

IASB[®] meeting

Date	October 2022
Project	Rate-regulated Activities
Topic	Consultative Group for Rate Regulation meeting
Contacts	Mariela Isern (misern@ifrs.org)

This paper has been prepared for discussion at a public meeting of the International Accounting Standards Board (IASB). This paper does not represent the views of the IASB or any individual IASB member. Any comments in the paper do not purport to set out what would be an acceptable or unacceptable application of IFRS[®] Accounting Standards. The IASB's technical decisions are made in public and are reported in the IASB *Update*.

Objective

1. This paper includes the summary notes (pages 2–9) and the material prepared (pages 10–31) for the Consultative Group for Rate Regulation (CGRR) meeting held on 28 March 2022. At that meeting the CGRR discussed how the IASB could respond to feedback on its proposals on the accounting for regulatory assets and regulatory liabilities arising from differences between the recovery pace of the regulatory capital base and the assets' useful lives.
2. These notes and the material are for information only. We are not asking the IASB to make decisions on this paper.

Meeting Notes—Consultative Group for Rate Regulation

The Consultative Group for Rate Regulation (CGRR) held a virtual meeting on 28 March 2022. These notes are prepared by the staff of the International Accounting Standards Board (IASB) and summarise the discussion.¹

About this meeting

- The purpose of the meeting was to explore how the IASB might respond to feedback on its proposals on the accounting for regulatory assets and regulatory liabilities arising from differences between the recovery pace of the regulatory asset base² and the assets' useful lives.
- 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
Leonardo George de Magalhães	Companhia Energética de Minas Gerais	Brazil
John Leotta	Deloitte Touche Tohmatsu	Australia
Richard McCabe	Consultant for Electricity Canada	Canada
Christopher McCusker	National Grid	USA
Sureta Moolman	Eskom Holdings SOC Ltd	South Africa
Tim Murray	RBC Capital Markets, Royal Bank of Canada	Canada
Michel Picard	KPMG	Canada
Christina Scharf	TenneT Holding B.V.	Germany
Silvia Blanco Sánchez ³	Ferrovial SA	Spain
Michael Timar	PricewaterhouseCoopers	United Kingdom
Yeshvir Singh	Fitch Ratings	United Kingdom
Stefanie Voelz (observer)	Moody's Investors Service Ltd	United Kingdom
	European Financial Reporting Advisory Group (observer)	Europe

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

² The Exposure Draft referred to the 'regulatory asset base' as the 'regulatory capital base'. Other common terms are 'regulatory asset value' or 'regulatory capital value'.

³ Replacing Jesús Herranz Lumbreras at this meeting.

3. Meeting notes structure:
 - a. background (paragraphs 4–8);
 - b. the regulatory asset base and an entity's assets (paragraphs 9–10);
 - c. course of action 1 (paragraphs 11–16);
 - d. courses of action 2 and 3 (paragraphs 17–21);
 - e. other comments (paragraphs 22–24); and
 - f. next steps (paragraph 25).

Background

4. The staff summarised [Agenda Paper 1](#) and possible courses of action the IASB could take in relation to its proposal on accounting for regulatory assets and regulatory liabilities arising from differences between the regulatory asset base's recovery pace and the assets' useful lives.
5. Paragraph B7 of the Exposure Draft *Regulatory Assets and Regulatory Liabilities* proposes that:

... IAS 16 *Property, Plant and Equipment* specifies how to allocate the depreciable amount of an item of plant on a systematic basis over its useful life. *If a regulatory agreement allows an entity to recover the cost of an asset through the regulated rates charged to customers, the depreciation expense recognised in a period, by applying IAS 16, is an allowable expense and the amount that recovers that depreciation expense forms part of the total allowed compensation for goods or services supplied in the same period. That is the case even if, under the terms of the regulatory agreement, the recovery of the depreciation expense occurs in a different period—for example, if the regulatory agreement uses a longer or shorter period of recovery than the asset's useful life [emphasis added].*
6. Agenda Paper 1 also included an overview of the comments received from respondents to the Exposure Draft. Some comments from respondents are relevant to discussions on the possible courses of action, for example:
 - a. the Exposure Draft proposes that differences between the regulatory asset base's recovery pace and the assets' useful lives would give rise to differences in timing that would be accounted for as regulatory assets or regulatory liabilities. These differences in timing would not represent adjustments to future rates. Some respondents referred to these differences in timing as 'non-cash differences in timing'. Some respondents said these regulatory assets or regulatory liabilities would not result in useful information.
 - b. respondents subject to incentive-based schemes said an entity's regulatory asset base cannot be linked or reconciled to the fixed asset register the entity uses for accounting. These respondents said the recognition of the regulatory depreciation (that is, the regulatory compensation to recover the regulatory asset base) should be based on the regulatory agreement, instead of when accounting depreciation is recognised.
7. The possible courses of action available to the IASB include:
 - a. *course of action 1*—to consider the relationship between regulatory depreciation and accounting depreciation. This course of action would require that an entity determine whether there is a direct relationship between the regulatory compensation (regulatory depreciation) and the underlying expense (depreciation expense). If the entity were to conclude there is no direct relationship, the

entity would not be required to account for regulatory assets or regulatory liabilities but to disclose specific information.

- b. *course of action 2*—to make an overall calculation based on comparable regulatory and accounting bases. This course of action would be aimed at identifying differences in timing by comparing the regulatory asset base and the entity's total assets.
 - c. *course of action 3*—to confirm the proposals.
8. The staff asked members:
- a. whether the staff has correctly analysed the pros and cons of each course of action.
 - b. whether any implementation issues might arise if the IASB took courses of action 1 or 2.
 - c. whether the indicators suggested for course of action 1 are appropriate.
 - d. whether the suggested disclosures are appropriate for entities that do not account for regulatory assets or regulatory liabilities in accordance with course of action 1.
 - e. whether the staff should consider any other potential courses of action.
 - f. how common it is for a regulatory agreement to allow an entity to include amounts in rates charged during the construction of an asset that recover part of the carrying amount of the asset. The staff also asked members whether any information resulting from this fact pattern would be useful for users of financial statements.

The regulatory asset base and an entity's assets

9. A few members from jurisdictions where entities are subject to incentive-based schemes noted that it is unusual for the entity's asset base to have a direct relationship with the regulatory asset base. Consequently, comparisons between these two bases may not be meaningful. For these members, recognising regulatory assets and regulatory liabilities for differences between the regulatory recovery pace and the assets' useful lives would not result in useful information.
10. A few members from jurisdictions where entities are subject to regulatory schemes that are cost-based or similar to cost-based schemes commented on the relationship between the regulatory asset base and an entity's assets. They said that typically, the regulatory asset base is directly related to an entity's assets and that, therefore, the regulatory depreciation is directly related to the accounting depreciation. These members said entities in those jurisdictions are generally required to reconcile accounting and regulatory fixed asset registers regularly.

Course of action 1

11. Almost all members preferred course of action 1. Some members said course of action 1:
- a. is consistent with a principles-based approach that can be applied to different regulatory schemes.
 - b. is aligned with the concept of differences in timing, which is at the core of the model and:
 - i. would not create links between the regulatory compensation (regulatory depreciation) and an item of expense (depreciation expense) when none existed. They said that when regulatory compensation is unrelated to accounting depreciation, disclosures would provide useful information.
 - ii. would result in information about the differences between the regulatory asset base's recovery pace and the assets' useful lives when there is a direct relationship between regulatory

depreciation and accounting depreciation. Entities taking this course of action would be required to account for the corresponding regulatory assets and regulatory liabilities.

12. A few members, including members that are users of financial statements, said that users' analyses focus on the impact of rate regulation on future cash flows (that is, cash differences in timing). For users it is important to know the amount of the regulatory depreciation that has flowed into revenue and will turn to cash flows and how that amount differs from the accounting depreciation. One of those members preferred that an entity should be required to account for regulatory assets or regulatory liabilities arising from cash differences in timing only.
13. A member preferring course of action 1 said this course of action would not necessarily address the root cause of the problem, which is the way total allowed compensation is described in the proposed application guidance. According to this member, the Exposure Draft assumes that all regulatory regimes aim to entitle entities to recover their costs and, consequently, that the recovery of cost is directly related to revenue. However, some regulatory schemes give entities an allowed revenue that does not guarantee the recovery of costs while other regulatory schemes are hybrid schemes (that is, schemes that give the entity an allowed revenue and pass-through costs). For this member, focusing only on whether there is a direct relationship between regulatory depreciation and accounting depreciation may not address the root cause of the problem because that relationship might be just one of many problematic issues in the proposed application guidance. This member suggested the guidance state that total allowed compensation comprises allowable expenses and target profit or allowed revenue for the provision of goods or services for a specified period. Entities would then need to apply judgment to determine which components of total allowed compensation are relevant to them for the purposes of identifying differences in timing.
14. A few members commented on the indicators that course of action 1 suggest entities could use to determine when linking regulatory depreciation to accounting depreciation. They said:
 - a. the indicators are reasonable and that entities can use them to determine that there is no direct relationship between regulatory depreciation and accounting depreciation.
 - b. the descriptions of the indicators raise some questions. For example, it is unclear what is meant by the italicised words in the phrases 'the regulatory asset base departs *significantly* from the assets' and '*not possible* for items in the regulatory asset base to be reconciled to audited financial statements'.
 - c. the indicators could be supplemented with additional guidance, including specific examples of indicators such as inflation and efficiency adjustments to the regulatory asset base, and different measurement bases between the regulatory asset base and an entity's assets.
15. A few members commented on the information an entity should disclose when it does not account for a regulatory asset or a regulatory liability. They said:
 - a. the entity should be required to disclose qualitative information only. When there is no direct relationship between regulatory depreciation and accounting depreciation, it would be very complex and costly to provide quantitative information that reconciles regulatory depreciation to depreciation

expense. Quantitative information about links between the regulatory compensation and the accounting depreciation would not be useful for users of financial statements.

- b. examples of useful qualitative information include:
 - i. a description of the regulatory schemes and the recovery mechanism for the regulatory asset base disclosed separately for each jurisdiction in which an entity operates.
 - ii. an explanation for the lack of a direct relationship between regulatory depreciation and accounting depreciation, the main differences between the value of the regulatory asset base and the carrying amount of the assets, and the key regulatory and accounting assumptions.
 - iii. how the regulatory asset base's recovery pace is determined, whether the recovery pace has changed during the period and, if so, the underlying reasons for the change.
 - iv. if the regulatory depreciation has not been fully recovered, information about the recoverable amount and any regulatory approval required for the true-up adjustment to the future rates.

16. A few members commented on the pros and cons of course of action 1. They said:

- a. this course of action should also be followed for any other items of expense for which there is no direct relationship between the regulatory compensation and those items of expense.
- b. entities could reach different conclusions about whether there is a direct relationship between regulatory depreciation and accounting depreciation based on the same or similar fact patterns or situations. A few members said:
 - i. the IASB could mitigate this risk by providing the right indicators and additional guidance or examples in the Standard.
 - ii. if an entity did not account for the related regulatory assets or regulatory liabilities, the information the entity would be required to disclose could mitigate a potential lack of comparability.
 - iii. whether a direct relationship exists between regulatory depreciation and accounting depreciation will depend on the regulatory regime—it is largely a matter of fact rather than judgment. Consequently, opportunities to apply judgment to achieve a preferred accounting outcome would be limited. One member said that in their jurisdiction, entities are subject to cost-based regulatory schemes. The assets' regulatory recovery period is subject to a rigorous independent review process. Entities maintain separate regulatory and accounting records of individual assets and submit reconciliations of regulatory assets and accounting assets as part of their regulatory reporting.

Courses of action 2 and 3

- 17. No members supported course of action 3. Only one member said course of action 2 might be feasible as it requires the reconciliation between the regulatory asset base and an entity's assets to be done at

an aggregate level rather than at an asset level. However, this member was concerned about the auditability of the assumptions and the information used when applying this course of action.

18. Many members said both courses of action would require entities to account for regulatory assets and regulatory liabilities even when there is no direct relationship between regulatory depreciation and accounting depreciation. As mentioned in paragraph 15(a), these members said:
 - a. a reconciliation of regulatory depreciation to depreciation expense would be very complex and costly; and
 - b. the reported regulatory assets and regulatory liabilities would not constitute useful information for users of financial statements.
19. In relation to course of action 2 a few members said:
 - a. making the two bases (that is, the regulatory asset base and an entity's total assets) comparable would be complex and costly because:
 - i. new variances between the value of the regulatory asset base and the carrying amount of the assets would arise on an ongoing basis, which an entity would need to track.
 - ii. following course of action 2 could require an entity to obtain information at a more detailed level than that maintained for regulatory purposes (for example, information aggregated by asset classes and high-level reconciliations). This could be the case even in cases where regulatory depreciation is directly related to accounting depreciation. These members were also concerned about the ease of auditing information at that level of detail.
 - b. it is unclear:
 - i. why the recovery or fulfilment period of the regulatory asset or regulatory liability should be based on the assets' weighted average useful lives. One member said the resulting regulatory expense or regulatory income is intended to supplement the revenue information, but there is no clear linkage between revenue recognition and the assets' weighted average useful lives.
 - ii. how an entity would treat items such as adjustments for inflation and measurement differences that would form part of an entity's total allowed compensation but that would need to be removed to make the bases comparable.
20. Members said course of action 3 would not respond to respondents' concerns and would fail to reflect regulatory schemes other than cost-based schemes. They said the proposed model assumes a direct

relationship between the regulatory compensation and the accounting depreciation, but that this is not always the case.

21. A member said, in addition to the identified disadvantages of courses of action 2 and 3, that entities subject to incentive-based schemes might need to present alternative performance measures reflecting the regulatory compensation.

Other comments

22. A member surveyed 14 stakeholders (preparers, regulators and a user) from the United Kingdom, Australia and Canada and presented the results of the survey.⁴ The comments in the paragraphs above also include feedback on the survey. The main messages from the survey were that:
- a. stakeholders based in the United Kingdom and Australia generally supported course of action 1 because, in their view, the relationship between the regulatory asset base and an entity's assets is weak. In addition, some stakeholders in these jurisdictions said the assets or liabilities arising from differences between the regulatory asset base's recovery pace and the assets' useful lives would not meet the definitions of a regulatory asset or a regulatory liability. These stakeholders also said the disclosures for course of action 1 should be minimal and should be qualitative rather than quantitative.
 - b. courses of action 2 and 3 did not receive much support from stakeholders from the United Kingdom and Australia because they are complex to apply and could confuse users of financial statements.

Recovery of assets' carrying amounts through rates charged during construction

23. A few members said the fact pattern in which rates charged during the construction of an asset recover part of the carrying amount of the asset is:
- a. common in the regulatory schemes of a jurisdiction in Europe, in which there is no direct relationship between regulatory depreciation and accounting depreciation; and
 - b. uncommon in the regulatory schemes of two jurisdictions in North and South America in which there is a direct relationship between regulatory depreciation and accounting depreciation.
24. A member suggested the accounting for a regulatory liability and the related regulatory expense relating to an asset's carrying amount recovered during construction would be inconsistent with the requirements in *Property, Plant and Equipment: Proceeds before Intended Use* (Amendments to IAS 16). Those amendments require an entity to recognise in profit or loss the proceeds from selling and the cost of any items produced while bringing an asset to the location and condition necessary for its intended use. According to that member, if part of the asset's carrying amount recovered during construction was recognised in revenue as a result of goods or services already supplied, in accordance with IFRS 15 *Revenue from Contracts with Customers*, it was unclear why the entity should

⁴ The presentation from this member of the CGRR can be found [here](#).

be required to defer recognising the effects of that amount in profit or loss by recognising a regulatory liability.

Next steps

25. The staff will analyse the feedback received from the members of the CGRR on the topics discussed at the meeting held on 4 March 2022 and at this meeting. The staff may also consult the CGRR or individual members of the CGRR on specific matters.



Agenda Paper 1

Accounting for regulatory assets and regulatory liabilities arising from differences between the regulatory recovery pace and assets' useful lives

Consultative Group for Rate Regulation meeting
28 March 2022

CONTACT(S)

Mariela Isern

misern@ifrs.org

This paper has been prepared for discussion at a public meeting of the Consultative Group for Rate Regulation. The views expressed in this paper do not represent the views of the International Accounting Standards Board (IASB) or any individual member of the IASB. Comments on the application of IFRS® Standards do not purport to set out acceptable or unacceptable application of the Standards.

Purpose of the paper

- To discuss comments received from entities subject to incentive-based schemes on the proposals in the [Exposure Draft *Regulatory Assets and Regulatory Liabilities*](#) (Exposure Draft) relating to the **accounting for regulatory assets and regulatory liabilities arising from differences between regulatory recovery pace and assets' useful lives**.
- To explore possible alternative approaches that the International Accounting Standards Board (IASB) may consider in its redeliberations on those proposals.

Structure of the paper

- The paper is divided into the following sections:
 - Types of regulatory schemes—Background information (pages 10–15);
 - Proposals in the Exposure Draft (pages 16–17);
 - Comments received (pages 17–18); and
 - Staff analysis (pages 18–29).
- Questions for the Group are included on page 30.

Types of regulatory schemes—Background information

- This section aims to provide a summary of features of different regulatory schemes that the IASB received from its consultation [Request for Information *Rate Regulation*](#) published in 2013 and other sources (see References on page 31).
- Respondents to the Request for Information highlighted two general types of regulatory schemes:
 - cost-based (commonly known as 'cost-of-service' or 'return-on-base rate')—page 11; or
 - incentive-based (including revenue-cap or price-cap regulation)—pages 12–13.

Types of regulatory schemes—Background information—*continued*

Cost-based

- Theory—Regulator allows the entity to recover its expenses and a return on the investment. The approach is good for limiting the risks borne by the entities but provides no incentives for cost reduction.
- The allowed revenue is closely linked to operating expenditure, depreciation and interest costs as appearing in the statutory accounts, although the cost of equity is generally set at a level that is considered ‘fair’ and capital expenditure is scrutinised for its prudence before the entity being permitted to earn a return on it and start recovering it through depreciation. True-up mechanisms ensure that actual input costs are recovered. Consequently, this regulatory scheme generally relies heavily on setting allowed revenues based on recognised costs under the relevant accounting standards, and therefore it maps revenues to audited financial statements.
- Cost-based schemes could also determine the allowed revenue based on estimates of costs. True-up mechanisms would be used to adjust differences between estimated and actual costs. The adjustment is for cost (rather than volume) differences.

Types of regulatory schemes—Background information—*continued*

Incentive-based

- Theory—Regulator sets *ex ante* a fixed price for the service provided by the entity, who is then incentivised to optimise its processes since it will make a profit by reducing costs. Typically it provides larger incentives to cost reduction and creates more risks to entities than cost-based schemes.
- The calculation of the regulated rate tends to be more focused on targeted outputs (ie quantity/quality of the services) rather than on a set of inputs to control (ie output regulation rather than input regulation).
- Within incentive-based, we highlight a couple of approaches: building-block and total expenditures (totex).

Incentive-based—Building-block approach

- This approach uses a ‘building-block’ methodology to determine ‘allowed revenue’. Each of the individual building blocks are separately assessed and determined *ex ante* based on forecasts. Main building blocks to determine the ‘allowed revenue’ are:
 - depreciation of the Regulatory Asset Base (RAB)⁽¹⁾;
 - returns on the RAB;
 - operating expenditures;
 - incentives (bonuses or penalties); and
 - other adjustments.
- Differences between forecasts and actual amounts may give rise to true-ups in regulated rates charged in the future.

(1): The Exposure Draft referred to RAB as regulatory capital base (RCB).

Types of regulatory schemes—Background information—*continued*

Incentive-based—Totex (total expenditures) approach

- The regulator assesses total expenditures (Totex: opex and capex) for efficiency and productivity targets for the purposes of determining an ‘allowed revenue’ amount.
- A fixed part of Totex is capitalised in the RAB (slow money), with the non-capitalised part of Totex being recovered in the year in which it is allowed (fast money). The rate to split Totex between slow and fast money is informed by the ratio Opex/Totex and Capex/Totex and other considerations (eg companies’ business plans, incentives for companies to consider solutions that would imply operating rather than capital expenditures etc). As a result, this approach dilutes the link between the RAB and the actual assets of an entity.
- The ‘allowed revenue’ would include depreciation of RAB and returns on RAB. It would also include other items such as performance incentives—included on a forecast basis—and other adjustments.

In both approaches (building-block and Totex) regulators may apply different techniques to assess the efficiency of the operating/capital expenditures to be included as part of the ‘allowed revenue’ amount—efficiency audits, efficiency factors, benchmark techniques etc.

When using benchmarking techniques, each entity can increase its profit if it is more efficient than the benchmarked level. This technique increases the risk for entities because their revenue is disconnected from their actual costs.

Types of regulatory schemes—Background information—*continued*

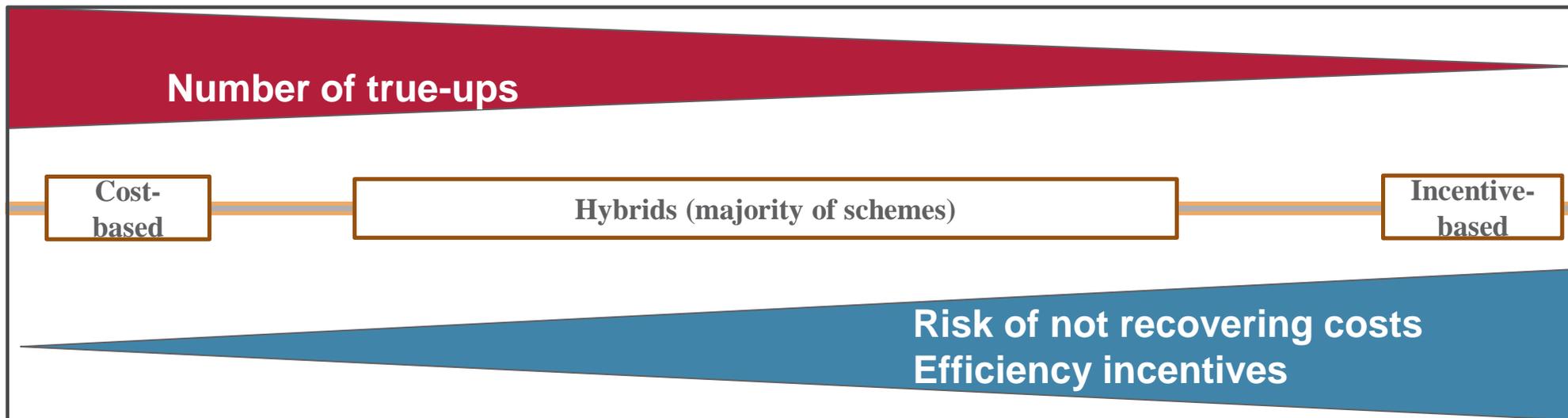
Pure cost-based and incentive-based schemes represent two extremes with most regulatory schemes falling in between, depending on the additional regulatory instruments implemented by the regulators in the schemes.

For example, many incentive-based schemes include true-ups and other adjustments that seek a combination of objectives (lowering risks borne by entities, allowing higher transfers to final customers etc). For example:

- Sharing of efficiency gains, determined by comparing actual incurred costs with expected/budgeted costs. This regulatory instrument balances properties of cost-based with properties of incentive-based at a level that depends on the applied sharing rule.
- Volume variances—variances between forecasted and actual consumption volumes are adjusted in future rates. This instrument seeks to pass demand risk to final customers.
- Non-controllable costs—variances between forecasted and actual non-controllable costs are adjusted in future rates.

Types of regulatory schemes—Background information—*continued*

Based on the features on pages 11–13, we would expect the number of true-ups to be higher in cost-based schemes, with the risk of not recovering the costs and the efficiency incentives being higher in incentive-based schemes.



Consequently, the population of regulatory assets (RAs) and regulatory liabilities (RLs) for entities subject to the final Standard⁽²⁾ will vary depending on the differences in timing arising from the different regulatory agreements. At a very high level, we could infer that the population of RAs/RLs could be larger entities subject to cost-based schemes than for entities subject to incentive-based schemes. However, this will vary and depend on the specific regulatory instruments used by the regulators.



(2): Any reference to ‘the Standard’ in this paper should be read as the final Standard that the IASB would issue after redeliberating the proposals in the Exposure Draft *Regulatory Assets and Regulatory Liabilities*.

Proposals in the Exposure Draft

- The objective of the Exposure Draft is for an entity to provide ‘relevant information that faithfully represents how regulatory income and regulatory expense affect the entity’s financial performance, and how regulatory assets and regulatory liabilities affects its financial position.’
- In other words, the objective of the Exposure Draft is for entities to provide useful information about the effects of differences in timing in an entity’s financial statements.
- The Basis for Conclusions on the Exposure Draft discusses that differences in timing give rise to rights or obligations that fulfil the definitions of assets and liabilities in the Conceptual Framework (paragraphs BC37–BC47). The Exposure Draft captures differences in timing in the definitions of regulatory assets and regulatory liabilities (emphasis added):

Regulatory asset—**An enforceable present right**, created by a regulatory agreement, **to add an amount** in determining a regulated rate to be charged to customers in future periods because part of the total allowed compensation for goods or services already supplied will be included in revenue in the future.

Regulatory liability—**An enforceable present obligation**, created by a regulatory agreement, **to deduct an amount** in determining a regulated rate to be charged to customers in future periods because the revenue already recognised includes an amount that will provide part of the total allowed compensation for goods or services to be supplied in the future.

- Consequently, when a **difference in timing arises**:

Revenue recognised
in a period

≠

Total allowed
compensation

- The Exposure Draft defines total allowed compensation (for goods or services supplied) as (**emphasis added**):

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.
- The application guidance of the Exposure Draft aims to help an entity determine in which period that compensation should be reflected in profit or loss, regardless of when that compensation (or part of that compensation) was included in the rates charged.
- The application guidance on the Exposure Draft says that total allowed compensation comprises:
 - allowable expenses minus chargeable income;
 - target profit; and
 - regulatory interest income or regulatory interest expense.
- In relation to today’s topic (the accounting for regulatory assets or regulatory liability arising from differences between the regulatory recovery pace and assets’ useful lives), the proposed requirements that have raised most concerns from respondents that are subject to incentive-based schemes are included on page 17.

Proposals in the Exposure Draft—continued

- Paragraph B7 of the Exposure says (**emphasis added**):

[...] IAS 16 *Property, Plant and Equipment* specifies how to allocate the depreciable amount of an item of plant on a systematic basis over its useful life. **If a regulatory agreement allows an entity to recover the cost of an asset through the regulated rates charged to customers, the depreciation expense recognised in a period**, by applying IAS 16, is an **allowable expense** and the amount that recovers that depreciation expense forms part of the total allowed compensation for goods or services supplied in the same period. **That is the case even if, under the terms of the regulatory agreement, the recovery of the depreciation expense occurs in a different period**—for example, if the regulatory agreement uses a longer or shorter period of recovery than the asset’s useful life.
- [Illustrative Examples 2B and 2C](#) accompanying the Exposure Draft illustrate the case when the regulatory recovery period of the regulatory capital base is longer or shorter than an asset’s useful life.
- Many of the regulatory assets and regulatory liabilities in the Exposure Draft are actual adjustments to the future rates (cash differences in timing). However, some other are not. In particular, this may happen when the regulator considers a criterion for allowing an entity to include an item of expense in the rates charged that is different from that followed in accounting (see page 19). The case of differences between the regulatory recovery pace and the assets’ useful lives would be an example of regulatory assets or regulatory liabilities that would not give rise to adjustments in future rates (non-cash differences in timing).

Comments received

- The comments received from respondents subject to incentive-based schemes relating to the accounting for regulatory assets and regulatory liabilities arising from differences between regulatory recovery pace and assets’ useful lives are detailed below.
- Respondents generally thought these regulatory assets and regulatory liabilities:
 - did not represent enforceable rights and enforceable obligations arising from their regulatory agreements;
 - would not meet the definitions of regulatory assets and regulatory liabilities (because they do not represent ‘rights to add an amount to’ or ‘obligations to deduct an amount from’ future rates); and
 - would not result in useful information to users of financial statements if recognised in the financial statements.
- In some cases, respondents referred to these regulatory assets and regulatory liabilities as ‘non-cash differences in timing’. This is because the cash flows from those differences in timing do not correspond to adjustments that the regulatory agreement will consider when determining the future rates.
- Respondents said that the Exposure Draft considers the RAB as if it was a regulatory asset register. However, according to them, an entity’s RAB cannot be linked or reconciled to the fixed asset register used for accounting purposes because:
 - the asset classes in the RAB and corresponding recovery periods are different to the asset classes and useful lives in the accounting asset register.
 - regulators may assess capex efficiency and decide to exclude capex from RAB.
 - RAB may be adjusted for inflation annually, whereas fixed assets are measured mainly at cost for accounting purposes.

Comments received—*continued*

- RAB may include items that would not qualify for capitalisation under IAS 16 *Property, Plant and Equipment* (eg bonuses and penalties and operating expenditures).
- costs capitalised for accounting purposes may not have been included in the RAB (eg contributed assets).
- fair value adjustments made to the accounting cost base due to business combinations may not have been included in the RAB.
- These respondents did not believe it is appropriate to link regulatory depreciation with accounting depreciation—ie recognition of revenue for regulatory schemes should be based on an entity’s regulatory agreement and not based on when accounting depreciation is recognised in accordance with IFRS Accounting Standards.

Staff analysis

The staff analysis explores possible courses of action for addressing respondents’ concerns on the accounting for regulatory assets and regulatory liabilities arising from differences between recovery pace of the RAB and assets’ useful lives.

The staff analysis is structured as follows:

- differences in timing as the common denominator of different regulatory schemes;
- cash and non-cash differences in timing;
- determining total allowed compensation when the recovery pace of the RAB differs from assets’ useful lives; and
- possible courses of action.

Differences in timing as the common denominator

- The main challenge of this project is to determine a set of principles that would enable the accounting for regulatory assets and regulatory liabilities arising from a wide variety of regulatory schemes.
- To do so, we think we need to focus on differences in timing. This is because the existence of differences in timing is the common denominator of the variety of regulatory schemes that will be in the scope of the final Standard. However, the population of regulatory assets and regulatory liabilities accounted for by entities will differ depending on the differences in timing arising in the different regulatory schemes.

Staff analysis—Continued

Cash and non-cash differences in timing

- Even though regulatory assets and regulatory liabilities are defined as enforceable present rights *to add an amount to* a future regulated rate (enforceable present obligations *to deduct an amount from* future regulated rates), the Exposure Draft does not limit differences in timing to those resulting to adjustments in future rates (cash differences in timing).
- For example, assume a regulatory agreement allows the recovery of an item of expense but considering a different pace than that for accounting purposes (**Example 1**):

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

- 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 accounting criterion for recognising this item of expense. Consequently, the regulatory agreement would *not* give the entity an ‘explicit’ right in Year 1 to increase rates charged in Year 2 and Year 3 by CU2 and CU6, respectively (ie a total amount of CU8). 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 a non-cash difference in timing.
- In this example, the entity has a right to recover an item of expense. In accordance with the Exposure Draft, amounts that recover an item of expense would form part of total allowed compensation as the entity incurs that item of expense.
- In **Example 1**, the compensation for the item of expense is (partially) included in rates charged (and therefore in revenue) in a period that differs from the period when the entity incurred the corresponding expense to supply goods or services. Consequently, in Example 1 a difference in timing arises in Year 1.
- This shows that implicit rights can arise when the regulatory agreement explicitly allows an item to be included in the rates charged but the timing of when the item is included in rates differs from when that item would be considered as forming part of the total allowed compensation for accounting purposes.
- **Example 1** is overly simplistic and assumes that the regulatory compensation can be *easily linked* to a specific item of expense that is recognised in the financial statements that the regulatory agreement entitles an entity to recover.
- What happens when it is difficult to establish a direct relationship between the regulatory compensation (regulatory depreciation) and the underlying expense (accounting depreciation)? This leads us to the next section: determining total allowed compensation when the recovery pace of the RAB differs from the assets’ useful lives (determining total allowed compensation).

(3): Monetary amounts are denominated in ‘currency units’ (CU).

Staff analysis—Continued

Determining total allowed compensation

- Some respondents to the Exposure Draft said that they disagreed with how the Exposure Draft proposed to determine total allowed compensation when the recovery pace of the RAB differed from the assets' useful lives.
- The accounting for regulatory assets or regulatory liabilities arising from differences between recovery pace of the RAB and assets' useful lives is primarily tackled in the Illustrative Examples accompanying the Exposure Draft.
- The Illustrative Examples assume the following simplifications:
 - there is a one-to-one relationship between regulatory compensation and accounting expense (for example, regulatory depreciation can be traced back to accounting depreciation);
 - the RAB consists of a single asset, which implies the RAB can be reconciled with an entity's fixed asset register; and
 - the measurement basis of the RAB coincides with that used to measure property, plant and equipment in accordance with IAS 16 *Property, Plant and Equipment* (ie cost).
- We are aware that in some jurisdictions (**Case A**), the following takes place:
 - Regulatory accounting and reporting requirements are aligned as much as possible to IFRS Standards, with any deviations being in the public interest. This means that:
 - componentisation of assets recorded for regulatory purposes is broadly aligned to that used for accounting purposes with any differences tracked separately;
 - measurement basis and capitalisation policies used for accounting purposes are generally aligned with those used for regulatory purposes with any differences tracked separately; and
 - depreciation rates used for regulatory purposes broadly coincide with those used for accounting purposes, with regulators reserving their right to deviate from accounting if necessary when approving entities' revenue requirements.
 - Regulatory rules require regulatory information to be reconciled to audited financial statements for both income statement and balance sheet items (it may be a high level reconciliation though).
 - The rate setting aims to reflect cause and effect relationships in matching an entity's expenses with its revenue requirements and rates charged to customers.

We think the proposals in the Exposure Draft can be operationalised in this regulatory setting. The regulatory setting above seems to have features closer to 'cost-based' schemes on page 11.

Staff analysis—Continued

- We are however aware the regulatory practices in other jurisdictions differ from those described for Case A (**Case B**):
 - Componentisation of the RAB—The RAB may include operating and capital expenditures and other items such as working capital movements or performance incentives.

The RAB may be split in asset classes that are different from those used for accounting purposes.

In some other cases, once assets have entered the RAB they may be treated as being a single ‘lump’. This makes removing any capital expenditure that is disallowed (on efficiency and prudence grounds) by the regulator straightforward. However that means one cannot reconcile the RAB with the entity’s assets register.
 - Measurement of the RAB—The RAB may be measured using historical cost but also other measurement bases (for example, replacement cost).

In addition, regulators may (a) apply efficiency measures to capex, which may mean that amounts included in the RAB would differ from those in accounting and (b) index the RAB to reflect inflation.
 - Depreciation of the RAB—In those cases where the RAB is split in asset classes, each class would have its own depreciation profile (for example, depreciation rate for a class may be the average of the economic lives of the assets included in that class).

When assets enter the RAB as a single ‘lump’, regulators may use the weighted average of the useful lives of the assets as the main factor for determining the depreciation pace. Regulators may adjust the weighted average to consider a variety of factors such as the financeability of the entity (considering both an entity’s financing needs and the financing available to the entity, for example, via bonds) and intergenerational equity.⁽⁴⁾
- Our understanding is that entities in regulatory schemes similar to that described in Case B would be subject to incentive-based schemes (pages 3–4). These entities have a right to recover the RAB through regulatory depreciation.
- The main component of RAB will be, in most cases, capex and therefore, there is a connection between regulatory depreciation and accounting depreciation. However, in Case B, the accounting depreciation is not used as a basis for determining the regulatory depreciation, which means the link between regulatory depreciation with accounting depreciation is not as direct as in Case A.
- Operationally, Case B brings into question whether the benefits of accounting for regulatory assets and regulatory liabilities arising from differences between the recovery pace of the RAB and assets’ useful lives outweigh the relating costs.
- We still think that differences between RAB’s recovery pace and assets’ useful lives can provide users of financial statements with useful information. This is because regulators determine the RAB’s depreciation profile considering an entity’s financeability. For example, an accelerated depreciation profile of the RAB compared to assets’ useful lives could indicate the regulator is trying to avoid financeability issues for the entity. Consequently, for entities subject to Case B, the final Standard could require disclosures that help users bridge regulatory depreciation and accounting depreciation.

(4): Financeability refers to the duty placed on regulators to ensure that a regulated entity is able to finance its functions. This duty has two components: (a) enabling the entity to earn a return on its RAB that is at least equal to its cost of capital, and (b) enabling the entity to raise finance from capital markets readily and on reasonable terms.

Staff analysis—Possible courses of action

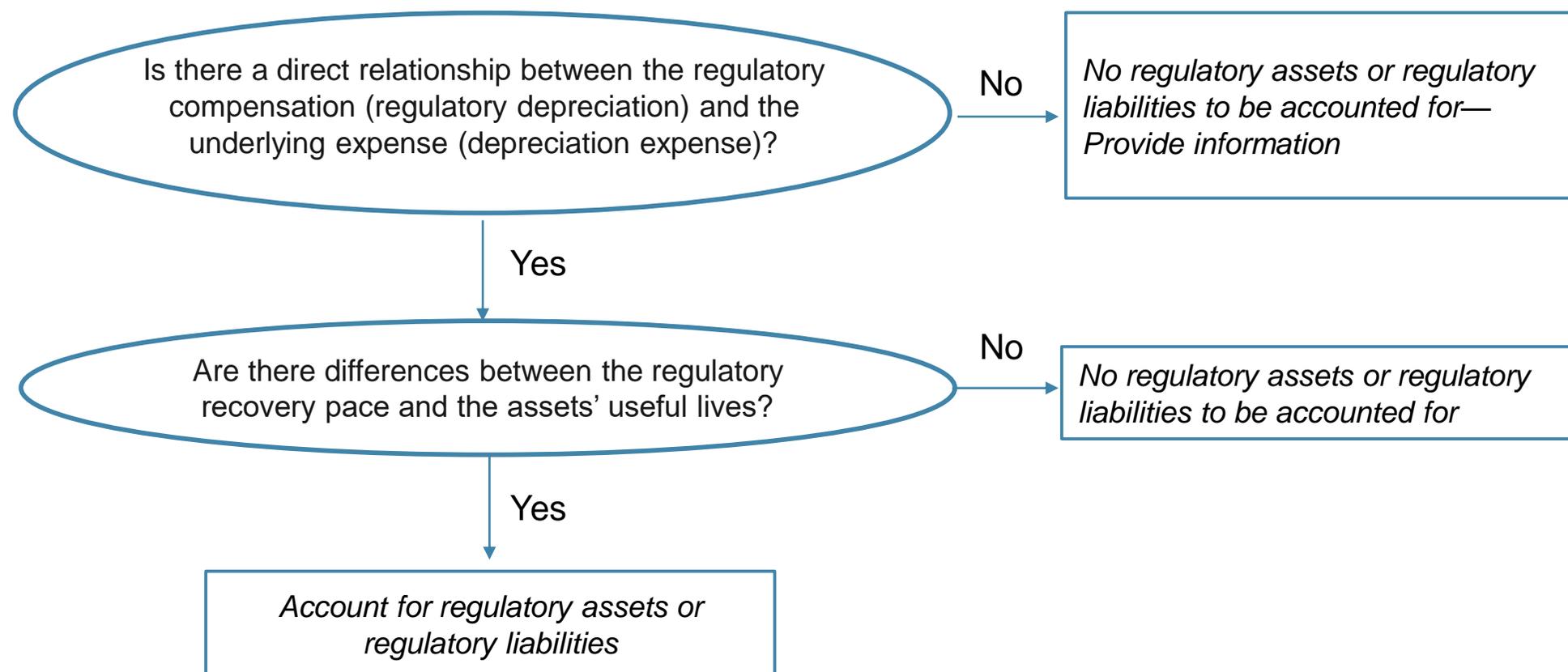
- The Exposure Draft provides application guidance for entities to determine in which periods components of total allowed compensation affect profit or loss.
- Many respondents raised concerns about the way the Exposure Draft proposed to determine total allowed compensation for depreciation expense (ie an allowable expense).
- The determination of total allowed compensation for allowable expenses proposed in the Exposure Draft (framed in **dark red** in the table on the right) did not cause concerns:
 - when the regulatory compensation is determined on the basis of accounting expenses (Case A on page 20); and
 - generally for pass-through adjustments relating to items of expense.
- However, respondents subject to incentive-based schemes said that the final Standard should not assume regulatory depreciation can be directly linked to accounting depreciation.
- The following pages deal with some possible courses of action:
 - Course of Action 1—consider the relationship between regulatory depreciation and accounting depreciation (pages 23–25);
 - Course of Action 2—overall calculation (pages 26–27); and
 - Course of Action 3—confirm the proposals (page 28).
- Page 29 includes a description of a fact pattern that is related to today’s topic. Question 5 on page 30 specifically refers to this matter.

Table BC2 Components of total allowed compensation	
Component	When the component affects profit or loss
Amount that recovers allowable expenses minus chargeable income (see paragraph BC89)	In the period when an entity recognises the expense or income by applying IFRS Standards
Any component of target profit not listed below (see paragraph BC90)	In the period when the regulatory agreement entitles an entity to add that component in determining a regulated rate for goods or services supplied in that period
Profit margins on allowable expenses (see paragraph BC91)	In the period when an entity recognises the expense by applying IFRS Standards
All regulatory returns (see paragraphs BC92–BC95), except those on assets not yet available for use	In the period when the regulatory agreement entitles an entity to add that return in determining a regulated rate for goods or services supplied in that period
Regulatory returns on assets not yet available for use (see paragraphs BC96–BC100)	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 (see paragraphs BC101–BC110)	In the period in which an entity’s performance gives rise to the incentive bonus or penalty
Regulatory interest income and regulatory interest expense (see paragraphs BC111–BC113)	As the discount unwinds until recovery of the regulatory asset or fulfilment of the regulatory liability

Staff analysis—Possible courses of action—continued

Course of Action 1—Consider the relationship between regulatory depreciation and accounting depreciation

- The final Standard could provide guidance (for example, in the form of indicators) for entities to determine when linking regulatory depreciation back to accounting depreciation would not be appropriate and may result in costs (mainly implementation costs for preparers) outweighing the benefits of providing the information.
- The flowchart in this page aims to help visualise how the final Standard could articulate the proposals relating to accounting for regulatory assets and regulatory liabilities when the regulatory recovery pace differs from assets’ useful lives.



Staff analysis—Possible courses of action—*continued*

Course of Action 1—*continued*

- If the proposals for accounting for regulatory assets and regulatory liabilities arising from differences between the regulatory recovery pace and assets' useful lives are articulated using the flowchart in page 23, entities would need to be equipped with application guidance to determine:
 - when it would not be appropriate to link regulatory depreciation to accounting depreciation (**Judgement 1**).
 - **Judgement 1**—The majority of the items within the RAB are items that an entity capitalises for accounting purposes. This means that, to some extent, there is a link between the RAB and items of property, plant and equipment. However, in some cases there is little or no direct link. When this happens, accounting for regulatory assets and regulatory liabilities may not result in useful information.
 - **Examples of indicators** that may provide evidence there is little or no direct link between regulatory depreciation and accounting depreciation are:
 - the determination of the regulatory depreciation included in rates is not based on the accounting depreciation or the regulatory depreciation is based on a RAB that departs significantly from the entity's assets.
 - the determination of the regulatory depreciation pace considers factors other than useful life of the assets and those factors can have an impact in the regulatory recovery pace of the RAB (for example, intergenerational equity).
 - it is not possible for items in the RAB to be reconciled to audited financial statements.
-
- If an entity concluded that:
 - there is no direct relationship between regulatory depreciation and accounting depreciation (link is weak) and therefore the benefits would not outweigh the costs (**Judgement 1**)
 the entity would not need to account for regulatory assets or regulatory liabilities in those cases when the regulatory recovery pace and assets' useful lives differ.
- These entities would instead need to **provide information**, including:
- Description of the main reasons that support the conclusion there is no direct relationship between regulatory depreciation and accounting depreciation. This may include a description of:
 - items forming part of the RAB, with an explanation of the main differences between RAB and property, plant and equipment; and
 - information that compares regulatory depreciation vs accounting depreciation and description of the main factors explaining the difference (ie main criteria underpinning the RAB recovery period and the assets' useful lives).

The list of indicators would not be exhaustive.

Staff analysis—Possible courses of action—continued

Course of Action 1—continued

- The following table aims to consider pros and cons of the Course of Action 1:

Pros	Cons
<p>May provide a feasible solution for entities subject to regulatory schemes in which there is no direct relationship between regulatory depreciation and accounting depreciation. This course of action may also be less costly to implement than the proposals in the Exposure Draft.</p>	<p>It could provide an incentive for entities to analogise the requirements to other situations to conclude there is no direct link between regulatory compensation and underlying items of expense. This possibility could however be overcome by restricting the application of this course of action to depreciation expense only.</p>
<p>May result in different outcomes that reflect differences in the way rates are set between different regulatory schemes.</p>	<p>It may be difficult for entities to determine whether there is a direct relationship between regulatory depreciation and accounting depreciation, which may lead to entities reaching different judgments for the same or similar fact patterns/situations.</p>

Staff analysis—Possible courses of action—*continued*

Course of Action 2—Overall calculation

- A possible course of action could be to identify differences in timing by comparing two bases (ie the RAB and the entity's total assets).
- An entity would first need to make the bases comparable. To do so an entity would need to (the list is not exhaustive):
 - remove from the RAB all items that are not in the entity's fixed assets register;
 - not consider assets in its fixed assets register that are not part of the RAB (for example, contributed assets); and
 - remove differences between the RAB and the entity's assets that relate to measurement differences between the two bases.
- Once the bases are comparable:
 - A regulatory asset would arise when the difference between the RAB and the total assets of the entity (ie $RAB > \text{entity's assets}$) is fully due to the regulatory recovery pace of the RAB being longer than the useful lives of the entity's assets. The final Standard could establish the recovery period of that regulatory asset to be the assets' weighted average useful lives. This would be a non-cash difference in timing.
 - A regulatory liability would arise when the difference between the RAB and the total assets of the entity (ie $RAB < \text{entity's assets}$) is fully due to the regulatory recovery pace of the RAB being shorter than the useful lives of the entity's assets. The final Standard could establish the fulfilment period of that regulatory liability to be the assets' weighted average useful lives. This would be a non-cash difference in timing.

Staff analysis—Possible courses of action—continued

Course of Action 2—continued

- The following table aims to consider pros and cons of the Course of Action 2:

Pros	Cons
<p>Would result in comparable information across entities applying the final Standard.</p>	<p>Entities would need to ensure the RAB is a base that is comparable to an entity’s assets on a yearly basis. This may be both operational challenging and complex, which may impact on the feasibility of this option. See pages 17–18 for items that make the RAB not comparable with an entity’s assets. However, it can be argued this course of action may be less costly to implement than the proposals in the Exposure Draft.</p>
<p>It could decrease operational complexity as the regulatory asset or regulatory liability would be accounted for at the level of the RAB/an entity’s total assets rather than at an entity’s individual assets level.</p>	<p>The weighted average of the useful lives of an entity’s assets would keep on changing mainly due to capex and assets’ retirements. In addition, the recovery pace of the RAB may also change. This means that an entity would need to reflect these changes in the accounting for the regulatory asset or regulatory liability.</p>
	<p>The usefulness of the resulting information could be questioned for entities for which there is no direct relationship between regulatory depreciation and accounting depreciation.</p>

Staff analysis—Possible courses of action—continued

Course of Action 3—Confirm the proposals

- A possible course of action could be to confirm the proposals in paragraphs B5–B7 of the Exposure Draft and [Illustrative Examples](#) IE2B and IE2C accompanying the Exposure Draft. Under this course of action an entity would account for regulatory assets and regulatory liabilities arising from differences between the recovery pace of the RAB and assets’ useful lives.
- The following table aims to consider pros and cons of the Course of Action 3:

Pros	Cons
<p>Would result in comparable outcomes for all entities applying the final Standard.</p>	<p>Questions the feasibility and implementation costs of the proposals for entities for which the RAB cannot be linked or reconciled to the fixed asset register used for accounting purposes (pages 17–18).</p>
	<p>Users we have talked to have said they would not find the information that would arise from the accounting of regulatory assets or regulatory liabilities arising from differences between the recovery pace of the RAB and assets’ useful lives to be useful. A few of them said they would not consider these assets or liabilities in their analyses.</p>

Staff analysis—RELATED MATTER

Pre-funding of an asset

- The Exposure Draft includes an illustrative example that has some analogies with the topic covered in this material and therefore it is worth discussing. In particular when the recovery period of the RAB is shorter than the asset's useful lives.
- [Illustrative Example 6A](#) deals with an entity that supplies goods or services to customers. During Year 1 the entity constructs an asset that is available for use from the beginning of Year 2 and has a useful life of 20 years. The cost of the asset is CU1,000. The entity obtained CU60 through rates charged during Year 1 (ie when the asset was not yet available for use). The entity will recover the remainder of the cost (ie CU940) through rates charged over the life of the asset (ie CU47 per year over 20 years).
- The Exposure Draft considers the CU60 received through rates in Year 1, and recognised in revenue in that same period, to be pre-funding that allows the entity to cover part of the cost of the asset during the construction period—ie the pre-funding of CU60 provides part of the total allowed compensation for goods or services to be supplied in the future when the asset is in operation.
- The Exposure Draft proposes to account for a regulatory liability of CU60 in Year 1. That regulatory liability will be fulfilled over the asset's useful life (ie CU3 per year: CU60 of pre-funding divided by the 20-year useful life).
- Entities in regulatory environments such as that described in Case B (page 21) could raise similar concerns to those raised for the accounting for regulatory assets and regulatory liabilities arising from differences between the recovery pace of the RAB and the assets' useful lives (pages 17–18).
- Question 5 on page 30 refers to this fact pattern.

Questions for the Consultative Group:

1. Have we correctly analysed the pros and cons of each course of action?
2. Are there any implementation issues associated with Courses of Action 1 and 2, which we should be aware of?⁽⁵⁾
3. For Course of Action 1:
 - (a) what do you think about the indicators that an entity would consider in relation to Judgement 1 on page 24? Are there any other indicators we should consider?
 - (b) page 24 identifies information entities would provide if they do not account for regulatory assets and regulatory liabilities arising from differences between the recovery pace of the RAB and the assets' useful lives. Do you agree these entities should provide this information? What other information, if any, should these entities provide?
4. Are there other potential courses of action we should consider?
5. Page 29 describes a fact pattern that has similarities to the case when the recovery period of the RAB is shorter than the assets' useful lives. We would like to understand:
 - (a) how common is the fact pattern (ie rates charged during the construction of an asset recover part of the carrying amount of the asset) in your jurisdiction.
 - (b) whether there is information relating to this fact pattern that would be useful for users of the financial statements the IASB should consider requiring in the final Standard.

(5): Implementation issues associated with Course of Action 3 are summarised on pages 17–18.

References

- Response summary from the Request for Information ([AP9 July 2013](#)).
- Glachant J.M., Sagan M., Rious V. and Douguet V. (2013). *Incentives for investments: Comparing EU electricity TSO regulatory schemes*. Florence School of Regulation. Available at: https://cadmus.eui.eu/bitstream/handle/1814/29677/2013_Glachant_et-al_IncentivesForInvestments_dig.pdf
- Economic Consulting Associates. September 2018. Methodologies and parameters used to determine the allowed or target revenue of gas transmission system operators (TSOs). Available at: https://documents.acer.europa.eu/Official_documents/Acts_of_the_Agency/Publication/Consultant%20Report.pdf
- Oxera (2010). Meeting the financeability challenge in energy networks. Available at: https://www.oxera.com/wp-content/uploads/2018/03/Meeting-the-financeability-challenge-in-energy-networks_1.pdf