Staff paper

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IASB meeting

Date	**December 2022**
Project	**Rate-regulated Activities**
Topic	**Other items included in the regulatory capital base**
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Objective

1. This paper sets out staff analysis and recommendations on the proposals in the Exposure Draft *Regulatory Assets and Regulatory Liabilities* (Exposure Draft) for the accounting for allowable expenses or performance incentives included in an entity's regulatory capital base.

Staff recommendations

2. We recommend the final Accounting Standard specify that:
   (a) an entity shall recognise a regulatory asset (regulatory liability) relating to an allowable expense or performance incentive included in its regulatory capital base when:
      (i) there is a direct relationship between the entity's regulatory capital base and its property, plant and equipment; 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 shall not recognise a regulatory asset (regulatory liability) relating to an allowable expense or performance incentive included in its regulatory capital base when there is no direct relationship between the entity's regulatory capital base and its property, plant and equipment.

Structure of the paper

3. This paper is structured as follows:
   (a) proposals in the Exposure Draft (paragraphs 5–8);
   (b) feedback received (paragraph 9);
   (c) staff analysis (paragraphs 10–24); and
   (d) conclusion (paragraph 25).
4. Agenda Paper 9D discusses the use of the direct relationship concept in the model. That paper provides context for the topic dealt with in this paper.

Proposals in the Exposure Draft

5. The Exposure Draft defines allowable expense as:

> An expense, as defined in IFRS Standards, that a regulatory agreement entitles an entity to recover by adding an amount in determining a regulated rate.

6. Paragraph B4 of the Exposure Draft says that:

> If an expense is allowable under the terms of a regulatory agreement, that fact establishes that the expense relates to the supply of goods or services in some period. In applying this [draft] Standard, an entity shall treat that allowable expense as relating to the supply of goods or services in the period when the entity recognises the expense applying IFRS Standards. Thus, the amount that recovers that allowable expense forms part of total allowed compensation for goods or services supplied in that period. […]

7. Illustrative Example 7A.6 accompanying the Exposure Draft illustrates how an entity would apply the model when a regulator treats an item of expense (for example, overheads) as an addition to the regulatory capital base and gives the entity the right to recover it through the regulated rates to be charged to customers in the future. Illustrative Example 7A.6 states:

> **Fact pattern**
>
> An entity recognises an expense in the current period by applying IFRS Standards. The regulatory agreement treats that expense as an addition to the regulatory capital base and gives the entity the right to recover it through the regulated rates to be charged to customers in future periods.
>
> **Analysis**
>
> The amount that recovers the expense that the entity recognised in the current period is part of total allowed compensation for goods or services supplied in the current period. Because the regulatory agreement requires the entity to add this expense to the regulatory capital base, this part of total allowed compensation for goods or services already supplied will be included in revenue in the future.
>
> The entity recognises as a regulatory asset its right to add the amount of this part (that is, the amount of the expense added to the regulatory capital base) in determining the regulated rates to be charged to customers in future periods.

8. Paragraphs B16–B20 of the Exposure Draft propose that amounts relating to a performance incentive form part of or reduce the total allowed compensation for goods or services supplied in the period in which an entity's performance gives rise to the incentive.

Feedback received

9. A preparer and a few standard-setters in Europe said the final Standard should provide further clarity about the required accounting when components of total allowed compensation are included in the regulatory capital base. For example, allowable expenses or performance incentives (for example, bonuses) may be recovered by being added to an entity's regulatory capital base. According to these respondents, it is unclear whether such items should be carved out from the regulatory capital base and be treated as separate regulatory assets.

Staff analysis

10. The paragraphs that follow aim to address whether:

    (a) an allowable expense added to the regulatory capital base would give rise to a regulatory asset that an entity should be required to recognise.

    (b) a performance incentive added to (deducted from) an entity's regulatory capital base would give rise to a regulatory asset (regulatory liability) that an entity should be required to recognise.

11. We think those questions could be addressed by considering whether:

    (a) the regulatory asset or regulatory liability definition would be met (paragraphs 12–17); and

    (b) the costs of recognising the regulatory asset or regulatory liability would outweigh the benefits (paragraphs 18–24).

Meeting the definition of regulatory asset or regulatory liability

12. We have learned that:

    (a) regulators' capitalisation policies differ from those of entities—for example, an entity may expense an item whereas the regulator may require the entity to add that item to its regulatory capital base so that the entity recovers the item in future regulated rates.

    (b) some regulators require entities to add (or deduct) performance incentives to (from) the regulatory capital base. In such cases, the performance incentive is recovered (fulfilled) as the regulatory capital base is depreciated—that is, over time.

13. The question of whether an allowable expense or a performance incentive added to (deducted from) an entity's regulatory capital base would give rise to a regulatory asset (regulatory liability) is similar to whether an inflation adjustment to the regulatory capital base would give rise to a regulatory asset (Agenda Paper 9A). When analysing this question in Agenda Paper 9A, we considered whether an

entity would have an enforceable present right to add the inflation adjustment to future regulated rates and whether that adjustment represents part of the entity's total allowed compensation for goods or services already supplied. This paper carries out the same analysis for an allowable expense or performance incentive that a regulator includes in an entity's regulatory capital base.

14. Similar to an inflation adjustment to the regulatory capital base, an entity needs to consider the legal and regulatory framework in which it operates when deciding whether it has an enforceable present right (obligation) to recover (to fulfil) an allowable expense or performance incentive that is added to (deducted from) its regulatory capital base (see paragraphs 24–30 of Agenda Paper 9A).

15. When considering whether an allowable expense that is included in the regulatory capital base represents total allowed compensation for goods or services already supplied, the entity would apply the proposals for allowable expense (paragraphs B3–B9 of the Exposure Draft). Applying these paragraphs, compensation for an allowable expense forms part of the total allowed compensation for the goods or services supplied in the period the entity recognises the allowable expense.

16. Similarly, when considering whether an amount relating to a performance incentive that is included in the regulatory capital base represents part of the entity's total allowed compensation for goods or services already supplied, the entity would apply the proposals for performance incentives (paragraphs B16–B20 of the Exposure Draft). Applying these paragraphs, the performance incentive would form part of the total allowed compensation for goods or services supplied in the period in which the performance occurs.

17. We think that an allowable expense or a performance incentive added to (deducted from) the regulatory capital base would give rise to a regulatory asset (regulatory liability) if an entity has an enforceable present right (obligation) to add these amounts to (deduct these amounts from) regulated rates charged in the future. This is because that allowable expense or performance incentive forms part of the total allowed compensation for goods or services already supplied.

Assessing the costs and benefits of recognising the regulatory asset (regulatory liability)

18. The paragraphs that follow analyse whether the costs of recognising a regulatory asset (regulatory liability) relating to an allowable expense or performance incentive added to the regulatory capital base would outweigh the benefits.

19. For an entity to recognise a regulatory asset (regulatory liability) arising from an allowable expense or performance incentive added to the regulatory capital base, the entity would need to be able to identify and track the movement of these items within the regulatory capital base. The entity would also need to be able to estimate the amount and timing of future cash flows arising from that regulatory asset (regulatory liability).

20. In schemes where an entity's regulatory capital base has a direct relationship with its property, plant and equipment, the regulatory and accounting requirements are closely aligned. In addition, differences between the regulatory capital base and the entity's property, plant and equipment are generally required to be tracked.[1] Our understanding is that in these schemes:

    (a) it is common that regulators include items of allowable expense in entities' regulatory capital base. However, it would be uncommon that regulators include performance incentives in the entities' regulatory capital base.

    (b) it is feasible for an entity to track allowable expenses or performance incentives and follow up the corresponding recovery (fulfilment) through regulated rates charged.

21. For entities subject to schemes of this type, we think that accounting for a regulatory asset (regulatory liability) arising from an allowable expense or performance incentive included in the regulatory capital base would result in costs similar to those for any other regulatory asset (regulatory liability). Consequently, we think that the benefits of recognising these regulatory assets (regulatory liabilities) would outweigh the costs.

22. In some other regulatory schemes, the link between an entity's regulatory capital base and its property, plant and equipment is less direct. Our understanding is that in these schemes:

    (a) the regulatory capital base may include items of expense. In those schemes, entities do not reconcile their regulatory capital base with their fixed asset register and differences, which will include items of expense, are not tracked.

    (b) some regulators include performance incentives in the regulatory capital base. However, our understanding is that this may not be very common and when performance incentives are included in the regulatory capital base they generally relate to bonuses and are not significant. This is because regulators would generally prefer penalties to be deducted from regulated rates charged to customers in the next period(s) rather than over time through the depreciation of the regulatory capital base.

23. In these schemes, for reasons similar to those described for an inflation adjustment to the regulatory capital base (paragraphs 41–42 of Agenda Paper 9A), we think it would be difficult and costly for entities to track the movement of individual items of allowable expense or performance incentives included in the regulatory capital base. Consequently, we think the costs of recognising regulatory assets or regulatory liabilities in such cases would outweigh the benefits. For this reason, we recommend that entities subject to schemes where there is no direct relationship between the regulatory capital base and the entities' property plant and equipment should not recognise regulatory

[1] Agenda Paper 9B of October 2022 and Agenda Paper 9A of November 2022 IASB meetings discuss the features of schemes that lead to entities' regulatory capital base having a direct (no direct) relationship with their property, plant and equipment.

assets (regulatory liabilities) arising from allowable expenses or performance incentives included in their regulatory capital base.

24. Paragraph 5.11 of the Conceptual Framework for Financial Reporting (*Conceptual Framework*) states that entities may need to disclose information about recognised and unrecognised assets and liabilities in the notes. The *Conceptual Framework* states that it is important to consider how to make such information sufficiently visible to compensate for the item's absence from the structured summary provided by the statement of financial position and the statement(s) of financial performance. We plan to discuss disclosures with the IASB at a future meeting.

Conclusion

25. We recommend the final Accounting Standard specify that:

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

      (i) there is a direct relationship between the entity's regulatory capital base and its property, plant and equipment; 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 shall not recognise a regulatory asset (regulatory liability) relating to an allowable expense or performance incentive included in its regulatory capital base when there is no direct relationship between the entity's regulatory capital base and its property, plant and equipment.

Question for the IASB

1. Does the IASB agree the final Accounting Standard specify that:

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

      (i) there is a direct relationship between the entity's regulatory capital base and its property, plant and equipment; 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 shall not recognise a regulatory asset (regulatory liability) relating to an allowable expense or performance incentive included in its regulatory capital base when there is no direct relationship between the entity's regulatory capital base and its property, plant and equipment (paragraph 25)?