

Hans Hoogervorst
Chairman
IASB
30 Cannon Street
London
EC4M 6XH

28 May 2013

Dear Hans,

IASB Request for Information *Rate Regulation*

I am writing on behalf of the Financial Reporting Council (FRC), about the above Request for Information (RfI).

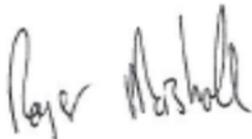
The RfI is focussed on the nature of rate regulation rather than on the accounting for it, and many of the questions require specialist knowledge of each area of regulation. The FRC will therefore not be submitting a formal response but suggests that the IASB may wish to contact the relevant regulators to seek answers to its questions. Some key UK rate regulators are as follows:

- Office of Communications (OFCOM);
- Office of Gas and Electricity Markets (OFGEM);
- Office of Rail Regulation (ORR);
- Water Services Regulation Authority (OFWAT);
- Civil Aviation Authority (CAA).

The Appendix to this letter provides a brief outline of our understanding of the nature of the rate regulation imposed by the above regulators.

If you would like to discuss these comments, or if we can assist the IASB further in this debate, please contact Grant Chatterton on 020 7492 2426, e-mail g.chatterton@frc.org.uk, or me.

Yours sincerely



Roger Marshall
Chairman, Accounting Council
Director, FRC

Appendix: Rate Regulation in the UK

- A1 A dominant form of rate regulation in the UK is price-cap regulation, whereby the company's prices are adjusted according to a price cap index that reflects the overall rate of inflation in the economy, the ability of the company to gain efficiencies relative to the average firm in the economy, and the inflation in the company's input prices relative to the average firm in the economy.
- A2 Price-cap regulation forces a company to charge a price below its profit-maximising price. In the UK, the formula $RPI - X$ is widely used to regulate the prices of privatised utilities, where RPI (Retail Price Index) represents the current rate of inflation and where X is the expected efficiency gain that the regulator believes would have existed had the firm operated in a competitive market.
- A3 The $RPI - X$ approach was originally proposed by Professor Stephen Littlechild (1983) for the telecoms sector, but it has since been adapted and now takes a number of different forms. In the case of water supply, for example, OFWAT recognised the need for capital investment in infrastructure and so the uses the formula $RPI + K + U$, where K is the price limit and where U is any unused 'credit' from previous years.
- A4 Sometimes, revenue rather than price may be the regulated variable, which is known as revenue-cap regulation.
- A5 Some key UK rate regulators are listed below, together with a brief outline of the nature of the rate regulation they impose:

Office of Communications (OFCOM):

OFCOM is responsible for regulation of the television, radio, telecoms and postal sectors in the United Kingdom. OFCOM is best known for setting the prices which Openreach, a division of the BT Group, can charge communications providers for access to its wholesale telecoms infrastructure. OFCOM recently announced plans to cap the prices BT can charge for wholesale Ethernet services outside London and Hull, using a cap of 11% below inflation. OFCOM has also applied price caps to the Royal Mail to protect 'vulnerable customers' (e.g. the price of second class stamps for standard letters, and of second class small parcels and large letters).

Office of Gas and Electricity Markets (OFGEM):

OFGEM is responsible for regulation of the electricity and downstream natural gas markets in Great Britain. OFGEM applied the $RPI - X$ approach (or a variant of it) until April 2013. From April 2013, it introduced RIIO, Revenue= Incentives + Innovation + Outputs, with an 8 year review period. RIIO was designed to create a stable framework to attract significant investment at a fair price to consumers. The revenue

that Network Operators (NWOs) can collect is determined by the RIIO mechanism, by reference to delivery against key specified outputs relating to safety (provision of a safe energy network), reliability (reliable energy provision, without interruption, adapting to climate change), environmental impact (facilitating the reduction of carbon emissions, and reducing carbon footprint), customer and stakeholder satisfaction, customer connection (connecting customers quickly and efficiently) and social obligations. OFGEM determines the efficient level of total expenditure, called 'totex', required to deliver these outputs. The 'totex' is split, based on a percentage, between 'fast money' and 'slow money'. The 'slow money' is added to the regulated asset base (RAV), which represents the value of NWOs regulated assets. The revenue that NWOs can collect is then determined as 'fast money' + Depreciation of RAV + Permitted return on RAV + Performance against incentives + Allowance for other specific costs such as taxes.

Office of Rail Regulation (ORR):

ORR is the independent safety and economic regulator for Britain's railways. One of its key roles is to regulate Network Rail. ORR sets the contractual and financial framework within which Network Rail operates the network, ensuring that the company carries out its activities efficiently and is appropriately funded. ORR review Network Rail's access charges using a hybrid revenue/price form of incentive based regulation.

Water Services Regulation Authority (OFWAT):

OFWAT is responsible for regulation of the privatised water and sewerage industry in England and Wales. It performs a 'Price Review' every five years, to set limits on the prices which UK water and sewerage companies can charge to their customers. Overview details of the calculation are set out in paragraph A3.

Civil Aviation Authority (CAA):

The CAA regulates civil aviation in the United Kingdom. Historically, it has set price caps on airport charges every five years at airports designated by the Secretary of State. The airports currently designated are Heathrow, Gatwick and Stansted, as it is considered that they have sufficient market power to make price regulation necessary. The CAA applies an RPI +/- X% approach to the charges which are regulated on a revenue per passenger basis. The price control is formulated by considering a 'regulatory asset base' (RAB). The RAB is valued and, as time progresses, capex (capital expenditure) is added to it. Depreciation is deducted, with the resulting figure uplifted by RPI. The cost of capital and depreciation allowance are building blocks that, along with the projected level of operating expenditure and revenue from other sources, are used to calculate the revenue requirement. Under the

Civil Aviation Act 2012, from April 2014 the CAA will itself decide which airports require price regulation. Its current views (published in April 2013) are that it should impose price caps on airport charges at Heathrow and Gatwick, and that it should monitor prices at Stansted rather than impose a price cap.

The CAA also regulates NATS' en-route air traffic services. The CAA's price control of NATS originated with UK legislation (the Transport Act 2000) but is also now mandated by European legislation. The European legislation takes primacy over the UK legislation. The price control is based on a regulatory asset base (RAB). Each year capital expenditure is added to and depreciation deducted from the RAB, with the resulting figure uplifted by RPI. The price control is based on a number of building blocks including the cost of capital, depreciation allowance and operating expenditure with NERL's revenues from other sources (such as from the Ministry of Defence) deducted.

- A4 There are other forms of rate regulation in the UK. For example, the prices charged by pharmaceutical companies are subject to rate regulation by the government, and 'Monitor' regulates the prices for NHS-funded care.