

Survey results – Direct (no direct) relationship concept

Agenda paper 08-02

IASB project – Regulatory Assets and Regulatory Liabilities

EFRAG FRB meeting 22 March 2024



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OVERVIEW

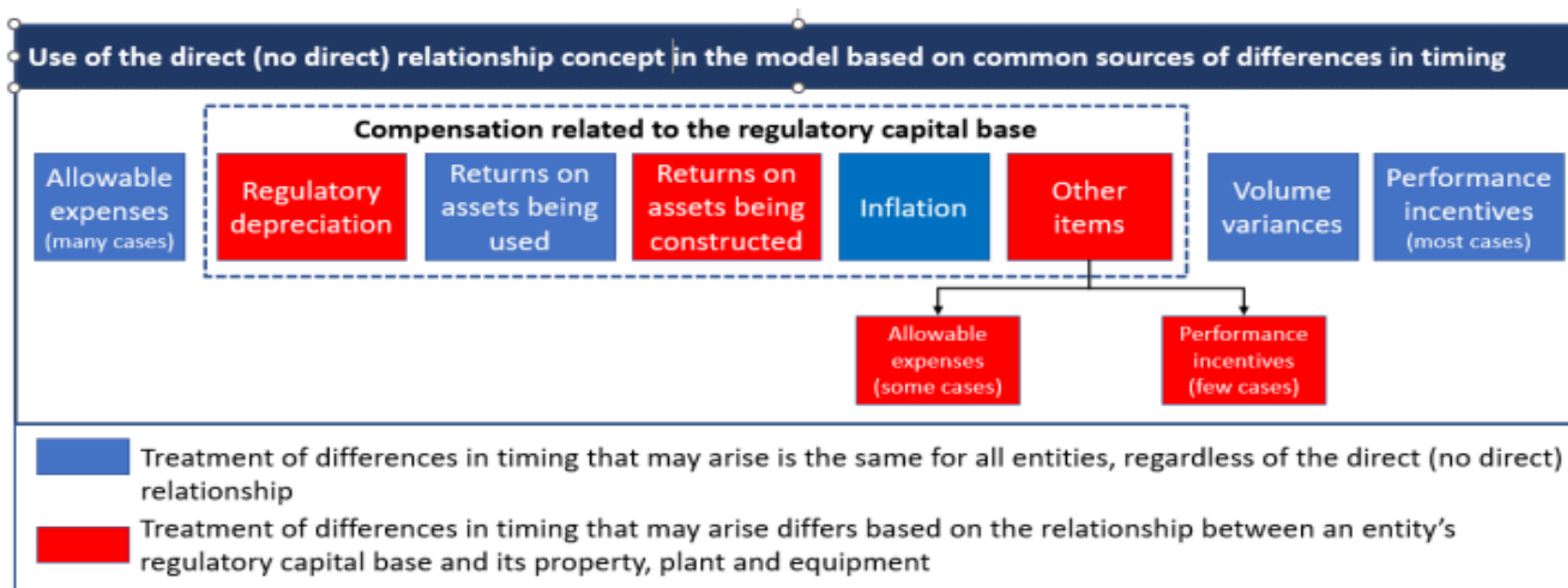
- OVERVIEW - THE DIRECT (NO DIRECT) RELATIONSHIP CONCEPT
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INTRODUCTION - THE DIRECT (INDIRECT) RELATIONSHIP CONCEPT

OVERVIEW - THE DIRECT (INDIRECT) RELATIONSHIP CONCEPT

During its re-deliberations, the IASB tentatively decided that some of the accounting requirements will depend on whether the entity has a direct (no direct) relationship between the entity's regulatory capital base (RCB) and its property, plant and equipment (PPE) – referred to as the direct (no direct) relationship concept in the accounting model. The following diagram (taken from IASB agenda paper 9A October 2023) provides an overview of this concept:



Use of the direct (no direct) concept in the IASB tentative decisions

The use of the direct (no direct) relationship concept will affect the accounting for regulatory assets and regulatory liabilities that arise from:

- **Differences between the RCB recovery period and PPE useful lives.** Applying the IASB tentative decision, entities that conclude they have an indirect relationship would not account for regulatory assets and regulatory liabilities from differences between the RCB and PPE useful lives
- **Regulatory returns on assets being constructed when an entity capitalises borrowing costs incurred to construct the asset.** Specific accounting requirements apply when an entity concludes it has a direct relationship
- **Items that a regulator includes in an entity's RCB (such as allowable expenses and performance incentives).** Entities that conclude they have an indirect relationship would not account for regulatory assets and regulatory liabilities relating to an allowable expense or performance incentive included in its RCB

Indicators to assess direct (no direct) relationship concept

- The IASB discussed the following indicators to determine whether an entity's RCB has a direct (no direct) relationship with its PPE
 - the assets recorded for regulatory purposes are **broadly aligned** with that used for accounting purposes. Any differences in componentisation are tracked separately
 - the **measurement basis and capitalisation policies** used for regulatory purposes are broadly aligned with those used for accounting purposes with any differences tracked separately
 - **depreciation rates** used for regulatory purposes are broadly aligned with those used for accounting purposes, with regulators requiring depreciation rates that are different from those used for accounting if necessary to meet a public interest objective
- To test these indicators with preparers, the IASB staff published a survey which was shared with members of the Accounting Standards Advisory Forum (ASAF) as well as members of the IASB's Consultative Group for Rate Regulation – the survey is discussed in the next section



IASB STAFF SURVEY

IASB staff survey on the direct (no direct) concept

- The IASB discussed the findings from the survey at its September and October 2023 meetings
- The IASB staff received 48 completed surveys from 39 respondents in 16 jurisdictions (some respondents completed more than one survey for each of their group entities) – [IASB agenda paper 9B](#) of the September 2023 IASB meeting provides a summary of the results
- The EFRAG project team on RRA received copies of most surveys submitted by European companies – in total we received surveys from 23 respondents from 8 European jurisdictions

Main outcomes from the IASB staff survey on direct (indirect)

- Most respondents (41 /48 surveys) were able to conclude whether their entities' RCB had a direct (no direct) relationship with their PPE
- In 21 surveys, respondents concluded that their entities' RCB and PPE had a **direct relationship**. These entities mainly operate:
 - in the electricity and gas sectors in North America, Europe, Asia-Oceania and Africa. These entities are generally subject to cost-based regulatory schemes
 - in the electricity and gas sectors in Brazil and the transport (motorways) sector in Europe. These entities operate through service concession arrangements within the scope of IFRIC 12 *Service Concession Arrangements*

Main outcomes from the IASB staff survey on direct (indirect)... Continued...

- 20 survey respondents concluded that their entities' RCB and PPE had **no direct relationship**. These entities mainly operate:
 - entities subject to regulatory schemes that use a total expenditures ('totex') approach – companies operating in the electricity transmission and distribution and water sectors in the United Kingdom; and
 - entities subject to features of regulatory schemes in a way that it would be impracticable to reconcile their RCB and PPE at the individual asset level
- Of these 20 respondents, three were from entities operating in the electricity transmission and distribution and the water sectors in the United Kingdom. The remaining surveys were mostly from entities subject to incentive-based schemes in Europe
- Overall, respondents to the surveys agreed that the indicators provided by the IASB to determine a direct (no direct) relationship are useful

Main outcomes from the IASB staff survey on direct (indirect)... Continued...

The feedback on the survey has shown that there are two different cases in which the respondents have concluded that there is no direct relationship:

- the RCB is a regulatory construct that has no relationship with an entity's property, plant and equipment (these are mainly UK companies); and
- the RCB uses inputs from an entity's property, plant and equipment but a reconciliation at an individual asset level may be impracticable. This is because:
 - the regulatory capital base is not a tool to recover the cost of assets in the PPE. Instead, it is a tool to calculate an amount of allowable costs that the regulator will consider in determining regulated rates
 - in some cases, there are fundamental differences between the RCB and the PPE (for example assets that are capitalised for RCB purposes but not for IFRS purposes)
 - there are differences between the regulatory recovery period and the assets' useful lives. In some cases, the asset classes in the RCB are different from the asset classes in property, plant and equipment. As a result, each regulatory asset class contains assets with different useful lives

Main outcomes from the IASB staff survey on direct (indirect)... CONT

- Other than the UK, feedback from the surveys did not disagree with the direct (no direct) relationship concept
- Entities from the UK expressed concerns with the IASB's tentative decision to prohibit them from accounting for regulatory assets and regulatory liabilities arising from other items that the regulator may add to the RCB. These entities said that the accounting treatment would not faithfully represent the economics of the regulatory compensation. Such cases include:
 - A major event that may allow an entity to recover an amount related to lost revenue that the regulator has allowed the entity to recover an amount related to lost revenue by adding that amount to the RCB
 - Performance incentives that allow an entity to add (or deduct from) the RCB a portion of totex overspend (underspend) representing the difference between the actual and estimated totex.



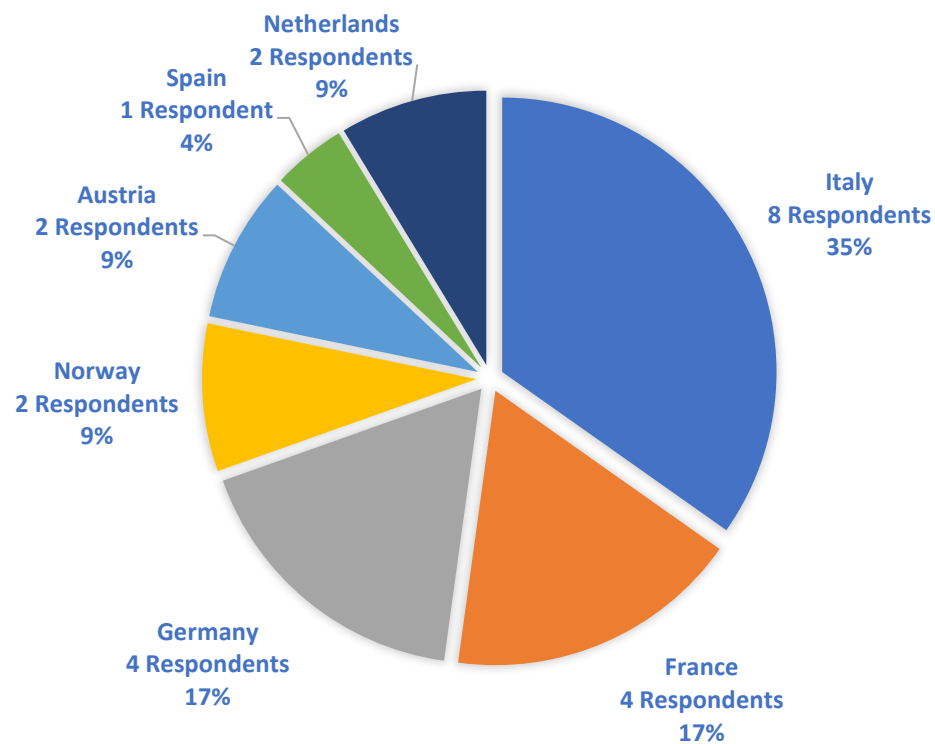
SURVEY RESULTS FOR EUROPEAN COMPANIES

Summary of EU findings

- We received surveys from **23 respondents represented in 8 EU jurisdictions** – of these 3 respondents represented multiple jurisdictions
- 19 out of the 23 respondents reported that they were able to conclude whether their RCB had a direct (no direct) relationship with PPE
- 11 of the 23 respondents concluded that there was **no direct relationship** between their RCB and their PPE
- 8 of the 23 respondents concluded that there was a **direct relationship** between their RCB and their PPE
- 4 of the 23 respondents said that they were unable to conclude whether there was a direct (no direct) relationship and concluded that they have a **mix of direct and no direct relationship** between their RCB and their PPE

By jurisdiction – summary of respondents

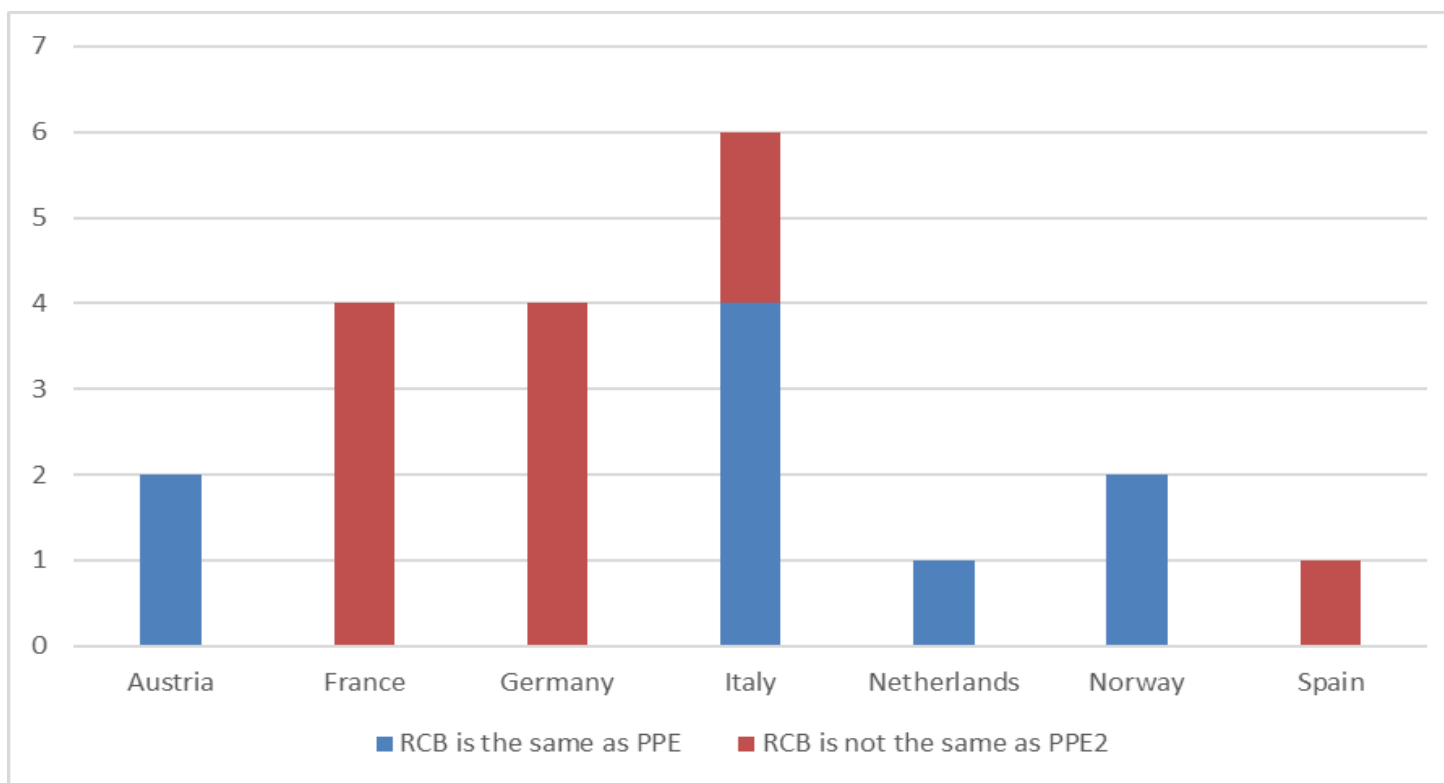
- 2 respondents from Italy represented multiple jurisdictions
- 1 respondent from The Netherlands represented more than one jurisdiction



Relationship between RCB and PPE (Q2 of the survey)

- 9 of the 23 respondents said that the items included in their RCB **are the same** as those included in their PPE
- 14 of the 23 respondents said that the items included in their RCB **are not the same** as those included in their PPE
 - 10 of these respondents reported an indirect relationship between RCB and PPE
 - 2 respondents (Spain, Italy) reported a direct relationship between RCB and PPE
 - 2 respondents reported a “mixed” relationship between direct and no direct relationship

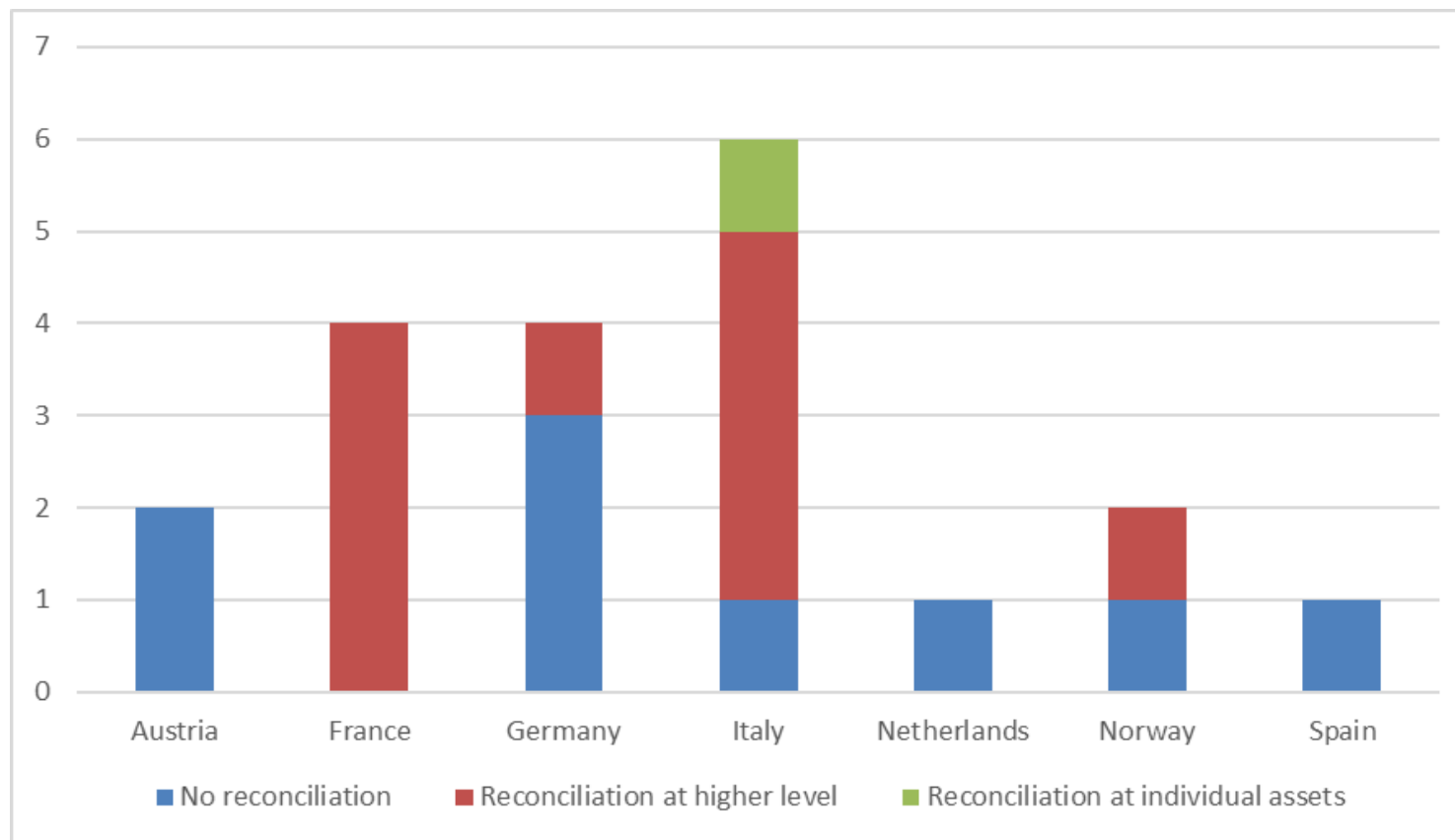
By jurisdiction: Relationship between PPE and RCB by jurisdiction (excludes 3 respondents that are active in multiple jurisdictions)



Reconciliation between RCB and PPE (Q3/Q4 of the survey)

- 13 of the 23 respondents said that a reconciliation between RCB and PPE **is required**
- 10 of the 23 respondents said that a reconciliation between RCB and PPE **is not required**
- One respondent noted that a reconciliation between RCB and PPE is done by the regulator based on the information the company sends
- Some respondents that said a reconciliation is required also said that they are unable to track differences between RCB and PPE or that tracking would be complex and costly – would depend on the level at which the reconciliation is done

By jurisdiction: Reconciliation between RCB and PPE by jurisdiction (excludes 3 respondents that are active in multiple jurisdictions)



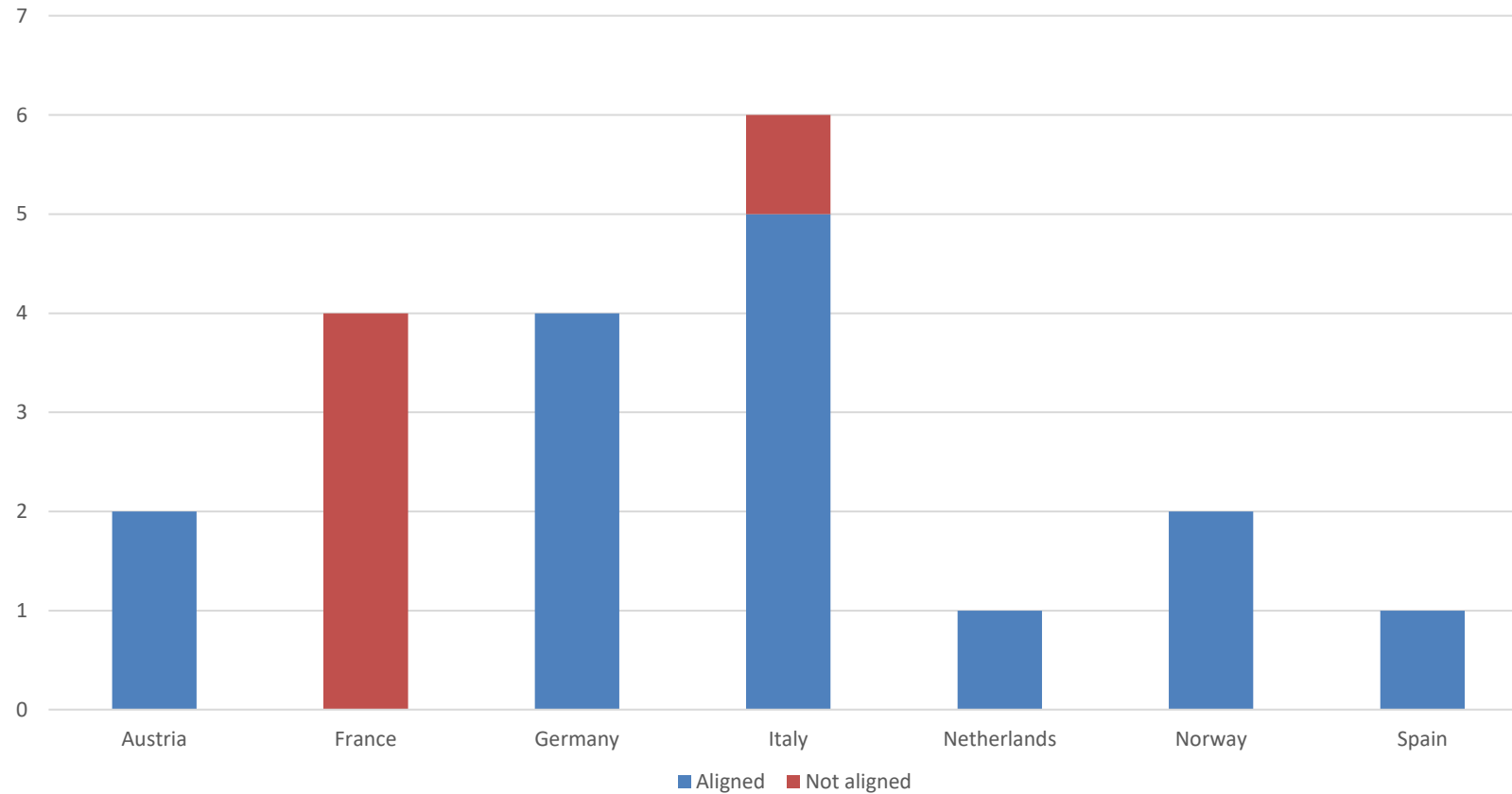
Measurement of RCB and PPE (Q5 of the survey)

- 19 of the 23 respondents said that there **are differences** between the measurement of your RCB and the measurement of an entity's PPE
- Some of these 19 respondents said that the differences are not significant and can be traced (for example Italian entities noted that the main difference is that the RCB is revalued for inflation - generally differences can be tracked although some said that the tracking could be very complex and costly) – these respondents generally considered that they had a direct relationship between RCB and PPE
- 4 respondents said that there are no significant differences between RCB and PPE

Alignment between regulatory recovery period of RCB and PPE useful lives (Q 6 of the survey)

- 16 of the 23 respondents said that the regulatory recovery period of assets included in the RCB is **closely aligned** with the PPE assets' useful lives
- 7 of the 23 respondents said regulatory recovery period of assets included in the RCB is **not closely aligned** with the PPE assets' useful lives
- Some of the reasons cited for not being closely aligned (not the same) include:
 - Items with various useful lives are aggregated and an average “regulated lifetime” is used to determine the regulatory recovery period of the aggregate
 - Depreciation for regulatory purposes always starts on 1 January
 - For IFRS depreciation periods, especially for our long-term assets there could be reassessments of useful life (e.g. main transport pipelines) . This is usually not the case for regulatory accounting (no annual reassessment for existing assets)
 - Depreciation for regulatory purposes is generally determined based on regulatory objectives

By jurisdiction: Alignment between regulatory recovery period of RCB and PPE useful lives - (excludes 3 respondents that are active in multiple jurisdictions)



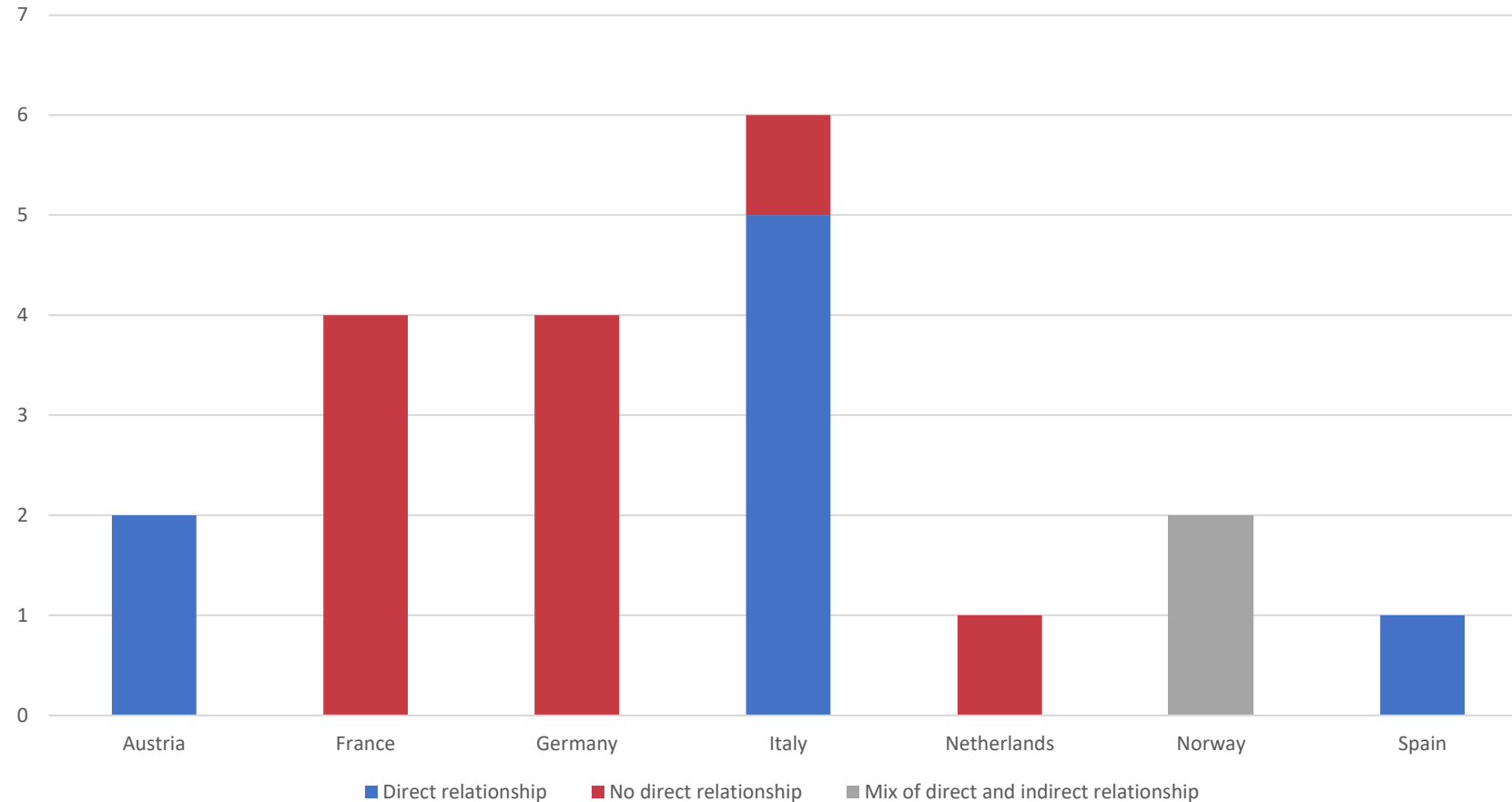
Assessment of direct (no direct relationship) – (Q 8 of the survey)

- 11 of the 23 respondents concluded that there was **no direct relationship** between their RCB and their PPE
- 8 of the 23 respondents concluded that there was a **direct relationship** between their RCB and their PPE
- 4 of the 23 respondents said that they were unable to conclude whether there was a direct (no direct) relationship and concluded that they have a **mix of direct and no direct relationship** between their RCB and their PPE

Assessment of direct (no direct) relationship ... (continued)

- One respondent concluded that their RCB had a direct relationship with PPE and that the main component of the regulatory RAB is the real cost of PPE. Also, the depreciation expense is calculated according to the useful lives of the PPE
- Some respondents concluded that their RCB have a significant less direct relationship with their PPE because they operate in an incentive-based regulatory scheme or a hybrid regulatory scheme and not in a cost-based scheme
- Respondents from Norway, which concluded that the relationship between their RCB and PPE is a mix between direct relationship and no direct relationship, said that there is a direct relationship for 30% of the capital base but not for the remaining 70% because only 30% of total allowed compensation is based on the operator's own expenses (including expenses related to its regulatory capital base), the remaining 70% is based on benchmarking models

By jurisdiction - Assessment of whether there is a direct (no direct) EFRAG relationship between RCB and PPE - excludes 3 respondents that are active in multiple jurisdictions



Features of the RCB considered to assess the direct (no direct) relationship concept (Q 9 of the survey)

- This section provides the reasoning (features) given by respondents to assess whether they have a **direct relationship** between RCB and PPE
- The **Austrian respondents** said:
 - The local GAAP book values being the basis for the RCB have been given substantial weight in our conclusion. The missing reconciliation requirement of individual assets to the RCB (that could lead to a different conclusion) has been given substantially less weight.
 - The regulatory regime in Austria is constantly evolving. We have answered from a status quo perspective without considering future developments that may arise. However, we do not expect that the local GAAP book values being the basis for RCB are likely to change in the foreseeable future

Features of the RCB considered to assess the direct (no direct) relationship concept ... (continued)

- The **Italian respondents** said
 - The RCB and PPE are sufficiently similar for the entity to be able to reconcile any differences between the RCB and PPE.
 - The “depreciation rates used for regulatory and accounting purposes” are broadly aligned and any differences is tracked
 - Based on the regulatory framework currently in place, the regulator might require regulated entities to reconcile the RCB and PPE
 - Some Italian respondents placed more weight on traceability of the differences between RCB and PPE when making the assessment
- The **Spanish company** said
 - RCB and PPE use the same recovery period (useful life)
 - The formula to calculate the return on investment is based on the carrying amount of the PPE

Features of the RCB considered to assess the direct (no direct) relationship concept ... (continued)

- This section provides the reasoning (features) used respondents to assess whether they have an **indirect relationship** between RCB and PPE
- The **French respondents** said:
 - The features on which we have given more weight is the measurement since the RCB is inflated, which is a major factor of difference between the historical cost used either under French GAAP or under IFRS, with a follow up to be made on the differences between the projected inflation vs the actual inflation
 - Another feature is that the regulation provides for a return on CWIP computed on an average basis, thus entitling to charge a rate which is not consistent with the interest incurred for the financing of each individual CWIP
 - Lastly, another main feature is the step ups recognised during the 2008 business combination, which have not been allocated to the various assets contributed but treated as a single amount

Features of the RCB considered to assess the direct (no direct) relationship concept ... (continued)

- This section provides the reasoning (features) used respondents to assess whether they have an **indirect relationship** between RCB and PPE
- The **German respondents** said:
 - For incentive-based regulatory schemes and with specific reference to potentially unfavourable cost benefit considerations, the IASB Staff Paper comprehensively illustrates that the relationship between the RCB and PPE is significantly less direct than in cost-based schemes
- The **Netherlands respondents** said:
 - The regulator determines the RAB on a sector level and therefore it includes inputs that are unrelated to PPE of an individual RGO
 - The RGO is unable to track differences between the RAB and its IFRS PPE because the RGO has only very limited insight in the RAB and only after each regulatory period. RGOs are not allowed to exchange information

Need for additional guidance to conclude on the direct (no direct) relationship concept (Q 10 of the survey)

- Most respondents either did not respond to this question or said that additional was not needed
- 4 respondents asked for additional guidance or a different focus when making the assessment
 - The 2 respondents from Norway stated that a guidance was needed on whether the conclusion on the relationship between the RAB and the PPE should be based on total allowed compensation as a whole or on its individual parts
 - One respondent stated that transitioning to regulatory rate accounting will involve some estimates in determining the regulatory asset value particularly for old assets and this should be addressed in the application guidance
 - Another respondent said that it would be helpful to have more examples about what items could be considered in defining the non-direct relationship between the RCB and PPE, to allow a more objective assessment. This respondent also asked the IASB to test the provisions and to evaluate if a more broad definition of the concept could lead to a more faithful representation of regulatory assets and liabilities, for example not requiring necessarily a reconciliation of the regulatory capital base with PPEs at individual level but simply at the same level of aggregation required by the regulation and providing some practical expedients to allow to find a certain relationship also in the case of TOTEX approach that could become more widespread in Europe in some industries in the scope of the ED



IASB TENTATIVE DECISIONS RELATING TO THE DIRECT (INDIRECT) CONCEPT

IASB tentative decisions (1/2)

At its meeting in September 2023, the IASB tentatively decided to:

- include the direct (no direct) relationship concept to help an entity identify differences in timing arising from the regulatory compensation the entity receives on its regulatory capital base;
- specify that an entity's ability to trace differences between the RCB and its PPE at an asset level is a strong indicator that they have a direct relationship;
- specify that, in the case of service concession arrangements, an entity determines whether the RCB has a direct (no direct) relationship with the intangible asset that arises from the service concession arrangement; and
- include examples to illustrate how an entity determines the direct (no direct) relationship using specific fact patterns

IASB tentative decisions (2/2)

At its meeting in October 2023, the IASB tentatively decided to:

- include in the prospective Accounting Standard guidance on how to account for **regulatory returns on an asset not yet available for use** that compensate for borrowing costs an entity has capitalised. The guidance would illustrate how an entity accounts for such regulatory returns if:
 - the entity determines the capitalised borrowing costs at a higher level of aggregation than the individual asset level; or
 - a regulator determines the regulatory returns on a real basis

*In November 2022, the IASB tentatively decided that when an entity's RCB and its PPE have a **direct relationship** and the entity capitalises its borrowing costs:*

- *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*
- *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 (in this case a regulatory liability would be recognised)*



FEEDBACK RECEIVED ON IASB TENTATIVE DECISIONS

Feedback on the direct (indirect) relationship concept (1/3)-

EFRAG RRAWG (February and November 2023)- Also included in Appendix of 08-01

- Most members generally support the relief provided by the direct (no direct) relationship concept because the calculations necessary to compute regulatory assets and liabilities would not be practical under some regulatory regimes faced by companies
- However, one member considered that the concept could be seen as an ‘exit route’ for entities to not recognise regulatory assets and regulatory liabilities
- The observer from the UKEB expressed a concern that not reflecting regulatory assets and regulatory liabilities would fail to reflect the economics and result in a lack of comparability.

Feedback on the direct (indirect) relationship concept (2/3)

EFRAG FR TEG (January 2024)- Also included in Appendix of 08-01

- Members viewed the direct (no direct) concept as a pragmatic approach to solving the concerns raised by preparers. A member considered it as a practical expedient towards treatment of minor differences. Some comments and questions included
 - The assessment of whether an entity is direct (no direct) depends on the entity's ability to reconcile accounting balances with regulatory balances may result in earnings management and put some pressure on auditors
 - It was questioned whether the reconciliations between accounting balances and regulatory balances should be made (group level or individual asset level)
 - It was questioned whether an entity would be allowed to change from the direct to the no-direct approach or vice versa
- Members suggested outreach to European companies within the scope of the prospective IFRS Standard to further ascertain the consequences of the direct (no direct) relationship concept

Feedback on the direct (indirect) relationship concept (3/3)- EFRAG CFSS (March 2024)

- Members did not disagree with the IASB's tentative decision to introduce this concept. A member noted that companies that had "no direct" relationship would still be in the scope of the prospective Standard and would recognize regulatory assets (liabilities) (e.g., due to volume variances).
- One member noted that it was important to better understand the effects of the direct (no direct) concept on European companies impacted by the prospective IFRS Standard and outreach was currently being undertaken with different NSS.
- The observer from the UKEB explained that all UK companies in scope have a "no direct relationship" and due to these companies not being able to recognize some regulatory (liabilities), there was a questionable cost-benefit of the IASB proposed model. That said, to support the finalisation of the Standard, the UKEB Staff were currently developing a "top-down" model to address their concerns and supplement the IASB proposals for the final Standard.



FOLLOW-UP EFRAG/NSS OUTREACH ON DIRECT (NO DIRECT) CONCEPT

Follow-up outreach on the direct (no direct) relationship concept (1/3)

- **To build on the findings of the IASB survey**, in collaboration with NSS, the EFRAG Secretariat is performing outreach activities to further assess the implication of the direct (no direct) concept across Europe. The main objectives of the outreach are to:
 - Identify the main industries in the scope of the rate-regulated activities future standard across the main EU jurisdictions and liaise with affected companies;
 - Obtain an understanding of how the regulatory agreements work to assess whether they could have a direct or no direct relationship; and
 - Anticipate work for the future endorsement of the standard.

Follow-up outreach on the direct (no direct) relationship concept (2/3)

- The EFRAG Secretariat has had discussions with **several national standard-setters and affected entities**. In addition, we are reaching out to other jurisdictions to broaden the scope of the outreach:
 - **France** – In collaboration with the **ANC**, the EFRAG Secretariat liaised with three entities of different industries. One of them is likely to be outside of the scope of the Standard, the other considered that it was no direct because of the differences between RCB and PPE. Reconciliation may be possible but complex and costly. The last company flagged difficulties in determining the unit of account at a low level. Further meetings with other companies are scheduled
 - **Germany** – EFRAG representatives met with the German TSOs and the **DRSC** to discuss the timing of the publication of the prospective IFRS Standard and the implications of the direct (no direct) concept. TSOs are the main companies affected by the Standard in Germany. They considered to be ‘no direct’ and they supported the IASB’s approach.

Follow-up outreach on the direct (no direct) relationship concept (3/3)

- **Italy – The OIC** is assessing the implications of the direct (no direct) approach in Italy and will share the outcome with the EFRAG Secretariat. The assessment will take into consideration the ongoing shift in regulation towards a ‘Totex’ approach.
- **Netherlands** – The EFRAG Secretariat met with **the DASB**. The main companies affected by the Standard in the Netherlands are national and regional grid operators (electricity and gas) and airport businesses. The characteristics of the regulatory agreements vary across industries. The EFRAG Secretariat aims at engaging with Dutch entities to better understand the schemes.
- **Norway** – The EFRAG Secretariat met with **the NASB**. TSOs are the main companies affected by the Standard in Norway. The schemes have a mix approach where there is a direct relationship for 30% of the RCB, which is almost fully aligned with PPE, and a no direct relationship for 70% of the RCB as the cost base is affected by an efficiency score, which is calculated based on the performance of all TSOs.

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35 Square de Meeûs, B-1000 Brussels
info@efrag.org - www.efrag.org



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