IFRS Accounting

Staff paper

Agenda reference: 9A

IASB® meeting

Date	**October 2023**
Project	**Rate-regulated Activities**
Topic	**Survey on the direct (no direct) relationship concept—Additional feedback**
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Objective

1. This paper complements Agenda Paper 9B discussed at the September 2023 IASB meeting. It sets out:

   (a) the staff's analysis of additional feedback from the survey on the direct (no direct) relationship concept relating to:

      (i) capitalised borrowing costs;

      (ii) inflation; and

      (iii) other items included in the regulatory capital base; and

   (b) the staff's recommendations on next steps.

Staff recommendations

2. The staff recommend that the final Accounting Standard includes guidance on how an entity accounts for a regulatory asset or regulatory liability arising from regulatory returns on an asset not yet available for use that compensate for capitalised borrowing costs if:

(a) the entity determines its capitalised borrowing costs at a higher level of aggregation than the individual asset level; or

(b) the regulatory returns are determined on a real basis.

Executive summary

3. In September 2023, the IASB discussed feedback from a survey and subsequent outreach on the direct (no direct) relationship concept.[1] As part of the outreach with respondents to the survey and other stakeholders, we also gathered feedback on the IASB's tentative decisions that are based on the direct (no direct) relationship concept (paragraph 8) and that deal with the treatment of the inflation adjustment to the regulatory capital base (paragraph 9).

4. The feedback shows:

   (a) respondents are generally able to implement the IASB's tentative decisions;

   (b) stakeholders from one jurisdiction are concerned about unrecognised regulatory assets in cases of no direct relationship; and

   (c) there are a few areas that may need additional guidance in the final Standard.

Structure of the paper

5. This paper is structured as follows:

   (a) background (paragraphs 6–9);

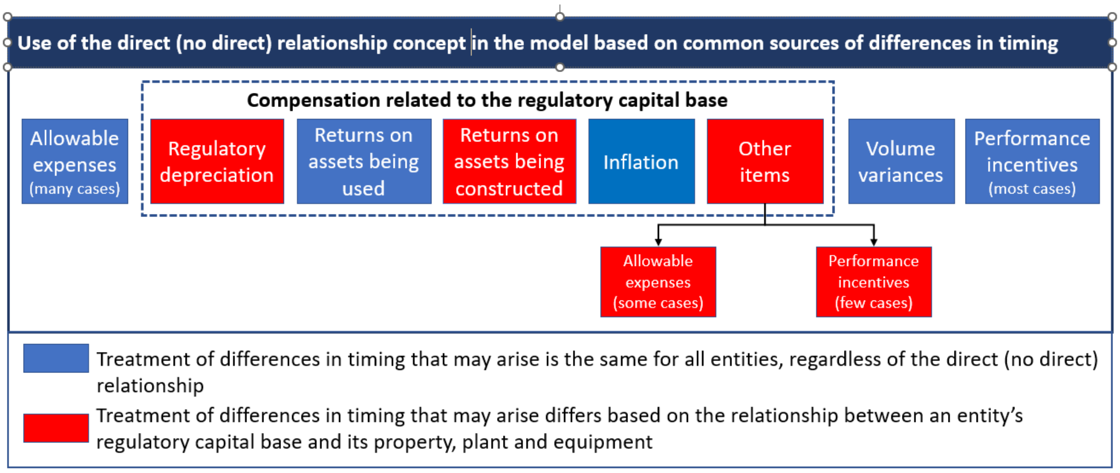
   (b) feedback (paragraphs 10–37); and

   (c) conclusions and next steps (paragraphs 38–39).

[1] Agenda Paper 9B discussed at the September 2023 IASB meeting.

Background

6. When redeliberating the proposals in the Exposure Draft *Regulatory Assets and Regulatory Liabilities* (Exposure Draft), the IASB tentatively decided to base some accounting requirements on whether there is a direct (no direct) relationship between an entity's regulatory capital base and its property, plant and equipment (the direct (no direct) relationship concept). The diagram below provides an overview of the use of the direct (no direct) relationship concept in the model.



7. At its September 2023 meeting, the IASB discussed feedback from a survey and the subsequent outreach on the direct (no direct) relationship concept. The survey gathered input from preparers on the indicators that an entity could use to determine whether there is a direct (no direct) relationship.

8. As part of the subsequent outreach, we gathered feedback from some respondents to the survey and other stakeholders on the tentative decisions in which the IASB used the direct (no direct) relationship concept:[2]

   (a) regulatory returns on an asset not yet available for use when an entity capitalises borrowing costs incurred to construct that asset;[3] and

[2] Agenda Paper 9B of the September 2023 IASB meeting also discussed feedback on the IASB's tentative decision dealing with differences between the regulatory recovery period and the assets' useful lives.

[3] Agenda Paper 9A discussed at the November 2022 IASB meeting.

(b) items that a regulator includes in an entity's regulatory capital base (for example, allowable expenses and performance incentives).[4]

9. We also gathered feedback on the IASB's tentative decision dealing with the inflation adjustment to the regulatory capital base, even though this tentative decision does not depend on the direct (no direct) relationship concept.[5]

Feedback

10. This section analyses the feedback received from the subsequent outreach on the IASB's tentative decisions in paragraphs 8 and 9. The subsequent outreach aimed to identify:

(a) additional information that the IASB has not considered in these tentative decisions;

(b) operational difficulties an entity might have when implementing these tentative decisions; and

(c) additional guidance that could be included in the final Standard.

11. It is structured as follows:

(a) capitalised borrowing costs (paragraphs 12–24);

(b) inflation (paragraphs 25–33); and

(c) other items included in the regulatory capital base (paragraphs 34–37).

Capitalised borrowing costs

12. In November 2022 the IASB tentatively decided that when an entity's regulatory capital base and its property, plant and equipment have a direct relationship and the entity capitalises its borrowing costs:

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4 Agenda Paper 9C discussed at the December 2022 IASB meeting.

5 Agenda Paper 9A discussed at the December 2022 IASB meeting.

(a) if the regulatory agreement provides the entity with both a debt and an equity return on an asset not yet available for use—to require the entity to reflect only those returns in excess of the entity's capitalised borrowing costs in the statement of financial performance during the construction period; and

(b) if the regulatory agreement provides the entity with only a debt return on such an asset—to prohibit the entity from reflecting the return in the statement of financial performance during the construction period.

13. The feedback relates to the following matters:

(a) regulatory returns on assets not yet available for use included in rates charged during construction (paragraphs 14–15);

(b) regulatory returns on assets not yet available for use included in rates charged during operation (paragraphs 16–22); and

(c) regulatory returns on assets not yet available for use consisting of returns on equity (paragraphs 23–24).

Regulatory returns on assets not yet available for use included in rates charged during construction

14. Survey responses suggest that situations when there is a direct relationship and regulatory returns are charged during construction, rather than during operation, may be more common than we thought when the IASB made its tentative decision.

15. In a few regulatory schemes in Europe and Africa, an entity has a direct relationship and receives a *real* regulatory return rate applied to assets not yet available for use that are adjusted for inflation during the construction period. That real regulatory return includes both a debt and an equity return. However, the entity's capitalised borrowing costs are in *nominal* terms. Considering the IASB's tentative decision on capitalised borrowing costs, the entity would need to account for a regulatory liability arising from the part of regulatory returns that provides compensation for the capitalised borrowing costs during the construction period. In this case, we think the entity should determine the regulatory liability arising from the regulatory returns in

real terms by applying a real interest rate to the inflation-adjusted assets not yet available for use. During the operation period, the entity would recognise:

(a) depreciation expense that would include an amount for capitalised borrowing costs in nominal terms; and

(b) an income in nominal terms comprising regulatory depreciation of the inflation adjustment on the regulatory capital base and regulatory income arising from the fulfilment of the regulatory liability determined using capitalised borrowing costs in real terms.

Regulatory returns on assets not yet available for use included in rates charged during operation

16. A few respondents with operations in North America that concluded there is a direct relationship raised concerns about the operational challenges of applying the IASB's tentative decision on capitalised borrowing costs (paragraph 12) at the individual asset level.

17. The regulator provides regulatory returns (both a debt and an equity return) on assets not yet available for use. These entities accumulate the regulatory returns during construction. The regulator allows entities to include these returns in regulated rates charged when individual assets are in operation. When applying the local generally accepted accounting principles, these entities capitalise these regulatory returns as part of the cost of their property, plant and equipment.

18. IAS 23 *Borrowing Costs* specifies that borrowing costs incurred in constructing an asset are capitalised as part of the cost of that asset when specified conditions are met. For the purpose of the financial statements prepared in accordance with IFRS Accounting Standards, these entities remove the regulatory returns on assets not yet available for use and capitalise the amount of borrowing costs applying IAS 23.

19. Applying the IASB's tentative decision, the entities would account for the regulatory returns in excess of the capitalised borrowing costs as a regulatory asset during the

construction period. The entities would recover the regulatory asset during the period in which the assets are in operation.

20. One of the respondents said when applying IAS 23, it determines the capitalised borrowing costs at a higher level of aggregation (for example, at a capital investment project level), rather than at the individual asset level. Because of this, the respondent was concerned about the operational difficulties of tracking, at the individual asset level, the recovery of the regulatory asset related to regulatory returns in excess of the capitalised borrowing costs. The respondent wondered whether the final Standard would provide a relief, for example, by allowing an entity to account for the regulatory asset at the same level of aggregation that the entity has used to determine the capitalised borrowing costs applying IAS 23. The respondent said this would not significantly reduce the usefulness of the information.

21. In addition, this respondent raised concerns about applying the proposed retrospective approach on *transition* at the individual asset level. The respondent asked whether the IASB could consider modified retrospective transition requirements such as those used in IFRS 16 *Leases*.

22. Another respondent said the regulator determines the regulatory returns based on the annual average balances of the assets not yet available for use. Applying the IASB's tentative decision, the entity would need to account for the recovery of the regulatory asset related to regulatory returns in excess of the capitalised borrowing costs during the period in which the assets are in operation. The respondent said it is able to use a reasonable basis to allocate those regulatory returns to individual assets not yet available for use. The respondent said, however, it is able to perform the allocation prospectively but not retrospectively.

Regulatory returns on assets not yet available for use consisting of returns on equity

23. Among European entities that have concluded that there is no direct relationship, some in the electricity transmission sector receive a return on equity on their assets that are being constructed. The regulator provides compensation for borrowing costs

as a separate component within the entity's allowed revenue (that is, borrowing costs is an allowable expense for regulatory purposes).

24. Considering this fact pattern and the IASB's tentative decision, these entities would:

(a) reflect the regulatory equity return on the assets not yet available for use during the construction period. The accounting for this regulatory equity return is not dependant on the direct (no direct) relationship concept.

(b) determine whether a difference in timing arises from the compensation for borrowing costs. That difference in timing will not depend on the direct (no direct) relationship concept. An entity would need to determine the amount of the compensation received in a period that relates to the borrowing costs capitalised as part of the cost of assets not yet available for use. If the entity receives the compensation for capitalised borrowing costs during construction, the entity would account for a regulatory liability for that compensation. The entity would fulfil the regulatory liability when the assets are in operation—that is, when the capitalised borrowing costs are included in the depreciation expense. We think that an entity may be able to allocate the amount of compensation for borrowing costs that relates to the borrowing costs capitalised in a period.

Inflation

25. In December 2022, the IASB tentatively decided that the final Standard specify that an entity is neither required nor permitted to recognise as a regulatory asset the inflation adjustments to the regulatory capital base.[6]

26. Although the IASB's tentative decision on inflation does not depend on the direct (no direct) relationship concept, we have split the feedback on inflation from the survey and subsequent outreach between entities whose regulatory capital base has:

[6] Agenda Paper 9A discussed at the December 2022 IASB meeting.

(a) a direct relationship with their property, plant and equipment (paragraphs 27–29); and

(b) no direct relationship with their property, plant and equipment (paragraphs 30–33).

Direct relationship

27. Survey responses suggest that situations when there is a direct relationship and real regulatory returns are applied to a regulatory capital base that is adjusted by inflation may be more common than we thought when the IASB made its tentative decision.

28. A few respondents operating under service concession arrangements in the electricity and gas sectors in Brazil said entities should account for a regulatory asset arising from the inflation adjustment to the regulatory capital base. If an entity had accounted for such a regulatory asset, the inflation-related regulatory asset would be recovered as part of the regulatory depreciation that the entity includes in regulated rates charged. The entity would need to track the amount of inflation adjustment included in the regulated rates for each reporting period.

29. Based on feedback from the survey and subsequent outreach, there is diversity in how entities track the inflation adjustment made to the regulatory capital base. In some cases, respondents said they track the inflation adjustment at the individual asset level within the regulatory capital base. In those cases, a few respondents said they are able to track the amount of inflation adjustment included in the regulatory depreciation for which they receive compensation through regulated rates. However, a respondent said it would be operationally difficult to track the amount of inflation adjustment included in the regulatory depreciation—and hence, in regulated rates.

No direct relationship

30. At subsequent outreach meetings, a group of regulated entities based in the United Kingdom expressed concerns that the IASB's tentative decision would prohibit them from reflecting the inflation adjustment to the regulatory capital base as a regulatory asset.

31. These respondents are subject to regulatory schemes that use a total expenditures ('totex') approach.[7] According to these respondents, the regulatory capital base is a 'lump-sum' balance and the entire base is adjusted by inflation. We think it would be difficult to reasonably estimate the amount and timing of the future cash flows that will arise from a regulatory asset related to the inflation adjustment. This is because:

    (a) it would be operationally challenging to track the movement of the inflation adjustment to the regulatory capital base. For example, we think these entities would be unable to disaggregate the regulatory depreciation into individual components, and hence, to determine the amount of inflation adjustment included in the regulatory depreciation for a specific period.

    (b) the recovery of the inflation adjustment depends on the future pace of regulatory depreciation and the pace of regulatory depreciation depends on factors that can be difficult to foresee—for example, future financing needs of the entity or future technological changes.

    Consequently, apart from the operational challenges, items (a) and (b) above could result in significant measurement uncertainty of an inflation-related regulatory asset.

32. We understand some of these entities raised the concerns in paragraph 30 because they have inflation-linked debt (bonds and bank borrowings). The high inflation rates in the recent year have resulted in an increase in the inflation-adjusted principal of the debt that these entities recognised as finance expense. However, applying the IASB's tentative decision these entities would recognise the inflation adjustment to their regulatory capital base in revenue over time as the regulatory depreciation is included in regulated rates charged. The IASB's tentative decisions would not change the current accounting treatment for the inflation adjustment. These entities thought the recognition of a regulatory asset for the inflation adjustment could reduce such a

[7] Regulators allocate totex to both slow money (that is, the regulatory capital base) and fast money (that is, the non-capitalised part of totex that an entity is entitled to recover after the regulator treats it as allowable). The percentage of totex allocated to the regulatory capital base typically does not equate to the capex-to-totex ratio. Regulators often allocate a higher percentage of totex to fast money than that represented by the opex-to-totex ratio. In addition, regulators typically change the percentage of totex allocated to the regulatory capital base between regulatory periods for different reasons (for example, an entity's financing needs).

mismatch in profit or loss. However, another entity that has inflation-linked debt did not think recognition of a regulatory asset for the inflation adjustment would provide useful information.

33. Regulatory schemes in other jurisdictions (Germany and Australia) also adjust the regulatory capital base for inflation. Stakeholders in these jurisdictions have not raised similar concerns about the tentative decision made by the IASB on inflation in December 2022. Our understanding is that in these jurisdictions, the use of inflation-linked debt is not common.

Other items included in the regulatory capital base (operating expenses, performance incentives)

34. In December 2022, the IASB tentatively decided that the Standard specify that:[8]

    (a) an entity is required to recognise a regulatory asset or a regulatory liability relating to an allowable expense or performance incentive included in its regulatory capital base when:

        (i) the entity's regulatory capital base and its property, plant and equipment have a direct relationship; and

        (ii) the entity has an enforceable present right (obligation) to add (deduct) the allowable expense or performance incentive to (from) future regulated rates.

    (b) an entity is neither required nor permitted to recognise a regulatory asset or a regulatory liability relating to an allowable expense or performance incentive included in its regulatory capital base when the entity's regulatory capital base and its property, plant and equipment have no direct relationship.

35. At subsequent outreach meetings, a group of regulated entities based in the United Kingdom expressed concerns that the IASB's tentative decision would prohibit them

[8] Agenda Paper 9C discussed at the December 2022 IASB meeting.

from accounting for regulatory assets arising from other items that the regulator may add to the regulatory capital base. This is discussed in paragraphs 36(b) and (d).

36. These entities are subject to regulatory schemes that use a 'totex' approach (paragraph 31). Within the regulatory capital base, described as a lump-sum balance by some respondents, the regulator:

    (a) includes a portion of both capital expenditures and operating expenditures. In some cases, the recovery period of the regulatory capital base is shorter than the assets' useful lives.[9] Applying the IASB's tentative decision, these entities would not account for any regulatory liabilities arising from differences between the regulatory recovery period and the assets' useful lives.[10] Neither would the entity account for any regulatory assets arising from operating expenditure for which the entity has recognised as an expense (paragraph 34(b)). The entities did not raise concerns about unrecognised regulatory assets and regulatory liabilities in such cases.

    (b) may include items other than capital expenditures and operating expenditures that these entities would be unable to account for as a regulatory asset. For example, a major event may occur that reduces an entity's activities significantly (for example, the Covid-19 pandemic). Consequently, a regulator may allow an entity to recover an amount related to lost revenue by adding that amount to the regulatory capital base. Applying the IASB's tentative decision, the entity would not account for as a regulatory asset the lost revenue that the regulator has allowed the entity to recover. At the outreach, the entities said that accounting treatment would not faithfully represent the economics of the regulatory compensation. Moreover, the regulator may not track such an amount separately from other components of the regulatory capital base. Therefore, accounting for a regulatory asset related to that

[9] At its September 2023 meeting, the IASB discussed that in these regulatory schemes, the regulatory recovery period of the regulatory capital base is different from the assets' useful lives (Agenda Paper 9B).

[10] Agenda Paper 9B discussed at the October 2022 IASB meeting and update of decisions tentatively made at that meeting.

amount may give rise to similar challenges as those arising from the accounting for an inflation-related regulatory asset (paragraph 31).

(c) may exclude part of the costs capitalised in the property, plant and equipment that is recovered as fast money (see footnote 7). Consistent with the IASB's tentative decision, we think an entity would not account for a regulatory liability arising from the compensation for these capitalised costs that the entity receives immediately rather than over the useful life of the assets. At the outreach, the entities did not raise concerns about this outcome. In recent years, capital expenditures for some entities have been increasing comparatively more than their operating expenditures. However, the percentage of totex allocated to the regulatory capital base has remained stable. This suggests that for those entities, the related unrecognised regulatory liabilities have been increasing more than the unrecognised regulatory assets arising from operating expenditures recovered as slow money (paragraph (a)).

(d) includes performance incentives. For example, a performance incentive scheme allows addition to (or deduction from) the regulatory capital base a portion of totex overspend (underspend)—that is, a portion of the difference between the actual and estimated totex. We understand such a scheme is common in the water industry. Applying the IASB's tentative decision, the entity would not account for any totex overspend (underspend) as a regulatory asset (regulatory liability). At the outreach, the entities said that accounting treatment would not faithfully represent the economics of the regulatory compensation. According to feedback from the outreach, the overspend (underspend) mainly arises from capital expenditures. We think entities would provide incomplete information about the regulatory compensation if, for example, the entities accounted for regulatory assets arising from totex overspend but not regulatory liabilities arising from the underlying capital expenditures (paragraph (a)). The outreach provided mixed feedback on the significance of performance incentives included in the regulatory capital base.

Performance incentives represent a significant adjustment to the regulatory capital base for some entities but not for some others.

37. We are planning additional meetings with a few entities to obtain a better understanding of the concerns raised. We plan to consider whether disclosures of unrecognised regulatory assets and regulatory liabilities may help to address these concerns.

Conclusions and next steps

38. Table 1 summarises the staff's conclusions from each of the individual sub-sections within the feedback section of the paper and any necessary next steps.

Table 1—Summary of conclusions and next steps

Feedback section	Conclusions	Next steps
Capitalised borrowing costs (paragraphs 12–24)	For entities that concluded there is a direct relationship, we think those entities would be generally able to operationalise the IASB's tentative decision in November 2022. Nevertheless, we think it would be helpful to consider: (a) allowing an entity to accounting for a difference in timing at the same level of aggregation that the entity has used to determine the capitalised borrowing costs applying IAS 23 (paragraph 20). This may be at a level of aggregation higher than the individual asset level. (b) providing specific reliefs for the transition to the final Standard (paragraphs 21–22).	1. We have not identified a need for the IASB to reconsider its tentative decision. 2. However, we think the IASB should consider the feedback from the survey to ensure that the costs of applying the final Standard would not outweigh the benefits when: (a) drafting the requirements dealing with differences in timing related to capitalised borrowing costs (item (a) in second column); and (b) redeliberating the proposed transition requirements (item (b) in second column) at a future meeting.

Table 1—Summary of conclusions and next steps		
Feedback section	**Conclusions**	**Next steps**
	The survey also provided information that could be included in the final Standard. For example, in some regulatory schemes: (c) an entity receives a real regulatory return rate applied to assets not yet available for use that are adjusted for inflation during construction (paragraph 15). In those cases, we think the entity should determine the regulatory liability arising from the real regulatory returns in real terms by applying a real interest rate to the inflation-adjusted assets not yet available for use. (d) the regulator provides a return on equity on assets not yet available for use and compensates entities for borrowing costs separately (paragraphs 23–24). In those cases, entities would:	3. We think the final Standard could include guidance on item (c) in second column.

Table 1—Summary of conclusions and next steps		
Feedback section	**Conclusions**	**Next steps**
	(i) reflect the regulatory equity return during the construction period; and (ii) determine whether a difference in timing arises from the compensation for borrowing costs. The direct (no direct) relationship determination has no effect on items (i) and (ii) above. We think the Exposure Draft and the IASB's tentative decisions are clear on this matter.	
Inflation (paragraphs 25–33)	For entities that have concluded there is a direct relationship, accounting for a regulatory asset related to the inflation adjustment to the regulatory capital base seems to be operationally feasible for some entities but operationally costly for some other entities.	4. We are planning additional meetings with a few entities in the United Kingdom to obtain a better understanding of the concerns raised. We have not observed a need for the IASB to reconsider its tentative decision on inflation at this stage.

Table 1—Summary of conclusions and next steps		
Feedback section	**Conclusions**	**Next steps**
	Entities in the United Kingdom that are subject to a totex approach said the IASB's tentative decision would prohibit them from accounting for the inflation adjustment as a regulatory asset. The evidence gathered from the survey suggests that these entities would be unable to track the inflation-related regulatory asset. Regulatory schemes in other jurisdictions (Germany and Australia) also adjust the regulatory capital base for inflation. Stakeholders in these jurisdictions have not raised concerns about the IASB's tentative decision.	
Other items included in the regulatory capital base	Feedback from an outreach carried out with a group of regulated entities in the United Kingdom questioned the outcome of the IASB's tentative decision in December 2022. These entities said that a regulator may add to the regulatory	5. We are aware that some regulators had authorised the recovery of significant amounts through entities' regulatory capital base that would have no direct relationship. In those cases, these entities would be

Table 1—Summary of conclusions and next steps		
Feedback section	**Conclusions**	**Next steps**
(paragraphs 34–37)	capital base items other than operating expenditures (for example, lost revenues due to the Covid 19 pandemic) and performance incentives related to totex that these entities would not be able to account for as a regulatory asset.	unable to account for related regulatory assets applying the IASB's tentative decision in December 2022. Apart from: (a) items within totex that may be of an operational nature; (b) inflation adjustments; (c) some performance incentives; and (d) some costs (or lost revenues) arising from major events such as a pandemic we are not aware of other items that are significant and are added to the regulatory capital base. We understand the entities are currently assessing the materiality of these items.

Table 1—Summary of conclusions and next steps		
Feedback section	**Conclusions**	**Next steps**
		6. The IASB's tentative decision in December 2022 would also result in unrecognised regulatory liabilities arising from regulatory compensation these entities receive on their regulatory capital base. Examples include some costs capitalised in the property, plant and equipment that are recovered as fast money and differences in timing that arise when the regulatory recovery period is shorter than the assets' useful lives. 7. We are planning additional meetings with a few entities to obtain a better understanding of the concerns raised. We plan to consider whether disclosures for unrecognised regulatory assets and unrecognised regulatory liabilities may help to address these concerns.

Table 1—Summary of conclusions and next steps		
Feedback section	**Conclusions**	**Next steps**
		We will discuss these matters, if needed, at a future meeting.

39. Based on the staff conclusions in Table 1, we recommend that the final Accounting Standard includes guidance on how an entity accounts for a regulatory asset or regulatory liability arising from regulatory returns on an asset not yet available for use that compensate for capitalised borrowing costs if:

    (a) the entity determines the capitalised borrowing costs at a higher level of aggregation than the individual asset level (paragraph 2(a) in Table 1); or

    (b) the regulatory returns are determined on a real basis (paragraph 3 in Table 1).

Questions for the IASB
1. Does the IASB have any questions or comments on the staff analysis of the feedback from the survey in paragraphs 12–38 of the paper?
2. Does the IASB agree with the staff recommendation in paragraph 39?