

Issues Paper – IASB Request for Information *Rate Regulation*

Introduction and background

- 1 The purpose of this issues paper is to outline proposed responses to the questions in the request for information (RFI) (see Agenda Paper 12.3) and decide whether there are any other matters that should be included in the AASB's submission on the RFI. This paper is structured to broadly correspond to the questions asked by the IASB in the RFI.
- 2 At the date of writing this paper, no comment letters have been received from constituents. The comments below reflect feedback received based on limited targeted outreach by AASB staff to large accounting firms in Australia. AASB staff have focussed outreach on rate-regulation in which prices are set on a multi-year basis, rather than on a yearly basis.
- 3 Staff are continuing to undertake outreach, and have a number of outreach meetings scheduled prior to the AASB meeting in May. Staff will raise at the Board meeting any additional feedback received subsequent to writing this paper.

Types of goods or services subject to rate regulation

- 4 Based on the feedback received to date, it is our understanding that the key industries subject to rate regulation in Australia are:
 - (a) electricity transmission and distribution networks;
 - (b) gas transmission and distribution pipelines;
 - (c) water; and
 - (d) some railways.
- 5 The IASB RFI is not clear as to whether the intention of the IASB is to scope out entities within the scope of IFRIC 12 *Service Concession Arrangements*. There are a number of entities, such as those entities responsible for toll roads, that would appear to meet the IASB's working definition of 'rate regulation' that are currently within the scope of IFRIC 12.

Objectives of the rate regulation

- 6 Based on the feedback received to date, it is our understanding that rate regulation occurs in Australia when there is deemed to be insufficient competition in an industry. In such circumstances it is considered that there is a risk there could be no market restraint of price in the absence of rate regulation. That is, the objective of the rate regulation is to help ensure the customer is not overcharged for the service provided by the entity.
- 7 A general criterion for regulation is whether it is difficult for other entities in the industry to duplicate the services provided by the entity/ies subject to the regulation (i.e. high barriers to entry).

Rights and obligations created by the regulation

- 8 Based on the feedback received to date, we were informed that there are three broad types of rate regulation in Australia described as:
- (a) *Access undertakings* – arrangements (including prices) between two parties that may be approved by a regulator, or negotiated between the parties. For example, a mining entity may build a railway to a mining tenement. A second mining entity may wish to be granted access to the railway. If the parties are not able to negotiate a pricing arrangement for access to the railway a regulator may need to step in to provide a price for the access.
 - (b) *Access arrangements* – arrangements in which the regulator is the arbitrator. In these cases the regulator sets standard prices that are regulated. An example of this may be Pharmaceutical Benefits Scheme prices for medicines.
 - (c) *Access regimes* – arrangements in which the regulator regulates standard terms and conditions in addition to the price. Prices are set within constraints and are applicable to all customers. Access regimes may be price capped or revenue capped.

Price capped access regimes

- 9 Based on the feedback received to date, it is our understanding that most rate regulation in Australia is price capped access regime. That is, entities are able to charge a maximum average price for the period. This is calculated as:

$$\text{Revenue} / \text{Forecast volume}$$

If volume changes, the revenue will also change, therefore the business takes volume risk.

- 10 In price capped access regimes, inputs to determine revenue assumptions (on which the maximum average price is determined) are based on a 'Building Block Approach'. The building blocks to price determination include:

- (a) Depreciation
- (b) Return on capital investment
- (c) Cost of tax
- (d) Operating and maintenance costs

- 11 These costs are projected out over a period of time, say five years, present valued and prices are then determined. Prices are usually set in a way that results in a smooth increase over time.

- 12 An example of this form of regulation in Australia is water regulation. Water regulation is on a 'cost plus' basis. Regulation is for a period of five years with a submission prepared to the regulator based on prediction of future expenditure. There is no 'look back' to true up based on previous experience. The biggest impact on prices is the volume of water taken/expected to be taken; however, cost is also influenced by the source of the water, i.e. whether it is sourced from a water storage dam or a desalination plant.

Enforcement of rate-regulated entity's obligations

- 13 We were informed that enforcement of regulated entity obligations arising from price regulation in Australia is via the Australian Competition Consumer Commission (ACCC), an independent authority of the Australian Government. The Australian

Energy Regulator (AER) regulates Australia's energy market. The AER is an independent statutory authority of the Australian Government.

Recovery or reversal of under or over recoveries of allowable costs

- 14 Based on the feedback received to date, it is our understanding that if a regulated incurs costs greater than forecast they are generally not able to pass the additional costs through to customers. In addition, businesses are only able to recover 'efficient' cost, not all costs.
- 15 A current exception to this in Australia is regulation in the electricity industry. In this industry the process for determining prices has regard to capital expenditure. If an entity has more capital expenditure than expected during the regulation period (five years) the entity cannot recover the costs during that five years, but they are able to include some of the costs in the cost base for the following five years¹.
- 16 In some cases, electricity entities may also benefit from an efficiency carry-over. This encourages utilities to achieve cost savings without eroding the cost base. For example, if the regulator accepts a cost base for a period of \$100 and the entity achieves \$95, the entity will retain (via a formula) part of this saving in the following reset cost base.

Question to the Board:

Do you have any comments on the description of rate regulation in the Australian environment noted above?

1 Note that the national electricity rules are currently undergoing changes such that potentially the regulator will retrospectively decide whether this expenditure is efficient expenditure before permitting it to be included into the subsequent cost base.