



Project	Rate-regulated activities
Topic	Scope — additional considerations

Introduction

1. In February 2009, the Board decided that rate-regulated activities would meet the scope requirement of the standards if two criteria are met:
 - (a) an authorised body is empowered to establish rates that bind customers;
and
 - (b) the rate regulation takes the form of a cost-of-service regulation.

Objective of this paper

2. The objective of this paper is to establish the factors that should be included in the standard's application guidance on determining whether the regulatory environment meets the scope criteria.

Staff analysis

General

3. In almost all circumstances in which rates are regulated, the service provided is considered essential. In addition, providing the service generally requires the construction and installation of high cost infrastructure by the service provider. Such conditions often result in a natural monopoly.
4. Rate regulation exists to ensure that prices are kept as low as reasonably possible for customers while still ensuring good service. The regulator ensures that the operator will not get unreasonably high returns because of the monopolistic situation. As a corollary, the entity must be permitted sufficient returns that it can raise necessary capital to maintain, improve and expand the infrastructure to provide safe and reliable service.

This paper has been prepared by the technical staff of the IASB for the purposes of discussion at a public meeting of the IASB.

The views expressed in this paper are those of the staff preparing the paper and do not purport to represent the views of any individual members of the Board or the IASB.

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5. These characteristics do not preclude the existence of different types of regulation. However, the Board concluded that only cost-of-service regulation results in the existence of assets and liabilities that meet the criteria to be recognised in the financial statements. The second criterion in the scope definition differentiates between cost-of-service and other forms of regulation.
6. As discussed in Agenda Paper 9A, the staff believes that the scope criteria also effectively serve as recognition criteria for assets and liabilities arising from rate regulation. As a result, the staff does not propose to include in the standard any separate recognition criteria. If the Board agrees with this recommendation, it is obviously essential that the scope criteria be applied consistently. In the staff's view, application guidance will be needed to assist entities in making the necessary judgements consistently.

Criterion 1 – setting prices that bind customers

7. Satisfying Criterion 1 requires an entity to establish two facts:
 - (a) an identifiable body is authorised in some way to set prices for the regulated goods or services, and
 - (b) the prices set by that body bind the entity's customers.
8. The existence and authority of the price-setting body should be readily determinable as it is usually established by statute or regulation.
9. The key factor to consider in determining if the regulated operations satisfy Criterion 1 is whether prices are negotiable on a customer by customer basis. The existence of differential pricing for different classes of customers would not violate this condition provided that the regulator approves the definition of the classes, sets the price for each class and all customers of the same class are charged the same price.
10. Based on this analysis, the staff does not believe that application guidance is required to assist entities to apply Criterion 1 consistently. However, the guidance in paragraph 9 should be included in the standard itself.

The staff recommends that the only application guidance needed for Criterion 1 should be the discussion of prices in paragraph 9. Does the Board agree? If not, what other guidance is needed and where should it be included?

Criterion 2 – cost-of-service regulation

11. The second criterion limits the scope of the project to cost-of-service regulation. In accordance with this specific form of regulation, the rates are designed to recover the specific entity's *allowable costs* of providing the goods and services. *Allowable costs* include interest costs and a reasonable return on shareholders' investments.
12. In many cases, determining whether the entity's regulatory regime qualifies as cost-of-service will be straight-forward. In others, significant judgement will be required.
13. The staff recommends that the following indicators be included in application guidance to the standard to help an entity determine whether its regulatory plan qualifies as cost-of-service:
 - (a) is the plan designed to provide recovery of the specific entity's costs?
 - (b) if actual costs are not used to establish rates, does the plan provide for a 'true-up' to actual costs incurred?
 - (c) can the regulated entity elect to return to direct cost-based rate regulation if the results of an alternative form of rate regulation do not provide for recovery of costs?
 - (d) in the case of a 'price cap' plan, is there a true-up to actual costs through a rate of return sharing mechanism?
 - (e) if the entity is required to provide a rate discount, is the rate discount temporary or permanent?
 - (f) if a short period of a moratorium on rate increases is imposed, will it be followed by a return to direct cost-based regulation?
14. The first four indicators help establish that the plan is intended to permit the entity to recover its specific costs rather than industry averages, costs based on other indices or targets. The last two indicators help establish whether the entity is being permitted to recover its costs (including financing costs) and earn an adequate return on its shareholder's investment. Concluding that a regulatory plan does not provide a sufficient return for shareholders to justify the

application of the standard will require considerable judgement. Therefore, the staff believes that it would also be helpful to provide the following indicators that could lead to that conclusion:

- (a) is there abnormally excessive capacity?
 - (b) are rates per unit are currently higher - or forecasted to be in the future - than those of neighbouring utilities and/or alternative competitive energy sources? This may indicate that the regulator will disallow costs.
 - (c) is there competition requiring the utility to discount its prices below those authorised by the regulator?
 - (d) has the regulatory environment changed?
 - (i) creation of unrecoverable investments
 - (ii) substantial regulatory disallowances
 - (iii) creation of phase-in plans and/or trend toward increasing amounts of regulatory assets
 - (iv) proposed or actual ratemakings that are designed to stimulate competition and/or rates that are based on other than pure cost-of-service concept
 - (v) rate freeze periods that extend beyond a few years.
15. Material is available that illustrates how these indicators could be applied in specific fact patterns. The staff believes that it would be helpful to include some explanation of why the indicators in paragraphs 13 and 14 support or refute an entity's conclusion that its activities are within the scope of the standard. That explanation would be provided in the application guidance. In addition, more comprehensive examples could be included as non-authoritative illustrative examples.

Recommendation and question 2 - Criterion 2 guidance

The staff recommends that application guidance should be included in the standard to provide indicators whether a regulatory plan qualifies as a cost-of-service form of regulation? Does the Board agree?

Does the Board agree that explanations of the indicators should also be included in the application guidance?

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Does the Board want to include more comprehensive examples as illustrative examples?