

March 2013

Request for Information

Rate Regulation

Comments to be received by 30 May 2013

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Published by the International Accounting Standards Board
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Introduction

For the purpose of this Request for Information, rate regulation is 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. It is widespread and has a significant impact on the timing and amount of revenue of many rate-regulated entities. In some jurisdictions, national GAAP permits or requires entities to recognise the effects of some aspects of the rate regulation in the financial statements of rate-regulated entities. There is no equivalent specific guidance in IFRS.

In July 2009 the IASB published the Exposure Draft *Rate-regulated Activities* (the '2009 ED'), which focused on a particular type of rate-regulatory scheme (a cost-of-service scheme). Respondents to the 2009 ED expressed divergent views as to how the consequences of rate regulation should be reflected in financial statements, if at all. Those responses highlighted that there are many types of rate regulation. They suggested that the scope of the project should be expanded to look at a wider variety of rate regulation in order to identify common characteristics from which accounting guidance might be developed. A consensus could not be reached at that time and the project was suspended in September 2010.

In the light of feedback received from its three-yearly agenda consultation, the IASB has decided to restart the Rate-regulated Activities project. We aim to develop a Discussion Paper that will identify and more clearly articulate:

- (a) the common features of rate regulation;
- (b) whether these common features create economic resources for, or claims against, a rate-regulated entity that should be recognised in IFRS financial statements; and
- (c) the information about the consequences of rate regulation that would be most useful for users of IFRS financial statements.

An early step in this process to develop the Discussion Paper is to identify the range of rate-regulatory schemes that stakeholders think should be included within the scope of the project. This Request for Information (RFI) will help us in this process.

At this stage, we are not seeking views about whether the features of rate regulation create assets and liabilities that can or should be recognised in IFRS financial statements. We are seeking high-level overviews of the types of rate regulation that are currently in force in order to provide factual evidence and examples on which to base our work. We will seek views on specific proposals at a later stage.

This public consultation will permit everyone in the IFRS community to provide information that will then be used in the IASB's review of rate regulation. The process is an entirely open one—all responses received will be published on the IASB's website. We also will seek to supplement information from this RFI with interviews and research on publicly available descriptions of significant rate-regulatory schemes.

Background to the Rate-regulated Activities project

The IASB is undertaking research to identify the common features of rate regulation to help it analyse the specific rights and obligations created by rate regulation. We will use the information gathered through this RFI process to help to determine the scope of a Discussion Paper. This will, in turn, help us to consider what information about the consequences of rate regulation would be most useful for users of IFRS financial statements and whether to develop specific guidance for accounting for the consequences of rate regulation.

Rate regulation

When there is a lack of effective competition to constrain the prices (rates) that an entity can charge to provide essential goods or services, the resulting monopoly or dominant market position gives that entity excessive market power. In such cases, governments might impose rate regulation. This is usually done by setting up an authorised body (the rate regulator) and giving it the power to restrict the rates of a specific entity or categories of entities (for example, electricity distribution utilities or providers of public transport services).

The most common, high-level objective of rate regulation is to set ‘just and reasonable’ rates, ie rates that balance the interests of both the rate-regulated entity and the entity’s customers. The way that rate regulation is structured (ie the rate-setting mechanism) will reflect the more detailed objectives of the rate regulation, which vary. For example, the objectives of some rate-regulatory schemes focus on allowing the rate-regulated entity to recover its ‘allowable’ costs, plus a reasonable return on those costs. Other rate-regulatory schemes may try to encourage the rate-regulated entity to maximise efficiency to reduce costs and thereby reduce prices that are charged to end-users of the rate-regulated goods or services.

In other cases, the rate-setting mechanism reflects objectives that aim to influence the behaviour of the rate-regulated entity or its customers and thereby influence the levels of supply or demand. For example, the rate regulator might design the rate-setting mechanism to encourage the rate-regulated entity to invest in infrastructure in order to increase supply capacity or reliability. Alternatively, the rate regulator might want to curb demand and so might inflate the prices charged to customers. Understanding the objectives behind the rate-setting mechanism is an important factor when analysing the nature of the rate-regulatory scheme and the rights and obligations that it creates.

Requests for guidance

The IASB and the International Financial Reporting Standards (IFRS) Interpretations Committee (‘the Interpretations Committee’) have received requests for guidance on whether rate-regulated entities can or should recognise, in their IFRS financial statements, the balances of ‘regulatory deferral (or variance) accounts’, often called ‘regulatory assets’ and ‘regulatory liabilities’. In some types of rate-regulatory schemes, these regulatory deferral account balances arise because of timing differences between the recognition of various costs (or income) for the purposes of IFRS financial reporting and for the rate-setting mechanism.

In June 2005, the Interpretations Committee received a request about the requirements in US Financial Accounting Standards Board (FASB) SFAS 71 *Accounting for the Effects of Certain Types of Regulation*.¹ The submitter asked whether an entity could recognise regulatory assets in IFRS financial statements by applying SFAS 71 in accordance with the hierarchy in paragraphs 10–12 of IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors* when selecting an accounting policy in the absence of specific guidance in IFRS.

The Interpretations Committee concluded that the requirements of SFAS 71 were not indicative of the requirements of IFRS, because applying SFAS 71 would result in the recognition of regulatory deferral (or variance) account balances as assets or liabilities in some cases in which those balances would not meet the recognition criteria of relevant Standards. Consequently, the Interpretations Committee concluded that entities applying IFRS should recognise regulatory assets only to the extent that they meet the criteria to be recognised as assets in accordance with existing IFRS.

Further requests led the IASB to add the project to its technical agenda in 2008 and to publish the 2009 ED. The comment period for the 2009 ED ended on 20 November 2009 and we received 156 comment letters. The IASB could not reach a consensus at that time and the project was suspended in September 2010.

Why we are developing a Discussion Paper

The 2009 ED started from the premise that regulatory deferral (or variance) account balances should be recognised in specified circumstances. It explained the rationale for this, which was focused on a strict, cost-based rate-setting mechanism that has a predictable and clearly identifiable causal effect between costs incurred and the rates charged to, and collected from, customers. However, the responses received suggested that a more fundamental discussion was needed as to whether this was the right starting point. In particular, many responses questioned the principles behind the proposed approach, suggesting instead that the proposals were rule-based and applicable to only a narrow range of circumstances.

The IASB has decided to develop a Discussion Paper in order to explore whether the features of rate regulation can be analysed further to identify, at a more fundamental level, the common features that create rights and obligations. The IASB can then consider whether such rights and obligations satisfy the definitions of assets and liabilities in the IFRS *Conceptual Framework*. If they do not, then the IASB can consider the best course of action and whether information about the rights and obligations should be required to be disclosed. Alternatively, some respondents to the 2009 ED suggested that some items should be recognised in the statement of financial position even if they do not meet the definition of assets and liabilities.

Currently, the IASB is developing a Discussion Paper on the *Conceptual Framework*, which includes a reconsideration of the definitions of assets and liabilities. The fact patterns identified through this RFI, and other research on the features of different rate-regulatory schemes, will be tested against the existing definitions of assets and liabilities, and will be used when discussing possible changes to the definitions of assets and liabilities being developed in the Conceptual Framework project.

¹ The guidance in SFAS 71, together with subsequent amendments and related guidance, has now been incorporated into Topic 980 *Regulated Operations* in the *FASB Accounting Standards Codification*[®].

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The IASB is seeking examples of rate-regulatory schemes to help identify both the range of approaches and the common features of such schemes in order to inform our further analysis. To assist in focusing our research, we are seeking only a high-level overview of the rate regulation requirements. It would be helpful if responses could indicate where we could obtain more detailed information if we decided to do more research on any particular rate-regulatory scheme.

It will be most helpful if respondents focus on the types of rate regulation that they think would be useful for us to consider in the Discussion Paper (ie the types of rate regulation for which some consequences might be relevant to IFRS financial statements). If respondents think that a particular type of rate regulation should not be considered in the Discussion Paper, then indicating this in your response will also be useful to us.

You do not have to answer every question and you are encouraged to comment on any additional matters that you think are relevant to our research of the common features of rate regulation. If you would like to address more than one rate-regulatory scheme, it would be helpful if you would address each scheme separately.

We will consider all responses received by **30 May 2013**.

1. The regulated industry and why it should be considered

Rate regulation is widespread and affects industries across many jurisdictions. It would be helpful if respondents indicate whether they think that recognising, in IFRS financial statements, the effects of the rate-regulatory scheme being described would provide relevant information about the consequences of rate regulation to users of financial statements. It is easier for us to understand the information that you give us if we know what industry the rate regulation relates to.

Question 1

For the types of rate regulation that you think would be useful for us to consider in the Discussion Paper (or would not be useful to consider, if applicable), what types of goods or services are subject to the rate regulation being described?

In providing this information, please also tell us:

- (a) whether you are a rate-regulator, a financial statements preparer, auditor, user or other (please specify);**
- (b) what jurisdiction the rate regulation that you are describing is in;**
- (c) whether that jurisdiction is a recent adopter of IFRS; and**
- (d) whether the main suppliers of the rate-regulated goods or services (ie the rate-regulated entities), including your company if applicable, are predominantly private-sector entities, government entities or closely related to the rate regulator.**

If the jurisdiction has not adopted IFRS, your views are still useful to us. It would be helpful if you could include information about what local GAAP is applied and how the effects of the rate-regulatory scheme are reported in accordance with that local GAAP.

2. The objectives of the rate regulation

The objectives of rate regulation are influenced by many factors, such as the nature of the goods or services that are being provided, the economic climate, environmental factors, etc. It is useful to know the high-level objectives of the rate regulation under review because those objectives will influence the nature of the rate-setting mechanism employed by the rate regulator.

The objectives of rate regulation may change over time. We are most interested in your current situation but it would be helpful if you could indicate whether there has been a recent change or a trend towards alternative objectives.

Question 2

What are the objectives of the rate regulation and how do they influence the interaction between the rate regulator, the rate-regulated entity and customers?

In providing this information, please tell us:

- (a) what are the high-level objectives of the rate regulation (for example, to restrict prices or to influence the levels of supply and demand or to restrict or encourage competition); and**
- (b) how these objectives are reflected in the nature of the rate-setting mechanism? For example, to what extent:**
 - (i) is the rate-setting mechanism designed to give the rate-regulated entity a 'fair rate of return' (for example, a cost-plus mechanism) or is the focus more on reducing the cost to customers (for example, a price-cap or other incentive-based mechanism);**
 - (ii) are there incentives to meet targets that are not directly related to the cost-rate relationship (for example, efficiency, service levels, infrastructure investment, increased supply capacity or reliability, use of alternative resources or reduction in customer demand or usage);**
 - (iii) does the rate regulation fix the price per unit or does it provide some flexibility for the entity to set prices (for example, through price ranges or caps, based on either unit prices or total revenue or total profitability); and**
 - (iv) are there other aspects of the rate-setting mechanism that reflect any specific objectives not envisaged above?**

3. The rights and obligations established by the rate regulation

Information about the nature and amounts of a reporting entity's economic resources and claims can help users to identify the reporting entity's financial strengths and weaknesses.² It is important for us to understand what rights and obligations are commonly established by rate regulation so that we can identify more clearly the types of economic resources and claims that might arise. At this stage, we are looking for a factual summary of the rights and obligations created by the rate regulation. We are not asking respondents to analyse

² Paragraph OB13 of the *Conceptual Framework*.

whether those rights and obligations should be recognised as assets and liabilities in IFRS financial statements. That analysis will be done when developing the Discussion Paper.

Question 3

What sort of rights or obligations does the regulation create?

In providing this information, please consider:

- (a) whether the rate-regulated entity has an exclusive right to operate in the market;
- (b) if the entity's right to operate in the market is established by licence:
 - (i) is there a cost to acquire the licence; and
 - (ii) can the licence be revoked, renewed or transferred;
- (c) how competition is excluded or encouraged;
- (d) how the rights and obligations are expressed, for example, as a cap on the rate of return, as the right to recover entity-specific costs, as a right to recover an allowed level of costs (whether or not incurred by the entity), or as a right to recover specific types of costs without limit if and when incurred; and
- (e) whether the entity can choose to stop providing the goods or services that are subject to rate regulation and, if so:
 - (i) how is this achieved; and
 - (ii) what are the consequences for the entity?

4. The enforcement of rights and obligations

To help us to identify what features of the rate regulation might create economic resources for or claims against the rate-regulated entity, it is important for us to understand how the rights and obligations established by the rate regulation are enforced or settled respectively.

Question 4

For the rights and obligations identified in response to Question 3, how does the rate-regulated entity enforce its rights, or how does the rate regulator enforce the settlement of the rate-regulated entity's obligations?

In providing this information, please tell us:

- (a) does the rate regulation provide for retrospective recovery or reversal of under- or over-recoveries of allowable costs? If so, how is this achieved, for example through cash payments or other asset transfers to or from parties outside the rate-regulated entity (such as individual customers or groups of customers, the rate regulator or the government);
- (b) are the rights and obligations separable from the business; and
- (c) what happens to the rights or obligations when the entity ceases to provide the rate-regulated goods or services?

5. The recovery or reversal of cost and income variances

We understand that, in many rate-regulatory schemes, the rate-setting mechanism uses estimates of future costs and income as well as actual costs incurred. In such circumstances, the rate regulator usually requires that the rate-regulated entity must keep records of variances between the estimated and actual amounts. These variance amounts are then recovered or reversed over an agreed period of time through inclusion in the calculation of future rates, either automatically or with the approval of the rate regulator.

Irrespective of whether these variance amounts are recognised in general purpose financial statements, we want to learn more about the effectiveness of the rate regulation in ensuring their recovery or reversal, particularly when there have been shifts in demand for the regulated goods or services.

Question 5

How does the rate regulation ensure the recovery or reversal of under- or over-recoveries of allowable costs (ie variance amounts) (if applicable)? Are these mechanisms effective in recovering or reversing those amounts within the targeted time frame?

In providing this information, please tell us:

- (a) what is the mechanism for tracking the recovery or reversal of such variance amounts;**
- (b) how does the rate-setting mechanism adjust for unexpected changes in demand for the rate-regulated goods or services;**
- (c) has there been a recent trend whereby the balances of the variance amounts have been increasing? If so:
 - (i) is this caused by an increase or a decrease in the demand of the rate-regulated goods or services;**
 - (ii) has the trend resulted in a net debit position (ie under-recovery of costs) or a net credit position (ie over-recovery of costs); and**
 - (iii) what are the main components of the variance amounts (ie what are the main categories of cost or income variances)?****

Respond in writing

The IASB invites responses to this RFI until **30 May 2013**. Instructions for submitting a response can be found at <http://ifrs.org/Current-Projects/IASB-Projects/Rate-regulated-activities/Request-for-information-March-2013/Pages/Request-for-Information-and-comment-letters.aspx>

All responses are public documents and will be published on our website.