

STAFF PAPER

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Project	Rate-regulated Activities		
Paper topic	The meaning of 'performance' when constructing assets for use in a rate-regulated business		
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This paper has been prepared for discussion at a public meeting of the Global Preparers Forum. The views expressed in this paper do not represent the views of the International Accounting Standards Board (the Board) or any individual member of the Board. Comments on the application of IFRS Standards do not purport to set out acceptable or unacceptable application of IFRS Standards. Technical decisions are made in public and reported in the IASB <i>Update</i> .			

The purpose of the session

1. In September 2014, the IASB published a Discussion Paper *Reporting the Financial Effects of Rate Regulation* (the DP). The DP highlighted the rights and obligations created by a particular type of rate regulation, termed 'defined rate regulation' in the DP. To participate in this discussion, GPF members do not need to be familiar with the DP or the description of defined rate regulation. However, Appendix 2 summarises the description of defined rate regulation, providing optional background reading.
2. In this meeting, IASB staff are seeking input from GPF members to help inform future discussions with the IASB about:
 - (a) how to define 'performance' in the context of defined rate regulation; and
 - (b) identify which activities should lead to the recognition of revenue.
3. In Appendix 1, we set out an illustrative example in which a government (through a rate regulator) requires the construction of a new water treatment plant. The rate regulator is considering four options for the funding of the construction. GPF members are asked to consider what assets, liabilities, income and expenses they think the rate-regulated water company should recognise under each option.

Background

4. Feedback on the DP suggests that the existing predominant IFRS practice for recognising revenue from activities that are subject to defined rate regulation may not reflect the economic substance of the regulatory agreement imposed on an entity that is subject to defined rate regulation. The existing predominant IFRS practice results in revenue being recognised for goods or services delivered to customers during the period using the ‘regulated rate’, ie the rate chargeable to customers as determined through the rate regulation. However, the regulated rate includes amounts that typically reflect activities that:
- (a) occur in a different period; and/ or
 - (b) do not meet the definition of a ‘performance obligation’ in IFRS 15 *Revenue from Contracts with Customers* (for example, construction of assets for the entity’s own use—see paragraph 5).
5. At this time, IASB staff are exploring whether we can develop proposals for an accounting model to more faithfully reflect the financial effects of defined rate regulation in IFRS financial statements. Responses to the DP suggested that we should try to use the principles of IFRS 15 as a starting point. However, an area of difficulty with this approach is that IFRS 15 defines ‘performance obligations’ as promises in a contract to transfer goods or services to the customer. However, in defined rate regulation, the regulatory agreement may oblige the entity to carry out some activities that do not meet the definition of a performance obligation but for which the entity receives consideration from customers, through the regulated rate charged for the goods and services delivered in the period. This paper focusses on one such example in which the rate regulator requires the construction of property, plant and equipment that will be used to provide services to customers in the future.

Questions for GPF members

The illustrative example in Appendix 1 outlines four possible scenarios for the construction and funding of a new water treatment plant that will be used to deliver water services that are subject to defined rate regulation. For each of the four scenarios:

- 1) What is the nature of the assets and/ or liabilities, if any, that Entity W should recognise at 31 December 20X1, 20X2 and 20X3?
- 2) What is the nature of the income and/ or expenses, if any, that Entity W should recognise in profit or loss during each year ended 20X1, 20X2 and 20X3?

Please indicate the reasons for your responses. In particular, please explain:

- (a) to what service/ performance any revenue recognised relates;
- (b) whether the accelerated recovery of the cost of the new water treatment plant through the rate charged to customers is relevant to the depreciation or carrying amount of the asset (options (a) and (d)); and
- (c) whether the exclusion of the cost of the new water treatment plant from the rate charged to customers is relevant to the carrying amount of the asset (options (b) and (c)).

6. For convenience, workshop participants may use the following table to indicate what assets/ liabilities, income/ expenses should be recognised for each scenario by Entity W. Please indicate the nature of the items recognised. It is not necessary to identify the monetary amounts.

	Option (a) CU million	Option (b) CU million	Option (c) CU million	Option (d) CU million
20X1 (funding put in place)				
Asset(s) at 31 December				
Liability/ Liabilities at 31 December				
Income for the year				
Expense for the year				
20X2 (construction of the plant)				
Asset(s) at 31 December				
Liability/ Liabilities at 31 December				
Income for the year				
Expense for the year				
20X3 (plant comes into use)				
Asset(s) at 31 December				
Liability/ Liabilities at 31 December				
Income for the year				
Expense for the year				

Appendix 1: Illustrative example for discussion

- A1. Entity W is the sole supplier of clean and waste water services in Country X. Entity W is subject to a well-established and stable system of defined rate regulation, as described in the DP. Entity W prepares financial statements for its reporting periods ending 31 December each year.
- A2. During 20X0, the government of Country X announced a 5-year plan to develop a new residential area on the outskirts of the capital city. The development is designed to address an increasing city population. The plan includes the following features:
- (a) 50,000 new homes will be built, plus schools, shops and other community facilities. Building work will begin in January 20X1 and be completed by the end of 20X5. The first phase of 15,000 homes will be complete and ready for occupation in January 20X3.
 - (b) In order to maintain the quality of water services to be provided, a new water treatment plant will be constructed during 20X2. It will begin operating in January 20X3, providing water services to customers in the newly developed residential area.
 - (c) The water treatment plant will be owned and operated by Entity W. The cost of the plant will be CU20 million and the useful economic life is estimated to be 40 years.¹
 - (d) There will be no price discrimination for water services between existing customers and customers in the new properties, that is, the customers in the new properties will pay the same regulated rate as other customers for water services, without having to pay an additional connection fee.
- A3. The rate regulator, which is a government office, is considering the following four options for the construction and funding of the new water treatment plant,

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

together with the related infrastructure needed to connect the plant to the new residential area:

- (a) **Fully retrospective recovery from customers:** The regulatory agreement will require Entity W to construct the plant and fund its construction. Subsequently, the regulated rate for water services will be increased for all customers from January 20X3 so that Entity W will recover the construction cost of CU20 million plus interest over the following 10 years. It is assumed that Entity W will borrow CU20 million in December 20X1 and will repay the loan in instalments commencing January 20X4.
- (b) **Fully prospective funding by government grant:** The regulatory agreement will require the water utility company, Entity W, to construct the plant. The government will provide a government grant of CU20 million to fund it. Subsequently, the cost of construction will not be recognised by the rate regulator when calculating future regulated rates for Entity W.
- (c) **Contribution by property developers:** Instead of requiring Entity W to construct the new water treatment plant, the government will make the property developers that are building the new homes to be responsible for constructing it. On completion in December 20X2, the new water treatment plant and related infrastructure will be transferred to Entity W. Subsequently, the cost of construction will not be recognised by the rate regulator when calculating future regulated rates for Entity W.
- (d) **Partly prospective, partly retrospective recovery from customers:** The regulatory agreement will require Entity W to construct the plant and fund its construction. However, the regulated rate for water services will increase from January 20X1 so that, in this case, Entity W will recover construction costs of CU2 million in each of 20X1 and 20X2. Subsequently, the rate regulator will recognise the remaining CU16 million plus interest in the determination of the regulated rate in order to recover this from customers over a ten year period beginning in

January 20X3. It is assumed that Entity W will borrow CU16 million in December 20X1 and will repay the loan in instalments commencing January 20X4.

- A4. The following table shows the relevant cash flows, excluding interest, that would result from the four options for Entity W:

	Option (a) CU million	Option (b) CU million	Option (c) CU million	Option (d) CU million
20X1 (funding put in place)				
Receipt of government grant—December	-	20	-	-
Receipt of loan—December	20	-	-	16
Receipt of cash through customer billings (existing customers only)	-	-	-	2
20X2 (construction of the plant)				
Receipt of cash through customer billings (existing customers only)	-	-	-	2
Construction of new water treatment plant	(20)	(20)	-	(20)
20X3 (plant comes into use)				
Receipt of cash through customer billings (both existing and new customers)	2	-	-	2

Appendix 2: Summary of defined rate regulation

A5. Paragraphs 4.4–4.6 of the DP summarise the key features of defined rate regulation. Paragraph 4.4 notes:

“that defined rate regulation involves a regulatory pricing (ie rate-setting) framework that includes all of the following:

- (a) it applies in situations in which customers have little or no choice but to purchase the goods or services from the rate-regulated entity because:
 - (i) there is no effective competition to supply; and
 - (ii) the rate-regulated goods or services are essential to customers (such as clean water or electricity).
- (b) it establishes parameters to maintain the availability and quality of the supply of the rate-regulated goods or services and other rate-regulated activities of the entity.
- (c) it establishes parameters for rates (sometimes referred to as prices or tariffs) that provide regulatory protections that:
 - (i) support greater stability of prices for customers; and
 - (ii) support the financial viability of the rate-regulated entity.
- (d) it creates rights and obligations that are enforceable on the rate-regulated entity and on the rate regulator.”

A6. Defined rate regulation establishes:

The entity’s obligations to:

- ensure the rate-regulated services are available without disruption to supply;
- deliver rate-regulated services on demand; and
- carry out other specified activities to achieve other government policies, eg social, environmental, fiscal policies.

The entity’s right to

charge customers a determinable amount of consideration in exchange for satisfying its regulatory obligations (the revenue requirement).

A7. The rights and obligations are set out in a 'regulatory agreement' between the rate regulator and the entity. The regulatory agreement

- (a) establishes the revenue requirement for a defined period (which may cover several years);
- (b) identifies the estimated level of demand for the regulated services over that period;
- (c) determines the regulated rate for the period, based on the combination of:
 - (i) estimated revenue requirement;
 - (ii) estimated demand; and
 - (iii) timing of billing to customers.
- (d) includes a rate adjustment mechanism to:
 - (i) 'correct' for variances from estimates; and
 - (ii) adjust the timing of when the revenue requirement is billed to customers to enable the rate regulator to moderate rate fluctuations/ cash flows.

A8. The regulated rate comprises:

- (a) a 'standing charge', ie a fixed amount, and/ or
- (b) a rate per unit.