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Purpose of the paper

1. In recent discussions with the IASB and with the Accounting Standards Advisory Forum (ASAF), the staff were asked to consider an additional approach to recognising the impact of rate regulation. So far, we have focused on whether particular regulatory accounting balances meet the definitions of assets and liabilities, as defined in the *Conceptual Framework for Financial Reporting* (the '*Conceptual Framework*'). We have been asked instead to consider the issue from the perspective of reporting performance, in particular revenue recognition.

2. The purpose of this paper is to outline our initial analysis of whether the principles and requirements contained in the forthcoming IFRS [15] *Revenue from Contracts with Customers* (the '[draft] Revenue Standard') might provide a suitable framework for recognising revenue for rate-regulated activities.

3. There are many similarities between a contract with a customer and the regulatory agreement between the rate regulator and the entity. However, we think that there are a number of areas, outlined in this paper, in which the revenue model contained in the [draft] Revenue Standard is neither intended nor designed to deal with the relationship between the entity and the rate regulator. In particular, we think that the steps in the revenue model that relate to identifying the contract with the customer, identifying the performance obligations and allocating the transaction price to the performance obligations in the contract would need to be modified in order to make them applicable to the regulatory agreement.

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4. Consequently, we conclude that the [draft] Revenue Standard would not be directly applicable to the regulatory agreement. However, we think that it could provide a useful framework for developing a tailored model for the rate-regulated activities performed by an entity in accordance with the regulatory agreement. We ask the IASB if it agrees with the staff recommendation to develop this analysis further as a potential accounting model for rate-regulated activities.

Introduction

5. In the Discussion Paper being developed for this project, we will consider the relative advantages and disadvantages of alternative accounting models for recognition and measurement that could be used to faithfully represent the impact of rate regulation.

6. We have heard from users that they value information that helps them to understand the rate-regulatory environment and its impact on the financial position and performance of a rate-regulated entity. In particular, users are interested in distinguishing variability in performance that is compensated for through the rate regulation from variability in performance for which there is no rate-regulatory compensation. In addition, users are looking for transparency of information about the amounts, timing and certainty of cash flows arising from the entity's rate-regulated activities.

7. In the form of rate regulation that we are currently focusing on, the rate regulator and the entity agree on the range of activities that will be performed in accordance with the regulatory agreement. They will also agree on the amount of 'allowable revenue' that the entity is entitled to earn in exchange for performing those activities. The rate-regulatory mechanism will then ensure that the allowable revenue will be billable to individual customers through the price per unit charged to them for the rate-regulated goods or services delivered.

8. It may be argued that a rate-regulated entity should recognise revenue for the goods or services that it transfers to individual customers during the period, simply using the billable price per unit. The timing of recognition for that revenue will then match the timing of delivery of those goods and services. This approach

is consistent with the established IFRS practice for most rate-regulated entities and the approach used by non-rate-regulated entities.

9. However, the reason why we are carrying out this project is because the IASB has repeatedly been told that particular aspects of rate regulation create special economic conditions that are not faithfully represented by the established IFRS accounting. We have been told that accounting only for the revenue that the entity is entitled to invoice to individual customers for the goods or services that it transfers to them during the period results in an entity reporting volatility in the profit or loss account that does not reflect the entity's performance.

10. Consequently, the rest of the paper focuses on the features that we have identified as distinguishing the conditions under which rate-regulated activities are conducted and explores whether these might be better represented by taking a fresh look at revenue recognition. We are using the [draft] Revenue Standard as the basis of our initial analysis for this new approach because the objective of the [draft] Revenue Standard is to establish principles that result in an entity reporting useful information about the nature, amount, timing and uncertainty of revenue and cash flows arising from a contract with a customer. This objective seems closely matched to the users' needs outlined in paragraph 6.

Background

11. Discussions in recent IASB meetings have focused on whether particular 'balancing adjustments' identified in our earlier descriptions of rate regulation meet the definitions of assets and liabilities, as defined in the *Conceptual Framework*. In this meeting, we are developing an additional approach, focusing on reporting performance, in particular revenue recognition. As part of this approach, we will consider what we mean by 'performance' in the context of identifying 'performance obligations' in the regulatory agreement and how those performance obligations are satisfied.

12. We have refined our definition of rate regulation (see Agenda Paper AP9B) and have identified that the rate regulation sets out an agreed regulatory agreement or terms of service that identifies the rate-regulated activities to be performed by the entity during the regulatory period. This regulatory agreement also sets out the

mechanism to be used in order to determine the amount of allowable revenue that the entity is entitled to earn in exchange for performing the agreed rate-regulated activities.

13. In this paper, we examine whether the recognition and measurement models used in the [draft] Revenue Standard may be useful as a starting point for analysing the regulatory agreement in order to identify how to most faithfully represent the performance of an entity in earning the allowable revenue for the period, as determined in accordance with the terms of service contained in the rate regulation.

What do we mean by 'performance'?

14. The [draft] Revenue Standard defines a performance obligation as a "promise in a contract with a customer to transfer [goods or services] to the customer" and requires that revenue is recognised when (or as) the entity satisfies a performance obligation. As we highlight through our analysis in this paper, one of the major difficulties that we face when considering the performance of a rate-regulated entity is that the regulatory agreement obliges the entity to perform a variety of activities, some of which, in our view, do not meet the definition of a performance obligation.

15. The activities that the regulatory agreement requires the entity to perform can be split into two general categories:
    (a) deliver the distinct rate-regulated goods or services to the individual customers; and
    (b) carry out other activities that are directly or indirectly related to the delivery of the rate-regulated goods or services, but which also achieve other objectives of the rate regulator or the government.

16. Many of these other rate-regulated activities involve actions that affect the property, plant and equipment and infrastructure assets of the entity. For example, the rate regulator may require the entity to construct additional infrastructure assets in order to increase capacity and add new customers to the network when a new town is created. In order to help fund this construction, the rate regulator

may, in advance of the construction work being done, increase the rate to be charged to customers for the rate-regulated goods or services delivered to them.

17. It could be argued that the entity should not recognise revenue for the amount of the selling price of the goods or services delivered to individual customers that relates to the construction work. Instead, the cost of the construction work could be argued to be an investment in the entity's own assets. Consequently, revenue should not be recognised for the 'performance' of this activity before or during construction. Instead, the amount billed to customer for this activity would be accounted for as a source of finance.

18. A counter argument would be that many non-rate-regulated entities that finance construction of property, plant and equipment from retained earnings are effectively doing the same thing. However, there is generally no question that the amounts that they invoice to customers for the delivery of goods or services, which builds up the retained profits needed to fund the construction, should be recognised as revenue.

19. However, a notable difference between rate-regulated and non-rate-regulated entities is that the decision to invest in property, plant and equipment by a rate-regulated entity is usually significantly influenced by the rate regulator and the allowable revenue is established in order to facilitate the agreed decisions. In addition, if the planned construction is cancelled or terminated before completion, the rate regulator will commonly reduce the allowable revenue of future periods to 'refund' the amounts previously collected but not used for the intended purpose.

20. At this early stage of our analysis, we have not proposed a solution to this problem. We have highlighted it here to provide some context to our conclusion that some of the entity's rate-regulated activities do not meet the definition of a performance obligation. We provide more detail of some of the issues involved through our initial analysis presented in this paper and ask the IASB to consider how we might address the problem through this project.

21. We see some interaction between this issue and the requirements of IFRIC 12 *Service Concession Agreements* because IFRIC 12 addresses questions about the construction and upgrade of infrastructure that is used to provide 'public' services. The rate that the concession operator can charge for the use of those services is

commonly rate-regulated through the service concession agreement. Consequently, we intend to bring a further paper on the interaction of rate-regulated activities with IFRIC 12 to the IASB at a later date.

What type of rate regulation are we analysing?

22. In Agenda Paper AP9B, we describe the type of rate regulation that we would like to focus on for the purpose of our current analysis as to whether rate regulation can create assets and liabilities, as defined in the *Conceptual Framework*.

23. In that paper, we suggest that our analysis should, for the time being at least, focus on types of rate regulation that involve a formal regulatory pricing framework that:

    (a) applies in situations where there is little or no competition;

    (b) establishes parameters for rates (sometimes referred to as prices or tariffs) that provide regulatory protections that:

        (i) support greater stability and affordability of prices for customers; and

        (ii) support the financial viability of the rate-regulated entity.

    (c) establishes parameters to maintain the quality and availability of the supply of the rate-regulated goods or services and other rate-regulated activities of the entity; and

    (d) creates rights and obligation that are legally enforceable and binding on the rate-regulated entity and on the 'rate regulator'.

24. As noted in AP9B, the type of rate regulation that we are currently focusing on establishes the amount of revenue and/or profit that an entity can earn in exchange for carrying out the rate-regulated activities in accordance with the specified terms of service. These rate-regulated activities are not restricted to just delivering the rate-regulated goods or services directly to the end-users, ie the individual customers. Instead, the rate-regulated activities also involve satisfying related government objectives such as changes to the infrastructure network (expansion, contraction, renewal or upgrading) and/or other environmental, social or economic

policies, such as reducing polluting emissions or changing customer consumption patterns.

25. As described in AP9C, in the type of rate regulation being discussed in this meeting, there is some form of mechanism within the rate-regulatory framework that is designed ensure that the rate-regulated entity earns no more and no less than the amount of revenue and/or profit that it is entitled to earn during the regulatory period in accordance with the terms of service. If, due to variances, deferrals or timing differences, the amount of revenue billed to individual customers differs from the total allowable revenue, then the rate regulation will correct the mismatch by adjusting the price that the entity can charge to individual customers for future sales of the rate-regulated goods or services.

A revenue recognition approach

26. The rate-regulated activities to be performed by the entity, and the entity's right to earn a determinable amount of revenue in exchange for those activities, is established within the rate regulation. This could be done using an explicit licence or other agreement between the rate regulator and the entity or by directly setting it out in the regulation itself. In each case, the rate regulation establishes a legally binding agreement between the entity and the rate regulator (the rate regulator is usually acting on behalf of the government).

27. Through this regulatory agreement, the entity is obliged to perform various rate-regulated activities. Some activities result in the entity delivering distinct goods or services directly to the individual customers, such as gas, electricity, water, telecommunication or transport services. Some activities may relate to other objectives of the government or rate regulator, such as increasing capacity to serve more customers, improving the quality of services provided to customers, reducing pollutants or changing consumption patterns.

28. A major difficulty that we have in using the five-step revenue model in the [draft] Revenue Standard is the identification of the 'customer'. The five-step model has been designed primarily for arrangements between two parties—the entity and the customer. As we discuss in paragraphs 40–45, the analysis is more complicated when there are more parties to the agreement (the entity, the rate regulator, the

end-users/consumers of the rate-regulated goods or services and maybe the government too). For the purposes of this paper, we focus on the regulatory agreement between the rate regulator and the entity. References to the individual customers or the customer base mean the end-users of the rate-regulated goods or services. We will explore the inter-relationship between the regulatory agreement and the contracts with individual customers in a future meeting.

29. In exchange for carrying out the required rate-regulated activities during the regulatory period, the rate regulation will establish the amount of revenue that the entity is entitled to earn. In many cases, the rate regulation will also establish the amount of profit that the entity is entitled to earn. However, we do not think that this is an essential feature for the purpose of this analysis, which focuses on the revenue determined by the rate regulation.

30. The remainder of this paper outlines the requirements of the revenue model contained in the [draft] Revenue Standard to assess whether that model might provide a framework that could be adapted to account for the allowable revenue attributable to the various rate-regulated activities performed. To aid the analysis, we have provided, in Appendix A, a brief summary of the requirements expected to be issued in the [draft] Revenue Standard. This summary reflects the IASB's tentative technical decisions made in public meetings up to and including October 2013.

Aspects of rate regulation that we are not dealing with here

31. Before considering the steps set out in the [draft] Revenue Standard, we would like to reiterate that we are focusing on the aspects of rate regulation that are not already dealt with in IFRS.

32. We noted in AP9B and AP9C that some other Standards may already deal with particular aspects of the regulatory agreement. For example, part of the allowable revenue may be paid by way of a government grant or other incentive, which would be accounted for in accordance with IAS 20 *Accounting for Government Grants and Disclosure of Government Assistance* (see paragraph 7 of AP9C); some revenue mismatch amounts may be paid through the rate regulator or through billing adjustments and would be accounted for in accordance with

IFRS 9 *Financial Instruments*.[1] At this stage of our analysis, we are focusing on situations in which the rates charged to individual customers are designed to cover all of the allowable revenue. Later in the project, we will consider situations in which part of the allowable revenue is paid by the government or the rate regulator in order to explore the interactions with these other Standards.

33. The relationship between the individual customers (ie the end-users of the rate-regulated goods or services) and the entity, which results in the transfer of the rate-regulated goods or services to be invoiced to the individual customer at the regulated price per unit, will be accounted for in accordance with the [draft] Revenue Standard. As noted in paragraph 28, we will consider the interaction of the regulatory agreement and the contracts with individual customers in a future meeting.

Using the [draft] Revenue Standard model

34. Previously, some who have argued that regulatory deferral account balances should be recognised in financial statements have suggested that the regulatory agreement between the entity and the rate regulator forms a ‘quasi-contract’ between the entity and the individual customers as a collective group (the ‘customer base’). This is because, they claim, the rate regulator is acting on behalf of the customers and the prices set through the rate regulation binds the customers to the agreement. Consequently, some have suggested that this ‘quasi-contract’ between the entity and the customer base as a whole should be accounted for in the same way as a sales contract between an entity and a single customer.

35. We do not agree with that argument. Although the customer base has to accept the outcome of the regulatory agreement, it is not a direct party to the agreement. In addition, the rate regulator is not just acting on behalf of the customers. As we have previously discussed, the rate regulator has to balance the interests of the customers, the entity and, usually, the government as well.

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[1] For entities that do not yet apply IFRS 9 *Financial Instruments*, any reference to IFRS 9 should be read as a reference to IAS 39 *Financial Instruments: Recognition and Measurement*.

36. Although we do not think that the agreement between the rate regulator and the entity falls within the scope of the [draft] Revenue Standard, we think that the accounting model that will be required by it is useful to consider for the purposes of developing the Discussion Paper. We also think that it is important to explore, in the Discussion Paper, the impact that the regulatory agreement has on the contracts with individual customers. As already noted, we will discuss this in a future meeting with the IASB. Before considering the revenue model, we explain why we think it could be useful in the context of rate regulation.

37. The [draft] Revenue Standard will apply to contracts with customers only when all of the following criteria are met:

    (a) the parties to the contract have approved the contract and are committed to performing their respective obligations;

    (b) the entity can identify each party's rights regarding the goods and services to be transferred;

    (c) the entity can identify the payment terms for the goods or services to be transferred;

    (d) the contract has commercial substance (that is, the risk, timing or amount of the entity's future cash flows is expected to change as a result of the contract); and

    (e) it is probable that the entity will collect the consideration to which it will be entitled in exchange for the goods and services that will be transferred to the customer.

38. In the context of the regulatory agreement:

    (a) both the entity and the rate regulator are parties to the agreement. In many cases, there is some negotiation about the details of the activities to be performed during the regulatory period but the outcome of those negotiations will be agreed through the setting of the pricing structure for the regulatory period.

    (b) each party's rights regarding the rate-regulated activities to be performed will be established in the pricing agreement and the terms of service contained within the rate regulation. This will cover both the

goods or services to be delivered to individual customers and also the other activities that the entity needs to perform during the regulatory period, some of which may be contingent on future events outside the control of the entity and the rate regulator, for example, the need to repair storm damage.

(c) the pricing agreement will establish the payment terms for the goods or services to be transferred to individual customers and for the other rate-regulated activities that need to be performed. Commonly, the rate regulation establishes an estimate for the total amount of consideration (ie the allowable revenue) that is considered 'fair and reasonable' to reflect the rate-regulated activities to be performed. This total amount is then usually divided by the estimated number of units expected to be delivered to give a price per unit. This price per unit is then often 'fixed' for the duration of the regulatory period, unless the pricing formula provides for adjustments through the period (see AP9C for a description of a typical pricing mechanism).

(d) the rate regulation has commercial substance. When establishing the rate to be charged to customers, the rate regulator balances the need for affordability and stability in the price that is to be charged to individual customers and the entity's need for financial viability and access to cash or financing in order to carry out its obligations under the rate regulation. The actions of the rate regulator are recognised to have a significant impact on the risk, timing and amount of the entity's future cash flows.

(e) when establishing the regulated rate, the rate regulator takes into account the ability of the customers to absorb any price increases and the entity's ability to absorb price decreases. Consequently, when establishing the rate, both the demand risk and the credit risk of the customer base as a whole is considered. The rate set will usually reflect an assessment that the entity will collect the consideration to which it will ultimately be entitled to invoice customers during the regulatory period or future periods. In some cases, the amount of consideration related to activities carried out in the period will be deferred, in order to

spread the cost for the customer base. In such cases, the rate established commonly incorporates an interest element in order to reflect the time value of money. If the amount of consideration that is needed to reflect the rate-regulated activities to be performed exceeds the amount that is considered collectible through rates, the rate regulation may establish alternative ways of remunerating the entity, such as government subsidies.

39. The analysis above indicates that the regulatory agreement between the entity and the rate regulator has many similarities to a contract between an entity and a customer. Consequently, we think that it is worthwhile considering the steps in the accounting model to be used in the [draft] Revenue Standard in the context of rate-regulated activities in order to identify whether the steps could be adapted to reflect the economic impact of the regulatory agreement.

Step 1: Identify the contract(s) with a customer

40. The forthcoming [draft] Revenue Standard defines a customer as a “party that has contracted with an entity to obtain goods or services that are an output of the entity’s ordinary activities in exchange for consideration”.

41. In the context of rate-regulated activities, the parties to the contract, ie the regulatory agreement, are the rate regulator and the entity. However, the entity rarely transfers to the rate regulator the rate-regulated goods or services that are an output of the entity’s ordinary activities. Typically, the entity transfers the rate-regulated goods or services to the individual customers, but those individual customers are not direct parties to the regulatory agreement.

42. The regulatory agreement will set out a variety of activities that the entity is obliged to perform, in addition to delivering the rate-regulated goods and services to the individual customers. For example, the entity may construct, in accordance with the regulatory agreement, additional infrastructure assets in order to expand the network so that it can provide rate-regulated goods or services to additional customers. The nature and extent of the construction will be established by the rate regulation but the newly constructed asset is not transferred by the entity. Instead, the entity retains the new infrastructure asset and uses it in its ordinary

activities in order to deliver rate-regulated goods or services to customers. Although the entity will receive consideration in exchange for this construction work, it does not receive that consideration from the rate regulator. Instead, the consideration is reflected through the allowable revenue that is to be received from the individual customers.

43. In our view, the regulatory agreement between the rate regulator and the entity would not, therefore, meet the criteria required in order to apply the requirements of the [draft] Revenue Standard to the agreement as a whole.

44. The transfer of rate-regulated goods or services to a customer in exchange for consideration is most clearly achieved when the entity provides the rate-regulated goods or services to individual customers. In our view, it is only this transfer between the entity and the individual customers that will be captured within the scope of the [draft] Revenue Standard. As noted earlier in this paper, in a future meeting we will explore the inter-relationship between the regulatory agreement and the contracts between the entity and the individual customers.

45. Although we do not think that the regulatory agreement would meet the criteria required to apply the [draft] Revenue Standard directly, we do think that there are sufficient similarities to enable us to use the revenue model as a reasonable starting point to build on. Our initial analysis suggests that the principles of the revenue model could be tailored to develop a reasonably consistent approach in the context of rate regulation. Part of this tailoring would require an analysis of which party we identify as 'the customer' for this purpose, ie the rate regulator, the individual customers, the customer base or a combination of these.

Step 2: Identify the performance obligations in the contract

46. The agreement between the rate regulator and the entity will establish what rate-regulated activities the entity is obliged to perform during the regulatory period. Many of these rate-regulated activities will not satisfy the definition of a "performance obligation" contained within the [draft] Revenue Standard because they do not result in the transfer of goods or services to the rate regulator (or to the individual customers).

47. Although many of these activities do not meet the definition of performance obligations in the [draft] Revenue Standard, they have many similarities because the entity will be able to identify contractually agreed upon tasks that it is required to perform in accordance with the regulatory agreement. The regulatory agreement will also establish the amount of consideration that the entity will be entitled to receive in exchange for these tasks. Consequently, we again think that some analogies can be drawn with the [draft] Revenue Standard, but we would need to develop a tailored model to reflect the different circumstances of rate regulation. In particular, it will be necessary to identify criteria to establish whether and, if so, when an entity can recognise the attributable revenue in circumstances when there is no transfer of goods or service from the entity.

Identifying the contractually agreed upon tasks

48. The tasks that the rate regulator may require the entity to perform in exchange for determinable consideration are varied. The following paragraphs outline a few examples that will be referred to in the analysis of the remaining steps but similar analysis could be applied to other tasks, depending on the facts and circumstances. Although some of these tasks will not meet the definition of a performance obligation, they are promises in the regulatory agreement to perform distinct tasks, for which consideration will be receivable from customers through the rate charged for the delivery of the rate-regulated goods or services.

Repairing storm damage

49. Some public services, such as the supply of electricity, gas or water, may be at risk of serious disruption due to adverse weather conditions. For example, a storm could disrupt electricity transmission or distribution services by damaging power lines or sub-stations. Commonly, rate regulation will contain provisions to ensure that the entity will repair the damage as quickly and efficiently as possible and, in exchange, will be entitled to receive a determinable amount of consideration. This consideration may be limited to costs actually incurred or may include a mark-up, which may vary depending on how efficiently the damage was repaired. The consideration is usually reflected in the rate established for future regulatory period(s)

50. Repairing the storm damage and re-establishing the service does not transfer a good or service. Instead, it re-establishes the ability of the entity to meet the service-level requirements of the regulatory agreement. However, it is a promise made in the rate regulatory agreement and the satisfaction of the promise can be identified as a distinct task performed, for which the entity is entitled to receive a determinable amount of allowable revenue.

Reducing emissions and/or increasing the use of renewable sources of energy

51. Rate regulation commonly applies in the utilities industry, for example, in electricity generation.[2] Rate regulators are increasingly encouraging or requiring generating companies to reduce emissions in a variety of ways. In some cases, the focus is on using power stations that are more environmentally efficient. In other cases, the focus is on switching from fossil fuels to renewable or greener energy sources, such as solar or wind.

52. The methods used by rate regulators to achieve the emissions reduction or the switch to alternative energy sources vary. In some cases, the rate regulator may require the entity to make specified changes to the infrastructure assets. In other cases, the rate regulator may establish a target but then allow the entity to decide what changes it needs to make in order to achieve the target. To help fund the relevant changes, the government may introduce an emissions trading rights scheme or may provide grants or other subsidies to fund the changes required. However, for the purpose of this analysis, we assume that the rate regulator will use the total allowable revenue calculation to provide the funding for agreed infrastructure asset changes or to provide the other incentives, which are designed to achieve the objective for which changes are needed. We will consider the interaction with other sources of funding at a later date.

Making changes to the network capacity

53. The types of goods or services that are subject to the type of rate regulation that we are focusing on are considered to be ‘essential’ or ‘public’ goods or services. Consequently, the rate regulator’s objectives will include the need to ensure that

[2] In some countries, electricity generation is being opened up to competition and the type of rate regulation is changing. In some cases, the competition is sufficiently strong that rate regulation no longer applies. The discussion in this paper, however, is focused on those cases where there is still little or no competition for electricity generation.

the entity has sufficient capacity to provide the volume of supply to satisfy demand. In addition, the rate regulator acts on behalf of customers to ensure that the supplier operates efficiently in order to keep prices low.

54. The rate regulator will often have the power to influence the entity's decisions related to the property, plant and equipment, including infrastructure assets, used by the entity to provide the rate-regulated goods or services. For example, the rate regulator could require the entity to invest in additional capacity, perhaps to add new customers to the network if a new town or new commercial development is created. Alternatively, the rate regulator could require the entity to retire part of the plant or infrastructure before the end of its previously assessed useful economic life in order to eliminate inefficient or surplus capacity.

55. The rate regulator may adjust the allowable revenue to provide funding, incentives or compensation, depending on what capacity changes are needed.

Improve service quality and achieve customer satisfaction targets

56. In the type of rate-regulated activities being discussed, the customers have little or no choice but to purchase the rate-regulated goods or services from a single supplier. Historically, this sometimes resulted in poor quality and high levels of customer dissatisfaction. Increasingly, rate regulators are setting targets to improve quality and customer service by incentivising entities through adjustments to the allowable revenue. This often involves a combination of penalties and bonuses, which are reflected as adjustments to the allowable revenue and the price per unit that is charged for future sales.

Step 3: Determine the transaction price

57. The regulatory agreement will establish what revenue the entity will be entitled to receive in exchange for the rate-regulated activities that are to be performed and the time period over which the activities should be completed. This will determine the overall transaction price. The transaction price normally includes both fixed and variable amounts and, together with other elements, will be used to establish the allowable revenue for the regulatory period.

58. The time period over which some of the activities are to be completed may span two or more regulatory periods. In addition, when establishing the allowable

revenue for the regulatory period, the rate regulator needs to balance the needs of the customers with the needs of the entity. Consequently, the rate regulator may defer or accelerate the inclusion of the consideration in the allowable revenue when compared to the timing of the activities being performed, in order to influence the timing of the related cash flows. For example, the rate regulator may accelerate an amount to allow the entity to payback related borrowings more quickly or to provide funding for future activities. Alternatively, the rate regulator could defer an amount to spread the cost for individual customers without reducing demand for the rate-regulated goods or services.

59. The elements used to establish the allowable revenue for the regulatory period are described in AP9C. As noted, the allowable revenue for the regulatory period does not always equal the transaction price for the activities to be performed during the period, but may include amounts that relate to the activities performed in other periods. Such amounts may have been deferred from earlier periods or may be included in advance of the related activities being performed. The rate regulation will determine whether these deferrals or prepayments will earn interest or be subject to a finance charge and, if so, what rate of interest will be applied.

60. We think that the regulatory agreement will enable entities to identify the overall transaction price. The transaction price envisaged in the [draft] Revenue Standard is generally anchored in a single contract that contains performance obligations to transfer distinct goods or services. The [draft] Revenue Standard addresses a number of issues that could make identifying the transaction price more difficult, such as the presence of variable consideration, and provides guidance relating to those issues.

61. If we develop an accounting model for rate regulation around the requirements of the [draft] Revenue Standard, we will need to look carefully at the application requirements associated with this step. The inclusion of variable consideration and the existence of financing components in the regulatory agreement, together with the interaction of the transaction price and the allowable revenue, create additional complications that are not dealt with in the [draft] Revenue Standard, but that would need to be addressed for rate regulation.

Step 4: Allocate the transaction price to the performance obligations in the contract

62. Although the entity will be able to identify the promises within the regulatory agreement to carry out the contractually agreed tasks, allocating the transaction price to each type of rate-regulated activity is likely to be complicated. Many of the rate-regulatory activities that are required to be performed in accordance with the regulatory agreement do not meet the definition of performance obligations because they do not, as we have previously noted, involve the transfer of distinct goods or services. Consequently, there will not be an observable stand-alone selling price for these activities.

63. In addition, the allowable revenue for the period does not reflect just the rate-regulated activities to be performed during the regulatory period. Instead, the allowable revenue for the period usually includes amounts that relate to performance in earlier or later periods. These amounts include:

    (a) **prepayments**—for example, the rate regulator may agree with the entity that a new wind farm will be constructed, which will take three years to construct. Construction will start at the mid-point of the next three-year regulatory period (Period t1) and will start to provide electricity to the grid at the mid-point of the following three-yearly regulatory period. To help fund the construction, the rate regulator increases the allowable revenue from the start of Period t1, which is 18 months prior to the construction work commencing and 54 months before the wind farm starts to produce electricity. Consequently, the entity receives 'consideration' for the construction activities before it performs those activities. Another example relates to the build-up of a reserve related to storm damage (see paragraph 68).

    (b) **deferrals**—for example, the rate regulator might decide that the amount of revenue that the entity is entitled to earn in exchange for performing the required rate-regulated activities for the period is higher than customers can afford to pay during the period. Consequently, the rate regulator restricts the price per unit that the entity can charge during the

period in order to spread the cost and defer part of it to future regulatory periods.

(c) **timing differences**—although the allowed revenue for the period usually includes both variable and fixed amounts, the price per unit that the entity can charge to customers is usually fixed. This creates a number of variances, many of which are not adjusted for during the period, but instead are carried forward to correct through a change to the allowable revenue and the price per unit is charged in a future period.

(d) **penalties/bonuses**—increasingly, rate regulators are incentivising rate-regulated entities in a variety of areas of activity. For example, the rate regulator may require the entity to improve customer satisfaction levels and set a measurable target to help achieve this objective. The rate regulation may use an adjustment to the allowable revenue as a mechanism to impose a penalty for failing to meet the target or to grant a bonus for achieving it. This penalty or bonus will usually be applied as a decrease or increase in the allowable revenue for the next regulatory period.

64. The rate regulator will establish the overall transaction price for all of the activities required to be performed when establishing the allowable revenue for the period and any amounts to be prepaid or deferred. The entity will need to apply judgement to allocate the transaction price to the various contractually agreed tasks that are to be performed during the period. In addition, the entity will need to apply judgement to take into account the various adjustments that are made to the allowable revenue for the period to reflect previous, current and future performance. Consequently, we think that the Discussion Paper will need to explore what guidance or criteria might need to be developed to help with this allocation. This could use the principles and guidance contained in the [draft] Revenue Standard to try to develop a consistent approach.

Step 5: Recognise revenue when (or as) the entity satisfies a performance obligation

65. The [draft] Revenue Standard requires an entity to recognise revenue when (or as) the entity satisfies a performance obligation by transferring a promised good or service (ie an asset) to a customer. Such a transfer occurs when (or as) the customer obtains control of the asset. In addition, the entity is required to determine whether it satisfies each performance obligation over time or at a point in time.

66. As previously identified in this paper, many of the contractually agreed tasks (ie the rate-regulated activities) do not involve the transfer of an asset to the rate regulator or to the individual customers. In addition, the timing of billing of the consideration allocated to these activities is established through the allowable revenue mechanism. The timing of billing is often deferred or accelerated relative to the timing of the performance of the activities in order to balance the cash flow needs of the entity and the individual customers. This raises questions about the timing of recognition of such revenue relative to the timing of the performance by the entity.

67. Consequently, and as with the allocation of the transaction price, we think that the Discussion Paper should explore what guidance or criteria might need to be developed to help identify when the allowable revenue should be recognised. This again could build on the principles and guidance used for the [draft] Revenue Standard to try to develop a consistent approach.

68. In some cases, the rate regulation itself may contain guidance to help identify when the entity is entitled to parts of the allowable revenue. For example, we have identified that, in some cases, the allowable revenue for a period includes an amount that is intended to build up a reserve that the entity can draw upon when a contingent event, such as a storm, occurs. The rate regulation is clear that the entity is not entitled to consider this revenue as ‘earned’ until the storm strikes and the entity repairs the damage (see paragraph 19(f) of AP9C).

69. Another example relates to an incentive penalty or bonus adjustment. The rate regulation will specify the incentivised performance required and the period over which it is to be measured. Although the regulated price per unit may not be

adjusted until a future period, which will determine the timing of the payment or receipt of the penalty or bonus, the amount by which the allowable revenue will be adjusted will be established once the incentive period is completed.

Conclusion

70. We think that it would be worthwhile including, in the Discussion Paper, a discussion around the use of a revenue recognition approach for rate-regulated activities, in addition to an asset/liability approach. This is because we think that the regulatory agreement between the rate regulator and the rate-regulated entity has many similarities to a contract with a customer, based on the criteria set out in the [draft] Revenue Standard.

71. Consequently, we recommend that the Discussion Paper should include an outline of a potential accounting model, which is developed around the requirements of the forthcoming [draft] Revenue Standard. This model would need to be specifically developed around the distinguishing features of the rate regulation because we do not think that the [draft] Revenue Standard would be directly applicable to the regulatory agreement. This is because, in our view, the regulatory agreement between the rate regulator and the entity does not meet the definition of a contract with a customer. In addition, many rate-regulated activities do not meet the definition of a performance obligation because they do not involve the transfer of an asset to the customer (or the rate regulator).

72. If the IASB agrees with our recommendation, we will prepare a more detailed analysis of the requirements of the [draft] Revenue Standard and how the requirements might be tailored to reflect the different circumstances of rate regulation.

Questions for the IASB

Developing a revenue model for rate-regulated activities
1. Does the IASB agree that the revenue model contained in the [draft] Revenue Standard could form a reasonable framework for developing a potential revenue model for rate-regulated activities? a. If so, does the IASB have any advice for staff as to how the revenue model could be adapted? b. If not, why not? 2. Does the IASB have any other comments or advice for the staff on the issues raised in this paper?

Appendix A
Summary of the expected requirements for the forthcoming IFRS 15 *Revenue from Contracts with Customers*

A1. The core principle of IFRS 15 is that an entity shall recognise revenue to depict the transfer of promised goods or services to customers in an amount that reflects the consideration to which the entity expects to be entitled in exchange for those goods or services. To achieve that core principle, an entity shall apply all of the following steps:

(a) **Step 1: Identify the contract(s) with a customer**—an entity would apply the requirements to the enforceable rights and obligations in each contract that has been agreed with a customer. In order to apply the revenue model, an entity must consider customer credit risk (and not other uncertainties) and conclude that it is probable that the entity will collect the consideration to which it will be ultimately entitled in exchange for the goods or services that will be transferred to the customer. In some cases, an entity may combine contracts and account for them as one contract.

(b) **Step 2: Identify the performance obligations in the contract**—a contract includes promises to transfer goods or services to a customer. When those goods or services are distinct, the promises are called performance obligations and are accounted for separately. A good or service is distinct if the customer can benefit from the good or service on its own or together with other resources readily available to the customer and the entity's promise to transfer the good or service to the customer is separable from other promises in the contract.

(c) **Step 3: Determine the transaction price**—the transaction price is the amount of consideration (ie payment) to which an entity expects to be entitled in exchange for transferring promised goods or services to a customer. The transaction price can be a fixed amount of customer consideration; however, sometimes it may include variable consideration (that must be estimated) or consideration in a form other than cash. The transaction price would also be adjusted for the effects of a significant financing component and for any consideration

payable to the customer. The requirements would limit the transaction price to include some, but not all, of the estimated amount of variable consideration if it is highly probable that the estimate would not result in a significant revenue reversal.

(d) **Step 4: Allocate the transaction price to the performance obligations in the contract—**an entity would typically allocate the transaction price to each performance obligation on the basis of the relative stand-alone selling price of each distinct good or service. If a stand-alone selling price is not observable, an entity would estimate it. Sometimes, the transaction price would include a discount or a contingent amount of consideration that relates entirely to one of the performance obligations in a contract. The requirements specify when an entity should allocate the discount or contingent consideration to one performance obligation rather than to all performance obligations in the contract.

(e) **Step 5: Recognise revenue when (or as) the entity satisfies a performance obligation**—an entity would recognise revenue when (or as) it satisfies a performance obligation by transferring a promised good or service to a customer (which is when the customer obtains control of that good or service). The amount of revenue an entity recognises would be the amount allocated to the satisfied performance obligation. A performance obligation may be satisfied at a point in time (typically for promises to transfer goods to a customer) or over time (typically for promises to transfer services to a customer). For performance obligations satisfied over time, an entity would select an appropriate measure of progress to determine how much revenue should be recognised as the performance obligation is satisfied.