Agenda Paper 2
Regulatory returns on construction work-in-progress (CWIP)

Consultative Group for Rate Regulation meeting

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Purpose of the paper

- To explore possible courses of action the IASB may consider in redeliberating its proposal on regulatory returns on CWIP.

Structure of the paper

- The paper is divided into the following sections:
  - summary of the proposal (pages 1–2);
  - feedback summary (page 2); and
  - staff analysis (pages 2–15).
  - questions for the Group (page 16).

Summary of the proposal

- Paragraph B10 of the Exposure Draft sets out the general principle for target profit—target profit that a regulatory agreement entitles an entity to add in determining a regulated rate for goods or services supplied in a period forms part of the total allowed compensation (TAC) for goods or services supplied in the same period.
- As an exception to that general principle, paragraph B15 of the Exposure Draft proposes that:
  - regulatory returns on CWIP should form part of TAC for goods or services supplied once the assets are available for use and over the remaining periods in which the entity recovers the carrying amount of the assets through the regulated rates; and
  - an entity use a reasonable and supportable basis in determining how to allocate the returns on CWIP over those remaining periods and apply that basis consistently.

- Paragraph B15 is closely aligned with the principle adopted by the Exposure Draft that an entity should reflect the TAC for goods or services supplied as part of its reported financial performance for the period in which those goods or services are supplied (see paragraph 16 of the Exposure Draft). An entity cannot supply goods or services using assets under construction and, therefore, is not entitled to any compensation during the construction period.

Feedback summary

- Most respondents disagreed with paragraph B15 mainly because, in their view, applying the proposal would result in:
  - information that does not reflect the economic substance of regulation, and therefore would not be useful to the users of financial statements; and
  - significant implementation costs for preparers that outweigh any potential benefits to the users of financial statements.
- Other reasons for disagreement include:
  - arguably inconsistent principles underpinning the different parts of the proposed guidance on TAC for goods or services (for example, the proposed treatment of construction-related performance incentives was often cited as being inconsistent with the proposed treatment of regulatory returns on CWIP); and
  - resulting financial information not comparable with that provided applying US GAAP.
- See paragraphs 18–56 of Agenda Paper 9C of the October 2021 IASB meeting for a detailed summary of comments received.
- Most respondents suggested the IASB require an entity to reflect regulatory returns on CWIP in the reported financial performance for the construction period.

Staff analysis

The staff analysis is structured as follows:

- regulatory approaches for regulatory returns on CWIP (pages 2–3);
- applying the proposals to the regulatory approaches (pages 4–5);
- preferred solution of respondents (pages 6–7); and
- possible courses of action available to the IASB (pages 8–15).

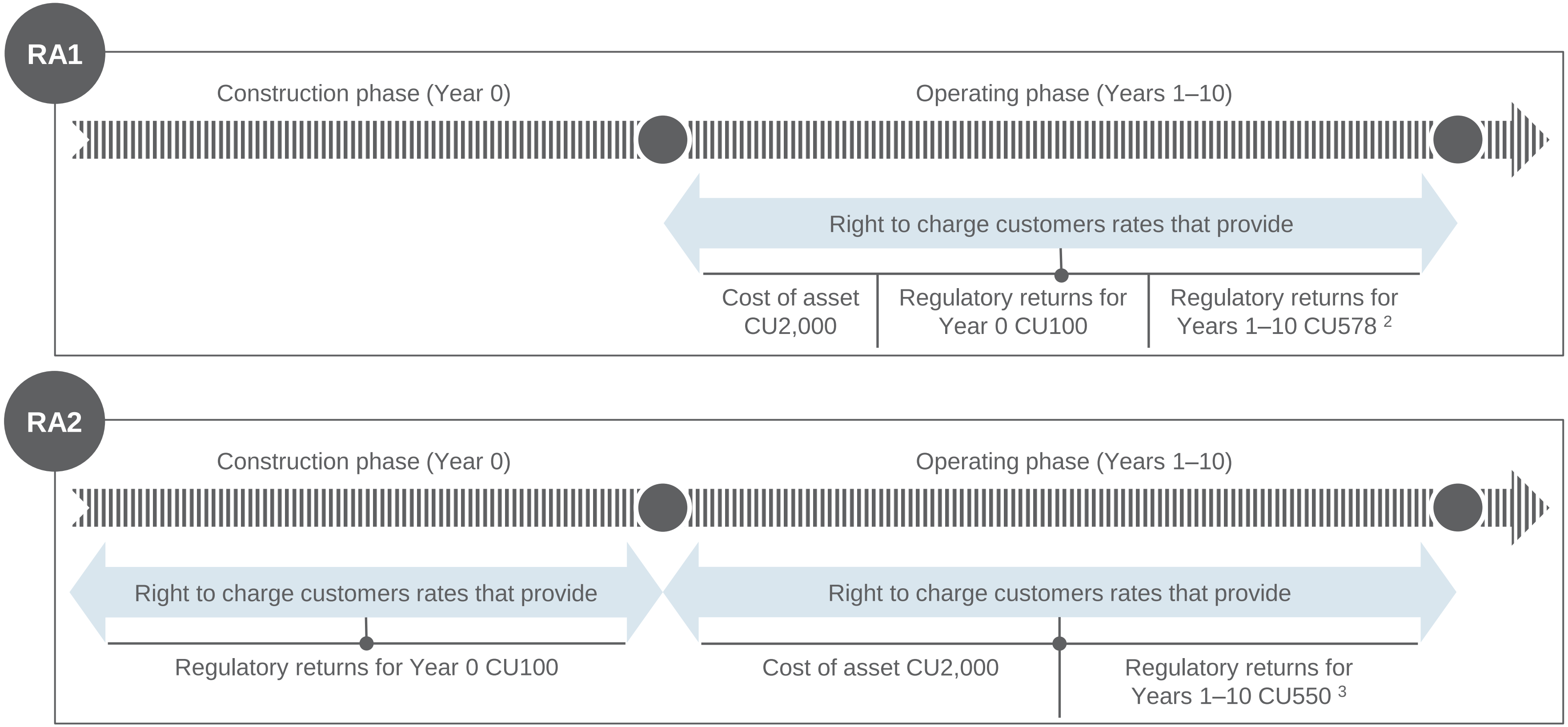
Staff analysis—regulatory approaches for regulatory returns on CWIP

- Assume that an entity spends CU2,000 in Year 0 for constructing a plant.[1] Assume also that a regulatory agreement entitles the entity to a regulatory return of 5% per annum on the invested capital and gives the entity a right to recover the invested capital over Years 1–10, the operating phase of the plant. The entity is therefore entitled to regulatory return of CU100 for Year 0. We are aware of two prevalent regulatory approaches for regulatory returns on CWIP.
  - **Regulatory Approach 1 (RA1)**: The regulatory agreement entitles the entity to include the regulatory returns of CU100 on CWIP in the rates charged to customers during the operating phase of the plant (Years 1–10).
  - **Regulatory Approach 2 (RA2)**: The regulatory agreement entitles the entity to include the regulatory returns of CU100 on CWIP in the rates charged to customers during the construction period (Year 0) for goods or services supplied using another plant.

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

Staff analysis—regulatory approaches for regulatory returns on CWIP *(continued)*

- A diagrammatic representation of, and the similarity and difference between, the two regulatory approaches are as follows:



In both **RA1** and **RA2**, an entity has a right to accrue regulatory returns on CWIP during the construction period.

However, the period in which those returns are included in the rates charged to customers differs based on whether an entity is in **RA1** or **RA2**.

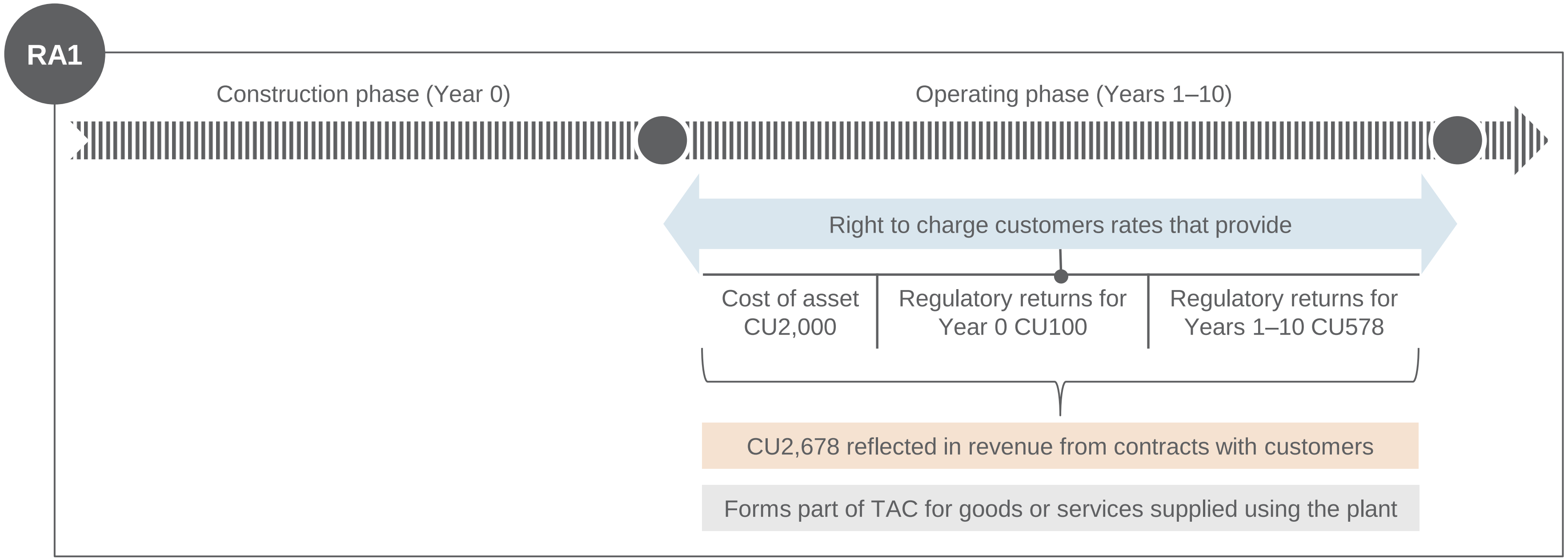
2 Regulatory returns computed at 5% on CU2,100 reduced by a recovery of CU210 per year.

3 Regulatory returns computed at 5% on CU2,000 reduced by a recovery of CU200 per year.

Staff analysis—applying the proposals to the regulatory approaches

Applying the proposals together with IFRS 15 *Revenue from Contracts with Customers* to **RA1**, an entity would:

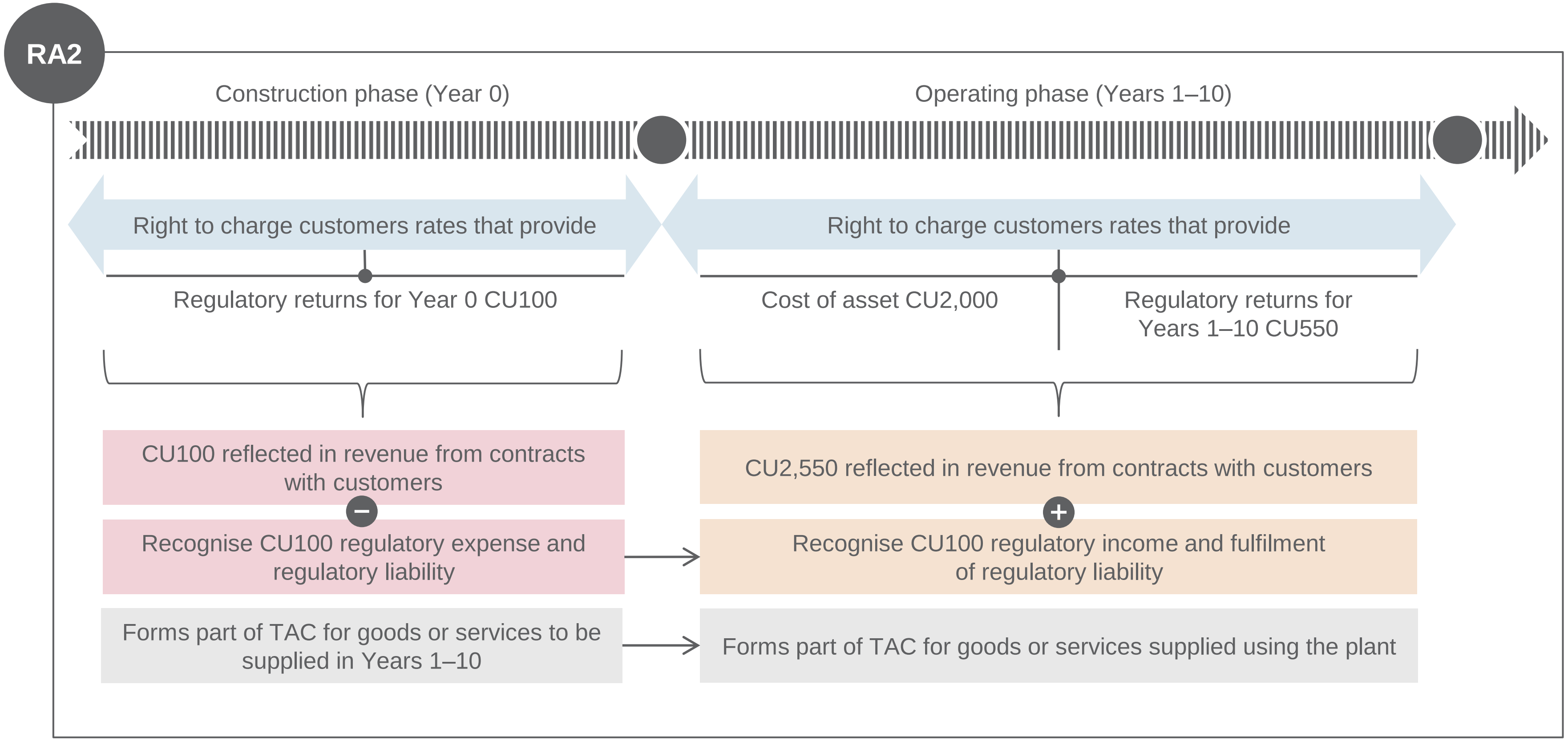
- reflect the regulatory returns of CU100 on CWIP as part of the reported financial performance for Years 1–10 because that amount would form part of TAC for goods or services supplied during those years using the plant. This period also coincides with the period over which the entity is entitled to include the CU100 in the rates charged, and therefore include in reported revenue.



Staff analysis—applying the proposals to the regulatory approaches *(continued)*

Applying the proposals together with IFRS 15 *Revenue from Contracts with Customers* to **RA2**, an entity would:

- recognise a regulatory liability and a corresponding regulatory expense at the end of Year 0 because revenue for Year 0 includes CU100 that would provide part of the TAC for goods or services supplied using the plant in Years 1–10; and
- recognise regulatory income and corresponding fulfilment of the regulatory liability during Years 1–10 to reflect the TAC for goods or services supplied in those years using the plant.



Staff analysis—preferred solution of respondents

- Most respondents suggested the IASB require an entity to reflect regulatory returns on CWIP in the reported financial performance for the construction period for the reasons summarised on page 2.
- Therefore for an entity in **RA1**, the statement of financial performance and the statement of financial position prepared applying the proposals would compare with those prepared applying the preferred solution of most respondents as follows:

RA1

Applying the proposals

Statement of financial performance		*(Amounts in CU)*
	Year 0	*Years 1–10*
Revenue	-	2,678
Regulatory income (Regulatory expense)	-	-
Depreciation	-	(2,000)
Profit	-	678

Statement of financial position		*(Amounts in CU)*
	Year 0	*Year 10*
Assets		
Property, plant and equipment	2,000	-
Regulatory asset	-	-

Preferred solution of most respondents

Statement of financial performance		*(Amounts in CU)*
	Year 0	*Years 1–10*
Revenue	-	2,678
Regulatory income (Regulatory expense)	100	(100)
Depreciation	-	(2,000)
Profit	100	578

Statement of financial position		*(Amounts in CU)*
	Year 0	*Year 10*
Assets		
Property, plant and equipment	2,000	-
Regulatory asset	100	-

Staff analysis—preferred solution of respondents *(continued)*

- For an entity in **RA2**, the statement of financial performance and the statement of financial position prepared applying the proposals would compare with those prepared applying the preferred solution of most respondents as follows:

RA2

Applying the proposals

Statement of financial performance		*(Amounts in CU)*
	Year 0	*Years 1–10*
Revenue	100	2,550
Regulatory income (Regulatory expense)	(100)	100
Depreciation	-	(2,000)
Profit	-	650

Statement of financial position		*(Amounts in CU)*
	Year 0	*Year 10*
Assets		
Property, plant and equipment	2,000	-
Liabilities		
Regulatory liability	100	-

Preferred solution of most respondents

Statement of financial performance		*(Amounts in CU)*
	Year 0	*Years 1–10*
Revenue	100	2,550
Regulatory income (Regulatory expense)	-	-
Depreciation	-	(2,000)
Profit	100	550

Statement of financial position		*(Amounts in CU)*
	Year 0	*Year 10*
Assets		
Property, plant and equipment	2,000	-
Liabilities		
Regulatory liability	-	-

Staff analysis—possible courses of action available to the IASB

- In responding to the feedback, the following courses of action are available to the IASB:
  - courses of action that respond to feedback from both entities in **RA1** and entities in **RA2**
    1. expand the scope of the Standard[4] to include rights and obligations that are not regulatory assets and regulatory liabilities
    2. broaden 'goods or services supplied' to include satisfying service requirements specified by a regulatory agreement
  - courses of action that respond only to feedback from entities in **RA2**
    3. remove paragraph B15 of the Exposure Draft
  - other courses of action
    4. confirm the proposal
    5. narrow the application of the proposal to long-duration construction projects.
- The basis for each course of action and the consequences for the two regulatory approaches are discussed below.

1 Expanding the scope of the Standard

- The IASB published the Exposure Draft with the objective of providing useful information to the users of financial statements about the financial effects of regulatory assets and regulatory liabilities.
- Having said that, the IASB asked stakeholders whether they agree that an entity should not recognise any assets or liabilities created by a regulatory agreement other than regulatory assets and regulatory liabilities and other assets and liabilities, if any, that are already required or permitted to be recognised by IFRS Accounting Standards (Question 1(f) of the Invitation to Comment).
- Respondents' feedback on regulatory returns on CWIP can be construed as suggesting the IASB expand the objective and scope to include other rights and obligations created by a regulatory agreement.
- As explained before, in both **RA1** and **RA2**, an entity has a right to accrue regulatory returns on CWIP during the construction period. However, the period in which those returns are included in the rates charged to customers differs based on whether an entity is in **RA1** or **RA2**.
- The right to accrue regulatory returns on CWIP, which is a right created by a regulatory agreement, is not a regulatory asset because that right does not arise from the supply of goods or services using the plant. That right would also not be accounted for as an asset applying other IFRS Accounting Standards.
- The IASB could, therefore, consider expanding the scope of the Standard to require an entity to recognise as an asset, with a corresponding income, its right to accrue regulatory returns on CWIP during the construction period.

4 Any reference to 'the Standard' in this paper should be read as the IFRS Accounting Standard [X] *Regulatory Assets and Regulatory Liabilities* the IASB would issue in the future after redeliberating the proposals.

Staff analysis—possible courses of action available to the IASB *(continued)*

- The right to accrue regulatory returns on CWIP during the construction period could be argued as meeting the definition of an asset in the *Conceptual Framework for Financial Reporting* because:
  - it is an enforceable right created by a regulatory agreement;
  - that right has the potential to produce economic benefits in the form of a right to add those regulatory returns in the rates charged to customers either in the construction period itself (**RA2**) or in the operating phase of the plant (**RA1**); and
  - it is a present right that an entity controls because of a past event: the entity invested funds for constructing an item of plant.
- After analysing whether that right meets the definition of an asset. the IASB has to determine the classification, measurement and presentation requirements of that right in an entity's financial statements.
- If the IASB were to take this course of action and issue the Standard:
  - applying the Standard in **RA1** would produce outcomes similar to the preferred solution of respondents. An entity would recognise an asset and a corresponding income associated with its right to accrue regulatory returns on CWIP during the construction period.
  - applying the Standard in **RA2** would also produce outcomes similar to the preferred solution of respondents. In **RA2**, regulatory returns on CWIP are charged to customers during the construction period. Therefore, the amount of CU100 included in revenue already recognised (see pages 5 and 7) would provide for the recovery of the accrued regulatory returns on CWIP. An entity, therefore, would have no regulatory liability because revenue already recognised would not include an amount that will provide part of the TAC for goods or services to be supplied in the future.
- Paragraph B15 of the Exposure Draft would become redundant and, therefore, should be removed when finalising the proposals to avoid any unintended consequences.
- The pros and cons of expanding the scope of the Standard are as follows:

+	−
• A pragmatic solution that is based on concepts • Caters to both RA1 and RA2 • Eliminates concerns about the cost of implementing the proposal • Resolves concerns about arguably inconsistent principles underpinning the different parts of the proposed guidance on TAC for goods or services	• Expands the proposed objective and scope.

Staff analysis—possible courses of action available to the IASB *(continued)*

❷ Broadening 'goods or services supplied'

- Some respondents said the goods or services supplied by a rate-regulated entity should be viewed broadly to include, in addition to goods or services supplied to customers, the service of making an infrastructure available for an uninterrupted supply of goods or services to existing and future customers.
- Based on the broader notion of goods or services supplied, an entity's right to accrue regulatory returns on CWIP during the construction period could be argued as arising from providing the service of making an infrastructure available. Consequently, regulatory returns on CWIP that accrue during the construction period should be reflected in the reported financial performance for the construction period irrespective of the period in which those returns are included in the rates charged to customers.
- Paragraph B15 of the Exposure Draft would become redundant and, therefore, should be removed when finalising the proposals.
- If the IASB were to pursue this course of action and issue the Standard, applying the Standard would produce outcomes similar to the preferred solution of respondents in both **RA1** and **RA2**.
- In **RA1**, an entity would recognise a regulatory asset and regulatory income associated with its right to accrue regulatory returns on CWIP during the construction period.
- In **RA2**, an entity would not have a regulatory liability and regulatory expense associated with returns on CWIP charged to customers during the construction period. The rates charges to customers, and therefore the revenue recognised, represent TAC for goods or services supplied during the construction period.
- Having said that, the IASB may have to consider the effects of pursuing this course of action on another proposal in the Exposure Draft.
- The IASB proposed that compensation for recovering the carrying amount of an asset forms part of the TAC for goods or services supplied over the operating phase of the asset. Consequently, an entity would have a regulatory asset or regulatory liability if the period over which the compensation is charged to customers differs from the useful life of the asset. (See paragraphs B6–B8 of the Exposure Draft).
- In some jurisdictions, a regulatory agreement entitles an entity to recover the carrying amount of an asset even before the asset becomes available for its intended use. Applying the Exposure Draft would result in the entity recognising a regulatory liability for amounts charged during the construction period. However, adopting the broader notion of goods or services would imply that the amounts charged to customers for recovering the carrying amount of an asset would form part of TAC for goods or services supplied during the construction period. The entity would, therefore, not have a regulatory liability.
- In other jurisdictions, a regulatory agreement entitles an entity to recover the carrying amount of an asset only after the asset becomes available for its intended use. However, applying the broader notion of goods or services supplied an entity can conclude that it should reflect some compensation in the reported financial performance for the service it renders during the construction period, irrespective of the period in which that compensation is included in the rates charged to customers.

Staff analysis—possible courses of action available to the IASB *(continued)*

- The pros and cons of broadening the notion of goods or services supplied are as follows:

+ (Pros)

- Caters to both **RA1** and **RA2**.
- Eliminates concerns about the cost of implementing the proposal.
- Resolves concerns about arguably inconsistent principles underpinning the different parts of the proposed guidance on TAC for goods or services

− (Cons)

- Expands the notion of 'goods or services supplied (to customers)' adopted by the Exposure Draft.
- Might provide latitude to preparers to manage income recognition.

3 Removing paragraph B15 of the Exposure Draft

- The IASB could consider removing paragraph B15 of the Exposure Draft and instead requiring an entity to apply to regulatory returns on CWIP the general principle that the entity would apply to target profit (paragraph B10 of the Exposure Draft).
- Consequently, regulatory returns on CWIP that a regulatory agreement entitles an entity to add in determining a regulated rate for goods or services supplied in a period would form part of the total allowed compensation for goods or services supplied in the same period.
- This course of action would result in the application of the Standard producing outcomes similar to the preferred solution of respondents in **RA2**. An entity would not have a regulatory liability associated with regulatory returns on CWIP charged to customers during the construction period.
- However in **RA1**, a regulatory agreement entitles an entity to include returns on CWIP in the rates charged during the operating phase. Therefore, applying the target profit principle would not result in an entity reporting returns on CWIP in financial performance for the construction period.
- The IASB could resolve to some extent respondents' concerns in **RA1** by requiring an entity to disclose the amount of regulatory returns on CWIP that accrue during the construction period. Entities in **RA1** that currently apply IFRS 14 *Regulatory Deferral Accounts* recognise regulatory returns on CWIP as a regulatory deferral account balance. A few users of financial statements of those entities suggested the IASB require disclosure of the amount of regulatory returns on CWIP that accrue during the construction period if the IASB were to confirm paragraph B15 as proposed.

Staff analysis—possible courses of action available to the IASB *(continued)*

- In removing paragraph B15, the IASB may have to consider whether removing that paragraph would be consistent with the principle in paragraph 16 of the Exposure Draft: an entity should reflect the TAC for goods or services supplied as part of its reported financial performance for the period in which those goods or services are supplied.
- The pros and cons of removing paragraph B15 are as follows:

+	−
• A simple course of action. • Eliminates concerns about the cost of implementing the proposal. • Resolves concerns of entities in **RA2** about arguably inconsistent principles underpinning the different parts of the proposed guidance on TAC for goods or services	• Does not respond to the respondents' main concern in **RA1** about not reflecting regulatory returns on CWIP in the reported financial performance for the construction period.

4 Confirming the proposal

- As explained before, the IASB issued the Exposure Draft with the objective of providing useful information to the users of financial statements about the financial effects of regulatory assets and regulatory liabilities. The objective was not:
  - to align financial reporting with regulatory reporting; or
  - to account for rights and obligations created by a regulatory agreement that are not regulatory assets or regulatory liabilities or within the scope of other IFRS Accounting Standards.
- Consequently, in developing the definitions of a regulatory asset and regulatory liability, the IASB adopted:
  - a model that does not modify the application of, but provides information that supplements the information provided by applying, other IFRS Accounting Standards (supplementary model); and
  - a principle that an entity should reflect the TAC for goods or services supplied as part of its reported financial performance for the period in which those goods or services are supplied (paragraph 16 of the Exposure Draft).
- The IASB expects that the information about regulatory income or regulatory expense together with information required by other IFRS Accounting Standards would enable users of financial statements to understand the relationship between an entity's revenue and expenses as completely as would have been possible if there are no differences in timing associated with regulatory assets and regulatory liabilities.
- The IASB also expects the supplementary model to produce financial information that is comparable with that of entities that are not subject to rate regulation.

Staff analysis—possible courses of action available to the IASB *(continued)*

- Most respondents supported the objective of the Exposure Draft, the supplementary model and the principle in paragraph 16.
- Paragraph B15 of the Exposure Draft is closely aligned with the principle in paragraph 16. The IASB could, therefore, confirm the requirement as proposed.
- Further, the IASB may not require an entity to recognise as an asset its right to accrue regulatory returns on CWIP because requiring recognition of that right would be inconsistent with the objective.
- The effects of an entity's right to charge regulatory returns on CWIP are reflected in the revenue line item of the statement of financial performance(s) in the period in which the entity includes those returns in the rates charged to customers and recognises revenue applying IFRS 15 *Revenue from Contracts with Customers*.
- The IASB could resolve some of the respondents' concerns by:
  - requiring an entity in **RA1** to disclose the amount of regulatory returns on CWIP that accrue during the construction period; and
  - changing the unit of account (paragraph 24 of the Exposure Draft) to allow an entity in **RA2** to consider regulatory returns on CWIP as one unit of account.
- Entities in **RA2** raised concerns about the cost of implementing paragraph B15. Paragraph 24 of the Exposure Draft proposed that a right or obligation arising from each individual difference in timing should be accounted for as a separate unit of account. While the Exposure Draft does not describe an individual difference in timing, many respondents read that paragraph together with the proposed illustrative examples as requiring an entity to identify regulatory returns on CWIP with each component of property, plant and equipment.
- The IASB could consider changing the proposed unit of account to allow an entity to consider regulatory returns on CWIP as one unit of account without identifying those returns with each component of property, plant and equipment. An entity would:
  - in measuring the regulatory liability, estimate the amount of accumulated regulatory returns on CWIP relating to all items of property, plant and equipment that become available for use in a period; and
  - in recognising the fulfilment of the regulatory liability, use the average recovery period of the carrying amount of those items.
- This may potentially reduce the cost of implementing paragraph B15.
- The pros and cons of confirming the proposal are as follows:

+	−
• A simple course of action that retains the proposed objective, supplementary model and principles. • Alleviates concerns about the cost of implementing the proposal.	• Does not respond to the respondents' main concern about not reflecting regulatory returns on CWIP in the reported financial performance for the construction period.

Staff analysis—possible courses of action available to the IASB *(continued)*

5 Narrowing the application of the proposal

- A few users of financial statements who supported the proposal suggested the IASB consider narrowing the application of paragraph B15 of the Exposure Draft to long-duration construction projects. They thought applying the proposal would provide useful information only for long-duration construction projects.
- Therefore, the IASB could consider narrowing the application of the proposal to, say, all qualifying assets as defined in IAS 23 *Borrowing Costs*.[5]
- If the IASB were to take this course of action and issue the Standard, applying the Standard in **RA2** would produce outcomes similar to the preferred solution of respondents for CWIP that is not a qualifying asset as defined in IAS 23.
- Furthermore, as in the previous course of action, the IASB could resolve some of the respondents' concerns by:
  - requiring an entity in **RA1** to disclose the amount of regulatory returns on CWIP that accrue during the construction period; and
  - changing the unit of account (paragraph 24 of the Exposure Draft) to allow an entity in **RA2** to consider regulatory returns on CWIP as one unit of account.

- The pros and cons of narrowing the application of the proposal are as follows:

+ (Pros)	− (Cons)
• A simple course of action that retains the proposed objective, supplementary model and principles. • Focuses on information that is useful to the users of financial statements. • Alleviates concerns about the cost of implementing the proposal.	• Does not respond to the respondents' main concern about not reflecting regulatory returns on CWIP in the reported financial performance for the construction period.

5 IAS 23 defines a qualifying asset as an asset that necessarily takes a substantial period of time to get ready for its intended use or sale.

Staff analysis—possible courses of action available to the IASB *(continued)*

Other considerations

- As explained before, the IASB adopted a supplementary model in developing the Exposure Draft.
- In making any changes to the proposals, the IASB has to consider whether those changes would:
  - be consistent with the supplementary model; and
  - meet the objective of enabling users of financial statements to understand the relationship between an entity's revenue and expenses as completely as would have been possible if there are no differences in timing associated with regulatory assets and regulatory liabilities.
- For example, if the IASB were to decide to allow an entity to reflect regulatory returns on CWIP in the reported financial performance for the construction period, it may also have to consider whether to require an entity to recognise in profit or loss borrowing costs that are directly attributable to the acquisition, construction or production of a qualifying asset (IAS 23).[6]

6 IAS 23 defines borrowing costs as interest and other costs that an entity incurs in connection with the borrowing of funds.

Questions for the Group
1. Have we correctly analysed the pros and cons of each course of action?
2. Are there any implementation issues associated with the different courses of action, which we should be aware of?
3. Are there other potential courses of action we should consider?