IFRS

STAFF PAPER

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Accounting Standards Advisory Forum

Project	Rate-regulated Activities		
Paper topic	Constructing assets for use in a rate-regulated business		
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The purpose of the session

1. In this meeting, IASB staff are seeking input from ASAF 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.

2. This is a follow-up discussion to one held with ASAF members in July 2015. In the July 2015 meeting, ASAF members discussed three illustrative examples for which the regulatory revenue requirement has been, or will be, adjusted to reflect specified activities of the entity that do not directly relate to the delivery of units of water during the period.[1,2] The discussion highlighted difficulties in applying the principles of IFRS 15 *Revenue from Contracts with Customers* to identify which specified activities could meet a definition of 'performance' in the context of defined rate regulation and should lead to the recognition of revenue.

3. In this meeting, we would like to approach the issue from a different perspective. We are asking ASAF members to consider the illustrative example set out in

[1] The examples are set out in Agenda Paper 8 *Rate-regulated Activities: Cover Note*, July 2015.

[2] The 'revenue requirement' is the amount of consideration, determined through the defined rate regulation, that the entity is allowed to charge to customers in exchange for satisfying its regulatory obligations (see Appendix 2).

Appendix 1. Instead of focussing on the requirements of IFRS 15, we are looking more generally at how to reflect the economic substance of the specific scenarios outlined in Appendix 1 through the recognition of assets, liabilities, income and expenditure.

4. In the illustrative example in Appendix 1, 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. ASAF members are asked to identify what assets, liabilities, income (whether described as revenue or not) and expenses they think the rate-regulated water company should recognise under each option, and to explain the reasons for their responses.

Background

5. 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 (for example, construction of assets for the entity’s own use, which is the focus of this paper).

6. 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. 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 in IFRS 15 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.

Next steps

7. The IASB staff plan to use the input from ASAF members in a future analysis of whether, and if so how, the principles of IFRS 15 could be used to develop proposals for an accounting model that could more faithfully reflect the financial effects of defined rate regulation in IFRS financial statements. The IASB staff will also use the ASAF members' input in reconciling any proposals for an accounting model to the proposed revisions to the *Conceptual Framework for Financial Reporting*.

Questions for ASAF members

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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) the reason for selecting which of the accounting policies available in IAS 20 *Accounting for Government Grants and Disclosure of Government Assistance* to use to account for the government grant (option (a));
(b) to what service/ performance any revenue recognised relates;
(c) 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 (c) and (d)); and
(d) 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 (a) and (b)).

8. For convenience, ASAF members 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 unless considered helpful in explaining the response.

	Option (a) Fully prospective funding by government grant **CU million**	**Option (b)** Contribution by property developers **CU million**	**Option (c)** Fully retrospective recovery from customers **CU million**	**Option (d)** Partly prospective, partly retrospective recovery from customers **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 has been granted the right to be the sole supplier of water services for an indefinite period, in exchange for agreeing to provide water services in accordance with the regulatory agreement. The rate regulator can only terminate the agreement if Entity W persistently fails to satisfy its obligations under the regulatory agreement. Entity W prepares financial statements for its reporting periods ending 31 December each year.

A2. During 20X0, the government of Country X announced a 20-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 government expects the population to continue to increase for at least the next 20 years and then stabilise. The first 5-year phase of the development 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 to both existing and new customers, 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. The new water treatment plant is designed to provide sufficient capacity to cover 120,000 homes and related community facilities, which will support further population increase and residential development beyond the current 5-year phase of the plan.

(c) The cost of the plant will be CU20 million and the useful economic life is estimated to be 40 years.[3] The water treatment plant will be owned, operated and controlled by Entity W. The regulatory agreement does not explicitly require Entity W to use the new water treatment plant to provide water services to customers, or set out how Entity W should operate the plant. However, the regulatory agreement establishes the quantity and quality of water services to be provided to customers. The quantity of services required to be provided will increase in line with the government's expectations about population growth. The rate regulator has indicated that the existing quality criteria in the regulatory agreement will not be reduced. Consequently, Entity W will not be able to satisfy its obligations to provide the water services required by the regulatory agreement without using the new water treatment plant.

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

(a) **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.

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

(b) **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 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.

(c) **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.

(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) Fully prospective funding by government grant CU million	Option (b) Contribution by property developers CU million	Option (c) Fully retrospective recovery from customers CU million	Option (d) Partly prospective, partly retrospective recovery from customers 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.