

IASB[®] meeting

Date	December 2022
Project	Rate-regulated Activities
Topic	Consultative Group for Rate Regulation meeting
Contacts	Nhlanhla Mungwe (nmungwe@ifrs.org) Mariela Isern (misern@ifrs.org)

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Objective

1. This paper includes the summary notes (pages 2–8) and the material prepared (pages 9–17) for the Consultative Group for Rate Regulation (CGRR) meeting held on 4 October 2022 dealing with the topic analysed in Agenda Paper 9A—that is, the accounting for inflation when a regulatory agreement adjusts the regulatory capital base for inflation.
2. These notes and the material are for information only. We are not asking the IASB to make decisions on this paper.

Meeting Notes—Consultative Group for Rate Regulation

The Consultative Group for Rate Regulation (CGRR) held a virtual meeting on 4 October 2022. These notes have been prepared by the staff of the International Accounting Standards Board (IASB) to summarise the discussions that took place at it.¹

About the meeting

1. The purpose of the meeting was to explore how the IASB might respond to feedback on the proposed treatment of the inflation adjustment to the regulatory capital base, as set out in the IASB's Exposure Draft *Regulatory Assets and Regulatory Liabilities* (Exposure Draft).
2. Meeting participants:

<i>Name</i>	<i>Organisation</i>	<i>Country/Region</i>
Giorgio Acunzo	Ernst & Young	Italy
Eric Chan	CLP Power Hong Kong Limited	Hong Kong
Anil Kumar Gautam	NTPC Ltd	India
Jesús Herranz Lumbreras	Ferrovial SA	Spain
John Leotta	Deloitte Touche Tohmatsu	Australia
Richard McCabe	Consultant for Electricity Canada	Canada
Christopher McCusker	National Grid	USA

¹ The papers discussed with the Consultative Group for Rate Regulation can be found [here](#). A recording of the meeting is available on the IFRS Foundation website.

<i>Name</i>	<i>Organisation</i>	<i>Country/Region</i>
Sureta Moolman	Eskom Holdings SOC Ltd	South Africa
Pascale Mourvillier	PAM Expertise	France
Tim Murray	RBC Capital Markets, Royal Bank of Canada	Canada
Michel Picard	KPMG	Canada
Yeshvir Singh (observer)	Fitch Ratings	United Kingdom
Michael Timar	PricewaterhouseCoopers	United Kingdom
Stefanie Voelz (observer)	Moody's Investors Service Ltd	United Kingdom
	European Financial Reporting Advisory Group (observer)	Europe

Inflation

3. The meeting notes follow this structure:
 - a. background (paragraphs 4–8);
 - b. existence of a regulatory asset (paragraphs 9–12);
 - c. operational challenges (paragraphs 13–14); and
 - d. usefulness of the information (paragraphs 15–16).

Background

4. The staff summarised [Agenda Paper 3](#).
5. The staff explained that the Exposure Draft states that regulators typically use two regulatory approaches that are broadly equivalent in order to compensate entities for inflation:

- a. Approach 1 (the nominal approach)—some regulatory agreements apply a nominal return that includes inflation to the regulatory capital base; and
 - b. Approach 2 (the real approach)—other regulatory agreements adjust the regulatory capital base for inflation and apply to it a real return rate excluding inflation.
6. The Exposure Draft treats inflation adjustments to the regulatory capital base as a form of target profit. Target profit that a regulatory agreement entitles an entity to add in a regulated rate for goods or services supplied in a period forms part of the total allowed compensation for goods or services supplied in the same period. (See Illustrative Example 7C.2 accompanying the Exposure Draft.)
7. A few respondents argued that the inflation adjustment to the regulatory capital base would give rise to a regulatory asset. These respondents said that the Standard should clarify that the inflation adjustment to the regulatory capital base that an entity is entitled to recover through increased rates in the future should be deemed to be a regulatory asset.
8. The staff asked members whether:
 - a. they agreed with feedback from some respondents that an inflation-adjusted regulatory capital base would give rise to a regulatory asset (paragraphs 9–12);
 - b. they would anticipate any operational challenges if the Standard required an entity to account for such an inflation-related regulatory asset (paragraphs 13–14); and

- c. such an inflation-related regulatory asset would provide useful information to users of financial statements (paragraphs 15–16).

Existence of a regulatory asset

9. A member from North America said that regulatory schemes in his jurisdiction followed the nominal approach. Consequently, the treatment of the inflation adjustment to the regulatory capital base was not an issue there. This member had consulted with colleagues from other jurisdictions within his organisation. He said views were mixed. Some held that an entity subject to the nominal and real regulatory approaches would have rights to different revenue streams; consequently, such an entity should only account for them by applying IFRS 15 *Revenue from Contracts with Customers*. Others thought that, if both regulatory approaches resulted in the same economic outcome, the accounting for a regulatory asset for an entity subject to the real approach would allow it to reflect a similar financial performance to that of entities subject to the nominal approach. This member also said that other parties he had consulted said that if the IASB decides not to require an entity to account for regulatory assets or regulatory liabilities arising from differences between the regulatory recovery period and the assets' useful lives when there is no direct relationship between an entity's regulatory capital base and its property, plant and equipment, then the same conclusion should be extended to the accounting for an inflation-related regulatory asset.
10. A few members from Europe said that the inflation adjustment to the regulatory capital base does not give rise to a regulatory asset. According to them:

- a. the inflation adjustment to the regulatory capital base will give rise to a higher amount of regulatory depreciation and, therefore, to a higher amount of revenue in future periods. However, an entity does not have a right to the higher revenues until the regulator determines the allowed revenue for a specified period.
 - b. accounting for future revenues as a regulatory asset could have unexpected consequences. One of these members from Europe also thought that accounting for the inflation-related adjustment as a regulatory asset could implicitly change the measurement basis of property, plant and equipment from cost to current value. This member said that it may be preferable for an entity subject to the real approach to provide disclosures in the notes.
11. A member from Asia-Oceania said that the issue did not arise in his jurisdiction. But, if it did, accounting for an inflation-related regulatory asset would be appropriate, he thought.
12. The member from Africa and a member from Europe said that an inflation-adjusted regulatory capital base would give rise to a regulatory asset. They said that an entity would have already earned the inflation-related compensation for goods or services already provided. The decision of the regulator to include that adjustment in future regulated rates aims to smooth future revenues in order to protect customers. That decision did not affect the entity's right to the inflation-related compensation.

Operational challenges

13. A member from Africa said that her entity tracks the inflation adjustment and that accounting for the related regulatory asset would be feasible. She acknowledged that the auditability of this asset could be challenging.
14. A few members from Europe were of the view that accounting for the inflation-related regulatory asset would be challenging. One of these members (a user of financial statements) said that the regulatory capital base is affected by regulatory decisions that may take place in the future. These decisions may affect the accounting for the inflation-related regulatory asset. However, assessing the effects would be difficult.

Usefulness of information

15. The member from Africa thought that accounting for an inflation-related regulatory asset would result in useful information to users of financial statements. However, a member from Europe said that it is the total value of the regulatory capital base that provides users of financial statements with useful information, rather than the inflation-related adjustment to the regulatory capital base.
16. Another member (a user of financial statements) said that if the IASB decides to require entities to account for an inflation-related regulatory asset it would also be important to require disclosures about the asset. This member said that it is useful to understand the effect of inflation in future rates but she was not sure whether she would want an entity to recognise an inflation-related regulatory asset. This member also said that some entities that are subject to the real approach have inflation-linked debt that pays a real amount and accumulates the effects of inflation in the principal of the

debt. According to this member, these entities issue inflation-linked debt because they get a real return on the regulatory capital base that grows with the inflation adjustment. This member also said that accounting for an inflation-related regulatory asset would improve an entity's interest and debt cover ratios.

Consultative Group for Rate Regulation

Date **October 2022**

Project **Rate-regulated Activities**

Topic **Inflation**

Contacts **Nhlanhla Mungwe (nmungwe@ifrs.org)**
Mariela Isern (misern@ifrs.org)

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Purpose of the paper

- This purpose of this paper is to gather input from the members of the IASB Consultative Group for Rate Regulation (Consultative Group) on the feedback received on the proposed treatment of inflation in the Exposure Draft *Regulatory Assets and Regulatory Liabilities* (Exposure Draft). In particular, the feedback relates to the proposals for the accounting for inflation when a regulatory agreement adjusts the regulatory capital base for inflation.

Structure of the paper

- The paper is divided into the following sections:
 - proposed requirements;
 - feedback received;
 - regulatory approaches used to compensate inflation; and
 - questions for the Consultative Group.

Proposed requirements

- Paragraph B13 of the Exposure Draft says that the regulatory capital base might measure property, plant and equipment on a basis including an inflation adjustment not reflected in an entity's financial statements prepared by applying IFRS Standards.

Proposed requirements—*continued*

- Illustrative example 7C.2 accompanying the Exposure Draft illustrates that if a regulatory agreement adjusted the regulatory capital base in the current period for inflation, giving an entity the right to add an inflation adjustment in the regulated rates to be charged to customers in future periods, that right would not meet the definition of a regulatory asset. This is because, according to the Exposure Draft, it is not a right to recover total allowed compensation for goods or services already supplied to customers.
- The Exposure Draft sees the inflation adjustment to the regulatory capital base as a form of target profit provided by the regulatory agreement. Applying the requirement in paragraph B10 of the Exposure Draft, target profit that a regulatory agreement entitles an entity to add in a regulated rate for goods or services supplied in a period forms part of the total allowed compensation for goods or services supplied in the same period. In Illustrative example 7C.2 the inflation adjustment will be included in the regulated rate only in future periods.
- The footnote to Illustrative example 7C.2 states that two broadly equivalent regulatory approaches are typically used to compensate entities for inflation:
 - some regulatory agreements apply a nominal return that includes inflation to the regulatory capital base.
 - other regulatory agreements adjust the regulatory capital base for inflation and apply to it a real return rate excluding inflation.
- The Exposure Draft says that neither approach results in a regulatory asset.

Feedback received

- A few respondents—mainly a few standard-setters in Asia-Oceania and Europe, a few accounting firms and a few preparers—said it was unclear how the proposals deal with inflation adjustments reflected in either the regulatory returns or the regulatory capital base. Some of these respondents said the Standard should make clearer that the inflation adjustment to the regulatory capital base that an entity is entitled to recover through increased rates in the future should be considered a regulatory asset.

Regulatory approaches used to compensate inflation

- As previously mentioned, two regulatory approaches are typically used to compensate entities for inflation on the regulatory capital base (RCB):
 - **Nominal RCB x Nominal return rate (nominal approach)**—the nominal regulatory capital base is multiplied by a return rate that includes inflation. A regulatory capital base that stays constant in nominal terms effectively loses its underlying value by inflation each year and the nominal return rate aims to compensate for that loss.
 - **Real RCB x Real return rate (real approach)**—the regulatory capital base is adjusted by inflation so that it holds its value over time. The regulatory capital base is multiplied by a real return rate because inflation is already compensated for through the inflation-adjusted regulatory capital base.

Regulatory approaches used to compensate inflation—continued

- To illustrate the two regulatory approaches, assume the following example. The regulatory capital base consists of a single asset with a value of CU100.¹ The asset’s expected useful life is 10 years. The nominal return rate is 7.11%, the real return rate is 4.5% and the expected inflation is 2.5%. The nominal and real return rates are applied to the unrecovered balance of the regulatory capital base at the beginning of the year. Both the nominal and real rates remain constant during the period of 10 years.
- Table 1 shows the entity’s future revenues, both on an undiscounted and discounted basis, when a **nominal rate** of return is applied to a **nominal regulatory capital base (RCB)**.

Table 1 Nominal approach												
Nominal return		7.11%										
<i>In CU</i>		1	2	3	4	5	6	7	8	9	10	Total
Opening RCB		100	90	80	70	60	50	40	30	20	10	
Depreciation (A)		10	10	10	10	10	10	10	10	10	10	100
Closing RCB		90	80	70	60	50	40	30	20	10	0	
Nominal return (B)		7.11	6.40	5.69	4.98	4.27	3.56	2.85	2.13	1.42	0.71	39.12
Revenue (A) + (B)		17.11	16.40	15.69	14.98	14.27	13.56	12.85	12.13	11.42	10.71	139.12
<i>Discount factor (7.11%)</i>		0.93	0.87	0.81	0.76	0.71	0.66	0.62	0.58	0.54	0.50	
Present value	100.00	15.98	14.30	12.77	11.38	10.12	8.98	7.94	7.00	6.15	5.39	

- Table 2 shows an entity’s future revenues, both on an undiscounted and discounted basis, when a **real rate** of return is applied to an **inflation adjusted regulatory capital base**.

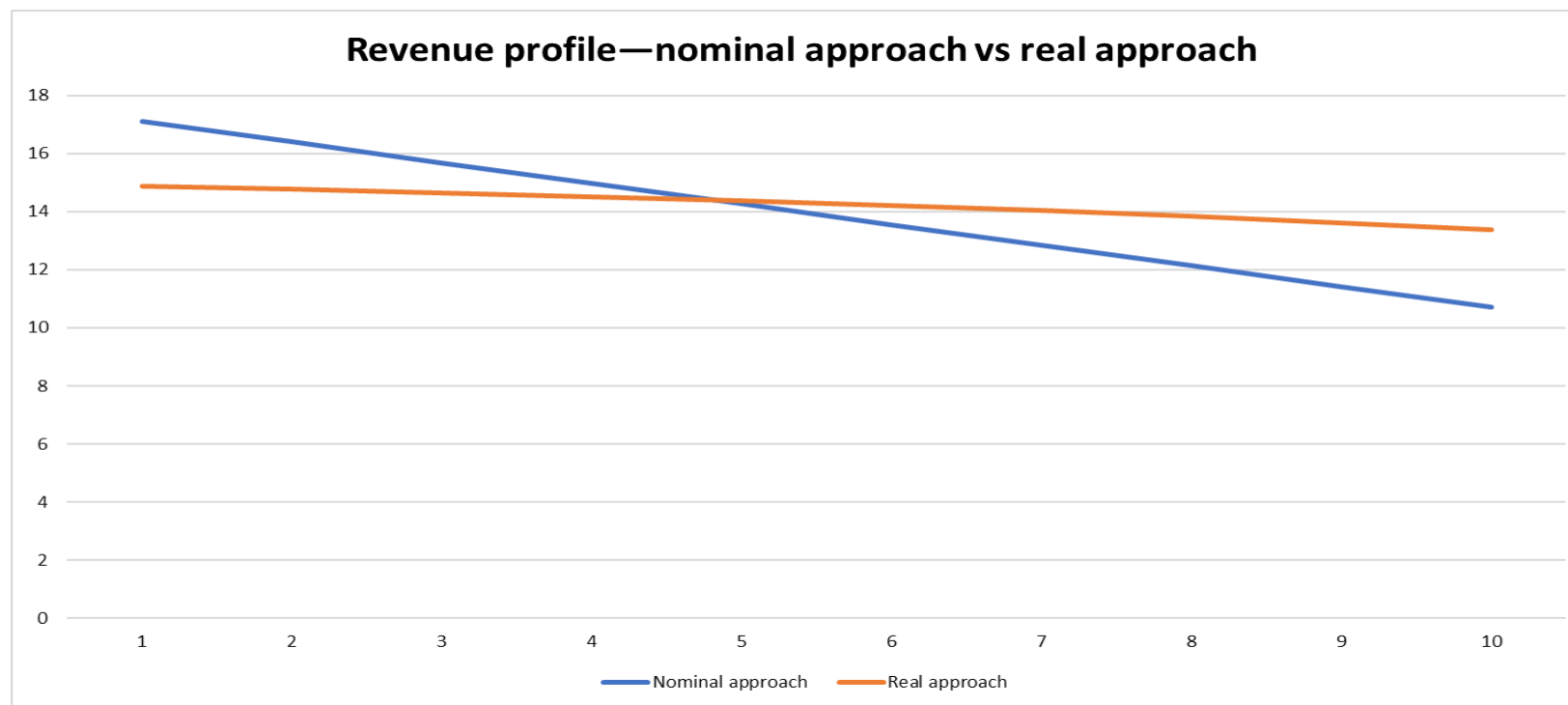
Table 2 Real approach												
Inflation		2.50%										
Real return		4.50%										
<i>In CU</i>		1	2	3	4	5	6	7	8	9	10	Total
Opening RCB		100.00	92.25	84.05	75.38	66.23	56.57	46.39	35.66	24.37	12.49	
Inflation adjustment (Table 3)		2.50	2.31	2.10	1.88	1.66	1.41	1.16	0.89	0.61	0.31	14.83
Depreciation (A)		10.25	10.51	10.77	11.04	11.31	11.60	11.89	12.18	12.49	12.80	114.83
Closing RCB		92.25	84.05	75.38	66.23	56.57	46.39	35.66	24.37	12.49	0.00	
Real return (B)		4.61	4.26	3.88	3.48	3.05	2.61	2.14	1.64	1.12	0.58	27.37
Revenue (A) + (B) (Table 4)		14.86	14.76	14.65	14.52	14.37	14.21	14.03	13.83	13.61	13.38	142.20
<i>Discount factor (7.11%)</i>		0.93	0.87	0.81	0.76	0.71	0.66	0.62	0.58	0.54	0.50	
Present value	100.00	13.88	12.87	11.92	11.03	10.19	9.41	8.67	7.98	7.33	6.73	

- Both regulatory approaches are **equivalent in present value terms**.

(1): Monetary amounts are denominated in ‘currency units’ (CU).

Regulatory approaches used to compensate inflation—*continued*

- Although both regulatory approaches are equivalent in present value terms, over the life of the asset the two approaches can result in very different revenue profiles.
- The graph illustrates the revenue profiles for the nominal approach and the real approach.



- In the nominal approach, revenues are higher in the earlier part of an asset's life and lower later in the asset's life. This approach brings the cash flows forward, which may be better aligned with an entity's debt servicing requirements. This means the rates consumers pay are higher in the earlier part of an asset's life. In the real approach, the revenues are more stable throughout the life of the asset.
- When considering which approach to use, the regulators consider different factors. For example, regulators would consider whether the priority is to improve an entity's ability to finance the investments (if so, the nominal approach may be preferable) or to maintain more stable rates for customers over time (if so, the real approach may be preferable).

Regulatory approaches used to compensate inflation —continued

- A few respondents argued that the inflation adjustment to the regulatory capital base would give rise to a regulatory asset.
- Table 3 considers the example in page 4 and assumes the inflation adjustment to the regulatory capital base gives rise to a regulatory asset. Table 3 shows the reconciliation of such a regulatory asset from Year 1 to Year 10.

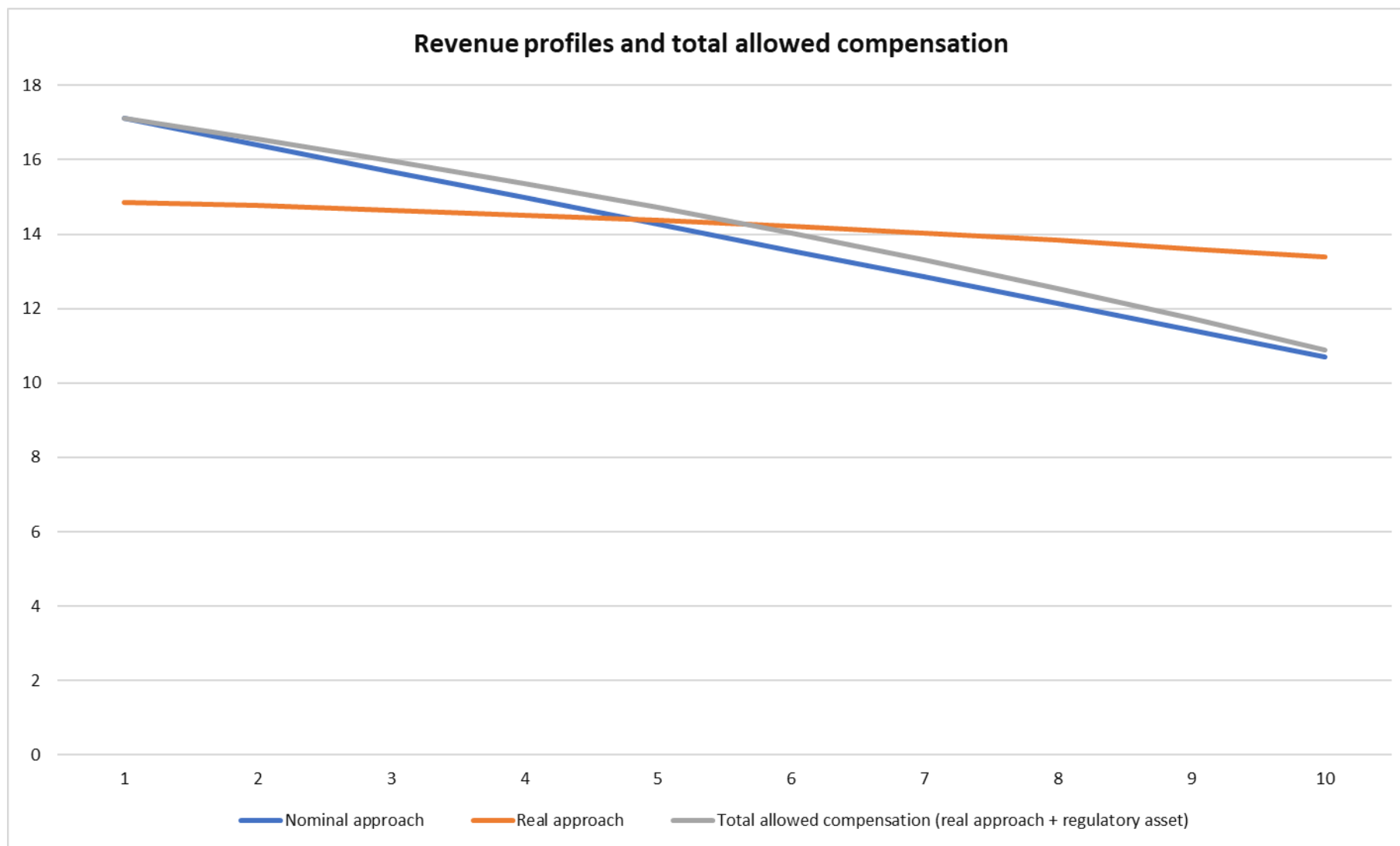
<i>In CU</i>	1	2	3	4	5	6	7	8	9	10	Total
Opening balance	0.00	2.25	4.05	5.38	6.23	6.57	6.39	5.66	4.37	2.49	
Addition (Table 2)	2.50	2.31	2.10	1.88	1.66	1.41	1.16	0.89	0.61	0.31	14.83
Regulatory interest income	0.11	0.21	0.28	0.33	0.35	0.36	0.34	0.29	0.22	0.13	2.62
Recovery	-0.36	-0.71	-1.05	-1.37	-1.67	-1.96	-2.23	-2.48	-2.71	-2.93	-17.45
Closing balance	2.25	4.05	5.38	6.23	6.57	6.39	5.66	4.37	2.49	0.00	

- Table 4 shows the total allowed compensation (TAC) for the goods or services supplied in each of the years the asset is being operated.

<i>In CU</i>	1	2	3	4	5	6	7	8	9	10	Total
Revenue (real approach) (Table 2)	14.86	14.76	14.65	14.52	14.37	14.21	14.03	13.83	13.61	13.38	142.20
Reg income / (Reg expense)	2.25	1.80	1.33	0.85	0.34	-0.18	-0.73	-1.29	-1.88	-2.49	0.00
TAC	17.11	16.56	15.98	15.36	14.71	14.02	13.30	12.54	11.73	10.89	142.20

Regulatory approaches used to compensate inflation—*continued*

- The graph below illustrates the revenue profile using the nominal approach (blue line), the real approach (orange line) and the total allowed compensation profile using the real approach combined with the accounting for the regulatory asset (grey line).



Questions for the Consultative Group:

1. Would you agree with feedback received from some respondents that an inflation-adjusted regulatory capital base would give rise to a regulatory asset? Why or why not?
2. If the final Standard would require entities to account for such an inflation related regulatory asset, would you anticipate any operational challenges?
3. Would such an inflation related regulatory asset provide useful information to users of financial statements?

References

- Australian Energy Regulator, *Why do we index the regulatory asset base?*. Available at: <https://www.aer.gov.au/system/files/Fact%20sheet%20-%20Indexation%20of%20the%20regulatory%20asset%20base.pdf>
- Economic Consulting Associates, *A regulatory puzzle: Inflation, RAB and WACC*, October 2021. Available at: <https://www.eca-uk.com/2021/10/12/a-regulatory-puzzle-inflation-rab-and-wacc/>