STAFF PAPER

September 2013

IASB Meeting

Project	**Rate-regulated Activities: Research project**
Paper topic	Rate regulation: Scope issues

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Purpose of the paper

1. The purpose of this paper is to set out the staff's proposals to define the scope of the planned Discussion Paper that is being developed as part of the IASB's Rate-regulated Activities project (the planned DP). This planned DP will try to identify whether an accounting model should be developed for rate-regulated activities and, if so, what that model might look like.

2. The proposals (outlined in paragraphs 14-15 below) reflect our consideration of the responses to the Exposure Draft *Rate-regulated Activities*, published in July 2009 (the 2009 ED), the Request for Information *Rate Regulation*, published in March 2013 (the RfI) and discussions with the IASB's Rate-regulated Activities Consultative Group (the Consultative Group), during its first meeting in July 2013.

Background

The 2009 ED

3. The vast majority of responses to the 2009 ED commented negatively on the scope of that project. The scope of the 2009 ED proposals was set out in paragraph 3 of that ED:

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

> (a) an authorised body (the **regulator**) establishes the price the entity must charge its customers for the goods or services the entity provides, and that price binds the customers; 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. The following definitions are relevant to the scope proposals:

> **Regulator**: An authorised body empowered by statute or contract to set rates that bind an entity's customers. The regulator may be a third-party body or may be the entity's own governing board if the board is required by statute or contract to set rates both in the interest of the customers and to ensure the overall financial viability of the entity.
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> **Cost-of-service regulation:** 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. Some respondents supported a narrower scope, suggesting that it should be aligned more closely with the US GAAP requirements in SFAS 71 *Accounting for the Effects of Certain Types of Regulation* and subsequent related guidance and amendments (now Topic 980 *Regulated Operations* in the *FASB Accounting Standards Codification*®). The current scope of Topic 980 is reproduced in Appendix A for reference.

6. Many other respondents supported a broader scope, suggesting that the scope distinction separating entities as being subject to either "cost-of-service" or "incentive-based" rate regulation was an arbitrary rule.

7. Many of the respondents, however, when proposing changes to the scope, focused on their desired outcome of what types of regulation should be in or out of the scope of the ED rather than identifying a core principle. Many of those comments

referred to their existing practices and regulatory regimes when supporting their views (and whether regulatory assets and regulatory liabilities were recognised in their local GAAP)[1].

Request for Information Rate Regulation (RfI)

8. The RFI was an important step in the current IASB research project. Its intention was to assist in investigating a wide variety of rate-regulatory schemes to try to find common features that could guide the scope of any potential guidance or accounting requirements that might be produced by the IASB for rate-regulated activities.

9. All of the respondents to the RfI 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 requirements applicable to only certain types of schemes. Instead they would prefer principle-based guidance or requirements that could be applied to a wide variety of circumstances, particularly in environments where the mechanisms used for rate regulation are changing.

Messages from the July 2013 Consultative Group meeting

10. The Consultative Group members discussed some of the common features of rate regulation identified in the responses to the RfI.[2] Those responses highlight that there is a wide variety of types of rate-regulatory frameworks and schemes. Although the frameworks 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. These schemes differ from country to country and industry to 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

[1] Further details are contained in paragraphs 26-30 of IASB Agenda Paper 7: *Summary comment letter analysis*, February 2010

[2] The Consultative Group used, as the starting point for their discussion, IASB Agenda Paper 9: *Request for Information response summary*, July 2013

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 geographical constraints, different natural resource availability, etc.

11. As a result, we have been unable to identify common principles that we think could be applied to define a clear scope for the planned DP (and so for any guidance that may be developed subsequently) based on the general type of rate regulation to be applied. Consequently, the Consultative Group considered other features of rate regulation in order to identify those features that distinguish rate-regulated activities from general competitive commercial activities. The Consultative Group also considered the features of rate-regulation that earlier discussions about user needs had highlighted as being important to users in assessing the financial position and performance of rate-regulated entities.[3]

12. The main features identified by many Consultative Group members as being most relevant to the scope are:

    (a) the monopoly status of the supplier, restrictions on customer choice and the 'essential' nature of the service supporting a 'captive' customer base (ie customers cannot choose to stop using the goods/services, and nor can they choose to change suppliers);

    (b) the natural barriers to competition created by the high level of infrastructure investment needed and the physical (as well as regulatory) restrictions on redeploying it or on competitors being able to supply alternative infrastructure (for example, an electricity transmission grid);

    (c) the source of the rate regulators' authority, importance of statutory support to establish a 'true-up' process/mechanism designed to recover costs or other amounts, the reliability of those mechanisms and the interaction between the entity and the rate regulator that provide high levels of assurance that past under-/over-recoveries will be reversed; and

[3] See IASB Agenda Paper 9A: *Rate Regulation: user needs*, September 2013

(d) the impact of the rate regulation on the timing of cash flows and the level of assurance of recovery provided by the rate regulation (that is, the certainty of future cash flows), including the impact of demand/volume risk and which party (eg the government, the customers or the regulated entity) bears that risk.

13. There was also some discussion about the distinction between 'market regulation' (such as a price cap that applies to all suppliers in a competitive market) and 'rate regulation' (that is, restrictions on prices to be charged by a specific (and usually monopolistic) supplier of goods or services). Several Consultative Group members commented that the scope should focus on entity-specific regulation of prices to be charged by monopoly suppliers where the rate regulation provides a high level of certainty about future cash flows. Other types of price regulation applied in competitive markets should not be within the scope of the project. This is because such 'market regulation':

(a) is too widespread and could unintentionally capture an unmanageably wide range of industries; and

(b) does not provide the framework that establishes, for the entity, the rights and obligations that distinguish rate-regulated activities from general commercial activities. (These rights and obligations, together with the other common features proposed in paragraphs 14-15 below, provide the levels of certainty related to cash flows and earnings that we understand are important to the users of financial statements of rate-regulated entities (see Agenda Paper 9A).)

Summary

14. We propose that activities to be considered within the scope of the planned DP should be regulated within a rate-regulatory framework that meets the following criteria[4]:

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[4] If the IASB agrees that these common features are suitable for establishing the scope of the planned DP, the staff will prepare additional papers in order to facilitate further discussions about how strictly the features are to be defined.

(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).

15. In many of the examples described in the responses to the RfI, the supply of the rate-regulated goods or services requires significant infrastructure assets.

Consequently, we think that the following would be considered as typical, but not essential (see Agenda Paper 9B(i)):

(a) there is a high level of capital investment needed to develop and maintain the infrastructure necessary to provide the goods or service, which acts as a barrier to competition; and

(b) the type of infrastructure needed to provide the goods or services prevents it from being 'substituted' by a competitor or being redeployed by the supplier.

16. The following Agenda Papers set out the proposals in more detail:

(a) Agenda Paper 9B(i): *Sole supplier of essential goods*

(b) Agenda Paper 9B(ii): *Defining the rate regulator*

(c) Agenda Paper 9B(iii): *The rate-setting mechanism*

Appendix: Extract from Topic 980 *Regulated Operations* in the *FASB Accounting Standards Codification*®: Scope

980-10-15-2 The guidance in the Regulated Operations Topic applies to general-purpose external financial statements of an entity that has regulated operations that meet all of the following criteria:

a. The entity's rates for regulated services or products provided to its customers are established by or are subject to approval by an independent, third-party regulator or by its own governing board empowered by statute or contract to establish rates that bind customers.

b. The regulated rates are designed to recover the specific entity's costs of providing the regulated services or products. This criterion is intended to be applied to the substance of the regulation, rather than its form. If an entity's regulated rates are based on the costs of a group of entities and the entity is so large in relation to the group of entities that its costs are, in essence, the group's costs, the regulation would meet this criterion for that entity.

c. In view of the demand for the regulated services or products and the level of competition, direct and indirect, it is reasonable to assume that rates set at levels that will recover the entity's costs can be charged to and collected from customers. This criterion requires consideration of anticipated changes in levels of demand or competition during the recovery period for any capitalized costs. This last criterion is not intended as a requirement that the entity earn a fair return on shareholders' investment under all conditions; an entity can earn less than a fair return for many reasons unrelated to the ability to bill and collect rates that will recover allowable costs. For example, mild weather might reduce demand for energy utility services. In that case, rates that were expected to recover an entity's allowable costs might not do so. The resulting decreased earnings do not demonstrate an inability to charge and collect rates that would recover the entity's costs; rather they demonstrate the uncertainty inherent in estimating weather conditions. This requirement must also be evaluated in light of the circumstances. For example, if the entity has an exclusive franchise to provide regulated services or products in an area and competition from other services or products is minimal, there is usually a reasonable expectation that it will continue to meet the other criteria. Exclusive franchises can be revoked, but they seldom are. If the entity has no exclusive franchise but has made the very large capital investment required to provide either the regulated services or products or an acceptable substitute, future competition also may be unlikely.