AASB Exposure Draft

ED 185
July 2009

Rate-regulated Activities

Comments to AASB by 9 October 2009

Australian Government

Australian Accounting Standards Board

Commenting on this AASB Exposure Draft

Constituents are strongly encouraged to respond to the AASB and the IASB. The AASB is seeking comment by 9 October 2009. This will enable the AASB to consider Australian constituents' comments in the process of formulating its own comments to the IASB, which are due by 20 November 2009. Comments should be addressed to:

The Chairman
Australian Accounting Standards Board
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E-mail: standard@aasb.gov.au

Respondents to the IASB are asked to send their comments electronically through the 'Open to Comment' page on the IASB website (www.iasb.org)

All non-confidential submissions to the AASB will be made available to the public on the AASB website: www.aasb.gov.au.

Obtaining a Copy of this AASB Exposure Draft

This AASB Exposure Draft is available on the AASB website: www.aasb.gov.au. Alternatively, printed copies of this AASB Exposure Draft are available by contacting:

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AASB REQUEST FOR COMMENTS

In light of the Australian Accounting Standards Board's (AASB's) policy of incorporating International Financial Reporting Standards (IFRSs) into Australian Accounting Standards, the AASB is inviting comments on:

(a) any of the proposals in the attached International Accounting Standards Board (IASB) Exposure Draft, including the specific questions on the proposals as listed in the Invitation to Comment section of the attached IASB Exposure Draft; and

(b) the 'AASB Specific Matters for Comment' listed below.

The AASB would prefer that respondents supplement their opinions with detailed comments, whether supportive or critical, on the major issues. The AASB regards both critical and supportive comments as essential to a balanced review and will consider all submissions, whether they address all specific matters, additional issues or only one issue.

Due Date for Comments to the AASB

Comments should be submitted to the AASB by 9 October 2009. This will enable the AASB to consider those comments in the process of formulating its own comments to the IASB. Constituents are also strongly encouraged to send their response to the IASB.

AASB Specific Matters for Comment

The AASB would particularly value comments on whether:

(a) there are any regulatory issues or other issues arising in the Australian environment that may affect the implementation of the proposals, particularly any issues relating to:

   (i) not-for-profit entities; and

   (ii) public sector entities.

(b) overall, the proposals would result in financial statements that would be useful to users; and

(c) the proposals are in the best interests of the Australian economy.

July 2009

Exposure Draft ED/2009/8

Rate-regulated Activities

Comments to be received by 20 November 2009

International
Accounting Standards
Board®

Exposure Draft

RATE-REGULATED ACTIVITIES

Comments to be received by 20 November 2009

ED/2009/8

This exposure draft *Rate-regulated Activities* is published by the International Accounting Standards Board (IASB) for comment only. The proposals may be modified in the light of the comments received before being issued as an International Financial Reporting Standard (IFRS). Comments on the draft IFRS and its accompanying documents (see separate booklets) should be submitted in writing so as to be received by **20 November 2009.** Respondents are asked to send their comments electronically to the IASB website (www.iasb.org), using the 'Open to Comment' page.

All responses will be put on the public record unless the respondent requests confidentiality. However, such requests will not normally be granted unless supported by good reason, such as commercial confidence.

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Introduction and invitation to comment

Reasons for publishing the exposure draft

The International Accounting Standards Board has developed the proposed IFRS to define regulatory assets and regulatory liabilities, set out criteria for their recognition, specify how they should be measured and require disclosures about their financial effects.

The Board added this project to its agenda in December 2008 because of differences of views in practice about whether it was appropriate for entities to recognise assets and liabilities arising from rate regulation and ongoing requests for guidance on this issue. IFRSs do not currently provide guidance on the recognition and measurement of such assets and liabilities. Consequently, preparers of financial statements must develop accounting policies in accordance with the hierarchy in IAS 8 *Accounting Policies*, *Changes in Accounting Estimates and Errors*, considering the definitions in the *Framework*.

Rate regulation is a restriction on the setting of prices that can be charged to customers for services or products. A number of regulatory methodologies exist and, for each, application can vary by regulator, the entity being regulated and the particular circumstances.

The Board's objectives for the proposed IFRS are:

(a) to establish criteria for the recognition of assets and liabilities arising from rate regulation

(b) to clarify that regulated entities follow the requirements of all other IFRSs in addition to the proposed IFRS

(c) to require disclosures to enable users to understand the nature and financial effects of rate regulation on an entity's activities.

Main features of the draft IFRS

The draft IFRS specifically addresses rate-regulated activities that meet the following two criteria:

(a) an authorised body is empowered to establish rates that bind customers.

(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).

When the scope criteria are met, the entity recognises regulatory assets and regulatory liabilities in addition to the assets and liabilities recognised in accordance with other IFRSs. The effect of this requirement is initially to recognise as an asset (liability) an amount that would otherwise be recognised in that period in the statement of comprehensive income as an expense (income).

On initial recognition and at the end of each subsequent reporting period regulatory assets and regulatory liabilities are measured at their expected present value. Regulatory assets are assessed for impairment when 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.

Invitation to comment

The Board invites comments on any aspect of the exposure draft of its proposed IFRS *Rate-regulated Activities*. It would particularly welcome answers to the questions set out below. Comments are most helpful if they:

(a) respond to the questions as stated,

(b) indicate the specific paragraph or paragraphs to which the comments relate,

(c) contain a clear rationale, and

(d) describe any other approaches the Board should consider, if applicable.

Respondents need not comment on all of the questions and are encouraged to comment on any additional issues.

The Board will consider all comments received in writing by **20 November 2009**. In considering the comments, the Board will base its conclusions on the merits of the arguments for and against each approach, not on the number of responses supporting each approach.

Scope

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?

Recognition and measurement

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?

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?

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 this exception justified? Why or why not?

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?

Disclosures

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.

Transition

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?

First-time adoption

The exposure draft includes proposed amendments to IFRS 1 *First-time Adoption of International Financial Reporting Standards* (see paragraph C1 of the draft IFRS). These amendments are the result of the Board's exposure draft *Additional Exemptions for First-time Adopters* published in September 2008. These amendments reflect the comments received on that exposure draft and the Board's redeliberations.

Other comments

Question 8

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

[Draft] International Financial Reporting Standard X *Rate-regulated Activities* ([draft] IFRS X) is set out in paragraphs 1—32 and Appendices A–C. All the paragraphs have equal authority. Paragraphs in **bold type** state the main principles. Terms defined in Appendix A are in *italics* the first time they appear in the [draft] IFRS. Definitions of other terms are given in the Glossary for International Financial Reporting Standards. [Draft] IFRS X should be read in the context of its core principle and the Basis for Conclusions, the *Preface to International Financial Reporting Standards* and the *Framework for the Preparation and Presentation of Financial Statements*. IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors* provides a basis for selecting and applying accounting policies in the absence of explicit guidance.

[Draft] International Financial Reporting Standard X *Rate-regulated Activities*

Core principle

1 **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*.**

2 In particular, this [draft] IFRS requires an entity:

(a) to recognise a *regulatory asset* or *regulatory liability* if the *regulator* permits the entity to recover specific previously incurred costs or requires it to refund previously collected amounts and to earn a specified return on its regulated activities by adjusting the prices it charges its customers.

(b) to measure a regulatory asset or regulatory liability at the *expected present value* of the cash flows to be recovered or refunded as a result of regulation, both on initial recognition and at the end of each subsequent reporting period.

(c) to provide disclosures that identify and explain the amounts recognised in the entity's financial statements arising from a regulatory asset or regulatory liability and assist users of those financial statements to understand the nature and financial effects of its rate-regulated activities.

Scope

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*.

Recognition and measurement

8 An entity shall recognise:

(a) a regulatory asset for its right to recover specific previously incurred costs and to earn a specified return, or

(b) a regulatory liability for its obligation to refund previously collected amounts and to pay a specified return

when it has the right to increase or the obligation to decrease rates in future periods as a result of the actual or expected actions of the regulator.

9 Regulated entities comply with the requirements of IFRSs in the same way as other entities. Although regulators can determine the timing of recovery of costs or settlement of refunds in rates, they cannot change the characteristics of assets and liabilities that would exist in accordance with IFRSs. Therefore, if the criteria in paragraph 3 are satisfied, the entity shall recognise regulatory assets and regulatory liabilities in addition to the assets and liabilities recognised in accordance with other IFRSs.

10 An effect of applying the requirements in paragraph 8 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). Consequently, 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.

11 When an entity recognises a regulatory asset or regulatory liability, it shall determine whether a temporary difference exists that requires the recognition of a deferred tax asset or a deferred tax liability in accordance with IAS 12 *Income Taxes*.

12 On initial recognition and at the end of each subsequent reporting period, an entity shall measure a regulatory asset or regulatory liability at its expected present value.

Components of an expected present value measurement

13 An entity shall reflect the following elements in the measurement of the expected present value of a regulatory asset or a regulatory liability:

(a) an estimate of the future cash flows that will arise in a range of possible outcomes.

(b) an estimate of the probability of each outcome occurring.

(c) the time value of money, represented by the current market risk-free rate of interest.

(d) the price for bearing the uncertainty inherent in the regulatory asset or regulatory liability.

14 An entity shall determine a range of possible outcomes and estimate the cash flows that it will recover or refund for each outcome. It shall also estimate the probability that each outcome will occur, including the probability that in the entity's future rates the regulator will allow the entity to include the actual costs incurred or require the entity to include amounts collected.

15 Interest rates used to discount the estimated cash flows shall reflect assumptions that are consistent with those inherent in the estimated cash flows. In other words, the discount rates used shall not reflect risks for which the estimated cash flows have been adjusted. However, the fact that the estimated future cash flows have been adjusted for the probability of different outcomes occurring does not eliminate the need

to include in the discount rate the price for bearing the uncertainty inherent in the regulatory asset or regulatory liability. The price for uncertainty relates to the entity's estimates of both the amount and the timing of the cash flows and the probabilities of different outcomes.

16 In some cases, a regulator requires an entity to capitalise, as part of the cost of self-constructed property, plant and equipment or internally generated intangible assets, amounts that would otherwise be recognised as regulatory assets in accordance with this [draft] IFRS. After the construction or generation is completed, the resulting capitalised cost is the basis for depreciation or amortisation and unrecovered investment for rate-making purposes. In such cases, the amounts included in the cost of the asset for rate-making purposes shall also be included in its cost for financial reporting purposes, even if IAS 16 *Property, Plant and Equipment*, IAS 23 *Borrowing Costs* or IAS 38 *Intangible Assets* would not permit the entity to do so. Those amounts shall be included in the cost of the asset only if their inclusion in the cost for rate-making purposes is highly probable. Otherwise, they shall be accounted for as regulatory assets in accordance with this [draft] IFRS.

Recoverability

17 In some cases, regulatory assets recognised individually in accordance with this [draft] IFRS are not partially or fully recoverable when considered in total. A particular regulator may permit a variety of specific costs to be recovered. However, when the entity considers the net effect on its future rates of all the regulatory assets and regulatory liabilities arising from the actions of that regulator, it may conclude that rates set at those levels would affect demand. In particular, significant increases in rates to recover the net regulatory assets may result in customers reducing the number of units consumed either by conservation or by switching to alternative sources.

18 At each reporting date, an entity shall consider the net effect on its rates of its regulatory assets and regulatory liabilities arising from the actions of each regulator for the periods in which the regulation is expected to affect rates. The entity shall determine whether it is reasonable to assume that rates set at levels that will recover the entity's costs can be collected from customers. In making this determination, the entity shall consider estimated changes in the level of demand or competition during the recovery period.

19 If an 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, this is an indication that the cash-generating unit in which the regulatory assets and regulatory liabilities are included may be impaired. Accordingly, the entity shall test that cash-generating unit for impairment in accordance with IAS 36 *Impairment of Assets*.

20 An entity shall recognise any impairment loss determined in accordance with IAS 36 and shall allocate it to the assets of the cash-generating unit in accordance with that standard. An entity shall reflect the impairment loss allocated to each regulatory asset by reducing the entity's estimate of the future cash flows that it will receive from the regulatory asset as required by paragraphs 13(a) and 14 of this [draft] IFRS.

Derecognition

21 An entity shall derecognise the entire carrying amount of regulatory assets and regulatory liabilities when the underlying activities fail to meet the criteria in paragraph 3.

Presentation

22 An entity shall present in the statement of financial position current and non-current regulatory assets and regulatory liabilities, without offsetting, separately from other assets and liabilities.

23 An entity may present a net regulatory asset or a net regulatory liability for each category of asset or liability subject to the same regulator.

Disclosures

24 An entity shall disclose information that:

(a) enables users of the financial statements to understand the nature and the financial effects of rate regulation on its activities; and

(b) identifies and explains the amounts of regulatory assets and regulatory liabilities, and related income and expenses, recognised in its financial statements.

25 An entity shall disclose the fact that some or all of its operating activities are subject to rate regulation, including a description of their nature and extent.

26 For each set of operating activities subject to a different regulator, an entity shall disclose the following information:

(a) if the regulator is a related party (as defined in IAS 24 *Related Party Disclosures*), a statement to that effect, together with an explanation of why the regulator is related to the entity.

(b) an explanation of the approval process for the rate subject to regulation (including the rate of return), including information about how that process affects both the underlying operating activities and the specified rate of return.

(c) the indicators that management considered in concluding that such operating activities are within the scope of this [draft] IFRS, if that conclusion requires significant judgement.

(d) significant assumptions used to measure the expected present value of a recognised regulatory asset or regulatory liability including:

(i) the supporting regulatory action, for example, the issue of a formal approval for costs to be recovered pending a final ruling at a later date and that date, when known, or

(ii) the entity's assessment of the expected future regulatory actions.

(e) the risks and uncertainties affecting the future recovery of the regulatory asset or final settlement of the regulatory liability, including the expected timing.

27 An entity shall disclose the following information for each category of regulatory asset or regulatory liability recognised that is subject to a different regulator:

(a) a reconciliation from the beginning to the end of the period, in tabular format unless another format is more appropriate, of the carrying amount in the statement of financial position of the regulatory asset or regulatory liability, including at least the following elements:

(i) the amount recognised in the statement of comprehensive income relating to balances from prior periods collected or refunded in the current period.

(ii) the amount of costs incurred in the current period that were recognised in the statement of financial position as regulatory assets or regulatory liabilities to be recovered or refunded in future periods.

(iii) other amounts that affected the regulatory asset or regulatory liability, such as items acquired or assumed in business combinations or the effects of changes in foreign exchange rates, discount rates or estimated cash flows. If a single cause has a significant effect on the regulatory asset or regulatory liability, the entity shall disclose it separately.

(b) the remaining period over which the entity expects to recover the carrying amount of the regulatory asset or to settle the regulatory liability.

(c) the amount of financing cost included in the cost of self-constructed property, plant and equipment and internally developed intangible assets in the current period in accordance with paragraph 16 that would not have been capitalised in accordance with IAS 23.

28 When an entity recognises an impairment loss in accordance with paragraph 20, it shall provide the disclosures required by IAS 36.

29 When an entity derecognises regulatory assets and regulatory liabilities in accordance with paragraph 21 because the related operating activities fail to meet the criteria in paragraph 3, it shall disclose a statement to that effect, the reasons for the conclusion that the criteria in paragraph 3 are not met, a description of the operating activities affected and the amount of regulatory assets and regulatory liabilities derecognised.

30 If the disclosures required by paragraphs 25–29 of this [draft] IFRS do not meet the objectives set out in paragraph 24, the entity shall disclose whatever additional information is necessary to meet those objectives.

Effective date and transition

Effective date

31 An entity shall apply this [draft] IFRS for annual periods beginning on or after [date to be inserted after exposure]. Earlier application is permitted. If an entity applies this [draft] IFRS for an earlier period, it shall disclose that fact.

Transition

32 An entity shall apply this [draft] IFRS to regulatory assets and regulatory liabilities that exist at the beginning of the earliest comparative period presented when it applies this [draft] IFRS. The entity shall reflect any adjustments required as a result of applying this [draft] IFRS in the opening balance of retained earnings of that comparative period.

Appendix A
Defined terms

This appendix is an integral part of the [draft] IFRS.

Cost-of-service regulation	A form of regulation for setting an entity's prices (rates) in which there is a cause-and-effect relationship between the entity's specific costs and its revenues.
Expected cash flow approach	A measurement method that weights the expected cash flows of possible outcomes by the probabilities associated with those outcomes.
Expected present value	The estimated probability-weighted average of the present value of the expected cash flows related to an asset or liability.
Regulator	An authorised body empowered by statute or contract to set rates that bind an entity's customers. The regulator may be a third-party body or may be the entity's own governing board if the board is required by statute or contract to set rates both in the interest of the customers and to ensure the overall financial viability of the entity.
Regulatory asset	An entity's right to recover specific previously incurred costs and to earn a specified return by increasing rates in future periods as a result of the actual or expected actions of its **regulator.**
Regulatory liability	An entity's obligation to refund previously collected income and to pay a specified return by decreasing rates in future periods as a result of the actual or expected actions of its **regulator**.

Appendix B
Application guidance

This appendix is an integral part of the [draft] IFRS.

Scope

Prices that bind customers

B1 The first criterion to consider in determining if the regulated operating activities are within the scope of the [draft] IFRS is whether the regulator is empowered to determine prices that bind the entity's customers. The regulator's ability to determine rates is established by statute or by a contract delegating such authority. For example, a public utility commission may be elected or appointed to establish prices that are intended to be fair to both the entity and its customers.

B2 In a co-operative utility, the members of the entity's governing board may be empowered to set its rates in a manner consistent with the purpose and governance of the organisation. This would satisfy the first criterion provided that the board is similarly required by statute or contract to set rates both in the interest of the customers and to ensure the overall financial viability of the entity.

Cost-of-service regulation

B3 The second criterion to consider in determining if the regulated operating activities are within the scope of the [draft] IFRS is whether the rate established by regulation is designed to recover the specific costs the entity incurs in providing the regulated goods or services and to earn a specified return, ie whether the entity is subject to a cost-of-service form of regulation. This criterion requires a cause-and-effect relationship between an entity's costs and its rate-based revenue stream.

B4 In many cases, determining whether the entity is subject to cost-of-service regulation will be straightforward. In others, significant judgement will be required. The following circumstances are indicators of cost-of-service regulation:

(a) The regulation is designed to provide recovery of the specific entity's costs.

(b) If actual costs are not used to establish rates, the regulation provides for a 'true-up' to actual costs incurred.

(c) In the case of a 'price cap' plan, there is a true-up to actual costs through a rate of return sharing mechanism.

(d) If the entity is required to provide a rate discount, the rate discount is temporary rather than permanent.

(e) If a short moratorium on rate increases is imposed, it will be followed by a return to direct cost-based regulation.

B5 The first three indicators relate to whether the plan is intended to permit the entity to recover its specific costs rather than industry averages, costs based on other indices or targets. The last two indicators relate to whether the entity is permitted to recover its costs (including financing costs) and earn an adequate return on its shareholder's investment.

B6 Concluding that a regulatory plan does not provide a sufficient return for shareholders to justify the application of the [draft] IFRS requires judgement. One or a combination of the following indicators could lead to that conclusion:

(a) Abnormal excess capacity exists.

(b) The rates per unit are currently higher (or are forecast to be higher in the future) than those of entities in neighbouring jurisdictions or alternative competitive sources. This may indicate that the regulator will disallow costs.

(c) The regulatory environment has changed, as indicated by:

- (i) the existence of unrecoverable investments.
- (ii) substantial regulatory disallowances.
- (iii) the establishment of phase-in plans or a trend towards increasing amounts of regulatory assets.
- (iv) proposed or actual rate-making that is designed to stimulate competition or rates set based on other than a pure cost-of-service concept.
- (v) rate freeze periods that extend beyond a reasonable time.

Recognition and measurement

Permitted costs

B7 In the form of regulation described in the scope of the [draft] IFRS, the rates set by the regulator are designed to recover an entity's specific costs of providing the goods and services.

B8 Not all costs that an entity incurs are automatically recoverable from its customers. Regulators typically review entities' costs to ensure that they were appropriately incurred to provide the regulated service and were 'prudent'. Consequently, a cost must be permitted by the regulator to be included in the determination of rates. In cost-of-service regulation, such costs are the actual or estimated costs for which revenue is intended to provide recovery and include costs of debt and a reasonable return on shareholders' investments.

B9 Cost-of-service rate-making does not necessarily equal a one-for-one pass-through of costs. Rate-making involves projections and assumptions; as a result actual costs will differ from estimated amounts assumed in the rate-making process itself, commonly referred to as regulatory lag. Rates should be established to provide that the entity will recover its costs using reasonable assumptions regarding demand as well as normal expenditures.

Probability of cost recovery

B10 Paragraph 14 requires an entity to consider the probability that the regulator will allow or require the entity to include in the entity's future rates the costs incurred or amounts collected. In practice, an entity may incur costs several periods before the regulator formally considers them. Consequently, the entity considers a variety of evidence in determining the probability that the regulator will allow particular costs when it reviews them.

B11 Indicators that an entity shall consider in assessing the probability of recovery include:

(a) statutes or regulations that specifically provide for the recovery of the cost in rates that cannot be overturned by future regulatory decisions;

(b) formal approvals from the regulator specifically authorising recovery of the cost in rates;

(c) previous formal approvals from the regulator allowing recovery for substantially similar costs (precedents) for a specific entity or other entities in the same jurisdiction;

(d) written approval from the regulator (although not a formal approval) approving future recovery in rates;

(e) uniform regulatory accounting guidance providing for the accounting treatment of various costs that the regulator typically follows in setting rates;

(f) written confirmation from the regulator's staff that they will recommend approval of the cost that is not legally binding on the regulatory body that sets rates; and

(g) analysis of recoverability of the cost from internal or external legal counsel on the basis of regulations and past practice.

Expected present value

B12 If the timing of the estimated cash flows is the same for all outcomes, the discount rate can be applied to the probability-weighted estimated cash flows to determine their present value. Otherwise, the present value for each possible outcome must be determined before the probability factor is applied. The results are then accumulated to determine the probability-weighted average of the present value of the cash flows.

B13 In some situations, the rate of return set by the regulator may be a reasonable approximation of the discount rate that would be appropriate to use in the measurement of the regulatory assets and regulatory liabilities in accordance with paragraph 15. However, this cannot always be assumed to be the case. In addition, the entity would have to consider whether the cash flows have already been adjusted for any of the risks included in the regulatory rate of return (see paragraph 15).

Recoverability

B14 In accordance with paragraphs 17–20, an entity considers the net effect on its rates of all the regulatory assets and regulatory liabilities arising from the actions of a particular regulator. For example, an entity might expect that if it were to charge the electricity rates necessary to recover all the costs permitted by the regulator, its customers would have a strong incentive to reduce their consumption of electricity or to switch to less expensive sources of energy. A conclusion that the reduction in demand would result in total revenue not recovering the entity's net regulatory assets and regulatory liabilities is an indication of impairment. The entity shall include the regulatory assets and regulatory liabilities with the other assets and liabilities of the cash-generating unit and test them for impairment in accordance with IAS 36.

B15 Given the characteristics of the regulatory environment within the scope of the [draft] IFRS, entities will be able to determine when the costs of all the assets in the cash-generating unit are expected to affect rates and by how much. Consequently, the entity's estimates will identify the periods in which changes in demand will affect future cash flows to such an extent that the entity will not recover its costs. The entity uses this information to comply with the requirement in paragraph 18 to reflect the impairment loss determined and allocated in accordance with IAS 36 to each regulatory asset.

B16 In accordance with paragraph 105 of IAS 36, in allocating an impairment loss for a cash-generating unit to the assets in that unit, an entity shall not reduce the carrying amount of an asset below the highest of:

(a) its fair value less costs to sell (if determinable);

(b) its value in use (if determinable); and

(c) zero.

B17 Because the entity is able to estimate both the amount and timing of the cash flows of the regulatory asset, the entity is able to estimate the asset's value in use. An entity may determine that the value in use of an individual regulatory asset equals the amount previously determined in accordance with paragraph 12. In this case, the entity shall allocate no impairment loss to the regulatory asset. Conversely, changes in the amount or timing of cash flows to be received may result in the current value in use being less than the amount previously determined in accordance with paragraph 12. In these instances, an impairment loss shall be allocated to the regulatory asset.

B18 If a recognised impairment loss is allocated to a regulatory asset, in subsequent periods the entity shall continue to measure the asset in accordance with paragraph 12 using the amount and timing of the estimated cash flows used in determining the amount of the impairment loss.

B19 If an entity subsequently determines that impairment indicators no longer exist, the entity shall follow the provisions of IAS 36 for reversing an impairment loss for a cash-generating unit.

Regulatory liabilities

B20 Regulation can establish three types of regulatory liabilities:

(a) The regulator requires refunds to be made to customers in the form of reduced future rates. However, if the refunds are to be made in determinable amounts to specific customers, they are financial liabilities and are not within the scope of this [draft] IFRS.

(b) The regulator provides current rates intended to recover costs that are expected to be incurred in the future with the understanding that if those costs are not incurred, future rates will be reduced accordingly. A liability is recognised only if the entity will be required to refund amounts collected in advance of expenditure.

(c) The regulator requires a realised gain or other reduction of cost to be refunded to customers in the form of reduced rates over future periods.

B21 In accordance with paragraph 9, a regulator cannot eliminate or change the measurement of a liability that was not created by that regulator.

Appendix C
Amendments to other IFRSs

The amendments in this [draft] appendix shall be applied for annual periods beginning on or after [date to be inserted after exposure]. If an entity applies this [draft] IFRS for an earlier period, these amendments shall be applied for that earlier period. Amended paragraphs are shown with new text underlined and deleted text struck through.

IFRS 1 *First-time Adoption of International Financial Reporting Standards*

C1 Paragraph D1 is amended and paragraph D25 is added.

D1 An entity may elect to use one or more of the following exemptions:

(a) ...

(n) borrowing costs (paragraph D23); ~~and~~

(o) transfers of assets from customers (paragraph D24)~~.~~; and

(p) regulatory assets (paragraph D25).

D25 Entities with rate-regulated activities as defined in [draft] IFRS X *Rate-regulated Activities* may hold, or have previously held, items of property, plant and equipment or intangible assets for use in those activities. The carrying amount of such items sometimes includes amounts that were included in accordance with previous GAAP that would be recognised separately as regulatory assets in accordance with [draft] IFRS X. If this is the case, a first-time adopter may elect to use the carrying amount of such an item at the date of transition to IFRSs as deemed cost. An entity may use this election or that relating to borrowing costs in paragraph D23 but not both.

IAS 36 *Impairment of Assets*

C2 Paragraph 5 is amended as follows.

5 This Standard does not apply to financial assets within the scope of IAS 39, investment property measured at fair value in accordance with IAS 40, ~~or~~ biological assets related to agricultural activity measured at fair value less costs to sell in accordance with IAS 41, or individual regulatory assets measured at their expected present value in accordance with [draft] IFRS X *Rate-regulated Activities*.

However, this Standard applies to assets that are carried at revalued amount (ie fair value) in accordance with other IFRSs, such as the revaluation model in IAS 16 *Property, Plant and Equipment*. Identifying ...

C3 Paragraph 67A is added before paragraph 68.

67A Individual regulatory assets are not subject to impairment testing because they are measured at their expected present value. However, when the conditions in paragraphs 19 and 20 of [draft] IFRS X exist, regulatory assets and regulatory liabilities shall be included in the cash-generating unit containing the assets used to provide the regulated goods and services.

IAS 37 *Provisions, Contingent Liabilities and Contingent Assets*

C4 Paragraph 5 is amended as follows.

5 When another Standard deals with a specific type of provision, contingent liability or contingent asset, an entity applies that Standard instead of this Standard. For example, some types of provisions are addressed in Standards on:

(a) ...

(d) employee benefits (see IAS 19 *Employee Benefits*); ~~and~~

(e) insurance contracts (see IFRS 4 *Insurance Contracts*). However, this Standard applies to provisions, contingent liabilities and contingent assets of an insurer, other than those arising from its contractual obligations and rights under insurance contracts within the scope of IFRS 4~~.~~; and

(f) rate-regulated activities (see [draft] IFRS X *Rate-regulated Activities*).

IAS 38 *Intangible Assets*

C5 Paragraph 2 is amended as follows.

2 This Standard shall be applied in accounting for intangible assets, except:

(a) ...

(c) **the recognition and measurement of exploration and evaluation assets (see IFRS 6 *Exploration for and Evaluation of Mineral Resources*);** ~~**and**~~

(d) **expenditure on the development and extraction of minerals, oil, natural gas and similar non-regenerative resources**~~**.**~~**; and**

(e) **the recognition and measurement of regulatory assets (see [draft] IFRS X *Rate-regulated Activities*).**

C6 Paragraph 3 is amended as follows.

3 If another Standard prescribes the accounting for a specific type of intangible asset, an entity applies that Standard instead of this Standard. For example, this Standard does not apply to:

(a) ...

(i) regulatory assets (as defined in [draft] IFRS X).

IFRIC 12 *Service Concession Arrangements*

C7 Paragraph 9A is added.

9A An entity that operates a public-to-private service concession arrangement that is within the scope of this Interpretation should also consider whether its operating activities provided using the infrastructure in accordance with the concession arrangement are within the scope of [draft] IFRS X *Rate-regulated Activities*.

Approval by the Board of *Rate-regulated Activities* published in July 2009

The exposure draft *Rate-regulated Activities* was approved for publication by twelve of the fourteen members of the International Accounting Standards Board. Messrs Cooper and Zhang voted against its publication. Their alternative views are set out after the Basis for Conclusions.

Sir David Tweedie	Chairman
Thomas E Jones	Vice-Chairman
Mary E Barth	
Stephen Cooper	
Philippe Danjou	
Jan Engström	
Robert P Garnett	
Gilbert Gélard	
Prabhakar Kalavacherla	
James J Leisenring	
Warren J McGregor	
John T Smith	
Tatsumi Yamada	
Wei-Guo Zhang	

July 2009

Basis for Conclusions
Exposure Draft ED/2009/8

Rate-regulated Activities

Comments to be received by 20 November 2009

International
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Basis for Conclusions on Exposure Draft

RATE-REGULATED ACTIVITIES

Comments to be received by 20 November 2009

ED/2009/8

This Basis for Conclusions accompanies the proposed International Financial Reporting Standard (IFRS) set out in the exposure draft *Rate-regulated Activities* (see separate booklet). Comments on the draft IFRS and its accompanying documents should be submitted in writing so as to be received by **20 November 2009.** Respondents are asked to send their comments electronically to the IASB website (www.iasb.org), using the 'Open to Comment' page.

All responses will be put on the public record unless the respondent requests confidentiality. However, such requests will not normally be granted unless supported by good reason, such as commercial confidence.

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CONTENTS

Basis for Conclusions on the exposure draft *Rate-regulated Activities*

This Basis for Conclusions accompanies, but is not part of, the draft IFRS.

Introduction

BC1 This Basis for Conclusions summarises the considerations of the International Accounting Standards Board in reaching the conclusions in the exposure draft *Rate-regulated Activities*. Individual Board members gave greater weight to some factors than to others.

BC2 The Board added this project to its agenda in December 2008 because of ongoing differences of views in practice regarding whether it was appropriate for entities to recognise assets and liabilities arising from rate regulation.

BC3 In June 2005 the International Financial Reporting Interpretations Committee (IFRIC) received a request about the US standard SFAS 71 *Accounting for the Effects of Certain Types of Regulation*. The request asked whether SFAS 71 could be applied in accordance with the hierarchy in IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors* to select an accounting policy in the absence of specific guidance in IFRSs.

BC4 US generally accepted accounting principles (GAAP) have recognised the economic effect of rate regulation on US rate-regulated entities since at least 1962. In 1982, SFAS 71 formalised many of those principles. In the absence of specific national guidance, practice in many other jurisdictions followed SFAS 71.

BC5 The IFRIC discussed the possible recognition of regulatory assets as part of its project on service concessions. As a result of its consideration of the issues at that time, the IFRIC concluded 'that entities applying IFRSs should recognise only assets that qualified for recognition in accordance with the IASB's *Framework for the Preparation and Presentation of Financial Statements* and relevant accounting standards, such as IAS 11 *Construction Contracts*, IAS 18 *Revenue*, IAS 16 *Property, Plant and Equipment* and IAS 38 *Intangible Assets*.' In other words, the IFRIC thought that an entity should recognise regulatory assets to the extent that they meet the criteria to be recognised as assets in accordance with existing IFRSs.

BC6 Following this first request, the IFRIC published an agenda decision in August 2005 not to add a project on regulatory assets to its agenda. The IFRIC agenda decision did not preclude the recognition of regulatory assets and regulatory liabilities.

BC7 In January 2008 the IFRIC received a second request to consider whether regulated entities could or should recognise a liability (or an asset) as a result of regulation by regulatory bodies or governments. This indicated that the previous agenda decision had not resolved the practice problems related to this issue. The IFRIC again decided not to add the issue to its agenda for several reasons. Importantly, it concluded that divergence did not seem to be significant in practice for entities that were already applying IFRSs. However, the IFRIC also noted that rate regulation is widespread and significantly affects the economic environment of many entities.

BC8 The Board noted the ongoing requests for guidance on this issue. It also considered the comments received on the IFRIC's tentative agenda decision. Those comments pointed out that although divergence in practice did not currently exist, several jurisdictions whose local accounting principles permitted or required the recognition of regulatory assets and regulatory liabilities would be adopting IFRSs in the near future. This would increase pressure for a definitive conclusion on the question. Consequently, the Board added the project to its agenda.

Background

BC9 Rate regulation is a restriction on the setting of prices that can be charged to customers for services or products. The goal of some forms of rate regulation is to set 'just and reasonable rates', ie rates that charge the customer a reasonable price and allow the entity to earn a fair rate of return.

BC10 Generally, rates are regulated when an entity has a monopoly or a dominant market position that gives it excessive market power. In such situations, there is a lack of effective competition to constrain the prices the entity can charge. To compensate, governments impose rate regulation by setting up a regulatory authority and giving it jurisdiction to approve the rates of a specific entity or categories of entities (for example, electricity distribution utilities). Entities within the jurisdiction of the regulatory authority are not allowed to charge prices for regulated goods or services other than those approved by the regulatory authority. In those circumstances, the regulator acts on behalf of the customers who individually would have no bargaining power with the entity.

BC11 A number of regulatory methodologies exist and, for each, application can vary by regulator, the entity being regulated and the particular circumstances. One regulatory methodology for essential services charged to individual customers is cost-of-service regulation (also referred to as return-on-rate-base regulation). Under this approach, rates are set to give the entity the opportunity to recover its costs of providing the good or service plus a fair return.

BC12 In cost-of-service regulation, the rates are set by working backwards from the desired return on the previously incurred costs (the rate base), to derive a revenue requirement and using an estimate of volume to set the rate. In recent years there has been a trend to incentive-based regulatory methodologies, such as so-called 'price cap' regulation. With price cap regulation, initial rates may reflect the cost of service, but are allowed to increase, or are required to decrease, over time in accordance with a formula. Hybrid methodologies that are combinations of price cap and cost-of-service approaches also exist.

Scope

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.

Can regulation create assets and liabilities?

BC15 The threshold question the Board had to address was whether the effects of rate regulation could result in items that meet the definitions of assets and liabilities in the *Framework*. If the answer to that question was yes, the Board then had to consider the circumstances in which those assets and liabilities could arise. This second question is discussed in paragraphs BC26–BC39. The two issues are interrelated.

Regulatory assets

BC16 The definition of an asset set out in paragraph 49(a) of the *Framework* is 'a resource controlled by an entity as a result of past events and from which future economic benefits are expected to flow to the entity.' The Board concluded that in some forms of regulation, the resource is a promise by the regulator that the costs the entity incurs will result in future cash flows. In such environments, incurring costs creates an enforceable right to set rates at a level that permits the entity to recover those costs, perhaps plus a specified return, from an aggregate customer base. The adjustment of future rates is the mechanism the regulator uses to implement its promise.

BC17 The Board decided that the cause-and-effect relationship between an entity's costs and its rate-based revenue is important to the conclusion that an asset exists. In this case, the entity's right that arises as a result of regulation relates to identifiable future cash flows linked to costs it previously incurred, rather than a general expectation of future cash flows based on the existence of predictable demand. Without a cause-and-effect relationship with previously incurred costs, the Board agreed with those who believe that the effect of rate regulation is just the permission to charge customers a specified price in the future. Such permission does not satisfy the definition of an asset because the regulator provides no assurance that future economic benefits will result.

BC18 Some who do not support the recognition of regulatory assets believe that a rate-regulated entity does not control the recoverability of future economic benefits because it does not control whether the customers will use the good or service. They believe that because the entity cannot force individual customers to purchase goods or services in the future, the entity's right to increase future rates does not create an asset.

BC19 However, in the Board's view, because regulation governs the entity's relationship with its customer base as a whole, rate regulation creates a present right to receive from or a present obligation to pay economic benefits to that aggregate customer base. Although the individual members of that group may change over time, the relationship the regulator oversees is between the entity and the group. The regulator has the authority to permit the entity to set rates at a level that will ensure the entity receives the promised cash flows from the customers as a whole. Therefore, the Board concluded that recognition of regulatory assets and regulatory liabilities should be considered at the aggregate customer level.

BC20 The Board also noted that the *Framework* states that control over the future economic benefits is sufficient for an asset to exist, even in the absence of legal rights. In many examples involving the definition of an asset, an entity will have power, as well as the ability, to obtain cash inflows. For example, in the case of some economic resources an entity owns, the entity has the power to cause cash inflows to arise from those resources either from sale or from use. However, in other examples, the entity need not have the power to cause the cash inflows to arise (ie although the power criterion is a sufficient condition, it is not a necessary condition). The key notion is that the entity has access to a resource and can limit others' access to that resource.

BC21 For example, in the case of established customer relationships, an entity does not have the power to force its existing customers to do business with the entity. But, if they do, the entity will obtain future cash inflows. The entity has an asset resulting from the existing relationship between the entity and its customers that can result in future cash inflows to the entity. This conclusion is reflected in accounting for customer relationship intangible assets in business combinations. Another example is intangible assets recognised by operators in service concession arrangements in accordance with IFRIC 12 *Service Concession Arrangements*. The operator recognises as an intangible asset the right it receives (a licence) to charge users of the public service, even though the amount to be received under the licence is contingent on the public's use of the service.

BC22 In the Board's view, these examples illustrate the general conclusion that an asset exists because the entity has a present right to a resource (the regulator's promise). The fact that the cash flows the right will generate are uncertain because they are subject to risks relating to future demand affects the measurement of the right not its existence or recognition. Any other conclusion would result in a failure to recognise a wide variety of intangible assets, such as royalty and franchise agreements, among others. Moreover, the Board notes that an entity does not control the recoverability of many other types of assets, recoverability being often dependent on the actions of others. For example, even though an entity may have a contractual right to repayment of a loan, recoverability will depend on the counterparty's willingness and ability to pay. That uncertainty does not mean the right is not recognised as an asset. Consequently, the Board believes that those who do not support the recognition of regulatory assets because the rate-regulated entity does not control the recoverability of future economic benefits are confusing the issues of recognition and measurement.

Regulatory liabilities

BC23 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 Board concluded that in some forms of regulation, an obligation arises because of a requirement to refund to customers amounts collected in previous periods. In such environments, collecting amounts in excess of costs and the allowed return creates an obligation to return the payments to the aggregate customer base.

BC24 Some believe that the obligation arising from the arrangement with the regulator is not a present obligation but a possible future obligation because its existence depends on the occurrence of uncertain future events: the future sales. If a sale is made in the future period, the customer's usage will be billed at a decreased rate in that future period because of the regulator's requirement. Once again, the Board concluded that the regulator has the authority to ensure that future cash flows from the customer base as a whole would be reduced to refund amounts previously collected.

BC25 Much of the basis for the Board's conclusion that rate regulation can result in items that meet the definition of liabilities parallels its analysis of the recognition of assets set out in paragraphs BC16–BC22:

(a) The obligation relates to amounts the entity has already collected from customers.

(b) The obligation is owed to the entity's customer base as a whole, not to individual customers.

(c) The obligation exists even though its amount may be uncertain because it depends on the actions of others. In this respect, a regulatory liability is similar to a mortgage with a feature that obliges the borrower to share some portion of the profits from the use of the property with the lender.

The Board also concluded that an economic obligation is something that results in reduced cash inflows, directly or indirectly, as well as something that results in increased cash outflows. A regulator has the ability to enforce the entity's obligation to reduce rates until the specified amount has been returned to the customers.

Circumstances in which assets and liabilities can arise

BC26 Having concluded that regulation can result in items that meet the definitions of assets and liabilities, the Board then considered the circumstances in which those assets or liabilities could arise. The Board identified two criteria that an entity's activities must satisfy to be within the scope of the proposed IFRS. In other words, an entity is not within the scope of the proposed IFRS and therefore would not recognise regulatory assets and regulatory liabilities simply because it was subject to some form of rate regulation.

BC27 The Board concluded that the situation of an entity that satisfies these criteria is not economically similar to the situation of an entity that does not. Therefore, failure to recognise regulatory assets and regulatory liabilities when they exist would make unlike situations look alike. This outcome is just as detrimental to comparability as making like situations look different. The Board also noted that the return an entity reports in its financial statements is the result of the appropriate recognition and measurement of items that meet the *Framework*'s definitions of assets and liabilities, not the application of any type of mechanism.

Criterion 1 – Prices that bind customers

BC28 The first criterion requires an entity to satisfy two conditions:

(a) An identifiable body is authorised to set prices for the regulated goods or services it provides to its customers.

(b) The prices set by that body bind the entity's customers.

BC29 The Board noted that the existence and authority of the price-setting body should be readily determinable because it is established by statute or contract.

BC30 Agreements between a rate-regulated entity and its customers cannot be understood without reference to the regulation. Therefore, some believe that such agreements are different from agreements between an entity and its customers in a non-regulated environment. An alternative view is the one adopted by the Board in its revenue recognition project. In that project the Board concluded that the terms required by relevant regulation did not need to be included in a customer contract for them to affect the accounting for that contract. Thus, customer contracts in rate-regulated environments have the same effect as those in non-regulated environments in that the terms imposed by legislation/regulation have to be considered. Therefore, no matter which view is adopted, the effect of regulation needs to be considered as part of the agreement with the customer.

BC31 Some believe that the ability to charge a higher or lower price is not a differentiating feature. In fact, all entities have this ability and it does not give rise to an asset or a liability. For example, as a result of a new competitor entering the market, an entity may decide to decrease its prices, but such a decision does not give rise to a liability.

BC32 However, rate-regulated entities are not allowed to charge rates for regulated goods or services other than those approved by the regulator. The regulator has the ability to require price reductions until a specified amount has been returned to customers through those decreases. When an entity reduces its prices to match competition, there is no link to previous profits.

BC33 As previously discussed, regulatory assets and regulatory liabilities arise when the regulator acts on behalf of the customers who individually would have no bargaining power with the regulated entity. It is this aggregate customer base that is both represented by the regulator and bound by the regulator's actions.

Criterion 2 – Cost-of-service regulation

BC34 As discussed in paragraphs BC16 and BC17, the Board concluded that a cause-and-effect relationship between the entity's costs and the future revenue cash flows is the principal economic effect of regulation on the accounting for regulated entities. The regulator's action promising the recovery of a cost creates a future economic benefit, which is the critical feature in the definition of an asset. Consequently, the Board concluded that only regulation in which rates are designed to recover the specific costs the entity incurs in providing the regulated goods or services and to earn a return would result in items that meet the definitions of assets and liabilities.

BC35 In many cases, determining whether the entity's regulatory regime qualifies as cost-of-service regulation will be straightforward. In others, significant judgement will be required. The Board included in Appendix B of the draft IFRS indicators to help an entity determine whether its regulatory regime is cost-of-service regulation.

BC36 The Board noted that the definition of cost-of-service regulation, to some extent, is similar to the definition of a cost plus contract in IAS 11: 'a construction contract in which the contractor is reimbursed for allowable or otherwise defined costs, plus a percentage of these costs or a fixed fee.' From the perspective of the regulated entity, contracts with the customers together with the cost-of-service regulation have, in substance, economic effects similar to cost plus contracts directly negotiated with customers in a non-regulated environment. In the case of regulated entities, the regulator acts on behalf of the customers as a group to identify which costs are allowable.

BC37 In considering rate-regulated activities, the Board noted that IFRIC 12 provides guidance on determining the nature of the asset received (an intangible or a financial asset) by the operator in exchange for the acquisition or construction of the infrastructure used in the service concession. Paragraph 17 of IFRIC 12 states that 'the operator shall recognise an intangible asset to the extent that it receives a right (a licence) to charge users of the public service.' Thus, IFRIC 12 requires an entity to recognise an asset for a right to charge customers for use of a public service at a price controlled or regulated by the grantor even though the entity bears the demand risk. The Board concluded that it would be inconsistent not to recognise regulatory assets when an entity has a similar right as a result of regulation rather than a contract.

BC38 Some believe that rate regulation does not give rise to the recognition of an intangible asset because it does not change the nature of the existing licence. First, in most cases, the licence is not recognised as an intangible asset as it is when it is acquired in circumstances such as those covered by IFRIC 12 or a business combination. Second, the nature of the licence or the service provided under it may not have changed but the rates charged for that service have been changed by the regulation. The Board concluded that the value of the licence reflects the general regulatory environment. In other words, the value of the licence reflects the regulator's promise that, in return for the entity providing reliable service, the regulator will set 'just and reasonable rates' permitting the entity to recover its costs and make a fair return. The permission for the entity to recover specific costs that it has incurred creates an intangible asset separate from the licence.

BC39 The Board also noted that an entity with an arrangement within the scope of IFRIC 12 would have to consider whether it has rate-regulated activities that are within the scope of the proposed IFRS. For example, in one service concession arrangement, the grantor may give the operator only the right to charge customers for use of the public service at the price the grantor controls. In another service concession arrangement, the grantor may give the operator the right to recover the operator's costs and earn a specified return as well as the right to charge customers to use the public service. If it does, the entity would apply both IFRIC 12 and the proposed IFRS on rate-regulated activities.

Recognition and measurement

Recognition of regulatory assets and regulatory liabilities

Recognition criterion and probability of recovery

BC40 The Board considered whether the proposed IFRS should include a separate recognition criterion for regulatory assets and regulatory liabilities. Paragraph 83 of the *Framework* indicates that an asset or liability should be recognised if:

(a) it is probable that any future economic benefit associated with the item will flow to or from the entity; and

(b) the item has a cost or value that can be measured reliably.

BC41 Paragraph 85 of the *Framework* explains that this notion of probability is used in the same sense as it is employed in other standards and defined in the Glossary, ie 'more likely than not'. The Board concluded that if rate-regulated activities satisfied the scope criteria in the proposed IFRS, the actions of a regulator provide reasonable assurance that the economic benefit will flow to or from the entity. In addition, because regulatory assets and regulatory liabilities relate to specifically identifiable amounts expended or collected by the entity, the Board concluded that reliable measurement was possible.

BC42 The Board decided that the scope criteria are both necessary and sufficient for the recognition of regulatory assets and regulatory liabilities. Consequently, once the scope criteria have been satisfied, assets and liabilities exist that meet the criteria for recognition. As a result, the Board decided not to propose a separate recognition criterion in the draft IFRS.

Type of assets or liabilities

BC43 Typically, regulatory assets or regulatory liabilities that would be recognised as a result of applying the proposed IFRS are not financial instruments subject to the requirements of IAS 39. The entity does not have the right to request reimbursement from, or the obligation to make payments to, individual customers for fixed or determinable amounts. Rather, rights or obligations created as a result of rate regulation are rights from or obligations to an aggregate customer base. In this respect, regulatory liabilities are similar to some liabilities recognised in accordance with IAS 37 *Provisions, Contingent Liabilities and Contingent Assets*, in which the identity of the party to whom the obligation is owed is not known. In other respects, regulatory liabilities resemble obligations to perform future services recognised in accordance with IAS 18 *Revenue*. In rare circumstances, the regulator may direct that specific amounts should be paid to or recovered from specific customers. In that case, the definition of a financial instrument would be satisfied.

Measurement of regulatory assets and regulatory liabilities

Probability-weighted average of possible outcomes

BC44 The Board decided that measuring regulatory assets and regulatory liabilities at the present value of expected future cash flows is consistent with the current guidance in IAS 37. Moreover, this approach is consistent with the approach to the determination of expected cash flows the Board recently proposed in its exposure draft *Income Tax* published in March 2009.

BC45 The Board concluded that this measurement approach more faithfully reflects the entity's expectations of future cash flows than does an approach in which satisfying a recognition requirement results in the recognition of the entire asset or liability as if it was certain. The Board concluded that a recognition criterion was unnecessary given the scope criteria. In addition, such a recognition criterion would postpone the recognition of assets and liabilities with future cash flows that can be estimated. Consequently, the Board decided that it was preferable to include the probability of the cash flows in the measurement of the regulatory asset or regulatory liability.

BC46 The draft IFRS requires an entity, in estimating future cash flows, to consider the probability that the regulator will allow or require the entity to include a specific item in the determination of future rates. Usually, the rate-making process is initiated by the entity preparing and filing a rate case designed to show the costs of providing service to customers. When a cost has been considered as part of a finalised rate case, the regulator has provided clear evidence of its agreement on costs that are allowable. Such evidence can be in the form of a formal approval (eg a final rate order), setting out findings of fact and of law, issued by the regulator to support its decisions. Appendix B of the draft IFRS describes additional evidence an entity would consider in estimating the probability of regulatory approval to assist entities in applying its requirements.

Discount rate

BC47 In some jurisdictions regulators allow entities to earn a rate of return that is intended to be consistent with their market-based cost of capital. In these situations, the rate of return set by the regulator may be a reasonable approximation of the discount rate appropriate for the measurement of the regulatory assets and regulatory liabilities. However, this cannot be assumed. Therefore, the Board proposes in paragraph B13 of the draft IFRS that the discount rate should be determined in accordance with the draft IFRS independently of the rate allowed for reimbursement by the regulator.

BC48 The Board noted that the general principle for determination of an appropriate discount rate in an expected present value measurement proposed in paragraph 15 of the draft IFRS is consistent with both paragraph 55 of IAS 36 *Impairment of Assets* and paragraph 47 of IAS 37.

Cost of self-constructed or internally generated assets

BC49 The Board noted that in some cases, a regulator requires an entity to include as part of the cost of property, plant and equipment or internally generated intangible assets amounts that would not be included by non-regulated entities. Such amounts may be indirect overheads not permitted in accordance with IAS 16 or IAS 38 or the cost of financing construction or development that is not in accordance with IAS 23 *Borrowing Costs*. The regulator may require a computed interest cost and a designated cost of equity funds to be included in the cost of the asset.

BC50 The Board acknowledged that two alternatives exist for accounting for these costs. Proponents of the first alternative believe that regulatory assets that would be recognised as a result of the proposed IFRS do not have the same characteristics as assets recognised in accordance with other IFRSs. Therefore, proponents of this alternative believe that all regulatory assets should be presented separately from assets recognised in accordance with other IFRSs.

BC51 Proponents of the second alternative believe that some regulatory assets that would be recognised as a result of the proposed IFRS are so closely related to other assets of the entity that accounting for them separately does not provide additional information to users. Proponents of this alternative believe that when regulatory assets are complementary to other assets and have similar useful lives, there is no need to incur the costs of separate accounting. In accordance with this alternative, an entity includes the cost of the regulatory asset in the cost of the asset recognised in accordance with other IFRSs as a single asset.

BC52 The Board concluded that when it is highly probable that the regulator will require amounts to be included in the cost of self-constructed or internally generated assets that would not be permitted in accordance with IFRSs, those amounts should be included in the cost of the assets rather than being accounted for separately in accordance with the proposed IFRS. If it is highly probable that the regulator will require the amount to be included in the cost of the asset, only one possible difference exists between the accounting the Board proposes and the accounting that would otherwise be required by the proposed IFRS. The proposed IFRS would require a regulatory asset recognised separately to be adjusted for changes in interest rates. The Board concluded that an exception to the principles in the proposed IFRS was justified on cost-benefit grounds.

Recoverability

BC53 The Board concluded that an entity may determine that individual regulatory assets and regulatory liabilities exist and that it should recognise them. However, the Board also concluded that there may be situations in which the net effect of the regulatory assets and regulatory liabilities an entity recognises will result in significant increases in future rates to be charged to customers. A significant increase in an entity's future rates may create a strong incentive for customers to reduce their consumption or switch to an alternative good or service. In these cases, even though rates are increased, expected reductions in volume might mean that the entity will not achieve its total revenue requirements.

BC54 The Board concluded that when it is not reasonable to assume that the entity will be able to collect sufficient revenues from its customers to recover its costs and earn a fair return, an indicator of impairment exists. The regulatory assets and regulatory liabilities should then be included with the other assets and liabilities of the cash-generating unit and tested for impairment in accordance with IAS 36. 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.

Derecognition

BC55 The exposure draft proposes that all items that meet the scope criteria of the draft IFRS should be recognised. As a consequence, the draft IFRS does not include additional criteria specifying when regulatory assets and regulatory liabilities should be derecognised. Failure to satisfy the scope criteria for some activities would automatically result in the derecognition of all previously recognised regulatory assets and regulatory liabilities related to those activities.

Presentation

BC56 Regulatory assets and regulatory liabilities typically do not meet the definition of financial instruments because the assets and liabilities created as a result of regulation relate to the interaction of the entity with the aggregate customer base and not with individual customers. Consequently, they cannot meet the criteria to be presented net set out in IAS 32 *Financial Instruments: Presentation*.

BC57 IAS 12 *Income Taxes* permits (non-financial) current and deferred tax assets and liabilities to be offset if specified conditions are satisfied. One of those conditions is that the entity must have a legal right to set off the recognised amounts. This condition can be satisfied for income taxes because ultimately payments will be made to or received from a single taxing authority.

BC58 Regulatory assets and regulatory liabilities arise from specific costs to be collected from or amounts to be refunded to the aggregate customer base. The Board noted that all the regulatory assets and regulatory liabilities recognised that are related to a distinct regulatory activity will affect the determination of the same rate, but decided not to permit offsetting them as a single net position. However, the Board concluded that the presentation of a net regulatory asset or net regulatory liability for each category subject to the same regulator would be appropriate.

Disclosures

BC59 The Board is aware that most entities already recognising regulatory assets and regulatory liabilities in accordance with US GAAP or similar requirements in other jurisdictions currently provide virtually all of the information proposed to be disclosed by paragraph 24 of the draft IFRS. However, the Board observed that the information is often disclosed in various places throughout the financial statements in a way that can make it difficult for a user to appreciate the overall effect that rate regulation has had on the amounts recognised in the financial statements.

BC60 In the draft IFRS, the Board proposes that entities should meet the minimum disclosure requirements by providing a table showing a reconciliation, from the beginning to the end of the period, of the carrying amount in the statement of financial position of the various categories of regulatory items. This table will be required unless another format is more appropriate. This reconciliation should show in one place the changes in the amounts recognised in the statement of comprehensive income. The Board noted such a table would be useful in helping users to understand how the entity's reported financial results and position have been affected by rate regulation.

Effective date and transition

BC61 The Board will set the effective date for the proposals in the exposure draft when it approves the IFRS on rate-regulated activities. The Board intends to allow a minimum of one year between the date when wholly new IFRSs or major amendments to IFRSs are issued and the date when implementation is required.

BC62 The Board noted that jurisdictions throughout the world have a variety of types of rate regulation to serve a variety of purposes. The current accounting treatment may vary from one jurisdiction to another depending on the application of IFRSs to the specific regulations. The Board considered whether it should provide an exemption from retrospective application of the proposed IFRS because entities must obtain information necessary to determine the probability-weighted present value of future cash flows. The Board believes that this information may be available in many, but not all, instances given the regulatory environment in which such entities operate. The Board noted that determining the probability-weighted present value of future cash flows in these instances would require the use of hindsight and might not achieve comparability.

BC63 Accordingly, the Board proposes not to require full retrospective application. Instead, the Board proposes to require application of the proposed IFRS to regulatory assets and regulatory liabilities existing at the beginning of the earliest comparative period presented in the period in which the entity applies the proposed IFRS. The Board recognises that this requirement means that it may need to extend the normal period between the date of finalising the IFRS and its effective date.

Costs and benefits

BC64 The objective of financial statements is to provide information about an entity's financial position, financial performance and cash flows that is useful to a wide range of users in making economic decisions. To attain this objective, the Board tries to ensure that a proposed IFRS will meet a significant need and that the overall benefits of the resulting information justify the costs of providing it. Although the costs to implement a new IFRS might not be borne evenly, users of financial statements benefit from improvements in financial reporting, thereby facilitating the functioning of markets for capital and credit and the efficient allocation of resources in the economy.

BC65 The evaluation of costs and benefits is necessarily subjective. In making its judgement, the Board considers the following:

(a) the costs incurred by preparers of financial statements.

(b) the costs incurred by users of financial statements when information is not available.

(c) the comparative advantage that preparers have in developing information, compared with the costs that users would incur to develop surrogate information.

(d) the benefit of better economic decision-making as a result of improved financial reporting.

BC66 The Board concluded that the proposed IFRS would meet a significant need because questions continue to arise on the application of IFRSs to various types of regulated activities. In the Board's view, it is more efficient for the Board to develop an IFRS than to require each entity to reach its own conclusions on the application of the *Framework*.

BC67 The Board decided that particular types of regulation create assets and liabilities. The draft IFRS requires those assets and liabilities to be recognised in the financial statements. The Board believes that consistent recognition of elements that meet the definitions of assets and liabilities improves financial reporting and consequently economic decision-making.

BC68 In the case of regulatory assets and regulatory liabilities, the Board believes that the additional costs that preparers of financial statements need to incur should not be significant because the detailed information is already required in most circumstances for reporting to the regulator. Consequently, preparers have a large advantage in developing information when compared with the costs that users would incur to develop surrogate information.

Alternative views on exposure draft

Alternative views of Stephen Cooper and Wei-Guo Zhang

AV1 Messrs Cooper and Zhang voted against the publication of the exposure draft of the proposed International Financial Reporting Standard *Rate-regulated Activities* for the reasons set out below.

Definition of an asset or a liability

AV2 Messrs Cooper and Zhang do not agree that assets or liabilities should be recognised solely as a result of rate regulation. The definitions of an asset and a liability in the *Framework for the Preparation and Presentation of Financial Statements* are not met for items arising from rate regulation. By requiring them to be treated as assets and liabilities, the exposure draft proposes a departure from the *Framework*.

AV3 Regulators are empowered to establish the price charged for regulated activities or the rate of return allowed on assets used in such activities. In doing so they may approve, for the purposes of computation, accruals or deferrals of related costs to meet that specified rate of return. But in the view of Messrs Cooper and Zhang, those actions do not create an enforceable right to recover cost plus a rate of return. Nor do they assure the level of future demand. As a result, the entity cannot control adequate transactions in the future to enable its recovery of cost plus return.

AV4 The exposure draft uses the concept of 'a group of customers' or 'customer base' to justify the recognition of regulatory assets and regulatory liabilities. Messrs Cooper and Zhang's alternative view is that there is no justification to presume that the customers as a group will use a given level of service at a given price in the future. The rate allowed by regulation is not necessarily the rate the customers will be willing or able to pay for the level of demand envisaged. They acknowledge that the proposed IFRS includes recoverability and impairment tests. However, imposing such tests does not overcome their view that the regulatory asset should not be recognised in the first instance.

AV5 An entity cannot demand payment of any deferred cost until it forms part of an actual transaction in a future period. The reverse is equally true. Reducing the rate and/or the rate of return in the future does not mean that the regulated entity is liable to refund or reimburse any excess past return to the customers.

AV6 Since the regulator cannot ensure the demand, Messrs Cooper and Zhang cannot see how the right or obligation that arises as a result of regulation can be related to identifiable future cash flows. Furthermore, in practice, the pattern of cash flows is often complicated by: using estimated rather than actual cost to establish rates and to approve deferred debits or credits; time lags between the submission and approval; differences between expected and actual transaction volumes; different classes of customers subject to different rates; and activities that are subject to different regulations. These complications make it virtually impossible to establish any direct link between the regulatory right or obligation and the entity's future cash flows. The proposed treatment will confuse users and preparers of financial reports, as well as cause extra time and effort, which in their opinion outweigh any perceived benefits.

Inconsistencies with existing IFRSs and comparability

AV7 The exposure draft would require regulated entities to recognise as assets or liabilities items that unregulated entities are prohibited from recognising as assets or liabilities, for example, research costs, indirect overheads, damaged fixed assets, and the imputed cost of equity capital used in financing the construction of plant and equipment. Messrs Cooper and Zhang find no basis for overriding the principles that other IFRSs would require to be applied in such cases.

AV8 Messrs Cooper and Zhang believe that because of the inconsistent requirements with other IFRSs, this exposure draft will lead to a lack of comparability: economically similar situations will be accounted for differently within a regulatory entity over time, or among different regulatory entities, and between regulated and unregulated entities.

AV9 Furthermore, since jurisdictions may have different approaches to regulated activities with different sizes and different schemes that are evolving over time, Messrs Cooper and Zhang have deep concerns over whether the proposed IFRS will be interpreted and applied consistently.

Objective of financial reporting and the provision of useful information

AV10 The IASB has asserted that the objective of financial reporting is different from that of government regulation, and accounting principles serving the objective of financial reporting should not be the same as the one serving the objective of government regulation.

AV11 Messrs Cooper and Zhang consider the proposed treatment will result in the regulated entity reporting a stabilised rate of return allowed by the regulator in a particular period. They recognise that stability is clearly the objective of the regulator. However, they question whether such a profit-smoothing mechanism is desirable for financial reporting purposes. Actual results will always differ from regulatory decisions or expectations because of deviations in the volume of transactions, the cost of production etc. Financial reports will be more useful if they reflect the actual results of each period rather than the expected or stabilised results permitted by a regulator.

AV12 Messrs Cooper and Zhang do not deny that a regulated entity has some unique features, and the decisions taken by regulators may affect the entity's current or future financial position or operating results. In their judgement, what is called for is appropriate disclosure rather than setting accounting standards inconsistent with the existing *Framework* and IFRSs.

Transparency

AV13 If in due course the Board requires the recognition of regulatory assets and regulatory liabilities Messrs Cooper and Zhang consider it vital that the impact on the financial statements should be transparent so that investors can clearly identify how this accounting has affected profit or loss and financial position. In this regard, they do not believe that regulatory assets should be included as a component of self-constructed assets as proposed.

July 2009

Illustrative Examples
Exposure Draft ED/2009/8

Rate-regulated Activities

Comments to be received by 20 November 2009

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Draft Illustrative Examples

Exposure Draft

RATE-REGULATED ACTIVITIES

Comments to be received by 20 November 2009

ED/2009/8

These draft Illustrative Examples accompany the proposed International Financial Reporting Standard (IFRS) set out in the exposure draft *Rate-regulated Activities* (see separate booklet). Comments on the draft IFRS and its accompanying documents should be submitted in writing so as to be received by **20 November 2009.** Respondents are asked to send their comments electronically to the IASB website (www.iasb.org), using the 'Open to Comment' page.

All responses will be put on the public record unless the respondent requests confidentiality. However, such requests will not normally be granted unless supported by good reason, such as commercial confidence.

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CONTENTS

IFRS X *Rate-regulated Activities*
[Draft] Illustrative examples

These examples accompany, but are not part of, the draft IFRS.

The Board plans to publish examples 1–6 with the IFRS. Examples 7–9 are included in the exposure draft to help respondents.

Application of the scope

Example 1 – Example of rate-regulated operations

IE1 Company X, the owner of electricity transmission infrastructure and related assets, has been licensed for twenty years to operate a transmission system in a particular jurisdiction. Only one operator is authorised to manage and operate the transmission system.

IE2 Company X charges its customers for access to the network at prices that must be approved by the regulator. Pricing structures are defined in the law and related guidelines, and are determined on a 'cost plus' basis that is based on budget estimates. Once approved, prices are published and apply to all customers. Prices are not negotiable with individual customers.

IE3 Prices are set to allow Company X to achieve a fair return on its invested capital and to recover all reasonable costs incurred. At the end of each year, Company X reports to the regulator deviations between the actual and budgeted results. If the regulator approves the differences as 'reasonable costs', they are included in the determination of rates for future periods.

IE4 Such rate-regulated activities are within the scope of the [draft] IFRS because the regulator establishes the prices Company X charges its customers, those prices bind the customers, and the prices are designed to recover Company X's specific costs and earn a fair return.

Example 2 – Incentive-based regulation in energy transmission and distribution

IE5 Company Y operates in a jurisdiction where revenue rather than rates is regulated for energy distribution. The regulator sets a total 'allowable revenue' for each year. To the extent that Company Y collects more or less than the allowable revenue in any year, it must adjust its prices for the following year.

IE6 The regulator resets allowable revenue every five years after reviewing every entity in the industry and taking into account the differences in their operations and geographical distribution of customers. The regulator then determines for each entity:

(a) an efficient level of operating costs;

(b) an agreed programme of capital expenditure over the next five years; and

(c) a cost of capital.

IE7 Allowable revenue for the first year of the price review is generally determined by adding together a level of operating costs that will be allowed for recovery (based on existing levels of operating costs) and a return on the regulated asset base (based on existing assets, plus the capital expenditure programme at the allowed cost of capital).

IE8 For subsequent years, allowable revenue is adjusted by an efficiency factor related to the reduction of allowable operating costs that the regulator has determined is achievable by Company Y.

IE9 Such regulation is not within the scope of the [draft] IFRS because:

(a) Company Y's allowable total revenue is determined on the basis of industry averages and targeted reductions in operating costs rather than the actual costs Company Y incurs;

(b) the regulator controls Company Y's total revenues rather than the prices it charges customers; and

(c) Company Y is entitled to retain any profits (or suffers any losses) from exceeding or failing to meet the regulator's deemed level of efficient operating costs rather than being entitled to recover excess costs or having to return excess profits to customers through future rates.

Example 3 – Supply of energy in a rate-regulated environment

IE10 In some jurisdictions distributors are allowed to make a profit or loss only on the distribution of energy, not on the energy supplied. Therefore, a company in these jurisdictions charges its customers two rates—one for the cost of energy and another for the cost of distribution. This separation allows customers to obtain their energy from suppliers other than the distributor.

IE11 Company Z determines the difference between the revenue received at the rate charged and the purchase cost of the energy each month. This difference is then recovered from or returned to customers by adjusting the rates charged for energy over the next twelve months, beginning in the month after the energy is supplied. Thus, the rate Company Z charges customers for energy supplied in September will be determined as the estimated cost of energy in September, adjusted by one-twelfth of any profit or loss on energy supplied in the previous twelve months.

IE12 In the absence of rate regulation, Company Z would simply bill each customer the difference between the price it charged and its cost for the energy the customer used in September. Because an identifiable amount, based on that customer's prior usage, would be due from an individual customer, a financial asset or financial liability would exist. However, by regulation Company Z may recover its specific cost of energy supplied to customers only by adjusting future rates. Because the profit or loss from the supply of energy will be recovered over twelve months from the customer base as a whole, Company Z recognises a regulatory asset or regulatory liability within the scope of the [draft] IFRS.

Example 4 – Cost-of-service regulation with a determinable variable return

IE13 Company A operates under a cost-of-service regulation with a determinable variable return. The performance incentive mechanism allows it to retain 25 per cent of the amount by which its actual return exceeds the target return allowed by the regulator (referred to as 'over earnings'). The regulator requires the customers' share of the over earnings (75 per cent) to be returned to them as rate reductions over three years beginning in the year following its approval of the determination of such over earnings. If Company A earns less than the return allowed by the regulator, it is permitted to increase rates in the following three years to recover 50 per cent of the difference. In both cases, the amount is adjusted by interest at the company's cost of capital to compensate the party receiving the payment for the delay in recovery.

IE14 This regulation is within the scope of the [draft] IFRS. The permitted rates of return are based on the entity's specific costs incurred and the entity has a right to recover 50 per cent of the amount by which its actual return is lower than the regulator's target and similarly an obligation to return to its customers 75 per cent of over earnings. However, if Company A consistently fails to recover a reasonable return, it would need to consider the indicators in paragraphs B4–B6 of the [draft] IFRS to determine whether it continues to be within the scope of the [draft] IFRS.

Example 5 – Example of price cap regulation

IE15 Company B operates in a jurisdiction where the prices it charges its customers for the goods or services it provides are regulated according to a 'price cap index'. The regulator sets prices considering various factors such as competition and inflation. Company B cannot charge more than the set prices.

IE16 Under such regulation the buyer is assured of the result while the supplier takes the risk and receives the rewards from additional effort or from the implementation of cost-reducing innovations.

IE17 Though such regulation meets the criterion in paragraph 3(a) of the [draft] IFRS in that prices are regulated and bind customers, it fails the criterion in paragraph 3(b) because prices are not designed to recover Company B's specific costs to provide the goods or services.

Rate-regulated assets and liabilities

Example 6 – Example of a regulatory asset

IE18 Company C, an entity operating rate-regulated activities, received formal approval from the regulator before recognising a regulatory asset. Consequently, Company C did not need to assess the probability of regulatory approval.[*]

[*] The example oversimplifies the calculation as it does not take into account variations such as volume of use or load conditions which would affect the units used and billed to customers in individual periods.

IE19 Following a major storm that destroyed its distribution towers, Company C received a rate order from its regulator that allows it to recover the replacement costs of CU100* straight-line over five years with a yearly allowed return of 5 per cent. The 5 per cent return applies to the net carrying amount of the unrecovered costs at the end of each year.

The table below shows the cash flows generated:

	Y1	Y2	Y3	Y4	Y5
Allowed storm costs	20	20	20	20	20
Allowed return	5	4	3	2	1
Total cash inflows	25	24	23	22	21

The regulatory asset is the expected present value of the total cash inflows received from customers generated by the incurrence of the replacement costs and the allowance of the costs and the return by the regulator.

IE20 The regulatory asset arises because the regulator has approved the recovery of costs that would otherwise have been recognised as an expense in the period when the costs were incurred:

(a) if Company C had recognised the original distribution towers as an asset, it would have derecognised their carrying amount as a loss in profit or loss and included the costs of the new towers in property, plant and equipment in accordance with IAS 16.

(b) if Company C had recognised the cost of the original distribution towers as an expense in profit or loss, it would similarly have recognised the cost of their replacements as an expense in profit or loss.

IE21 In either case, recognition of the regulatory asset reduces the amount Company C recognises as expense in profit or loss in the period.

* In this guidance monetary amounts are denominated in ‘currency units (CU)’.

Other examples

Example 7 – Determination of the regulated rate

IE22 The formula for determining a rate per unit of goods or services provided to customers generally entails the determination of a rate base, a rate of return and operating expenses as follows:

Rate base × rate of return + operating expenses = revenue requirement

IE23 Then, to determine the rate to be charged to customers (the price of each unit of service), the revenue requirement is divided by the total units of service expected to be used by the customers. So:

Revenue requirement/estimated volume = rate per unit

IE24 The following is an example of how the rates are usually determined in a cost-of-service regulation.

An entity operates a rate-regulated activity for which the following items are allowed by the regulator (all amounts are expressed in CU):

Operating costs	
Fuel	10,000
Operations	
(including property, plant and equipment depreciation)	8,000
Maintenance	2,000
Selling, general and administration	1,000
Allowed operating expenses	21,000
Rate base	
Plant in service (carrying amount)	1,000,000
Construction work in progress	300,000
Allowed rate base	1,300,000

Because the intention is to provide for earnings on all balances necessary for utility operations, the allowed costs also include the cost of debt financing for the following items:

continued...

...continued

Other assets/liabilities

Working capital	3,000
Net regulatory assets	5,000
Net other assets/liabilities	(1,000)
Allowed other assets/liabilities base	7,000

The capital structure of the entity is assumed to include 50 per cent debt and 50 per cent equity. The average borrowing rate is 6 per cent and the allowed return on equity is 10 per cent. The allowed rate of return on the rate base is the average of the debt cost and the equity return, ie 8 per cent.

The total allowed costs is the sum of the allowed operating expenses and the cost of financing both the rate base, by application of the rate of return, and the other assets and liabilities, by application of the borrowing rate:

Allowed operating expenses		21,000
Cost of financing rate base		
	1,300,000 × 8% =	104,000
Cost of financing other assets		
	7,000 × 6% =	420
		125,420

Expected units to be billed	1,000,000
Regulated rate per unit	0.12542

Example 8 – Balancing account

IE25 In some jurisdictions, regulators have separated the cost of the goods provided to customers from the costs of their distribution. This permits customers to purchase the goods from alternative suppliers, increasing competition. Entities operating in such environments are often prohibited from earning a return on the supply of goods. However, they are permitted to recover their purchase costs on the basis of a one-for-one pass through to retail customers. Such a mechanism may be included in legislation or could take the form of an automatic adjustment clause.

IE26 To reduce volatility in rates charged to customers, regulators generally require differences between actual and estimated costs to be collected or refunded over time. The cumulative adjustments for the under-collection or over-collection of these costs are recognised as a regulatory asset or liability in the statement of financial position, until they affect future billings to customers.

Illustrative example

IE27 The example below illustrates the effect of variations in the cost of gas on an entity's rate-regulated activities over a three year period. In practice, the recovery process for variances in costs would generally be over periods from three to twelve months.

IE28 During 20X1, sales volume was lower than expected and natural gas prices increased as a result of supply shortages in the region.

IE29 The table below shows the entity's actual gas supply costs and the amount collected in rates for each of the three years, taking into account the provision in rates for the effect of volumes and cost variances:

	20X1	**20X2**	**20X3**
	CU	**CU**	**CU**
Actual gas supply costs	1,034	1,040	978
Amount collected in rates	917	1,085	1,055

IE30 The entity did not recover gas supply costs of CU117 (CU1,034 − CU917) in year 20X1. For this example, assume that as of 1 January 20X1, the entity has a nil balance in its balancing account. The amount not recovered is recognised as a regulatory asset for CU117 in the statement of financial position in 20X1 and reduces gas costs in the statement of comprehensive income for this period.

IE31 In 20X2, the net amount recovered in excess of cost is calculated as follows:

20X2	CU
Amount collected in rates	1,085
Actual gas supply costs	1,040
Difference	45
Amortisation of prior period balance	(39)[a]
Net excess recovery in 20X2 refundable over three years	**6** [b]

(a) The entity is entitled to recover CU39 during 20X2 (CU117 over three years) related to costs not recovered in 20X1, leaving CU78 to be recovered in the next two years.

(b) The entity decreases the carrying amount of its regulatory asset by CU6 at the end of 20X2, leaving a cumulative net balance of CU72.

IE32 In 20X3, the net amount recovered in excess of cost is calculated as follows:

20X3	CU
Rate collection	1,055
Actual gas supply costs	978
Difference	77
Amortisation of prior period balance (from 20X1)	(39)[a]
Amortisation of prior period balance (from 20X2)	2 [b]
Net excess recovery in 20X3 refundable over three years	**40** [c]

(a) The entity is entitled to recover CU39 during 20X3 (CU117 over three years) related to costs not recovered in 20X1, leaving CU39 to be recovered in the following year.

(b) The entity is required to refund CU2 during 20X3 (CU6 over three years) related to excess recoveries in 20X2, leaving CU4 to be refunded in the next two years.

(c) The entity decreases the carrying amount of its regulatory asset by CU40 at the end of 20X3, leaving a cumulative net balance of CU(5).

IE33 The statement of financial position includes a line for the current regulatory asset showing the balance at the end of each period:

	20X3	20X2	20X1
	CU	CU	CU
Balancing account, net	(5)	72	117

IE34 The statement of comprehensive income shows the following line items related to gas costs and the balancing account:

	20X3	20X2	20X1
	CU	CU	CU
Cost of gas purchased in the period	978	1,040	1,034
Current period net (deferral)/recovery	40	6	(117)
Total amortisation of deferred gas costs	37	39	–
Amount included in profit or loss	1,055	1,085	917

Note: Normally the regulator would permit the entity to recover a return on the outstanding balance to reflect the deferred payment; however, to simplify the example such amounts are not included in the calculations.

Example 9 – Regulatory liability

IE35 An electricity distribution company sells land originally purchased to construct its operations centre for CU20 (carrying amount of the land is CU1). The entity is building two new operations centres at other locations and their cost will be included in the rate base when they are complete.

IE36 The regulator approved the sale of the land but the approving order does not address accounting for the gain on sale. However, in prior property sales, the entity has been required to return gains to customers and amounts returned have ranged from 75 per cent to 100 per cent.

IE37 The entity plans to address the accounting for the gain in its next general rate case. However, on the basis of previous decisions and the facts and circumstances for this particular sale, it expects the regulator to require it to return the entire gain to customers (estimated probability of total refund is 100 per cent). Consequently, it recognises the following amounts when the sale takes place:

Sale of property

	Dr	Cr
Cash (statement of financial position - SFP)	20	
Land (SFP)		1
Gain on sale of property (statement of comprehensive income - SCI)		19

Recognition of the regulatory liability arising from the gain on sale of land

	Dr	Cr
Gain on sale of property (SCI)	19	
Regulatory liability (SFP)		19

IE38 In the following year, the entity files its general rate case. As expected, the regulator orders the entity to refund the entire gain to its customers over the next ten years. The amortisation of this non-cash amount is included in the determination of the entity's revenue requirement. Thus, the amortisation results in reduced customer rates which settle the liability over ten years. Therefore, the entity will record the following entry in each subsequent year:

	Dr	Cr
Regulatory liability (SFP)	1.9	
Other income/expense (SCI)		1.9

Note: Normally the regulator would also require the entity to provide a return on the outstanding balance of the liability to reflect its deferred settlement; however, to simplify the example these amounts are excluded.