Issues Paper

TAC- Regulatory assets and regulatory liabilities arising from differences in regulatory recovery pace and assets' useful lives

Objective

1. This issues paper aims to update and obtain the EFRAG FR TEG views on another key concern raised in response to the IASB ED related to Total Allowed Compensation (TAC). Specifically, where regulatory assets and regulatory liabilities arise from differences between regulatory recovery pace and assets' useful lives. The issue was discussed in the IASB's Consultative Group for Rate Regulation in its 28 March 2022 meeting (see related IASB staff paper) and at the EFRAG RRAWG meeting on 28 April 2022.
2. The rest of this paper is structured as follows:
   (a) The related ED requirements
   (b) Feedback received on the ED requirements
   (c) Contextualising information: features of different regulatory schemes
   (d) IASB staff proposed courses of action
   (e) IASB consultative group views meeting on 28 March 2022
   (f) EFRAG RRAWG views meeting on 28 April 2022
   (g) IASB discussion on 26 May 2022

The related ED requirements

3. The ED's requirements related to regulatory assets and regulatory liabilities arising from differences in regulatory recovery pace and assets' useful lives are detailed on pages 7 and 8 of the IASB staff paper. Specifically, Paragraph B7 of the ED states that depreciation under IAS 16 *Property, Plant and Equipment* is an allowable expense. Furthermore, illustrative Examples 2B and 2C accompanying the Exposure Draft (Paragraphs IE 30 to IE 45) illustrate the case when the regulatory recovery period of the regulatory capital base is longer or shorter than an asset's useful life.

Feedback received on the ED requirements

Comments received by the IASB

4. The IASB received comments related to the 'amount that recovers the allowable expense less chargeable income' component of the TAC model (B3 - B9 of the ED). The comments highlighted concerns related to regulatory assets and regulatory

liabilities arising from what respondents describe as non-cash timing differences that under the proposed requirements would occur due to a) the regulatory asset base (RAB) not being aligned to the IFRS PPE; and b) the regulatory depreciation/recovery of expenses differing from the accounting depreciation (i.e., differences in regulatory recovery pace and assets' useful lives). The feedback/concerns are further detailed on pages 8 to 9 of the IASB staff paper.

5. Respondents considered that these regulatory assets and regulatory liabilities arising from non-cash timing differences did not represent enforceable rights (obligations) to increase (reduce) future rates charged to customers arising from their regulatory agreements and therefore would not meet the ED's definitions of regulatory assets and regulatory liabilities. They also commented that this subset of regulatory assets and liabilities would not result in useful information to users of financial statements if recognised in the financial statements.

6. Respondents did not believe it is appropriate to link regulatory depreciation with accounting depreciation as the entity's regulatory asset base is irreconcilable to the accounting fixed asset register for various reasons (e.g., RAB may be inflation-adjusted, capex may be excluded from RAB, asset classes and recovery period between RAB and IFRS PPE may differ).

EFRAG final comment letter response

7. EFRAG's FCL was aligned with the overall feedback received by the IASB and it noted concerns on the proposed determination of the 'amount that recovers allowable expense less chargeable income' component of TAC (paragraphs B3 to B9 of the ED) arising due to:
   (a) rates charged to the customer are based on expenses from regulatory accounting and not IFRS-based expenses;
   (b) the outcome of the proposed approach would not be consistent with the regulatory agreement, situations where the application of paragraphs B3-B9 of the ED could result in the recognition of regulatory assets and regulatory liabilities that are a by-product of the mechanics of the proposed accounting model rather than reflecting enforceable economic rights or obligations arising from the regulatory agreement.

8. Due to these concerns, EFRAG recommended further analysis of paragraphs B3-B9 of the ED and their functioning in diverse regulatory regimes.

Contextualising information- Features of different regulatory schemes

9. On 26 May 2022, the IASB received a presentation from IASB staff on the features of different regulatory schemes (see IASB agenda paper, also included as background paper-agenda paper 05-05 for this meeting). Page 15 of the presentation highlights there is a continuum in types of schemes ranging from cost-based to incentive-based and the majority of schemes tend to be hybrid schemes. Incentive-based schemes are common in certain jurisdictions (e.g., Germany, Netherlands and the UK).

10. The presentation also highlighted the limitations of applying the ED proposals to incentive-based schemes (see pages 27 and 28 of the IASB agenda paper). For instance, the recoverability of costs plays a less important role in incentive-based schemes than in cost-based schemes. Consequently, any direct link between regulatory compensation and allowable expenses may be limited to some passthrough costs. For these schemes, it is more challenging to ascertain whether there are timing differences that give rise to regulatory assets and regulatory liabilities.

IASB staff proposed courses of action

11. In response to the concerns raised about regulatory assets and regulatory liabilities arising from non-cash timing differences, the IASB staff presented three possible courses of action for discussion at the March Consultative Group meeting, namely:

    (a) **Course of Action 1: Consider the relationship between regulatory and accounting depreciation (i.e., RA and RL recognition would occur depending on the linkage between recovery of allowable expense under the regulatory agreement and accounting depreciation)** (see pages 14 to 16 of the IASB staff paper for a detailed description of this course of action including its pros and cons).

    (b) **Course of action 2: Overall calculation (i.e., making the regulatory asset register-RAB and accounting fixed asset register comparable)** (see pages 17 to 18 of the IASB staff paper for a detailed description of this course of action including its pros and cons).

    (c) **Course of action 3: Confirm ED's proposals** (see page 19 of the IASB staff paper for a detailed description of this course of action including its pros and cons).

IASB Consultative Group's views expressed on 28 March 2022

12. The IASB Consultative Group members confirmed the underlying causes of the disconnect between RAB and IFRS PPE as highlighted by the feedback to the ED. The user members highlighted that undercharged revenue is included in RAB in some instances. They noted that some RAB amounts were initiated during the privatisation of some activities as a basis for determining revenue but had no connection to reported PPE (e.g., air traffic).

13. Regarding the IASB staff proposed courses of action, on balance, the IASB Consultative Group members including user representatives mostly supported Course of Action 1 where reporting entities would recognise Regulatory Assets and Regulatory Liabilities if and only if: a) there is a direct relationship between the regulatory recoverable expense (regulatory depreciation) and the underlying IFRS expense (accounting depreciation expense); and b) there are differences between the regulatory pace and the assets' useful lives.

14. Under Course of Action 1, members proposed that even in the absence of recognition of regulatory assets and regulatory liabilities, either of the following disclosures should be in place

    (a) A brief explanation of the (lack of a) relationship between the regulatory recoverable expense (regulatory depreciation) and the underlying IFRS expense (accounting depreciation expense).

    (b) Disclose the RAB with information about the main reasons for the difference between RAB and PPE. A user expressed the need for disclosure of RAB determination and recovery pace across jurisdictions due to the variety of regulatory approaches to determining RAB.

    (c) Qualitative and not quantitative information (i.e., no reconciliation) if there is no linkage between RAB and PPE.

15. A member of the IASB Consultative Group provided a summary of findings (agenda paper 04-03) after outreach to multiple (14) stakeholders (i.e., 2 regulators, 1 investor, 6 energy entities, 5 water entities) in the UK (11), Australia (2) and Canada (1) on the IASB three possible courses of actions.. This member's report shows support for Course of Action 1 with limited disclosures and that users would back

out any regulatory assets and regulatory liabilities arising from non-cash timing differences from their EBITDA calculations.

16. There were a variety of reservations expressed on Course of Action 2 that would entail making the RAB and accounting fixed asset register comparable**.** The discussion highlighted that even though, in some jurisdictions with cost-recovery schemes (Canada, Hong Kong, US), there is an alignment[1] of the RAB and accounting PPE, many members from other jurisdictions had reservations about the practicality, cost-benefit of reconciling RAB to the accounting PPE. A few members had concerns that Course of Action 2 would not capture the substance of the transaction (or certain components). Moreover, there would be questions on how to deal with components that were stripped out to make the different bases comparable.

17. The Consultative Group members were either silent on or opposed to Course of Action 3, which is to confirm the ED's requirements.

EFRAG RRAWG views expressed on 28 April 2022

18. Overall, members supported course of action 1 as it would be the only workable solution, is principle-based and caters for evolution in regulatory regimes and due to concerns about the complexities associated with course of action 2.

19. One member that supported course of action 1 confirmed that in his jurisdiction/ sector (UK- water utility) there is no link between the regulatory base and the accounting base which makes a reconciliation between these impossible.

20. One member supported course of action 1 noting that it would be more consistent with the objective of the standard of ensuring alignment between regulatory and IFRS accounting.

21. One member noted that course of action 2 would be complex and would not address the range of concerns related to TAC (e.g., does not address inflation related to the regulatory asset base).

22. A member supported course of action 1 but suggested that disclosures should be restricted to those that are qualitative due to the noted difficulties in reconciling RAB to IFRS PPE. A user member elaborated on why quantitative disclosures could be useful observing that in her analysis primacy is accorded to future cash flows over profit or loss portrayal that may depict non-cash items under the ED's proposals. Nonetheless, it would be helpful to have quantitative disclosures that help users to understand how the regulator recovery of allowable expense may differ from accounting depreciation.

IASB Board meeting discussion on 26 May 2022

23. Following the IASB staff presentation on the different features of regulatory schemes as described in paragraphs 9 and 10 above, a Board member questioned the appropriateness of the characterisation of differences between regulatory recovery pace and the assets' useful lives as non-cash differences in timing. The Board member pointed out that even in cases where the regulatory depreciation and the accounting depreciation are disconnected, the regulatory depreciation that is charged to customers allows the entity to some extent the recovery of the accounting depreciation. Hence, these would be implicit rather than explicit differences in timing.

[1] A Consultative Group preparer member highlighted that in Canada where there are 100+utility companies within the scope of the proposed Standard, they regularly disclose the reconciliation of differences between RAB and accounting PPE under IFRS 14.

24. Several board members acknowledged that the outreach had brought to light new information including the challenges related to incentive-based schemes. The Board members made comments supporting the retention of the ED principles and for these to be applied in a manner that considers the features of different regulatory schemes.

25. A Board member questioned whether the main takeaway was that there was greater existence and measurement uncertainty associated with incentive-based schemes. The IASB staff clarified that the differences between cost-based and incentive-based schemes arise due to differences in contractual terms, which may translate to entities subject to these schemes having different regulatory assets and regulatory liabilities. The Board member then observed that the task is to identify where differences in timing exist based on the principles of the ED rather than developing a model that is tailored for incentive-based schemes. The Board member underscored the role of disclosures in providing information about the features of incentive-based schemes. In other words, it is not about bringing all aspects of regulatory reporting into the accounting model.

Questions for EFRAG FR TEG

26. Do you have any comments on the views expressed by the IASB Consultative Group, and EFRAG RRAWG on the IASB staff's three potential courses of action summarised in paragraph 11?

27. Do you have any comments on the IASB discussion summarised in paragraphs 23 to 25?