STAFF PAPER

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IASB® meeting

Project	Rate-regulated Activities
Paper topic	Components of total allowed compensation

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Objective

1. This paper:

   (a) analyses the feedback from comment letters and outreach events on how the Exposure Draft *Regulatory Assets and Regulatory Liabilities* (Exposure Draft) would apply to incentive-based regulatory schemes. In particular, this paper analyses whether the proposed components of total allowed compensation appropriately reflect the economics of incentive-based schemes; and

   (b) recommends changes to the proposed application guidance to address some of the concerns raised in the feedback.

Staff recommendations

2. We recommend the application guidance of the final Standard does not specify the components of total allowed compensation but rather focuses on helping entities identify differences in timing. The application guidance will focus on the most common differences in timing that may arise from different types of regulatory schemes.

Structure of the paper

3. This paper is structured as follows:

   (a) proposals in the Exposure Draft (paragraphs 5–8);

   (b) feedback received (paragraph 9); and

   (c) staff analysis (paragraphs 10–27).

4. The appendix to this paper includes a description of different types of differences in timing.

Proposals in the Exposure Draft

5. The Exposure Draft 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.

6. Paragraph B2 of the Exposure Draft says that:

   > B2 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. Paragraphs B2–B27 aim to help entities determine whether components of total allowed compensation included in determining the regulated rates charged to customers in a period relate to goods or services supplied in the same period or to goods or services supplied in a different period. In other words, the application guidance aims to help an entity 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.

8. The Exposure Draft 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:

> 12 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:
>
> (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) (paragraphs 13–17); or
>
> […]

Feedback received

9. Some respondents—mainly accounting firms and preparers in Europe and Asia-Oceania—said that:

   (a) the proposed components of total allowed compensation, particularly components in paragraphs B2(a)–(b) of the Exposure Draft, fit well with the features of cost-based schemes. This is because cost-based schemes mainly aim to entitle entities to recover their costs and obtain a return on their investments.[1] However, the proposed components do not work well with incentive-based schemes because these schemes may give entities an 'allowed revenue'[2] amount as well as compensation that entitles an entity to, for example, pass demand risk to customers or to recover some specific costs. In this circumstance, these respondents suggest total allowed compensation

[1] Agenda Paper 9A discussed at the May 2022 IASB meeting discusses features of different regulatory schemes.
[2] Other commonly used terms are 'revenue requirement' or 'authorised revenue'.

consists of the allowed revenue for the period plus some differences in timing that may arise or reverse in that period (for example, volume variances).[3]

(b) the proposals appear to assume all components of total allowed compensation proposed in paragraph B2 of the Exposure Draft would be present in all regulatory agreements. However, 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. For example, 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 of the Exposure Draft. For example, some regulatory agreements allow entities to recover volume variances in future periods so that entities are able to 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.

Staff analysis

10. Paragraph B2, the Exposure Draft states that 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

[3] Paragraph 16(a) provides a description for volume variances.

(c) regulatory interest income and regulatory interest expense (see paragraphs B21–B27).

11. The componentisation of total allowed compensation described in paragraph B2 works well for cost-based schemes (paragraph 9(a)). This is because these schemes seek primarily to provide an entity with compensation for costs incurred and a return on its investment. These components (that is, costs and returns) are included in the allowed revenue to which these entities are entitled for a period. The allowed revenue for a period together with an estimate of goods or services to be supplied in that period will be used to derive the per unit rate the entity will charge customers during that period. Future adjustments to the regulated rates are mostly caused by differences between the estimated amounts used to set the regulated rates and actual amounts. These adjustments ensure the entity recovers its costs.

12. The components of total allowed compensation described in paragraph B2 and the application guidance on how entities would determine total allowed compensation for goods or services supplied in a period assume there is a mapping between different types of compensation in the regulator's calculation of allowed revenue and different types of expenses incurred by an entity. This assumed mapping is also reflected in many of the illustrative examples accompanying the Exposure Draft. For example, Illustrative Examples 2A–2C, 3 and others assume that regulatory depreciation of the regulatory capital base can be mapped to depreciation expense. This mapping between regulatory compensation and underlying expenses exists in cost-based schemes but it is not always present in incentive-based schemes.

13. Some respondents have told us that the final Standard needs to be sufficiently principles-based to ensure different regulatory schemes that create differences in timing can apply the requirements in the Standard. This feedback is consistent with feedback received throughout the project—that is, we should avoid developing requirements that would be applicable for only certain types of schemes and identify instead principles that can be applied to a broad range of regulatory schemes.

14. In some incentive-based schemes, 'allowed revenue' is set to provide entities with incentives for cost reduction rather than ensuring recoverability of their costs.[4] In

[4] The IASB discussed features of different regulatory schemes at its meeting in May 2022 (Agenda Paper 9A).

some of these schemes, entities are entitled to the 'allowed revenue' amount for a period with only a small number of adjustments to this allowed revenue to lower the entity's risk or to compensate the entity for actual costs incurred in specified circumstances. For example, the regulator may allow an entity to adjust allowed revenue for a period to recover unfavourable volume variances that arose in a previous period but may not permit the entity to adjust allowed revenue to recover costs incurred in a previous period when these were higher than the costs that were used to determine the allowed revenue for that previous period.

15. In such situations, trying to identify a mapping between different types of compensation included in the calculation of the allowed revenue and an entity's underlying expenses may not result in useful information. This is because the regulatory scheme is not seeking to ensure the entity recovers its actual costs. The entity is at risk for the actual costs incurred in much the same way as a non-regulated entity.

16. In many incentive-based schemes, the initial calculation of the allowed revenue for a period would be adjusted to include (the list is non exhaustive):

    (a) volume variances—in some regulatory schemes, entities are able to transfer demand risk to customers. 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. In this case, a regulatory agreement would determine that an entity has an enforceable right, or enforceable obligation, to add an amount to, or deduct an amount from, rates to be charged to customers in the future due to volume variances;

    (b) true ups from previous periods—these would include differences between items included on a forecasted basis in the allowed revenue amount of previous periods that are adjusted to actuals in the rates charged during the current period; and

    (c) performance incentives relating to performance that may have occurred in previous periods but that are included in rates charged during the current period.

17. In the circumstances when allowed revenue is adjusted for items similar to those in paragraph 16, respondents suggested total allowed compensation for the goods or services supplied in a period consists of the allowed revenue for the period plus some differences in timing that may arise or reverse in that period—paragraph 9(a).

18. In response to the suggestion in paragraph 17, we considered whether the final Standard should state that total allowed compensation for the goods or services supplied in a period comprises allowed revenue and differences in timing originating or reversing in the period. However, we rejected this approach because it would mean introducing a new concept ('allowed revenue'). Allowed revenue would need to be defined and distinguished from IFRS 15 revenue and the total allowed compensation for goods or services supplied in a period.

19. For a regulatory asset or regulatory liability to exist, the regulatory agreement must be capable of creating differences in timing. Consequently, differences in timing are a feature that is common to the variety of regulatory schemes that will be in the scope of the final Standard. We think that rather than specifying the components of total allowed compensation as it is done in paragraph B2 of the Exposure Draft, the application guidance of the final Standard should identify common types of differences in timing that may arise from a variety of regulatory schemes that would give rise to regulatory assets and regulatory liabilities. Focusing on differences in timing rather than on the components of total allowed compensation would:

    (a) prevent the Standard being read as targeting a specific type of regulatory scheme (paragraph 9(a));

    (b) prevent the Standard being read as implying all regulatory agreements have all components of total allowed compensation in paragraph B2 (paragraph 9(b)); and

    (c) ensure that components of total allowed compensation that are present in some regulatory schemes (for example, volume variances—paragraph 9(c)) are not excluded.

    The following paragraphs describe how an approach that focuses on differences in timing might work.

Focusing on differences in timing

20. Differences in timing arise when part or all of the total allowed compensation for goods or services supplied in one period is charged to customers—and hence is recognised in revenue—in a different period (past or future)—paragraph 6(c) of the Exposure Draft.

21. The application guidance of the final Standard could focus on helping entities identify differences in timing that may arise from different types of regulatory schemes. When doing so the final Standard would:

    (a) not include application guidance for *all* possible differences in timing but only those that are most common and from which entities could derive principles that could be used in similar circumstances; and

    (b) clarify that different regulatory schemes may give rise to different differences in timing, and therefore to different regulatory assets and regulatory liabilities. Consequently, the identification of differences in timing will be dependent on the terms of the regulatory agreements.

22. We think differences in timing would mainly arise from:

    (a) volume variances;

    (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 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 costs).

(c) regulatory returns on both assets not yet available for use (see Agenda Paper 9B discussed at this IASB meeting) and assets in use;[5] and

(d) performance incentives.

23. The Exposure Draft included both explicit differences in timing and implicit differences in timing. Explicit differences in timing are those that result in actual adjustments to the future rates; implicit differences in timing are those that arise when the regulatory agreement uses a basis for including an item of expense or income in the regulated rates charged that differs from the basis used in accounting.[6] The appendix to this paper illustrates these different types of differences in timing. Some stakeholders said the final Standard should only focus on differences in timing that represent actual adjustments to the regulated rates in the future. The appendix also includes the main arguments of these stakeholders. We are planning to discuss this matter with the IASB at a future meeting.

24. We note that each of the proposed components of total allowed compensation in the Exposure Draft had 'a trigger' so that entities could determine when those components would form part of or reduce the total allowed compensation for goods or services supplied in a period. For example:

Proposed component	**Trigger and period when the component affects profit or loss**
Amount that recovers allowable expenses minus chargeable income	*Trigger:* recognition of the expense or income (paragraphs B4 and B9 of the Exposure Draft) *Period:* in the period when an entity recognises the expense or income by applying IFRS Accounting Standards
All regulatory returns except those on assets not yet available for use	*Trigger:* regulatory agreement entitlement (paragraph B10 of the Exposure Draft) *Period:* in the period when the regulatory agreement entitles an entity to add regulatory returns in determining a regulated rate for goods or services supplied in that period

[5] This would include discussing whether inflation-adjusted regulatory capital base gives rise to a regulatory asset.

[6] Some stakeholders refer to these differences in timing as cash and non-cash differences in timing.

Proposed component	Trigger and period when the component affects profit or loss
Returns on assets not yet available for use	*Trigger:* only when the asset is available for use is when goods or services are supplied (paragraph B15 of the Exposure Draft) *Period:* only once the asset is available for use and then over the remaining periods in which the carrying amount of the asset is recovered through the regulated rates
Performance incentives	*Trigger:* performance *Period:* in the period in which an entity's performance gives rise to the incentive bonus or penalty (paragraph B17 of the Exposure Draft)
…	…

25. When recommending how entities would identify differences in timing for each of the categories in paragraph 22, we would refer to:

    (a) the triggers that the Exposure Draft proposed for each of the components of total allowed compensation in paragraph B2 (see table in paragraph 24); and

    (b) the feedback received from respondents on these triggers.

26. For example, consider performance incentives. In many cases, the regulator's basis for determining the regulated rates gives rise to differences in timing that are related to performance incentives. Paragraph B17 of the Exposure Draft said that 'amounts relating to a performance incentive form part of or reduce the total allowed compensation for goods or services supplied in the period in which the entity's performance gives rise to the incentive'. Stakeholders have expressed strong support for this trigger (that is, **'the period when performance occurs'**). Considering that as a starting point, differences in timing would arise when the regulated rates charged in a period, and recognised in revenue in the same period:

    (a) include amounts relating to a bonus or penalty, that are linked to an entity's performance in a previous period; and/or

    (b) exclude amounts relating to a bonus or penalty, that are linked to an entity's performance for the current period.

27. In future IASB meetings the staff will provide analysis of the different types of differences in timing that should be described in the application guidance. That analysis will use the triggers identified in the application guidance on the Exposure Draft as a basis for determining when amounts would form part of or reduce the total allowed compensation for the goods or services supplied in the period, enabling an entity to identify differences in timing.

Question for the IASB
Does the IASB agree that the application guidance of the final Standard does not specify the components of total allowed compensation but rather focuses on helping entities identify differences in timing by focusing on the most common differences in timing that may arise from different types of regulatory schemes?

APPENDIX—Explicit and implicit differences in timing

A1. Many of the regulatory assets and regulatory liabilities in the Exposure Draft represent explicit rights given by a regulatory agreement to adjust future rates. For example, regulatory assets or regulatory liabilities relating to differences between estimated costs and actual costs that will be adjusted for in future rates. Those regulatory assets or regulatory liabilities represent explicit rights to add an amount to (explicit obligations to deduct an amount from) future rates. These would be the case of Illustrative Examples 1 and 2A accompanying the Exposure Draft.[7]

A2. Other differences in timing may arise from implicit rights and obligations to adjust the rates in the future. For example, when a regulatory agreement allows an entity to include an item of expense in the rates charged using a basis that is different from the basis on which the expense is recognised in the financial statements. These would be the case of Illustrative Examples 2B and 2C accompanying the Exposure Draft.

A3. For example, assume a regulatory agreement allows the recovery of an item of expense at a different pace to the recognition of that expense in the financial statements:

Item of expense (in CU)	Year 1	Year 2	Year 3	TOTAL
Regulatory compensation included in rates charged (recovery of an allowable expense)	25	35	40	100
Accounting expense	33	33	34	100
Difference	(8)	2	6	-
Regulatory asset	**8**	**6**	**-**	**-**

A4. In this case, the regulatory agreement 'explicitly' gives the entity a right to recover the item of expense. However, when establishing the regulatory compensation to which the entity is entitled in Years 2 and 3, the regulatory agreement would not consider the

[7] The Illustrative Examples accompanying the Exposure Draft can be accessed here.

accounting method for recognising this item of expense. Consequently, the regulatory asset amounting to CU8 in Year 1 represents a difference in timing between the difference in the pace of recovery in rates and the pace of recognition per accounting. The regulatory asset of CU8 in Year 1 does not represent an 'explicit' right to increase rates charged in Year 2 and Year 3 by CU2 and CU6, respectively—the regulated rates charged increased by CU10 in Year 2 and by CU5 in Year 3. However, this right is 'implicit' as the regulatory agreement entitles the entity to recover the item of expense (ie CU100). The regulatory asset of CU8 in Year 1 would be an example of an implicit difference in timing.

A5. Some respondents—mainly preparers in Europe and Asia-Oceania and a few national standard-setters in Asia-Oceania and in Europe—said the final Standard should only focus on explicit differences in timing. They argue that:

(a) regulatory assets and regulatory liabilities arising from implicit differences in timing do not meet the proposed definitions of regulatory assets and regulatory liabilities because, according to these stakeholders, they do not represent an entity's *right to add* an amount to, or an entity's *obligation to deduct* an amount from, the regulated rates in the future. In other words, the cash flows from those regulatory assets and regulatory liabilities do not correspond to adjustments that the regulatory agreement will consider when determining the future rates. Consequently, these respondents do not think these regulatory assets and regulatory liabilities represent enforceable rights or enforceable obligations from the regulatory agreements for the entity.

(b) recognising regulatory assets and regulatory liabilities arising from implicit differences in timing would:

(i) result in confusing or misleading information for users of financial statements. Their recognition may cause users of financial statements to 'look through' these regulatory assets and regulatory liabilities in order to reconcile the reported revenue to the regulatory agreements and cash positions;

(ii) result in an increase in non-IFRS disclosures to remove the effect of the recognition of these regulatory assets and regulatory liabilities; and

(iii) affect financial covenants or credit metrics, which may necessitate amendments to financing documents and create legal and compliance costs.

A6. Some of these comments relate to specific regulatory assets or regulatory liabilities proposed in the Exposure Draft—for example, the proposals for accounting for regulatory assets or regulatory liabilities that would arise when there are differences between the regulatory recovery pace and the assets' useful lives. We are planning to discuss implicit differences in timing proposed by the Exposure Draft as the matters they relate to (for example, allowable expenses) are redeliberated at future meetings.