

STAFF PAPER

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Rate-regulated Activities Consultative Group

Project	Rate Regulation
Paper topic	Scope issues: Types of rate regulation
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Introduction

1. We have analysed the information received from the responses to the Request for Information *Rate Regulation* published in March 2013 (the RFI). This has been done to identify common features or principles that could be used to define the scope of the planned Discussion Paper (‘the planned Rate Regulation DP’ or ‘the planned DP’) that is being developed as part of the IASB’s Rate-regulated Activities project. This planned DP will try to identify whether an accounting model can be developed for rate-regulated activities and, if so, what that model might look like.
2. Agenda paper 4 summarises the responses to the RFI. This highlights that there is a wide variety of types of rate-regulatory schemes. Although the schemes can generally be categorised into two broad types (cost-of-service regulation and incentive-based regulation), almost all schemes identified contain elements of both types. This has created an almost indefinite number of different types of rate-regulatory schemes.

Defining the scope using cost-of-service regulation – the 2009 ED

3. The scope of the proposals in Exposure Draft *Rate-regulated Activities*, published in July 2009 (the 2009 ED) was restricted to a particular type of rate regulation; “cost-of-service” regulation (paragraph 3 of the 2009 ED):

“3 An entity shall apply this [draft] IFRS to its operating activities that meet the following criteria:

(a) ; and

(b) the price established by regulation (the rate) is designed to recover the specific costs the entity incurs in providing the regulated goods or services and to earn a specified return (**cost-of-service regulation**). The specified return could be a minimum or range and need not be a fixed or guaranteed return.”

4. Cost-of-service regulation was defined as:

A form of regulation for setting an entity’s prices (rates) in which there is a cause-and-effect relationship between the entity’s specific costs and its revenues.

5. The vast majority of the responses to the 2009 ED raised concerns about the proposed scope. Many of those responses noted that the focus on cost-of-service regulation created many problems, including:

(a) The proposed scope is rule-based: in order to apply this in practice, a list of rules or exceptions would be needed to provide guidance that would accommodate the wide range of types of rate regulation;

(b) There is a global trend to move away from ‘pure’ cost-of-service regulation and increase the use of incentive-based mechanisms. Consequently, any guidance produced would only apply to an increasingly small population of entities and moving from cost-of-service regulation to another form would result in a large ‘cliff-edge’ for accounting for the economic impact of rate regulation.

(c) Many types of rate regulation involve ‘hybrid’ mechanisms that use a combination of cost-of-service tools and incentive-based tools. In many cases, the ‘regulatory period’ is increasing (traditionally, rate-setting reviews were performed each year) so that a full cost-of-service type rate-setting review is performed at intervals (commonly at two- to five-year periods or longer). A formula is then used to adjust the rate for each intervening year, which usually incorporates some incentive-based

adjustments. Many respondents raised the question as to whether an entity that is subject to this type of rate regulation would switch in and out of scope depending on whether it was subject to a cost-of-service rate-setting review during the reporting period or was in the intervening incentive-based formula periods.

- (d) The requirement that the rate regulation should be designed to recover the entity's "specific costs" such that there is "a cause-and-effect relationship between the entity's specific costs and its revenues" also caused concerns. Paragraph B4 in Appendix B to the 2009 ED¹ provided some indicators to help identify whether a particular type of rate regulation was within the scope of the proposals. This suggested that a rate-setting mechanism could use estimated or benchmark costs as long as there was a subsequent 'true-up' to actual costs. In many rate-regulatory schemes, the true-up does not apply to all costs but may apply only to specified types of costs. This raised questions as to what level of true-up was needed for the rate regulation to be within the scope of the proposals.
- (e) Many respondents to the 2009 ED raised questions about the requirement for the rate-regulated entity "to earn a specified return". Although the scope paragraph 3(b) used the term 'specified return', the application guidance used the terms 'adequate' return (paragraph B5) and 'sufficient' return (paragraph B6). The Basis for Conclusions went on to also use the term 'fair' return (paragraphs BC9, BC11, BC38, and BC54). The mixed terminology confused respondents and was considered by them likely to raise application problems.

Defining the scope by reference to types of regulation

6. As previously noted, the vast majority of the responses to the 2009 ED raised concerns about the proposed scope. As well as the problems highlighted above, many respondents requested that the IASB consider broadening the scope to other

¹ The application guidance relating to the scope of the proposals is reproduced in the Appendix to this paper.

types of rate regulation. However, when proposing changes to the proposed scope, many of the respondents focused on their desired outcome of what types of rate regulation should be in or out of the scope rather than identifying a core principle.

7. These schemes not only differ from country to country or industry to industry, but can differ within a country or industry. The rate-regulatory scheme can also differ between rate-regulated entities in the same country or industry – even when subject to rate regulation by the same rate regulator. This is because there are usually few entities supplying the rate-regulated goods or services, each of which may supply a different geographical area. Each area may have unique features that require different rate regulation, for example, a different demographic profile of consumers, different physical or geographic constraints, different natural resource availability, etc.
8. As a result, we have been unable to identify common principles that we think could be applied to define a clear scope for the Discussion Paper (and so for any guidance that may be developed subsequently) based on the type of rate regulation to be applied. Consequent, we think that the scope should be defined using other features of rate regulation.

Defining the scope by reference to other features of rate regulation

9. The common features of rate regulation described in the responses to the RFI that we have identified as having the potential to provide a suitable basis for the scope of planned rate Regulation DP are:
 - (a) The use of variance or deferral accounts;
 - (b) The presence of a rate regulatory body, supported by legislation or government regulations; and
 - (c) The approval or determination of prices that bind the customers.
10. Each of these features are considered in agenda papers 6B-6D.

Questions for the Consultative group

Defining the scope: Types of rate regulation

1. Do you agree with the staff's conclusion that the type of rate regulation should not be used to define the scope of the Discussion Paper?
2. If you do not agree; what types of rate regulation should be in the scope and how do you propose to define the scope?
3. If you do agree, are there any other features of rate regulation, in addition to those highlighted in paragraph 9 above, that you think should be incorporated into the scope definition?

Appendix: Extract from Exposure Draft *Rate-regulated Activities*, published in July 2009 (the 2009 ED): Appendix B Application Guidance**Cost-of-service regulation**

- B3 The second criterion to consider in determining if the regulated operating activities are within the scope of the [draft] IFRS is whether the rate established by regulation is designed to recover the specific costs the entity incurs in providing the regulated goods or services and to earn a specified return, ie whether the entity is subject to a cost-of-service form of regulation. This criterion requires a cause-and-effect relationship between an entity's costs and its rate-based revenue stream.
- B4 In many cases, determining whether the entity is subject to cost-of-service regulation will be straightforward. In others, significant judgement will be required. The following circumstances are indicators of cost-of-service regulation:
- (a) The regulation is designed to provide recovery of the specific entity's costs.
 - (b) If actual costs are not used to establish rates, the regulation provides for a 'true-up' to actual costs incurred.
 - (c) In the case of a 'price cap' plan, there is a true-up to actual costs through a rate of return sharing mechanism.
 - (d) If the entity is required to provide a rate discount, the rate discount is temporary rather than permanent.
 - (e) If a short moratorium on rate increases is imposed, it will be followed by a return to direct cost-based regulation.
- B5 The first three indicators relate to whether 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 relate to whether the entity is permitted to recover its costs (including financing costs) and earn an adequate return on its shareholder's investment.
- B6 Concluding that a regulatory plan does not provide a sufficient return for shareholders to justify the application of the [draft] IFRS requires

judgement. One or a combination of the following indicators could lead to that conclusion:

- (a) Abnormal excess capacity exists.
- (b) The rates per unit are currently higher (or are forecast to be higher in the future) than those of entities in neighbouring jurisdictions or alternative competitive sources. This may indicate that the regulator will disallow costs.
- (c) The regulatory environment has changed, as indicated by:
 - (i) the existence of unrecoverable investments.
 - (ii) substantial regulatory disallowances.
 - (iii) the establishment of phase-in plans or a trend towards increasing amounts of regulatory assets.
 - (iv) proposed or actual rate-making that is designed to stimulate competition or rates set based on other than a pure cost-of-service concept.
 - (v) rate freeze periods that extend beyond a reasonable time.