's intention to not impose additional recognition criteria, paragraph 8 sets out separate recognition criteria for regulatory assets and regulatory liabilities.

HoTARAC notes that scoping criteria are conceptually distinguishable from asset or liability definition and recognition criteria. The scope paragraphs of an Accounting Standard should continue to be used to indicate whether activities are covered by the Standard, rather than whether they qualify for recognition as assets or liabilities. In the present case, the scope criteria do not appear to be drawn from the definition or recognition criteria for assets and liabilities under the *Framework for the Preparation and Presentation of Financial Statements*.

Secondly, paragraph 21 requires regulatory assets to be derecognised when the underlying activities fail to meet the scoping criteria. HoTARAC considers that derecognition should be determined by reference to definition and recognition criteria rather than scoping criteria.

Thirdly, the ED deals with recognition and measurement under the one heading preceding paragraph 8. HoTARAC considers that, because they are conceptually different, recognition and measurement should be discussed under separate headings.

Overall, HoTARAC considers that the ED would be clearer and more robust if the conceptually distinct matters of scope, definition, recognition and measurement were dealt with separately. HoTARAC does not consider that the ED needs to introduce recognition criteria additional to those in the Framework.

HoTARAC has several other concerns with the definition and recognition aspects of the ED. These are discussed below.

- **How do the *Framework's* definitions of asset and liability apply?**

Appendix A defines regulatory asset and regulatory liability and paragraph 8 requires an entity to recognise them in certain circumstances. Paragraphs BC16 and BC17 also discuss the nature of regulatory assets and regulatory liabilities. However, the ED does not satisfactorily explain how a regulatory asset and a regulatory liability meet the definitions of asset and liability as set out in Paragraph 49 of the Framework. The ED is also inconsistent when describing the nature of the regulatory asset and regulatory liability.

Paragraph 49(a) of the Framework defines an asset as "a resource controlled by the entity as a result of past events and from which future economic benefits are expected to flow to the entity".

The exact nature of the controlled resource and the past event are therefore unclear.

The ED indicates variously that a regulatory asset is:

- a right to increase rates [Appendix A];
- a right to recover specific previously incurred costs and earn a specified return [Appendix A];
- a promise by the regulator [B16];
- an enforceable right to set rates [BC16];
- an assurance that future economic benefits will result [BC17]; and
- the cause-and-effect relationship between an entity's costs and its rate-based revenue [BC17].

Paragraph 49(b) of the Framework defines a liability as "a present obligation of the entity arising from past events, the settlement of which is expected to result in an outflow from the entity of resources embodying economic benefits".

The exact nature of the past event giving rise to the present obligation is therefore unclear.

The ED indicates variously that a regulatory liability arises from:

- collecting amounts in excess of costs [BC23]; and
- actual or expected actions of the regulator [Appendix A].

This ambiguity could affect the timing of recognising the asset or liability.

HoTARAC requests the Board to clarify exactly how the elements of the definition of an asset and liability apply. This would ensure consistency with the Framework, remove ambiguity and obviate the potential for diverse practice to arise in applying the ED.

- **Is the regulator's promise really an asset (or liability)?**

Paragraph BC16 indicates that the resource controlled by the entity, giving rise to the regulatory asset, "is a promise by the regulator that the costs the entity incurs will result in future cash flows". Paragraph BC10 states that "the regulator acts on behalf of the customers who individually would have no bargaining power with the entity".

HoTARAC doubts that a regulator's promise can qualify as an asset or liability of the supplier, especially when it also represents a promise to the customers for whom the regulator is an advocate. It seems to be equally arguable that the regulator's promise is an asset of the customer, especially where the regulated rate represents a partial refund to them.

The supplier does not appear to have any means of forcing the regulator to fulfil its promise that the entity will recover its previously incurred costs. Likewise, the regulator has no power to require customers to enter into transactions after any rate adjustment takes effect. The supplier's recovery of previously incurred costs therefore appears to be contingent on customer actions, in making further purchases, rather than the regulator's action.

It is therefore unclear how a supplier could recognise a regulator's promise as a regulatory asset or regulatory liability where the supplier has no enforceable right or obligation prior to further sales occurring and where the regulator has no coercive powers over the customers. If a regulatory asset or liability does arise, HoTARAC considers that it can only do so when the customer purchases the goods or services at the adjusted rate.

- **Is an anticipated action of the regulator really an asset (or liability)?**

Paragraph 8 requires an entity to recognise a regulatory asset or a regulatory liability arising as a result of the actual or expected actions of the regulator.

An expected action of the regulator appears to be a future event, which may be uncertain and unenforceable. HoTARAC is not convinced that a recognisable asset or liability would arise in relation to rate adjustments that are merely anticipated future actions of the regulator.

Paragraph 58 of the Framework states that "transactions or events expected to occur in the future do not, of themselves, give rise to assets". Similarly, Paragraph 49 of the Framework defines a liability as a present obligation.

Further, if an entity recognises a regulatory asset or regulatory liability based on the expected action of the regulator and the regulator ultimately acts differently from the way anticipated, the entity would have misstated the asset or liability in the interim.

HoTARAC therefore does not consider that a supplier could recognise a regulator's expected action as a regulatory asset or regulatory liability.

- **Classification of a regulatory liability**

Paragraph BC38 notes that a regulatory asset is an intangible asset. However, there is no corresponding guidance on how a regulatory liability should be described.

It would be helpful if the Standard arising from this ED indicated how a regulatory liability should be classified.

- **Capitalising costs that would otherwise be expensed**

Paragraph 10 notes that:

> "An effect of applying the requirements in Paragraph 8 [ie the right to recover previously-incurred costs and the obligation to refund previously-collected amounts] is to recognise as an asset (liability) initially amounts that would otherwise be recognised in that period in the statement of comprehensive income as an expense (revenue)..."

Recoverability of costs should not determine whether those costs are expensed or capitalised. This would be a departure from the Framework. Recoverability of an expense may give rise to a corresponding income item.

HoTARAC considers that a cost should be classified as an expense or an asset according to its nature rather than the possibility that it will be recovered.

- **Relationship to other applicable standards**

Paragraph 10 also states that:

> "... this [draft] IFRS is not applicable when items related to regulated operating activities have been recognised as assets or liabilities in accordance with other IFRSs."

This requirement would prevent the proposed Standard from being applied if another Standard applied, even if the former was not in conflict with the latter.

To allow for situations where the proposed Standard might complement existing applicable Standards, it may be better to state the proposed paragraph thus:

> "This [draft] IFRS is not applicable to the extent that items related to regulated operating activities have been recognised as assets or liabilities in accordance with other IFRSs".

Question 3

The exposure draft proposes that an entity should measure regulatory assets and regulatory liabilities on initial recognition and subsequently at their expected present value, which is the estimated probability-weighted average of the present value of the expected cash flows (see paragraphs 12–16 of the draft IFRS and paragraphs BC44–BC46 of the Basis for Conclusions).

Is this measurement approach appropriate? Why or why not?

HoTARAC broadly supports the proposal in the ED to measure regulatory assets and regulatory liabilities on initial recognition and subsequently at their expected present value.

HoTARAC recommends that the requirements and guidance about determining the value of the regulatory asset and liability be clarified, particularly in respect of factoring in risk, to reflect how such present values are likely to be determined in practice. In this respect, the wording of the eventual Standard needs to prevent any suggestion that risks may be double-counted.

For example, paragraph 13 of the ED separately refers to:

- estimating future cash flows;
- estimating probabilities associated with those cash flows; and
- determining a price for inherent uncertainty (which may relate to either or both of the above factors).

Paragraph 12 gives initial and subsequent measurement requirements for regulatory assets and regulatory liabilities. However, the ED gives no other guidance on subsequent accounting.

It is unclear whether the regulatory asset or liability should be progressively written off, or written back, as amounts are collected from customers, or whether the asset or liability should merely be adjusted at the end of each reporting period. Also, no guidance is given on accounting for remeasurements.

Question 4

The exposure draft proposes that an entity should include in the cost of self-constructed property, plant and equipment or internally generated intangible assets used in regulated activities all the amounts included by the regulator even if those amounts would not be included in the assets' cost in accordance with other IFRSs (see paragraph 16 of the draft IFRS and paragraphs BC49-BC52 of the Basis for Conclusions). The Board concluded that this exception to the requirements of the proposed IFRS was justified on cost-benefit grounds.

Is the exception justified? Why or why not?

HoTARAC does not think the proposed exception is justified.

Requirements of Standards should not be ignored on cost-benefit grounds. There is no conceptual basis for doing so. The ED would set an inappropriate precedent, endorsing departures from Accounting Standards where compliance would be inconvenient for operational/pricing purposes. It would also reduce comparability between like assets among entities.

Moreover, the permission to depart from other Standards under paragraph 16 appears to be inconsistent with the requirement to give priority to other Standards under paragraph 10.

HoTARAC is of the view that the IASB should explore whether a "rateable asset value" (being the property, plant and equipment asset cost that regulators use) is in fact the most appropriate value for financial accounting purposes. Refer to comments under Question 3.

Question 5

The exposure draft proposes that at each reporting date an entity should consider the effect on its rates of its net regulatory assets and regulatory liabilities arising from the actions of each different regulator. If the entity concludes that it is not reasonable to assume that it will be able to collect sufficient revenues from its customers to recover its costs, it tests the cash-generating unit in which the regulatory assets and regulatory liabilities are included for impairment in accordance with IAS 36 *Impairment of Assets*. Any impairment determined in accordance with IAS 36 is recognised and allocated to the assets of the cash-generating unit in accordance with that standard (see paragraphs 17-20 of the draft IFRS and paragraphs BC53 and BC54 of the Basis for Conclusions).

Is this approach to recoverability appropriate? Why or why not?

HoTARAC agrees with the proposed approach to recoverability.

However, HoTARAC notes that, where an entity measures its property, plant and equipment at fair value or remeasures its assets to reflect an impairment loss, those measurements (where based on expected future cash flows) may capture the financial effects of cost-of-service regulation. Where an impairment loss arises, the separate recognition of regulatory assets and regulatory liabilities would be unacceptable.

Question 6

The exposure draft proposes disclosure requirements to enable users of financial statements to understand the nature and the financial effects of rate regulation on the entity's activities and to identify and explain the amounts of regulatory assets and regulatory liabilities recognised in the financial statements (see paragraphs 24–30 of the draft IFRS and paragraphs BC59 and BC60 of the Basis for Conclusions).

Do the proposed disclosure requirements provide decision-useful information?

Why or why not? Please identify any disclosure requirements that you think should be removed from, or added to, the draft IFRS.

HoTARAC believes the proposed disclosures are reasonable in respect of rate-regulated activities.

Question 7

The exposure draft proposes that an entity should apply its requirements to regulatory assets and regulatory liabilities existing at the beginning of the earliest comparative period presented in the period in which it is adopted (see paragraph 32 of the draft IFRS and paragraphs BC62 and BC63 of the Basis for Conclusions). Any adjustments arising from the application of the draft IFRS are recognised in the opening balance of retained earnings.

Is this approach appropriate? Why or why not?

HoTARAC has concerns about the impracticability of the retrospective approach proposed, particularly in the context of the requirements of paragraph 10(f) of IAS 1 *Presentation of Financial Statements*.

Therefore, if the disclosure required by paragraph 10(f) of IAS 1 would be invoked by this ED's proposed retrospective application, HoTARAC is of the view that this needs to be made clear in the eventual Standard.

Question 8

Do you have any other comments on the proposals in the exposure draft?

■ **Core principle**

Paragraph 1 states the core principle, thus:

> "An entity shall recognise the effects on its financial statements of its operating activities that provide goods or services whose prices are subject to cost-of-service regulation."

HoTARAC considers that the ED does not sufficiently justify how this principle can be applied within the existing Framework and Standards.