

STAFF PAPER

July 2013

[IASB Meeting]

Project	Rate-regulated Activities – Rate Regulation		
Paper topic	Request for Information response summary		
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Introduction

1. In March 2013, the IASB published the Request for Information (RFI) – *Rate Regulation*. The objective of the RFI was to gather high-level overviews of the types of rate regulation that are currently in force in order to provide factual evidence and examples that will be used to help to determine the scope of a Discussion Paper. This will, in turn, help us to consider what information about the consequences of rate regulation would be most useful for users of IFRS financial statements and whether to develop specific guidance for accounting for the consequences of rate regulation
2. The RFI asked five groups of questions under the following headings:
 - (a) The regulated industry and why it should be considered;
 - (b) The objectives of the rate regulation;
 - (c) The rights and obligations established by the rate regulation;
 - (d) The enforcement of rights and obligations; and
 - (e) The recovery or reversal of cost and income variances.
3. The response period ended on 30 May 2013 and we received 79 responses.

Structure of the paper

4. This paper provides a summary and brief analysis of the RFI responses received.

It contains the following sections:

- (a) Objective of the paper;
- (b) Summary of respondents;
- (c) General comments:
 - (i) Scope;
 - (ii) Types of rate regulation;
- (d) Responses to the RFI questions:
 - (i) Regulated industries;
 - (ii) Objectives of rate regulation;
 - (iii) Rights and obligations established by rate regulation;
 - (iv) Enforcement of rights and obligations;
 - (v) Recovery or reversal of variances;
- (e) Other issues;
 - (i) Interaction with IFRIC 12 *Service Concession Arrangements*;
 - (ii) Interaction with the ED *Clarification of Acceptable Methods of Depreciation and Amortisation*.

Objective of the paper

5. The objective of this paper is to provide a summary and analysis of the RFI responses received. We will also present this analysis to the Rate-Regulated Activities Consultative Group (the Consultative group) at their first meeting on Friday 26 July 2013. During that meeting, we will discuss in detail the potential scope of the Discussion Paper and the types of rate regulation that should be included within it.

6. At this stage, we are not asking the IASB to make any formal decisions but we are interested in gathering any initial views and comments. In particular, we would

like the IASB to highlight any issues that the Consultative Group or the staff could usefully focus on. We will provide a more detailed analysis of the issues raised through the RFI and the discussions of the Consultative Group and ask the IASB to begin their formal decision-making discussions at their next meeting in September 2013.

Summary of respondents

7. 79 responses¹ were received from 25 countries, which describe aspects of rate regulation in 37 countries. Appendix A shows a breakdown of the geographic distribution of respondents. 64 of the responses came from jurisdictions that currently use IFRS or that noted that IFRS is used by some of the entities that are subject to the rate regulation described.
8. An analysis of the respondent types is also provided in Appendix A. The majority of respondents (65%) are preparers of financial statements and preparer representative bodies. Other respondents are primarily rate regulators (12%), accounting firms or bodies (9%) and standard-setters (12%).
9. 10 of the responses (13%) are from preparer representative bodies. Consequently, the number of preparer entities that have participated in the response is higher than the number of individual letters suggest.
10. Some of the rate regulators that responded to the RFI noted that they classify themselves as users of the financial statements and that the published financial statements provide a valuable source of information for regulatory purposes.

General comments from respondents

Scope

11. All of the respondents that commented on the scope of the project welcomed the IASB's decision to investigate a wide variety of rate regulatory schemes. They caution the IASB against developing rule-based guidance applicable to only certain types of schemes. This is consistent with many of the responses to the

¹ Responses received by 9 July 2013

Exposure Draft *Rate-regulated Activities* (the 2009 ED), published in July 2009. That ED focused on a specific type of rate regulation (commonly known as ‘cost-of-service’ or ‘return-on-base-rate’ regulation). This type of rate regulation is becoming less common as a result of an increasing trend towards more incentive-based rate regulatory mechanisms (see paragraph 26).

12. Consequently, the respondents to the RFI encourage the IASB to try to identify broader principles that can be applied to a broad range of rate regulation. In many jurisdictions, rate regulation is evolving and the nature of the rate regulatory mechanisms is changing to capture a wider range of regulatory objectives. It is important that any guidance produced as a result of this project should be sufficiently principle-based so that an entity will be able to identify when a change of accounting policy may be required (and what that change should be) when the rate regulator makes changes to the rate regulation.

Types of rate regulation

13. There are two general types of rate regulation identified in the responses to the RFI:
 - (a) Cost-based (commonly known as ‘cost-of-service’ or ‘return-on-base-rate’ regulation); and
 - (b) Incentive-based (including price-cap or revenue-cap regulation).
14. However, these two types represent two extremes of a very broad range of rate regulation. At one extreme of the range, the formula used to calculate the rate is focused on the entity’s actual input, with a ‘true-up’ mechanism. Such a cost-based formula typically incorporates:
 - (a) the specific operating costs of providing the regulated goods/service;
 - (b) the specific capital costs of the assets used to provide the regulated goods/service (commonly referred to as the ‘regulatory asset base’);
 - (c) a specific targeted rate of return on the entity’s capital investment, for example, the entity’s specific weighted average cost of capital. This rate is applied to the value of the regulatory asset base; and

- (d) variance or deferral accounts, which are used to ‘true-up’ most, if not all, of the entity’s deviations between actual and estimated costs and revenue included in the approved rate.
15. At the other extreme of the range, the formula used to calculate the rate is focused on targeted outputs, with little or no ‘true-up’ to actual results:
- (a) The starting point for setting the initial rate is usually ‘benchmark’ or target costs, expenditure and return rate;
 - (b) The target input measures are then adjusted for inflation and for a variety of output-based objectives, with incentives or penalties applied through the rate formula; and
 - (c) Few items are tracked for variances between actual and estimated amounts. Consequently, the risk of changes in demand and input costs is retained by the entity.
16. Few, if any, schemes fall neatly into either extreme. Almost all of schemes described in the responses to the RFI incorporate some aspects of both types. Consequently, an analysis of the responses highlights that the high-level terminology commonly used when describing rate regulation can be misleading.
17. For example, the more detailed descriptions of some schemes described as ‘cost-of-service’ included some incentive-based elements. These ranged from the use of ‘benchmark’ costs, instead of the entity’s specific costs, industry average weighted average cost of capital or market return rates instead of the entity’s specific debt/equity mix or actual cost of capital through to incentive/penalty adjustments to the rate for other (usually output-based) objectives.
18. Alternatively, the more detailed descriptions of some schemes described as ‘incentive-based’, contain very similar mechanisms to those described in the ‘cost-of-service’ schemes outlined in paragraph 17 above.

Responses to the RFI questions

Regulated industries

19. The types of industries identified as being subject to rate regulation are varied but can be grouped into the following broad categories:

- (a) energy (including electricity, gas, oil/petroleum, heating);
 - (b) water;
 - (c) public transport (including trains, buses, taxis);
 - (d) other transportation (including toll roads, air traffic control, port and airport services);
 - (e) telecommunications;
 - (f) postal services;
 - (g) insurance;
 - (h) other (including fertilisers, health services, cemeteries).
20. In some of these categories, further sub-divisions may exist in some jurisdictions. In particular, in the electricity and gas industries, vertical integration of the supply stages from extraction/generation through transportation/transmission and distribution to retail supply to the end user is sometimes broken down into separate stages. Different levels of rate regulation may then apply to the different stages. Where competition is possible (commonly at the extraction/generation and retail supply stages) deregulation has sometimes occurred. However, the transportation/transmission stage is often a ‘natural monopoly’ because of the high levels of infrastructure investment required, together with the physical limitations of installing alternative transportation/transmission lines (see paragraph 28 below).
21. Few respondents commented on why particular types of industries should be specifically considered as part of the IASB’s Rate-regulated Activities project or whether such industries should be covered by any guidance produced. As noted earlier, respondents to both the 2009 ED and the RFI encourage the IASB to use a wide variety of rate-regulatory industries and schemes in order to identify high-level principles that can be applied broadly. It is hoped that this broad-based approach will help to avoid industry-specific, rule-based guidance.

Objectives of rate regulation

22. Many respondents noted that the overall objective of rate regulation is to act as a substitute for competition. However, the more detailed comments suggest that

this is not an accurate description because the public service nature of most of the activities that are subject to rate regulation create added complexities that do not occur in fully competitive markets. This means that rate regulators need to design the rate regulatory scheme in such a way that it balances the interests of both the supplier and the consumers.

23. Consequently, although the detailed objectives of rate-regulatory schemes can vary widely, the following high-level objectives appear to be common to most schemes described in responses:
- (a) to protect the interests of consumers by:
 - (i) controlling the price charged to customers (a ‘fair and reasonable rate’); and
 - (ii) providing rate stability;
 - (b) to maintain the (public) service; and
 - (c) to provide investors with a ‘fair rate of return’.
24. Maintenance of the (public) service is an important factor that underpins the rate-regulatory environment. This is reflected in a variety of ways in the rate-regulatory schemes described in the responses to the RFI. In particular, it imposes significant obligations on the supplier that would not usually be expected in a truly competitive market (see paragraph 30).
25. The responses indicate a global trend moving toward more qualitative as well as quantitative objectives, many of which focus on improving service levels, not just maintaining them. Such objectives include:
- (a) improvements in the quality and efficiency of service;
 - (b) increased customer satisfaction;
 - (c) increases in supply capacity and reliability;
 - (d) achievement of environmental goals/reductions in emissions;
 - (e) development of innovative technologies/use of alternative resources;
 - (f) encouragement of competition; and
 - (g) decreases (or increases) in customer demand or usage.

26. These increasingly complex and cross-cutting objectives are leading to a trend toward rate regulatory schemes that are increasingly incentive based. Such schemes vary from the use of input-based mechanisms, such as a cost-based formula, which is then adjusted for incentives or penalties; through to more output-based mechanisms, which focus more on the quantity and/or quality of service instead of the entity's cost of supplying that service.

Rights and obligations established by rate regulation

27. The rights and obligations created by the rate regulation usually reflect both the objectives of the rate regulation and the public-service nature of the supply.
28. Typically, the entities that are subject to rate regulation have a monopoly or near-monopoly right to operate in a pre-determined geographical service territory. The monopoly right may be:
- (a) explicit - for example, the right may be defined by an exclusive licence agreement with the rate regulatory or other licensing body, or through a service concession arrangement (which may or may not be within the scope of IFRIC 12 *Service Concession Arrangements* (see paragraph 44 below), or through legislation/regulation; or
 - (b) implicit - for example, there may be significant barriers to entry (a 'natural monopoly') due to, for example, the high-level of capital investment required or because of physical constraints that apply to putting the necessary infrastructure in place (for example, accessing private land in order to lay a pipeline).
29. When a supplier entity is granted an explicit right to operate in a particular area, the specific direct cost to acquire or renew the right is typically not significant. The length of time that the explicit right is granted for varies widely. It is typically granted for a medium- or long-term period (for example, five to 30 years). Renewal is sometimes open to competition but is more typically automatic, as long as the entity can demonstrate compliance with the terms of the licence.
30. Although the direct cost to acquire or renew an explicit right to operate is typically not significant, the rate regulation typically imposes significant

obligations on the supplier. These obligations may require significant expenditure by the supplier (both capital expenditure and some operating costs). Common obligations include:

- (a) services must be provided to consumers on a non-discriminatory basis (which usually means that network access and connection to the network cannot be refused or that services must be provided to certain classes of consumers at the regulated rate, irrespective of the cost of providing services to that particular class of consumer, for example, those in remote or rural areas);
- (b) defined minimum service levels must be achieved;
- (c) specified levels of investment in infrastructure capacity and reliability must be achieved; and
- (d) emissions and other environmental targets must be met, which may include participation in conservation programmes or investment in the use of cleaner or more sustainable energy or material sources.

31. In exchange for these obligations, the regulation typically provides them with a right, in law, to have the opportunity to recover their costs and earn a fair rate of return. Consequently, the rate-setting mechanism set by the rate regulator must reflect this and provide a reasonable assurance that the supplier will recover its costs and earn a fair return, although it does not guarantee recovery. This is because the rate is usually based on expected costs and expected demand. Actual results may be materially different, for example, mild weather might reduce demand for energy utility services or a natural disaster such as an earthquake or hurricane could significantly increase the cost of supply.

32. The use of variance/deferral accounts is, however, considered by many of the respondents to increase the assurance that the amounts in those accounts will be recovered or reversed. The use of these accounts tracks unexpected variations to provide a further opportunity for the rate-regulated entity to recover the tracked costs (or for the excess recovery to be reversed). This is usually achieved by adjusting the future rate or by making a temporary change to the rate by charging consumers a 'rate rider' or 'rate tracker' surcharge (see paragraphs 40-41).

Continuing operations

33. The consensus of respondents is that the rate-regulated entity cannot cease, suspend, restructure or transfer operations (and the rights and obligations attached to those operations) without the approval of the rate regulator. In most cases, this inability to cease operations is explicit in the licence, rate regulation or legislation. Where there is no explicit obligation to continue to operate, the common understanding is that there is an implicit obligation and the rate regulator or other government controlled body would step-in to ensure continuity of supply if necessary.
34. The responses to the RFI also confirmed that the rights and obligations created by the rate regulation are rarely separable from the rate-regulated business. In particular, the method of recovery or reversal of any variance/deferral account balances most commonly relies on the future activities of the supply (see paragraphs 39-43).

Regulatory reporting requirements

35. In addition to the rights and obligations summarised above, rate regulated entities are subject to specified regulatory reporting requirements. These often require detailed accounting records to be kept so that the entity, and subsequently the rate regulator, can monitor the specified income and expenditure that is subject to the rate regulation.
36. The regulatory reporting requirements support the calculation of the rate to be charged to consumers. As previously noted, this rate (or rates) is usually designed in order to give the rate regulated entity the opportunity to recover its reasonably incurred costs of providing the service and to earn a fair rate of return (see paragraph 31 above).

Enforcement of rights and obligations

37. The rights and obligations of the rate regulated entity, the rate regulator and consumers are usually enforced through the application of the terms and conditions set out in the rate regulations, legislation, licence, concession arrangement, etc. However, judgement is usually required to apply the rate-setting formula. This is because the entity and the rate regulator need to decide issues such as what costs are 'prudently' or 'reasonably' incurred, what is a

‘reasonable’ or ‘fair’ rate of return, and whether qualitative targets have been achieved.

38. Commonly, the rate-regulated entity submits its regulatory application for the next rate-setting process, which is then assessed by the rate regulator. The regulatory records are usually subject to audit, either by an independent auditor or by the rate regulator or both. Regulatory proceedings are usually then carried out either in private between the rate regulator and the rate regulated entity or the proceedings are open to public comment. If agreement cannot be reached, this may result in an arbitration or appeal hearing, which may be done through the Courts and result in a Court ruling.

Recovery or reversal of variances

39. Without exception, the rate-setting mechanisms described in the responses to the RFI use estimated amounts to establish the rate to be charged for the future supply of the goods/services that are subject to the rate regulation. The estimated amounts may or may not be based on actual past costs and demand levels, but all rely on adjustments and assumptions related to future costs and future demand levels. Although the rate-setting mechanisms vary widely, almost all respondents to the RFI noted that variance/deferral accounts are used to record differences between the estimated and actual amounts for certain pre-defined types of income or expenditure. In many schemes, the supplier may also apply to the regulator to track additional types of variances in certain conditions.
40. The mechanisms used to recover/reverse these variance/deferral account balances vary and the success of the mechanism in ensuring reversal/recovery also varies. However, the following general observations can be made from the responses:
- (a) Retrospective recovery/reversal based on past usage/consumption by the customer through specific billing adjustments to individual customers is generally prohibited and so is extremely rare;
 - (b) Most commonly, variance/deferral accounts balances are recovered or reversed through adjustment to the rate charged for the future sales of the rate regulated goods/services. Again, the mechanisms used for this adjustment vary but include the following:

- (i) adjustment to the regulatory asset base (RAB);
 - (ii) adjustment to the allowed rate of return;
 - (iii) adjustment to the approved rate throughout the next regulatory period (ie until the next rate-setting procedure);
and
 - (iv) temporary adjustment to the approved rate for a specified period (commonly referred to as a ‘rate-rider’ or ‘rate-tracker’, often highlighted to consumers as a separate element of the rate);
- (c) In a few cases, specified variance account balances may be recovered/reversed through a cash payment from or to the rate regulator (or other designated body or ‘clearing house’);
- (d) If a rate regulator approves the sale or transfer of a rate-regulated business to another entity, the rights and obligations usually transfer with the business. Consequently, the price agreed to transfer the business usually reflects the balances on the variance/deferral accounts, which will be recovered/reversed through future sales made by the incoming supplier.; and
- (e) In one case, noted by most respondents in Alberta, Canada, one utility company in that Province has previously factored or sold a regulatory deferral account debit balance to a bank in exchange for cash. This was done with the approval of the rate regulator.
41. Where variance/deferral account balances are recovered or reversed through adjustment to the future rate, the adjustment in some cases is automatic (ie explicitly included in the rate formula) but in other cases, the adjustment cannot be made until specifically approved by the rate regulator.
42. If actual demand does not allow for full recovery/reversal of approved amounts, the remaining balance may or may not be carried forward for subsequent adjustment to future rates.
43. In many cases, the rate-setting mechanism allows the entity, the rate regulator or consumers to request a rate review before the end of the normal regulatory period (commonly termed an ‘off-ramp’ provision). This mechanism is often invoked

when the variance(s) from estimates are larger than expected and the rate is no longer considered ‘fair and reasonable’ by one or more of the parties that can request a review. Sometimes, the off-ramp is automatically triggered when variances exceed a pre-determined limit or ‘corridor’, which may occur due to a cumulative shift in the trend or because of a major, unexpected event such as a severe storm.

Other issues

Interaction with IFRIC 12 Service Concession Arrangements

44. Some of the respondents raised questions about the interaction between rate regulation and the accounting for service concession arrangements in accordance with IFRIC 12 *Service Concession Arrangements*. Paragraph 3(c) of IFRIC 12 notes that a common feature of a service concession arrangement is that the “[service concession] contract sets out the initial prices to be levied by the operator and regulates price revisions over the period of the service arrangement”. This feature is confirmed within the scope criteria in paragraph 5(a) of IFRIC 12.

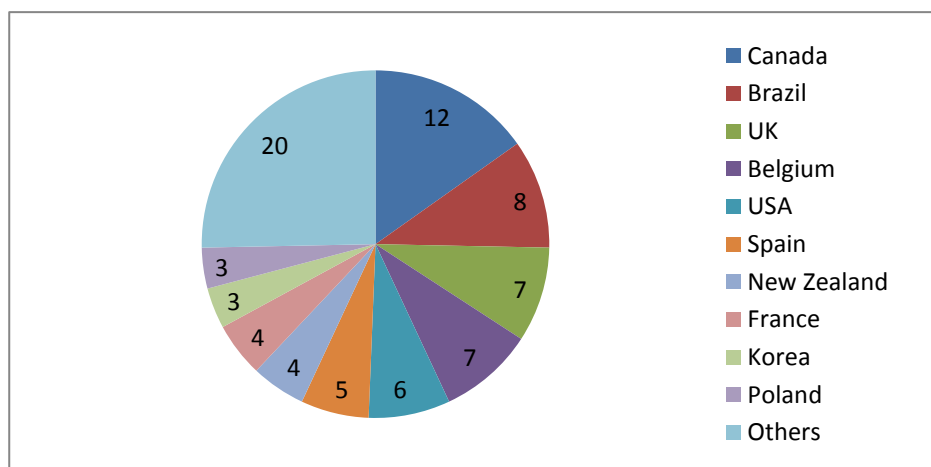
Interaction with the Exposure Draft (ED) Clarification of Acceptable methods of Depreciation and Amortisation

45. Paragraphs 19-27 of the Agenda Paper 6 for the IFRS Interpretations Committee meeting in July 2013, notes that several respondents to the Exposure Draft (ED) *Clarification of Acceptable methods of Depreciation and Amortisation*, which was published by the IASB in December 2012, noted a possible interaction between the proposals in that ED and the requirements of IFRIC 12. The ED contains a proposal to amend IAS 16 *Property, Plant and equipment* and IAS 38 *Intangible Assets*. Those respondents raised concerns about the nature of the intangible asset that arises in the context of a service concession arrangement and is recognised in accordance with IFRIC 12. One respondent thinks that the amortisation of SCAs should be analysed as part of the Rate-regulated Activities project.
46. The staff observes the comments made in the IFRS Interpretations Committee Agenda Paper 6, July 2013, and will consider the forthcoming discussions on the issue as the Rate-regulated Activities project progresses.

Appendix A: respondents by geography

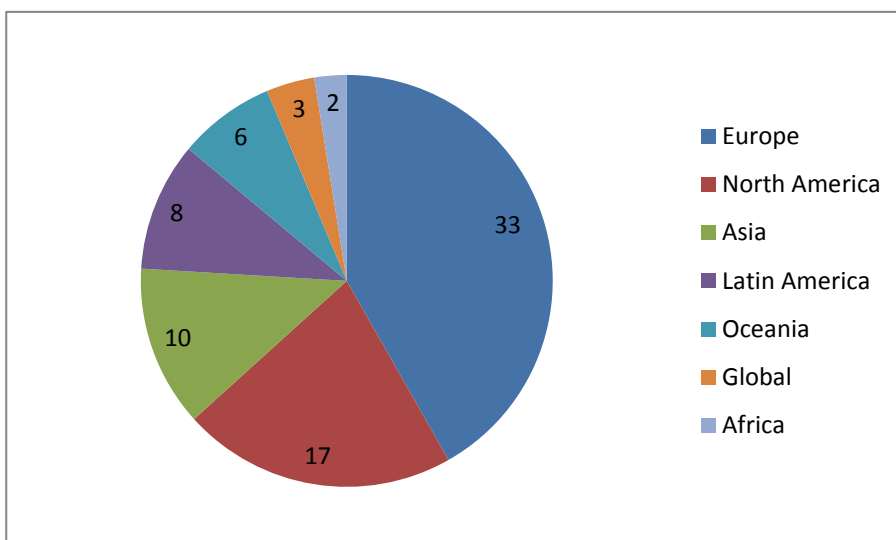
The following tables and charts summarise the geographical distribution of responses to the request for Information: *Rate regulation*.

	Country of comment letter respondent	Number of letters
1	Canada (including one 'global' response)	12
2	Brazil (a single 'form letter' was submitted by 7 of these respondents)	8
3	UK (including two 'global' responses)	7
4	Belgium (including one 'Europe' response)	7
5	USA	6
6	New Zealand	4
7	Spain	5
8	France	4
9	Korea	3
10	Poland	3
11	Australia	2
12	Denmark	2
13	Hong Kong	2
14	Japan	2
15	Malaysia	2
16	Austria	1
17	Germany	1
18	India	1
19	Israel	1
20	Italy	1
21	Netherlands	1
22	Norway	1
23	South Africa	1
24	Sweden	1
25	Zambia	1
	Total	79



Other countries for which aspects of rate regulation is described within responses from other countries (see paragraph 7 of the paper)	
1	Barbados
2	Bulgaria
3	Czech Republic
4	Lithuania
5	Slovakia
6	Ireland
7	Mexico
8	Venezuela
9	Chile
10	Argentina
11	Colombia
12	Peru

Distribution of responses by region		
1	Africa	2
2	Asia	10
3	Europe	33
4	Latin America	8
5	North America	17
6	Global	3
7	Oceania	6
	Total	79



Appendix B: Respondents by type

The following tables and charts summarise the distribution of responses to the request for Information: *Rate regulation* by type of respondent.

Academia or Think tank	1
Accountancy body	5
Accounting firm (Big 4 and others)	2
Preparer	40
Preparer / Representative body	11
Regulator / Other	9
Standard-setting body [incl. endorsement advice bodies]	9
User / representative body	2
Total	79

