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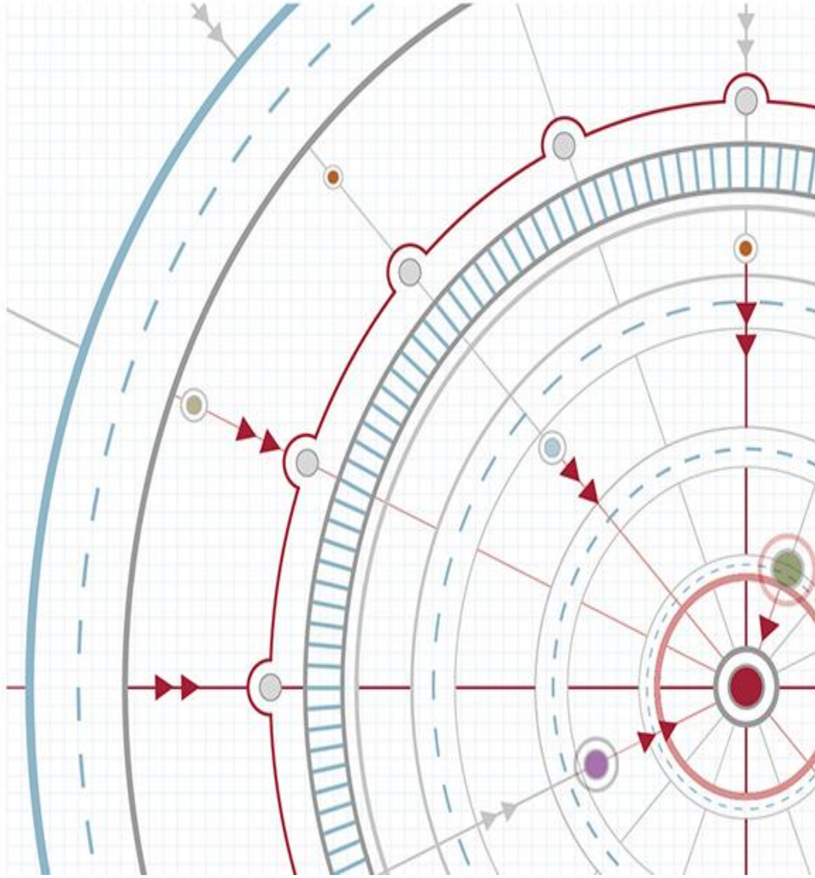

Rate-regulated activities

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Agenda

- Introduction
  - Why we are doing the project
  - Discussion Paper: *Reporting the Financial Effects of Rate Regulation*
- *Conceptual Framework*
  - Elements
  - Executory contract
- Defined Rate Regulation
  - What is ‘Defined rate regulation’?
  - The revenue requirement
  - Accounting question

Rate-regulated Activities
Why we are doing the project

- Many stakeholders have told the Board that, for entities that are subject to some types of rate regulation,
  - current **predominant IFRS practice** does not reflect the economic substance of the rights and obligations created by the rate regulation; and
  - IFRS financial statements currently do not provide investors and lenders with sufficient **relevant information** needed to make investing and lending decisions.

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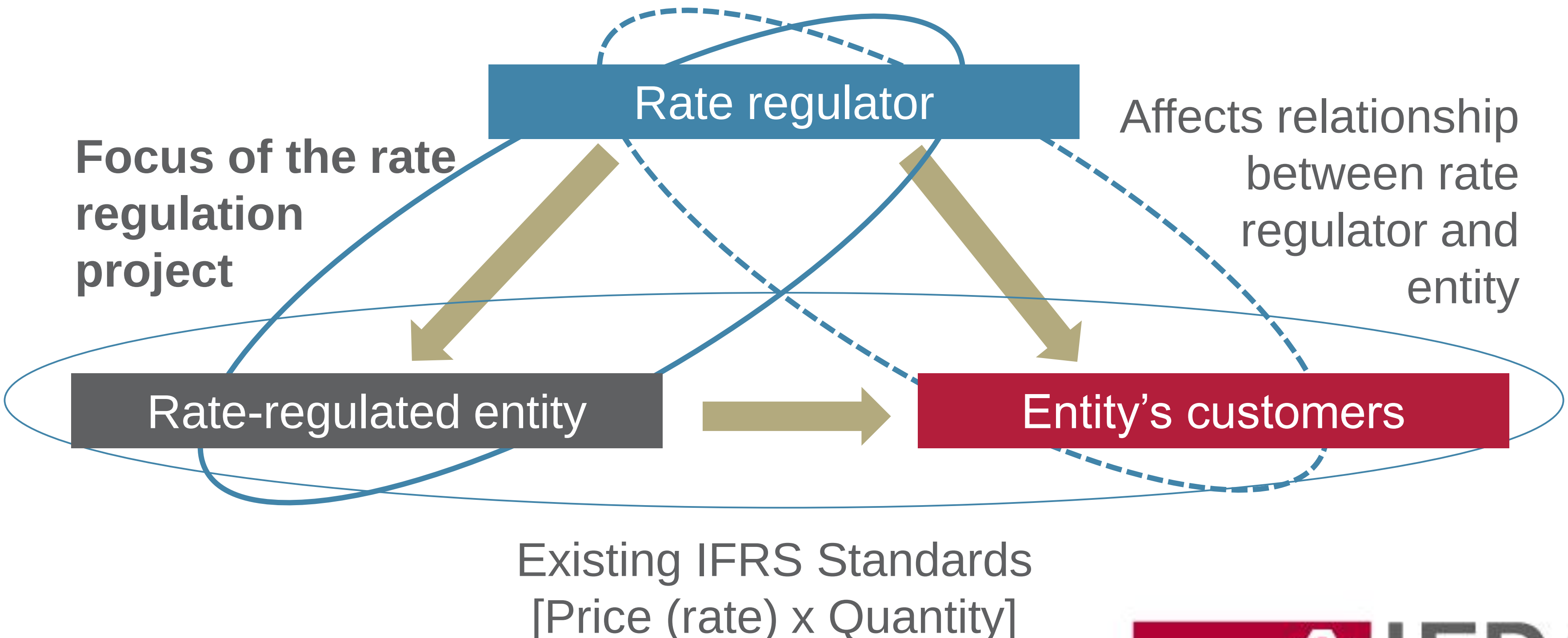
Current predominant IFRS practice

- Except for specified first-time adopters that apply IFRS 14 *Regulatory Deferral Accounts,* almost all entities:
  - eliminate '**regulatory deferral account balances**' when adopting IFRS Standards; and
  - do not recognise such balances in IFRS financial statements; and
  - recognise revenue by using the regulated rate and the quantity of goods or services delivered to customers in the period (ie based on the entity's contracts with its customers).

Revenue = **P**rice (rate) x **Q**uantity

Discussion Paper
Reporting the financial effects of rate regulation

- Identified rights and obligations created by different types of rate regulation, focusing on '**defined rate regulation**'
- Explored possible viable financial reporting approaches to reflect the 'overlay' of the regulatory agreement between entity and rate regulator



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Discussion Paper
Reporting the financial effects of rate regulation

- Responses to DP suggest strong support for recognising some '**regulatory deferral account balances**'
- Most common suggestion is focus on a 'revenue-based' approach, using either:
  - an Interpretation of / amendment to IFRS 15 *Revenue from Contracts with Customers*; or
  - a separate Standard based on the principles in IFRS 15
- Many requests to relate the rights and obligations to the definitions of asset and liability in the revised *Conceptual Framework*

Rate-regulated Activities
Applying the Board's *Conceptual Framework*

- Is the regulatory agreement analogous to an executory contract?
- Do the rights and obligations create assets/ liabilities?
- If so:
  - Should they be recognised?
  - What is the nature of those assets/ liabilities?
  - When should they be recognised?
  - How should they be measured?
  - How should they be presented?
- How should changes in any assets/ liabilities recognised be presented in the statement(s) of profit or loss and other comprehensive income?
- What is meant by 'performance'?
  - Transfer to customers?
  - Transfer to rate regulator?
  - Other?

Conceptual Framework
Proposed revisions

- In May 2015, the Board published proposals to revise the *Conceptual Framework*
- Project objectives: To improve financial reporting by providing a more complete, clearer and updated *Conceptual Framework* that can be used by:
  - the Board when it develops International Financial Reporting Standards (IFRS Standards); and
  - others to help them understand and apply IFRS Standards.

The Board is currently considering the feedback from the Exposure Draft

Conceptual Framework
Elements

- Elements are the basic building blocks from which financial statements are constructed

Statement of financial position

Assets | **Liabilities** | **Equity**

Statement(s) of financial performance

Income | **Expenses**

Conceptual Framework
Proposed definitions of Elements

Asset: Present economic resources controlled by the entity as a result of past events

Liability: Present obligations of the entity to transfer an economic resource as a result of past events

Equity: Assets - Liabilities

- An economic resource is a right that has the potential to produce economic benefits.
- A present obligation is an obligation [that has the potential to require the entity] to transfer economic resources that:
  - the entity has no practical ability to avoid; and
  - has arisen from a past event (ie economic benefits already received or activities already conducted)

Conceptual Framework
Proposed concepts—executory contracts

- An executory contract is a contract that is **equally unperformed**:
  - neither party has fulfilled any of its obligations, or
  - both parties have fulfilled their obligations partially and to an equal extent.

- An executory contract establishes a right and an obligation to exchange economic resources. The entity has:
  - an asset if the terms of exchange are favourable; or
  - a liability if the terms of exchange are unfavourable.

- To the extent that a party fulfils its obligations under the contract, the contract ceases to be executory.
  - If the reporting entity performs first under the contract, that **performance** is the event that changes the reporting entity's right and obligation to exchange economic resources into a right to receive an economic resource (ie an asset).

Conceptual Framework ED paragraphs 4. 40-4.42.

Defined rate regulation

‘Defined rate regulation’
What we mean by the term

Defined rate regulation:

- Restricts the setting of prices that an entity can charge to customers for essential goods or services
- Regulates the timing and amount of revenue (and profit) that an entity can bill to its customers
- Requires an entity to adjust the selling price (rate) to
  - recover ‘allowable’ costs and unbilled revenue amounts, or
  - eliminate ‘excess’ revenue or profits
- Establishes rights and obligations for an entity (and a rate regulator) through a ‘**regulatory agreement**’

Defined rate regulation creates differences between amounts reported to the rate regulator and those reported in IFRS financial statements (‘**regulatory deferral account balances**’)

The regulatory agreement
Rights and obligations

- The **regulatory agreement** establishes the entity's:
  - **obligations** to:
    - ensure the rate-regulated services are available without disruption to supply;
    - deliver rate-regulated services on demand;
    - carry out other specified activities to achieve other government policies, eg social, environmental, fiscal policies.
  - **right** to receive a determinable amount of consideration in exchange for satisfying its obligations (the **revenue requirement**).

Regulatory agreement
Revenue requirement

- The **revenue requirement** for the period is the amount of consideration that an entity has a right to bill its customers in exchange for satisfying its regulatory obligations
- The regulatory agreement includes a mechanism for determining the revenue requirement. This mechanism establishes:
  - the **regulated rate** for the period, which is based on the combination of:
    - estimated revenue requirement; and
    - estimated demand

Regulated rate comprises: a rate per unit, and/or a 'standing charge', ie a fixed amount.

  - a rate adjustment mechanism to:
    - 'correct' for variances from estimates
    - adjust the timing of when the revenue requirement is billed to customers to enable the rate regulator to moderate rate fluctuations/ cash flows

Revenue requirement
Regulated rate

- The **regulated rate** typically includes amounts related to:
  - goods or services delivered to customers:
    - in the current period; and
    - in a different period
  - other specified activities (that may not meet the definition of a 'performance obligation' in IFRS 15), which are carried out
    - in the current period; and
    - in a different period
  - adjustments for variances from estimates relating to past periods

Revenue requirement
Accounting question

Should the entity recognise a ‘regulatory asset’ or ‘regulatory liability’ when:

- the regulated rate reflects activities that:
  - occur in a different period?
  - do not meet the definition of a ‘performance obligation’ in IFRS 15?
- the regulated rate will be adjusted in the next or subsequent period(s) to reverse any under- or over-recovery by the entity

Revenue Requirement
Example

Fact Pattern

- Entity A's rate regulator determines a fixed revenue requirement of CU200million per year for 3 year period (x1, x2 and x3)
- Determination includes:
  - CU7m per year for project to install insulation free of charge in the homes of specified customers (project starts in x2)
  - CU10m per year for storm repair costs (no costs in x1 or x2, CU30m in x3)
  - CU5m per year for CU15m under-recovered in periods prior to x1
- In x1, A actually receives CU210m due to higher than estimated demand

How much revenue should Entity A report in x1?
If not CU210m, what should happen to the difference?

Next steps

- Continue research with targeted consultation/ field work
- Develop proposals for an accounting model
- Consider implications of the responses to the *Conceptual Framework* proposals
- Consult more widely through a second Discussion Paper

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