KERALA STATE ELECTRICITY REGULATORY COMMISSION

THIRUVANANTHAPURAM

Suo-motu Proceedings on

Recovery of depreciation on Assets Created out of Contribution and Grants

As per the provisions of the Electricity Act 2003, it is the duty of the licensees to establish transmission system or distribution system as the case may be and the generating company to establish, operate and maintain generating stations. In a cost plus regime, any reasonably incurred expenses (revenue as well as capital) are recovered through tariffs as determined by the respective Commissions. Accordingly it is ensured that the investments made in the sector by the entities are reasonably recovered from the consumers. In the cost plus regime, investments in fixed assets are recovered through the financing cost (cost of capital) and depreciation (recovery of capital). However, there are instances where assets are developed with contribution from consumers or through grants *(hereinafter referred to as 'contribution' for short)* received from Government or other institutions. In such situations, the legitimate issue arises as to whether the licensees are entitled to recover the capital created out of contributions.

The Commission observes that there is no distinction regarding recovery of depreciation made in the books of accounts of the licensees on the assets created out of contribution and funded by the licensees themselves. Depreciation is claimed for all assets, irrespective of the source of funds. Further replacement of such assets is funded through regular capital investment programme. The Commission is of the view that this treatment involves double burden on the consumers and also violates the general principle of Accounting Standards (AS 12). AS 12 provides for the recognition of the value of fixed assets acquired with Grants. The entity receiving the grant appropriately adjusts the books of accounts so as to have no additional financial gains or its impact on income and expenditure statement will be nil.

However, it can be seen that in the books of accounts of the licensees, the impact of receipt of grants is clearly reflected by charging depreciation. Hence, it is legitimate that the depreciation already claimed from the consumers for the assets created out of grants/contribution needs to be clawed back. The Commission in various ARR&ERC have allowed the licensees to charge depreciation on all assets irrespective of source of funds, on the premise that replacement of the assets are the

responsibility of the licensees. However, in the regular capital expenditure programme no such distinction is made on the replacement of assets created out of contribution. **Accordingly, the Commission hereby proposes to initiate *suo-motu* proceedings to clawback the depreciation already claimed by the licensees on the assets created out of contribution**. In the present proceedings, the case of Kerala State Electricity Board (the *Board* for short) is taken up.

The details of contribution received for creating capital assets as per the accounts of the Kerala State Electricity Board as on March 31 from 2003-04 is given below:

Table:1.Contribution and grants towards creation of capital assets (2003/04 - 2008/09)

(Rs. Crore at the end of the year)

	2003-04	2004-05	2005-06	2006-07	2007-08	2008-09
Consumer contribution	1060.75	1203.18	1345.82	1478.06	1623.818	1,881.76
Subsidies for cost of capital assets	1.6	2.13	2.55	55.05	55.05	9.17
Grants for cost of capital assets	111.67	168.92	278.4	322.23	346.625	410.35
Contribution from PWD	37.77	38.78	51.98	84.08	100.39	178.96
Contribution from Public towards cost of capital assets	0.063	0.063	0.1307	2.8307	2.8307	23.89
Total	**1,211.85**	**1,413.07**	**1,678.88**	**1,942.25**	**2,128.71**	**2,504.13**

As on 31-3-2009, a total of Rs.2504.13 Crore has been collected by the Board on this account, which should have been used for creation of assets. Function wise gross fixed assets as per the accounts of the Board are as follows:

Table 2. Function wise Gross Fixed Assets (GFA) from 2003-04 to 2008-09

(Rs.Crore)

Gross block	2003-04	2004-05	2005-06	2006-07	2007-08	2008-09
Thermal Generation	947.07	950.85	968.44	978.16	982.98	986.93
Hydel generation	1,646.00	1,704.83	1,954.59	2,017.48	2,081.27	2,145.10
Transmission	2,023.01	2,230.55	2,399.22	2,580.86	2,774.42	3,029.03
Distribution	**1,943.75**	**2,174.08**	**2,389.37**	**2,640.35**	**2,845.86**	**3,088.04**
Total GFA	**6,559.82**	**7,060.31**	**7,711.62**	**8,216.85**	**8,684.53**	**9,249.10**
Total Contribution/Grants received	***1211.85***	***1413.07***	***1678.88***	***1942.25***	***2128.71***	***2504.13***
% of contribution/grants in Distribution GFA	***62.35%***	***65.00%***	***70.26%***	***73.56%***	***74.80%***	***81.09%***

It can be seen from the Table 2 that, contribution and grants received by the Board has increased from 62% in 2003-04 to about 81% of GFA of distribution in 2008-09. Hence, of the total depreciation claimed for distribution assets, 62% to 81% is to be reasonably accounted as part of the assets created using contribution/grants. Based

on this premise, the share of depreciation on the assets created out of contribution/grants is worked out as follows for 2003-04 to 2008-09.

Table – 3 Share of depreciation for assets created out of contribution/grants

Year	GFA (Distribution)	Contribution/ Grants	Depreciation claimed for Distribution	Share of Depreciation for assets created out of Contribution/grants
	Rs. Crore	Rs. Crore	Rs. Crore	Rs. Crore
2003-04	1,943.75	1,211.85	116.26	72.48
2004-05	2,174.08	1,413.07	137.49	89.36
2005-06	2,389.37	1,678.88	148.45	104.31
2006-07	2,640.35	1,942.25	155.16	114.13
2007-08	2,845.86	2,128.71	159.06	118.98
2008-09	3,088.04	2,504.13	162.66	131.90
Total			**879.08**	**631.70**

The Table 3 shows the depreciation booked by the Board as per their accounts. Of the total depreciation of Rs.879.08 Crore booked from 2003-04 to 2008-09 for distribution, Rs.631.70 Crore is for the share of assets created out of contribution/grants. However, the Commission has been allowing depreciation as per the CERC Norms from 2006-07 onwards. Accordingly depreciation allowed by the Commission and booked as per the accounts of the Board are different. Based on that, depreciation attributable to the assets created out of depreciation from 2003-04 to 2008-09 based on the approved figures would be as follows:

Table 4: Share of depreciation for assets created out of depreciation based on the approved depreciation

Year	As per Accounts		Approved by the Commission		
	Total depreciation	Depreciation for distribution Assets	Total depreciation	Depreciation for distribution Assets	Share of Depreciation for assets created out of Contribution/ grants
	Rs. Crore	Rs. Crore	Rs. Crore	Rs. Crore	Rs. Crore
2003-04	326.19	116.26	326.19	116.26	72.48
2004-05	374.77	137.49	374.77	137.49	89.36
2005-06	392.65	148.45	392.65	148.45	104.31
2006-07	405.98	155.16	230.67	88.16	64.85
2007-08	419.07	159.06	260.18	98.75	73.87
2008-09	434.74	162.66	290.69	108.76	88.20
Total		**879.08**			**493.07**

The above mentioned calculations show that about Rs.493 Crore on account of depreciation has been realised by the Board on assets created out of contribution upto 2008-09. **Thus, it is proposed that the depreciation claimed already by the Board to the tune of about Rs.493 Crore between 2003-04 to 2008-09 has to be recouped and returned to the consumers through proper allowance in the ARR&ERC.**

The Commission invites views/suggestion/objections from the licensees, consumers and other stakeholders in the matter which may be sent directly **by 20-12-2010** to the Secretary, Kerala State Electricity Regulatory Commission, KPFC Bhavan, Vellayambalam, Thiruvananthapuram-10. The Commission will hold a public hearing on the matter on **30-12-2010** at Commissions Office, Thiruvananthapuram for which no separate notice will be issued. Interested persons may participate in the hearing and submit their views before the Commission.

SECRETARY
Kerala State Electricity Regulatory Commission

KERALA STATE ELECTRICITY REGULATORY COMMISSION

Background note

Treatment of depreciation on Assets Created out of Contribution and Grants

Introduction

As per the provisions of the Electricity Act 2003, it is the duty of the licensees to establish transmission system or distribution system as the case may be and the generating company to establish, operate and maintain generating stations. In a cost plus regime, any reasonably incurred expenses (revenue as well as capital) are recovered through tariffs as determined by the respective Commissions. Accordingly it is ensured that the investments made in the sector by the entities are reasonably recovered from the consumers. However, there are instances where the investments are funded from sources other than the licensees. In other words, assets are developed with contribution from consumers or through grants *(hereinafter referred to as 'contribution' for short)* received from Government or other institutions. In such situations, the legitimate issue arises as to whether the licensees are entitled to recover the capital created out of contributions.

In the cost plus regime, investments in fixed assets are recovered through the financing cost (cost of capital) and depreciation (recovery of capital). In the case of contributions or grants, the issue of cost of capital does not arise, where as the issue of recovery of capital through depreciation and financing of replacement of assets are pertinent. The Commission in the ARR&ERC Orders have allowed depreciation on the Gross Fixed Assets of the Kerala State Electricity Board *(Board for short)*. However, it has been noticed that a substantial portion of the assets are funded out of contribution from consumers and/or Government or other institutions. The details of contribution received for creating capital assets as per the accounts of the as on March 31 of each year from financial year 2003-04 is as shown below:

Table:1.Contribution and grants towards creation of capital assets (2003/04 - 2008/09)

(Rs. Crore at the end of the year)

	2003-04	2004-05	2005-06	2006-07	2007-08	2008-09
Consumer contribution	1060.75	1203.18	1345.82	1478.06	1623.818	1,881.76
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Contribution from Public towards	0.063	0.063	0.1307	2.8307	2.8307	23.89

cost of capital assets						
Total	**1,211.85**	**1,413.07**	**1,678.88**	**1,942.25**	**2,128.71**	**2,504.13**

As on 31-3-2009, a total of Rs.2504.13 Crore has been collected by the Board on this account, which should have been used for creation of assets. Function wise gross fixed assets as per the accounts of the Board are as follows:

Table 2. Function wise Gross Fixed Assets (GFA) from 2003-04 to 2008-09

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Distribution	**1,943.75**	**2,174.08**	**2,389.37**	**2,640.35**	**2,845.86**	**3,088.04**
Total GFA	**6,559.82**	**7,060.31**	**7,711.62**	**8,216.85**	**8,684.53**	**9,249.10**
Total Contribution/Grants received	***1211.853***	***1413.073***	***1678.8807***	***1942.2507***	***2128.714***	***2504.129***
% of contribution/grants in Distribution GFA	***62.35%***	***65.00%***	***70.26%***	***73.56%***	***74.80%***	***81.09%***

Since the contribution received is for creating assets for providing connections to the Consumers, ideally it should form part of the assets of Distribution function. It can be seen from the table 2 that, contribution and grants received by the Board has been increased from 62% in 2003-04 to about 81% of GFA of distribution in 2008-09. Hence, of the total depreciation claimed for distribution assets, 62% to 81% is reasonably can be accounted as part of the assets created using contribution/grants. Based on this premise, the share of depreciation on the assets created out of contribution/grants is worked out as follows for 2003-04 to 2008-09.

Table – 3 Share of depreciation for assets created out of contribution/grants

Year	GFA (Distribution)	Contribution/ Grants	Depreciation claimed for Distribution	Share of Depreciation for assets created out of Contribution/grants
	Rs. Crore	Rs. Crore	Rs. Crore	Rs. Crore
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Total			**879.08**	**631.70**

The table 3 shows the depreciation booked by the Board as per the accounts. Of the total depreciation of Rs.879.08 Crore booked from 2003-04 to 2008-09 for distribution, Rs.631.70 Crore is for the share of assets created out of contribution/grants. However, the Commission has been allowing depreciation as per the CERC Norms from 2006-07 onwards. Accordingly distribution allowed by the Commission and booked as per the accounts of the Board are different. Based on that, depreciation attributable to the assets created out of depreciation from 2003-04 to 2008-09 based on the approved figures would be as follows:

Table 4: Share of depreciation for assets created out of depreciation based on the approved depreciation

Year	As per Accounts		Approved by the Commission		
	Total depreciation	Depreciation for distribution Assets	Total depreciation	Depreciation for distribution Assets	Share of Depreciation for assets created out of Contribution/ grants
	Rs. Crore	Rs. Crore	Rs. Crore	Rs. Crore	Rs. Crore
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2007-08	419.07	159.06	260.18	98.75	73.87
2008-09	434.74	162.66	290.69	108.76	88.20
Total		**879.08**			**493.07**

The above calculations show that about Rs.493 Crore of depreciation has been realised by the Board on account of assets created out of contribution. The Commission has the policy that if the replacement of assets are done by the entity claiming depreciation, the same can be allowed even if the assets are created out of contribution. However, it can be seen from the capital expenditure programme that, the Board is not excluding the replacement of assets created out of contribution/grants from the normal capital expenditure programme. This amounts to double counting since depreciation for the assets created out of contribution is claimed from the tariff on the one side and replacement of assets are also included part of general capital expenditure programme which is also funded through the tariff. Accordingly, the Commission is concerned with double recovery of capital in the present scheme of things. This issue is further analysed in the following sections.

Recovery of capital through depreciation:

In the tariff determination process, the Commission is concerned with two issues regarding depreciation:

a. The rate of depreciation

b. The assets on which depreciation is to be allowed.

We begin by examining the concept of depreciation. Depreciation is one item in the Aggregate Revenue Requirements allowed to Generating companies and licensees for the recovery of capital through tariffs charged on to the consumers. Depreciation of fixed assets is defined in the Accounting Standard 6 (AS6) formulated by Institute of Chartered Accountants of India. In para 3.1 of AS6 says that depreciation is :

> *"a measure of the wearing out, consumption or other loss of value of a depreciable asset arising from use, efflux of time or obsolescence through technology and market changes. Depreciation is allowed so as to charge a fair portion of the depreciable amount in each accounting period during the expected useful life of the asset. Depreciation include amortization of assets whose useful life is predetermined".*

As per para 6 of AS 6, the cost of depreciable assets is the total cost of acquisition, installation and commissioning as well as the addition or improvement of assets. Generally, in the electricity Industry the depreciation shall be calculated annually based on straight-line method over the useful life of the asset. The residual life of the asset shall be considered as 10% and depreciation shall be allowed up to a maximum of 90% of the historical capital cost of asset.

Depreciation is one important item of allowable expenses in the ARR mainly due to the fact that it is a non-cash item which provide the licensees/generating companies necessary cash for meeting obligations which are not directly passed on to the tariff, for eg: repayment of debt. Further, the changes in method of depreciation and the rates may affect the tariffs (front loading or backloading). However, such issues are almost settled in the light of the decision of Hon. Supreme Court in DERC Vs BSES dated 15-2-2007. The Apex Court had elaborately considered the concept of depreciation and has held that depreciation shall be based on useful life of the asset and is for the recovery of capital and shall not be linked to repayment obligations. In the light of this, we may examine the rate of depreciation that can be allowed for the fixed assets.

Para 5.3 (c) of Tariff Policy published by Government of India states that :

> *"The Central Commission may notify the rates of depreciation in respect of generation and transmission assets. The depreciation rates so notified would also be applicable for distribution with appropriate modification as may be evolved by Forum of Regulators. The rates of depreciation so notified would be applicable for purpose of tariffs as well as accounting."*

The Secretariat of the Forum of Regulators vide letter No. 1/2 (6)/2006-Tariff Policy/CERC dated 23-6-2006, communicated that, the depreciation rates as specified by CERC (Terms and Conditions of Tariff) Regulations, 2004 may be treated as the rates of depreciation for the purpose under para 5.3 (C) of tariff policy dated 6-1-2006. This method of treatment was also held by the Appellate Tribunal of Electricity (APTEL) in Appeal No. 5 of 2009 in KSEB Vs KSERC. Hence, it is a settled position that the rates of depreciation is as per the norms of CERC unless separate rates are notified by the respective Commissions through subordinate legislations.

The next issue is regarding the assets on which depreciation is to be allowed. The capital expenditure programme of licensees/generating companies are approved by the respective Commission so that such assets form the *ratebase* on which financing costs (interest, returns and depreciation) are recovered. The basic rationale is that if the licensees incur any prudent costs for providing service (electricity in this case), such costs are to be reasonably recovered from the Consumers through tariff or other means.

In case of investments in assets are made out of the contribution, source of funds is not from the licensee/generating companies. In such situation, the legitimate question is whether is it fair to allow the licensees to recover such investments through depreciation. However, there is a genuine issue that, though initially the assets are created out of contribution, the responsibility of replacement of assets generally vests with the licensees. If the recovery of capital is allowed, the licensee can replace the assets as and when it is worn out. Hence, there are two issues involved in the matter:

1. Whether depreciation is to be allowed for assets created out of grants/contribution ?
2. How the replacement of assets is to be funded ?

These issues are examined below:

1. Whether depreciation to be allowed for assets created out of grants/contribution

This issue is dealt in the Accounting Standards 12 (AS12), which states about the recognition of the value of fixed assets acquired with Government Grants. As per para 14 of AS12,

> *"Government grants related to specific fixed assets should be presented in the balance sheet by showing the grant as a deduction from the gross value of assets concerned in arriving at their book value. Where the grant released to a specific fixed asset equals the whole, or virtually the whole, of the cost of the assets, the assets should be shown in the balance sheet at a nominal value. Alternatively government grant related to depreciable fixed assets may be treated as deferred income which should be recognised in the profit and loss statement on a systematic and rational basis over the useful life of asset ie., such grant should be allocated to income over the periods and in the proportions in which depreciation on those assets is charged. Grants related to non-depreciable assets should be credited to capital reserve under this method. However, if a grant related to a non-depreciable asset requires the fulfilment of certain obligations, the grant should be credited to income over the same period over which the cost of meeting such obligations is charged to income. The deferred income balance should be separately disclosed in the financial statements."*

Thus, as per the Accounting Standards, the entity receiving the grant appropriately adjust the books of accounts so as not to have any additional financial gains or its impact on income and expenditure statement is nil. If the asset is a depreciable asset the same can be shown in the books of accounts in two ways:

a. the value of the fixed asset can be shown by deducting the amount of government grant received from the total value of assets. That means the balance amount if any after deducting the Government grant only need to be depreciated over its useful life period.

b. Alternatively, the total value including government grant can be depreciated over the useful life period of the fixed asset; but the same time govt. grant received for that particular asset need to be treated as a deferred income proportionate to the depreciation of the asset.

The above two methods ensure that net impact of the depreciation and deferred income in the income and expenditure statement will be zero. Thus the accounting standards provide that even if grants or contributions are received, its effect shall not create any impact on the accounting statements.

2. Method of replacement of assets created out contribution/grants

In the electricity industry Government grants/contributions from the consumers are available for creation of assets. However, the responsibility of replacement of such assets always rests on the licensees. General practice is that all assets - new or replacement – are included in the annual capital expenditure programme which become part of the allowable ARR. This method is legitimate if there is no depreciation claimed for the assets created out of contributions.

However, the Commission observes that there is no distinction is made in the books of accounts of the licensees on the assets created out of contribution and funded by the licensees themselves. The depreciation is claimed for all assets. Further in the capital investment programme which forms the part of allowable ARR, replacement of all assets including that created out of contribution are also included. The Commission is of the view that this type of treatment involves double impact on the consumers and also violates the principle of AS 12. The consumers are made to pay for the replacement of assets created out of contribution through depreciation. The consumers are also burdened for creation of assets by financing it if the same is included in the capital expenditure programme.

According to the Commission, it is fair to allow depreciation for assets which are created out of contribution if replacement of assets are not included in the capital expenditure programme. Alternatively, depreciation cannot be allowed as per the principle of AS12, if the replacement of assets are included in the capital expenditure programme financed through ARR.

The depreciation already claimed from the consumers needs to be returned by the Board. Accordingly, the Commission is of the view that depreciation claimed already by the Board to the tune of about **Rs. 493 Crore** has to be recouped and returned to the consumers by including proper allowance in the net revenue gap.