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Issues Paper

Total Allowed Compensation - Regulatory returns on CWIP

Objective

- 1 As mentioned in the cover note, the feedback to the IASB ED highlights Total Allowed Compensation (TAC) as one of the significant topics of concern and a priority topic for the IASB redeliberation process. Within TAC, two of the main concerns¹ are on:
 - (a) regulatory returns on construction work-in-progress (CWIP)- a component of TAC-target profit addressed in this issues paper; and
 - (b) regulatory assets and regulatory liabilities arising from differences in regulatory recovery pace and assets' useful lives. This concern is addressed in agenda paper 05-04.
- 2 The objective of this issues paper is to inform and obtain the preliminary views of EFRAG FR TEG on possible courses of action the IASB could consider in responding to the feedback on the ED's proposal on regulatory returns on CWIP.
- 3 These courses of action were discussed with the IASB's Rate-regulated Activities (RRA) Consultative Group at their meeting on 4 March 2022 (see [IASB staff paper](#)). The EFRAG RRAWG also discussed these courses of action on 28 April 2022.
- 4 The rest of this paper is structured as follows:
 - (a) The ED proposals on regulatory returns on CWIP
 - (b) Regulatory regimes relevant for regulatory returns on CWIP
 - (c) Feedback received by the IASB on the proposals
 - (d) IASB staff suggested alternative approaches to address concerns raised
 - (e) IASB RRA Consultative Group views expressed on 4 March 2022

¹ The December 2021 IASB staff paper on the redeliberation plan indicates that, in respect of TAC, there will also be IASB papers on a) exploring whether and, if so, how to amend the proposed guidance on total allowed compensation for allowance-based regulatory schemes; b) the definition of allowable expenses and tension between the proposed requirements in paragraphs B4 and B15 of the Exposure Draft. And the IASB will also consider whether any changes to the TAC proposals affect the proposed objective of the ED; and whether to developing guidance or illustrative examples for the final Standard dealing with inflation adjustments reflected either in the regulatory returns or the regulatory capital base.

- (f) EFRAG RRAWG views expressed during the 28 April 2022 meeting
- (g) IASB discussion on 26 May 2022.

The ED proposals on regulatory returns on CWIP

- 5 Paragraph B10 of the ED sets out the general principle for target profit and states that: The target profit that a regulatory agreement entitles an entity to add in determining a regulated rate for goods or services supplied in a period forms part² of the TAC for goods or services supplied in the same period. As an exception to this general principle for target profit, paragraph B15 of the ED proposes that:
- (a) regulatory returns on CWIP should form part of TAC for goods or services supplied once the assets are available for use and over the remaining periods in which the entity recovers the carrying amount of the assets through the regulated rates; and
 - (b) an entity uses a reasonable and supportable basis in determining how to allocate the returns on CWIP over those remaining periods and applies that basis consistently.
- 6 Nonetheless, the IASB concluded that the proposal in paragraph B15 of the ED is consistent with the principle underlying the model because no goods or services are being supplied using an asset before it is available for use. The goods and services under the proposed model are the goods and services that the customer receives and pays for, rather than a broader notion of goods and services including the ongoing supply of goods and services by building and maintaining the infrastructure that provides the goods and services. For this reason, regulatory returns earned by an entity during CWIP (and recognised as revenue under IFRS 15 *Revenue from Contracts with Customers*) are deferred to when the asset is available for use.

Regulatory regimes relevant for regulatory returns on CWIP

- 7 Regulatory agreements typically determine the regulatory return for a period by specifying a return rate and a regulatory asset base to which that return rate applies, and when they are included in the regulated rate that is charged to customers. Such returns aim to compensate an entity for fulfilling the obligations during the construction period which include the provision of capital (debt and equity) to fund investment in the network.
- 8 The period(s) in which an entity receives the regulatory return in the rates charged to customers can differ and depend on the applicable regulatory regime. Consider the following example that was discussed at the IASB's Rate-regulated Activities Consultative Group meeting on 4 March 2022.
- Assume that an entity spends CU2,000 in Year 0 for constructing a plant. Assume also that a regulatory agreement entitles the entity to a regulatory return of 5% per annum on the invested capital and gives the entity a right to recover the invested capital over Years 1–10, the operating phase of the plant. The entity is therefore entitled to a regulatory return of CU100 for Year 0.*
- 9 Based on the feedback from respondents, the IASB has identified the following two types of regulatory approaches (regimes):
- (a) **Allowance for funds used during construction approach - regulatory Approach 1 (RA1)** - The regulatory agreement entitles the entity to include the regulatory returns of CU 100 on CWIP in the rates charged to customers during the operating phase of the plant (Years 1-10). RA1 is also referred to

² Other components of TAC are allowable expenses minus chargeable income, profit margin, performance incentives and regulatory interest expense (income). In addition to regulatory returns, Profit margin and performance incentives are elements of the target profit.

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as “Allowance for funds used during construction” regulatory approach (AFUDC)

- (b) **Rate Base - Regulatory Approach 2 (RA2)** - The regulatory agreement entitles the entity to include the regulatory returns of CU 100 on CWIP in the rates charged to customers during the construction period (Year 0) for goods or services supplied using another plant. The RA2 is also referred to as the “Rate Base” regulatory approach.

- 10 In both **RA1** and **RA2**, an entity has a right, under the regulatory agreement, to accrue regulatory returns on CWIP during the construction period; but the periods in which those returns are included in the rates charged to customers are different.

RA1 compared to RA2

Regulatory approach	RA1 – AFUDC	RA2 – Rate Base
Description	Regulatory returns accumulate while the asset is being constructed and are included in the regulated rates charged to customers only once the asset is in operation	Regulatory returns are included in the regulated rates charged to customers during periods when the asset is being constructed
Jurisdictions	Prevalent in North America (Canada and United States).	Prevalent in Asia-Oceania (Australia, Hong Kong), Europe (Austria, Germany, Italy, The Netherlands, United Kingdom)
Current accounting	Entities applying US GAAP or local GAAP based on US GAAP capitalise the AFUDC amount during the construction period. Because entities incur interest expense, the net effect of this capitalisation in profit or loss would typically be the equity component of AFUDC	These returns are recognised in revenue under IFRS 15 as they are included in the rates charged to customers during the construction period
Effects of the proposals	Under the proposals, an entity would not recognise a regulatory asset for approved AFUDC amounts during the construction period The proposals would require an entity to recognise the AFUDC amounts in profit or loss as they are included in the rates charged to customers during the operation of the asset	The proposals would require entities to account for these regulatory returns as a regulatory liability (debiting regulatory expense) during the construction period. In the example, an entity would recognise a regulatory liability of CU100 and a corresponding regulatory expense Once the asset is in operation, the entity would fulfil the regulatory liability and recognise regulatory income over the remaining periods the entity recovers the carrying amount of the asset

Feedback received by the IASB on the proposals

General feedback

- 11 Most respondents, including EFRAG, disagreed with the proposal in B15 that an entity should reflect returns on an asset not yet available for use in the period when the asset is being used to supply goods or services to customers, and defer regulatory returns on CWIP and recognise a regulatory liability. According to these respondents, the proposals would:
- (a) not reflect the economic substance of the regulatory agreements and thus would not result in useful information for users of financial statements. This is because:
 - (i) entities in receipt of returns on CWIP have no legal or economic obligation to reduce future rates either in the form of cash outflows or lower cash inflows – even if the construction of the asset is not completed or assets are abandoned—i.e. entities' entitlement to the regulatory returns on construction work in progress is not dependent on whether goods or services are supplied to customers using the completed assets; and
 - (ii) the returns on CWIP compensate entities for investing in approved capital projects during the construction period (and not for providing goods and services using a particular asset)
 - (b) result in significant implementation costs for preparers that outweigh any potential benefits to the users of financial statements – for example, entities would need to allocate the returns to individual assets under construction, which would be costly
 - (c) result in inconsistent principles underpinning the different parts of the proposed guidance on TAC for goods or services (for example, the proposed treatment of construction-related performance incentives was often cited as being inconsistent with the proposed treatment of regulatory returns on CWIP)
 - (d) be inconsistent with the proposed treatment for construction-related performance incentives in paragraph B18 of the ED. The ED proposed that performance incentives, including incentives for performing construction work, form part of or reduce the total allowed compensation for goods or services supplied in the period in which the entity's performance gives rise to the incentive
 - (e) be inconsistent with the US generally accepted accounting principles (GAAP).
- 12 Most users that provided feedback to the IASB during the comment period of the ED also disagreed with the proposals on CWIP.

Suggestions made by respondents

- 13 Most respondents suggested the IASB require an entity to reflect regulatory returns on CWIP in the reported financial performance (in profit or loss) for the construction period. Respondents made various suggestions on how this could be done, including deleting B15 from the ED or/and expanding on what is meant by the delivery of 'goods or services'.
- 14 Many respondents—mainly preparers and national standard-setters across different jurisdictions—said regulatory returns on construction work in progress compensate entities for fulfilling the following obligations during the construction period:
- (a) the construction of the assets—continuous investment in the network infrastructure to ensure reliable, secure and efficient supply of goods or services to customers; and
 - (b) the provision of capital (debt and equity) to fund investment in the network.

- 15 These respondents argued the obligations in the paragraph above are the goods or services supplied to customers during the construction period. Consequently, they suggested that reflecting regulatory returns on construction work in progress in profit or loss during the construction period would be consistent with the underlying principle of the ED in paragraph B10, which is to reflect in the profit or loss the total allowed compensation for goods or services supplied during that period.
- 16 Many respondents were of the view that the arguments that the IASB used for proposing the recognition of construction-related performance incentives during the construction period are equally valid for returns on construction work in progress. Consequently, these respondents recommended the final Standard aligns the treatment of returns on construction work in progress with that for construction-related performance incentives.

Feedback specific to regulatory regimes subject to the AFUDC' – RA1 regulatory regimes

- 17 Some respondents with regulatory agreements subject to the AFUDC approach (see paragraphs 9 and 10 discussing these types of regulatory regimes) said that this allowance for a regulatory return represents an amount that the regulators approve to form part of the costs of the assets during the construction period. This amount typically includes a return for debt and a return for equity.
- 18 In the view of these respondents, an entity would be entitled to recover these returns through the rates charged to customers when the assets are available for use. The proposals would not reflect the entities' right to the regulatory returns on construction work in progress in the construction period. These respondents thought that right would meet the asset definition because:
 - (a) entities have an enforceable right in accordance with the regulatory agreement to include the AFUDC amount in the rates charged in the future;
 - (b) the right that has the potential to generate economic benefits and results from a past event—i.e. the construction work and the provision of funds during the construction period; and
 - (c) entities control that right because they have the enforceable present right to include those amounts in the future rates and obtain the corresponding economic benefits.

Suggestions made by respondents

- 19 For the reasons in paragraph 18, these respondents suggested that entities be required to reflect regulatory returns on CWIP in profit or loss for the construction period. Under this suggested approach, entities would therefore recognise a regulatory asset and a corresponding regulatory income for the regulatory returns.

IASB staff suggested alternative approaches to address concerns raised

- 20 At the IASB Rate-regulated Activities Consultative Group (Consultative Group) meeting on 4 March 2022, the IASB staff presented an example comprising two different fictional jurisdictions where regulatory returns on CWIP either could or could not be considered in the amounts charged to the customer in the period the construction took place (i.e., RA1- AFUDC where regulatory returns are charged to the customer during operation and RA2-Rate Base where regulatory returns are charged to the customer during construction). These examples are summarised above in paragraphs 7 to 10.
- 21 Based on the analysis for both jurisdictions, the following five courses of action (alternative approaches) were presented by the IASB staff as possible solutions to address the concerns reported by respondents on the IASB proposal:

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- (a) **expand the scope of the Standard** to include rights and obligations that are not regulatory assets and regulatory liabilities;
 - (b) **broaden ‘goods or services supplied’** to include satisfying service requirements specified by a regulatory agreement;
 - (c) **remove paragraph B15** of the ED;
 - (d) **confirm the proposal**; and
 - (e) **narrow the scope paragraph of B15** to long-term projects.
- 22 A detailed analysis of the above alternatives (pros and cons) is provided as agenda paper 03.02. A summary of the analysis is provided below.

Expand the scope of the Standard (see pages 8-9 agenda paper 03.02)

- 23 As explained in paragraph 10, the IASB agree that an entity has a right to accrue regulatory returns on CWIP during the construction period, even if the period in which those returns are included in the rates charged to customers in a later period. This would be consistent with the key principle of accrual accounting (as opposed to cash accounting).
- 24 In the ED, paragraph B15, the IASB explains that the right to accrue regulatory returns on CWIP, which is a right created by a regulatory agreement, is not a regulatory asset because that right does not arise from the supply of goods or services using the plant. That right would also not be accounted for as an asset applying other IFRS Standards.
- 25 The IASB could, therefore, consider expanding the scope of the Standard to require an entity to recognise as an asset, with a corresponding income, its right to accrue regulatory returns on CWIP during the construction period. The right to accrue regulatory returns on CWIP during the construction period could be argued as meeting the definition of an asset in the *Conceptual Framework for Financial Reporting*.
- 26 If the IASB were to take this course of action it would solve the concerns and address the suggestions for RA1-AFUDC and RA2-Rate Base.
- (a) In RA1, an entity would recognise a regulatory asset and regulatory income associated with its right to accrue regulatory returns on CWIP during the construction period.
 - (b) In RA2, an entity would not have a regulatory liability and regulatory expense associated with returns on CWIP charged to customers during the construction period. The rates charged to customers, and therefore the revenue recognised, represent TAC for goods or services supplied during the construction period.

Broaden ‘goods or services supplied’ (see pages 10-11 agenda paper 03.02)

- 27 As suggested by some respondents, including the EFRAG FCL, applying a broader notion of goods or services supplied, an entity’s right to accrue regulatory returns on CWIP during the construction period could be argued as arising from providing the service of making particular infrastructure available. Consequently, regulatory returns on CWIP that accrue during the construction period should be reflected in the reported financial performance for the construction period irrespective of the period in which those returns are included in the rates charged to customers.
- 28 Paragraph B15 of the ED would become redundant and, therefore, should be removed when finalising the proposals.
- 29 If the IASB were to pursue this course of action, applying the final Standard would produce outcomes similar to the preferred solution of respondents in both RA1 and RA2.

Remove paragraph B15 (see pages 11-12 agenda paper 03.02)

- 30 As suggested by many respondents, the IASB could consider removing paragraph B15 of the ED and instead require an entity to apply to regulatory returns on CWIP the general principle under paragraph B10 of the ED.
- 31 If B15 were removed, regulatory returns on CWIP that a regulatory agreement entitles an entity to add in determining a regulated rate for goods or services supplied in a period would form part of the total allowed compensation for goods or services supplied in the same period.
- (a) This would address the concerns reported by respondents in RA2, as an entity would not recognise a regulatory liability associated with regulatory returns on CWIP charged to customers during the construction period.
- (b) However, removing B15 would not affect entities in RA1 for which the regulator allows them to include returns on CWIP only during the operating phase. These entities would apply paragraph B10 which says that returns to which a regulator entitles an entity to include in the rates in a period should be reflected in PL in that same period.
- 32 In deleting paragraph B15, the IASB may have to consider whether deleting that paragraph would be consistent with the principle in paragraph 16 of the ED: an entity should reflect the TAC for goods or services supplied as part of its reported financial performance for the period in which those goods or services are supplied.

Confirm the proposal (see page 14 agenda paper 03.02)

- 33 This approach would not address respondents' concerns, including the concerns noted by EFRAG in its FCL on the ED on its disagreement with the proposal in B15.

Narrow the scope paragraph of B15 (see pages 10-11 agenda paper 03.02)

- 34 A few users of financial statements who supported the proposal suggested the IASB consider narrowing the application of paragraph B15 of the ED to long-duration construction projects. They thought applying the proposal would provide useful information only for long-duration construction projects.
- 35 Therefore, the IASB could consider narrowing the application of the proposal to, say, all qualifying assets as defined in IAS 23 *Borrowing Costs*. Under this approach, entities subject to RA2 would produce outcomes similar to the preferred solution of respondents for CWIP that is not a qualifying asset as defined in IAS 23. However, it might not address all entities in the same way (as some entities would qualify as long-term contracts. Furthermore, it would not address the suggested approach by entities subject to the RA1.

IASB RRA Consultative Group views expressed on 4 March 2022

- 36 Most members of the IASB RRA Consultative Group supported either the option to remove B15 of the ED or/and to broaden the meaning of 'goods or services supplied' to include satisfying requirements set out in the regulatory agreement. Members noted that both solutions would be needed if they were to address the concerns in both RA1 and RA2 regulatory regimes.
- 37 One member (user) noted that it did not make sense to recognise a liability (as per the proposal) and considered that an entity should recognise a regulatory return when it has earned it. Some members also supported expanding the scope of the standard to include rights and obligations on CWIP while others expressed the need for a closer examination of this option to prevent unintended consequences.
- 38 Members generally noted that a key issue is what is the 'right' the entity has that entitles it to a regulatory return during the construction phase and whether that right meets the definition of an asset under the *Conceptual Framework*. This understanding of the "right" was important regardless of the regulatory regime.

- 39 It was also important to understand what were the 'goods or services' the entity provided that were linked to that right. The ED referred to the 'goods or services' provided to customers when the asset under construction is being used. However, many members considered that the goods or services supplied by a rate-regulated entity should be viewed broadly to include the service of making infrastructure available for an uninterrupted supply of goods or services to existing and future customers.
- 40 Some members did not agree with a solution that would only solve half the problem. These members would therefore support a combination of deleting B15 **and** expanding the notion of goods or services. This would address the concerns of entities operating in RA1-AFUDC and RA2-Rate Base.
- 41 Some members considered that the proposals focused on an individual asset. However, entities had many assets and it would be extremely complex to apply the proposal in 'real-life' cases.

EFRAG RRAWG views expressed on 28 April 2022

- 42 EFRAG RRAWG members provided the following views:
- (a) Some members supported the course of action to remove paragraph B15 as entities knew what types of goods or services they offered and are compensated for. For example, in the water supply sector, what was important to a customer was that when they turned on the tap there was water. However, goods and services to the regulator can be different from goods and services to the customer. Hence, some members considered that there was a need to broaden the definition of goods and services. This view is consistent with the view expressed in the EFRAG FCL. One member also noted that there is ambiguity on the term customers, and it would be helpful to define customers and whether they represent the customer base rather than individual customers.
 - (b) Some members noted that regulation evolved and that both types of regimes discussed in the agenda paper (RA1 and RA2) were applicable to their organisations. This was the case for France. The course of action should address the concerns in both regulatory regimes and removing B15 might not do that. Hence a solution based on removing B15 and broadening the notion of goods or services would work better.
 - (c) One member explained that the regulatory agreement in their entity allowed the pre-financing of assets given that billions of EUR were being spent to build a nuclear plant. They had created an SPV to undertake the project and it would be odd to have revenue and no costs should the entity recognise revenue for the returns on CWIP but the infrastructure was still WIP and hence there would be no depreciation costs. It would be helpful to have a broader definition of goods or services.
 - (d) Some members preferred to expand the definition of goods and services as removing paragraph B15 could create an inconsistency with the principles in IFRS 15 regarding meeting an obligation to deliver goods or services. One suggestion was to focus on what the regulation says – if the regulation says that an entity has a right to the regulatory return then the entity should recognise revenue. It was important to develop a principle that focused on the rights and obligations under the applicable regulation. Again, this view aligns with the position expressed in the EFRAG FCL.
 - (e) Some members noted that it was important to note that the regulatory return on RAB (assets in use) was different (in terms of amount or percentage) to the regulatory return granted on CWIP - so the notion of a broader context of goods or services was important.

- 43 Overall, members supported a principle-based solution that would address the concerns in all applicable regulatory regimes, keeping in mind that regulation evolves. This solution could be a mix of deleting paragraph B15 and having a broader notion of goods or services that focused on what the regulation says.

IASB discussion on 26 May 2022

At the May meeting, the IASB received feedback on the consultative group discussions on regulatory returns on CWIP and other aspects of TAC and the timetable for the redeliberation plan on these topics, but the IASB did not discuss the possible courses of action enumerated in this paper.

Question for EFRAG FR TEG

- 44 Do you have any comments on the views expressed by the IASB Consultative Group, EFRAG RRAWG (summarised in paragraphs 36 to 43) on the IASB staff's five potential courses of action summarised in paragraphs 20 to 35?