

Mr Hans Hoogervorst  
Chairman  
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Email: [commentletters@ifrs.org](mailto:commentletters@ifrs.org)

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Dear Mr Hoogervorst

## **Request for Information – Rate Regulation**

Deloitte Touche Tohmatsu Limited is pleased to respond to the International Accounting Standards Board's ('the IASB's') *Request for Information – Rate Regulation* ('the request for information').

We welcome the IASB's initiative to collect information on the different forms of rate regulation as standard-setting activity on rate regulation needs to be underpinned by a comprehensive understanding of how rate regulation operates in a wide variety of jurisdictions and industries. We are happy to provide further input throughout the project, including via the IASB's consultative group on rate-regulated activities.

We highlight that the forms of rate regulation and the mechanisms for rate setting vary greatly depending on the industry and jurisdiction. Our response to this request for information focuses on some of the generic forms of rate regulation that are applicable across a wide variety of industries and jurisdictions. This includes price or revenue caps which are periodically agreed by the regulator based on forecast operating and capital expenditure or on the determination by the entity of the rates it wishes to charge consumers which are then subject to negotiation and approval by the regulator.

Firstly, the objectives of these rate mechanisms, and rate regulation in general, is to provide a balance between protecting customers from unjust or unreasonable rates from entities and industries that tend to have 'natural monopolies,' while allowing the entity or industry the opportunity to earn a reasonable return on its costs and investments. In many jurisdictions, rate regulation is also used by the regulator to incentivise the entity or industry to meet certain targets such as over-delivering on customer service or outperforming operating and capital expenditure targets.

Secondly, the ability of the entity to enforce its rights or obligations will vary depending on the industry or jurisdiction. Generally, the entity will only have the ability to recover its costs (operating and capital) or the rates it wishes to charge with the permission of the regulator. In many jurisdictions this permission will not be automatic and may be rejected. If rejected, the mechanism that the rate-regulated entity can use to enforce its rights and obligations will vary depending on the regulations or legal system in each

jurisdiction (i.e. through an established process agreed between the regulator and the entity, a mechanism enshrined in legislation or through the legal system and courts).

Finally, if a claim, either by the rate-regulated entity or the regulator is successful then the mechanism for either recouping or repaying under or overcharges will vary depending on the industry or jurisdiction. Common mechanisms include a recovery over the next financial or calendar year or a recovery over a longer period of time. In some jurisdictions, to the extent that actual costs are below those initially forecast (i.e. an under-recovery) then the rate-regulated entity may be entitled to keep the benefit, at least for a period of time.

Our detailed responses to the questions in the invitation to comment are included in Appendix 1 to this letter. We have also included in Appendix 2 a summary of the key forms of rate regulation across different jurisdictions primarily based on power and gas (generation, transmission or supply) but also touching on some of the wide range of other industries that are subject to rate regulation. We hope you find this information useful.

If you have any questions concerning our comments, please contact Veronica Poole in London at +44 20 7007 0884.

Yours sincerely



Veronica Poole  
Global IFRS Leader  
Technical

## Appendix 1

### Question 1 – The regulated industry and why it should be considered

***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 (i.e. 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.***

This response is submitted on behalf of member firms of the Deloitte Touche Tohmatsu network. This network includes member firms operating in jurisdictions that have required public companies to report under IFRSs for a number of years, jurisdictions that have recently implemented such a requirement and jurisdictions that do not require the use of IFRSs.

For the purposes of responding to the request for information questions, we are commenting in our capacity as auditors of financial statements and our response covers the generic forms of rate regulation across a number of jurisdictions and industries where the main supplier of the rate-regulated goods or services could include private-sector entities or government entities,

From our perspective, we would welcome your consideration of all types of rate regulation to ensure that any final standard is appropriately scoped. The goods or services subject to rate regulation are varied, but may include power (generation, transmission and /or supply), heating (production and distribution), gas (transmission), water, airport capacity, port capacity, waste collection, telecommunications and postal services. In many jurisdictions, goods and services provided under concession arrangements (including motorways, public transport, and medical clinics) will also be subject to some form of rate regulation. It will be important to appropriately identify the types of rate regulation that warrant specific consideration from an accounting perspective.

## Question 2 – The objectives of the rate regulation

***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?***

The main objectives of rate regulation differ by industry and jurisdiction. However the high-level objectives of rate regulation may be:

- to protect customers from unjust or unreasonable rates from entities and industries that tend to have ‘natural monopolies’;
- to allow the entity or industry a reasonable opportunity to recoup operating and capital expenditure costs and earn a fair return on their investment; and
- to incentivise the rate-regulated entity or industry to meet certain targets such as over-delivering on customer service targets or outperform operating and capital expenditure targets which is an objective that is becoming more common in some jurisdictions.

The rate setting mechanisms that are used to meet these objectives will differ by industry and jurisdiction. Common forms of rate setting mechanisms include:

- a periodic price or revenue cap (for example every 4 or 5 years) based on forecast operating and capital expenditure with intervening adjustments for factors such as inflation and efficiency measures;
- the determination by the entity or industry of the rates it wishes to charge which are then subject to negotiation or approval by the regulator; and
- a ‘right’ to earn a fixed rate of return based on incurred actual costs or invested capital.

In practice, there may be a large number of other mechanisms for setting rates to meet the main objectives of rate regulation.

## Question 3 – The rights and obligations established by the rate regulation

*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?**

Rate regulated entities providing utilities such as water and power will generally have a 'natural monopoly' to operate within a particular market as a result of possessing the only available infrastructure for provision of those utilities. However, this may not be the case in other industries subject to regulation.

The entity's right to operate in a market will normally be established by a licence but, in some jurisdictions and industries, entities may not be licensed and the right to operate may be granted by law.

The regulator will generally have powers to take enforcement action against the entity and may have the ability to revoke licences, although in many jurisdictions this requires a substantial notice period for termination which may extend to several years. In the utilities industry, there is generally limited experience of rate regulated entities ceasing to provide goods and services given the barriers to entry for any competitor and the necessity to maintain supply of utilities.

The rights and obligations in respect of costs and obligations within an industry or jurisdiction will generally be expressed based on the forms of rate setting mechanisms (please refer to Question 2). Different forms of regulation contain different cost recovery mechanisms, whether based on assumed or agreed costs, or actual costs and what variations may be allowable against assumed costs, and where allowable, how they are recovered.

## Question 4 – The enforcement of rights and obligations

*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?**

The mechanism by which the entity or the regulator enforces its rights will vary depending on the industry and jurisdiction. Generally an entity will only have the ability to recover costs with the express permission of the regulator which either may be implicit (i.e. based on the nature of the cost such as commodity price rises) or explicit (including one off unforeseen costs or circumstances). If initially rejected by the regulator, in many jurisdictions, the rate-regulated entity will have the ability to appeal against the regulator's decision either through an established process agreed between the regulator and the entity, a mechanism enshrined in legislation or through that jurisdiction's legal system and courts. The outcome of these appeals is generally not automatic.

## **Question 5 – The recovery or reversal of cost and income variances**

***How does the rate regulation ensure the recovery or reversal of under- or over-recoveries of allowable costs (i.e. 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 (i.e. under-recovery of costs) or a net credit position (i.e. over-recovery of costs); and**
- (iii) what are the main components of the variance amounts (i.e. what are the main categories of cost or income variances)?**

The mechanism for the recovery or reversal of under or over-recoveries will vary by jurisdiction and industry and is dependent on the rate setting mechanism in force (please refer to Question 2). Where the rate setting mechanism is based on a price or revenue cap, then where actual costs are in excess of those original forecast, in some circumstances a claim may be made to the regulator depending on the cause of the excess although the claim may not be automatic. If a claim is successful then the excess may either be recovered over the next year (which may lead to one off increases in rates) or recovered over a longer period of time as prescribed by the regulator.

In some circumstances, the regulator may reject the rate regulated entity's claim for a recovery of costs with the objective of motivating the rate regulated entity to improve efficiency and lower costs where that jurisdiction has adopted a model to incentivise entities and industries to lower costs.

Where the actual costs under the price or revenue cap model are below those originally forecast then the rate regulated entity may, depending on the industry or jurisdiction, keep the benefit, be required by the

regulator to reverse the benefit over the next year or be required by the regulator to reverse the benefit over a longer period of time.