STAFF PAPER

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Rate-regulated Activities Consultative Group meeting

Project	**Rate-regulated Activities: Research project**
Paper topic	What is performance?

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Introduction

1. Paragraph 5.34 of the Discussion Paper *Reporting the Financial Effects of Rate Regulation* (the Discussion Paper) summarised four possible accounting approaches for reporting the financial effects of rate regulation. Paragraph 61 of the Appendix to Agenda Paper 2 *Initial analysis of responses to the Discussion Paper* notes that the strongest support is for the approach that would recognise the financial effects of rate regulation through specific IFRS requirements. Most supporters of this approach favoured adjusting the timing of recognition of revenue or of a combination of revenue and costs.

2. The most common suggestion made for how to develop an accounting approach is to develop specific IFRS requirements using the principles contained in IFRS 15 *Revenue from Contracts with Customers*. Several respondents note that the rate-setting mechanism and adjustments to the revenue requirement focus primarily on determining the amount of consideration to which the entity is entitled in exchange for performing its rate-regulated activities. Consequently, it seems logical to focus any accounting requirements on revenue recognition and measurement.

3. Several respondents note, in addition, that the combination of an adjustment to the timing of revenue recognition and the deferral of cost recognition are not incompatible with the principles of IFRS 15. Using the requirements of IFRS 15,

an entity recognises particular contract costs as an asset if specified conditions are met.

Purpose of this paper

4. The purpose of this paper is to explore some of the issues that are likely to need more detailed analysis and evidence-gathering before asking the IASB to consider whether, and if so how, it might adapt the principles in IFRS 15 to reflect the financial effects of rate regulation.

5. The purpose of the discussion at this meeting is to gather the initial views of the Consultative Group about how we might be able to analyse different types of rate-regulated activities within the context of the revenue recognition principles in IFRS 15.

Recognising revenue in accordance with IFRS 15

6. Paragraph 31 of IFRS 15 states:

> An entity shall recognise revenue when (or as) the entity satisfies a performance obligation by transferring a promised good or service (ie an asset) to a customer. An asset is transferred when (or as) the customer obtains control of that asset.

7. Appendix A of IFRS 15 defines a performance obligation as:

> A promise in a **contract** with a **customer** to transfer to the customer either:
>
> (a) A good or service (or bundle of goods or services) that is distinct; or
>
> (b) A series of distinct goods or services that are substantially the same and that have the same pattern of transfer to the customer.

8. In addition, Appendix A of IFRS 15 contains the following definitions:

> **Contract:** An agreement between two or more parties that creates enforceable rights and obligations.

> **Customer:** A party that has contracted with the entity to obtain goods or services that are an output of the entity's ordinary activities in exchange for consideration.

9. Paragraphs 24-25 of IFRS 15 provide additional guidance about distinguishing performance obligations involving transfers to customers from other promises in contracts with customers that do not lead to revenue recognition.

> **Promises in contracts with customers**
>
> 24 A contract with a customer generally explicitly states the goods or services that an entity promises to transfer to a customer. However, the performance obligations identified in a contract with a customer may not be limited to the goods or services that are explicitly stated in that contract. This is because a contract with a customer may also include promises that are implied by an entity's customary business practices, published policies or specific statements if, at the time of entering into the contract, those promises create a valid expectation of the customer that the entity will transfer a good or service to the customer.
>
> 25 Performance obligations do not include activities that an entity must undertake to fulfil a contract unless those activities transfer a good or service to a customer. For example, a services provider may need to perform various administrative tasks to set up a contract. The performance of those tasks does not transfer a service to the customer as the tasks are performed. Therefore, those setup activities are not a performance obligation.

What activities represent performance obligations in defined rate regulation?

10. Section 4 and Appendix B of the Discussion Paper provide background information about the revenue requirement and the rate-setting mechanism. This information highlights that the revenue requirement typically reflects the expected performance of activities that are both directly related to providing the goods or

services that are delivered and billed to the customers and other indirect activities required by the rate regulation. In some cases, the rate regulator will take into account the cash flow needs of the entity (and/or the customers) when establishing the revenue requirement for the period. Consequently, the revenue requirement may not reflect merely the performance of the current period, but also includes adjustments related to performance of other periods, which could be both past and future periods.

11. Several respondents note that the direct and indirect activities can create different types of obligations, only some of which involve the transfer to the customers of distinct goods or services. Some of these respondents suggest that it is particularly important to assess whether revenue should be recognised only for goods or services delivered to the customers. Some indirect activities may not be directly linked to the satisfaction of performance obligations to the customers and should, therefore, not result in the recognition of revenue, even if they directly affect an entity's current right to the revenue requirement.

12. Some respondents suggest that, in cases in which the rate-adjustment 'de-couples' or shifts volume or demand risk away from the entity to the customers, this may suggest that the service performed is not directly related to the volume of the activity. For example, the Autorité des Normes Comptables (ANC) suggests that:

> . . . For an energy distribution company, under DRR [defined rate regulation], the key service promised is the availability of the network.

13. We would like to explore, with the Consultative Group, whether it is possible to distinguish between types of activities/service promises that could or should result in revenue recognition, and other activities that the entity must undertake to fulfil its regulatory obligations but that do not support the recognition of revenue. To assist with this discussion, we have set out a short illustrative example, which contains some activities that we understand may be required by rate regulation and would typically be included in the calculation of the revenue requirements. These are for illustrative purposes only. We are also interested in other types of activities that the members of the Consultative Group can identify and would like to discuss.

Questions for the Consultative Group

Using the following example, and any other examples that you would like to introduce, how would you distinguish between the activities that you think involve the transfer to the customers of distinct goods or services and those that may not be directly linked to the satisfaction of performance obligations to the customers? Please explain the reasons for your answer.

14. The following illustrative example provides very simplified information. It is not intended to provide a comprehensive example of the rate regulation or the calculation of the revenue requirement. It is merely designed to provide a basis for discussion about the nature of the activities required. The focus of the discussion should be about whether each activity could or should be considered to relate to the satisfaction of performance obligations to the customers.

Illustrative example

Entity W provides household water services (provision of clean water and removal of waste water) to 200,000 customers in its local jurisdiction. It is the only provider of such services in that jurisdiction and is subject to defined rate regulation.

The rate regulator has established that its revenue requirement for the year ended 31 December 20X4 is made up as follows:

		CU000[1]	**CU000**
Regulatory depreciation of the regulatory asset base (RAB)			50,000
Allowable rate of return on the RAB			4,000
Fixed costs:			
Labour		16,000	
Repairs and maintenance (minimum level)		5,000	
Other fixed overheads		3,000	
			24,000
Variable costs:			
Waste water treatment		10,000	
Other variable overheads		2,000	
			12,000
Funding for development of environmentally-friendly water treatment processes[1]			1,500
Construction of new water treatment plant[2]			8,000
Total revenue requirement			99,500
Rate per unit to charge to customers (CU99.5m / 500,000 units)	CU0.199		

Notes

1. The rate regulator has allocated CU1.5m per annum for three years to the revenue requirement, starting in 20X4, for Entity W to carry out research and development work to reduce the environmental impact of the chemicals that it uses in its water treatment plant. The regulator has set a quantifiable target for the reduction, to be achieved by the end of 20X6. Failure to meet the target will result in the reduction of future revenue requirements to 'refund' all or part of the funding. Entity W commenced work on the project in March 20X4 and expects to achieve the target reduction within the allocated time frame. During 20X4, Entity W incurred costs on the project of CU250,000, which have been recognised as expenses (as research costs) in the period.
2. During 20X3, the rate regulator approved plans for Entity W to build a new water treatment plant to expand its capacity to process waste water. The expansion is required because the local government plans to build a new town within the jurisdiction to deal with an expected population increase related to the development of new industrial and business parks. The rate regulator has allocated CU8m per annum for two years to the revenue requirement, starting in 20X4, to help fund the construction, which commenced in March 20X4 and is expected to be completed during 20X5.

Additional note:
During 20X4, there was major unexpected flooding in the jurisdiction. As a result, Entity W incurred additional clean-up (water treatment costs) of CU0.5m and additional repairs and maintenance costs of CU1.5m. The rate regulator has confirmed that these additional costs will be included in the calculation of the revenue requirement for 20X6.

[1] In this Staff Paper, currency amounts are denominated in 'currency units' (CU).