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## Regulatory Assets and Regulatory Liabilities

### Scope and total allowed compensation Update on IASB tentative decisions

#### Objective

- 1 The purpose of this session is to provide an update on the IASB redeliberation of the Exposure Draft ED/2021/1 *Regulatory Assets and Regulatory Liabilities* ('the ED') on the IASB tentative decisions taken from May 2022 to September 2022 on:
  - (a) Scope of the final Standard
  - (b) The following aspects of total allowed compensation:
    - (i) Components of total allowed compensation
    - (ii) Regulatory returns on an asset not yet available for use (CWIP)

#### Scope of the final Standard

##### *Proposals in the ED*

- 2 Paragraph 3 of the ED proposes that an entity applies the rate-regulated activities ('RRA') model to all its regulatory assets and regulatory liabilities.
- 3 Furthermore, paragraph 6 of the ED specifies that a regulatory asset and a regulatory liability can exist only if:
  - (a) an entity is party to a regulatory agreement;
  - (b) the regulatory agreement determines the regulated rate the entity charges for the goods or services it supplies to customers; and
  - (c) part of the total allowed compensation for goods or services supplied in one period is charged to customers through the regulated rates for goods or services supplied in a different period (that is, there are differences in timing).
- 4 Paragraph 7 of the ED defines a regulatory agreement as a set of enforceable rights and obligations that determine the regulated rate to be charged to customers. The ED does not restrict the scope to regulatory agreements with a particular legal form, or that have particular features.

##### *Concerns raised by respondents*

- 5 The general feedback received by the IASB on the scope of the proposed Standard is consistent with EFRAG's position in its FCL.
- 6 There was a general concern that the scope may be too broad. Many respondents were uncertain about which regulatory agreements, arrangements or activities would be within the scope of the proposals. Some of these uncertainties are due to:

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- (a) the exclusion of some of the features of ‘defined rate regulation’ as described in paragraph BC82 of the ED (i.e. there is no effective competition to supply the regulated goods and services, the regulation establishes parameters to maintain the availability of the supply and provide greater price stability for customers and support the financial viability for the regulated entity);
- (b) not specifying whether a particular body, such as a regulator, is required for a regulatory asset or regulatory liability to exist may capture a wide range of activities and arrangements that should not be included in the scope;
- (c) difficulty in identifying the rights and obligations that may constitute a regulatory agreement;
- (d) uncertainty about whether particular features may cause a regulatory agreement to be within, or outside, the scope of the proposals;
- (e) the interaction between the proposals and other Standards (mainly, IFRS 9 *Financial Instruments*, IFRS 17 *Insurance Contracts* and IFRIC 12 *Service Concession Arrangements*). Respondents asked the IASB to develop detailed guidance and illustrative examples on how an entity would account for regulatory assets and regulatory liabilities by applying either the financial asset, the intangible asset or a hybrid model in IFRIC 12;
- (f) the proposed definition of ‘regulatory agreement’ and whether a regulator is needed for regulatory assets or regulatory liabilities to exist. According to these respondents, both the broad proposed definition of ‘regulatory agreement’ and the lack of definition of ‘regulator’ may capture a wide range of activities and arrangements that should not be included in the scope and may make consistent application of the final requirements difficult.

### *IASB tentative decisions on scope taken in 2022*

- 7 At its February meeting, the IASB started redeliberating:
  - (a) the conditions for a regulatory asset or regulatory liability to exist and determining whether a regulatory agreement with particular features is in the scope; and
  - (b) the role, definition of the regulator and whether self-regulation is in scope.
- 8 At its May meeting, the IASB discussed stakeholders’ concerns related to difficulties to determine whether a regulatory agreement is within the scope of the ED because of a lack of clarity about how to interpret the term ‘customers’ in the definition of ‘regulatory agreement’ and ‘regulated rate’ in certain situations (e.g. the regulated rate being charged to customers indirectly through another party; recovery or reversal of differences in timing to different groups of customers).
- 9 Additionally, the IASB considered concerns expressed by many respondents to the consultation that the proposed scope might be broader than intended and capture financial instruments within the scope of IFRS 9 that might give rise to regulatory assets and regulatory liabilities.
- 10 At its September meeting, the IASB considered four examples that illustrate the interaction between the RRA model and the intangible asset model in IFRIC 12. The IASB considers that arrangements accounted for using the financial asset model are not expected to give rise to regulatory assets or regulatory liabilities if the total expected consideration forms part of the financial asset initially recognised and any consequent changes to an entity’s rights to future cash flows would be captured as part of the measurement of the financial asset.

### *Determining whether a regulatory agreement is within the scope*

- 11 The IASB tentatively decided:

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- (a) to reconfirm the proposals in the ED:
  - (i) to require an entity to apply the Standard to all its regulatory assets and regulatory liabilities;
  - (ii) that the Standard will apply to all regulatory agreements and not only to those that have a particular legal form;
  - (iii) to confirm the conditions necessary for a regulatory asset or a regulatory liability to exist;
- (b) to not explicitly specify in the Standard which regulatory schemes would be within or outside its scope;
- (c) to clarify in the Standard that a regulatory agreement:
  - (i) may include enforceable rights and enforceable obligations to adjust the regulated rate beyond the current regulatory period;
  - (ii) that creates either regulatory assets or regulatory liabilities, but not both, is within its scope;
  - (iii) that causes differences in timing when a specified regulatory threshold is met creates regulatory assets or regulatory liabilities;
  - (iv) is not required to determine a regulated rate using an entity's specific cost for the regulatory agreement to create regulatory assets or regulatory liabilities (i.e. some incentive-based regulatory schemes may establish differences between the entity's actual costs and average costs of a group of industry peers (benchmarked costs) which are fully or partially shared between the entity and its customers).

### *Definition of a regulator and self-regulation*

- 12 The IASB tentatively decided to:
- (a) include the existence of a regulator as part of the conditions necessary for a regulatory asset or a regulatory liability to exist;
  - (b) define a regulator as '*a body that is empowered by law or regulation to determine the regulated rate or a range of regulated rates*';
  - (c) include guidance to clarify that:
    - (i) self-regulation is outside the scope of the proposed Standard; and
    - (ii) a situation in which an entity or its related party determines the rates, but does so in accordance with a framework that is overseen by a body empowered by law or regulation, is not self-regulation for the purposes of the proposed Standard.

### *Clarifications relating to the term 'customers'*

- 13 The IASB tentatively decided to clarify that, for a regulatory asset or a regulatory liability to arise, it is necessary that differences in timing originate from, and reverse through, amounts included in the regulated rates that an entity accounts for as revenue in accordance with IFRS 15 *Revenue from Contracts with Customers*, even in cases when:
- (a) an entity charges the regulated rates to its customers indirectly through another party;
  - (b) the origination and reversal of differences in timing occur in different revenue streams through regulated rates charged to different groups of customers.
- 14 As a result, the IASB's tentative decision would imply that the term 'customers' in the ED should be understood as defined in IFRS 15.

*Interaction with IFRS 9 requirements*

- 15 The IASB conducted targeted outreach to gather further evidence about the existence of financial instruments that could give rise to regulatory assets and regulatory liabilities and how often these situations could happen. The outreach did not identify any examples of such situations and consequently, the IASB tentatively decided:
- (a) not to exclude from the scope of the proposed Standard regulatory assets or regulatory liabilities related to financial instruments within the scope of IFRS 9;
  - (b) to explain in the Basis for Conclusions on the proposed Standard that the regulation of interest rates is typically limited to setting a cap or floor on interest rates, therefore, this type of regulation is not expected to give rise to differences in timing.

*Interaction with IFRIC 12 requirements*

- 16 The IASB tentatively decided:
- (a) clarify the intended interaction between the proposed Standard and IFRIC 12 - that an entity would apply IFRIC 12 first and then apply the requirements of the proposed Standard to any remaining rights and obligations to determine if the entity has regulatory assets or regulatory liabilities; and
  - (b) include examples to illustrate that interaction, including:
    - (i) examples where the entity has a right to recover higher input costs incurred in a period in the regulated rates to be charged to customers in future periods;
    - (ii) examples where the entity has a right to recover higher input costs incurred in a period in the regulated rates to be charged to customers in a future period, but the grantor guarantees to pay any shortfalls between the higher input costs incurred and the amounts recovered from the customers; and
    - (iii) examples dealing with circumstances that are not expected to give rise to regulatory assets and regulatory liabilities.

*EFRAG TEG-CFSS discussion in September 2022*

- 17 EFRAG FR TEG and CFSS discussed the IASB tentative decisions relating to the term 'customers' for RRA. Members agreed with the IASB's direction of proposals.
- 18 EFRAG FR TEG and CFSS also discussed the IASB tentative decisions and the interaction with IFRS 9 requirements. Members supported the IASB's tentative decision not to exclude from the scope of the ED regulatory assets or regulatory liabilities related to financial instruments within the scope of IFRS 9. However, some members expressed the view that it would be better to have the IFRS 9 exclusion to avoid future circumstances when such situations might appear.

*EFRAG FIWG discussion in November 2022*

- 19 EFRAG FIWG discussed the IASB tentative decision related to the interaction of the RRA model with the IFRS 9 requirements. Members supported the IASB's tentative decision not to exclude from the scope of the final Standard regulatory assets or regulatory liabilities related to financial instruments within the scope of IFRS 9.
- 20 In their view, the measurement models used under IFRS 9 to account for financial instruments would capture possible timing differences that could arise. For instance, financial instruments accounted for under the amortised cost model would spread the interest charge over the period so no additional timing difference would be left to give rise to regulatory assets and regulatory liabilities under the RRA model.

When the fair value model is applied, there is no timing difference to account for as well.

*EFRAG RRAWG discussions in 2022*

- 21 EFRAG RRAWG members expressed support for the IASB tentative decisions on the scope of the final Standard made in April and November 2022. In particular:
- (a) members welcomed the IASB's direction of redeliberation on determining whether a regulatory agreement is within the scope, defining a regulator and self-regulation for entities subject to rate-regulation;
  - (b) the clarification of the term 'customers' for RRA was fully aligned with the EFRAG's final comment letter recommendations;
  - (c) the interaction with IFRS 9 requirements - members considered that it was important not to provide scope exclusion for IFRS 9 requirements because the RRA model was only an overlay model which would apply after IFRS Accounting Standards have been applied first;
  - (d) the interaction with IFRIC 12 requirements - members considered that the clarification was important to avoid confusion related to the interaction of the RRA model and IFRIC 12 because IFRIC 12 is only an interpretation and not a full Standard.

## **Total allowed compensation**

### **Components of total allowed compensation**

*Proposals in the ED*

- 22 The ED defines total allowed compensation for goods or services as:
- The full amount of compensation for goods or services supplied that a regulatory agreement entitles an entity to charge customers through the regulated rates, in either the period when the entity supplies those goods or services or a different period.
- 23 Paragraph B2 of the ED states that the total allowed compensation comprises:
- (a) amounts that recover allowable expenses minus chargeable income (see paragraphs B3–B9);
  - (b) target profit (see paragraphs B10–B20); and
  - (c) regulatory interest income and regulatory interest expense (see paragraphs B21–B27) 7
- 24 The application guidance in paragraphs B2–B27 aim to help entities determine whether components of total allowed compensation included in rates charged to customers and recognised in revenue in a period should affect profit or loss in the same period or a different period depending on the period the goods or services are provided.
- 25 The ED describes differences in timing as an item that causes the amount of revenue recognised in a period to differ from the total allowed compensation for the goods or services supplied in that period.
- 26 Paragraph 12 of the ED states that the amount of revenue an entity recognises in a period applying IFRS 15 *Revenue from Contracts with Customers* depends on the regulated rates for goods or services the entity supplies in the period. That amount of revenue differs from the total allowed compensation for the goods or services supplied in that period if:

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- (a) differences in timing arise because the regulatory agreement includes part of that total allowed compensation in determining the regulated rates for goods or services supplied in a different period (past or future); or
- (b) the entity supplies goods or services in one period but, by applying IFRS 15, recognises part or all of the resulting revenue in a future period.

### *Concerns raised by respondents*

- 27 The proposed components of total allowed compensation of the ED, particularly amounts that recover allowable expenses minus chargeable income and target profit, fit well with the features of cost-based schemes as such regimes typically entitle entities to recover their costs and obtain a return on their investments.
- 28 However, **some respondents to the IASB ED (mainly Europe and Asia-Oceania) noted that these proposed components do not appropriately reflect the economics of incentive-based regulatory regimes in their jurisdictions.** These respondents expressed the following concerns:
- (a) The proposed components did not work well with incentive-based schemes because these schemes may give entities an ‘allowed revenue’ amount as well as compensation that entitles an entity to, for example, pass demand risk to customers or to recover some specific costs. These respondents suggested that total allowed compensation should be defined as allowed revenue for the period plus some differences in timing that may arise or reverse in that period (for example, volume variances).
  - (b) The proposals may assume all proposed components of total allowed compensation would be applicable in all regulatory agreements. However, in some regulatory agreements, this may not be the case. For example, some regulatory agreements may not:
    - (i) provide for any form of profit because the regulator determines regulated rates with the aim that the entity achieves breakeven results; or
    - (ii) provide regulatory interest on regulatory assets or charge regulatory interest on regulatory liabilities. In some regimes, in determining the regulated rate, a regulatory agreement may allow an entity to receive a regulatory return on the regulatory capital base that would provide an overall adequate compensation. As a result, these regulatory agreements do not determine a compensation or a charge for the time value of money and uncertainty in the cash flows of any regulatory assets or regulatory liabilities.
  - (c) Some regulatory agreements may include components that are not included in paragraph B2 (with details in paragraphs B3-27) of the ED). For example, some regulatory agreements allow entities to recover volume variances in future periods so that entities can recover their allowed revenue. These volume variances however bear no relation to allowable expenses or target profit, consequently, according to these respondents, it is not clear how the proposals would treat these regulatory agreements.

### *IASB tentative decisions in July 2022*

- 29 In July 2022, the IASB discussed feedback about whether the proposed components of total allowed compensation appropriately reflect the economics of incentive-based schemes.
- 30 To address the concerns noted above, the **IASB tentatively decided** that in the final Standard, the application guidance focus on:
- (a) helping entities to identify differences in timing instead of specifying the components of total allowed compensation; and

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- (b) the most common differences in timing that could arise from various types of regulatory schemes.
- 31 In its discussions, IASB members were reluctant towards introducing ‘allowed revenue’ as an additional component of total allowed compensation as had been proposed by some respondents to the ED. The Board members agreed with the IASB staff proposal to focus on the common features across regulatory regimes. It was noted by the IASB staff that the issue of how to incorporate implicit timing differences (e.g., due to differences between regulatory and accounting depreciation, or benchmark expenses) that are in place for some regulatory agreements would be brought before the IASB at a later date (e.g., in October 2022, the IASB began to discuss benchmark expenses).

### *EFRAG TEG-CFSS discussion in September 2022*

- 32 EFRAG FR TEG and CFSS discussed the IASB tentative decision on the components of total allowed compensation in September 2022.
- 33 Members supported finding a solution for incentive-based regimes but noted that the question was more about the type of guidance and examples the IASB would be developing to help understand what comprised the total allowed compensation.

### *EFRAG RRAWG discussion in November 2022*

- 34 EFRAG RRAWG members noted that the IASB had responded well to the concerns of respondents and agreed with the decisions the IASB was taking on total allowed compensation and aligning the future requirements with the regulatory frameworks.
- 35 EFRAG RRAWG members agreed with a more principle-based approach to describe total allowed compensation which would work for entities that operate in incentive-based regulatory regimes.
- 36 Some members noted that regulation was constantly changing which meant that the components of total allowed compensation which formed the basis of the regulated rates entities could charge to customers were also changing. It was important that entities would be able to link regulatory total allowed compensation or the equivalent thereof (such as allowed revenue as it was referred to in some jurisdictions) with the accounting definition of total allowed compensation. The goal was for the accounting requirements to reflect the economics of regulation in the IFRS financial statements. Currently, some entities were more transparent than others by providing more detailed voluntary disclosure in their financial statements.

## **Regulatory returns on an asset not yet available for use (CWIP)**

### *Proposals in the ED*

- 37 Paragraph B10 of the ED sets out the general principle for target profit and states that: The target profit that a regulatory agreement entitles an entity to add in determining a regulated rate for goods or services supplied in a period forms part of the total allowed compensation for goods or services supplied in the same period. As an exception to this general principle for target profit, paragraph B15 of the ED proposes that:
- (a) regulatory returns on CWIP should form part of the total allowed compensation for goods or services supplied once the assets are available for use and over the remaining periods in which the entity recovers the carrying amount of the assets through the regulated rates; and
  - (b) an entity uses a reasonable and supportable basis in determining how to allocate the returns on CWIP over those remaining periods and applies that basis consistently.

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- 38 Nonetheless, the IASB concluded that the proposal in paragraph B15 of the ED is consistent with the principle underlying the model because no goods or services are being supplied using an asset before it is available for use. The goods and services under the proposed model are the goods and services that the customer receives and pays for, rather than a broader notion of goods and services including the ongoing supply of goods and services by building and maintaining the infrastructure that provides the goods and services. For this reason, regulatory returns earned by an entity during CWIP (and recognised as revenue under IFRS 15 Revenue from Contracts with Customers) are deferred to when the asset is available for use.

### *Concerns raised by respondents*

- 39 **Many respondents (particularly in jurisdictions where entities are entitled to a regulatory return during the construction phase) disagreed with the proposals** because:
- (a) regulatory agreements typically determine regulatory returns on an asset not yet available for use by applying a return rate either to the amount of capital invested in constructing the asset or to the outstanding amount of capital invested in the entire regulatory capital base that includes the asset. Therefore, one could argue that the returns provide compensation for the capital invested in constructing the asset; and
  - (b) entities fulfil a range of different obligations during the construction period that entitles them to these returns. For example, it has been suggested that, in addition to the provision of capital, these returns compensate the entity for construction services or the provision of a maintained network.
- 40 In EFRAG's Final Comment letter, EFRAG shared similar concerns to those in paragraph 39. These concerns were reiterated by EFRAG FR RRAWG members at the April 2022 meeting.

### *IASB tentative decisions in July 2022*

- 41 In July 2022, the IASB discussed feedback on the proposed treatment of regulatory returns on an asset not yet available for use
- 42 The IASB staff recommended that the final Standard specify that 'regulatory returns on an asset not yet available for use' relates to the provision of capital to finance the construction of the asset. However, the IASB did not agree with the staff recommendation as in their view there might be cases, depending on the regulatory agreements, when the regulatory return earned during the construction period is related to something other than the provision of finance.
- 43 After some discussion, the **IASB tentatively decided** that the final Standard:
- (a) Specify that when an entity has an enforceable present right to regulatory returns on an asset not yet available for use, those returns would form part of the total allowed compensation for goods or services supplied during the construction period of that asset.
  - (b) Provide guidance for entities to assess whether their rights to these regulatory returns are enforceable.

### *EFRAG FR TEG-CFSS discussion in September 2022*

- 44 In September 2022, EFRAG FR TEG and CFSS members discussed the IASB tentative decision and generally supported the IASB's efforts to find a solution to address respondent concerns.
- 45 However, some members noted that timing was relevant particularly when companies were not allowed to invoice the regulatory return but were entitled to it. It was important to understand when such entitlement should lead to recognition and some EFRAG FR TEG and CFSS members said they would appreciate to see



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the final guidance. The IASB staff explained that the affected regulatory schemes were mainly present in North America and not in Europe.

*EFRAG RRAWG discussion in November 2022*

- 46 EFRAG RRAWG members supported the IASB's tentative decision on the grounds that the IASB decision was bring the requirements in line with how regulation worked and how regulators compensated entities during the construction period.

**Question for EFRAG FRB members**

- 47 Does the EFRAG FR Board have any questions or comments about the IASB's tentative decisions on the scope and total allowed compensation as outlined in this paper?