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Project	**Rate-regulated Activities: Research project**		
Paper topic	A revised description of the distinguishing features of rate regulation		
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Background

1. In October 2013, the IASB discussed Agenda Paper AP9A *Features of rate regulation*. The paper described the features of rate regulation that are considered to distinguish rate-regulated activities from other commercial activities, and outlined the rights and obligations that might be created by the distinguishing features. The paper identified a specific feature that was considered to be central to distinguishing rate-regulated activities. This 'primary' feature was described as a 'true-up adjustment', in what was termed a 'dual-element adjustment rate-setting mechanism'.

2. Subsequently, the staff discussed the paper with the IASB's Rate-regulated Activities Consultative Group (the 'Consultative Group').

3. Some members of the Consultative Group expressed concerns that:

   (a) the description of the true-up adjustment and the dual-element adjustment rate-setting mechanism needs further refinement; and

   (b) the analysis of whether rate regulation might create assets and liabilities should not focus narrowly on the rate-setting mechanism but should also place more emphasis on:

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(i) the existence of an exclusive right to supply and the legally enforceable rights and obligations set out in the regulatory framework; and

(ii) the impact of rate regulation on the revenue and performance of the entity and the timing of reporting that impact.

4. The purpose of this paper is to set out our updated analysis of the distinguishing features of rate regulation.

What do we mean by rate regulation?

5. In March 2013, the IASB published the Request for Information *Rate Regulation* (the 'RfI'). For the purposes of the RfI, rate regulation was defined as "the mechanism by which a rate regulator imposes a control over the setting of prices that can be charged to customers for services or products".

6. The responses to the RfI confirmed that there is a wide variety of forms of rate regulation in force throughout the world. In some cases, the same terminology is used to describe different forms of regulation. In other cases, different terminology is used to describe similar forms of rate regulation. This has caused confusion and has made it difficult to define what is meant by the term 'rate regulation'.

7. During our research, we have identified some forms of rate regulation, which is sometimes called 'market regulation' and can be seen to apply in markets in which there is competition but the competition is inefficient. This type of rate regulation restricts the price that an entity can charge customers by establishing a cap on the price per unit. This price cap applies to all suppliers in the market. There is no price floor and no limit to the total amount of revenue that can be earned by an individual supplier. Customers have the ability to switch suppliers and an entity could obtain competitive advantage by charging less than the cap in order to achieve a higher market share and, ultimately, make more profit.

8. So far, we have not heard any requests for the IASB to develop any specific accounting guidance for this type of rate regulation, ie market regulation. Instead, the types of rate regulation that we have heard would benefit from analysis within

the IASB's Rate-regulated Activities research project are the more limited types that involve a formal regulatory pricing framework that:

(a) applies in situations in which there is little or no competition;

(b) establishes parameters for rates (sometimes referred to as prices or tariffs) that provide regulatory protections that:

   (i) support greater stability and affordability of prices for customers; and

   (ii) support the financial viability of the rate-regulated entity;

(c) establishes parameters to maintain the quality and availability of the supply of the rate-regulated goods or services and other rate-regulated activities of the entity; and

(d) creates rights and obligation that are legally enforceable and binding on the rate-regulated entity and on the 'rate regulator'.

9. Consequently, this paper focuses on describing the features commonly seen in this sort of rate-regulatory framework. These features have been filtered from a wider range of features of rate regulation identified in our research to date. This analysis is intended to capture the features that we consider distinguish this type of rate regulation from other forms of rate regulation, such as market regulation.

10. The description and filtering of the distinguishing features contained in this paper is still evolving as we continue our research. In the Discussion Paper we propose to include a description of the wider variety of features considered and why we have chosen to focus on the features described here. We anticipate that this will help to further refine the description of what we may intend to capture in any subsequent guidance that may be developed for 'rate-regulated activities'.

11. We will, in due course, also need to discuss what is meant by "little or no competition". In many cases that we have seen, there is a single supplier of an essential good or service and so the customer has little choice but to purchase from the single supplier. Although there may be some ability for the customer to reduce the volume of purchases, the essential nature means that the volume is reasonably predictable.

12. In other cases, the customer may have a limited choice—either because there is more than one supplier of the essential good or service, or because there is an alternative good or service. For example, in many countries the generation of electricity has been opened up to competition, creating more than one supplier to the grid. Initially, the government usually retains tight rate regulation over the suppliers until the quality and availability of supply and competition is considered sufficient to enable the government to either deregulate or reduce the regulation to a form of market regulation. Alternatively, there may be an alternative good or service available to the customer. For example, a customer might be able to choose to use a rate-regulated ferry service to make a one-hour journey, or could use a free road service that avoids the water route but takes five hours to reach the same destination.

13. To help focus the discussion, we aim to focus on the clearer cases in which there is a single supplier of an essential good and in which the customer has no choice but to purchase from the supplier. If the outcome of the analysis of the type of rate regulation typically found in this situation leads to a conclusion that the rate regulation creates assets and liabilities that are not already reflected in IFRS, the situations in which customers have limited choices will also need to be considered.

Market regulation

14. Although we do not think that market regulation needs any specific accounting guidance to be developed, we think it is worth outlining what we mean by market regulation to help more clearly distinguish it from the type of rate regulation that we think should form the focus of the analysis in this paper. We propose to include a fuller description of market regulation in the Discussion Paper.

15. This type of rate regulation often takes the form of a ‘price cap’ that applies to all suppliers in the competitive market. It places a maximum level on the price per unit that an entity can charge customers for the goods or services, ie a price cap, but does not set a ‘floor’ for that price. Consequently, although this type of rate regulation provides some protection for customers in the form of a capped price per unit, it does not provide any assurance to the entities in the market that they

will be able to make a reasonable return on the goods or services that are sold subject to the rate regulation. 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.

16. Using this type of rate regulation, the rate regulator does not restrict the total amount of revenue or profit that an entity can earn during the 'regulatory period' (ie the period over which the restricted price is required to be applied). Consequently, an entity may be able to gain a competitive advantage by reducing its selling price below the cap in order to gain market share and increase the volume of sales. This could result in the entity earning a higher level of revenue, which would provide a greater contribution to fixed costs and, therefore, result in the entity earning more profit.

17. However, an inefficient or weaker competitor may not be able generate an acceptable or sufficient level of profit within the price cap. Such an entity may choose to leave the market or may be forced to do so because it cannot make sufficient profit to sustain itself.

Why does rate regulation exist?

18. For the purposes of the remainder of this paper, we focus on rate regulation that establishes a legally enforceable pricing framework that:

(a) establishes parameters for rates (sometimes referred to as prices or tariffs) that provide financial protections both for customers and for the rate-regulated entity; and

(b) establishes parameters to maintain the quality and availability of the supply of the rate-regulated goods or services and other regulated activities of the entity; and

(c) creates rights and obligation that are legally enforceable and binding on the rate-regulated entity and on the 'rate regulator'.

19. This form of rate regulation is most commonly seen in situations in which the customer has little choice but to purchase the rate-regulated goods or services from a single supplier. This is because:

    (a) the goods or services are considered to be 'public services';[1] and

    (b) the rate-regulated entity is subject to little or no competition to supply the goods or services.

20. The term "public services" is hard to define precisely because of variations between jurisdictions. Public services tend to be those considered to be so essential to modern life that for moral reasons their universal provision should be guaranteed. The widespread provision of public services in developed countries usually includes gas, electricity and water services, transport, telecommunication and postal services, healthcare, education and others. Such services are still commonly provided by local or national government but private provision is becoming increasing significant in many countries. Nonetheless, such privately provided public services are often strongly rate regulated.

21. There are several ways of privatising public services, for example:

    (a) The government may establish a separate legal entity but keep ownership or voting power essentially in the hands of the government.

    (b) The entity may be sold to private investors and the government gives up direct control. Instead, the government establishes rate regulation of the type outlined in paragraph 18 in order to ensure that the entity fulfills certain public service duties.

    (c) The government may rely on a free market to provide the public services. In some countries, this free-market approach is becoming increasingly common for some types of services, such as electricity generation and supply (but not transmission) and telecommunications.

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[1] In the European Union, public services are sometimes called "services of general interest" (SGIs) or "services of general economic interest" (SGEIs).

As a result, such services are becoming deregulated or subject to 'lighter-touch' rate regulation or market regulation.

22. In some cases, the rate-regulated entity is a 'natural monopoly'. In this context, the rate-regulated entity operates in an industry in which it is most efficient for the service to be provided by a single entity. This tends to be the case in industries which are capital-intensive and require significant investment in infrastructure assets. This, together with physical constraints in constructing and placing the infrastructure assets, creates high barriers to entry. Examples of industries with such natural monopolies include public utilities such as water services and electricity transmission.

23. In other cases, there may be no natural monopoly, but the government decides to impose rate regulation to improve the quality, continuity, reliability and safety of service and to ensure that the service provision is not discriminatory among various groups of customers.

Regulatory agreements—the terms of service

24. As already noted, the type of rate regulation that we are considering in this paper applies where there the customer has little choice but to purchase the rate-regulated goods or services from the supplier. This situation commonly leads to the government considering the need for regulatory intervention. An important aspect of this intervention is the need for clear and agreed terms of service to be established in order to set out the rights and obligations of the supplier, the rate regulator (on behalf of the government) and the customers.

25. The terms of service that the entity must operate under are usually contained in an explicit licence or in the rate regulation or a combination of the two. The terms of service will include the basis for calculating the amount of revenue that the entity is entitled to earn in exchange for the services performed and/or goods provided.

26. In addition, the rate regulation will provide some regulatory protections to the supplier, including barriers to competition. These protections, together with the legally enforceable terms of service, provide the supplier with the opportunity to earn future revenue. The opportunity to earn revenue is not unique to

rate-regulated entities. Instead, other licence agreements can create similar opportunities to earn revenue.

27. The value of the opportunity to earn revenue is encapsulated in the value of the licence to operate, which may be an explicit licence or may be an implied licence contained within the rate regulation. In some cases, the entity will incur a cost to obtain or renew the licence. In such cases, the licence will be accounted for in accordance with IAS 38 *Intangible Assets*. In October 2013, the IASB expressed a preliminary view that the Discussion Paper should not, extend the discussion that was held during the previous Rate-regulated Activities project. Instead, the Discussion Paper is seeking to explore other approaches that focus on other distinguishing aspects of rate regulation and are not constrained by existing Standards.

The distinguishing features of rate regulation

28. Previously, the staff have presented summaries of what we consider to be the common distinguishing features of rate regulation.[2] In this paper, we refine our summary based on our additional research and on our discussions with the Consultative Group.

29. We continue to think that the entity's exclusive or near-exclusive right to supply the rate-regulated goods or services is an essential feature of rate regulation. This is because this we think that this situation not only contributes to the establishment of the type of rate regulation described in paragraph 18 but is also needed to ensure that the mechanism designed for recovering allowable amounts works to ensure that the rights and obligations set out in the terms of service can be achieved.

30. It is this type of rate regulation that we think creates the special economic conditions that we are being asked to examine to establish whether or not a specific accounting model is needed in order to faithfully represent the economics in IFRS financial statements.

[2] Agenda Paper (AP) 9B *Rate Regulation: Scope issues* and supporting papers AP 9B(i) *Sole supplier of essential goods*; AP 9B(ii) *Defining the rate regulator*; and AP 9B(iii) *The rate-setting mechanism*, September 2013 and AP 9A *Features of rate regulation*, October 2013.

31. We have not been able to identify common terminology to describe the type of rate regulation that we want to focus on in our analysis because the terminology commonly used (such as cost-based or incentive-based) can sometimes be confusing. This is because it does not adequately capture the features that we think are critical to distinguish rate-regulated activities from other commercial activities. The critical feature is not the rate-setting mechanism itself. Instead, it is the combination of rights and obligations established by the rate regulation that is critical. The rate-setting mechanism is, however, important because it enables the rights and obligations established by the terms of service to be enforced and settled.

32. We think that the critical form of rate-setting mechanism is seen when the rate regulation establishes the amount of ‘allowable revenue’ (sometimes called ‘authorised revenue’) and/or profit that an entity can earn in exchange for carrying out the required rate-regulated activities over a specified period of time, in accordance with the agreed terms of service. This is type of mechanism can be found in both cost-based (sometimes called ‘cost-of-service’) regulation and in incentive-based regulation. The mechanism focuses on the allowable revenue, instead of focusing primarily on allowable costs.

33. The rate-regulated activities that the entity is required to perform might not all be directly related to providing the goods or services that are invoiced to the customers. Instead, the activities may involve satisfying related government objectives such as changes to the infrastructure network (expansion, contraction, renewal or upgrading) and/or other environmental, social or economic policies.

34. Typically, the rate-setting mechanism uses an estimate of the expected quantity of rate-regulated goods or services to be delivered during the period to identify the total allowable revenue. The expected quantity and allowable revenue are then used to establish a ‘price per unit’ or a range of such prices, which is charged to customers for the duration of the ‘regulatory period’, ie the period between rate-setting reviews. This price per unit is designed to provide the entity with a billing mechanism that is intended to result in the recovery of the allowable revenue for the period.

35. Although the volume and type of services to be provided can often be reliably estimated, the actual output will vary according to a number of factors, including the occurrence or non-occurrence of contingent events that are outside the control of the rate-regulated entity. Consequently, a timing mismatch may arise because of differences between:

    (a) the variable amount of revenue that the entity is entitled to earn in exchange for carrying out the various activities that it is obliged carry out in accordance with the regulatory terms of service, ie the allowable revenue; and

    (b) the amount of revenue that the entity invoices customers in exchange for the regulated goods and services delivered, ie the billable revenue.

36. In the type of rate regulation being analysed here, there is some form of mechanism within the rate-regulatory framework that is designed to 'correct' for these timing mismatches. These mechanisms are intended to ensure that the rate-regulated entity earns no more and no less that the amount of allowable revenue and/or profit that it is entitled to earn during the regulatory period in accordance with the terms of service. However, this does not require there to be a full 'euro-for-euro' or 'dollar-for-dollar' true-up adjustment.

37. For the sake of efficiency and cost-benefit considerations, the rate regulation will allow some variances or revenue mismatches to 'flow through', without correction. Typically, these types of variances would not be significant in relation to the overall level of costs incurred or the level of allowable revenue.

38. We do not think that this should exclude the rate regulation from the scope of our analysis, but we would not expect that any variances that flow through without correction would be recognised as regulatory balances. Instead, they would also flow through the profit or loss account as they arise, unless they are permitted or required to be recognised as other assets in accordance with IFRS.

How does rate regulation settle revenue mismatches?

39. The most common method used for recovering or refunding the amount of the timing mismatch is to adjust the price for future sales in order to eliminate the

mismatch over a suitable period of time. The length of time usually depends on a number of factors, including the size of the mismatch, the ability of customers to absorb a price increase, the ability of the entity to fund price restrictions, etc.

40. The rate regulator is usually able to use future sales as a practical, low-cost and reliable mechanism for ensuring that the entity can recover the amount of any under-invoicing or refund the amount of any over-invoicing. This is because the mechanism is supported by the other distinguishing features of this type of rate regulation, in particular:

    (a) the exclusive or near-exclusive right to supply the rate-regulated goods or services; and

    (b) the public service or near-essential nature of those goods or services.

41. These two features contribute to relatively inelastic demand and a high level of predictability of the timing and probability of reversal through future sales.

42. In some, albeit rare, cases, the timing mismatch will be settled directly with the rate regulator. This means that the entity will pay cash to, or receive cash from, the rate regulator or other designated body, depending on whether the entity has invoiced more, or less, revenue to customers than the allowable revenue that relates to the activities it has completed during the regulatory period in accordance with the terms of service.

43. In other, again rare, cases, the entity will raise additional bills or credit notes to specific customers or groups of customers that had purchased the rate-regulated goods or services from the entity in the past. The amounts billed or credited will equal the value of the timing mismatch and will be allocated to the customers in proportion to their past purchases during the regulatory period.

44. The forms of retrospective correction of mismatches described in paragraphs 42 and 43 are rare because, in many rate-regulatory environments, such retrospective rate-setting is prohibited by law or explicitly by the rate regulation itself. In the rare situations where the revenue mismatch is settled directly in cash or through retrospective billing adjustments, it is generally accepted that the amounts receivable or payable will be accounted for as financial assets and liabilities in

accordance with IFRS 9 *Financial Instruments*.[3] Consequently, no specific accounting problems are expected to arise in these cases.

Conclusion

45. We recommend that the IASB should focus on the type of rate regulation described in this paper in order to progress the analysis as to whether rate regulation creates assets and liabilities in addition to those already recognised in accordance with IFRS for non-rate-regulated activities. We acknowledge that, depending on the outcome of that analysis, we may need to consider variations in the type of rate regulation at a future date. However, at this time, we think that keeping a narrower focus on a simpler set of fact patterns will provide a clearer basis on which to develop the Discussion Paper.

46. Consequently, Agenda Papers AP9C and AP9D are based on this type of rate regulation, which is most commonly seen in situations in which the customer has little choice but to purchase the rate-regulated goods or services from a single supplier. This type of rate regulation involves a formal regulatory pricing framework that:

    (a) applies in situations in which there is little or no competition;

    (b) establishes parameters for rates (sometimes referred to as prices or tariffs) that provide regulatory protections that:

        (i) support greater stability and affordability of prices for customers; and

        (ii) support the financial viability of the rate-regulated entity;

    (c) establishes parameters to maintain the quality and availability of the supply of the rate-regulated goods or services and other rate-regulated activities of the entity; and

    (d) creates rights and obligation that are legally enforceable and binding on the rate-regulated entity and on the 'rate regulator'.

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[3] For entities that do not yet apply IFRS 9 *Financial Instruments*, any reference to IFRS 9 should be read as a reference to IAS 39 *Financial Instruments: Recognition and Measurement*.

47. In addition, the rate regulation establishes the amount of 'allowable revenue' and/or profit that an entity can earn in exchange for carrying out the required rate-regulated activities over a specified period of time, in accordance with the agreed terms of service. There is, consequently, a mechanism for adjusting the price to be charged to customers for future sales in order to correct mismatches between the allowable revenue and the billable revenue. This mechanism will ensure that the rate-regulated entity earns no more and no less that the amount of allowable revenue and/or profit that it is entitled to earn during the regulatory period.

Questions for the IASB

Does the IASB have any comments or questions on the description of the type of rate regulation that we recommend should form the focus of the next steps in our analysis?

Does the IASB agree with our recommendation to focus on this type of rate regulation for the time being?