Recent developments in the IASB Rate-regulated Activities project

Objective

1 This paper provides an update on the IASB project on Rate-regulated Activities (the project) and the accounting model being developed for 'defined rate regulation' (the model). A more detailed summary of the recent IASB discussions and tentative decisions so far is presented in Appendix 1.

2 Agenda paper 07-02 - IASB Agenda paper 9A of the IASB December 2018 meeting - provides background information and summary of decisions to date about the model (provided for background purposes).

Summary of IASB discussions

3 As at December 2018, the IASB has made tentative decisions on the scope of the project and several aspects of the accounting model, including:

(a) general approach of the model, including a description of the regulatory timing differences that arise through the operation of the rate-adjustment mechanism;

(b) unit of account and whether regulatory timing differences meet the definitions of assets and liabilities under the revised *Conceptual Framework for Financial Reporting* (issued in March 2018);

(c) recognition of regulatory assets and regulatory liabilities;

(d) measurement of regulatory assets and liabilities including which discount rate to be used; and

(e) presentation requirements and disclosure objectives for defined rate regulation.

4 The model will apply to activities subject to 'defined rate regulation' established through a formal regulatory framework that is binding on both the entity and the regulator and establishes a basis for setting the regulated rate by a rate-adjustment mechanism contained in the regulatory agreement.

5 The model is a 'supplementary approach', which will supplement the requirements of the existing IFRS Standards. The model will focus on the incremental set of rights and obligations arising from the rate-setting mechanism contained in the regulatory agreement, which are currently not reflected in the IFRS financial statements. An entity will therefore apply the requirements of other IFRS Standards without modification, such as IFRS 15 *Revenue from Contracts with Customers,* IFRIC 12 *Service Concession Arrangements* and IAS 20 *Accounting for Government Grants and Disclosure of Government Assistance,* when applicable, before applying the model being developed.

6 The EFRAG Rate-regulated Activities Working Group discussed the IASB tentative decisions taken so far at its meeting in October 2018. A report of the EFRAG RRAWG Chairman reporting on the feedback received during the discussion, was presented at the November 2018 EFRAG TEG meeting.

Next steps

7 In December 2018, the IASB staff presented an overview of the current project plan which included the following next steps:

Topic	IASB meeting
Summary of the model	Jan 2019
Effects analysis, including US GAAP comparison	Feb 2019
Discussion Paper or Exposure Draft	Feb 2019
Transition	Feb 2019
Due process	Feb 2019

8 EFRAG TEG and EFRAG CFSS discussed the project several times since the IASB published its Discussion Paper *Reporting the Financial Effects of Rate Regulation* in September 2014. In June 2018, EFRAG TEG discussed practical examples of activities subject to some form of price or rate-setting mechanism to assess whether these examples would, and should, be within the scope of the IASB project. EFRAG TEG has been monitoring the development of the model through the discussions at EFRAG TEG-CFSS in preparation for the ASAF meetings. However, the EFRAG Secretariat is conscious that EFRAG TEG has not discussed in detail specific aspects of the IASB decisions that form the core aspects of the accounting model.

9 Given the substantial progress made on the model and key decisions taken so far, the EFRAG Secretariat proposes to bring papers to EFRAG TEG for discussion about the main aspects of the model in anticipation of the IASB exposure draft (or discussion paper), expected in H2 2019. We propose the following:

Topic	EFRAG TEG meeting
General approach and unit of account	March 2019
Recognition and measurement of regulatory assets and liabilities including discounting	May 2019
Interaction with other IFRS Standards	June 2019
Presentation and disclosure including other areas of focus for EFRAG	July 2019

10 At this stage the EFRAG Secretariat is not proposing specific outreach on any aspects of the model, although we do not dismiss the idea of performing targeted outreach for specific areas of the model that appear to be potentially challenging and which might benefit from discussion with interested parties and affected entities beyond those represented on the RRAWG.

Questions for EFRAG TEG members

11 Do EFRAG TEG members have any questions on the IASB's progress on the project?

12 Do EFRAG TEG members consider that any specific aspects of the project should be prioritised for the development of preliminary views by EFRAG TEG as next steps?

Appendix 1: Recent IASB tentative decisions

1 This Appendix provides a summary of the IASB tentative decisions on the model for 'defined rate regulation'.

February 2017

2 The IASB tentatively decided that the model represented a 'supplementary approach; and that a rate-regulated entity would apply other IFRS Standards, including IFRS 15, without amendment, before applying the model. The general approach meant that, using the model, an entity would then recognise rights and obligations arising from the rate-adjustment mechanism. The IASB confirmed this approach.

February 2018

3 The IASB discussed the ***unit of account*** and tentatively decided that:

(a) The accounting model would use as its unit of account the individual timing differences that created the incremental rights and obligations arising from the regulatory agreement.

(b) The present regulatory right - to charge a rate increased by an amount as a result of past events - met the definition of an asset in the *Conceptual Framework*.

(c) The present regulatory obligation - to provide goods or services at a rate reduced by an amount as a result of past events - met the definition of a liability in the *Conceptual Framework*.

March 2018

4 In March 2018, the IASB tentatively decided the ***scope*** and that the accounting model should apply to defined rate regulation established through a formal regulatory framework that:

(a) was binding on both the entity and the regulator; and

(b) established a basis for setting the rate for specified goods or services that included a rate-adjustment mechanism. That mechanism created, and subsequently reversed, rights and obligations caused by the regulated rate in one period including amounts related to specified activities the entity carried out in a different period.

5 The IASB tentatively decided that the accounting model:

(a) should require the ***recognition of regulatory assets or regulatory liabilities*** if it was more likely than not that they existed—the model set a symmetrical recognition threshold in cases of existence uncertainty; and

(b) should not set thresholds that would prevent recognition of a regulatory asset or regulatory liability for which there was:

(i) low probability of an inflow or outflow of economic benefits; or

(ii) high measurement uncertainty.

May 2018

6 In May 2018, the IASB tentatively decided that the ***measurement of regulatory assets*** should reflect.

(a) estimates of the future cash flows the regulatory assets would generate. These cash flows included amounts that resulted from:

(i) the costs of assets used, and operating expenses incurred;

(ii) any margins on the operating expenses incurred; and

(iii) any interest on the operating expenses incurred or returns on the costs of assets used.

(b) discounting the estimates of future cash flows if there was a significant financing component.

7 The IASB also tentatively decided that:

(a) the measurement of regulatory assets should reflect changes, if any, in the estimates of the future cash flows the regulatory assets will generate; and

(b) the discount rate established at initial recognition should remain unchanged during the subsequent measurement of the regulatory assets.

July 2018

8 At this meeting, the IASB continued its discussion from May 2018 on the **measurement of regulatory assets** and considered the following:

(a) estimating future cash flows;

(b) significant financing component and discount rate; and

(c) changes in estimated future cash flows, including changes caused by the discount rate.

Estimating future cash flows

9 The IASB tentatively decided that, for each regulatory asset recognised, an entity should:

(a) estimate future cash flows using either the 'most likely amount' method or the 'expected value' method, depending on which method the entity concludes would better predict the amount of the cash flows arising from a particular timing difference; and

(b) apply the same method consistently from the origination of the timing difference until its reversal.

Significant financing component and discount rate

No explicit financing component

10 The IASB also discussed how an entity should determine whether to consider the outcome of each timing difference separately or together with one or more other timing differences. The IASB tentatively decided such determinations should be based on the approach that would better predict the amount of the resulting future cash flows.

11 If the entity concludes the financing component is not significant, discounting the future cash flows is not required. However, if the entity concludes the financing component is significant, the entity should use a 'reasonable rate' to discount the estimated future cash flows and recognise any loss in profit or loss immediately.

Explicit financing component

12 The IASB tentatively decided that, when a financing component is explicit, an entity should measure the regulatory asset by discounting the estimated future cash flows using the interest rate or return rate established by the regulatory agreement for those cash flows. However, that requirement would not apply where clear evidence shows that the regulatory interest rate or return rate is set at a level that provides an excess or deficit in compensation because of an identifiable event or decision. In this circumstance, an entity should recognise the excess or deficit in compensation in the period in which the identifiable event or decision occurs.

Changes in estimated future cash flows, including changes caused by the discount rate

13 The IASB tentatively decided that the model should adopt the treatment required by IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors* to account for changes in estimated future cash flows. Consequently:

(a) the effect of a change in estimated future cash flows should be recognised prospectively in profit or loss in:

(i) the period of change, if the change affects only that period; or

(ii) the period of change and future periods, if the change affects both; and

(b) if the change gives rise to a change in a regulatory asset, the change should be recognised by adjusting the carrying amount of the related asset in the period of change.

14 When a regulator changes the interest rate or return rate used to compensate an entity for the period between the origination and reversal of a timing difference, the IASB tentatively decided that the entity should:

(a) measure the outstanding regulatory asset balance using the revised interest rate or return rate to discount the estimated future cash flows; and

(b) recognise any resulting change in the carrying amount of the regulatory asset in the period of change.

Measurement of regulatory liabilities

15 The IASB tentatively decided that the model should apply the same measurement requirements for regulatory liabilities and regulatory assets.

November 2018

Presentation and disclosure

16 With respect to the statement of financial position, the IASB tentatively decided that an entity should present regulatory assets and regulatory liabilities as separate line items and classify them as current or noncurrent except when the presentation is based on liquidity. The IASB also tentatively decided to permit but not require offsetting of regulatory assets and regulatory liabilities only if they are expected to lead to adjustments to the same future rate(s) charged to customers and have the following characteristics:

(a) have the same pattern and timing of reversal;

(b) arise in the same regulatory regime; and

(c) the entity has a legally enforceable right to offset them.

17 With respect to the statement of financial performance, the IASB tentatively decided that an entity should present all regulatory income and regulatory expense netted as a separate line item immediately below the revenue line in profit or loss, and not in other comprehensive income. The IASB also tentatively decided that an entity should include regulatory interest income and regulatory interest expense within the regulatory income or regulatory expense line item.

18 The IASB tentatively decided that the overall disclosure objective for defined rate regulation should be focused on the effects that the transactions or other events that give rise to regulatory timing differences have on an entity's financial performance and financial position and not to include information about all the effects of defined rate regulation.

19 Additionally, specific disclosure objectives should focus on information to help users of financial statements:

(a) to understand the effects of regulatory timing differences on the entity's financial performance by distinguishing between fluctuations in revenue and expenses which will be compensated for through the rate-adjustment mechanism and those which will not be compensated;

(b) to understand and assess the amount, timing and uncertainty of future cash flows resulting from the entity's regulatory assets and regulatory liabilities; and

(c) to understand how the entity's financial position was affected during the period by transactions or other events that caused changes in the carrying amounts of regulatory assets and regulatory liabilities.

20 In addition, the IASB tentatively decided that an entity should disclose:

(a) a breakdown of the regulatory income or regulatory expense by origination/ recovery/fulfilment/changes in the carrying amount of regulatory assets and regulatory liabilities;

(b) a maturity analysis of the carrying amounts of regulatory assets and of regulatory liabilities at the end of the period;

(c) the discount rate or ranges of discount rates used to discount the estimated cash flows reflected in the carrying amounts of regulatory assets and of regulatory liabilities;

(d) a reconciliation of the carrying amount of regulatory assets and of regulatory liabilities from the beginning to the end of the period.

Interactions between the model and IFRS Standards

21 The IASB tentatively decided that the measurement requirements of IAS 36 *Impairment of Assets* and IFRS 5 *Non-current Assets Held for Sale and Discontinued Operations* should not be applied to regulatory assets and regulatory liabilities.

22 The IASB tentatively decided **against** including an explicit statement, similar to the application guidance in paragraph B10 of IFRS 14 *Regulatory Deferral Accounts*, that other IFRS Standards apply to regulatory assets, regulatory liabilities, regulatory income and regulatory expense in the same way as they apply to other assets, liabilities, income and expenses.

23 Additionally, the IASB tentatively decided that any requirements and application guidance on interactions between the model and other IFRS Standards should be included in a future Standard on rate-regulated activities, rather than added to those other Standards.

December 2018

Discount rate

24 The IASB considered what would be the reasonable discount rate to be applied when measuring regulatory assets and regulatory liabilities arising from three types of regulatory timing differences. The IASB tentatively decided that:

(a) Capital expenditure (Capex) timing differences - regulatory timing differences that form part of the regulatory capital base should be discounted at 0% rate. Such timing differences should only consider estimated future cash flows arising from the original regulatory timing difference and not cash flows relating to the regulatory overall return.

(b) Operating expenditure (Opex) timing differences - regulatory timing differences that form part of the regulatory operating expenditure should be discounted using a discount rate that reflects, at least, compensation for the time value of money and uncertainty inherent in the cash flows. Usually, the discount rate in such circumstances is the regulatory interest rate or regulatory

return disclosed in the regulatory agreement. However, if the regulatory rate/ return provides an excess compensation the entity should investigate whether the excess relates to an identifiable transaction or event.

(c) Other timing differences - for regulatory timing differences that form part of the regulatory operating expenditure or the regulatory capital base when cash is paid or received, the IASB did not agree with the proposal to use the same discount rate as for the underlying assets or underlying liabilities and asked the IASB staff to provide further analysis.