IFRS

STAFF PAPER

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IASB® meeting

Project	**Rate-regulated Activities**
Paper topic	Total allowed compensation—Regulatory returns on an asset not yet available for use (Addendum)

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Objective

1. This paper supplements the staff analysis and recommendations in paragraphs 29–55 of Agenda Paper 9B that the IASB discussed at its meeting on 18 July 2022. That paper dealt with the proposed treatment of regulatory returns on an asset not yet available for use.

Summary of staff recommendations

2. We recommend the final Standard specifies that:
   (a) when a regulatory agreement entitles an entity to include regulatory returns on an asset not yet available for use in the regulated rates, these returns typically relate to the provision of capital to finance the construction of the asset.
   (b) when an entity has an enforceable present right to regulatory returns on an asset not yet available for use, those returns form part of the total allowed compensation for goods or services supplied during the period in which the entity provides the capital to construct the asset (the construction period).
   (c) in assessing whether an entity has an enforceable present right to regulatory returns on an asset not yet available for use, the final Standard distinguishes between cases when:

(i) the returns are included in regulated rates charged during the construction period—in this case, the fact that a regulatory agreement entitles an entity to include regulatory returns on an asset not yet available for use during the construction period and the entity charges those returns during that same period provides evidence the entity has an enforceable present right to these returns. In this case, however, the final Standard would provide guidance on when the terms of the regulatory agreement may affect the amounts of regulatory returns that the entity should reflect in profit or loss during the construction period.

(ii) the returns are included in rates charged during the operation period—in this case, an entity would need to assess whether it has an enforceable right to payment for the regulatory returns relating to the capital invested in constructing the asset to date—that is, for the regulatory returns accumulated to date. In making this assessment, the entity would need to consider the terms of the regulatory agreement and the legal environment in which the regulatory agreement is enforceable. If the entity concludes it has an enforceable present right to regulatory returns on an asset not yet available for use during the construction period, it would account for a regulatory asset and measure that regulatory asset applying the measurement requirements in the final Standard.

Structure of the paper

3. This paper is structured as follows:

   (a) what goods or services are supplied in exchange for regulatory returns on an asset not yet available for use (paragraphs 4–7); and

   (b) when regulatory returns on an asset not yet available for use are reflected in profit or loss (paragraphs 8–15).

What goods or services are supplied in exchange for regulatory returns on an asset not yet available for use

4. The feedback indicates that 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.

5. Therefore, when a regulatory agreement entitles an entity to include regulatory returns on an asset not yet available for use in the regulated rates, that fact provides evidence that the returns provide compensation for the capital invested in constructing the asset. In other words, we think that compensation in the form of regulatory returns on an asset not yet available for use typically relates to the provision of capital to finance the construction of the asset during the construction period. Paragraphs 30–36 of Agenda Paper 9B provide further analysis supporting this conclusion.

6. Regulatory returns on an asset not yet available for use typically aim to compensate for the provision of capital to finance the construction, even if:

    (a) the returns differ from the actual cost of capital incurred by the entity in constructing the asset. For example, the return rate may be determined with reference to benchmark rates to incentivise the entity to obtain efficient financing.

    (b) the entity is required to fulfil other obligations during the construction period, which may affect the amount of returns to which the entity will be finally entitled (paragraph 12).

7. Some have suggested that entities fulfil a range of different obligations during the construction period that entitle 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. We agree that in some agreements these features might be present. However, we think that requiring entities to analyse their regulatory agreements to determine whether the compensation they receive includes these features, in addition to compensation for the provision of capital, would be complex and may result in less comparable information. As a result, we think the costs of such an approach would be likely to

outweigh the benefits. Consequently, we recommend the final Standard specifies that regulatory returns on an asset not yet available for use relate to **the provision of capital** to finance the construction of the asset.

When regulatory returns on an asset not yet available for use are reflected in profit or loss

8. Considering the previous section, we think that if an entity has an **enforceable present right** to regulatory returns on an asset not yet available for use, those returns form part of the total allowed compensation for goods or services supplied during the period in which the entity invests the capital to construct the asset (the construction period).

9. Regulatory returns on an asset not yet available for use are typically included in regulated rates using either of these approaches:

   (a) as the asset is being constructed (paragraphs 10–12); or

   (b) over the period in which the asset is in operation (paragraphs 13–15).

Returns included in rates charged during construction

10. The fact that a regulatory agreement entitles an entity to include regulatory returns on an asset not yet available for use during the construction period and the entity charges those returns during that same period provides evidence that the entity has an enforceable present right to these returns. Having said that, the amount of returns to which an entity may be entitled during the construction period may be affected by the terms of the regulatory agreement.

11. We have learned that in many cases entities have no legal or economic obligation to reduce future regulated rates either in the form of cash outflows or lower cash inflows, even if the construction of the assets is not completed or the assets are abandoned (paragraph 45 of AP9B).

12. However, in some other cases, despite an entity being entitled to include regulatory returns as the asset is being constructed, regulators may disallow or restrict the amount of regulatory returns to which an entity is ultimately entitled during the construction period by requiring the entity to deduct amounts already charged from

future regulated rates. Paragraph 47 of Agenda Paper 9B provides different reasons why a regulator may do so. Consequently, in these cases, an entity may need to consider whether it needs to account for a regulatory liability during the construction period to reflect the regulator's restrictions or conditions on (part of) the regulatory returns. We recommend the final Standard provides guidance on how the terms of the regulatory agreement may affect the amount an entity reflects in profit or loss relating to regulatory returns on an asset not yet available for use during the construction period, when the entity is entitled to include these returns in rates charged during that period.

Returns included in rates charged during operation

13. When an entity is entitled to include regulatory returns on an asset not yet available for use in regulated rates charged only during the operation period, the entity would need to assess whether it has an enforceable present right to these regulatory returns during the construction period.

14. To do so an entity would need to consider whether it has an enforceable right to payment for the regulatory returns relating to the capital invested in constructing the asset similar to the principle in paragraph 35(c) of IFRS 15 *Revenue from Contracts with Customers*. This would include requiring an entity to consider:

    (a) that at all times throughout the duration of the construction, the entity is entitled to an amount that compensates the entity for the regulatory returns accumulated to date if the contract is terminated for reasons other than the entity's failure to perform as promised.

    (b) the terms of the regulatory agreement, including a regulator's approval for an entity to accumulate the regulatory returns during the construction of the asset, and the legal environment in which the regulatory agreement is enforceable.

15. If an entity concludes it has an enforceable present right to regulatory returns on an asset not yet available for use during the construction period, it would account for a regulatory asset in that period. In this case, the entity should consider whether the terms of the regulatory agreement would affect the measurement of that regulatory asset. For example, a regulator's assessment of an entity's efficiency and prudence

when incurring the costs of constructing the asset may affect the final amount of regulatory returns that an entity will be entitled to include in rates charged during the operation period.

Questions for the IASB
Does the IASB agree that the final Standard specifies that: a. when a regulatory agreement entitles an entity to include regulatory returns on an asset not yet available for use in the regulated rates, these returns typically relate to the provision of capital to finance the construction of the asset (paragraphs 4–7). b. when an entity has an enforceable present right to regulatory returns on an asset not yet available for use, those returns form part of the total allowed compensation for goods or services supplied during the period in which the entity provides the capital to construct the asset (the construction period) (paragraph 8). c. in assessing whether an entity has an enforceable present right to regulatory returns on an asset not yet available for use, the final Standard distinguishes between cases when: i. the returns are included in regulated rates charged during the construction period—in this case, the fact that a regulatory agreement entitles an entity to include regulatory returns on an asset not yet available for use during the construction period and the entity charges those returns during that same period provides evidence the entity has an enforceable present right to these returns. In this case, however, the final Standard would provide guidance on when the terms of the regulatory agreement may affect the amounts of regulatory returns that the entity should reflect in profit or loss during the construction period (paragraphs 10–12). ii. the returns are included in rates charged during the operation period—in this case, an entity would need to assess whether it has an enforceable right to payment for the regulatory returns relating to the capital invested

in constructing the asset to date—that is, for the regulatory returns accumulated to date. In making this assessment, the entity would need to consider the terms of the regulatory agreement and the legal environment in which the regulatory agreement is enforceable. If the entity concludes it has an enforceable present right to the regulatory returns on an asset not yet available for use during the construction period, it would account for a regulatory asset and measure that regulatory asset applying the measurement requirements in the final Standard (paragraphs 13–15).