STAFF PAPER

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IASB Meeting

Project	**Rate-regulated Activities: Research project**
Paper topic	Rate regulation: The rate-setting mechanism

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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 of the planned Discussion Paper on Rate-Regulated Activities (the planned DP) are:

   (a) 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

   (b) 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.

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

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 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 paragraph 3 below should not be considered in isolation but should be considered in the context of the wider criteria outlined in paragraphs 14-15 of 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 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; and

   (b) the formula for setting the rate consists of at least two distinct and identifiable components:

      (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).

Background

The 2009 ED

4. As noted in paragraph 3 of Agenda Paper 9B, the vast majority of responses to the Exposure Draft *Rate-regulated Activities*, published in July 2009 (the 2009 ED) commented negatively on the proposed scope, which was restricted to a specific type of rate regulation described as "cost-of-service regulation". Appendix A to the 2009 ED defined such rate regulation as follows:

> **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. The proposed scope of the 2009 ED expanded on that definition by including the following criterion:

> "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." (paragraph 3 of the 2009 ED)

6. Many of those responses noted that there were other types of rate regulation, generally described as either "incentive-based" regulation or "hybrid" regulation (being a combination of cost-of-service and incentive-based). In addition, those responses suggested that the economic outcome of different types of schemes was similar and that the scope distinction separating entities as being subject to either "cost-of-service" or "incentive-based" rate regulation was an arbitrary rule. Consequently, many of those responses asked the IASB to reconsider this aspect of the scope proposals.

7. Many of the responses to the 2009 ED noted that the focus on cost-of-service regulation created many problems, including:

    (a) the proposed scope is rule-based: in order to apply this in practice, a list of rules or exceptions would be needed to provide guidance that would accommodate the wide range of types of rate regulation;

(b) there is a global trend to move away from 'pure' cost-of-service regulation and increase the use of incentive-based mechanisms. Consequently, any guidance produced would only apply to an increasingly small population of entities and moving from cost-of-service regulation to another form would result in a large 'cliff-edge' for accounting for the economic impact of rate regulation;

(c) many types of rate regulation involve 'hybrid' mechanisms that use a combination of cost-of-service tools and incentive-based tools. Many respondents raised questions as to whether an entity that is subject to this type of rate regulation would be in scope or might switch in-and-out of scope;

(d) the requirement that the rate regulation should be designed to recover the entity's "specific costs" such that there is "a cause-and-effect relationship between the entity's specific costs and its revenues" also caused concerns. In many rate-regulatory schemes, there is a 'true-up' mechanism that may apply only to specified types of costs. This raised questions as to what level of true-up was needed and what level of correlation was needed between costs and revenues for the rate regulation to be within the scope of the proposals; and

(e) many respondents to the 2009 ED raised questions about the requirement for the rate-regulated entity "to earn a specified return". The 2009 ED used mixed terminology (specified, adequate, sufficient and fair return), which confused respondents and was considered by them likely to raise application problems.

8. Many of the respondents that raised the concerns above also requested that the IASB consider broadening the scope to other types of rate regulation. However, when proposing changes to the proposed scope, many of the respondents focused on their desired outcome of what types of rate regulation should be in or out of the scope rather than identifying a core principle.

Messages from the July 2013 Consultative Group meeting

9. In March 2013, the IASB published the Request for Information *Rate Regulation* (the RfI). 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 the planned DP.

10. In the first meeting of the IASB's Rate-regulated Activities Consultative Group, held in July 2013, the members discussed some of the common features of rate regulation identified in the responses to the RfI.[2] Although the rate-regulatory 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—irrespective of the general category the respondents used in their descriptions.

11. Consequently, the Consultative Group members agreed with the staff's analysis that the scope of the planned DP should not be based on a particular category of rate regulation. Instead, the Consultative Group considered other features of rate regulation in order to identify those features that distinguish rate-regulated activities from general commercial activities.

12. The main features identified by many Consultative Group members as being most relevant to the scope are listed in paragraph 12 of Agenda Paper 9B. This paper focuses on those that relate to the rate-setting mechanism within the regulatory framework, ie:

    (a) the statutory support to establish a 'true-up' process/mechanism designed to recover costs or other amounts and that provide high levels of assurance that past under-/over-recoveries will be reversed; and

    (b) 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.

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

Staff analysis

13. As noted in the summary of responses to that RfI,[3] the price- or rate-setting mechanisms that are used by rate regulators vary widely. However, a feature that is common to almost all of the mechanisms described in those responses is the use of regulatory accounts to record differences between the estimated and actual amounts for certain types of income or expenditure. There is then usually some mechanism within the rate-regulatory framework to enable or require the balance on those accounts to be recovered or reversed.

14. The common mechanisms for recovery or reversal of those regulatory accounts are set out in paragraph 40 of IASB Agenda Paper 9: *Request for Information response summary*, July 2013 and are summarised here for ease of reference:

    (a) Recovery / reversal through retrospective billing to past customers;

    (b) Recovery / reversal through adjustment to future rates;

    (c) Recovery / reversal through cash payment from or to the rate regulator or other designated body; and

    (d) Recovery / reversal by sale or transfer of the business to another entity.

15. In the responses to the RfI, we were told about a utility that was able to sell or factor a regulatory account debit balance to a bank in exchange for cash.

16. Recovery or reversal though retrospective billing to past customers or cash settlement with the rate regulator occurs rarely. The vast majority of rate-regulatory frameworks identified through the RfI rely on recovery or reversal through adjustment to future rates.

Recovery or reversal through adjustment to future rate

17. The main features of rate-setting mechanisms identified by many Consultative Group members as being most relevant to the scope of the planned DP are outlined in paragraph 12 above. The Consultative Group members consider that the rights and obligations built into the rate-setting mechanisms that incorporate

[3] See IASB Agenda Paper 9: *Request for Information response summary*, July 2013

these features are those that help to provide certainty about the amount and timing of future cash flows that relate to past transactions and events.

18. From the responses to the RfI, we have identified the following common features of the rate-setting mechanism that we think best fit those highlighted by the Consultative Group members as being important to the scope:

    (a) 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; and

    (b) the formula for setting the rate consists of at least two distinct and identifiable components:

        (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).

19. The responses to the RfI suggest that the majority of rate-regulatory frameworks require detailed records to be kept in order to clearly track costs and revenues. This facilitates not just the identification of amounts that relate to past transactions and events but also allows the rate regulator to validate those amounts. Commonly, the amounts that relate to the adjustments noted in paragraph 18(b)(ii) above are required to be recorded in designated 'regulatory accounts' in accordance with the rate regulation.

20. Commonly, the rate regulation does not permit the rate regulator to disallow or otherwise amend the amount of the balance in a regulatory account, as long as the rate-regulated entity has complied with the requirements of the rate regulation. However, to help reduce price volatility, the rate regulator usually has some flexibility to determine the time period over which the balances on those regulatory accounts are recovered or reversed. In addition, the rate regulator can determine whether interest is earned/charged on the remaining balance. However,

because the rate regulator must balance the interests of consumers and the supplier, the amount of flexibility is usually restricted by the terms of the rate-regulatory framework.

Certainty of future recovery/reversal

21. As noted above, we propose that the scope of the planned DP should be limited to rate-setting mechanisms that incorporate an automatic adjustment to be made to the rate for amounts based on past transactions, events and performance. Although some judgement may be needed to determine the amount of the adjustment (for example, whether the related costs have been ‘prudently incurred’ as required by the rate regulation), we do not think that this prevents the adjustment being considered “automatic”. Once the amount of the adjustment is determined, the volume of sales may influence the timing of the cash flows, but not the usually amount.

22. As noted in paragraphs 3-4 of Agenda Paper 9B(i), we propose that only those rate-regulated activities for which the demand for the regulated goods or services is relatively inelastic should be included in the scope of the planned DP. This inelasticity of demand 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.

23. Of course, complete inelasticity cannot be guaranteed. Sometimes, the level of demand may change from the predicted level, for example unusual weather conditions can result in a change in demand for gas or electricity.

24. A further common feature that we have seen relates to the mechanism within the rate regulation that deals with unexpected events or changes in demand. Such mechanisms again commonly trigger an automatic adjustment. In some cases, the first step in the process may be a new rate-review but we think that this review must exist in combination with a built-in process for making the adjustment. This feature reduces the rate-regulated entity’s exposure to demand risk and, therefore, increases the certainty of the amount of future cash flows related to past periods.

Questions for the IASB

Defining the scope: the rate-setting mechanism
1. Do you agree that the scope of the planned DP should focus rate-regulatory frameworks in which the rate-setting mechanism requires an automatic adjustment to be made to the rate for amounts based on past performance, such that there is a high level of certainty as to the amount and timing of related future cash flows?