

This paper has been prepared by the EFRAG Secretariat for discussion at a public meeting of EFRAG TEG. The paper forms part of an early stage of the development of a potential EFRAG position. Consequently, the paper does not represent the official views of EFRAG or any individual member of the EFRAG Board or EFRAG TEG. The paper is made available to enable the public to follow the discussions in the meeting. Tentative decisions are made in public and reported in the EFRAG Update. EFRAG positions, as approved by the EFRAG Board, are published as comment letters, discussion or position papers, or in any other form considered appropriate in the circumstances.

Regulatory returns on construction work in progress and total allowed compensation

Issues Paper

Objective

- 1 This paper aims to extend the discussion on the two different and inconclusive views in EFRAG's draft comment letter (DCL) on the IASB Exposure Draft *Regulatory assets and Regulatory Liabilities* (the ED) proposed requirements for **the recognition of regulatory returns** in circumstances where a regulatory agreement entitles an entity to include **construction work in progress (CWIP)** regulatory returns in the regulated rates charged to customers during construction. The ED proposes that these returns be only included in total allowed compensation when the asset is in operation. The discussion is intended to help EFRAG RRAWG and EFRAG TEG to reach a consensus in developing a position for EFRAG's final comment letter on the ED.

IASB proposal for total allowed compensation including regulatory returns on CWIP

- 2 Total allowed compensation is the amount that an entity is entitled to charge customers, in the same or a different period, in exchange for the goods or services supplied in a specified period, in accordance with the regulatory agreement.
- 3 As outlined in Paragraphs B3-B27 of the ED, total allowed compensation consists of the following components which affect profit or loss at these time intervals:
 - (a) Allowable expenses less income – An allowable expense is an expense, as defined in IFRS Standards, that a regulatory agreement entitles an entity to recover by adding an amount in determining a regulated rate. These are recognised when expenses/ income are incurred/ recognised under IFRS requirements.
 - (b) Profit margins – In some cases, a regulatory agreement entitles an entity to recover the amount of an allowable expense incurred plus a profit margin that varies with the amount of the expense—for example, a fixed percentage mark-up on the expense. Profit margin affects the profit or loss in the period when the entity recognises the underlying allowable expense as an expense by applying IFRS Standards.
 - (c) Performance incentives – A regulatory agreement may provide an entity with various performance incentives to reward it for meeting performance criteria, or to penalise it for failing to meet performance criteria. These criteria could

include, for example, targeted levels of service quality, reliability, or customer satisfaction, or may relate to the entity's performance in constructing an item of property, plant or equipment. Performance incentives are recognised in profit or loss during the period in which the entities' performance occurs.

- (d) Regulatory returns – regulatory agreements typically determine the regulatory return for a period by specifying a return rate and a base to which that return rate applies. Common terms for such a base are 'regulatory capital base' or 'regulatory asset base'¹, although other terms are also used. Regulatory returns are recognised in the profit or loss when the regulatory agreement entitles the entity to add it in determining the regulatory rate. However regulatory returns for assets under construction are only included in profit or loss when the asset is in use.
 - (e) Regulatory interest income/(expense) – As the discount unwinds until recovery of the regulated asset or the fulfilment of the regulatory liability.
- 4 For assets not yet in use or construction work in progress (CWIP), and where the regulatory agreement allows regulatory returns to be charged to customers while an asset is under construction; the ED proposes that these regulatory returns should be included in total allowed compensation **when the asset is in use and over the regulatory recovery period of the asset through the regulated rates**. Correspondingly, a regulatory liability is recognised during the construction period and regulatory income recognised when the asset is in use.
- 5 In effect, the regulatory returns on CWIP during construction will only be reflected in the entity's reported performance (profit or loss) when the asset is in use. Once the asset is available for use, the proposed guidance requires regulatory returns to be allocated over the remaining periods in which the entity recovers the carrying amount of the asset through the regulated rates. The ED proposes that an entity use a reasonable and supportable basis in determining how to allocate the return (Paragraphs B13 to B15 of ED includes specific requirements for regulatory returns).

EFRAG's analysis in the draft comment letter

- 6 The paragraphs below provide a summary of EFRAG's response to the proposal on when to include regulatory returns on CWIP in TAC (Question 3 of the ED).
- 7 EFRAG supports the proposed inclusion of the three components of target profit (profit margin, regulatory returns other than those related to assets not yet in use also referred to as construction work in progress – 'CWIP', and performance incentives) in the total allowed compensation, in the period when the regulatory agreement entitles an entity to add these components in determining a regulated rate for goods or services supplied in that period.
- 8 EFRAG acknowledges that as stated in BC 98, the proposal not to recognise regulatory return before the asset is in use would:
- (a) be in line with the proposed model's principle as no goods or services are being supplied using that asset before it is available for use; and

¹ Regulatory agreements typically determine the regulatory return for a period by specifying a return rate and a base to which that return rate applies. Some regulatory agreements specify more than one base, each with its own return rate. The items for which amounts are included in such a base are not necessarily recognised as assets or liabilities applying IFRS Standards, and a regulatory agreement does not necessarily measure assets or liabilities on the same basis as IFRS Standards.

- (b) lead to comparability between entities as one approach is applied irrespective of how the regulatory returns for CWIP is structured within the regulatory agreement.
- 9 EFRAG agrees with the decision that regulatory returns on a CWIP base included in the regulated rates charged to customers during the construction period form part of the total allowed compensation.
- 10 EFRAG sees conceptual merits in the IASB's proposal that the regulatory returns for CWIP are only included in profit or loss when the asset is in use. However, EFRAG understands from some preparers that an approach that recognises regulatory returns during the period the asset is under construction if granted by the regulatory agreement would be more practical and consistent with the objectives of the rate-regulated project (i.e., to reflect the enforceable rights and obligations arising from a regulatory agreement). Before concluding on its position in the final comment letter to the IASB, EFRAG seeks stakeholders' feedback on two views as outlined below: The first view is in favour of the proposal based on the underlying conceptual reasoning and relevance of reported information for some entities. The second view is against the proposal based on misalignment with regulator accounting, operational challenges, and cost-benefit considerations.
- 11 **View 1** (reason to disagree with the proposal): EFRAG notes there are several concerns with the proposal. Foremost being that it departs from the alignment of the accounting treatment with the regulatory treatment of regulatory returns. In addition, in certain cases like under IFRIC 12, it is not uncommon to recognise revenue during the construction period. Hence, under such circumstances, the proposal may fail to faithfully reflect performance throughout the duration of the contract. Whereas paragraph BC98 implies that recognition of regulatory returns on assets under construction would be inconsistent with the model's principle where recognition depends on goods or services being supplied, EFRAG notes that the delivery of goods or services often involves a combination of various assets, rather than a single asset. Therefore, an entity would provide goods or services, even if one of the assets was being constructed and it is difficult to attribute revenue generated to a single asset. Furthermore, EFRAG considers that:
- (a) the driver for recognition of regulatory returns for assets under construction is different to the accounting for performance incentives and penalties, including those related to assets under construction, which was based on performance, rather than the delivery of goods or services. This creates an inconsistency on how performance is being reflected as certain milestones could be set when the asset is not yet available for use.
- (b) preparers of some entities would face operational challenges of keeping track of assets under construction on a stand-alone basis rather than at a portfolio level due to their high volumes of new assets under construction and high volumes that concurrently become operational at any point in time.
- 12 **View 2** (reason to support the proposal): EFRAG notes the IASB proposal to defer recognition of regulatory returns will reflect revenue when the underlying asset is being used to provide goods or services and being consumed (through depreciation) and as noted in BC 98 is consistent with the model's principle. As a result, the proposed treatment will provide a faithful representation of profit patterns particularly for entities that have material and long-duration CWIP. For such entities, the profit margins would be misleadingly understated when the asset becomes operational if the regulatory returns were to be recognised during construction. Furthermore, as highlighted in BC 98, the proposal will contribute to comparability across entities regardless of how regulatory return is structured within regulatory agreements. EFRAG also notes the IASB reasoning in paragraphs BC99 and BC100 in favour of the proposals.

Developing an EFRAG Position- Points for further consideration by EFRAG TEG and EFRAG RRAWG

- 13 As detailed in paragraphs, there are several additional considerations for EFRAG RRAWG and EFRAG TEG that stakeholders have pointed out during the outreach that EFRAG Secretariat has participated in or observed so far. Views capture conceptual, usefulness and operational arguments and mostly against the IASB proposal and aligned with View 1 of the EFRAG DCL have revolved around the following factors:
- (a) *The economic purpose of granting regulatory returns when assets under construction are not necessarily linked to goods and services supplied during the reporting period:* Some preparers have noted that the returns compensate for provision of capacity and there is no obligation to refund the regulator or reduce rates if the construction project is not complete. Correspondingly, there is a question on whether regulatory agreements have clear terms that link the returns on CWIP to the provision of other services that are being provided during the construction period that are different from the goods or services that will be supplied when the asset is in operation.
 - (b) *What is the economic meaning of the associated regulatory liability initiated when the asset is under construction:* what does the regulatory liability represent in an economic sense if as per regulatory agreement there is no enforceable obligation to reduce future rate charged to customers.
 - (c) *Impact on regulatory agreements:* Consequences of proposed requirements on the terms of regulatory agreements. Some have opined that the accounting requirements may deter the granting of regulatory returns that can be charged to customers during construction. However, one regulator noted that such an outcome may be a desirable outcome as it will incentivise timely completion of projects.
 - (d) *Challenges interpreting financial statements-* For some entities, there could be regulatory liabilities on the balance sheet that could unwind over 40 years. Will these be misleading to investors? To allow investors to interpret balance sheet numbers will there be a need to differentiate regulatory liabilities such as those arising from the construction-phase regulatory returns from other regulatory liabilities that represent enforceable obligations to reduce future rates?
 - (e) *Questions on comparability goal/benefit:* The BC asserts that the proposed requirements ensure comparability of reporting across entities. One preparer questioned whether comparability of reporting should be a goal in cases where there are differences in entities regulatory agreements.
 - (f) *Performance should reflect cash inflows:* Some users² have indicated that reported performance should reflect cash inflows. The entity has revenue receipts during construction and therefore performance should reflect this economic reality.
 - (g) *Continued elaboration of operational challenges in accounting for CWIP regulatory returns:* These challenges include when CWIP is part of the regulatory asset base during a reporting period.
- 14 The arguments in favour of the IASB proposal (i.e., aligned with View 2 of the DCL) have included incentives for project completion, matching of income and expenses (e.g., borrowing costs that are amortised over the economic useful life).

² EFRAG Secretariat was invited by a non-EU standard setter to observe their outreach meeting with users in their jurisdiction.

Background- Summary of past IASB discussions

- 15 The summary of past IASB meetings below where the regulatory returns on CWIP was discussed, highlights and help to contextualise the reasoning underpinning the ED's proposed requirements.
- 16 The proposals for TAC were first discussed at the March 2020 IASB meeting. The discussion comprises three agenda papers ([AP 9A- Background and Regulatory Capital Base](#); [AP 9B Regulatory returns on construction work in progress base](#); [AP-9C Performance incentives \(less relevant for CWIP issue\)](#))
- 17 Paper AP 9A of the IASB Meeting March 2020 includes the definition of TAC, which is a key concept. To determine regulatory assets and regulatory liabilities, the TAC amount is compared to the amount that is charged to the customer (revenue under IFRS 15 *Revenues from contracts with customers*) in a reporting period (timing difference).
- 18 The meeting defined the components of TAC including target profit. The IASB staff noted that determining the related period for elements of target profit is in some cases straightforward (margins on allowable expenses, regulatory interest income/expense and performance incentives). However, it can be difficult under some circumstances, to establish the link between regulatory returns and goods or services provided in a particular period.
- 19 In the case of regulatory returns, it may not be clear whether the period in which a regulatory agreement entitles an entity to include these returns in the regulated rates is also the period in which that element of target profit is part of TAC for goods or services supplied to customers and whether it should affect profit or loss for that period. The IASB staff concluded that those **regulatory returns form part of TAC in the period the regulatory agreement entitles the entity to include them in the regulated rates** unless there is compelling evidence to link it to another period. Nevertheless, in the IASB staff's view, questions arise when regulatory returns for a period include amounts that relate to an item of PPE that is under construction.
- 20 As compensation for long-term, tied-up capital for investments in infrastructure, regulatory agreements typically provide entities with regulatory returns applied to an RCB that includes CWIP. The IASB staff observed that regulators commonly use two approaches for including:
 - (a) regulatory returns on CWIP accumulate during the construction phase and are included in regulated rates after the asset is placed in operation or
 - (b) regulatory returns on CWIP are included in regulated rates during the construction phase.
- 21 The IASB staff concluded that the treatment of regulatory returns under alternative (a) is aligned to the proposed accounting model's principle because such regulatory returns are included in TAC when the asset is capable of delivering goods or services.
- 22 Under alternative (b), entities are entitled to include regulatory returns on the CWIP in the regulated rates charged to customers for goods or services during construction. In the IASB staff's view, goods or services supplied during the construction period are delivered using other assets in operation. The IASB staff argued that when the CWIP is not in operation, there is a missing link between the goods or services provided in the specific period and the CWIP and recognising these regulatory returns would be inconsistent with the proposed accounting model's principle.
- 23 The IASB staff highlighted the following disadvantages of including CWIP regulatory returns in the total allowed compensation during the construction period:

- (a) It contradicts the general principle of the model because during the construction period of the asset no goods or services are being supplied using that asset.
- (b) It is inconsistent with the treatment of depreciation, which becomes TAC when the asset is consumed not when the regulatory agreement allows the depreciation to be included in the regulated rates.
- (c) It is not providing useful information because regulatory returns on CWIP base provide compensation for significant capitalized borrowing costs (IAS 23) and will affect profit or loss through the depreciation of the asset, whereas those returns would affect profit or loss in the construction period.
- (d) It results in a lack of comparability.

Moreover, from the IASB staff's perspective, if the entity only had assets under construction, it would not have been able to deliver any goods or services to customers.

- 24 Consequently, the IASB staff proposed that **regulatory returns on a CWIP base that are included in the regulated rates during the construction period should be regarded as part of TAC only during the operating period(s) of the asset** (i.e., when goods or services are being supplied with the asset to which those regulatory returns relate).
- 25 Consequently, and in line with the model's general principles, the IASB staff concluded that a **regulatory liability would arise when regulatory returns on CWIP base are included in the regulated rates charged during the construction period because those form part of TAC in a future period. The regulatory liability would be fulfilled/derecognised during the operating period(s).**

Summary of the EFRAG TEG/RRAWG meeting discussions

- 26 This topic was discussed with EFRAG TEG in March 2021. The topic was also discussed with RRAWG in meetings in June 2020 and March 2021 and with the EFRAG User Panel in April 2021.

Discussions in 2020

- 27 In June 2020, EFRAG RRAWG members had mixed views with regard to the issue of regulatory returns on CWIP included in the regulated rates charged to customers during the construction period are part of TAC only during the period when the asset is in operation.
- 28 Some EFRAG RRAWG members noted that it was not uncommon to recognise revenue over the construction period. Those that did have the view referred to the amendment in IAS 16 *Property, Plant and Equipment* where sales revenue can be recognised before an asset is ready for its intended use.
- 29 Some RRAWG members noted that tracking CWIP would be very burdensome. CWIP was not necessarily tracked in such detail for regulatory purposes.
- 30 Other RRAWG members questioned whether this proposal was aligned with the requirements for CWIP under IFRIC 12.

Discussions in 2021

RRAWG

- 31 In February and March 2021, an EFRAG RRAWG member stated that the rules should consider IAS 16 as the Standard is clear on the matter of proceeds earned being recognised before intended use. The member also noted that the construction of the asset relates to a regulated activity therefore the TAC was for the activity as a whole.
- 32 Another member noted that different regulatory agreements could be in place in the same jurisdiction, where in some cases CWIP expenses were charged to some customers during the construction phase, and in other cases, these expenses are not charged. The member also stated that some entities did not follow each asset during the construction phase but focus more on a portfolio basis level; what was charged to the customer was the return on a global amount. Following individual assets may not be practical given the volume of assets under construction.
- 33 A member of the EFRAG RRAWG was of the view that it was not a good idea to make an exception, as some entities would have a remuneration based on CWIP and others would not. If the exception were in place, there would not be an easy way to compare the performance of those entities based on the total compensation, which was available in accordance with the regulatory agreement.

EFRAG TEG

- 34 In March 2021. EFRAG TEG members had mixed views on the proposal that the regulatory returns for CWIP are only included in profit or loss when the asset is in use. The first view is against the proposal based on its misalignment with regulator accounting, associated operational challenges, and cost-benefit considerations. The second view is in favour of the proposal based on the underlying conceptual reasoning and relevance of the information for some entities.

User Panel

- 35 In April 2021, a member of the EFRAG User Panel opined that for CWIP, it would better not to recognise the revenues until the asset came into production. The matching principle was important in order to ensure comparability.

What the EFRAG project staff has heard during outreach

Regulatory returns are not linked to the provision of goods or services

- 36 Some preparers have argued that in the context of their jurisdiction, such regulatory returns should be included in TAC as the return is not dependent on the assets becoming operational. These preparers have stated that the regulatory return is a component of return on the capital invested even if the investment, defined and approved by the regulator, is not continued in the future.
- 37 These preparers have argued that such entities with regulatory asset and regulatory liabilities are obliged to continuously provide a useable infrastructure, which could also be interpreted as a certain kind of service. The provided infrastructure consists of a combination of several assets providing services in combination with each other (assets that are available for use and assets not yet available).
- 38 To distinguish between available and not yet available assets could be challenging and costly if the not yet available assets are not already tracked for regulatory purpose and regulatory returns are not attributed to a single asset. Preparers have questioned if these costs would be outweighed by the users' benefits.

Conceptual inconsistencies- deviation from regulatory treatment

- 39 Moreover, such preparers stated that due to the guidance proposed in paragraph B15 of the ED a regulatory liability would have to be recognised. As the entity in

certain jurisdiction has no obligation to refund the customer no legal or economic liability exists.

- 40 These preparers argued that, on the basis of the regulatory agreement, there is no enforceable obligation to deduct an amount in determining a regulated rate to be charged to customers in future periods. Therefore, they concluded that a regulatory liability would only exist as a consequence of the proposed requirements for CWIP regulatory returns and not from the regulatory agreement.
- 41 The preparers and other stakeholders have noted that the objective of the model is to align the regulatory and accounting treatment. The proposal on CWIP regulatory returns is inconsistent with this objective.

Economic and investor perspective

- 42 Preparers noted that a high level of investment would lead to a deferral of a significant portion of the regulatory return, earned for construction work, into the future. This would impact financial statement user analysis because the financial statements would not faithfully reflect the effects of regulation. As a result, preparers also noted that the proposed guidance could negatively impact their attractiveness to investors. This could prevent significant future investments in required infrastructure as the information provided would not be understood without full knowledge of the complexities of the proposed guidance.
- 43 A few users from a non-EU jurisdiction³ noted that the cash inflows from regulatory returns are obtained during the construction period, and it is a faithful reflection of the economics if the receipt of these cash flows is reflected in performance. They also had concerns and questions on why the IASB proposal differs from US GAAP.

Example

- 44 An entity constructs infrastructure over a five-year period. The asset will be available for use over a useful life of twenty years. During the construction phase, the entity receives 50 CU per year of regulatory returns and 25 currency units of regulatory returns per year during the useful life. Additionally, the company can recover 150 CU per year of depreciation as an allowable expense. During the construction phase, the regulator allows the entity to charge regulated rates to the customer.
- 45 Calculation without deferral (numbers per period):

Without deferral	t0-t5	t6-t25
regulatory return	50	25
depreciation	0	150
Revenue	50	175
EBITDA	50	175

- 46 Calculation with deferral and recognition of regulatory liability (numbers per period):

³ EFRAG Secretariat was invited by a non-EU standard setter to observe their outreach meeting with users in their jurisdiction

With deferral	t0-t5	t6-t25
regulatory return	50	25
depreciation	0	150
Revenue	50	175
Regulatory expense/income	-50	12,5
EBITDA	0	187,5
Regulatory liability t5	250	
Regulatory liability t10		187,5
Regulatory liability t15		125
Regulatory liability t20		62,5
Regulatory liability t25		0

- 47 During the construction phase the entity charges 50 CU to the customer every year and 250 CU over five years, but the regulatory return on the asset not yet available for use does not form part of TAC. As a result, EBITDA will be deferred into future periods and a regulatory liability of 250 CU accumulates until year five. The increase in EBITDA from year five onwards does not represent increased cash flow generation as the entity will not charge customers. The regulatory liability is not an enforceable obligation to reduce rates within period t6-t25. As stated before, some preparers question whether this results in a true and fair view of financial information.

Postings t1 – t5			
DR	Regulatory expense	CR	Regulatory liability

Matching of income and expense and incentivization of entities

- 48 However, some constituents argued that profit in the construction phase could be overstated if potential borrowing cost would be capitalised in accordance with IAS 23 *Borrowing Costs* because those costs would be capitalized and depreciated over the useful life of the asset at the point of time when it is available for use. Some argue that this situation could be overcome if regulatory income – as long as it reflects equity and borrowing costs - from the recovery of the regulatory liability would be matched with the depreciation on borrowing cost.
- 49 Moreover, one regulator pointed out that the deferral of such regulatory returns on CWIP with regard to their inclusion in TAC would be an incentive for the entities to complete those assets and bring them faster into operation. The regulator also mentioned that regulations should not allow entities to charge customers during the construction phase for regulatory returns on CWIP as this could be counterproductive. In some cases, increased funds were used to grant higher dividends potentially leading to a scarcity in financial resources in future periods (e.g., when new investments need to be made or the costs of the construction in progress increase). The regulator was of the opinion that the proposed accounting by the ED could make the regulators rethink the appropriateness of such returns and eventually change regulatory requirements.

Questions for EFRAG RRAWG members

- 50 Which of the two views (view 1 or view 2) in the EFRAG DCL on the treatment of regulatory returns on CWIP do you support and why?
- 51 Do you expect any implementation issues relating to the proposals in the ED to defer and recognise revenue from construction work in progress only in the operating phase?

- | | |
|----|---|
| 52 | Do you think that a regulatory liability for regulatory return on CWIP will negatively impact investor's perception of the reporting entity or result in misinterpretation of financial statements? |
| 53 | Should the notion of "goods or services supplied" within the proposed Standard be defined to be broader than goods or services delivered to the customer? |