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Regulatory assets and regulatory liabilities

The direct (no direct) relationship concept and impacts on the proposed accounting for regulatory assets and regulatory liabilities Issues paper

Objective

- 1 This paper:
 - (a) Explains the direct (no direct) relationship concept between an entity's regulatory capital base and its property, plant and equipment and its impacts on the accounting model in the forthcoming IASB's final Standard on accounting for regulatory assets and regulatory liabilities (the final Standard).¹
 - (b) Provides initial feedback from EFRAG FR TEG and the EFRAG RRAWG on the application of the direct (no direct) relationship concept.

The direct (no direct) relationship concept

- 2 In summary, when an entity's regulatory capital base has a direct relationship with its property, plant and equipment (PPE), the regulatory capital base and the PPE are:
 - (a) the same; or
 - (b) sufficiently similar for the entity to be able to reconcile any differences between the regulatory capital base and the PPE.
- 3 The direct (indirect) relationship concept in respect of the regulatory capital base and PPE will determine whether a reporting entity has differences in timing arising from the regulatory capital base that result in the recognition of regulatory assets and regulatory liabilities.

Structure of this paper

- 4 This paper is structured as follows:
 - (a) Background
 - (b) Different regulatory regimes and common sources of differences in timing

¹ This paper is based on the [IASB agenda paper 9D - Use of the direct relationship concept—Overview](#) - discussed at the IASB meeting in December 2022 and other relevant material. This paper refers to final Standard on the assumption that the IASB will not re-expose.

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- (c) How will the direct (no direct) relationship concept be included in the final Standard?
- (d) IASB staff outreach/survey
- (e) Feedback received from EFRAG FR TEG and EFRAG RRAWG
- (f) EFRAG Secretariat observations

Background

- 5 Over the past few months, the IASB has made several tentative decisions on the proposals in its Exposure Draft [Regulatory Assets and Regulatory Liabilities](#) (ED) dealing with various aspects of total allowed compensation.
- 6 One of the drivers of these decisions has been whether an entity's regulatory capital base has a direct (no direct) relationship with its PPE² – referred to as the direct (no direct) relationship concept. The inclusion of this concept in the accounting model aims to:
 - (a) cater for the diverse regulatory schemes where the regulatory capital base serves different purposes, and
 - (b) address respondents' concerns that, in some cases, it will be difficult and costly to reconcile the regulatory capital base and PPE, identify differences in timing at a sufficient level of granularity and track the reversal of these differences in future periods when they are reflected in the rates charged to customers.
- 7 The IASB introduced the direct (no direct) relationship concept in October 2022, when it discussed whether regulatory assets and regulatory liabilities arise due to differences between the regulatory recovery pace and IFRS assets' useful lives. As noted in paragraph 3, the direct (indirect) relationship concept will impact the recognition of regulatory assets and regulatory liabilities when these arise from differences between the regulatory capital base and PPE. The impacts on the accounting model relating to the various aspects of total allowed compensation are explained in the table included in paragraph 49.
- 8 The appendix to [IASB agenda paper 9D - Use of the direct relationship concept—Overview](#) - discussed at the IASB meeting in December 2022 summarises the use of the direct (no direct) relationship concept in the IASB's redeliberations of the proposed accounting model.
- 9 The tentative decisions made in November and December 2022 also make use of this concept. So far, the IASB refers to the direct (no direct) relationship concept in most of its tentative decisions on total allowed compensation that affect the regulatory capital base, thus making it a fundamental part of the accounting model. It will also have significant outcomes for entities that operate in regimes where there is a disconnect between the regulatory capital base and PPE (mainly incentive-based regimes).
- 10 The direct (no direct) relationship concept was not included in the ED. Through feedback to its ED and discussions with the IASB Consultative Group on RRA, the IASB has learned that the absence of a direct relationship makes it difficult for an entity to identify and track differences in timing that may arise between the regulatory capital base and its PPE. In some cases, these differences in timing give rise to regulatory assets and regulatory liabilities and in other cases not.

² We understand that capital expenditure included in the regulatory capital base may also relate to intangible assets. For simplicity, this paper (with reference to the IASB papers) uses the term 'property, plant and equipment' but this should be read as encompassing other types of assets.

Different regulatory regimes and common sources of differences in timing

- 11 Throughout the project, the IASB has learned that there are two general types of regulatory schemes:
- (a) Cost-based (commonly known as ‘cost-of-service’ or ‘return-on-base rate’). In cost-based schemes there is a high probability that the entity will recover its costs; and
 - (b) Incentive-based (including revenue-cap or price-cap regulation). In incentive-based schemes, the entity is incentivised to operate efficiently and as a result, there is a risk that it may not recover its costs.
- 12 The existence (lack of) a direct relationship between an entity’s regulatory capital base and its PPE, generally depends on the regulatory scheme under which the entity operates. Regulatory schemes however could be “hybrid” and contain features of both regimes.

Regimes with a direct relationship

- 13 In cost-based regulatory regimes, the regulatory requirements are closely aligned with the accounting requirements, meaning that a direct relationship between an entity’s regulatory capital base and its PPE generally arises.
- 14 In such regimes, regulators typically require entities to reconcile their regulatory capital base to their PPE and to track any differences. Although these types of regimes can exist in Europe, they seem more prominent in Canada and the United States. The regulation is often based on a mechanism that allows an entity to recover its costs (cost-based schemes).
- 15 In some jurisdictions (including some European jurisdictions³) the regulatory regimes might contain features of direct and indirect relationship between the regulatory capital base and an entity’s PPE.

Regimes with no direct relationship

- 16 Typically, in incentive-based regimes, the regulatory requirements are independent of the accounting requirements. Under these regimes, there is no direct relationship between the regulatory capital base and an entity’s PPE.
- 17 In these regimes, the regulatory capital base is only a regulatory tool for the regulator to derive the allowed revenue to which an entity is entitled to for a period - the regulatory capital base is largely disconnected from the entity’s PPE and it would be impracticable to identify the relationship between the regulatory capital base and an entity’s PPE at an individual asset level for a variety of reasons.
- 18 For example, both the componentisation of the items included in the regulatory capital base and their level of aggregation differ from those of an entity’s fixed asset register, the regulatory capital base may be adjusted for inflation or for differences between forecasted and actual amounts in lump sum amounts rather than at an individual asset level.
- 19 Incentive-based regulatory regimes are common in Europe. Companies within the scope of the project operating within these regimes might therefore determine that there is no direct relationship between the regulatory capital base and its PPE.

Common sources of differences in timing

- 20 Differences in timing can arise from:

³ At this stage we are unable to assess the extent to which European regulatory regimes are impacted by features of both direct and indirect relationship. The results of the IASB staff survey discussed in paragraphs 37 and 38, once publicly available, could assist with this information.

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- (a) Items affected by the relationship between the regulatory capital base and an entity's PPE; and
- (b) Items NOT affected by the relationship between the regulatory capital base and an entity's PPE.

Compensation affected by the relationship between the regulatory capital base and an entity's PPE

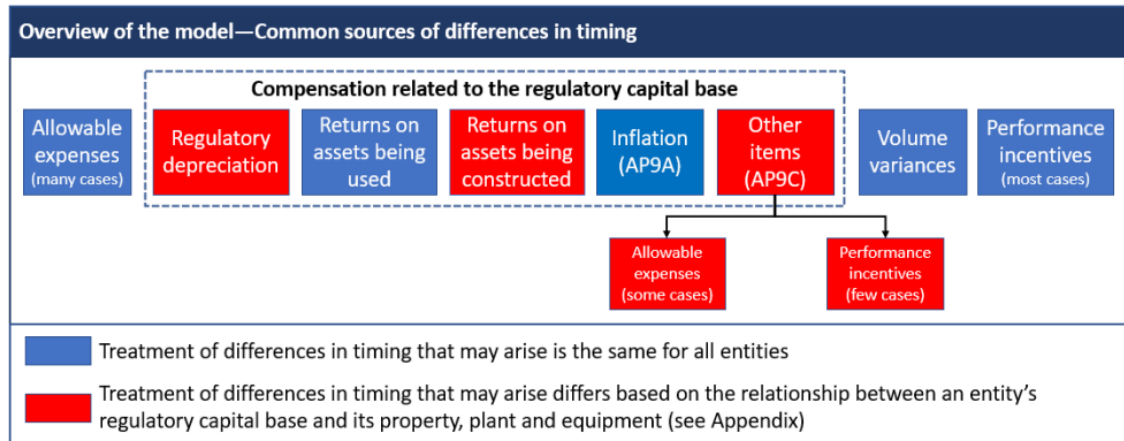
- 21 An entity's regulatory capital base includes the amounts invested by the entity in the assets that are used to supply goods or services. Regulators will use the regulatory capital base as a tool to determine the rates that entities can charge their customers for goods or services supplied.
- 22 Items of allowable expense affected by the relationship between the regulatory capital base and an entity's PPE include differences in timing that arise from items related to an entity's regulatory capital base such as:
 - (a) differences between the regulatory recovery pace and IFRS assets' useful lives (tentative decision by the IASB in October 2022);
 - (b) regulatory returns and interaction with borrowing costs under IAS 23 *Borrowing Costs* (tentative decision by the IASB in November 2022);
 - (c) inflation adjustments (tentative decision by the IASB in December 2022); and
 - (d) any other items, including performance incentives, included in the regulatory capital base (tentative decision by the IASB in December 2022).

Compensation not affected by the relationship between the regulatory capital base and an entity's PPE

- 23 Examples of differences in timing not affected by the relationship between the regulatory capital base and an entity's property, plant and equipment include:
 - (a) volume variances (volume variances arise when amounts charged to customers in a period are lower or higher than the allowed revenue amount to which entities are entitled to for the period due to differences between the estimated and actual volumes of goods or services supplied.)
 - (b) items of expense or income that a regulatory agreement allows an entity to recover or deduct in rates charged, including:
 - (i) items of expense or income affecting regulated rates only when related cash is paid or received;
 - (ii) items of expense or income affecting regulated rates on a basis of accounting other than IFRS (for example, local GAAP); and
 - (iii) items of expense allowable on a basis not specific to the entity (for example, benchmark expenses).
 - (c) performance incentives in the current period (not added or deducted from the regulatory capital base).

Overview of the common sources of differences

- 24 The table below (taken from the IASB agenda paper 9D of the December 2022 meeting) provides an overview of the common sources of differences in timing:



How will the direct (no direct) be included in the final Standard?

- 25 The IASB has tentatively agreed that the final Standard will provide guidance to help an entity determine whether its regulatory capital base has a direct relationship with its PPE. This guidance is expected to be application guidance in the final Standard in the form of a set of indicators.
- 26 At its October 2022 meeting (agenda paper 9B), the IASB discussed indicators (features that would typically be present) that an entity could use to determine whether its regulatory capital base has a direct (no direct) relationship with its PPE. These features are discussed in the paragraphs below.

Regimes with a direct relationship

- 27 The IASB discussed features that would typically be present when an entity's regulatory capital base has a direct relationship with its PPE:
- (a) the regulatory requirements affecting an entity's regulatory capital base are generally closely aligned with the accounting requirements relating to PPE. This enables the entity to map items included in the regulatory capital base to items of PPE and to track any differences—at an individual asset level in some cases.
 - (b) regulators generally require the entity to reconcile the regulatory capital base with its PPE.
 - (c) the depreciation expense is a key input to the determination of the regulatory depreciation, with depreciation rates used for regulatory and accounting purposes being broadly aligned and any differences being tracked.
- 28 When an entity's regulatory capital base has a **direct relationship** with its PPE, the regulatory requirements affecting the regulatory capital base are generally closely aligned with the accounting requirements relating to property, plant and equipment.
- 29 Those regulatory and accounting requirements may be closely aligned when:
- (a) Componentisation - the items recorded and the level of aggregation at which they are recorded for regulatory purposes are largely aligned with those for accounting purposes. For example, the entity is able to match items included in the regulatory capital base to items of PPE. In cases when the regulator adds to the entity's regulatory capital base an item that the entity has expensed because of different capitalisation policies, the entity is able to track that item of expense over the period it is recovered through regulated rates. In addition, when there are adjustments to the regulatory capital base such as efficiency adjustments and true-ups for differences between forecasted and actual amounts, those adjustments can be tracked at an individual asset level.

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- (b) Measurement basis - the measurement basis used for regulatory purposes is largely aligned with that used for accounting purposes. For example, the entity measures the regulatory capital base and its PPE at cost. When there are any adjustments to the measurement of specific items in the regulatory capital base or the PPE, those adjustments can be tracked at an individual asset level.
 - (c) Depreciation rate - the regulatory and accounting depreciation rates are largely aligned. For example, the regulator uses the assets' useful lives as the basis for determining the regulatory depreciation rate for assets in the regulatory capital base, or the accounting depreciation expense as a direct input in calculating regulated rates. In addition, the timing of when depreciation commences for regulatory and accounting purposes is largely aligned.
- 30 The IASB staff noted that when regulatory schemes have features similar to those in paragraph 27, the costs entities would need to incur to apply the proposals would not be expected to be significant. This is because the regulatory accounting and the accounting reporting requirements are aligned. Such an alignment means that there is a direct relationship between the regulatory capital base and the entity's PPE, and therefore, a direct relationship between the regulatory compensation and the related IFRS expense.

Regimes with no direct relationship

- 31 The IASB discussed features that would typically be present when an entity's regulatory capital base has no direct relationship with its PPE:
- (a) the regulatory and accounting requirements are generally substantially different. This makes it difficult for the entity to map items included in the regulatory capital base to items of PPE. For example, the regulator determines the regulatory capital base considering inputs that are unrelated to items of PPE.
 - (b) the entity is unable to track differences between the regulatory and accounting requirements at an individual asset level or the tracking would be complex and costly.
 - (c) the regulator determines the depreciation of the regulatory capital base considering also factors other than the useful lives of the items of PPE.
- 32 When an entity's regulatory capital base has **no direct relationship** with its PPE, the regulatory requirements affecting the regulatory capital base are generally substantially different from the accounting requirements relating to PPE.
- 33 Those regulatory and accounting requirements may be substantially different in various aspects. Differences in requirements that may cause tracking at an individual asset level to be complex and costly include:
- (a) Componentisation - the items recorded and the level of aggregation in which they are recorded for regulatory purposes are significantly different from those for accounting purposes. For example:
 - (i) the regulatory capital base includes items other than items of PPE and the entity is unable to track the movements of these other items. For example, an entity's regulatory capital base may include allowable expenses, performance incentives and other movements in working capital. In addition, in some cases, an entity's regulatory capital base is determined based on estimated ratios of capital and operating expenditures applied to an entity's total capital and operating expenditures.
 - (ii) the regulatory capital base either does not include any asset class or includes asset classes that are significantly different from those of PPE.

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- (iii) the regulatory capital base is adjusted for capital expenditure that cannot be mapped to the additions to the property, PPE (for example, in lump sum amounts).
 - (iv) the regulatory capital base is adjusted for disposals based on the amount of sales proceeds, or in some cases, is not adjusted for disposals.
 - (v) other adjustments to the regulatory capital base, such as efficiency adjustments and true-ups for differences between forecasted and actual amounts, are made in lump-sum amounts.
- (b) Measurement basis - the regulatory capital base is measured using a measurement basis that is different from that used for PPE. In some cases, the initial amount of the regulatory capital base may have been determined on a basis different from the carrying amount of PPE (for example, the entity's market value). In some other cases, the regulatory capital base may be adjusted by inflation. Those measurement differences or adjustments often cannot be tracked at an individual asset level.
- (c) Depreciation rate - the depreciation rates and when depreciation commences for regulatory purposes are significantly different from those for accounting purposes. For example:
- (i) the recovery period of the regulatory capital base may be determined as a blended rate based on the average economic lives of the assets in each asset class as a starting point. That blended rate is adjusted to achieve various regulatory objectives and changes over time. For example, the regulator seeks to achieve regulatory objectives by considering factors such as:
 - the financing of the entity—that is, an entity's financing needs and the financing available to the entity (for example, issuance of bonds with specific durations);
 - uncertainty about the future role of specific industries (for example, replacement by renewable energy sources) or technologies (for example, replacement by smart meters); and
 - intergenerational equity for customers.
 - (ii) the regulatory capital base includes assets under construction that are included in the determination of regulatory depreciation. Regulatory depreciation of assets under construction commences before those assets are depreciated for accounting purposes. The entity is not required to track which part of the depreciation of the regulatory capital base corresponds to assets under construction or to assets in operation.
 - (iii) the regulatory capital base is subject to capitalisation policies that are largely different from those for accounting purposes, resulting in significant differences in when depreciation commences for regulatory and accounting purposes.

34 The IASB staff noted that to apply the proposals in the ED entities would need to reconcile their regulatory capital base to their PPE. Such a reconciliation would be subjective and require significant estimates. In some cases, a full reconciliation may be impracticable. Consequently, for entities subject to incentive-based schemes (no direct relationship), the IASB staff concluded that the cost of applying the proposals would be significant. Furthermore, the benefits to users may be limited.

IASB discussion in December 2022

35 Several IASB members noted that the IASB is making great use of the direct (no direct) relationship concept in its tentative decisions and that it was not included in

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the ED. The consequences of its use are also shaping up to have significant accounting impacts on the model.

- 36 The members noted it was important that stakeholders were made aware of such consequences of introducing the direct (no direct) concept to avoid surprises once the final Standard was published. The IASB staff responded that they would be conducting outreach on this concept and in that way would inform stakeholders of the IASB's tentative decisions and the supporting rationale.

IASB staff outreach/survey

- 37 The IASB staff survey to preparers (open from February to end of April 2023) asks questions about the features of the regulatory schemes under which entities operate and entities' regulatory capital base and asks companies to assess whether they consider they have a direct (no direct) relationship between the regulatory capital base and their PPE.
- 38 The survey input will be used by the IASB staff to develop appropriate indicators and application guidance and will form part of the final Standard.

Feedback received from EFRAG FR TEG and EFRAG RRAWG

EFRAG FR TEG

- 39 EFRAG FR TEG discussed the direct (no direct) concept at its meeting in January 2023.
- 40 One member highlighted that there would be significant judgement involved to identify a direct (no direct) relationship between the regulatory capital base and the IFRS PPE. This member considered that it would be preferable for the IASB to develop factors rather than indicators to determine this relationship. The difference between would be that with "factors" an entity would need to comply, which was different to indicators. Therefore, making the decision based on factors would be clearer and more decisive.
- 41 Members asked whether, under incentive-based regulatory regimes, where there is no direct relationship, there would be any regulatory assets and regulatory liabilities to recognise. It was noted that many of the differences in timing that arose from differences between the regulatory capital base and the IFRS PPE would not result in the recognition of regulatory assets and regulatory liabilities if there was no direct relationship.
- 42 Members considered that it would be important to test the application of direct (no direct) relationship as this was a new concept in the IASB tentative decisions that would have a significant impact on the outcome of the RRA accounting model. Entities that assessed they had no direct relationship would not recognise regulatory assets and regulatory liabilities that arose from differences in timing affected by the regulatory capital base.
- 43 One member asked if/when, in light of the principle of a direct (no direct) relationship, regulatory assets and regulatory liabilities could arise for incentives-based schemes. It was clarified that differences in timing that result in the recognition of regulatory assets and regulatory liabilities still occur when there are volume variances and performance incentives among other areas.

EFRAG RRAWG

- 44 The EFRAG RRAWG discussed the direct (no direct) concept and the IASB staff proposed indicators at its meeting in February 2023. Several members noted the concept had been considered before.

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- 45 Overall, several members welcomed the concept and expressed the need to look carefully at the indicators (features) and see how it will work in practice. They noted the findings of the IASB survey will be important.
- 46 Most members welcomed the IASB's decision to apply this concept to cases where there is no direct relationship between an entity's regulatory capital base and its PPE. These members indicated how complex and costly such an exercise would be in their jurisdiction and other jurisdictions where a direct relationship does not exist. In their view, using this concept would also reduce subjectivity when assessing whether there are regulatory assets (regulatory liabilities) to recognise.
- 47 Some members noted they would be able to determine whether their entity has a direct or (no direct) relationship, with some indicating they had no direct relationship.
- 48 Other members, while not disagreeing with the use of the direct (no direct) concept, had the following comments:
- (a) It was questioned whether it was only the qualitative indicators that should be applied in determining whether there is a direct (no direct) relationship. The IASB staff clarified that there are no materiality indicators, and that the determination of the relationship was meant to be qualitative.
 - (b) Given the importance of the concept, the indicators (features) developed by the IASB staff and discussed with the IASB were too generic using words like "broadly aligned" which could lead to diversity in practice. It was suggested that practical examples should be developed.
 - (c) There would be cases when the regulatory regimes would be hybrid and contain features of both direct and no direct relationship within the same jurisdiction or different jurisdictions, which could also mean that some subsidiaries within the group would be direct and others indirect. Some members thought that there was a need to tighten the indicators to ensure they were clear and allowed entities to make a consistent assessment.

EFRAG Secretariat observations

- 49 Based on the IASB tentative decisions so far, we understand the IASB's use of the direct (no direct) relationship concept will impact the accounting model as follows:

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Timing differences	No direct relationship with the regulatory capital base	Direct relationship with the regulatory capital base
Recognise a regulatory asset (regulatory liability) when definitions and recognition criteria are met		
Items <u>affected</u> by the relationship between the regulatory capital base and an entity's PPE (see paragraph 22) excluding inflation adjustments	NO	YES
Inflation adjustments <u>affected</u> by the relationship between the regulatory capital base and an entity's PPE ⁴	NO	NO
Items <u>not affected</u> by the relationship between the regulatory capital base and an entity's PPE (see paragraph 23)	YES	YES

- 50 As noted above, the direct relationship concept was not included in the ED. We, therefore, consider it important to understand whether entities within the scope of the project will be able to determine whether they have a direct (no direct) relationship between their regulatory capital base and PPE.⁵ This will also be particularly important in cases where an entity operates in a hybrid regime that contains features of both direct (no direct) and making the assessment might not be straightforward.
- 51 Overall, the feedback received from the RRAWG and EFRAG FR TEG points to the involvement of a significant level of judgement in assessing if there is a direct relationship or no direct relationship which could significantly affect the comparability of information. There are also concerns that companies that can track and quantify the amount of difference in timing arising from the regulatory capital base will be prohibited from recognising regulatory assets and regulatory liabilities.
- 52 Based on initial (unofficial) feedback from European companies on the IASB staff survey (see paragraphs 37 and 38), there is potentially a mix of direct and no direct relationships within European companies. The companies that assess there is no direct relationship between the regulatory capital base and PPE support the IASB decision to introduce the direct (no direct) relationship concept as a solution to address the cost-benefits concerns with applying the proposals in the ED.

⁴ The IASB tentative decision in December 2022 on inflation adjustments focused on adjustments relating to the regulatory capital base. The IASB did not discuss inflation adjustments which are not related to the regulatory capital base.

⁵ Throughout this paper it is assumed the reference to PPE is under IFRS. However, in some jurisdictions it might be that the regulator uses local GAAP as a reference.

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- 53 As done by NSS in some other jurisdictions⁶, the EFRAG Secretariat will explore with the EFRAG RRAWG and EFRAG FR TEG whether EFRAG could consider commissioning an economic study on this aspect and any other aspects of the model where there is a need for a cost-benefit assessment. Such a study will cover European companies and be part of EFRAG's preparatory work for an endorsement advice. And it could help to understand the impact of the direct (no direct) concept and contribute to an effects assessment.

Questions for EFRAG FRB members

- 54 Do you have any comments or observations on the direct (no direct) relationship concept introduced by the IASB and its implications on the proposed accounting model for regulatory assets and regulatory liabilities?
- 55 At this stage, do you think you will be able to determine (from a practical and a reasonable cost perspective) whether the regulatory regime in your jurisdiction operates has a direct (no direct) relationship between the regulatory capital base and the PPE? Please explain your answer.

⁶The UKEB is currently conducting an economic study to assist the staff in its ex-ante impact analysis of the IASB ED (as subsequently amended and updated through ongoing IASB deliberations up to the start date of the study) by supporting the UKEB Secretariat with economic expertise in specified areas. The study will serve as an input to the assessment of whether the use of this ED is likely to have an adverse impact on the economy of the UK, including on economic growth.