Accounting & Regulatory Update

Meeting of the IASB Consultative Group (CG) on Rate Regulation

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October 26, 2017

Disclaimer

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Agenda

1. Objectives of the IASB CG meeting
2. Summary of the discussions held at the meeting
3. Overview of the proposals for an accounting model
4. Way forward

1. Objectives of the IASB CG meeting

Objectives

- **The objectives of the meeting with the IASB Consultative Group (CG) on rate regulation were:**
  - To present an overview of the model and Board discussions
  - To obtain information from CG on five key topics
    1. The scope – Whether the ‘defined rate regulation’ is sufficiently clear
    2. Rights and obligations – Identification and tracking of rate-adjustment balances
    3. Uncertainty – Sources of and impact on recognition and measurement
    4. Identifying the interest rate or return rate – How regulators compensate for the time-lag
    5. Presentation and disclosure – How feasible is it to disaggregate information and track the balances included in billing

This summary should be read in conjunction with the Agenda Papers available on the IFRS website at http://www.ifrs.org/news-and-events/calendar/2017/october/consultative-group-for-rate-regulation/

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2. Summary of discussions held at the meeting

1. Defining the Scope (1)

If the Board was to use the following description of ‘defined rate regulation’ to determine the scope of the model, do you think the description is sufficiently clear for entities to assess which of their activities would be within the scope of the model?

“Defined rate regulation is a form of economic regulation established through a formal regulatory framework that imposes limitations on entry into an industry (and on exit from it) and that:

a) is binding on both the entity and the rate regulator;

b) establishes a basis for setting the regulated rate chargeable by an entity to its customers for the transfer of specified goods and/ or services that comply with minimum quality levels or other service requirements; and

c) includes, as part of the basis for setting the regulated rate, a rate- adjustment mechanism that creates and reverses temporary differences when the regulated rate in one period includes amounts related to specified activities the entity carries out in a different period.”

1. Defining the Scope (2)

- **There has been lots of discussion around the phrase ‘imposes limitations on entry into an industry (and on exit from it)’**
  - Is this phrase really necessary to be within the scope?
  - Does this mean monopoly?
  - The method of providing the service is not important, e.g. monopoly. Instead it is the fact that essential services are provided and that the rate for providing those services is controlled by the regulator
  - Many expressed their view that this sentence is not necessary
- **The definition of ‘defined rate regulation’ should capture the majority of the Canadian rate-regulated entities**
- **The definition of ‘defined rate regulation’ should provide a link to the definitions of rate regulator / rate regulation as set out in IFRS 14**
- **The phrase ‘is binding on both the entity and the rate regulator’**
  - The definition of ‘defined rate regulation’ should include an explanatory note addressing that rate regulation is also binding to customers

1. Defining the Scope (3)

- **Concept of ‘temporary differences’ may add confusion**
- **The Board should focus on enforceable rights and obligations in establishing the scope**
- **‘Self-regulated entities’ by statute or regulation was discussed but no detail was offered as to how the scope will include those entities**
  - The definition of rate regulator in IFRS 14 is currently sufficient for those entities to be scoped-in

2. Rights and Obligations (1)

- **Par. 7 & 8 of Agenda Paper (AP) 4 are only an incomplete list of examples and the first line of each paragraph is too vague (see summary below)**
  - A right to charge a higher rate / obligation to charge a lower rate could reflect a variety of past events, such as the entity:

    (a) incurring costs / receiving amounts from customers in advance

    (b) meeting a bonus target / incurring a penalty; or

    (c) Being compensated / charged for the time-lag
- **The detailed requirements in regulatory agreements are normally clear enough to identify most temporary differences that qualify to be included in the rate-adjustment mechanism**
- **The detailed record-keeping requirements in regulatory agreements enable identification and tracking of individual adjustments from origination to the unwinding through amounts billed to customers**

3. Uncertainties (1)

- **Sources of uncertainty in making the assessment**
  - Key issue is the timing if not specified by regulator’s directive rather than whether the item will be recovered
  - Regulator may decide cost is not prudently incurred
- **Uncertainty related to demand risk**
  - Demand risk is a gating question for entities following ASC 980 (10-15-2(c))
  - The majority of the approved amounts are recovered/paid back over a short period of time (1-5 years)
  - There are only a few very long-term regulatory assets approved by regulators
  - However, there are many regulatory assets not subject to approval by the regulator. These are set-up as a result of accounting policy differences (e.g. deferred taxes, pension & OPEB and ARO, which are recovered on a cash basis) which may be affected by demand risk
  - It is not unusual in this industry to prepare budgets and forecasts for period up to 20 years

3. Uncertainties (2)

- **Discounting the regulatory assets and liabilities**
  - Lots of discussion as to whether regulatory assets and liabilities should be recognized at fair value with a day 1 gain or loss instead of historical cost
    - Many CG members are of the view that generally day 1 gain or loss should not be recognized unless impaired
    - Regulatory assets and liabilities acquired in a business combination are generally recognized at their carrying amounts

3. Uncertainties (3)

- **Evidence obtained for the assessment of uncertainty**
  - Entities use a hierarchy to address the evidence obtained
  - Rate decisions and directives provided by regulators
  - Prior decisions issued by the regulator
  - Precedent set by other utilities' rulings
  - Legal and regulatory expert - internal team or external counsel
- **Threshold used to determine whether to recognize**
  - Probable (defined by certain CG members as > 70-75%)

4. Identifying the interest rate or return rate (1)

- **Compensation for the time-lag**
  - Most regulators compensate or charge for the time-lag
    - Most regulatory assets / liabilities are subject to compensation or charge
    - Regulatory assets / liabilities not involving cash flows are normally not subject to compensation or charge
    - Same interest rate / rate of return is used for regulatory assets / liabilities, with some exceptions
- **Rates applied by regulators to compensate or charge**
  - Most regulators used a rate of return (e.g. WACC), with some exceptions
    - A few entities can only apply an interest rate (short-term or long-term depending on the timing of recovery)
    - Some not-for-profit entities are not permitted
  - Interest rate or rate of return applied are updated on a regular basis
    - Either quarterly, annually or at each rate application

5. Presentation and Disclosure (1)

Presentation

- **Some IASB Board members (Board) have indicated a preference for presenting regulatory assets and liabilities, and related movements on those items, as separate line items in the statements of financial position and of comprehensive income**
  - Many CG members did not see any added value in disaggregating information about individual rate-adjustment account balances, especially in the statement of comprehensive income
- **The Board tentatively decided that an entity will apply the requirements of other IFRS Standards, including IFRS 15, before applying the model**
  - Currently, entities reporting under IFRS used the one line item presentation at the bottom of the statement of comprehensive income, as required by IFRS 14
  - Likely that the presentation will permit the separate line item in the statement of comprehensive income as required under IFRS 14 to move within the statement and hopefully into additional separate line items

5. Presentation and Disclosure (2)

Disclosure

- **The Board has yet to discuss disclosure requirements but is expected to use the existing disclosure requirements in IFRS 14 as a starting point**
  - Disclosure requirement under IFRS 14 is an improvement for many entities and is well understood by the users
  - Entities currently disaggregate the balances by nature of each rate regulated activity
  - Most entities believe that it would be feasible to split the regulatory balances between current and non-current amounts

3. Overview of the proposals for an accounting model

Core principles and features of the model

To establish principles that an entity applies to inform users of the effects of the rate regulation on the entity's cash flows arising from past transactions, events and conditions.

To achieve this, the model:

– Supplements the requirements of existing IFRS Standards, ie an entity applies other IFRS Standards before applying the new model;

– Focuses on the rights and obligations arising from the regulatory agreement and restricts the scope of the proposed accounting to those regulatory adjustments that link, through the rate-setting mechanism, the entity's right to charge customers a determinable amount in exchange for satisfying specified regulatory obligations to the satisfaction of those obligations; and

– Addresses the satisfaction of the entity's regulatory obligations to the customer-base separately from the satisfaction of the entity's performance obligations to individual customers (which are addressed through IFRS 15)

The model based on my crystal ball

– Rate-regulated entities will recognize income, expenses, assets and liabilities in accordance with other IFRS Standards before applying the new model

– Based on a ‘rights and obligations’ model rather than deferred costs model (ie FAS 71)

– Measurement - unclear whether there will be a requirement to recognize regulatory assets and liabilities at fair value with a day 1 gain or loss

– Present separately:

  – Revenue recognized as (or when) the entity satisfies performance obligations contained in contracts with individual customers, using the regulated rate (ie recognized using IFRS 15); and

  – Regulatory adjustments that arise due to the origination and reversal of timing differences

– Disclosure likely to be based on IFRS 14

– Deemed cost of equity included in AFUDC, if permitted, and capitalized indirect costs will likely require to be presented separately with regulatory assets instead of PP&E

4. Way forward

Way Forward (1)

- **IASB meeting of December 2017**
  - Board expected to decide whether to issue a DP first or an ED directly

- **Timing of the issuance of a Standard**
  - **A DP is likely to be issued first to consult on the proposed model and some complex issues**
    - Likely to be issued at the end of Q2-2018
  - **An ED will likely be issued within a very short period of time**
    - Likely to be issued in Q2-2019

Way Forward (2)

- **At the end of the meeting, the IASB Board members and staff in attendance stated that they will welcome any additional information from the CG or the industry**
- In that respect, you may want to comment on the Agenda Papers discussed at the CG meeting or the proposed model, including the following issues:
  - How to scope-in self-regulated entities?
  - Should the regulatory assets and liabilities be measured at fair value with a day 1 gain or loss? What do you think such a day 1 gain or loss could represent?
  - Should the line items be segregated in the primary financial statements from other balances recognized under other standards? Do users need such a level of details?

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