

This paper has been prepared by the EFRAG Secretariat for discussion at a public meeting of EFRAG TEG. The paper forms part of an early stage of the development of a potential EFRAG position. Consequently, the paper does not represent the official views of EFRAG or any individual member of the EFRAG Board or EFRAG TEG. The paper is made available to enable the public to follow the discussions in the meeting. Tentative decisions are made in public and reported in the EFRAG Update. EFRAG positions, as approved by the EFRAG Board, are published as comment letters, discussion or position papers, or in any other form considered appropriate in the circumstances.

## **Rate-regulated Activities project**

### **Practical examples on the scope of defined rate regulation**

#### **Objective**

- 1 The objective of this paper is to consider the scope of the IASB project on rate-regulated activities (the project). The paper examines examples of activities in different sectors subject to price/rate controls and asks EFRAG TEG for views on whether the features and underlying rights and obligations of those activities:
  - (a) meet the definition of defined rate regulation as tentatively agreed by the IASB; and
  - (b) meet the definitions of an asset and a liability under the IASB's *Conceptual Framework for Financial Reporting* published in March 2018 ('Conceptual Framework').

#### **Introduction**

##### *Concerns raised by EFRAG TEG on the scope of the project*

- 2 During the April 2018 EFRAG TEG/CFSS meeting, some EFRAG TEG members noted that some entities might have activities with similar characteristics to those conducted by rate-regulated entities which, in their view, could meet the definitions of assets and liabilities under the Conceptual Framework, but might not qualify as defined rate regulation. The concern is that these entities might decide to apply the accounting model for defined rate regulation by analogy based on the accounting policy choice set out in paragraph 11(a) of IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors*, which might not be the intention of the IASB project.
- 3 Furthermore, in previous discussions, some EFRAG TEG members questioned whether defined rate regulation allowed the regulator to be a related party to the entity and if so how that would align with excluding self-regulation, which in the view of these members, should be excluded from the scope of the project. These members cautioned against unintended consequences and the scope becoming too broad.
- 4 The discussion at the ASAF April 2018 meeting highlighted similar concerns, with several ASAF members noting the importance of being clear on what was in and out of scope and whether self-regulation was intended to be covered by the scope.
- 5 Some ASAF members also questioned whether a regulator needed to be an 'independent' party in the tripartite relationship in defined rate regulation. In some jurisdictions a tripartite relationship clearly existed; however, in some countries, like China, state-owned enterprises still play a significant role and it might be that the regulator and the regulated entity were both state-owned.

*Response by the EFRAG Secretariat to the concerns raised*

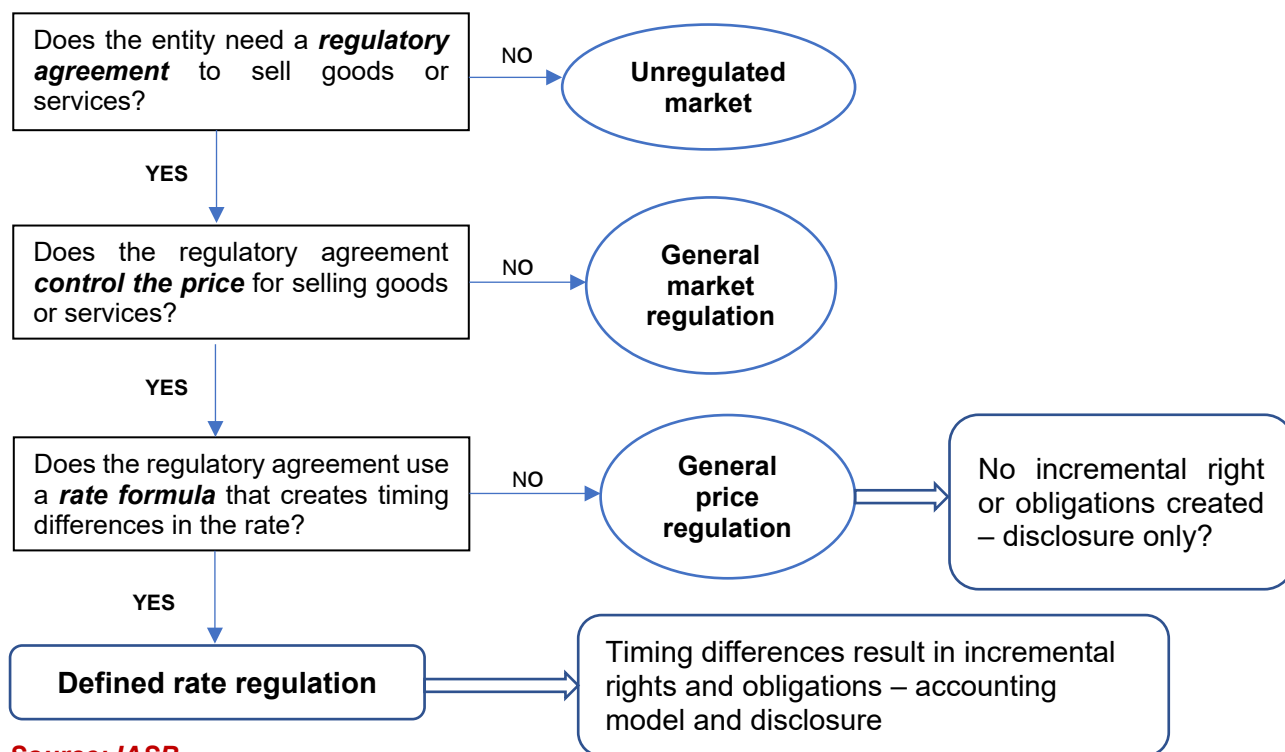
- 6 The EFRAG Secretariat asked some EFRAG TEG members to provide examples of activities with similar characteristics to activities subject to defined rate regulation. The following examples reflect the fact patterns provided:
- (a) **Example A** – Transfer pricing agreement between a parent company and its subsidiary;
  - (b) **Example B** – Pricing mechanism agreement between a water Cooperative and its customers; and
  - (c) **Example C** – Concession agreement between a municipality and its school cafeteria.
- 7 For each of the above examples, the EFRAG Secretariat assessed whether the activities met:
- (a) the definition of defined rate regulation; and
  - (b) the definitions of assets and liabilities under the *Conceptual Framework*.

**Applicable IFRS literature**

*Definition of defined rate regulation vs other regulation*

- 8 The IASB has tentatively decided that the scope of the project applies to defined rate regulation which is established through a **formal regulatory framework** that:
- (a) is **binding on both the entity and the regulator**; and
  - (b) establishes a basis for setting the rate for specified goods or services **that includes a rate-adjustment mechanism**. That mechanism creates, and subsequently reverses, rights and obligations caused by the regulated rate in one period including amounts related to specified activities the entity carries out in a different period (referred to as timing differences).
- 9 The IASB has stated that the purpose of defined rate regulation is to establish a basis for setting rates that are designed to give an entity (subject to the regulation) some protection against both input price risk and demand risk. Although not specifically mentioned in the definition of defined rate regulation in paragraph 8, the purpose of defined rate regulation is to establish a regulated rate that **balances financial viability of the entity and price stability for the customers**.
- 10 The IASB has indicated that defined rate regulation may be applied in cases where the goods or services are provided by a few entities (monopoly situation) and are considered to be 'essential' to the customers. Defined rate regulation ensures that entities are able provide the goods and services at a reasonable price and stay financially viable.
- 11 When the rate regulator's intervention is only limited to imposing a cap on the price to prevent suppliers from making excessive profits, both the input price risk and demand risk are born by the entity (and thus the entities bear the responsibility to remain financially viable). Such situations constitute a general price regulation, aimed to protect the customer, and are not intended to be included in the scope of defined rate regulation.
- 12 A more comprehensive description of defined rate regulation as well as a summary of the IASB's tentative decisions to date is included in Appendix 1.

- 13 The following decision tree summarises the steps to determine whether particular price regulation establishes a defined rate regulation. The chart was included in the IASB agenda paper 1B for the April 2018 ASAF meeting.



#### Definitions of assets and liabilities under the Conceptual Framework

- 14 An **asset** is a present economic resource controlled by the entity as a result of past events. An economic resource is a right that has the potential to produce economic benefits<sup>1</sup>.
- 15 A **liability** is a present obligation of the entity to transfer an economic resource as a result of past events. An obligation is a duty or responsibility that an entity has no practical ability to avoid.
- 16 Present obligation exists as a result of past events only if:
- the entity has already obtained economic benefits, or taken an action; and
  - as a consequence, the entity will or may have transfer an economic resource that it would not otherwise have had transfer.

#### IASB staff analysis of why regulatory assets and liabilities meet the definitions of assets and liabilities under the Conceptual Framework

- 17 At the ASAF April 2018 meeting, the IASB Staff presented an analysis of why the timing differences resulting from rate adjustments in defined rate regulation meet the definitions of assets and liabilities under the Conceptual Framework. EFRAG TEG discussed this analysis at the EFRAG TEG/CFSS meeting in March. EFRAG TEG members generally supported the IASB Staff analysis, although some

<sup>1</sup> The *Conceptual Framework* established: 'For an entity to control an economic resource, the economic benefits arising from that resource must flow to the entity (either directly or indirectly) rather than to another party. This aspect of control does not imply that the entity can ensure that the resource will produce economic benefits in all circumstances. Instead, it means that if the resource produces economic benefits, the entity is the party that will obtain them (either directly or indirectly).'

members were not entirely convinced that assets and liabilities existed in some cases of defined rate regulation.

**Example A - Transfer pricing agreement between a parent company and its subsidiary**

*Fact pattern*

- 18 Group A produces and sells high-end branded products globally. Its production facilities are based in a few countries while the marketing and selling activities are performed through its subsidiaries all over the world. In some countries, the sales activities are performed via a third-party franchisee.
- 19 Group A's subsidiaries (or franchisees) sell its products to end customers at prices determined by the parent company on global basis to avoid parallel import and reduce the risk of brand disruption. The selling prices are based on a formula (cost plus) and the transfer pricing is approved by the tax authorities both at the parent company level and at the subsidiary level.
- 20 The determination of the selling prices to the end customer is only one element of the transfer pricing agreement. There might be other elements to the transfer pricing agreement between the parent and the subsidiaries (or franchisees) providing compensation for marketing and investment costs, cost prices of materials, royalty rates etc. The objective is to obtain an average stable profit margin, over a specified period.
- 21 In some situations, the profit margin must be determined every year and the selling prices will be adjusted retrospectively based on past performance. In other situations, selling prices are adjusted prospectively when future sales are made. Consequently, the parent company compensates or receives compensation from the subsidiaries (or franchisees) based on an unconditional right or an obligation set out in the transfer pricing agreement.
- 22 The effects of the agreement will impact the financial statements of the subsidiaries (or franchisees) as in principle any reimbursements to and from the parent entity will not be eliminated in the subsidiaries' financial statements (separate and consolidated). To the extent any adjustments are not eliminated at the group/parent level, they would also impact the parent's separate and consolidated accounts.

*EFRAG Secretariat analysis*

- 23 We have performed the analysis from the **perspective of the rights and obligations of the subsidiary companies** (or franchisees).

*Do the activities meet the definition of defined rate regulation*

- 24 We have considered the elements in paragraphs 8 to assess whether the activities in Example A meet the definition of defined rate regulation.

***Does the entity operate through a formal regulatory framework with a binding regulatory agreement to sell goods or services?***

- 25 The EFRAG Secretariat observes that the transfer pricing agreement between the parent company and its subsidiary is not established by a regulatory body through a formal regulatory framework. This means that there is no tripartite relationship with an independent (unrelated) regulator and the activity is not regulated under a particular law or regulatory framework.

***Does the regulatory agreement control the price for selling goods or services under a rate-setting mechanism?***

- 26 The transfer pricing agreement ensures that the subsidiary sells goods and services to its customers at an agreed profit margin. The agreement establishes a basis for setting the selling price at a subsidiary level through a pricing formula.

- 27 It could be argued that in cases when the subsidiary has delivered the goods and services and the price is corrected in a future period, a timing difference arises. The formula in the agreement adjusts the profit margin, either retrospectively or prospectively.

***Does the regulatory agreement establish a regulated rate that balances financial viability of the entity and price stability for the customers?***

- 28 The agreement represents a transfer pricing agreement to guarantee a profit level for the subsidiary (and ultimately the parent as it controls the subsidiary). It has not been established through a regulatory body to serve a wider regulatory objective regarding price stability and reasonable prices for the customers. The objective appears one-sided as it focuses on the interests of the subsidiary and its parent.

*EFRAG Secretariat preliminary conclusion*

- 29 The EFRAG Secretariat's preliminary conclusion is that Example A does not meet the definition of defined rate regulation. This is because there is no independent rate regulator and because the objective of determining a 'stable' profit margin for the subsidiary is to ensure a constant subsidiary/group profit margin. There is no economic interest to ensure that the customers can acquire the goods or services at a reasonable price, and no indication that the goods or services are essential in nature.

*Do the rights of the subsidiary entity meet the definition of an asset?*

- 30 Under the transfer pricing agreement, the subsidiary appears to have the unconditional right to receive compensation from its parent when the profit margin for a particular year is lower than the level specified in the agreement.

- 31 Consequently, the subsidiary **controls the right** to receive compensation (**present economic resource**) for selling goods (**past event**) at a lower profit margin than the one set out in the transfer pricing agreement.

- 32 In EFRAG Secretariat's view, the subsidiary's unconditional right to receive compensation *meets the definition of an asset* as defined in the *Conceptual Framework*.

*Do the obligations meet the definition of a liability?*

- 33 The subsidiary appears to have the unconditional obligation to compensate its parent for any excess profit margin received, compared to the agreed profit established in the transfer pricing agreement

- 34 Consequently, the subsidiary **has the unconditional obligation** to compensate (**transfer an economic resource**) its parent for selling goods (**past event**) or to accept a future reduction in its profit margin for the difference between the profit it made and the agreed profit.

- 35 In the EFRAG Secretariat's view, the subsidiary's unconditional obligation to compensate its parent for any realised excess profit margin *meets the definition of a liability* as defined in the *Conceptual Framework*. The situation is less clear where the entity has an obligation to accept a future lower (but positive) profit margin. EFRAG Secretariat expects that this case would fall within paragraph 4.39(c) of the *Conceptual Framework* where reference is made to 'obligations to exchange economic resources with another party on unfavourable terms'.

*Summary*

- 36 In Example A, in the EFRAG Secretariat's view:
- (a) The subsidiary is not subject to defined rate regulation; and
  - (b) The rights and obligations of the subsidiary meet the definitions of assets and liabilities in the *Conceptual Framework*.

## Example B – Pricing mechanism between a water Cooperative and its customers

### *Fact pattern*

- 37 In certain countries cooperatives are very common in sectors such as agriculture and utilities and are established to serve the members of the cooperatives' community. In this example, Cooperative B (the cooperative) is privately owned and supplies water to its members.
- 38 Cooperative B is obliged to sell water to its members and the members of the cooperative, which are also its owners, are required to purchase water from it. Often, the members are not allowed to purchase water from a different water supplier as long as they are members of the cooperative. Cooperative B prepares consolidated financial statements in accordance with IFRS Standards.
- 39 Cooperative B establishes the price of water it delivers to its members based on a pricing mechanism included in the articles of association of the cooperative or based on an agreement between the cooperative and its members.
- 40 The pricing mechanism often reflects the overall objective that the cooperative's profit margin on average should be nil or relatively low based on a specific cost formula. When setting the water prices, the cooperative is not under the supervision of a regulator, although the objective is to ensure that it provides water services at a reasonable price to its members, which are also the owners of the cooperative.
- 41 Cooperatives use different pricing mechanisms to incorporate price adjustments:
- (a) **Retrospective catch-up approach** – some cooperatives adjust their sales prices retrospectively at year-end based on historical transactions with *existing members*. In this situation, any potential future members joining the cooperative will not be affected.
  - (b) **Prospective catch-up approach** – some cooperatives adjust for over- or under-performance compared to target profit margin of the cooperative for services delivered through future sales to *all members* of the cooperative. In this situation, any new (future) members of the cooperative will be affected and members who have left the cooperative will not be affected.
  - (c) **Combined approach** – some cooperatives apply a pricing mechanism which is a combination of the retrospective and the prospective approach as reflected in paragraphs 41(a) and (b) above.

### *EFRAG Secretariat analysis*

- 42 We have performed the analysis from the **perspective of the rights and obligations of Cooperative B**.

#### *Do the activities meet the definition of defined rate regulation*

*Does Cooperative B operate through a formal regulatory framework with a **binding regulatory agreement** to sell goods or services?*

- 43 The EFRAG Secretariat observes that the pricing mechanism included in the articles of association of Cooperative B or based on an agreement between the cooperative and its members is not established by a third party or formal regulatory framework. The EFRAG Secretariat does not consider that the cooperative's articles of association are the equivalent of a formal regulatory framework.

*Does the regulatory agreement **control the price** for selling goods or services under a **rate-setting mechanism**?*

- 44 The selling price is based on a cost formula that is established through a pricing mechanism included in the articles of association or agreement between the cooperative and its members.

***Does the regulatory agreement establish a regulated rate that balances financial viability of the entity and price stability for the customers?***

- 45 The EFRAG Secretariat understands that the pricing mechanism established through the cost formula aims to guarantee supply of water services at affordable prices to customers and at the same time enabling the cooperative to maintain its financial viability through a guaranteed a profit level. In other words, the indication is that the mechanism aims to balance the viability of Cooperative B and price stability for the customers.
- 46 At this stage, we have assumed that both the retrospective catch-up approach and the prospective catch-up approach discussed in paragraph 41 have a similar purpose. However; under the retrospective approach it will be the *existing customers* that will benefit from a price reduction or support the burden of a price increase and this would result from the application of IFRS 15 *Revenues from Contracts with Customers* rather than any analogy with defined rate regulation.

*EFRAG Secretariat preliminary conclusion*

- 47 We think that the water services provided by Cooperative B have similar features to defined rate regulation – firstly because they are subject to a rate-setting mechanism and secondly because the objective of that mechanism is to balance the financial viability for Cooperative B and the price stability for the customers.
- 48 However, although there is a binding agreement, we think that there is no evidence of a regulatory framework. Cooperative B is privately owned by its members who are also the customers. On this basis, our preliminary conclusion is that the activities would not qualify for defined rate regulation.
- 49 Furthermore, because the members are also the owners of the cooperative, one could argue that any benefits or costs imposed on the members (in the form of the rate adjustments), could result from their capacity as owners of the cooperative. To assess whether existing IFRS Standards apply, a more detailed fact pattern of how this works in practice would be needed, including information on the rights and obligations the members have as owners of the cooperative.

*Do the rights of Cooperative B meet the definition of an asset?*

- 50 Under the articles of association of the cooperative or based on an agreement between the cooperative and its members, Cooperative B appears to have the unconditional right to receive compensation from its members by increasing the price in future years or by retrospective adjustment when the profit margin for a particular year is lower than the level specified in the agreement.
- 51 Consequently, the cooperative **controls the right** to receive compensation (**present economic resource**) when its members consume less water and the cooperative achieves lower profit margin (**past event**) than the one set out in the agreed price mechanism.
- 52 In the EFRAG Secretariat's view, Cooperative B's unconditional right to receive economical compensation *meets the definition of an asset* as defined in the *Conceptual Framework*.

*Do the obligations of Cooperative B meet the definition of a liability?*

- 53 Conversely, Cooperative B has the unconditional obligation to give compensation to its members by reducing the price in future periods when the profit margin for a particular year is higher than the agreed margin.
- 54 Consequently, Cooperative B **appears to have the unconditional obligation** to compensate (**transfer an economic resource**) when its members consume more water and the cooperative achieves higher profit margin (**past event**) than the agreed margin.

- 55 In the EFRAG Secretariat's view, the Cooperative B's unconditional obligation to compensate its members for any shortfall of realised profit margin **meets the definition of a liability** as defined in the *Conceptual Framework*.

*Summary*

- 56 In Example B, in the EFRAG Secretariat's view:
- (a) The subsidiary is not subject to defined rate regulation; although we acknowledge that it is a 'borderline' case given the similar features; and
  - (b) The rights and obligations of the subsidiary meet the definitions of assets and liabilities in the *Conceptual Framework*.

**Example C – Concession agreement between a municipality and its school cafeteria**

*Fact pattern*

- 57 Municipality A owns and runs a school cafeteria. Municipality A outsources the operation of the school cafeteria to a commercial operator ('the operator'). The activities of the operator are based on a lease contract and a service contract with Municipality A. Under the lease contract the operator leases the facilities and buys certain pieces of equipment which will be returned at fair value at the termination of the lease.
- 58 The operation of the school is under the regulation and the supervision of the state school authority. The state school authority establishes extensive requirements on the quality of the food including various dietary requirements and procedures for quality assurance ("The Healthy School Food Code"). The regulation and guidance of the school authority form part of the service agreement.
- 59 The operator of the school cafeteria offers meals to students at reduced (subsidised) prices considered affordable for the students. The prices are based on a target price per meal established by Municipality A and is less than the per-unit cost to produce and serve the meal.
- 60 Under the service agreement the operator is reimbursed by Municipality A:
- (a) based on targeted per-unit cost to produce and serve the meals plus a pre-determined profit margin less revenue received from the sale of the meals; and
  - (b) for the cost and profit margin for free meals delivered to students who are not able to pay the target price.
- 61 The targeted per-unit cost of the meal is based on an estimated number of meals and is calculated based on a minimum occupancy of the school and not on a minimum number of meals served.
- 62 If the operator sells the estimated number of meals or more, the operator will fully recover its period costs. However, if occupancy is below the guaranteed minimum, the reimbursements will be reduced proportionally. The operator receives its reimbursements monthly, however, because the reimbursements are based on historic data, subject to audit and reviewed every 3 years, it is possible that the operator may face situations where the period costs will be reimbursed after the end of the review period.
- 63 The cost in the service agreement refers to a *Federal Regulation* that defines procedures for identifying the reimbursable cost under government contracts.
- 64 The lease and service agreements may have additional features that might grant the operator exclusive right to sell certain goods and services apart from the reimbursable lunch meals. The pricing of these items is at the operator's discretion.



Do the activities meet the definition of defined rate regulation

**Does the operator operate through a formal regulatory framework with a binding regulatory agreement to sell goods or services?**

- 65 The operator fulfils its responsibilities to deliver meals to the students at subsidised prices based on the service agreement with Municipality A. There is no third party regulator that observes and regulates the activities of the operator under a formal regulatory framework.

**Does the regulatory agreement control the price for selling goods or services under a rate-setting mechanism?**

- 66 The pricing mechanism is one of a price control that is adjusted when pre-determined profit margins are not achieved.
- 67 The EFRAG Secretariat understands that the per-unit cost of a meal for a particular period is 'capped' so that it guarantees affordability of meals to students.
- 68 The fact that the operator is compensated for the difference between the per-unit cost to produce and serve the meals including a certain profit margin and revenue received from the sale of meals is a pricing mechanism to regulate the price of meals over the period of the service contract with the municipality.
- 69 The revision of meal prices over the period of the service contract is a change in estimate of canteen occupants from the initially considered historical number of students and school staff.

**Does the regulatory agreement establish a regulated rate that balances financial viability of the entity and price stability for the customers?**

- 70 The service agreement between the operator and the municipality effectively caps the unit price per meal. In addition, any shortfall in the cafeteria demand which would not allow the operator to recover its unit costs plus promised profit margin is reimbursed by the Municipality and not from the customers.

*EFRAG Secretariat preliminary conclusion*

- 71 The EFRAG Secretariat is of the opinion that the fact pattern described in this example could be within the scope of existing IFRS Standards such as IAS 20 *Accounting for Government Grants and Disclosure of Government Assistance* and IFRIC 12 *Service Concession Arrangements* based on the following:
- (a) *Subsidised canteen services* - the shortfall in the agreed profit margin is reimbursed by Municipality A and not the customers, which indicates that Municipality A pays subsidies to the operator to carry out the canteen service.
  - (b) *Public-to-private arrangement* – the contractual agreement between the operator and Municipality A appears to be a public-to-private arrangement. The municipality regulates the type of services (some of the services) that the operator provides to the students, the quality of food and dietary requirements and the price per unit of meal.
  - (c) *Control of infrastructure* - the infrastructure given by the municipality to the operator under the lease contract is *de facto* not controlled by the operator as Municipality A partly controls the price per meal and this affects whether the operator controls the infrastructure.

Do the rights and obligations of the operator meet the definitions of an asset and a liability?

- 72 The EFRAG Secretariat is of the view that the activities in Example C would fall under IFRIC 12 and IAS 20. Because the customers are not responsible for the shortfall, we do not think they would fall under the scope of the IASB rate-regulated activities project.

- 73 If the service agreement is within the scope of IFRIC 12, the operator might use the financial asset model or the intangible asset model to account for its rights and obligations arising from the agreement. If IFRIC 12 could not be applied, then IAS 20 might apply to the financial support received from Municipality A.

*Summary*

- 74 In Example C, in the EFRAG Secretariat's view:
- (a) The subsidiary is not subject to defined rate regulation; and
  - (b) The activities are likely to fall within existing IFRS Standards.

**Overview of EFRAG Secretariat preliminary conclusions**

- 75 The following table summarises the EFRAG Secretariat preliminary conclusions for each of the examples:

	Defined rate regulation			Assets under the CF	Liabilities under the CF
	Binding regulatory agreement	Rate-setting mechanism	Balances financial viability for the entity and price stability for the customer		
Example A	X	✓	X	✓	✓
Example B	X	✓	✓	✓	✓
Example C	Existing IFRS Standards				

- 76 An important aspect of scope is whether it is necessary to have a **third party independent rate regulator**. The EFRAG Secretariat notes that in some cases, an entity's own governing board is required by statute or contract (for example in the articles of association of the entity or a transfer pricing agreement) to set rates designed to recover costs plus a return. The pricing mechanism could be designed to protect the interests of the entities or protect both the interests of the entities and the customers. Some could interpret those cases to encompass defined rate regulation, which would broaden the scope of the project, and might not be the intention of the IASB. On the other hand, there could be cases where an entity is set up to carry out previously state-run monopolistic activities and would be delegated powers by the State, in which case the conclusion might be different.
- 77 At the ASAF meeting in April 2018, some ASAF members encouraged the IASB to consider the specific industries that would be impacted and would meet the definition of defined rate regulation and those industries that were close and might not meet the definition, in order to provide guidance on the scope of the project. Furthermore, the IASB should consider outreach with regulatory bodies.
- 78 The EFRAG Secretariat supports the ASAF recommendations that a better understanding of the activities that are borderline cases is needed. This would allow consideration of whether they should be in or out of the scope of the project and what changes might be needed to refine the definition of defined rate regulation.

**Questions for EFRAG TEG members**

- 79 Do EFRAG TEG members agree with the EFRAG Secretariat analysis of Example A, Example B and Example C and the conclusions in paragraph 75?
- 80 Do you agree with the EFRAG Secretariat analysis in paragraphs 76 -78?
- 81 At this stage, do you have any other comments on the scope of the IASB project?

## Appendix 1: Overview of the accounting model for defined rate regulation

### Overview of the accounting model

- 1 The model aims to provide users of financial statements with useful information about those rights and obligations that are created by defined rate regulation and are not captured in a sufficiently useful way by existing IFRS Standards.
- 2 Defined rate regulation is typically applied for goods or services that governments consider essential for a reasonable quality of life for their citizens and for which there are significant barriers to effective competition for supply. In such cases, the defined rate regulation typically has objectives that include:
  - (a) **protecting customers** by ensuring:
    - (i) quality, quantity and availability of supply (done through establishing service requirements in the regulatory agreement); and
    - (ii) stability, predictability and affordability of pricing (done through the basis for setting rates established by the regulatory agreement).
  - (b) **protecting the financial viability of the rate-regulated entity** (entity) by ensuring the regulated rate (rate) enables the entity to obtain an adequate amount of compensation from customers in exchange for fulfilling its service requirements.
- 3 To achieve those objectives, there is a **binding regulatory agreement** through which:
  - (a) the entity has a right to:
    - (i) supply the rate-regulated goods or services (goods or services); and
    - (ii) charge a rate(s) for those goods or services that is designed such that the entity is able to fulfil the specified service requirements.and **in exchange**
  - (b) the entity is obliged to:
    - (i) fulfil specified service requirements (usually related to quality, quantity and availability of supply); and
    - (ii) accept the basis for setting rates established in the regulatory agreement.
- 4 The basis for setting rates operationalises the regulatory objectives and forms part of the binding regulatory agreement. The basis for setting rates helps to support the objective of protecting an entity's financial viability by giving the entity some protection against both input price risk and demand risk. As a result, the rate formula uses a rate-adjustment mechanism to adjust future rates for variances between estimated and actual inputs to the rate calculation. These variance adjustments create timing differences between when a transaction or event takes place and when some of the effects of that transaction or event are reflected in the rate.
- 5 Further timing differences may be created using the rate-adjustment mechanism to reduce the volatility of rate fluctuations, which contributes to stability, predictability and affordability of pricing for customers.
- 6 The regulatory agreement creates a direct and specific cause-and-effect relationship between when an entity carries out a rate-regulated activity (activity) to fulfil its service requirements and when amounts related to that activity are included in the rate(s) charged to customers. The direct and specific cause-and-effect relationship means that the rate formula can be used to identify:

- (a) the amount of compensation included in the current period rate in exchange for service requirements fulfilled in the current period (ie the basic rate);
- (b) positive and negative adjustments to the current period rate reflecting service requirements fulfilled in an earlier or later period(s); and
- (c) positive and negative adjustments that will be made to future period rate(s) reflecting service requirements fulfilled in an earlier or later period(s).

**IASB tentative decisions so far (as reported in the related IASB Update)**

7 So far, the IASB has explained that the accounting model being developed for rate-regulated activities is a 'supplementary model' meaning that a rate-regulated entity will first apply other IFRS Standards, including IFRS 15 *Revenue from Contracts with Customers*, without modification, before applying the model.

- (a) **Scope** – The IASB tentatively decided (**February 2018**) that the scope criteria for the model should focus on enforceable rights and obligations created through a formal regulatory pricing framework. The IASB has also tentatively decided (March 2018) that the accounting model should apply to defined rate regulation established through a formal regulatory framework that:
  - (i) is binding on both the entity and the regulator; and
  - (ii) establishes a basis for setting the rate for specified goods or services that includes a rate-adjustment mechanism. That mechanism creates, and subsequently reverses, rights and obligations caused by the regulated rate in one period including amounts to specified activities the entity carries out in a different period.
- (b) **Unit of account** – the IASB tentatively decided (**February 2018**) that:
  - (i) the accounting model will use as its unit of account the individual timing differences that create the incremental rights and obligations arising from the regulatory agreement;
  - (ii) the present regulatory right meets the definition of an asset in the *Conceptual Framework*; and
  - (iii) the present regulatory obligation meets the definition of a liability in the *Conceptual Framework*.
- (c) **Recognition of regulatory assets and liabilities** – the IASB has tentatively decided (**March 2018**) that the accounting model:
  - (i) should require the recognition of regulatory assets or regulatory liabilities if it is more likely than not that they exist—the model sets a symmetrical recognition threshold in cases of existence uncertainty; and
  - (ii) should not set thresholds that would prevent recognition of a regulatory asset or regulatory liability for which there is (i) low probability of an inflow or outflow of economic benefits or (ii) high measurement uncertainty.
- (d) **Measurement of regulatory assets and liabilities** – the IASB tentatively decided (**May 2018**) that the measurement of regulatory assets should reflect:
  - (i) estimates of the future cash flows the regulatory assets will generate. These cash flows include amounts that result from:
    - the costs of assets used and operating expenses incurred;
    - any margins on the operating expenses incurred; and
    - any interest on the operating expenses incurred or returns on the costs of assets used.

*Rate-regulated Activities examples - Issues Paper*

- (ii) the estimates of future cash flows should be discounted if there is a significant financing component.
- (iii) the measurement of regulatory assets should reflect changes, if any, in the estimates of the future cash flows that the regulatory assets will generate.
- (iii) the discount rate established at initial recognition should remain unchanged during the subsequent measurement of the regulatory assets.