



**Australian Government**  
**Australian Accounting  
Standards Board**

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7 June 2013

Mr Hans Hoogervorst  
Chairman  
International Accounting Standards Board  
30 Cannon Street  
London EC4M 6XH  
UNITED KINGDOM

Dear Hans

**IASB Request for Information: *Rate Regulation***

The Australian Accounting Standards Board (AASB) is pleased to respond to the IASB's Request for Information *Rate Regulation*. In formulating this response, the AASB sought and considered the views of Australian constituents received through targeted outreach.

In developing the responses to the questions in the Request for Information, the AASB has identified a number of industries in which prices are regulated, even in competitive environments. However, based on the feedback received by the AASB, the price regulation in very few of these industries results in rights or obligations.

AASB comments relating to issues relevant to the specific questions set out in the Request for Information are provided in Appendix A to this letter.

If you have any queries regarding any matters in this submission, please contact Nikole Gyles (ngyles@asb.gov.au).

Yours sincerely

A handwritten signature in black ink that reads 'K.M. Stevenson'.

Kevin M. Stevenson  
*Chairman and CEO*

## **Appendix A**

### **Types of goods or services subject to rate regulation**

Based on feedback received, the AASB understands that the key industries subject to rate regulation in Australia include:

- electricity transmission and distribution networks;
- gas transmission and distribution pipelines;
- fixed-line telecommunications;
- water authorities;
- port authorities;
- some railways;
- some public transport arrangements, including buses and taxis;
- basic letter rate postal services;
- private health insurance; and
- some cemeteries.

The AASB notes that the IASB RFI is not clear as to whether the IASB intends 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**

Based on the feedback received, the AASB understands that rate regulation often 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.

A general criterion for regulation is typically whether it is difficult for other entities in the industry to duplicate the services provided by the entity subject to the regulation (i.e. high barriers to entry).

A further objective of some rate regulation is a matter of social policy such that services are provided to everyone at affordable rates; for example, postal services. In other cases, the objective of the regulation may be partly social policy (potentially resulting in cross subsidisation from one cohort e.g. in capital cities to another cohort e.g. in rural areas) and partly prevention of price gouging.

### **Rights and obligations created by the regulation**

Based on the feedback received, the AASB understands that there are three broad types of rate regulation in Australia, described as:

- *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.
- *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.
- *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*

Based on the feedback received, the AASB understands that most rate regulation in Australia of an 'access regime' type is price capped. That is, entities are able to charge a maximum average price for the period. This is calculated in such a way that, if volume changes, total revenue also changes, and therefore the business takes volume risk.

In price capped access regimes, inputs to determine the maximum average price are based on a 'Building Block Approach'. The building blocks to price determination include:

- Asset depreciation costs
- Return on capital investment
- Cost of tax
- Operating and maintenance expenditure

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.

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.

A further example of this is electricity supply in the Australian state of Queensland. This regulation is based on retail operating costs (ROC), plus a retail margin. The ROC is the cost of services provided by a retailer to its customers. The same allowance is applied for all retailers. The retail margin represents the reward to investors for the retailer's exposure to systematic risks associated with providing customer retail services. The retail margin is set on an earnings before interest, tax, depreciation and amortisation (EBITDA) basis. The same margin is used for all retailers and is applied on the applicable cost pass through component (e.g., fixed network cost plus fixed retail cost, or variable network cost plus variable energy cost). Adjustments for cost of transmission and distribution to make up for under-recovered revenue in earlier years due to lower than forecast consumption are included in the network costs and treated as a pass through. Retailers will effectively earn

or lose a margin on these adjustments as the retail margin is based on network costs passed through.

### **Enforcement of rate-regulated entity's obligations**

The AASB was informed that enforcement of regulated entity obligations arising from price regulation in Australia at a federal level 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.

In addition, there are a number of state-based regulators, including:

- Queensland Competition Authority;
- Essential Services Commission, Victoria;
- Independent Pricing and Review Tribunal, New South Wales;
- Economic Regulation Authority, Western Australia;
- Tasmanian Economic Regulator;
- Essential Services Commission, South Australia; and
- Independent Competition and Regulatory Commission, Australian Capital Territory.

### **Recovery or reversal of under or over recoveries of allowable costs**

Based on the feedback received, it is the understanding of the AASB that if a regulated entity incurs costs greater than forecast (as reported to the regulator) 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.

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 it is able to include some of the costs in the cost base for the following five years<sup>1</sup>.

In some cases, electricity entities may also benefit from an efficiency carry-over. This encourages utilities to achieve cost savings without eroding the asset base. By way of a simplified 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 asset base.

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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.

**Other comments**

The AASB also notes that the interaction between any resulting IFRS and other Standards will need to be considered as part of the project - for example, IFRS 3 *Business Combinations*, in relation to considering the impact of assets and liabilities arising from price regulated contracts on purchase price allocation, and IAS 37 *Provisions, Contingent Liabilities and Contingent Assets*, in relation to onerous contracts.