

## STAFF PAPER

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## IASB Meeting

Project	Rate-regulated Activities: Research project		
Paper topic	Rate regulation: Defining the rate regulator		
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**Purpose of the paper**

1. The purpose of this paper is to set out the staff's proposals to define a "rate regulator" for the purposes of the planned Discussion Paper on Rate-regulated Activities (the planned DP).
2. Our proposed definition has changed little from the definition contained in the Exposure Draft *Rate-regulated Activities*, published in July 2009 (the 2009 ED). The 2009 ED definition was relatively uncontroversial and raised limited comments, other than those outlined in the 'Background' section below
3. We set out below our proposed definition (changes from the 2009 ED are marked, with deleted text struck through and new text underlined):

An authorised body empowered by statute or ~~contract~~ other regulation to ~~set~~ establish 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~~ other regulation to ~~set~~ establish rates both in the interest of the customers and to ensure the overall financial viability of the entity.

## Background

### ***To set rates that bind an entity's customers***

4. Some responses to the 2009 ED noted that in some rate-regulatory frameworks, the rate that is charged to customers is not “set” by the rate regulator. Instead, the rate is calculated by reference to a formula, or is proposed by the supplier, or sometimes it is negotiated between the supplier and consumer representatives. The resultant rate is then subject to an approval process by the rate regulator (see paragraphs 11-14 below).
5. In addition, the supplier may be granted some flexibility in the rates to be charged, usually within criteria set or approved by the rate regulator. Some respondents to the 2009 ED questioned whether entities that have some flexibility in pricing would be excluded from the scope (see paragraphs 15-19 below).
6. A few respondents to the 2009 ED questioned the applicability of the requirement within the definition that the rates set “bind an entity’s customers”. This was based mainly on the lack of clarity described in paragraphs 4-5 above. In addition, some respondents claimed that customers could choose whether or not to buy the regulated goods or services at the rate established by the rate regulator (see paragraph 20 below).

### ***Empowered by statute or contract***

7. The proposed definition in 2009 ED of a “rate regulator” included the term “or contract” when establishing the authority of the rate regulator. Some respondents to the 2009 ED were concerned that this term resulted in the definition being too broad. Those respondents assumed that the intention of including the entity’s own governing body was to (appropriately) capture those cases where an entity is established to carry on previously state-run monopolistic activities and would be delegated regulatory powers by the government.
8. However, the concern is that the scope could be applied, by analogy, to other commercial entities having monopolistic features. This concern was raised within the context of entities that, in the absence of an external regulator, self-regulate (for example, by formally agreeing this with investors through the articles of

association or other contractual arrangement). Entities may do this to avoid potential government intervention if they might otherwise be perceived to be abusing their strong market position. (See the analysis in paragraphs 21-23 below.)

9. In addition, there is a concern that more clarity is needed about whether other types of entity that are voluntarily ‘regulated’ by members or consumers should be included within the scope, for example, co-operatives (see paragraphs 24-32 below).

### **Staff analysis**

10. As noted in IASB 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 proposed definition of the “rate regulator” should not be considered in isolation but should be considered in the context of the wider criteria outlined in Agenda Paper 9B.

### ***To set rates that bind an entity’s customers***

11. The introduction to the Request for Information *Rate Regulation*, published in March 2013 (the RfI), defined rate regulation as “the mechanism by which a rate regulator imposes control over the setting of prices that can be charged to customers for services or products”. We think that the substance of that control is more important than the form that it takes.
12. In many rate-regulated environments, the rate regulation is designed to be transparent and, increasingly, to be seen by consumers as ‘customer-focused’. This often involves a focus on service quality, incorporating concepts of customer satisfaction and ‘value for money’ perceptions. In such environments, the supplier will submit a ‘rate application’, which proposes a rate to be charged. This is based on the formula or guidelines within the rate regulation and on the entity’s financial results, investment plans, budgets and forecasts. This is made publicly available and interested parties (primarily consumer representatives) are invited to comment.

13. One of the main objectives of rate regulation is to balance the interests of consumers and the supplier.<sup>1</sup> It is, therefore, consistent with that objective that some arbitration can take place between consumers and supplier. Ultimately, however, the rate regulator makes the final decision as to the rate to be charged in order to achieve the balance of objectives required by the rate regulation.
14. We suggest changing the term “to set” to “to establish” because this is less rigid and would incorporate the approval of a rate, as well as the setting of a rate directly by the rate regulator.

#### *Pricing flexibility*

15. In some cases, a regulator may impose a cap or other restriction on prices to be charged, without reference to the costs incurred by the suppliers of the goods or services that are subject to price-cap. For example, in Europe, there is a ‘blanket’ cap placed on mobile telephone ‘roaming’ charges across several countries; and in some jurisdictions there is a cap on the price that can be charged for processing credit card transactions. Entities have flexibility to charge lower prices than the maximum level of the capped price.
16. Usually, such price-cap mechanisms are found in markets where there is strong demand for the regulated goods or services, but there are few suppliers, each with a strong market presence. Consequently, there is only inefficient competition between suppliers, which allows them to maintain high prices in the absence of price regulation.
17. Although the goods or services subject to the price-cap may be considered essential or near-essential, the suppliers do not have an exclusive right to supply the goods. We do not, therefore, propose to include this type of price regulation within the scope of the planned DP definition of rate regulation because we consider it to be a form of market regulation. As noted in Agenda Paper 9B(i), we propose to focus the scope of the planned DP on non-competitive environments.
18. The responses to the RFI indicate that the price- or rate-setting mechanisms used by rate regulators vary widely. As well as the wide variety of formulas used to

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<sup>1</sup> See paragraphs 23-25 of IASB Agenda Paper 9: *Request for Information response summary*, July 2013

identify the price to be charged, there is a range of flexibility permitted in applying the price. Examples include:

- (a) a fixed price per unit that is charged to all customers in the whole customer base, irrespective of volume;
- (b) the whole customer base is divided into different groups of customers (for example, wholesale customers and retail customers) and a fixed price per unit is designated for each group, with that price charged to each customer within the group;
- (c) the regulator may set a maximum price, but the supplier can provide the regulated goods or services at a discount to that price – either to groups of customers or to individual customers;
- (d) the price might be set as a range of permitted prices (with a ceiling and a floor<sup>2</sup>), instead of a single point price;
- (e) the price might be set on a per unit basis according to one of the mechanisms above, but the supplier's overall revenue is capped at a maximum amount<sup>2</sup>. In such cases, the supplier may have some flexibility to adjust prices throughout the rate-regulatory period in order to achieve the permitted revenue.

19. Price flexibility is a common feature of many of the rate-regulatory frameworks described in the responses to the RfI. However, the flexibility is usually restrained by the rate-setting mechanism in order to contribute to achieving the rate-regulatory objectives. Consequently, we do not think that such flexibility should exclude the activities that are governed by that rate-regulatory framework. We think that it is sufficient that the rate regulator approves the pricing structure to ensure that the flexible pricing is consistent criteria contained within the rate-setting mechanism.

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<sup>2</sup> In limited circumstances, the rate-regulator may alternatively require the supplier to charge a rate or earn overall revenue subject to a 'floor', ie a minimum amount. This could be driven by various reasons, such as ensuring the financial viability of the supplier, restricting demand for the goods or services (eg to avoid power outages when there is a risk that demand for electricity will exceed capacity of supply or for environmental reasons, such as controlling emissions).

*Binding the customer*

20. We propose to include, within the planned DP, explanatory material to clarify what is meant by “rates that bind an entity’s customers”. In our view, the regulated rate binds the customer, because:
- (a) the consumer has no realistic alternative to purchasing the essential good or service from the entity (see Agenda Paper 9B(i), which proposes that the scope of the planned DP should focus on entities that have an exclusive or near-exclusive right to be the monopoly supplier of an essential or near-essential good or service); and
  - (b) although some negotiation may take place between consumers and the entity, the rate regulator makes the final decision as to the rate to be charged (see paragraph 13 above).

***Empowered by statute or contract****Monopolistic entities*

21. As noted in Agenda Paper 9B, rate regulation usually imposes obligations on the supplier, and grants compensatory rights to the rate-regulated entity, that distinguish rate-regulated activities from general commercial activities. These rights and obligations, together with the other common features proposed in paragraphs 14-15 of agenda paper 9B, 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). Although a “self-regulated” monopolist entity may display some similar characteristics, they are not supported by the enforceable rights and obligations that exist in a formal rate-regulatory framework.
22. The Exposure Draft of a proposed interim Standard *Regulatory Deferral Accounts*, published in April 2013 (the Interim ED), contains the same definition of a rate regulator that was proposed in the 2009 ED (see paragraph 3 above). Explanatory material in paragraph BC33 of the Basis for Conclusions on the Interim ED confirms the IASB’s previous decision that entities within the scope must be subject to formal rate regulation and that entities with monopolistic

features that are not subject to formal rate regulation cannot apply the [draft] interim Standard by analogy.

23. We appreciate the concern expressed about self-regulated entities in the responses to the 2009 ED (see paragraphs 8-9 above). This has been repeated in at least one response to the Interim ED,<sup>34</sup> which suggests that the comment in the Basis for Conclusion is not sufficiently clear. Consequently, we propose that the term “or contract” should not be included in the definition proposed in paragraph 3. In our view, this would help to clarify that commercial entities with monopolistic features that choose to self-regulate are excluded from the scope.

### **Co-operatives**

24. Some of the responses to the 2009 ED referred specifically to co-operatives and asked for greater clarity as to whether such entities should be included within the scope. Consequently, we address co-operatives here. In our view, the analysis here also applies to other types of similar entity that are voluntarily ‘regulated’ by members or consumers.
25. A co-operative is an autonomous association of persons united voluntarily to meet their common economic, social, and cultural needs and aspirations through a jointly-owned and democratically-controlled enterprise<sup>5</sup>. Co-operatives are formed for many reasons and can be of many types, such as worker, consumer, producer, purchasing, marketing, distributing, farming, electric, water or housing co-operatives.
26. Some co-operatives are formed through necessity to provide essential or near-essential goods or services, which commercial companies do not find profitable and which government is not willing or able to provide directly. For example, the cost of providing utility services such as electricity, gas, water and telecommunications in rural areas is usually much higher per consumer than in

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<sup>3</sup> Australian Accounting Standards Board

<sup>4</sup> At the time of preparing this paper, the staff had reviewed 30 comment letters received

<sup>5</sup> This definition is provided by the International Co-operative Alliance (ICA), an independent, non-governmental organisation that unites, represents and serves co-operatives worldwide. Details about the ICA can be found on their website at <http://ica.coop/en>.

towns and cities because of the cost of the infrastructure needed to deliver it and the lower population density.

27. Co-operatives are commonly self-regulated when it comes to setting prices for goods or services that they supply, which are usually supplied to the members of the co-operative. When the goods or services being supplied by the co-operative as considered essential, the self-regulatory framework is often designed around the same objectives as statutory rate regulation.
  
28. These high-level objectives, which are common to most rate-regulatory frameworks described in the responses to the RfI, 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;
  - (b) to maintain the (public ie essential or near-essential) service; and
  - (c) to provide investors with a ‘fair rate of return’.
  
29. The proposed definition in paragraph 3 above refers to the rates being set “both in the interest of the customers and to ensure the overall financial viability of the entity”. This aspect of the definition is consistent with the objectives noted in paragraph 28 above. It has not proved controversial in the past because it is recognised that the need to maintain the (public) service is an important factor that underpins the rate-regulatory environment. Consequently, it is important that the rate established by the rate regulation recognises the needs of the supplier to recover costs and to remain financially viable. This is necessary in order to ensure that the supplier is able to maintain and, when necessary, expand the availability of the regulated goods or services and at the necessary quality.
  
30. Consequently, many co-operatives that provide essential goods or services or goods are subject to some form of regulatory oversight that is designed to encourage or ensure that the co-operative provides those goods or services on a non-discriminatory basis and at a price that prevents excessive profit-making. For example, oversight may be exercised by a government department or other authorised body that provides loans, tax relief or other incentives to encourage the



co-operative to achieve similar objectives to those often identified in rate-regulatory frameworks that govern the commercial supply of essential or near-essential goods or services.

31. We propose that the definition of a rate regulator includes the term “or other regulation” in order to include in the scope, entities such as co-operatives that, although they are ‘self-regulating’, are still subject to formal oversight. We could set some criteria to help prevent unintended ‘scope-creep’ through structuring of self-regulation. For example, we could require that the co-operative or other entity:
- (a) should establish prices that balance the interest of the customers and to ensure the overall financial viability of the entity;
  - (b) is recognised by the government or other authorised body as the exclusive supplier of the essential or near-essential goods or services; and
  - (c) is subject to formal oversight by the government or other authorised body.
32. As noted previously in paragraph 10 above, other common features of rate-regulatory frameworks will also need to be present in order to include co-operatives or other such self-regulated entities within the intended scope of the planned DP.

## Questions for the IASB

### Defining the scope: the rate regulator

1. Do you agree that the ‘rate’ need not be a fixed amount set by the rate regulator but can be a flexible amount approved by the rate regulator within specified criteria in the rate-setting mechanism?
2. Do you agree that co-operatives and similar entities that self-regulate within a formal framework that is recognised and overseen by the government or other regulatory body should be included in the scope of the planned DP, but that commercial entities that voluntarily choose to

self-regulate without external regulatory intervention should be excluded?

3. Do you agree to include the proposed definition of the rate regulator in paragraph 3 within the planned DP?