

STAFF PAPER

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Project	Rate-regulated Activities: Research project		
Paper topic	Rate regulation: Sole supplier of essential goods		
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Introduction

1. As noted in paragraph 10 of Agenda Paper 9B, the IASB's Rate-regulated Activities Consultative Group members discussed some of the common features of rate regulation identified in the responses to the Request for Information *Rate Regulation*, issued in March 2013 (the RfI).¹ Two of 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
 - (b) 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.

Purpose of the paper

2. The purpose of this paper is to set out the staff's analysis of the features described above to support the staff's proposals for the scope of the planned DP related to

¹ The Consultative Group used, as the starting point for their discussion, IASB Agenda Paper 9: *Request for Information response summary*, July 2013

those features. As noted in Agenda Paper 9B, the staff propose to incorporate a number of features commonly seen in rate-regulatory frameworks into the scope of the planned DP. Consequently, the proposals in paragraphs 3 and 5 below should not be considered in isolation but should be considered within the context of the wider criteria outlined in agenda paper 9B.

Summary of proposals in this paper

3. We have considered the common features identified in the responses to the RfI in the light of the Consultative Group discussions. We propose that the activities to be considered within the scope of the planned DP should be regulated within a rate-regulatory framework that meets the following criteria:
 - (a) the rate regulation must give the supplier an exclusive or near-exclusive right (either in the form of a licence or some other regulatory action) to provide the rate-regulated goods or services (see paragraphs 7-10 below);
 - (b) the rate-regulated goods or services are considered essential or near-essential, resulting in relatively inelastic demand because customers have little or no choice but to buy the goods or services (see paragraphs 11-18 below); and
 - (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 paragraphs 19-21 below).
4. As a result of the criteria above, the demand for the regulated goods or services is relatively inelastic. This enables the rate regulator (and the entity subject to the rate regulation) to predict, with a relatively high level of confidence, the anticipated future demand for the regulated goods or services. This is usually an important feature of the rate-setting mechanism (see Agenda Paper 9B(iii)).
5. In addition, we think that the following would be considered as typical, but not essential features of the rate-regulatory environment (see paragraphs 22-24 below):

- (a) there is a high-level of capital investment needed to develop and maintain the infrastructure necessary to provide the regulated goods or services;
- (b) the type of infrastructure needed to provide the regulated goods or services prevents it from being ‘substituted’ by a competitor; or
- (c) the type of infrastructure needed to provide the regulated goods or services prevents it from being redeployed by the supplier.

Staff analysis

Exclusive right to supply essential goods or services

6. As noted above, many Consultative Group members identified the monopoly status of the supplier, restrictions on customer choice and the ‘essential’ nature of the goods or services supporting a ‘captive’ customer base as being an important common feature of the type of rate-regulatory environments that they consider should be included within the scope of the planned DP.

Exclusive right/monopoly or near-monopoly status

7. In the vast majority of responses to the RfI, the entities described as being subject to rate regulation have an exclusive monopoly or near-monopoly right to operate in a pre-determined service territory (which is commonly delineated by geographical boundaries). The exclusive 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*), 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).

8. In cases in which the monopoly right is perceived to be implicit, the related rate regulation usually imposes the same types of obligations on the supplier as those imposed through an explicit licence or similar arrangement (see paragraphs 19-21 below). In addition, the rate-regulatory framework will typically grant compensatory rights to the supplier that are again similar to those granted through an explicit licence or similar arrangement. Any potential competitor would usually need to apply to the rate regulatory or other authoritative body to seek permission to compete.
9. Consequently, we think that entities that have either an explicit or ‘natural monopoly’ right to supply the ‘rate-regulated’ goods or services should be included within the scope of the planned DP when the other scope criteria are also met.
10. The lack of competition contributes to the demand inelasticity that, in our view, is an important feature of the rate-regulatory environment.

Essential or near-essential goods or services

11. The types of industries identified in the responses to the RfI 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 transport (including toll roads, air traffic control, port and airport services);
 - (e) telecommunications;
 - (f) postal services;
 - (g) insurance; and
 - (h) other (including fertilisers, health services, cemeteries).
12. Although these categories seem quite different in kind, a common feature does link them. In each case, the goods or services are considered to be ‘essential’ (sometimes termed ‘public’) or near-essential in some jurisdictions. How essential the goods or services are considered often reflects the level of

availability compared to demand, the level of industrial development and the culture of the local environment.

13. In some jurisdictions, goods or services considered essential in nature are not subject to rate regulation because there is sufficient natural competition in supply to negate the need for such regulation. In some cases, rate regulation has been removed because changes in technology have reduced natural barriers to competition, for example in telecommunications.
14. In some cases, changes in regulatory attitudes have encouraged competition. For example, in the electricity and gas industries, vertical integration of the supply stages from extraction/generation through transport/transmission and distribution to retail supply to the end user is increasingly being broken down into separate stages. Different levels of rate regulation may then apply to the different stages.
15. Where competition is possible (commonly at the extraction/generation and retail supply stages) deregulation has sometimes occurred. However, the transport/transmission stage often remains as a 'natural monopoly' because of the high levels of infrastructure investment required, together with the physical limitations of installing alternative transport/transmission lines. Consequently, this segment of the supply chain is often still subject to rate regulation.
16. In our view, when the entity has an exclusive or near-exclusive right to supply 'essential' or near-essential regulated goods or services, this will contribute to creating a 'captive pool' of customers who have little or no choice but to buy the goods or services from the rate-regulated entity. This will result in demand being relatively inelastic. As noted in paragraph 10, this demand inelasticity is, in our view, an important feature of the rate-regulatory environment.
17. However, in some cases, judgement will be required to determine whether a good or service is 'essential' when an alternative good or service may be available but that alternative is considered too unattractive to be considered viable competition. For example, the alternative to a one-hour (rate-regulated) car ferry service may be an eight-hour road journey.
18. In our view, the scope of the planned DP should include 'essential' and 'near-essential' goods and services but should not specify the types of goods or services to be included. We think that this will not only avoid developing

guidance that might be considered as ‘industry-specific’, but is necessary to provide sufficient flexibility to reflect the very different circumstances that exist in different jurisdictions around the world.

Obligations imposed on the supplier

19. In the vast majority of the responses to the RfI, the rate regulation described imposed significant obligations on the rate-regulated entity that would not usually be present in an efficiently competitive market. This reflects, in particular, a common objective of rate regulation, which is to maintain the supply of the essential or near-essential services or goods.
20. Commonly, the rate-regulated entity is obliged to provide the regulated goods or services 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).
21. Again, this contributes to the relatively stable customer base and inelastic demand because the entity cannot choose to stop delivering the regulated goods or services.

Infrastructure restrictions

22. 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. The rate-regulatory frameworks described commonly oblige the entity to achieve specified levels of investment in the capacity and reliability of infrastructure. In many of the frameworks, the rate regulation also sets emissions and other environmental targets that must be met, which may include participation in conservation programmes or investment in the use of cleaner or more sustainable energy or material sources.
23. The level of investment needed and the associated obligations create a significant barrier to competition, which supports the monopoly status of the supplier. However, we do not consider that this is an essential feature of the rate regulation

that we think should be included in the scope of the planned DP. Natural barriers to competition caused by high levels of infrastructure investment exist in other markets but do not necessarily contribute significantly to inelastic demand.

24. Consequently, we propose to include infrastructure requirements as ‘typical characteristics’ but do not propose to include them as essential features. We think that the rights and obligations established by the rate-regulatory framework itself are more relevant to creating the features that distinguish rate-regulated activities from competitive commercial activities.

Questions for the IASB

Defining the scope: sole supplier of essential goods

1. Do you agree that the scope of the planned Rate Regulation Discussion Paper should focus on activities that are regulated within a rate-regulatory framework that meets the following criteria:
 - a. the rate regulation must give the supplier an exclusive or near-exclusive right (either in the form of a licence or some other regulatory action) to provide the rate-regulated goods or services;
 - b. the rate-regulated goods or services are considered essential or near-essential resulting in a ‘captive pool’ of customers who have little or no choice but to buy the goods or services from the rate-regulated entity; and
 - c. the rate regulator imposes obligations on the supplier to protect the availability of the regulated goods or services?
2. Do you agree that significant infrastructure requirements and restrictions should be included in the planned DP as typical characteristics but should not be required as part of the scope requirements?