New on the Horizon: Rate-regulated Activities

September 2009

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Foreword

The IASB has recently published an exposure draft of a proposed International Financial Reporting Standard (IFRS) on rate-regulated activities. The issue of regulatory assets and liabilities is not new, but this is the first time that the International Accounting Standards Board (IASB) itself has weighed in with proposals. In the run-up to the 2005 adoption of IFRSs in Europe and other countries, the International Financial Reporting Interpretations Committee (IFRIC) considered whether regulatory assets could be recognised under IFRSs, by analogy to the guidance in U.S. GAAP FAS 71 *Accounting for the Effects of Certain Types of Regulation*. The IFRIC concluded that the recognition criteria in FAS 71 were not consistent with IFRSs and declined to take the issue onto its agenda. Following that decision, the debate amongst companies applying IFRSs died down and as our December 2008 survey *The Application of IFRS: Power and Utilities* showed, regulatory assets and liabilities are not a feature of financial statements prepared in accordance with IFRSs.

However, this apparent disconnect between the industry business model and the accounting under IFRSs has continued to be a source of concern for some power and utility companies. In 2008 the IASB was urged by constituents from several jurisdictions, including countries in the process of adopting IFRSs, such as Canada and India; from existing IFRS territories, such as the European Union; and from the United States, to take on a project to address rate regulation. After the IASB added the project to its active agenda, these constituents have continued to be vocal about their support for the project. In fact, some Canadian and U.S. companies sent observers to the IASB public meetings in London as a show of support for the project.

Those constituents who were lobbying for the project will now be able to consider whether the proposals meet their concerns. It also now remains to be seen how other constituents react to the exposure draft – comments are due to the IASB by 20 November.

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About this publication

This publication has been produced by the KPMG International Standards Group (part of KPMG IFRG Limited).

We would like to acknowledge the efforts of the principal authors of this publication. Those authors include Julie Santoro and Nicole Perry of the KPMG International Standards Group, and Chris Jenkins of KPMG in the UK.

Content

This *New on the Horizon* considers the requirements of Exposure Draft (ED) 2009/8 *Rate-regulated Activities*. It includes a discussion of the key elements of the proposals and highlights areas that could result in a change of practice.

Further analysis and interpretation will be needed in order for an entity to consider the potential impact of this ED in light of its own facts, circumstances and individual transactions. The information contained in this publication is based on initial observations developed by the KPMG International Standards Group, and these observations may change.

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Overview of proposals

- **Rate-regulated operations fall within the scope of the proposed standard if: (1) an authorised body establishes the price that the entity must charge its customers, and that price is binding; and (2) the price is designed to recover the specific costs that the entity incurs in providing the regulated goods or services and to earn a specified return (cost-of-service regulation).**
- **A regulatory asset would represent the right to recover specific previously incurred costs and to earn a specified return by increasing prices in future periods; a regulatory liability would represent the obligation to refund collected amounts and to pay a specified return by decreasing prices in future periods.**
- **An asset or liability would be recognised based on either the actual and / or expected actions of the regulator.**
- **Instead of recognising a regulatory asset an entity would be required to include the amount of such asset in the carrying amount of the related self-constructed property, plant and equipment or intangible asset if the regulator requires such capitalisation for rate-making purposes.**
- **Regulatory assets and liabilities would be recognised initially, and remeasured at each reporting date, based on the present value of expected future cash flows.**
- **At each reporting date the entity would be required to assess the recoverability of recognised regulatory assets. If the entity assesses that it is "not reasonable to assume" recoverability of a regulatory asset, then impairment testing in accordance with IAS 36 *Impairment of Assets* would be required.**
- **Information about the nature and financial impact of rate regulation on the entity's activities would be disclosed, including an explanation of the underlying regulatory process and how it affects the entity's activities and its rate of return, and the significant assumptions supporting the valuation of regulatory assets and liabilities.**
- **A first-time adopter of IFRSs would be allowed to carry forward from previous GAAP the carrying amount of property, plant and equipment and intangible assets that includes items that would qualify for recognition as regulatory assets under the proposals.**
- **The deadline for comments is 20 November 2009.**

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1. Scope

The ED applies only to the operating activities of entities that are subject to cost-of-service regulation, and there are a number of illustrative examples that accompany the ED to describe scenarios that would be within and outside its scope. Entities that have both regulated and non-regulated activities would apply the final standard to only the regulated parts of their operations.

The activities of entities that have an arrangement within the scope of IFRIC 12 *Service Concession Arrangements* also may be within the scope of the proposals.

The two core requirements for entities to be within the scope of the ED are:

- an authorised body establishes the price that the entity must charge its customers, and that price is binding on customers; and
- the price is designed to recover the specific costs that the entity incurs in providing regulated goods or services and to earn a specified return (cost-of service regulation).

Observations

Scope is likely to be a key issue: entities within the scope of the ED are required to recognise regulatory assets and regulatory liabilities, while those outside the scope are prohibited from doing so. This places significant importance on the illustrative examples in the proposals, which constituents should review carefully.

Industries in which cost-of-service rate regulation is most common include power and utilities, telecommunications, pipelines, and transport infrastructure. Other affected industries may include hospitals and prisons in which private finance contracts are in operation. However, we expect that most entities affected by these proposals will be in the power and utilities industry.

Authorised body

An authorised body (regulator) sets rates that bind an entity's customers. The regulator can be empowered by statute or contract and does not have to be a third party to the entity. An example of this may be a commission or co-operative arrangement in which the governing body of the entity itself acts as the regulator; this is typical of some arrangements in Canada, for example.

Binding price

The ED proposes that the price that the entity charges customers must be binding, and it allows different prices for different categories of customers; both the categories of customer and the rates must be determined by the regulator. Prices cannot be negotiable on an individual customer basis.

Observations

Different prices for different categories of customers are common in practice. For example, a power retailer may have two main types of electricity tariffs: one for wholesale customers and one for retail customers. However, in some markets it is unusual for all customers within a category to be charged the same price, e.g., not all wholesale customers pay the same rate. Generally this is because of competition in the industry.

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The ED does not address specifically whether discounting, across the entire customer base or within categories, results in an entity being outside the scope of the proposals because the regulator would no longer be establishing *the price* that the entity must charge its customers. However, the Basis for Conclusions suggests that discounting prices below those set by the regulator would result in the activity being outside the scope of the proposed standard.

Recovery of specific costs

For an operating activity to fall within the scope of the proposed standard, the entity should be able to recover the actual costs that are specific to it providing services to customers, rather than average or industry-based amounts. The proposals explain that the purpose of this test is to ensure a cause-and-effect relationship between an entity's costs and its rate-based revenue stream. Accordingly, rate regulation that is based on how efficiently an entity runs its operations, or on target costs, is outside the scope of the proposals.

Appendix B to the ED gives a list of indicators of cost-of-service regulation, including:

- the regulation is designed to provide the recovery of specific costs;
- if actual costs are not used to establish rates, then the regulation provides for a true-up to actual costs incurred; or
- in the case of a price cap plan, there is a true-up to actual costs through a rate of return-sharing mechanism.

Observations

The scope of the ED does not contemplate a mixed-form or hybrid cost-of-service regulation scheme, whereby part of the price that the regulator sets is based on actual cost recovery, and part of the price is based on efficiencies or target costs. In our experience, such arrangements can be quite common in some countries and the extent of the efficiency / incentive impact on the price set can be in a broad range.

The Basis for Conclusions mentions the existence of hybrid schemes, but provides no explicit statement as to how the scope would be applied to such schemes. From a first reading of the proposals it seems that the entire operating activities for that rate regulation may be outside the scope of the proposed standard. It is unclear to us if an alternative approach, such as bifurcating the scheme and recognising a regulatory asset (liability) for the portion based on actual costs, or considering whether the portion of recovery not based on actual costs is significant, would be allowed.

Specified return

The ED proposes that the entity should earn a specified return, and describes "specified" in quantitative terms, such as a fixed amount, a minimum or a range of returns. In contrast, the indicators in appendix B are qualitative in nature, requiring a "sufficient" or "adequate" return; the appendix includes indicators that may suggest that an entity is not receiving a "sufficient" or "adequate" return, including the following:

- there is abnormal excess capacity;
- the rates per unit currently are higher, or are forecast to be higher, than those of entities in neighbouring jurisdictions or competitors; and / or
- a changing regulatory environment, indicated by, for example, substantial regulatory disallowances, or rate-making that is designed to stimulate competition.

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Observations

It is unclear to us whether the IASB intended a difference in terminology between the main body of the ED (quantitative test) and appendix B (qualitative tests). This conflict is likely to cause confusion.

Additionally, the ED proposes that a specified return may be a range of returns. This is demonstrated by illustrative example 4, in which an entity that has a variable return is within the scope of the proposals. The proposals mention that a range of returns is acceptable, although the example does not clarify whether there is a limit on the extent to which the return can be variable.

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2. Recognition and measurement

Recognition

The ED proposes that once the scope criteria are met, an entity should recognise regulatory assets and regulatory liabilities when it has the right to increase, or obligation to decrease, rates in future periods as a result of the actual or *expected actions* of the regulator. A regulatory asset is the right to recover specific previously incurred costs, including the cost of debt, and to earn a specified return. A regulatory liability is an obligation to refund previously collected amounts and to pay a specified return.

Regulatory assets (liabilities) do not include assets (liabilities) recognised in accordance with other IFRSs. Therefore the impact of the proposals would be to recognise additional assets that absent the proposals would be recognised as expenses in the statement of comprehensive income; and / or to recognise additional liabilities that absent the proposals would be recognised as income in the statement of comprehensive income.

Observations

For constituents considering the appropriateness of the proposals, a key focus is likely to be on whether a regulatory asset (liability) meets the definition of an asset (liability) in the conceptual framework. The Basis for Conclusions outlines the arguments in favour put forward by the IASB, noting the cause-and-effect relationship between previous costs incurred (amounts received) and future rate-based revenue from the customer base as a whole; the dissenting opinions of two Board members provide the alternative view for consideration.

The inclusion of "expected actions" of the regulator is a practical approach to the operation of many existing rate-regulation schemes. In many jurisdictions an entity will incur costs and then submit a statement to the regulator for approval. This approval could take many months to be received. However, in most cases the entity will be able to make a reasonable estimate of the costs that will be approved by the regulator. The entity's expectation of approval usually is based on historical actions by the regulator, informal decisions made by the regulator, guidance and rules published by the regulator, and in some cases peer decisions.

When costs sought to be recovered are of an unusual or one-off nature, we anticipate that entities would need to make assumptions about whether the regulator is likely to approve these costs unless approval, at least in principle, has been received. This is likely to be more difficult and involve more judgement than in respect of the assumptions applied to usual operational costs.

Measurement

The proposals would require regulatory assets (liabilities) to be measured at the expected present value of the future cash flows, and to be remeasured to present value at each reporting date. An entity would be required to use an expected cash flow approach, based on multiple, probability-weighted cash flow projections. The discount rate would reflect the risk attributable to the specific regulatory asset or liability. Inputs for this calculation would include the expected timing of recovery (settlement), the probability of recovery (settlement), and the impact of the uncertainty inherent in the regulatory asset (liability).

The proposals mean that even if the expected future cash flows are unchanged since the entity's last reporting date, the asset or liability would be remeasured for any changes in the appropriate discount rate.

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Observations
Although there may be questions as to why the IASB has chosen an expected present value approach as opposed to fair value, it appears that there may be limited difference between the two measures in practice. In our experience, although there are market transactions involving regulated businesses as a whole, no stand-alone transactions occur that would provide specific market indications of the value of regulatory assets (liabilities) on their own. However, the absence of market transactions does not mean that fair value cannot be calculated, but rather that a market approach to determining fair value is not possible. An income approach, such as a discounted cash flow approach, is a valid method for measuring fair value.

Exception to the general recognition and measurement requirements

In some cases a regulator, for rate-making purposes, requires an entity to capitalise costs that otherwise would have been recognised as regulatory assets under these proposals as part of the carrying amount of self-constructed property, plant and equipment or internally generated intangible assets. In that case the entity is required to include such amounts in the carrying amount of property, plant and equipment / intangible assets in its financial statements.

These costs would not be permitted to be recognised in accordance with IAS 16 *Property, Plant and Equipment* / IAS 38 *Intangible Assets* in the absence of this proposal, and it must be "highly probable" that the regulator will allow these costs to be included in the rate-base for the entity. If this test is not met, then the entity would recognise a regulatory asset for these costs.

Observations
The application of IAS 16 suggests that a component approach would need to be applied to these costs, i.e., such costs would be accounted for as if they were a separate item of property, plant and equipment, although presented as part of the wider class of property, plant and equipment. This approach also is followed in accounting for intangible assets in accordance with IAS 38.

Recoverability

The test proposed for the recoverability of regulatory assets is based on the concept of "reasonable assumption". An entity would determine whether it remains reasonable to assume that, based on the regulator's and customers' actions, the regulatory asset is recoverable. Changes in demand by customers, increased customer churn, increased competition and the general state of the economy may be indicators that the regulatory asset is not recoverable.

If an entity has determined that it is not reasonable to assume that its regulatory assets are recoverable, then the cash-generating unit (CGU) to which the regulatory asset belongs would be tested for impairment in accordance with IAS 36 *Impairment of Assets*. If there is an impairment loss, then it would be recognised and allocated in accordance with IAS 36, i.e., firstly against goodwill and then against other assets in the CGU on a *pro rata* basis. These general allocation requirements are subject to the *caveat* that the carrying amount of an individual asset should not be reduced to below the higher of its fair value less costs to sell, its value in use and zero.

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Observations

Since the measurement of a regulatory asset would be based on expected future cash flows (see above *Measurement*), we would expect any concerns about the recoverability of the asset to be taken into account in its measurement; therefore it is not clear to us whether an issue of the asset's recoverability would arise subsequently. However, because the recoverability of the asset depends on the entity's future operating activities, such concerns may raise broader questions about the recoverability of the carrying amount of the assets in the relevant CGU, triggering impairment testing.

The "reasonable assumption" test in the proposals may imply that the test of recoverability is on an undiscounted basis, and that discounting would be required only in measuring an impairment loss if it is concluded that such a loss exists. However, it appears that this is not the intention of the proposals; rather, the test is simply an indication of impairment, and any assessment of recoverable amount would be on a discounted basis in accordance with IAS 36.

Derecognition

When operating activities subject to rate-regulation no longer meet the scope requirements of the ED, then any recognised regulatory assets (liabilities) would be derecognised through the statement of comprehensive income.

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3. Presentation

The ED proposes that entities present each of regulatory assets and regulatory liabilities as separate line items on the face of the statement of financial position, classified as current and non-current as appropriate.

Offsetting generally would be prohibited as the Board discussed during its meetings that transparency would be better achieved by presenting regulatory assets and liabilities gross, with any additional information disclosed in the notes to the financial statements. Offsetting would be allowed within a category to the extent that the regulatory assets and liabilities are subject to the same regulator.

Observations

The proposals do not indicate whether regulatory assets are tangible or intangible, although the Basis for Conclusions mentions regulatory assets in conjunction with examples of intangible assets. Constituents should consider this issue and the implications for reporting to banks and other financial institutions information and ratios for the purposes of complying with covenants.

The proposals refer to offsetting within a category. While "category" is not defined in the ED, it appears to refer to the current and non-current designations in the statement of financial position.

The proposals indicate that entities "may" offset. It is unclear whether the IASB intended this to be an accounting policy choice.

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4. Disclosure

The proposed disclosure objectives focus on information about the nature and financial effect of rate regulation on an entity's operating activities, and information about the recognised regulatory assets (liabilities) and related income and expenses in the financial statements.

For each set of operating activities subject to a different regulator, an entity would disclose:

- whether the regulator is a related party to the entity;
- an explanation of the approval process for the rate subject to regulation;
- the indicators that management considered when determining whether any of the entity's activities were within the scope of the proposals if the conclusion was subject to significant judgement;
- significant assumptions used in the measurement of the expected present value; and
- the risks and uncertainties affecting future recovery (settlement), including the expected timing.

For each category of regulatory asset (liability) recognised that is subject to a different regulator, an entity would disclose:

- a reconciliation from the beginning to the end of the period of the carrying amount of the regulatory asset (liability);
- the remaining period of expected recovery (settlement); and
- the financing cost included in self-constructed property, plant and equipment and internally generated intangible assets that would not have been capitalised under IAS 23 *Borrowing Costs*.

When an impairment loss is recognised, an entity would apply the disclosure requirements of IAS 36. If an entity derecognises regulatory assets (liabilities) during the period, then an explanation of the reasons for derecognition and the amount derecognised would be required.

The proposals include a catch-all requirement to disclose any additional information that an entity believes would be required to meet the disclosure objectives of the proposals.

Observations

In our experience, many entities subject to rate regulation currently provide much of the proposed disclosures, although not necessarily as part of the financial statements.

It appears that the disclosure requirements, with the exception of borrowing costs capitalised in the current reporting period, apply only to amounts capitalised as a separate regulatory asset (liability). This means that there would be no information provided to users of the financial statements about amounts capitalised as part of the carrying amount of self-constructed property, plant and equipment or intangible assets (see *2. Recognition and measurement*).

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5. Effective date and transition

The ED does not propose an effective date, although early adoption would be allowed. When an entity applies the proposals for the first time, retrospective application would be required with an adjustment being made to the opening balance of retained earnings in the earliest comparative period.

Observations
From the Board's discussions prior to the release of the ED, we expect the effective date to be at least one year from the date of issue of a final standard. However, the early-adoption proposal would allow entities that are transitioning to IFRSs to apply the new standard immediately.

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6. First-time adoption of IFRSs

The ED proposes that first-time adopters of IFRSs be allowed to carry forward from previous GAAP the carrying amount of property, plant and equipment and intangible assets that includes items that would qualify for recognition as regulatory assets under the proposals. The "grandfathered" carrying amount would become deemed cost at the date of transition to IFRSs. However, a first-time adopter would be required to choose between this exemption and the exemption related to borrowing costs; it could not apply both.

The borrowing costs exemption allows a first-time adopter to apply the transitional requirements of the 2007 revision to IAS 23. To the extent that the adoption of IAS 23 upon transition is a change in accounting policy, these transitional requirements provide a first-time adopter relief from applying the standard retrospectively. Instead, IAS 23 is applied to qualifying assets for which the commencement date for capitalisation is on or after (1) the later of 1 January 2009 and the date of transition; or (2) an earlier date chosen by the first-time adopter. A first-time adopter that elects to apply the optional exemption in respect of borrowing costs must do so on a consistent basis across all relevant assets; the exemption cannot be applied on an asset-by-asset basis.

Observations

It is unclear to us how the rate-regulation and borrowing costs exemptions interact. A first reading of the proposals appears to indicate that if the rate-regulated exemption is applied to any asset, then the borrowing costs exemption is prohibited in its entirety rather than for just that asset. It is not clear that the IASB intended this outcome.

It is also unclear to us whether the exemption applies to property, plant and equipment whose carrying amount includes a net regulatory liability, which may be a relevant consideration for some constituents.

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