Meeting Notes—Consultative Group for Rate Regulation

The Consultative Group for Rate Regulation (CGRR) held a virtual meeting on 4 October 2022. These notes have been prepared by the staff of the International Accounting Standards Board (IASB) to summarise the discussions that took place at it.[1]

About the meeting

1. The purpose of the meeting was to explore:
   a. the interaction between the IASB's tentative decision on regulatory returns on an asset not yet available for use and an entity's capitalisation of its borrowing costs (Topic 1); and
   b. how the IASB might respond to feedback on the proposed treatment of the inflation adjustment to the regulatory capital base, as set out in the IASB's Exposure Draft *Regulatory Assets and Regulatory Liabilities* (Exposure Draft) (Topic 2).

2. Meeting participants:

Name	*Organisation*	*Country/Region*
Giorgio Acunzo	Ernst & Young	Italy
Eric Chan	CLP Power Hong Kong Limited	Hong Kong
Anil Kumar Gautam	NTPC Ltd	India
Jesús Herranz Lumbreras	Ferrovial SA	Spain
John Leotta	Deloitte Touche Tohmatsu	Australia
Richard McCabe	Consultant for Electricity Canada	Canada
Christopher McCusker	National Grid	USA

[1] The papers discussed with the Consultative Group for Rate Regulation can be found here. A recording of the meeting is available on the IFRS Foundation website.

Name	*Organisation*	*Country/Region*
Sureta Moolman	Eskom Holdings SOC Ltd	South Africa
Pascale Mourvillier	PAM Expertise	France
Tim Murray	RBC Capital Markets, Royal Bank of Canada	Canada
Michel Picard	KPMG	Canada
Yeshvir Singh (observer)	Fitch Ratings	United Kingdom
Michael Timar	PricewaterhouseCoopers	United Kingdom
Stefanie Voelz (observer)	Moody's Investors Service Ltd	United Kingdom
	European Financial Reporting Advisory Group (observer)	Europe

Topic 1—Capitalised borrowing costs

3. The meeting notes about Topic 1 follow this structure:

   a. background (paragraphs 5–8);

   b. compensation for borrowing costs (paragraphs 9–14);

   c. the problem (paragraphs 15–18);

   d. courses of action (paragraphs 19–26); and

   e. other comments (paragraph 27).

4. In these meeting notes, the term 'regulatory returns' refers to regulatory returns on an asset not yet available for use.

Background

5. Paragraph B15 of the Exposure Draft proposes that regulatory returns on an asset not yet available for use should form part of total allowed

compensation for goods or services supplied only once the asset is available for use.

6. Most respondents disagreed with this proposal. Many respondents said regulatory returns compensate an entity for the services it provides during the construction period.

7. In July 2022 the IASB tentatively decided that, when an entity has an enforceable present right to regulatory returns on an asset not yet available for use, those returns should form part of total allowed compensation for goods or services supplied during the construction period of an asset.

8. The staff summarised Agenda Paper 2, which discusses:

   a. how regulatory agreements typically compensate an entity for its borrowing costs;

   b. the problem that would arise from applying the IASB's tentative decision on regulatory returns when an entity capitalises its borrowing costs in certain circumstances; and

   c. the possible courses of action that the IASB could take to address the problem.

Compensation for borrowing costs

9. Regulatory agreements typically compensate an entity for its borrowing costs either as a regulatory return calculated on the regulatory capital base or as a pass-through cost.[2] The staff asked members:

[2] Regulatory agreements may use the term 'pass-through costs' to refer to those costs that a regulatory agreement allows an entity to recover based on the actual amount incurred by it. In Agenda Paper 2, discussed with the CGRR at this meeting, 'pass-through costs' also referred to costs that are included in regulated rates charged on the basis of estimated rather than actual costs.

a. how regulatory agreements establish a link between regulatory returns and the borrowing costs incurred by an entity in constructing an asset; and

b. how widespread are regulatory agreements involving a pass-through of borrowing costs, and whether there are accounting implications when the compensation relating to capitalised borrowing costs is included in regulated rates charged during the construction period.

10. Some members described the different features of regulatory returns in their jurisdictions.

11. A few members from North America said that:

a. their regulator generally maintains two regulatory bases, one concerned with assets in operation (rate base) and the other with assets being constructed (construction work in progress base). Regulatory agreements typically provide a regulatory return that includes both an equity return and a debt return. However, the regulatory return that is applied to the rate base may differ from the regulatory return that is applied to the construction work in progress base. There are also a few regulatory schemes that do not provide an equity return. Instead, an entity is only allowed to recover its borrowing costs incurred in constructing assets, determined in accordance with IAS 23 *Borrowing Costs*, once those assets are placed in operation.

b. an entity is required to track differences between its regulatory and accounting books. In the regulatory books an entity would capitalise the regulatory return provided by the regulatory agreement; whereas in the accounting books an entity would capitalise borrowing costs in accordance with IAS 23. The debt return provided by the regulator would typically differ from the borrowing costs capitalised by the entity.

c. regulatory agreements generally provide a regulatory return based on a weighted average cost of capital that is the same for all the entities regulated by the same regulator. That weighted average cost of capital is calculated based on all regulated entities' estimated costs of debt and equity. Those estimated costs may differ from an entity's actual capital costs. Any difference between the regulatory debt return and an entity's capitalised borrowing costs is not tracked at an individual asset level. However, regulatory returns on the construction work in progress *are* tracked at an individual asset level because these regulatory returns need to be included in the regulated rates charged over the life of these assets.

12. The member from Africa said that regulatory agreements typically provide a regulatory return on the regulatory capital base. She said that not all assets that are being constructed qualify for regulatory returns during the construction period. But, when an asset does so, the regulatory returns are applied to estimated amounts of construction work in progress, which are subsequently reconciled to actual costs.

13. A member from Asia-Oceania said that the regulatory capital base includes capitalised borrowing costs on construction work in progress, determined in accordance with IAS 23. The regulatory return rate on the regulatory

capital base is determined based on a negotiation with the regulator. This regulatory return rate does not depend on an entity's financing capital structure or cost of capital. The regulatory return rate also remains the same throughout the term of the regulatory agreement. The calculation of regulatory returns follows two steps. An entity first applies the regulatory return rate to the regulatory capital base, which includes the construction work in progress. From that amount the entity would then deduct the capitalised borrowing costs. Consequently, the amount of regulatory returns would include a small portion of capitalised borrowing costs.

14. A few members from Europe said that:

    a. typically, the regulatory capital base excludes borrowing costs capitalised as part of the costs of the assets. However, in some cases, a regulatory agreement allows capitalised borrowing costs to be included as part of the regulatory capital base. When an agreement does so, the amount of capitalised borrowing costs included in the regulatory capital base typically differs from the amount of borrowing costs capitalised by the entity.

    b. some regulatory schemes provide regulatory returns on the regulatory capital base computed as a weighted average cost of capital. In some jurisdictions, the regulatory capital base will include construction work in progress, which may have been included on an estimated basis. In addition, regulatory returns are generally computed using assumptions about interest rates that may subsequently be adjusted if the actual interest rates differ from such estimates. In some other cases, portions of the regulatory returns (either the equity return or the debt return) are determined by reference to an index. Changes in that index may also give rise to future adjustments to the regulated rates.

The problem

15. When an entity capitalises the borrowing costs it incurred in the construction of an asset, applying the IASB's tentative decision on regulatory returns could be viewed as creating an accounting mismatch and, in certain circumstances, as the front-loading of profit during the construction period. The staff thinks that this problem could arise when there is a direct relationship between an entity's regulatory capital base and its property, plant and equipment. The staff asked members whether this problem is one that the IASB should address.
16. A member from North America agreed that a problem arises when there is a direct relationship between an entity's regulatory capital base and its property, plant and equipment. Another member from North America said that, if an entity has an enforceable present right to regulatory returns during the construction period, it should reflect the entire amount of regulatory returns as a regulatory asset during that period.
17. A member from Asia-Oceania said the problem would not be common in his jurisdiction because entities there typically do not have an enforceable present right to regulatory returns on construction work in progress.
18. Another member (a user of financial statements) said that, because regulatory returns will not necessarily be the same as the amount an entity has capitalised, trying to link these two amounts would be very difficult. According to this member, trying to disentangle the debt and equity components from a regulatory return calculated on the basis of a weighted

average cost of capital would be complex. This member said that users sometimes adjust capitalised borrowing costs to treat those costs as an expense when they are incurred. Consequently, according to this member, any adjustments made to regulatory returns to address an accounting mismatch with the underlying borrowing costs could affect how users should analyse those borrowing costs. Therefore, this member suggested, additional disclosures would be necessary to help users to understand those adjustments.

Courses of action

19. The possible approaches the IASB could consider are:
    a. Approach 1—no further action;
    b. Approach 2—deferring the entire debt return;
    c. Approach 3—deferring part of regulatory returns equal to the capitalised borrowing costs; or
    d. Approach 4—prohibiting the capitalisation of borrowing costs.
20. The staff asked members whether:
    a. the staff has correctly analysed the arguments supporting or against each approach;
    b. any other implementation issues might arise from each approach;
    c. any additional disclosures would usefully supplement the information provided by applying each approach;
    d. the staff should consider any other potential approaches; and
    e. there are other problems that the IASB should consider.

21. A few members said that regulatory agreements provide compensation for borrowing costs in different ways; hence, the final IFRS Accounting Standard (Standard) should specify principle-based requirements to enable an entity to provide useful information about the compensation. One of those members said that applying principle-based requirements should result in an accounting outcome that reflects an entity's financial performance and avoids an accounting mismatch in profit or loss.
22. A few members from Europe said that they would agree with Approach 1 when there is no direct relationship between an entity's regulatory capital base and its property, plant and equipment.
23. Other members said that Approach 2 was easier and that it would result in more useful information. However, one of these members said that Approach 2 would require an entity to disentangle the debt component from a regulatory return computed using a weighted average cost of capital, which may be difficult. This member also said that it may not always be clear that the debt return is related to the entity's borrowing cost.
24. A member from North America preferred Approach 3; it better reflects the economics of the regulatory agreements, he thought. This member also said that North American entities currently apply an accounting treatment for regulatory returns that is similar to Approach 3.
25. A member from Europe said that Approach 3 would reduce volatility in profit or loss. However, according to this member, that approach could create an artificial relationship between the debt return and the capitalised borrowing costs determined in accordance IAS 23. The member also said

that Approach 3 could be more difficult to implement than the other approaches.

26. A few members disagreed with Approach 4. They said that it would be inconsistent with the IASB's conclusion in IAS 23 that the capitalisation of borrowing costs would provide useful information about the cost of a qualifying asset.[3] However, one member said that IAS 23 is 'an old IFRS Accounting Standard', and, hence, the IASB could consider amending it for situations—which were not necessarily foreseen when that Standard was developed—in which regulatory agreements provide regulatory returns as compensation for borrowing costs incurred when constructing assets.

Other comments

27. Members did not identify any other situations in which applying the IASB's tentative decision on regulatory returns would not provide useful information. Nor did they identify any other problems that the IASB should consider.

Topic 2—Inflation

28. The meeting notes for Topic 2 follow this structure:
    a. background (paragraphs 29–33);
    b. existence of a regulatory asset (paragraphs 34–37);
    c. operational challenges (paragraphs 38–39); and
    d. usefulness of the information (paragraphs 40–41).

[3] Paragraph BC9 of the Basis for Conclusions on IAS 23.

Background

29. The staff summarised Agenda Paper 3.
30. The staff explained that the Exposure Draft states that regulators typically use two regulatory approaches that are broadly equivalent in order to compensate entities for inflation:
    a. Approach 1 (the nominal approach)—some regulatory agreements apply a nominal return that includes inflation to the regulatory capital base; and
    b. Approach 2 (the real approach)—other regulatory agreements adjust the regulatory capital base for inflation and apply to it a real return rate excluding inflation.
31. The Exposure Draft treats inflation adjustments to the regulatory capital base as a form of target profit. Target profit that a regulatory agreement entitles an entity to add in 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. (See Illustrative Example 7C.2 accompanying the Exposure Draft.)
32. A few respondents argued that the inflation adjustment to the regulatory capital base would give rise to a regulatory asset. These respondents said that the Standard should clarify that the inflation adjustment to the regulatory capital base that an entity is entitled to recover through increased rates in the future should be deemed to be a regulatory asset.
33. The staff asked members whether:

a. they agreed with feedback from some respondents that an inflation-adjusted regulatory capital base would give rise to a regulatory asset (paragraphs 34–37);

b. they would anticipate any operational challenges if the Standard required an entity to account for such an inflation-related regulatory asset (paragraphs 38–39); and

c. such an inflation-related regulatory asset would provide useful information to users of financial statements (paragraphs 40–41).

Existence of a regulatory asset

34. A member from North America said that regulatory schemes in his jurisdiction followed the nominal approach. Consequently, the treatment of the inflation adjustment to the regulatory capital base was not an issue there. This member had consulted with colleagues from other jurisdictions within his organisation. He said views were mixed. Some held that an entity subject to the nominal and real regulatory approaches would have rights to different revenue streams; consequently, such an entity should only account for them by applying IFRS 15 *Revenue from Contracts with Customers*. Others thought that, if both regulatory approaches resulted in the same economic outcome, the accounting for a regulatory asset for an entity subject to the real approach would allow it to reflect a similar financial performance to that of entities subject to the nominal approach. This member also said that other parties he had consulted said that if the IASB decides not to require an entity to account for regulatory assets or regulatory liabilities arising from differences between the regulatory recovery period and the assets' useful lives when there is no direct

relationship between an entity's regulatory capital base and its property, plant and equipment, then the same conclusion should be extended to the accounting for an inflation-related regulatory asset.

35. A few members from Europe said that the inflation adjustment to the regulatory capital base does not give rise to a regulatory asset. According to them:

    a. the inflation adjustment to the regulatory capital base will give rise to a higher amount of regulatory depreciation and, therefore, to a higher amount of revenue in future periods. However, an entity does not have a right to the higher revenues until the regulator determines the allowed revenue for a specified period.

    b. accounting for future revenues as a regulatory asset could have unexpected consequences. One of these members from Europe also thought that accounting for the inflation-related adjustment as a regulatory asset could implicitly change the measurement basis of property, plant and equipment from cost to current value. This member said that it may be preferable for an entity subject to the real approach to provide disclosures in the notes.

36. A member from Asia-Oceania said that the issue did not arise in his jurisdiction. But, if it did, accounting for an inflation-related regulatory asset would be appropriate, he thought.

37. The member from Africa and a member from Europe said that an inflation-adjusted regulatory capital base would give rise to a regulatory asset. They said that an entity would have already earned the inflation-related compensation for goods or services already provided. The decision of the

regulator to include that adjustment in future regulated rates aims to smooth future revenues in order to protect customers. That decision did not affect the entity's right to the inflation-related compensation.

Operational challenges

38. A member from Africa said that her entity tracks the inflation adjustment and that accounting for the related regulatory asset would be feasible. She acknowledged that the auditability of this asset could be challenging.
39. A few members from Europe were of the view that accounting for the inflation-related regulatory asset would be challenging. One of these members (a user of financial statements) said that the regulatory capital base is affected by regulatory decisions that may take place in the future. These decisions may affect the accounting for the inflation-related regulatory asset. However, assessing the effects would be difficult.

Usefulness of information

40. The member from Africa thought that accounting for an inflation-related regulatory asset would result in useful information to users of financial statements. However, a member from Europe said that it is the total value of the regulatory capital base that provides users of financial statements with useful information, rather than the inflation-related adjustment to the regulatory capital base.
41. Another member (a user of financial statements) said that if the IASB decides to require entities to account for an inflation-related regulatory asset it would also be important to require disclosures about the asset. This member said that it is useful to understand the effect of inflation in future rates but she was not sure whether she would want an entity to recognise an

inflation-related regulatory asset. This member also said that some entities that are subject to the real approach have inflation-linked debt that pays a real amount and accumulates the effects of inflation in the principal of the debt. According to this member, these entities issue inflation-linked debt because they get a real return on the regulatory capital base that grows with the inflation adjustment. This member also said that accounting for an inflation-related regulatory asset would improve an entity's interest and debt cover ratios.

Other comments

42. A CGRR member asked when the IASB expected to finish the project. A member of the IASB said that the project has made good progress during 2022. And he expected that the IASB would have made most of its decisions about the project by the end of 2023, with the drafting process starting soon afterwards. Consequently, he expected the final Standard to be issued during 2024.
43. The same CGRR member also asked whether the objective was to publish a new IFRS Accounting Standard. The IASB staff confirmed that a new IFRS Accounting Standard on the accounting for regulatory assets and regulatory liabilities was indeed envisaged.
44. Another CGRR member asked whether the IASB anticipated re-exposure of the Exposure Draft. A member of the IASB said that he was not presently aware of any reason to do so. The IASB staff also reminded the members of the CGRR that the IASB will only decide on re-exposure once it has redeliberated all the topics and assessed the extent to which its

proposals have changed. But that changes to the proposals in response to feedback would not necessarily trigger a re-exposure.

Next steps

45. The staff will consider the feedback from the members of the CGRR on the topics discussed at this meeting when developing papers for future IASB meetings.
46. The staff also plans to consult the CGRR in 2023 on other aspects of the proposals in the Exposure Draft.