Rate-regulated Activities - Scope and total allowed compensation
Issues Paper

Objective

1 The purpose of this session is to:

(a) provide an update on the IASB redeliberation of the Exposure Draft ED/2021/1 *Regulatory Assets and Regulatory Liabilities* ('the ED'); and

(b) in preparation for the September IASB ASAF meeting, seek EFRAG FR TEG and EFRAG CFSS views on the IASB's tentative decisions taken in May and July 2022 on the proposals related to scope and total allowed compensation.

Background information

2 On 28 January 2021, the IASB published the ED with a comment period of 180 days and a comment deadline of 30 July 2021. EFRAG published its final comment letter on the ED on 10 September 2021 and a Feedback Statement in October 2021.

3 In October and November 2021, the IASB discussed the feedback received on its ED. Based on this feedback, certain topics were identified as being of significant concern, including scope, total allowed compensation, and discount rate.

4 In February 2022, the IASB started redeliberation of the proposals related to these topics. Further topics still to be redeliberated are included in Appendix 1 to this paper accordingly.

IASB's May tentative decisions on Scope

5 In May 2022, the IASB discussed stakeholders' concerns related to difficulties to determine whether a regulatory agreement is within the scope of the ED because of a lack of clarity about how to interpret the term 'customers' in the definition of 'regulatory agreement' and 'regulated rate' in certain situations (e.g. the regulated rate being charged to customers indirectly through another party; recovery or reversal of differences in timing to different groups of customers).

6 To address these concerns, the IASB tentatively decided to clarify that for a regulatory asset or a regulatory liability to arise, it is necessary that differences in timing originate from, and reverse through, amounts included in the regulated rates that an entity accounts for as revenue in accordance with IFRS 15 *Revenue from Contracts with Customers*, even in cases when:

(a) an entity charges the regulated rates to its customers indirectly through another party;

(b) the origination and reversal of differences in timing occur in different revenue streams through regulated rates charged to different groups of customers.

7 As a result, the IASB's tentative decision would imply that the term 'customers' in the ED should be understood as defined in IFRS 15.

8 Additionally, the IASB clarified the interaction between the scope of the proposed Standard and IFRS 9 *Financial Instruments*. Many respondents to the consultation expressed concerns that the proposed scope might be broader than intended and capture financial instruments within the scope of IFRS 9 that might give rise to regulatory assets and regulatory liabilities. As a result, the IASB conducted targeted outreach to gather further evidence about the existence of such financial instruments and how often these situations could happen. The outreach did not identify any examples of such situations and consequently, the IASB tentatively decided not to exclude from the scope of the proposed Standard regulatory assets or regulatory liabilities related to financial instruments within the scope of IFRS 9.

9 Furthermore, the IASB decided to explain in the Basis for Conclusions on the proposed Standard that the regulation of interest rates is typically limited to setting a cap or floor on interest rates. Therefore, this type of regulation is not expected to give rise to the differences in timing that result in the recognition of regulatory assets and regulatory liabilities.

IASB's July tentative decisions on Total allowed compensation

Components of total allowed compensation

10 In July 2022, the IASB discussed feedback about whether the proposed components of total allowed compensation appropriately reflect the economics of incentive-based schemes.

11 Paragraph B2 of the ED informs that total allowed compensation comprises: (a) amounts that recover allowable expenses minus chargeable income; (b) target profit including regulatory returns; and (c) regulatory interest income and regulatory interest expense.

12 Several respondents (including feedback from the IASB's Consultative Group on Rate-regulated Activities) expressed concerns that the proposed definition will fit well with the features of cost-based schemes[1] but does not work well with incentive-based schemes. The reasons given were as follows:

(a) Incentive-based schemes may give entities an 'allowed revenue' amount as well as compensation that entitles an entity to, for example, pass demand risk to customers or recover some specific costs;

(b) the proposals appear to assume all components of the total allowed compensation proposed in paragraph B2 of the ED (see paragraph 11) would be present in all regulatory agreements – however, this is not always the case for incentive-based schemes; and

(c) some regulatory agreements may include components that are not included in paragraph B2 of the ED (for example, some regulatory agreements allow entities to recover volume variances in future periods so that entities are able to recover their allowed revenue. These volume variances however bear no relation to allowable expenses or target profit, consequently, according to these respondents, it is not clear how the proposals would treat these regulatory agreements).

[1] Cost-based schemes aim to entitle entities to recover their costs and obtain a return on their investments.

13 To address the concerns noted above, the **IASB tentatively decided** that in the final Standard, the application guidance focus on:

(a) helping entities to identify differences in timing instead of specifying the components of total allowed compensation; and

(b) the most common differences in timing that could arise from various types of regulatory schemes

Regulatory returns on an asset not yet available for use

14 In July 2022, the IASB discussed feedback on the proposed treatment of regulatory returns on an asset not yet available for use.

15 On the basis that the IASB agreed with the IASB staff recommendation to amend the proposed treatment of those regulatory returns, the IASB staff also recommended analysing further whether an entity's capitalised borrowing costs should affect the amount of regulatory returns reflected in profit or loss during the construction period.

16 The feedback the IASB received (including feedback from the IASB's Consultative Group on Rate-regulated Activities) noted that:

(a) regulatory agreements typically determine regulatory returns on an asset not yet available for use by applying a return rate either to the amount of capital invested in constructing the asset or to the outstanding amount of capital invested in the entire regulatory capital base that includes the asset. Therefore, one could argue that the returns provide compensation for the capital invested in constructing the asset; and

(b) entities fulfil a range of different obligations during the construction period that entitle them to these returns. For example, it has been suggested that, in addition to the provision of capital, these returns compensate the entity for construction services or the provision of a maintained network.

17 The IASB staff recommendation in the agenda paper presented in July 2022, was for the final Standard to specify that regulatory returns on an asset not yet available for use relate to the provision of capital to finance the construction of the asset.

18 However, the IASB did not agree with the IASB staff recommendation as in their view there might be cases, depending on the regulatory agreements, when the regulatory return earned during the construction period related to something other than the provision of finance. Several IASB members thought that further outreach was needed to better understand the purpose of the return and why the entity was entitled to it.

19 After some discussion, the **IASB tentatively decided** that the Standard:

(a) Specify that when an entity has an enforceable present right to regulatory returns on an asset not yet available for use, those returns would form part of the total allowed compensation for goods or services supplied during the construction period of that asset.

(b) Provide guidance for entities to assess whether their rights to these regulatory returns are enforceable.

Questions for EFRAG FR TEG/CFSS

20 Do EFRAG FR TEG and EFRAG CFSS members consider that the IASB's tentative **decisions** in paragraphs 6 and 8 **on the scope** of the proposed Standard help address the concerns raised by stakeholders in your jurisdiction?

21 Do EFRAG FR TEG and EFRAG CFSS members consider that the IASB's tentative decisions in paragraphs 13 and 19 on the **total allowed compensation** proposal of the ED help address the concerns raised by stakeholders in your jurisdiction? If you do not agree, what suggestions would you propose?

Appendix 1: Topics still to be redeliberated by the IASB related to scope and total allowed compensation

Scope – topics to be discussed at future IASB meetings

1 In its next steps on scope, the IASB will discuss:

(a) interaction with IFRIC 12 *Service Concession Arrangements*;

(b) interaction with IFRS 17 *Insurance Contracts*; and

(c) enforceability of rights and obligations—to be discussed when redeliberating recognition and measurement.

Total allowed compensation - topics to be discussed at future IASB meetings

2 In its next steps on total allowed compensation the IASB will discuss:

(a) Allowable expenses:

(i) regulatory assets and regulatory liabilities arising from differences between regulatory recovery period and assets' useful lives;

(ii) expenses becoming allowable by reference to local GAAP;

(iii) allowable expenses based on benchmark figures.

(b) Inflation adjustments; and

(c) Performance incentives.