

STAFF PAPER

15 November 2013

Rate-regulated Activities Consultative Group

The Appendix to this paper reproduces IASB Agenda Paper 9A, October 2013

Project	Rate-regulated Activities: Rate regulation research project		
Paper topic	Analysing the rights and obligations arising from the distinguishing features of rate regulation		
CONTACT(S)	Jane Pike	jpike@ifrs.org	+44 (0)20 7246 6925

This paper has been prepared by the staff of the IFRS Foundation for discussion at a public meeting of the IASB and does not represent the views of the IASB or any individual member of the IASB. Comments on the application of IFRSs do not purport to set out acceptable or unacceptable application of IFRSs. Technical decisions are made in public and reported in IASB *Update*.

Introduction

1. The Appendix to this paper reproduces the analysis of the distinguishing features of rate regulation and what rights and obligations might result from each of them, which was contained in IASB Agenda Paper 9A *Research project: Features of rate regulation*, October 2013.
2. In October 2013, the IASB considered that analysis and, as a result, tentatively decided that the next stage of the staff's should focus on one particular feature. This feature is a regulatory 'true-up' adjustment, which arises in a 'dual-element adjustment' type of rate-setting mechanism that is described in the following paragraphs.¹ However, the IASB would like more information about this type of true-up adjustment and the other supporting features in order to support the further analysis.

Purpose of this paper

3. The purpose of this Agenda Paper 2 is to ask the Consultative Group to assist us in prioritising the features, rights and obligations related to rate regulation in order

¹ This is the second component of the adjustment arising from what is described as a 'dual-element' rate-setting mechanism in paragraphs 30-34 of IASB Agenda Paper 9A *Research project: Features of rate regulation*, October 2013 (see the Appendix to this paper).

to identify whether a single feature, right or obligation, or a combination of specific features/rights/obligations is or are sufficient to distinguish rate-regulated activities from similar commercial activities.

4. To help focus the discussion, we would like the Consultative Group to consider whether the analysis reproduced in the Appendix to this paper:
 - (a) adequately reflects the distinguishing features of rate regulation and the rights/obligations arising from them;
 - (b) appropriately identifies the ‘true-up’ adjustment within a ‘dual-element adjustment’ rate-setting mechanism as the primary distinguishing feature of rate regulation;
 - (c) appropriately identifies the other features that are considered important to support the use of the future sales price as a practical and reliable mechanism to collect/deliver the cash flows associated with this dual-element true-up adjustment; and
 - (d) describes the features that are likely to be applicable in a wide range of jurisdictions and to a wide range of entities.
5. We have provided a more detailed summary of the ‘dual-element adjustment’ in the paragraphs below. This includes a list of the types of items that we expect to be captured within the ‘true-up adjustment but would like Consultative group members to provide us with any additional items that they would expect to be included.

The ‘dual-element adjustment’ rate-setting mechanism

6. In a competitive market, the ‘value’ of the goods or services provided is most easily identified as the market price, which reflects the interaction between supply and demand and the market participants’ willingness to buy or sell at that price. However, within the context of this analysis, rate regulation applies in circumstances in which there is no competitive market.² Consequently, the rate regulation is designed to try to establish a ‘fair and reasonable’ price to reflect the value of the goods or services supplied.

² See IASB Agenda Paper 9A *Features of rate regulation*, October 2013.

7. The form of rate regulation being addressed in this analysis incorporates a rate-setting mechanism that sets the price to be charged to customers based on two distinguishable components:
 - (a) the estimated price for the period, reflecting the estimated costs and volumes for the period; and
 - (b) an identifiable ‘true-up’ adjustment that is based on past performance and events (see paragraph 10 below).
8. We do not consider the first component (the estimated price for the period) to be a distinguishing feature of rate regulation. Entities commonly set selling prices that use estimates of costs and volumes as a starting point, which may then be adjusted to reflect market conditions. In our view, the component of the price that reflects estimated costs and volumes represents the best estimate of the ‘fair and reasonable’ price for the goods that are sold during the period.
9. Without rate regulation, most entities can make ‘real-time’ adjustments to the selling price in reaction to changes in their estimates for costs or volumes. Such real-time price adjustments are rarely available to rate-regulated entities. Consequently, in the type of rate-setting mechanism under review, the selling price is fixed until the end of the regulatory period. The permitted true-up adjustment that is related to past performance and events is then accumulated until the selling price can be adjusted at the start of the next regulatory period.
10. The purpose of the true-up adjustment is to ensure that the entity is able to earn the amount of revenue permitted by the rate regulation during the regulatory period; that is the period for which the rate calculation established by the rate regulation applies. The items that are captured by the true-up adjustment will be specified in the rate regulation. The amount of this true-up adjustment is calculated based on past performance and/or events that have arisen during the regulatory period and before the financial reporting date. The common types of items captured include:
 - (a) volume and price variances from expected costs;
 - (b) volume variances from permitted revenues;

- (c) costs (or revenues) triggered by specified events (for example, costs incurred to repair storm damage or a gain/loss incurred on disposal of property, plant and equipment);
- (d) financial bonuses awarded or penalties imposed for meeting or failing to meet a performance target; and
- (e) timing differences between amounts recognised for financial reporting purposes and those recognised for regulatory purposes. For example, a timing difference can arise when pension costs are recognised for regulatory purposes only when paid, but for financial reporting purposes the entity's defined benefit pension costs are attributed to periods of service in accordance with the plan's benefit formula, or in some cases on a straight-line basis.

Appendix: IASB Agenda Paper 9A, October 2013

- A1. This Appendix reproduces the analysis of the distinguishing features of rate regulation and what rights and obligations might result from each of them, which was contained in IASB Agenda Paper 9A *Research project: Features of rate regulation*, October 2013.

Introduction

1. At the September 2013 meeting, the IASB tentatively decided that the Discussion Paper being developed for the Rate-regulated Activities research project (the planned DP) should focus on a number of common features of rate regulation that the staff has identified as being important to distinguish rate-regulated activities from other commercial activities. These features will be the focus of the discussion as to whether some forms of rate regulation establish rights and obligations that result in the recognition of assets and liabilities in IFRS financial statements.
2. Not all forms of rate regulation will contain all of these features. Consequently, we envisage that the planned DP will explore whether all of the features, or a combination of certain features, are needed to distinguish particular forms of rate regulation that should be captured within the scope of any accounting guidance that might subsequently be developed from this project. It will also explore, as a possible alternative, whether any particular feature is sufficient, in isolation, to distinguish any particular form of rate regulation from other commercial activities or from forms of rate regulation for which specific accounting guidance is not considered necessary.
3. In this paper, we set out the distinguishing features discussed in the September 2013 IASB meeting³ and identify what rights and obligations might result from each of them.
4. We provide this analysis as background information to the accompanying Agenda Paper 9B and do not have any specific questions to ask the IASB within

³ The list of features was contained in paragraph 14 of Agenda Paper 9B, September 2013, which is reproduced in the Appendix to this paper.

this Agenda Paper 9A. However, we would be interested in any comments that IASB members have about the analysis.

Distinguishing features of rate regulation

Exclusive or near exclusive right to supply⁴

5. In the vast majority of responses to the Request for Information *Rate Regulation*, published in March 2013 (the RfI), the entities described as being subject to rate regulation have an exclusive or near-exclusive right to operate in a predetermined service territory (which is commonly delineated by geographical boundaries). Competition is restricted and any potential competitor would usually need to apply to the rate regulator or other authoritative body to seek permission to compete.
6. The exclusive or near-exclusive right may be defined by an exclusive licence agreement with the rate regulator 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*), or through legislation/regulation.

Staff analysis

7. Licences or similar agreements that restrict competition and that grant an entity an exclusive right to sell particular goods or services in a defined service territory are common. Similar types of rights are commonly found in licensing agreements for items such as motion picture films, video recordings, plays, manuscripts, patents and copyrights.⁵
8. Consequently, we do not think that the exclusive licence, concession or other regulatory agreement is sufficient on its own to distinguish rate-regulated activities from other commercial activities. However, we think that this right is still an important feature of rate regulation. This is because, in our view, it supports the rate-setting mechanisms commonly used by rate regulators to affect

⁴ Item (a) in the Appendix to this paper.

⁵ Such licensing agreements are accounted for within the scope of IAS 38 *Intangible Assets* (see paragraph 7 of IAS 38).

the amount and timing of cash flows (see the section titled “The rate-setting mechanism” later in this paper).

Essential or near-essential goods or services⁶

9. The responses to the RfI highlighted that a wide variety of goods and services are subject to some form of rate regulation.⁷ In most cases, the goods or services are considered to be ‘essential’ (sometimes termed ‘public’) or near-essential in some jurisdictions. Whether a particular good or service is described as ‘essential’ depends on a number of factors. These factors include: the level of availability compared to demand, the level of industrial development and the culture of the local environment.

Staff analysis

10. The ‘essential’ nature of the goods or services supplied does not, in itself, create any specific rights or obligations. As noted in paragraphs 13-15 of Agenda Paper 9B(i), September 2013, not all ‘essential’ goods or services are rate regulated in every jurisdiction. This is because, in some jurisdictions, there may be a plentiful supply of the essential goods or services, together with competition among suppliers. In such cases, rate regulation would be unnecessary.
11. Consequently, we do not think that the essential nature of the goods or services is sufficient on its own to distinguish rate-regulated activities from other commercial activities. However, we think that this feature is still important because, in our view, it supports the rate-setting mechanisms commonly used by rate regulators to affect the amount and timing of cash flows.⁸

⁶ Item (b) in the Appendix to this paper.

⁷ See paragraph 11 of Agenda Paper 9B(i), September 2013. The broad categories identified are: energy; water; transport; telecommunications; postal services; insurance; and other (including fertilisers, health services, cemeteries).

⁸ See the section titled “The rate-setting mechanism” later in this paper.

Obligations imposed by rate regulation⁹

12. In the vast majority of the responses to the RFI, the rate regulation described imposes significant obligations on the rate-regulated entity that would not usually be present in an efficiently competitive market. This reflects, in particular, the two common objectives of rate regulation, which are:
 - (a) to control the prices charged; and
 - (b) to maintain the quality and availability of the supply of the essential or near-essential goods or services.
13. In general, the rate-regulated entity cannot choose to stop delivering the rate-regulated goods or services, and is obliged to provide them to consumers on a non-discriminatory basis. This usually means that network access 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.

Staff analysis

Control of prices charged

14. Rate regulation that is designed to control prices charged in a market in which competition is inefficient is commonplace. Examples of such regulation include the capping of prices that:
 - (a) banks in some jurisdictions can charge for processing credit card transactions; and
 - (b) European Union (EU)-based telecommunications providers can charge for mobile telephone ‘roaming’ services such as text messaging and telephone calls made in other EU countries.
15. Such price caps restrict the prices that an entity can charge and, as a result, may affect the total amount of revenue that the entity can earn. However, it does not oblige the entity to continue to operate in the market and does not directly fix the price in order to restrict the amount of profit that the entity can earn. For

⁹ Item (c) in the Appendix to this paper.

example, a bank could charge a lower price than the maximum ‘price cap’ in order to encourage higher demand and, consequently, earn more profit.

16. Consequently, we do not think that the capping or similar restriction of prices that is applicable to all suppliers or to a specific group of suppliers in a market is sufficient on its own to distinguish such rate-regulated activities from other commercial activities.

Maintaining the quality and availability of the supply

17. However, we do think that the obligations imposed by rate regulation that relate to the maintenance of the quality and availability of the supply of the rate-regulated goods or services are an important distinguishing feature from general commercial activities. An entity that has a strong or monopoly market share can usually choose whether or not to continue in that market, or can choose whether or not to sell goods or services to individual customers or groups of customers, or can choose to provide different levels of service or quality of goods to individual customers or groups of customers. This choice is denied to an entity that is subject to rate regulation that obliges the entity to supply the rate-regulated goods or services to consumers on a non-discriminatory basis.
18. We think that the obligation to supply to all customers for the regulated price and without discrimination is an important feature of rate regulation. This feature often supports the rate-setting mechanisms commonly used by rate regulators to affect the amount and timing of cash flows.¹⁰

An ‘authorised’ rate regulator¹¹

19. The existence of a rate regulator whose role and authority is established in legislation or other formal regulations was identified, by some members of the IASB’s Rate-regulated Activities Consultative Group, as an essential distinguishing feature. This view was shared by a few respondents to the Exposure Draft *Rate-regulated Activities*, issued in July 2009 (the 2009 ED), and to the Exposure Draft *Regulatory Deferral Accounts*, issued in April 2013 (the

¹⁰ See the section titles “The rate-setting mechanism” later in this paper

¹¹ Item (d) in the Appendix to this paper.

interim ED), who raised concerns that the scope of each of those EDs might inappropriately, in their view, capture self-regulated entities.

Staff analysis

20. The existence of a rate regulator whose role and authority is established in legislation or other formal regulations does not, in our view, of itself create any specific rights or obligations for an entity subject to rate regulation. However, we think that this is an important feature to consider when analysing what rights and obligations established by the rate regulation are enforceable. This is because we think that in order for there to be a right or obligation, there has to be an enforcement mechanism external to the entity. For example, a management decision to commit to a particular course of action can, without any external interaction, be changed or reversed by the entity. Consequently, we do not think that an internal decision without an external interaction is sufficient to create an obligation.

Pricing flexibility¹²

21. The ability of the entity to have some flexibility for charging different prices is not a distinguishing feature of rate regulation. Such flexibility is commonly used by entities engaged in general commercial activities that are not subject to rate regulation. This flexibility enables entities to influence demand for the goods or services and to influence whether customers buy from the entity or would instead buy from a competitor.
22. In the context of features that we think distinguish rate-regulated activities from general commercial activities, the entity's ability to change the price of the rate-regulated goods or services is limited. If the rate regulator approves the pricing structure to ensure that the flexible pricing is consistent with criteria contained within the rate-setting mechanism, then pricing flexibility should not preclude the activities from being considered to be rate-regulated. This is because any price flexibility permitted is intended to supplement the rate-setting mechanism, but does not negate the control imposed by that mechanism.

¹² Item (e) in the Appendix to this paper.

Staff analysis

23. We do not think that pricing flexibility is either necessary or sufficient to support rate regulation, and neither is its presence relevant to the assessment as to whether such rate-regulated activities are distinguishable from other commercial activities.

The rate-setting mechanism¹³

24. The responses to the RfI identified a wide variety of rate-setting mechanisms that used a wide variety of formulae to calculate the rate to be charged to customers for the rate-regulated goods or services. However, a feature that we have identified as being an important distinguishing feature is the inclusion of an ‘adjustment factor’ within the rate formula.
25. Often, the price to be charged is initially determined by using estimated costs and volumes. The entity will typically provide budgets and forecasts to the rate regulator, setting out what costs are expected to be incurred to provide the estimated volume of goods or services in the future ‘regulatory period’.¹⁴ This period has historically been set as one year but, increasingly, is being set for longer periods, typically three to five years.¹⁵

Single element adjustment

26. In some forms of rate regulation, there is no mechanism to ‘true-up’ for differences between estimated and actual amounts for previous periods. Consequently, the entity is subject to both demand risk and cost risk and is able to earn higher or lower levels of profit than was intended by the rate regulation.
27. If, for example, the entity’s costs are higher than anticipated during the regulatory period (Period 1), it will not be able to recover the higher costs already incurred in Period 1 during the next regulatory period (Period 2). Instead, if the higher cost

¹³ Items (f) and (g) in the Appendix to this paper.

¹⁴ In some cases, the rate regulator may influence these budgets and forecasts because the entity may be obliged, through the rate regulation, to incur additional capital investment costs in order to expand or improve the supply capacity.

¹⁵ The lengthening of the regulatory period is common in more stable and mature regulatory environments where costs and volumes for demand can often be more reliably predicted. This enables detailed ‘rate reviews’ to be performed less frequently. This helps to improve the efficiency of the regulatory process, which provides cost savings that can be passed on to customers.

level is expected to continue, then this will be reflected in the budget for expected costs in Period 2.

28. Alternatively, the entity's costs may be lower than expected or the demand for the goods or services may be higher, resulting in a greater contribution to fixed costs. In both cases, the entity would earn a higher level of profit than originally expected.
29. If the differences between the estimated and actual amounts are expected to continue, this will be reflected in the budgets and forecasts used to set the price for the next regulatory period. However, there will be no adjustment to 'true-up' the difference that arose in the previous period and that relate to past performance.

Dual element adjustment

30. In other forms of rate regulation, there is a mechanism to adjust for differences between estimated and actual amounts for previous periods. This mechanism is usually designed to balance the common objectives of the rate regulator,¹⁶ which are:
 - (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; and
 - (b) to maintain the quality and availability of the supply of the rate-regulated goods or services.
31. An important factor in maintaining the quality and availability of the supply is ensuring the financial viability of the supplier. Consequently, it is common to find rate-setting mechanisms that include an adjustment for differences between the estimated and actual results of earlier regulatory periods.
32. If the differences between the estimated and actual amounts are expected to continue, this will be reflected in the budgets and forecasts used to set the price for the next regulatory period. This is consistent with the 'single element adjustment' type of regulation noted in paragraphs 27-30 above.

¹⁶ See paragraph 23 of Agenda Paper 9 *Request for Information* response summary, July 2013.

33. However, in this case, there will be a separate adjustment (or adjustments) to ‘true-up’ the experience differences that arose in the previous period. In the vast majority of cases, the rate regulation will usually use a price adjustment for future sales as a pragmatic and practical mechanism for collecting/delivering the cash flows associated with this adjustment. The rate-setting mechanism will usually determine a target period over which this ‘true-up’ adjustment will apply, which might vary from a few months to several years, depending on the nature and amount of the difference.
34. In some cases, the adjustment is linked to differences in the cost of a specific item or items, for example, the cost of fuel or staff costs. In other cases, the differences that are captured by the adjustment need not be based solely on identifiable cost differences. Instead, the adjustment may relate to a group of costs, or to a profit amount or to an incentive target. For example, the rate-setting mechanism might include a bonus or penalty adjustment based on whether the entity has achieved a target level of customer satisfaction or reliability of service.

Staff analysis

35. We do not think that a restriction on the price that can be charged to customers, using the sort of mechanism described in paragraphs 26-29 above, is sufficient on its own to distinguish such rate-regulated activities from other commercial activities. This sort of adjustment is commonly used by entities to establish the selling price for their goods, irrespective of whether or not they are subject to rate regulation.
36. However, we think that rate regulation that uses the dual element adjustment mechanism described in paragraphs 30-34 above does distinguish the rate-regulated activities subject to this type of rate regulation from other commercial activities and from other forms of rate regulation. The specific adjustment that reverses out the difference between estimated and actual amounts for the previous period(s), and/or applies a bonus or penalty for past performance is, in our view, the significant distinguishing feature of rate regulation.

Conclusion

37. We think that the combination of all of the features described above contributes in some way to distinguishing rate-regulated activities from other commercial activities. However, for the purpose of our analysis in the planned DP, we think that we should focus on the following:
- (a) a primary feature, which is the dual element rate-setting mechanism that determines the adjustment(s) that arises from past performance; and
 - (b) a group of supporting features, which collectively support the use of the primary feature as an efficient and reliable mechanism to collect/deliver the cash flows related to the adjustment.
38. Consequently, we think that the most important and unique feature of rate regulation is the dual element adjustment, that is the feature of the rate-setting mechanism that requires a true-up adjustment to be made:
- (a) for differences between estimated and actual amounts for previous periods; and/or
 - (b) to award a bonus or to impose a penalty for meeting or failing to meet a performance target (see paragraphs 33-34 above).
39. In addition, we think that the following features are important because we think that they support the use of the future sales price as a practical and reliable mechanism to collect/deliver the cash flows associated with this dual element true-up adjustment:
- (a) the obligations to maintain the quality and supply of goods or services to customers on a non-discriminatory basis (see paragraphs 17-18 above);
 - (b) the exclusive or near-exclusive right to supply the rate-regulated goods or services (see paragraph 8 above);
 - (c) the existence of an authorised rate regulator(see paragraph 20 above); and
 - (d) the essential or near-essential nature of the goods or services that are subject to rate regulation(see paragraphs 10-11 above).

Appendix : Distinguishing features of rate regulation

The following list of distinguishing features was contained in paragraph 14 of Agenda Paper 9B, September 2013. At that meeting, the IASB tentatively agreed to use these features to form the basis of the staff's analysis as to whether they create rights and obligations that result in the recognition of assets and liabilities in IFRS financial statements. The Agenda Paper references at the end of each item refer to supporting papers to Agenda Paper 9B for the September 2013 IASB meeting. :

- (a) the rate regulation must give the supplier an exclusive right or near exclusive right to provide the rate-regulated goods or services (see Agenda Paper 9B(i));
- (b) the rate-regulated goods or services are considered 'essential' or near essential, resulting in relatively inelastic demand (see Agenda Paper 9B(i));
- (c) the rate regulator imposes obligations on the supplier
 - (i) to control the prices charged; and
 - (ii) to protect the quality and availability of the supply of the regulated goods or services (see Agenda Paper 9B(i));
- (d) there must be a 'rate regulator', whose role and authority is established in legislation or other formal regulations (see Agenda Paper 9B(ii));
- (e) the entity may have some flexibility for charging different prices, but only if the rate regulator approves the pricing structure to ensure that the flexible pricing is consistent with criteria contained within the rate setting mechanism (see Agenda Paper 9B(ii));
- (f) the rate regulation requires that the mechanism for setting the future rate charged to customers reflects an 'automatic' adjustment to the rate if the revenue billed to customers is lower than, or in excess of, the amount permitted by the rate regulation (see Agenda Paper 9B(iii)); and
- (g) the formula for setting the rate consists of at least two distinct and identifiable components (see Agenda Paper 9B(iii)):

- (i) an amount based on the budgeted costs, permitted margin and predicted sales volumes for the next 'regulatory period' (this is the price (or rate) for the goods/services supplied during the future period until the rate is next reset); and
- (ii) the adjustment made to the rate for amounts based on past performance (including both variances from expected costs, permitted revenues and bonuses/penalties for meeting or failing to meet incentive targets).