# Staff paper

Agenda reference: AP9D

## IASB meeting

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| Date | **December 2022** |
| Project | **Rate-regulated Activities** |
| Topic | **Use of the direct relationship concept—Overview** |
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## Objective

1. Over the last three months the IASB has redeliberated the proposals in the Exposure Draft *Regulatory Assets and Regulatory Liabilities* (Exposure Draft) dealing with total allowed compensation. One of the drivers of the IASB's tentative decisions in this area has been whether an entity's regulatory capital base has a direct (no direct) relationship with its property, plant and equipment. This paper provides an overview of the use of the direct (no direct) relationship concept in the IASB's redeliberation of the proposed model.

2. This paper is for information purposes only. We are not asking the IASB to make decisions on this paper. However, we ask the IASB for any questions or comments on the use of the direct (no direct) relationship concept in its tentative decisions to date.

## Structure of the paper

3. This paper is structured as follows:

   (a) items affected by the relationship between an entity's regulatory capital base and its property, plant and equipment (paragraphs 5–12).

   (b) other aspects of the model that will not be affected by the relationship between an entity's regulatory capital base and its property, plant and equipment (paragraphs 13–14).

4. The appendix to this paper summarises the use of the direct (no direct) relationship concept in the IASB's redeliberations of the proposed model.

## Items affected by the relationship between the regulatory capital base and an entity's property, plant and equipment

5. An entity's regulatory capital base includes the amounts invested by the entity in the assets that are used to supply goods or services. The recovery of the investments through the depreciation of the regulatory capital base and the regulatory returns on that base are key sources of revenue for regulated entities.

6. Paragraph 12(a) of the Exposure Draft proposes that differences in timing arise when part or all of the total allowed compensation for the goods or services supplied in a period is included in regulated rates charged, and therefore is included in revenue, in a different period. At its October 2022 meeting, the IASB discussed that for a difference in timing to arise, there is a need for:

   (a) the regulatory compensation and the accounting expense to be related; and

   (b) the regulatory compensation and accounting expense to be reflected in profit or loss in different periods.

7. At that meeting, the IASB discussed the accounting for regulatory assets or regulatory liabilities arising from differences between the regulatory recovery period and the assets' useful lives. The IASB noted that for the regulatory depreciation of the regulatory capital base to be related to the accounting depreciation expense, it was necessary that an entity's regulatory capital base and its property, plant and equipment had a direct relationship.

8. The IASB also noted that a direct relationship between an entity's regulatory capital base and its property, plant and equipment generally arises when the regulatory requirements are closely aligned with the accounting requirements. In such schemes, regulators typically require entities to reconcile their regulatory capital base to their property, plant and equipment and to track any differences.

9. In some other regulatory schemes, the link between an entity's regulatory capital base and its property, plant and equipment is less direct. In some cases, the regulatory capital base is only a regulatory tool for the regulator to derive the allowed revenue to which an entity is entitled for a period—the regulatory capital base is largely disconnected from the entity's property, plant and equipment. In other cases, it would be impracticable to identify the relationship between the regulatory capital base and an entity's property, plant and equipment 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.

10. Therefore, the IASB concluded that the benefits of accounting for regulatory assets and regulatory liabilities arising from differences between the regulatory recovery period and the assets' useful lives would exceed the costs only when there is a direct relationship between an entity's regulatory capital base and its property, plant and equipment. The table in the appendix summarises the IASB's tentative decisions on this matter.[1]

11. In November 2022, the IASB discussed the accounting for regulatory returns on an asset not yet available for use when an entity capitalises borrowing costs incurred to construct that asset. The IASB

[1] Agenda Paper 9B discussed by the IASB at its October 2022 meeting and update of decisions tentatively made at that meeting.

noted that when the entity's regulatory capital base and its property, plant and equipment have a direct relationship, part or all of those regulatory returns compensates the entity for the capitalised borrowing costs incurred in constructing the asset. Therefore, the IASB tentatively decided that when an entity's regulatory capital base and its property, plant and equipment have a direct relationship and the entity capitalises borrowing costs, the entity would:

(a) limit the amount of the regulatory returns on an asset not yet available for use in profit or loss during the construction period when the entity receives a regulatory return that includes both a debt and an equity return.

(b) reflect those regulatory returns in profit or loss during the operation period when the entity receives a regulatory return that includes a debt return only.

The table in the appendix summarises the IASB's tentative decisions on this matter.[2]

12. At this month's meeting, the IASB will discuss the accounting for items that a regulator may include in an entity's regulatory capital base. In particular, the IASB will discuss whether inflation adjustments, allowable expenses and performance incentives included in an entity's regulatory capital base give rise to regulatory assets that should be recognised in the financial statements. The analysis of these topics is affected by whether an entity's regulatory capital base has a direct (no direct) relationship with its property, plant and equipment. The use of a direct (no direct) relationship concept is helpful because it:

(a) splits the population of entities between those that would be able to trace and account for the recovery of individual items included in the regulatory capital base from those that would not; and

(b) helps to ensure that the staff recommendations for these topics are consistent with the IASB's tentative decisions made in October and November 2022.

## Other aspects of the model not affected by the relationship between the regulatory capital base and an entity's property, plant and equipment

13. Differences in timing will also arise from items unrelated to an entity's regulatory capital base—that is, from items that are separately included in the calculation of an entity's regulated rates. Consequently, the accounting for these differences in timing will not be affected by the relationship between an entity's regulatory capital base and its property, plant and equipment.

14. Examples of these differences in timing are:

(a) volume variances;[3]

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[2] Agenda Paper 9A and 9C discussed by the IASB at its November 2022 meeting and update of decisions tentatively made at that meeting.

[3] In some regulatory schemes, entities are able to transfer demand risk to customers (Agenda Paper 9A, July 2022). 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 for the period due to differences between the estimated and actual volumes of goods or services supplied.

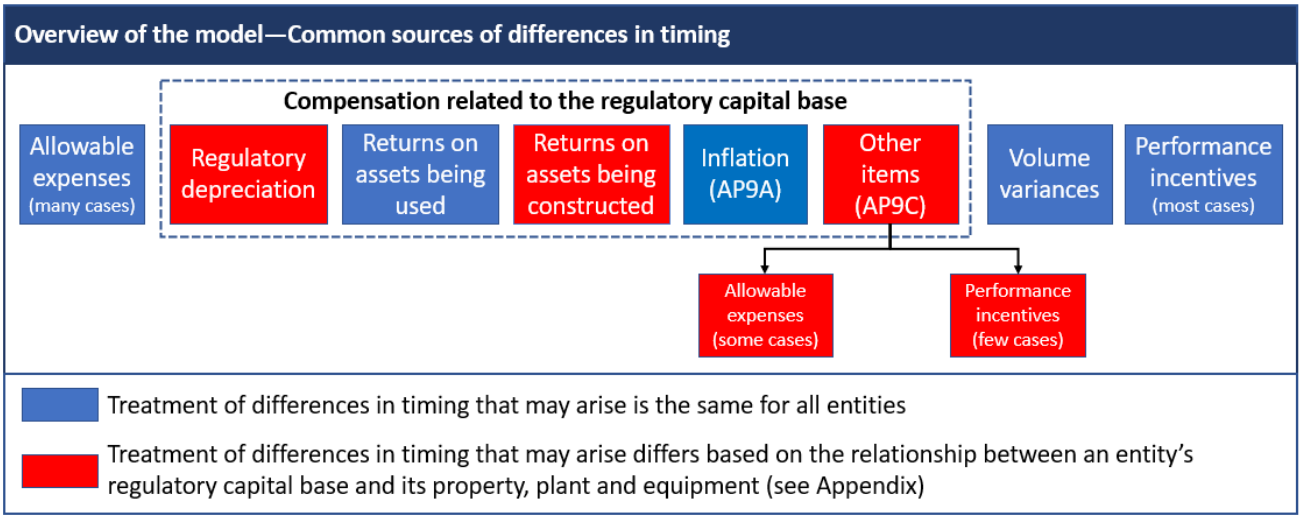
(b) items of expense or income that a regulatory agreement allows an entity to recover or deduct in rates charged, including:

  (i) items of expense or income affecting regulated rates only when related cash is paid or received (paragraphs 59–66 of the Exposure Draft);

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

  (iii) items of expense allowable on a basis not specific to the entity (for example, benchmark expenses).[4]

(c) performance incentives (paragraphs B16–B20 of the Exposure Draft).




| Question for the IASB |
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| Does the IASB have any questions or comments on the use of the direct (no direct) relationship concept in its tentative decisions to date? |

[4] The IASB discussed this matter at its October 2022 meeting (Agenda Paper 9A).

## APPENDIX—USE OF THE DIRECT (NO DIRECT) RELATIONSHIP CONCEPT

A1. The following table summarises the use of the direct (no direct) relationship concept in the IASB's redeliberations of the proposed model.

| DIRECT RELATIONSHIP BETWEEN REGULATORY CAPITAL BASE AND PROPERTY, PLANT AND EQUIPMENT | | | | |
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| **Compensation determined based on the regulatory capital base (paragraph 5)** | | **Items that may be included in the regulatory capital base (paragraph 12)** | | |
| **Regulatory depreciation** | **Regulatory returns on an asset not yet available for use** | **Inflation adjustments** | **Allowable expense** | **Performance incentives** |
| October 2022 IASB Meeting—Agenda Paper 9B<br><br>There is a direct relationship between the regulatory depreciation and the accounting depreciation. Consequently, the entity treats the compensation for regulatory depreciation as an amount that recovers the depreciation expense (the allowable expense).<br><br>An entity would account for regulatory assets or regulatory liabilities arising from differences between the | July 2022 IASB Meeting—Agenda Papers 9B and 9C<br><br>The regulatory returns on an asset not yet available for use would form part of the total allowed compensation for goods or services supplied during the construction period of that asset. That is, an entity would reflect the regulatory returns in profit or loss during the construction period. (However, this decision is modified if an entity capitalises borrowing costs—see below.) | December 2022 IASB Meeting—Agenda Paper 9A<br><br>Regulatory schemes that lead to a direct relationship between an entity's regulatory capital base and its property, plant and equipment would generally be subject to a nominal approach—that is, an inflation-adjusted regulatory capital base for such schemes is expected to be uncommon.<br><br>Based on an assessment of benefits and costs, Agenda Paper 9A recommends the final Standard specifies an entity shall not recognise as a | December 2022 IASB Meeting—Agenda Paper 9C<br><br>If an entity has an enforceable present right to add an allowable expense to future regulated rates, Agenda Paper 9C recommends the entity shall recognise a regulatory asset relating to that allowable expense. In doing so, the entity would apply the proposals for allowable expenses (paragraphs B3–B9 of the Exposure Draft).<br><br>Therefore, the entity would reflect in profit or loss the | December 2022 IASB Meeting—Agenda Paper 9C<br><br>If an entity has an enforceable present right (obligation) to add (deduct) a performance incentive to (from) future regulated rates, Agenda Paper 9C recommends the entity shall recognise a regulatory asset (regulatory liability) relating to a bonus (penalty) in the period its performance occurred in accordance with paragraphs B16–B20 of the Exposure Draft. |

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| regulatory recovery period and the assets' useful lives.<br><br>Therefore, the entity would reflect in profit or loss the amount that recovers depreciation expense over the assets' useful lives. | November 2022 IASB Meeting—Agenda Paper 9A<br><br>There is a direct relationship between the regulatory return on an asset not yet available for use and the borrowing costs incurred during construction.<br><br>If regulatory returns include both a debt and an equity return and an entity capitalises borrowing costs incurred during construction, the entity would reflect in profit or loss those returns that are:<br><br>• in excess of the capitalised borrowing costs during the construction period. This will typically approximate to the equity return on the amounts invested in the construction of the assets.<br>• equal to the capitalised borrowing costs during the operation period. | regulatory asset the inflation adjustment to the regulatory capital base.<br><br>Therefore, the entity would reflect in profit or loss the inflation adjustment over the periods the adjustment is included in regulated rates—and hence in revenue. | compensation for the allowable expense in the period when the entity recognises the expense. | However, we understand that it is uncommon for performance incentives to be included in the regulatory capital base for schemes of this type. |

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| | If regulatory returns include only a debt return and an entity capitalises borrowing costs incurred during construction, the entity would reflect the returns in profit or loss during the operation period. This approach treats the debt return as an amount that recovers allowable expenses—the capitalised borrowing costs included as part of depreciation expense. | | | |

| NO DIRECT RELATIONSHIP BETWEEN REGULATORY CAPITAL BASE AND PROPERTY, PLANT AND EQUIPMENT | | | | |
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| **Compensation determined based on the regulatory capital base (paragraph 5)** | | **Items that may be included in the regulatory capital base (paragraph 12)** | | |
| **Regulatory depreciation** | **Regulatory returns on an asset not yet available for use** | **Inflation adjustments** | **Allowable expense** | **Performance incentives** |
| October 2022 IASB Meeting—Agenda Paper 9B<br><br>An entity would not account for regulatory assets or regulatory liabilities arising from differences between the regulatory recovery period and the assets' useful lives.<br><br>Therefore, the entity would reflect in profit or loss the compensation relating to the regulatory depreciation in the period when it is included in regulated rates—and hence in revenue.<br><br>The entity would provide disclosures to enable users of financial statements to understand the reasons for its conclusion that its regulatory | July 2022 IASB Meeting—Agenda Papers 9B and 9C<br><br>The regulatory returns on an asset not yet available for use would form part of the total allowed compensation for goods or services supplied during the construction period of that asset. That is, an entity would reflect the regulatory returns in profit or loss during the construction period. | December 2022 IASB Meeting—Agenda Paper 9A<br><br>Based on an assessment of benefits and costs, Agenda Paper 9A recommends the final Standard specifies an entity shall not recognise as a regulatory asset the inflation adjustment to the regulatory capital base.<br><br>Therefore, the entity would reflect in profit or loss the inflation adjustment over the periods the adjustment is included in regulated rates—and hence in revenue. | December 2022 IASB Meeting—Agenda Paper 9C<br><br>Based on an assessment of benefits and costs, Agenda Paper 9C recommends the final Standard specifies an entity shall not recognise a regulatory asset relating to an allowable expense included in the regulatory capital base.<br><br>Therefore, the entity would reflect in profit or loss the compensation related to the allowable expense over the periods when that compensation is included in regulated rates—and hence in revenue. | December 2022 IASB Meeting—Agenda Paper 9C<br><br>Based on an assessment of benefits and costs, Agenda Paper 9C recommends the final Standard specifies an entity shall not recognise a regulatory asset or regulatory liability relating to a performance incentive included in the regulatory capital base.<br><br>Therefore, the entity would reflect in profit or loss the performance incentive over the periods when the related compensation is included in regulated rates—and hence in revenue. |

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| capital base and its property, plant and equipment have no direct relationship. | | | | However, we understand that it may not be very common for performance incentives to be included in the regulatory capital base for schemes of this type. |