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Regulatory Assets and Regulatory Liabilities

The direct (no direct) relationship concept and impacts on the accounting model

Objective

1 This paper explains the direct (no direct) relationship concept and its impacts on the accounting model in the forthcoming IASB's final Standard on Accounting for Regulatory Assets and Regulatory Liabilities.

2 This paper has been prepared based on the following IASB documents:

(a) IASB staff paper on the use of the direct relationship concept discussed during the December 2022 IASB meeting- Agenda Paper 9D, which is included for the session as background reading paper 05-02.

(b) Features of different regulatory schemes – IASB document – included as background reading paper 05-03.

Structure of this paper

3 This paper is structured as follows:

(a) Background

(b) Different regulatory regimes

(c) Common sources of differences in timing

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

(e) EFRAG Secretariat observations

Background

4 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.

5 One of the drivers of these decisions has been whether an entity's regulatory capital base has a direct (no direct) relationship with its property, plant, and equipment (PPE)[1] – referred to as the direct (no direct) relationship concept. The inclusion of this concept in the accounting model aims to:

[1] 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.

(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 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.

6 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. 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) 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 with significant outcomes for entities that operate in regimes where there is a disconnect between the regulatory capital base and PPE (mainly incentive-based regimes).

7 The direct (no direct) 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.

Different regulatory regimes

8 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.

9 In cost-based schemes, there is a high probability that the entity will recover its costs. 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. Most regulatory schemes however could be ''hybrid'' and contain features of both regimes.

10 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.).

Regimes with a direct relationship

11 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.

12 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).

Regimes where with no direct relationship

13 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.

14 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. 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 by inflation or it may be adjusted for differences between forecasted and actual amounts in lump sum amounts rather than at an individual asset level.

15 These types of regulatory regimes are common in Europe.

Common sources of differences in timing -

16 Differences in timing can arise from:

(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

17 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.

18 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).

19 The appendix included in the IASB agenda paper 9D (paper 05-02 for this meeting) summarises the use of the direct (no direct) relationship concept in the IASB's redeliberations of the proposed model.

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

20 Examples of differences in timing <u>not affected</u> 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;

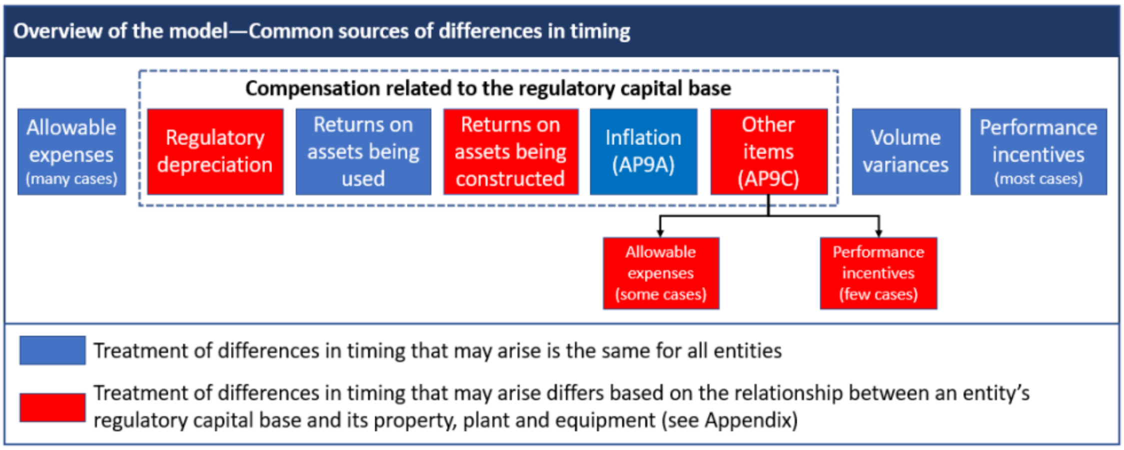
(ii) items of expense or income affecting regulated rates on a basis of accounting other than IFRS (for example, local GAAP); and

(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

21 The table below (taken from the IASB agenda paper 9D) provides an overview of the common sources of differences in timing:



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

22 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 form of a set of indicators.

23 At its October 2022 meeting (agenda paper 9B), the IASB discussed indicators that an entity could use to determine whether its regulatory capital base has a direct (no direct) relationship with its PPE. The indicators are discussed in the paragraphs below.

Regimes with a direct relationship

24 For regimes with a direct relationship, the proposed indicators are:

(a) the componentisation of assets recorded for regulatory purposes is broadly aligned with that used for accounting purposes. Any differences in componentisation are tracked separately.

(b) the measurement basis and capitalisation policies used for regulatory purposes are broadly aligned with those used for accounting purposes with any differences tracked separately.

(c) depreciation rates used for regulatory purposes are broadly aligned with those used for accounting purposes, with regulators requiring depreciation rates that are different from those used for accounting if necessary to meet a public interest objective.

25 The IASB staff noted that when regulatory schemes have features similar to those in paragraph 24, 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

26 For regimes with no direct relationship, the proposed indicators are:

(a) componentisation of the regulatory capital base—the regulatory capital base may not consist exclusively of capital expenditures but may also include operating expenditures, performance incentives and other movements in working capital. For example, we have learned that regulatory schemes in the electricity sector in a few jurisdictions in Europe determine the regulatory capital base as a percentage of an entity's total expenditures.6 As a result, for entities subject to these schemes, the link between their regulatory capital base and their property, plant and equipment is less direct. In other schemes, the regulatory capital base may be split into asset classes that are different from those used for accounting purposes. In addition, in some cases:

(i) the movements of the regulatory capital base—mainly amounts of capital expenditure and regulatory depreciation—may be based on forecasts made for a period. In such cases, regulatory agreements may adjust that base to reflect actual amounts. Both the forecasted amounts of capital expenditure and the adjustments are lump sum amounts and would not be broken down by individual assets.

(ii) the regulatory capital base may include assets that are being constructed (construction work in progress). In these cases, regulatory agreements may not distinguish construction work in progress from assets in operation, with regulatory depreciation calculated so as to recover both assets that are in operation and assets that are being constructed. Because of this, regulatory depreciation may start on a different date from accounting depreciation. For example, the depreciation of regulatory capex may start when there is a cash outflow, not when the asset is placed in service.

(iii) regulators disallow amounts of capital expenditure on efficiency and prudency grounds. When they do this, the amounts disallowed would not be broken down at an asset level making it difficult to reconcile the regulatory capital base to the entity's property plant and equipment.

(iv) different treatment of disposals. Disposals may be deducted from the regulatory capital base using the sales proceeds, not based on the assets' net book values.

(b) measurement of the regulatory capital base—the regulatory capital base may be measured using measurement bases other than historical cost (for example, replacement cost). In addition, regulators may index the regulatory capital base to reflect inflation.

(c) depreciation rate of the regulatory capital base—this may differ from the assets' useful lives.

27 The IASB staff noted that to apply the proposals such 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

28 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 the ED. The consequences of its use are also shaping up to have significant accounting impacts on the model. 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 tentative decisions and the rationale behind it.

IASB staff outreach

29 On 5 January 2023, the IASB staff sent an email to ASAF members seeking preparer volunteers to participate in a survey to explore the application of the direct (no direct) concept relationship between an entity's regulatory capital base with its PPE whilst determining whether or not an entity has recognisable regulatory assets and regulatory liabilities. The EFRAG Secretariat shared with request with the EFRAG RRAWG on 24 January 2023. The IASB staff deadline for completion of the survey is 27 March 2023.

30 The input will be used to develop application guidance that will form part of the final Standard. The survey asks questions about the features of the regulatory schemes under which entities operate and entities' regulatory capital base.

EFRAG Secretariat observations

31 In summary, we understand the IASB's use of the direct (no direct) concept will impact the accounting model as follows:

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 are met	
Items affected by the relationship between the regulatory capital base and an entity's PPE (see paragraph 18) excluding inflation adjustments	NO	YES
Inflation adjustments affected by the relationship between the regulatory	NO	NO

capital base and an entity's PPE[2]		
Items <u>not affected</u> by the relationship between the regulatory capital base and an entity's PPE (see paragraph 20)	YES	YES

32 We, therefore, consider it important to understand whether entities within the scope of the project will be able to the indicators being developed by the IASB staff to determine whether they have a direct (no direct) relationship between their regulatory capital base and PPE.[3] 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.

[2] The IASB tentative decision in December 2022 on inflation adjustments focused on adjustments <u>relating to the regulatory capital base</u>. The IASB did not discuss inflation adjustments which are not related to the regulatory capital base.

[3] Throughout this paper it is assumed the reference to PPE is under IFRS.