IFRS® Accounting

# Staff paper

Agenda reference: 9C

**IASB® meeting**

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| Date | **September 2023** |
| Project | **Rate-regulated Activities** |
| Topic | **The direct (no direct) relationship concept—*Survey and background information document*** |
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## Objective

1. This paper includes the survey used to gather input on the direct (no direct) relationship concept (pages 2–5) and the background information document accompanying the survey (pages 6–16).

2. The survey and the background information document are for information only. We are not asking the IASB to make decisions on this paper.

# The direct (no direct) relationship concept

### *The Survey*

1. This survey asks questions about the features of your regulatory scheme and regulatory capital base (sections B–D). Based on your answers to these questions, we would like you to assess whether your regulatory capital base has a direct (no direct) relationship with your property, plant and equipment (section E).

2. Please send your answers directly to Siok Mun Leong (smleong@ifrs.org) and Mariela Isern (misern@ifrs.org) by [date]. Thank you very much for completing this survey.

| **Description** | **Response** |
|---|---|
| **A. General** | |
| 1. Please specify:<br>(a) name of the entity; and<br>(b) industry and jurisdiction where the entity operates.[1] | |
| **B. Componentisation of the regulatory capital base (see paragraphs A2(a) and A4(a) in Appendix A to Background information document)** | |
| 2. Are the items included in your regulatory capital base the same as those included in your property, plant and equipment? If not, what are the main differences? | |
| 3. Does the regulator require a reconciliation between your regulatory capital base and your property, plant and equipment? If yes, | |

[1] If the entity is subject to different regulatory schemes (for example, because it operates in more than one industry or jurisdiction), please provide your answers separately for each of those regulatory schemes.

| Description | Response |
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| what is the level of aggregation of the reconciliation (for example, at an individual asset level)? | |
| 4. This question applies if your regulator does not require a reconciliation between your regulatory capital base and your property, plant and equipment or if your regulator requires only a reconciliation at a high level of aggregation. In this case, are you able to track any differences between your regulatory capital base and your property, plant and equipment at an individual asset level? Why or why not? | |
| **C. Measurement of the regulatory capital base (see paragraphs A2(b) and A4(b) in Appendix A to Background information document)** | |
| 5. How does the regulator measure the regulatory capital base? If there are differences between the measurement of your regulatory capital base and the measurement of your property, plant and equipment, are you able to track those differences and at what level of granularity can you track those differences (for example, at an individual asset level)? | |
| **D. Regulatory recovery period of the regulatory capital base (see paragraphs A2(c) and A4(c) in Appendix A to Background information document)** | |
| 6. Is the regulatory recovery period of the assets included in the regulatory capital base closely aligned to the assets' useful lives? If there are differences between the regulatory and accounting depreciation rates, are you able to | |

| Description | Response |
|---|---|
| track those differences and at what level of granularity can you track those differences (for example, at an individual asset level)? | |
| 7. If the regulatory recovery period of the assets included in the regulatory capital base is not closely aligned to the assets' useful lives, what factors other than the assets' useful lives does the regulator consider when determining the regulatory recovery period? | |
| **E. Self-assessment** | |
| 8. Considering the information in the 'Background information' paper and the features of your regulatory capital base (sections B–D), are you able to conclude that your regulatory capital base has a direct or no direct relationship with your property, plant and equipment? If not, why not. | |
| 9. If you are able to conclude on question 8, which features of the regulatory capital base: (a) have you considered? (b) have you given more weight and why? (c) are particularly subjective and why? | |
| 10. If you are unable to conclude on question 8, what additional guidance would you require? Are there additional features you would consider? If yes, what are these additional features and why would you consider them? Considering these features, would you conclude that the regulatory capital base has | |

| Description | Response |
|---|---|
| a direct or no direct relationship with your property, plant and equipment? | |
| **F. Others** | |
| 11. Please provide any other comments that may help the IASB to develop guidance on the direct (no direct) relationship assessment in the final Standard. | |
| 12. Would you be available for a follow-up discussion of your answers with the IASB staff? If yes, please provide your contact details. Thank you. | |

## Background information

### *Objective*

1. This document provides background information to help you complete the survey. The survey seeks input that will be used to develop application guidance that will form part of the final accounting Standard *Regulatory Assets and Regulatory Liabilities* (final Standard).

2. In particular, the survey asks questions about the features of your regulatory scheme and regulatory capital base. Those questions aim to identify features that will help an entity determine whether there is a direct (no direct) relationship between its regulatory capital base and its property, plant and equipment (the direct (no direct) relationship concept).

### *Background*

3. The objective of the Exposure Draft *Regulatory Assets and Regulatory Liabilities* (Exposure Draft) is to provide relevant information that faithfully represents how regulatory assets, regulatory liabilities, regulatory income and regulatory expense affect an entity's financial position, financial performance and future cash flows.

4. Regulatory assets and regulatory liabilities are enforceable present rights and enforceable present obligations arising from differences in timing. Differences in timing arise when part or all of the total allowed compensation for goods or services supplied in one period is included in the regulated rates charged to customers in a different period.[2]

5. In its redeliberations, the IASB discussed situations in which an entity's regulatory capital base has a direct (no direct) relationship with its property, plant and

[2] The Exposure Draft defines 'total allowed compensation (for goods or services)' as follows: '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.'

equipment. The direct (no direct) relationship concept was considered in the IASB's tentative decisions on the following topics:

(a) the accounting for regulatory assets and regulatory liabilities arising from differences between the regulatory recovery period and the assets' useful lives;

(b) the accounting for regulatory returns on an asset not yet available for use when an entity capitalises borrowing costs to construct that asset; and

(c) the accounting for allowable expenses or performance incentives included in an entity's regulatory capital base.

6. Appendix B summarises the tentative decisions in which the IASB has used the direct (no direct) relationship concept. Agenda Paper 9D discussed at the December 2022 IASB meeting provides an overview of the use of this concept in the IASB's redeliberation of the proposed model.

### *The direct (no direct) relationship concept*

7. In summary, when an entity's regulatory capital base has a direct relationship with its property, plant and equipment, the regulatory capital base and the property, plant and equipment are:

(a) the same; or

(b) sufficiently similar for the entity to be able to reconcile any differences between the regulatory capital base and the property, plant and equipment.

8. The paragraphs below provide a summary of the main features of regulatory schemes that would lead to an entity’s regulatory capital base having a direct (no direct) relationship with its property, plant and equipment. Appendix A provides further information about these features.

*A direct relationship between an entity's regulatory capital base and its property, plant and equipment*

9. The IASB discussed features that would typically be present when an entity's regulatory capital base has a direct relationship with its property, plant and equipment:

   (a) the regulatory requirements affecting an entity's regulatory capital base are generally closely aligned with the accounting requirements relating to property, plant and equipment. This enables the entity to map items included in the regulatory capital base to items of property, plant and equipment and to track any differences-at an individual asset level in some cases.

   (b) regulators generally require the entity to reconcile the regulatory capital base with its property, plant and equipment.

   (c) the depreciation expense is a key input to the determination of the regulatory depreciation, with depreciation rates used for regulatory and accounting purposes being broadly aligned and any differences being tracked.

*No direct relationship between an entity's regulatory capital base and its property, plant and equipment*

10. The IASB discussed features that would typically be present when an entity's regulatory capital base has no direct relationship with its property, plant and equipment:

    (a) the regulatory and accounting requirements are generally substantially different. This makes it difficult for the entity to map items included in the regulatory capital base to items of property, plant and equipment. For example, the regulator determines the regulatory capital base considering inputs that are unrelated to items of property, plant and equipment.

    (b) the entity is unable to track differences between the regulatory and accounting requirements at an individual asset level or the tracking would be complex and costly.

(c) the regulator determines the depreciation of the regulatory capital base considering also factors other than the useful lives of the items of property, plant and equipment.

## Appendix A— Examples of features of regulatory schemes that lead to an entity’s regulatory capital base and its property, plant and equipment having a direct (no direct) relationship

A1. When an entity's regulatory capital base has a **direct relationship** with its property, plant and equipment, the regulatory requirements affecting the regulatory capital base are generally closely aligned with the accounting requirements relating to property, plant and equipment (paragraph 9(a)).

A2. Those regulatory and accounting requirements may be closely aligned when:

(a) componentisation—the items recorded and the level of aggregation at which they are recorded for regulatory purposes are largely aligned with those for accounting purposes. For example, the entity is able to match items included in the regulatory capital base to items of property, plant and equipment. In cases when the regulator adds to the entity’s regulatory capital base an item that the entity has expensed because of different capitalisation policies, the entity is able to track that item of expense over the period it is recovered through regulated rates. In addition, when there are adjustments to the regulatory capital base such as efficiency adjustments and true-ups for differences between forecasted and actual amounts, those adjustments can be tracked at an individual asset level.

(b) measurement basis—the measurement basis used for regulatory purposes is largely aligned with that used for accounting purposes. For example, the entity measures the regulatory capital base and its property, plant and equipment at cost. When there are any adjustments to the measurement of specific items in the regulatory capital base or the property, plant and equipment, those adjustments can be tracked at an individual asset level.

(c) depreciation rate—the regulatory and accounting depreciation rates are largely aligned. For example, the regulator uses the assets’ useful lives as the basis for determining the regulatory depreciation rate for assets in the regulatory capital base, or the accounting depreciation expense as a direct input in calculating regulated rates. In addition, the timing of when depreciation commences for regulatory and accounting purposes is largely aligned.

A3. When an entity's regulatory capital base has **no direct relationship** with its property, plant and equipment, the regulatory requirements affecting the regulatory capital base are generally substantially different from the accounting requirements relating to property, plant and equipment (paragraph 10(a)).

A4. Those regulatory and accounting requirements may be substantially different in various aspects. Differences in requirements that may cause tracking at an individual asset level to be complex and costly include:

(a) componentisation—the items recorded and the level of aggregation in which they are recorded for regulatory purposes are significantly different from those for accounting purposes. For example:

(i) the regulatory capital base includes items other than items of property, plant and equipment and the entity is unable to track the movements of these other items. For example, an entity’s regulatory capital base may include allowable expenses, performance incentives and other movements in working capital. In addition, in some cases, an entity’s regulatory capital base is determined based on estimated ratios of capital and operating expenditures applied to an entity’s total capital and operating expenditures.

(ii) the regulatory capital base either does not include any asset class or includes asset classes that are significantly different from those of property, plant and equipment.

(iii) the regulatory capital base is adjusted for capital expenditure that cannot be mapped to the additions to the property, plant and equipment (for example, in lump sum amounts).

(iv) the regulatory capital base is adjusted for disposals based on the amount of sales proceeds, or in some cases, is not adjusted for disposals.

(v) other adjustments to the regulatory capital base, such as efficiency adjustments and true-ups for differences between forecasted and actual amounts, are made in lump sum amounts.

(b) measurement basis—the regulatory capital base is measured using a measurement basis that is different from that used for property, plant and equipment. In some cases, the initial amount of the regulatory capital base may have been determined on a basis different from the carrying amount of property, plant and equipment (for example, the entity's market value). In some other cases, the regulatory capital base may be adjusted by inflation. Those measurement differences or adjustments often cannot be tracked at an individual asset level.

(c) depreciation rate—the depreciation rates and when depreciation commences for regulatory purposes are significantly different from those for accounting purposes. For example:

(i) the recovery period of the regulatory capital base may be determined as a blended rate based on the average economic lives of the assets in each asset class as a starting point. That blended rate is adjusted to achieve various regulatory objectives and changes over time. For example, the regulator seeks to achieve regulatory objectives by considering factors such as:

- the financing of the entity—that is, an entity's financing needs and the financing available to the entity (for example, issuance of bonds with specific durations);
- uncertainty about the future role of specific industries (for example, replacement by renewable energy sources) or technologies (for example, replacement by smart meters); and
- intergenerational equity for customers.

(ii) the regulatory capital base includes assets under construction that are included in the determination of regulatory depreciation. Regulatory depreciation of assets under construction commences before those assets are depreciated for accounting purposes. The entity is not required to track which part of the depreciation of the regulatory capital base corresponds to assets under construction or to assets in operation.

(iii) the regulatory capital base is subject to capitalisation policies that are largely different from those for accounting purposes, resulting in significant differences in when depreciation commences for regulatory and accounting purposes.

## Appendix B— Summary of the IASB's tentative decisions that use the direct (no direct) relationship concept

B1. The IASB has used the direct (no direct) relationship concept in its tentative decisions dealing with:

(a) regulatory assets and regulatory liabilities arising from differences between the regulatory recovery period and the assets' useful lives[3] (paragraph B2);

(b) the accounting for regulatory returns on an asset not yet available for use when an entity capitalises borrowing costs to construct that asset[4] (paragraph B3); and

(c) the accounting for allowable expenses or performance incentives included in an entity's regulatory capital base[5] (paragraph B4).

### *Regulatory assets and regulatory liabilities arising from differences between the regulatory recovery period and the assets' useful lives*

B2. The IASB tentatively decided that the final Standard:

(a) provide guidance to help an entity determine whether its regulatory capital base and its property, plant and equipment have a direct relationship;

(b) retain the proposals for an entity to account for regulatory assets or regulatory liabilities arising from differences between the regulatory recovery period and the assets' useful lives if the entity has concluded that its regulatory capital base and its property, plant and equipment have a direct relationship; and

(c) require an entity that has concluded that its regulatory capital base and its property, plant and equipment have no direct relationship to provide disclosures to enable users of financial statements to understand the reasons for its conclusion.

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

[4] Agenda Paper 9A and 9C discussed by the IASB at its November 2022 meeting and update of decisions tentatively made at that meeting.

[5] Agenda Paper 9C discussed by the IASB at its December 2022 meeting and update of decisions tentatively made at that meeting.

### *Accounting for regulatory returns on an asset not yet available for use when an entity capitalises borrowing costs to construct that asset*

B3. The IASB tentatively decided that:

(a) when an entity's regulatory capital base and its property, plant and equipment have a direct relationship and the entity capitalises its borrowing costs:

(i) if the regulatory agreement provides the entity with both a debt and an equity return on an asset not yet available for use—the entity is required 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

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

(b) when an entity's regulatory capital base and its property, plant and equipment have no direct relationship, the entity would reflect all regulatory returns on an asset not yet available for use in profit or loss during the construction period of the asset.

### *Accounting for allowable expenses or performance incentives included in an entity's regulatory capital base*

B4. The IASB tentatively decided that the final Standard specify that:

(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.