

## STAFF PAPER

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Project	Rate-regulated Activities		
Paper topic	Performance incentives		
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**Purpose of this paper**

1. This paper discusses when performance incentives form part of total allowed compensation and gives special consideration to incentives for construction-related activities of the entity. As noted in Agenda Paper 9 *Cover note*, earlier discussions of the Board were not explicit on this topic.
2. This paper does not ask the Board to make any decisions. Questions pertaining to this paper are presented in Agenda Paper 9D *Summary of staff recommendations*.

**Structure of this paper**

3. This paper follows the discussion on total allowed compensation in Agenda Paper 9A *Background and Regulatory Capital Base (RCB)*, and is structured as follows:
  - (a) background (paragraphs 4–8);
  - (b) application of the principle for target profit in Agenda Paper 9A to non-construction-related performance incentives (paragraphs 9–14);
  - (c) construction-related performance incentives (paragraphs 15–19); and
  - (d) conclusion and staff recommendation (paragraphs 20-21).

## Background

4. During this project, the Board has learnt that performance incentives are a common feature of rate regulation in many jurisdictions. Incentive-based regulation will often incorporate financial rewards and penalties in the basis for setting the regulated rates to induce an entity to achieve desired regulatory objectives.
5. In July 2019, the Board discussed performance incentives— bonuses for achieving (or penalties for failing to achieve) specified performance criteria (eg targeted levels of service quality or reliability, customer satisfaction, etc) and how the model would apply when, at the financial reporting date, it is not yet certain whether an entity will become entitled to such a bonus (or liable for such a penalty).<sup>1</sup> The incentives discussed in July 2019 were those of an operational or non-construction-related nature. In this paper, staff distinguish these incentives from those pertaining to an entity's construction-related activities (paragraphs 15–19).
6. The staff's analysis presented in July 2019 concluded that non-construction-related performance incentives form part of total allowed compensation for goods or services supplied during the period to which the performance incentive relates—that is, the period in which the performance criteria for the performance incentive are monitored and evaluated. The Board considered the staff's analysis but was not asked to make any explicit decisions on it.
7. Paragraphs 9–14 analyse how the principle for target profit more broadly, as set out in paragraph 21 of Agenda Paper 9A, interacts with this conclusion for non-construction-related performance incentives.
8. Paragraphs 15–19 extend this analysis to construction-related performance incentives, exploring whether any further considerations are necessary.

### **Application of the principle for target profit in Agenda Paper 9A to non-construction-related performance incentives**

9. In paragraph 21 of Agenda Paper 9A, staff recommend the following principle for determining when target profit forms part of total allowed compensation:

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<sup>1</sup> Agenda Paper 9C discussed at the July 2019 Board meeting.

Target profit that a regulatory agreement entitles an entity to charge customers for a specified period forms part of total allowed compensation for goods or services supplied in that period.

10. The regulated rates charged to customers for a specified period:
  - (a) may include compensation for a performance incentive for which the relevant performance criteria were monitored and evaluated in a different period (ie an amount for a performance incentive that corresponds to a different period); or
  - (b) may not include compensation for a performance incentive for which the relevant performance criteria were monitored and evaluated in the same period (ie an amount for a performance incentive that corresponds to the same period).
11. Applying the principle for target profit in paragraph 9 without modification to non-construction-related performance incentives would not change the outcomes described in paragraph 10. In other words, applying the principle for target profit may result in compensation for achieving non-construction-related performance incentive criteria (or for failing to achieve it) affecting profit in a period that is different to the period in which the performance criteria were monitored and evaluated. This contradicts the **model's general principle** which aims to reflect compensation for goods or services in the period in which those goods or services are supplied.
12. Therefore, the staff recommend that:

Amounts relating to a performance incentive form part of total allowed compensation for goods or services supplied in the period in which the performance criteria are monitored and evaluated.<sup>2</sup>

13. That principle for non-construction-related performance incentives is consistent with Board's discussion of the staff's analysis in July 2019. Additionally, staff think that principle is aligned to the model's general principle because it treats incentives as part of total allowed compensation for goods or services supplied in the period the entity

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<sup>2</sup> In some cases, when the performance period over which these criteria are monitored and evaluated is not yet complete, an entity will need to estimate the compensation to which it is entitled (see Agenda Paper 9C discussed at the July 2019 Board meeting).

achieves, or fails to achieve, the performance criteria for the performance incentive. Consequently, staff consider that the principle remains appropriate, even though this constitutes a departure from the broader principle for target profit set out in paragraph 9.

14. Paragraphs 15–19 analyse whether this conclusion can be extended to construction-related performance incentives.

### **Construction-related performance incentives**

15. Some performance incentives relate to an entity's performance when carrying out construction activities, such as achieving specified milestones which are measured and evaluated during the construction of an asset.
16. Staff are of the view that, if the performance criteria relate primarily to construction activities and the entity has achieved (or failed to achieve) these criteria during the construction period, then the performance incentive should form part of the total allowed compensation during that period. This is **aligned with the approach for non-construction-related incentives set out in paragraph 12.**
17. Some may question whether recognising a construction-related performance incentive as total allowed compensation during the construction period is aligned with the model's general principle to reflect compensation for goods or services in the period in which those goods or services are supplied, because no goods or services are supplied with that asset whilst it is being constructed. However, we think that in this case, the compensation for the performance incentive is not related to the goods or services to be supplied with the asset being constructed, but is instead related to the entity's performance in executing the construction activity and thus should be recognised as total allowed compensation during this period.
18. Some construction-related performance incentives may be conditional on satisfying requirements when supplying goods or services in future periods with the asset under construction. For example, a regulatory agreement may provide an entity with a bonus for achieving specified construction milestones, but specify that this bonus can be included in the regulated rates only once the asset has been placed into use, and is subject to the asset continuing to operate at a specified level of capacity. In that case, the bonus is not solely for achieving the construction milestones, but also for

maintaining a given capacity levels over a period specified by the regulatory agreement.

19. In this scenario, the conditions attached to the performance incentive indicate that the incentive is not solely related to construction activities, but is, at least in part, related to the future supply of goods or services to customers. An entity should therefore view the part of the incentive which is conditional on the future supply of goods or services as forming part of the total allowed compensation the entity becomes entitled to for the supply of those goods or services. The entity should consider the terms of the regulatory agreement relating to the design of the performance incentive, and any other relevant facts and circumstances, to determine which period the performance incentive relates to.

### **Conclusion and staff recommendation**

20. In the staff's view, aligning the treatment of when amounts for non-construction-related and construction-related performance incentives form part of total allowed compensation has the following advantages:
  - (a) provides more useful and understandable information to the users of financial statements than using different approaches to reflect compensation for different types of incentives—having different requirements may only add confusion for users and not result in any added information value.
  - (b) lower costs for preparers from not having to develop and implement different policies and processes to account for performance incentives according to their type (except those construction-related incentives that are conditional on satisfying requirements when supplying goods or services in future periods, as discussed in paragraphs 18-19).
21. Therefore, the staff recommend that performance incentives, whether construction-related or non-construction-related, should form part of total allowed compensation for goods or services supplied in the period when the relevant performance criteria are monitored and evaluated.