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Regulatory assets and regulatory liabilities
Inflation adjustments to the regulatory capital base

Objective

1 The objective of the session is for EFRAG FR TEG to further discuss the December IASB's tentative decisions regarding inflation adjustments to an entity's regulatory capital base.

2 The IASB's tentative decision was discussed by EFRAG RRAWG in February 2023, and by EFRAG FR TEG-CFSS and ASAF in March 2023. A summary of these discussions is provided in paragraphs 36 to 44.

3 The following links to the IASB papers have been provided as background information:

(a) IASB Staff paper 9A: Inflation adjustments to the regulatory capital base; and

(b) IASB Staff paper 9B: Consultative Group for Rate Regulation meeting.

Background (Some of the content is reproduced from the March EFRAG FR TEG-CFSS meeting)

Proposals in the ED and feedback

4 Paragraph B13 of the Exposure Draft says that an entity's regulatory capital base might include property, plant and equipment measured on a basis that is different from the basis required by IFRS Accounting Standards. For example, the regulatory capital base may include an inflation adjustment.

5 Illustrative example 7C.2 accompanying the Exposure Draft illustrates that if a regulatory agreement adjusts the regulatory capital base in the current period for inflation, giving an entity the right to add an inflation adjustment in the regulated rates to be charged to customers in future periods, that right would not meet the definition of a regulatory asset. This is because, according to the Exposure Draft, that right is not a right to recover the total allowed compensation for goods or services already supplied to customers.

6 A few respondents to the Exposure Draft—mainly a few standard-setters in Asia-Oceania and Europe, a few accounting firms and a few preparers—disagreed with the illustrative example. These respondents thought the final Standard should treat an inflation adjustment to the regulatory capital base as a regulatory asset.

Introduction to the issue

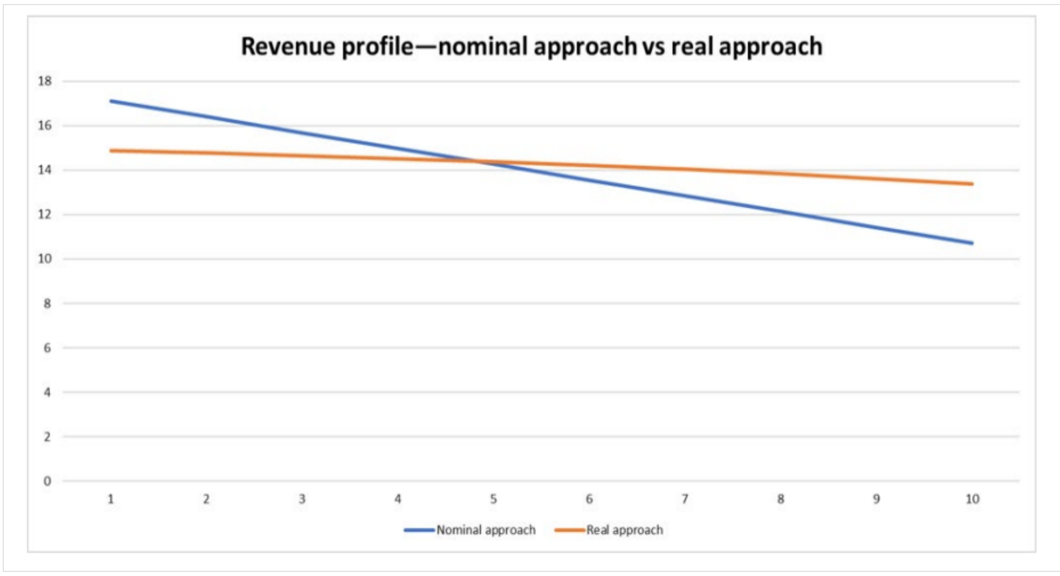
7 Two regulatory approaches are typically used to compensate entities for inflation on the regulatory capital base:

(a) nominal approach—under this approach entities receive a regulatory return that is computed by multiplying a nominal regulatory capital base by a return rate that includes inflation (that is, a nominal return rate). A regulatory capital base that stays constant in nominal terms effectively loses its underlying value by inflation each year with the nominal return rate aiming to compensate entities for that loss.

(b) real approach—under this approach entities receive a regulatory return that is computed by multiplying a regulatory capital base that is adjusted by inflation—so that it holds its value over time—by a return rate that does not include inflation (that is, a real return rate).

8 Both regulatory approaches are present value-neutral, that is, the present value of the future cash flows[1] that an entity receives from the nominal approach and real approach is the same.

9 Paragraph 14 of the IASB Staff paper 9A illustrates the revenue profiles of an entity subject to these regulatory approaches. The resulting revenue profiles for the nominal approach (blue line) and real approach (orange line) are as follows based on an example:



10 When considering which approach to use, regulators consider different factors. For example, regulators may use the nominal approach if their priority is to improve an entity's ability to finance its investments. Regulators may use the real approach if their priority is to maintain stable regulated rates for customers over time.

11 The IASB Staff have observed that the nominal approach is more commonly used by cost-based schemes and the real approach is more commonly used by incentive-based schemes.

12 The question is whether - the inflation adjustment to the regulatory capital base gives rise to a regulatory asset or not.

Summary of discussions with the IASB Consultative Group and other stakeholders received (The content is reproduced from the March EFRAG FR TEG-CFSS meeting)

13 The stakeholders had the following views:

Reason supporting view

[1] The future cash flows relating to the regulatory capital base are the compensation for depreciation of that base and the regulatory return on that base.

View 1: the inflation adjustment to the regulatory capital base gives rise to a regulatory asset
• The inflation adjustment to the regulatory capital base relates to compensation for goods or services that the entity has already supplied and consequently, it is compensation to which the entity is already entitled. • Accounting for a regulatory asset would result in entities that are subject to the real approach reporting a similar financial performance to that of entities subject to the nominal approach.
View 2: the inflation adjustment to the regulatory capital base does not give rise to a regulatory asset
• The inflation adjustment to the regulatory capital base will result in a higher amount of regulatory depreciation that the regulator will include when determining the allowed revenue to which an entity is entitled for a specified period. The entity would have an enforceable present right to recover only the allowed revenue amount for a specified period and not the remainder of the regulatory capital base at a given point in time. • The inflation adjustment to the regulatory capital base should be seen as a mechanism to adjust the measurement of the regulatory capital base so that it holds its value over time rather than an item that gives rise to a regulatory asset. • Accounting for the inflation adjustment as a regulatory asset could be seen as being equivalent to changing the measurement basis of property, plant and equipment from cost to current value (if an entity applies the cost model in IAS 16). • It is unclear why the final Standard would only account for the inflation adjustment as a regulatory asset, when other differences between the regulatory capital base and an entity's property, plant and equipment—that could be viewed as giving rise to regulatory assets and regulatory liabilities—are not considered. • It will be onerous and very judgemental for an entity to demonstrate that it has an enforceable present right to the inflation adjustment to the regulatory capital base.

IASB Staff analysis and recommendations

Does the inflation adjustment meet the definition of a regulatory asset

14 Appendix A of the Exposure Draft defines a regulatory asset as follows (emphasis added):

An **enforceable present right**, created by a regulatory agreement, **to add an amount** in determining the regulated rate to be charged to customers in future periods because **part of the total allowed compensation for goods or services already supplied** will be included in revenue in the future.

Enforceable present right

15 The real approach, as described in paragraph 7(b) above, could be viewed as the regulator splitting a nominal regulatory return for a specified period into two portions:

(a) the real portion, which the regulator would apply to an entity's (adjusted by inflation) regulatory capital base; and

(b) the inflation portion, which the regulator would add to the entity's (adjusted by inflation) regulatory capital base.

16 Whether the inflation-related adjustment to the regulatory capital base gives rise to a regulatory asset depends, in part, on whether an entity has an enforceable present right to recover the regulatory capital base through future regulated rates.

17 The IASB Staff consider that assessing whether an entity has an enforceable present right to add the inflation adjustment to future regulated rates will require judgement and will depend on the legal and regulatory environment in which the entity operates. The IASB Staff plan to discuss the enforceability of rights and obligations when discussing the recognition and measurement proposals with the IASB at a future meeting.

Total allowed compensation for goods or services already supplied

18 This section analyses whether the inflation adjustment to the regulatory capital base for a period would form part of the total allowed compensation for the goods or services supplied during that period.

19 In both approaches described in paragraph 7 above, the goods or services supplied by the entity in the period to which the inflation adjustment relates are the same. The only difference between the real and the nominal approach is when part of the compensation for the goods or services supplied is included in regulated rates charged.

(a) Applying the nominal approach, the compensation relating to the inflation adjustment is included in regulated rates charged in the period in which the goods or services are supplied;

(b) Applying the real approach that compensation is included in regulated rates charged over time through the recovery of the regulatory capital base.

20 Consequently, the IASB Staff consider that an enforceable present right to add the inflation adjustment to the regulated rates to be charged to customers in the future would meet the definition of a regulatory asset because the inflation adjustment compensates the entity for goods or services already supplied.

21 The revenue profile for an entity subject to the real approach is more stable over time than the revenue profile for an entity subject to the nominal approach. This creates greater stability in the regulated rates charged to customers. Consequently, the real approach provides the regulator with a tool for smoothing the regulated rates charged to customers.

22 The IASB Staff consider that the measurement effects of adjusting the regulatory capital base by inflation are the consequence of using the real approach rather than its main purpose - that is, a tool for smoothing the regulated rates charged to customers.

Would the costs of recognising a regulatory asset relating to the inflation adjustment to the regulatory capital base exceed the benefits

23 This section analyses whether the benefits of recognising a regulatory asset relating to the inflation adjustment to the regulatory capital base for those entities that had concluded they have an enforceable present right to add that adjustment in future regulated rates would lead to costs that outweigh benefits.

24 The IASB Staff discussed with users of financial statements—mainly credit and equity analysts covering the utilities sector in Europe—whether accounting for a regulatory asset relating to the inflation adjustment to the regulatory capital base would give rise to useful information. In general, these users said that accounting for the inflation adjustment to the regulatory capital base as a regulatory asset would provide useful information. This is because this regulatory asset would:

(a) provide useful information about the effect of inflation on future regulated rates;

(b) help users assess an entity's gearing levels by comparing the regulatory capital base (that includes inflation) with an entity's debt; and

(c) save them having to adjust an entity's profit or loss by inflation.

25 For an entity to recognise a regulatory asset arising from the inflation adjustment to the regulatory capital base, the entity would need to be able to identify and track changes in the inflation adjustment over time. The entity would also need to be able to estimate the amount and timing of future cash flows arising from that regulatory asset.

Schemes where an entity's regulatory capital base has a direct relationship with its property, plant and equipment

26 It may be feasible to track the inflation adjustment and account for the related regulatory asset. However, the accounting for the regulatory asset would be complex and costly, requiring the entity to track the inflation adjustment at an individual asset level for the high volume of assets typically included in a regulatory capital base.

27 In addition, the IASB Staff understand that such schemes generally apply a nominal approach. Consequently, a requirement to account for an inflation-related regulatory asset may not affect many entities subject to this type of scheme.

Schemes where an entity's regulatory capital base has no direct relationship with its property, plant and equipment

28 The real approach is more frequently applied in schemes where the relationship between an entity's regulatory capital base and its property, plant and equipment is less direct. In such schemes, the regulatory capital base may not consist exclusively of capital expenditures but may also include other items (operating expenditures, performance incentives and other movements in working capital). Consequently, for such schemes, it may be difficult to track the movement of the inflation adjustment included in the regulatory capital base.

29 In addition, it may be difficult to estimate the amount and timing of the future cash flows arising from an inflation-related regulatory asset. This is because future regulatory depreciation amounts, which include the recovery of the inflation adjustment, depend on factors that can be difficult to foresee—for example, the future financing needs of the entity or future technological changes. Consequently, the measurement uncertainty of an inflation-related regulatory asset for these entities could be significant.

IASB Staff conclusions on costs versus benefits of recognising a regulatory asset relating to the inflation adjustment to the regulatory capital base

30 The IASB Staff think that the costs for those preparing the information, which include:

(a) costs associated with assessing whether they have an enforceable present right to add the inflation adjustment in regulated rates in the future;

(b) operational costs of accounting for a regulatory asset relating to the inflation adjustment to the regulatory capital base; and

(c) the costs of obtaining a relevant measure of such an asset because it is subject to significant measurement uncertainty;

would outweigh the benefits of the information provided for users.

IASB Staff recommendations

31 The IASB Staff consider that an entity's right to add an amount relating to the inflation adjustment to the regulatory capital base to regulated rates charged in the future would give rise to a regulatory asset if that right is enforceable. The IASB Staff think that, however, the costs arising from the recognition of that asset would outweigh the benefits of the information provided for users.

32 Therefore, the IASB Staff recommend the final Accounting Standard specify that an entity shall not recognise as a regulatory asset, inflation adjustments to the regulatory capital base.

33 Paragraph 5.11 of the Conceptual Framework states that entities may need to disclose information about unrecognised assets and liabilities in the notes. Therefore, the IASB Staff plan to discuss disclosures with the IASB at a future meeting.

December IASB tentative decisions

34 The IASB tentatively decided that the final Accounting Standard specify that an entity is neither required nor permitted to recognise as a regulatory asset, inflation adjustments to the regulatory capital base.

35 All 12 IASB members agreed with this decision.

Feedback received so far

EFRAG RRAWG (February 2023) (This is reproduced from the March EFRAG FR TEG-CFSS meeting)

36 EFRAG RRAWG discussed the IASB's tentative decisions on inflation adjustments to an entity's regulatory capital base.

37 Members were, in general, in agreement with the IASB's tentative decision not to recognise a regulatory asset for inflation adjustments to the regulatory capital base. One member did not agree with the IASB's tentative decisions indicating that he was not convinced by the argument that it will be too costly to track inflation adjustments. This member indicated that based on the IASB's tentative decisions, example 7C.2 of the Exposure Draft would need to be rephrased.

38 One member confirmed that they apply a real return approach (incentive-based scheme). While another member was more familiar with the nominal approach.

39 One member questioned whether all incentive-based schemes apply a real return and the IASB Staff responded that it was not necessary that all incentive-based schemes have a real return. Based on what the IASB Staff have seen, cost-based schemes applying a nominal return and incentive-based schemes applying a real return were coincidental rather than a reflection of the features of the scheme.

40 In response to a member's question for clarification on whether the IASB Staff's recommendations were only for inflation adjustments linked to the regulatory asset base and not to other inflation adjustments, the IASB Staff confirmed that the tentative decisions relate only to inflation adjustments linked to the regulatory asset base. The IASB Staff indicated that the tentative decisions do not deal with other inflation adjustments that may be included in regulated rates. Also, the tentative decisions are for both a direct and non-direct relationship between an entity's regulatory capital base and its PPE.

EFRAG FR TEG-CFSS meeting (March 2023)

41 There were no comments on this topic.

High-level summary of ASAF discussions

42 Some members generally agreed with the IASB's tentative decisions while some other members considered the IASB's tentative decision to be too restrictive and therefore suggested to permit recognition of a regulatory asset if entities do not consider the tracking of the components to be very burdensome.

43 Another member indicated that in some jurisdictions, inflation is high and there is a tendency to build into the models an expectation of where inflation is likely to be going forward in setting tariffs. Organisations in those jurisdictions tended to include this in the accounting also. These organisations are concerned that if they have to exclude inflation adjustments, they are not sure how they can have the right tariffs in place and how the accounting would reflect what they are faced with in reality.

44 Another member indicated that example 7C.2 of the Exposure Draft would need to be updated. Also, it is not clear how other inflation adjustments not related to the regulatory capital base would be treated.

EFRAG Secretariat analysis

45 The EFRAG Secretariat notes most EFRAG RRAWG members supported the IASB tentative decision and there were no concerns raised by CFSS members. The EFRAG Secretariat considers that one of the important aspects to consider is the legal and regulatory framework in order to determine whether an entity has an enforceable present right for a regulatory asset to be recognised. Nevertheless, the EFRAG Secretariat considers that the costs may outweigh the benefits of the information provided for users based on the reasons provided by the IASB Staff.

46 The IASB Staff's recommendation was based on cost/benefit reasons. However, the EFRAG Secretariat understands from some stakeholders that they do not consider the tracking of the components too costly, therefore recognition of a regulatory asset would provide relevant information.

Questions for EFRAG FR TEG

47 Does EFRAG FR TEG agree with the IASB Staff's observation that the nominal approach is more commonly used by cost-based schemes and the real approach is more commonly used by incentive-based schemes (paragraph 11 above)? Please explain.

48 Does EFRAG FR TEG agree with the IASB's tentative decisions not to require nor permit recognition of a regulatory asset for an inflation adjustment to the regulatory capital base? Please explain.

49 Does EFRAG FR TEG consider that outreach is needed for this issue? Please explain.