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Discounting of regulatory assets and regulatory liabilities and sufficiency of the regulatory interest rate

Issues paper

Objective of this paper

1 This paper aims to extend discussion on the two different and inconclusive views expressed in EFRAG's draft comment letter (DCL) on the IASB Exposure Draft *Regulatory assets and Regulatory Liabilities* (the ED) proposal for the discounting of regulatory assets and regulatory liabilities. The discussion is intended to help EFRAG RRAWG and EFRAG TEG to reach a consensus in developing a position for EFRAG's final comment letter on the ED.

IASB proposal on discounting

2 Paragraphs 46-49 of the ED propose that an entity discount regulatory assets and regulatory liabilities using the regulatory interest rate (except when the regulatory interest rate for a regulatory asset is insufficient). Paragraphs BC159–BC166 of the Basis for Conclusions describe the reasoning behind the IASB's proposals.

3 In cases when there is an indication that the regulatory interest rate for a regulatory asset is not sufficient to compensate the entity for the time value of money and uncertainty risks, the ED (paragraphs 50–53) proposes that an entity estimates the "minimum interest rate' and to use this rate to discount the estimated future cash flows of the regulatory asset. For a regulatory liability, an entity would use the regulatory interest rate as the discount rate in all circumstances. Paragraphs BC167–BC170 of the Basis for Conclusions describe the reasoning behind the IASB's proposals.

4 Paragraph 54 of the ED proposes that, in cases when a regulatory agreement provides a series of different regulatory interest rates in successive periods, an entity translate those uneven rates into a single discount rate for use throughout the life of the regulatory asset or regulatory liability. The result would be similar to determining an effective interest rate.

EFRAG's position in the DCL

5 The paragraphs below provide a summary of EFRAG's response to the proposal on discounting and determining a minimum interest rate for regulatory assets when the regulatory rate is considered "insufficient" (Question 6 of the ED).

6 EFRAG supports the proposal to require an entity to discount the estimated future cash flows to their present value in measuring regulatory assets and regulatory liabilities. In EFRAG's view, the concept of discounting is a fundamental part of general IFRS requirements where the effects of the time value of money are significant.

7 Like in IFRS 15 *Revenue from Contracts with Customers*, EFRAG recommends that the IASB consider introducing a practical expedient to exempt entities from discounting if the effects of discounting are not significant.

8 EFRAG disagrees with the proposal for different discounting approaches for regulatory assets and regulatory liabilities.

9 EFRAG is concerned by the complexity of the proposal, particularly regarding the minimum rate. EFRAG considers that the IASB should better clarify the purpose of discounting and has not formed a view at this stage and seeks constituents' feedback on how regulatory assets and regulatory liabilities should be discounted and seeks stakeholders' assessment of the highlighted cost/benefit versus relevance of information - before concluding on its position in the final comment letter to the IASB. There are two possible views:

(a) **View 1**: Use the regulatory interest rate for regulatory assets and regulatory liabilities.

(b) **View 2**: Discounting of regulatory assets and regulatory liabilities should follow the general discounting principles in IFRS Standards because the objective of discounting is to appropriately reflect the effects of the time value of money. The regulatory interest rate might have a different objective. In cases where there is a significant financing component and the regulatory interest rate differs from the market rate, an entity should apply the requirements in IFRS 15 and use the prevailing interest rates in the relevant market.

10 Under both these views, EFRAG is concerned with the complexity introduced by the proposed minimum rate concept.

11 EFRAG agrees with the proposal that an entity should translate those rates into a single discount rate for use throughout the life of the regulatory asset or regulatory liability, in cases where the discount rates are uneven.

EFRAG's View 1 - Use the regulatory interest rate for regulatory assets and regulatory liabilities.

12 Under View 1, an entity would always use the regulatory interest rate to discount regulatory assets and regulatory liabilities. The regulatory interest rate is negotiated with the regulator and considered objective by users.

13 Supporters of this view disagree with the proposed application of a minimum interest rate as the discount rate for regulatory assets, when the regulatory interest rate provided for a regulatory asset is insufficient. What matters ought to be the discount rate agreed with the regulator, as this represents the rate the entity is entitled to recover (fulfil) when measuring its regulatory assets and regulatory liabilities. Therefore, the application of a minimum interest rate would not be relevant information for users to understand regulatory assets and regulatory liabilities.

EFRAG concerns about estimating minimum interest rate

14 EFRAG disagrees with the use of a minimum adequate rate as the discount rate for regulatory assets, when the regulatory interest rate provided for a regulatory asset is insufficient.

15 In EFRAG's view, the regulatory agreement does not use the concept of a minimum adequate rate and introducing such a rate in the accounting model might be a subjective and complex exercise for preparers. As a result, EFRAG considers that it would likely be challenging in practice to apply the concepts of minimum interest rate (or insufficient or inadequate rate) and would be subject to a lot of discussion with the auditors given the level of judgement involved to make this assessment.

16 What matters ought to be the discount rate agreed with the regulator, as this represents the rate the entity is entitled to recover (fulfil) when measuring its regulatory assets and regulatory liabilities. Therefore, EFRAG considers that the application of a minimum adequate rate would not be relevant information for users to understand regulatory assets and regulatory liabilities.

17 Moreover, EFRAG is concerned that assessing whether a discount rate is sufficient will involve a high degree of subjective judgement and it will be difficult to come to an agreement with auditors on what constitutes a sufficient discount rate. This will likely result in undue costs that will outweigh the benefits of the proposal.

EFRAG's view 2 – Apply the general discounting principles in IFRS Standards

18 Discounting of regulatory assets and regulatory liabilities should follow the general discounting principles in IFRS Standards because the objective of discounting is to appropriately reflect the effects of the time value of money. The regulatory interest rate might have a different objective. In cases where there is a significant financing component and the regulatory interest rate differs from the market rate, an entity should apply the requirements in IFRS 15 and use the prevailing interest rates in the relevant market.

Developing an EFRAG Position- Points for further consideration by EFRAG TEG and EFRAG RRAWG

19 Conceptual basis -- What attributes of regulatory assets and regulatory liabilities justify a different discounting approach from that applied for other assets and liabilities reported under IFRS Standards?

20 Usefulness of information- What does the regulatory interest rate represent (time value of money, business risk, both)? The regulatory interest rate can have differing objectives across jurisdictions- should this have implications on its application for discounting?

21 What are the costs and operational challenges associated with the proposed ED requirements for discounting? Addressed in paragraphs that summarise what we have heard so far from outreach.

Background information- IASB discussions on Discounting a regulatory asset and assessing "sufficiency"

22 The summary of past IASB meetings below where the discounting was discussed highlight and help to contextualise the reasoning underpinning the ED's proposed requirements.

23 The IASB discussed discounting of regulatory assets and regulatory liabilities at its June 2019 meeting (agenda paper 9D). A more detailed analysis of the IASB proposal on discounting is provided below.

24 In AP9D (paragraph 27) of the June 2019 IASB meeting, the IASB staff explained that:

(a) It is expected to be rare that an entity would conclude that the rate of interest or return being provided for an entire time band is inadequate[1]. Rather, it is more likely that a regulatory agreement would cause a specific regulatory asset to attract a rate of interest or return which is different than that for other items of similar duration and that this rate may not be adequate.

(b) However, if there exists any indication that the regulatory agreement is not providing a rate of interest or return which is adequate for the time and risks, then the IASB staff recommended that the entity be required to estimate a 'minimum adequate rate'.

(c) Having established the minimum adequate rate, the entity would then need to compare this to the rate being provided by the regulatory agreement for the regulatory asset. In instances where the rate being provided is less than the minimum adequate rate, a **'partial disallowance' has effectively been imposed on the entity** – that is, the entity will not recover the entire nominal value of the regulatory asset (i.e., the difference, at origination, between the total allowed compensation and the amount included in the rate(s) charged to customers).

25 The IASB staff reasoning in paragraph 24(c) is explained in the following example included in AP9D of the June 2019 IASB meeting:

[1] The ED refers to insufficient instead of inadequate.

Example 1

Fact pattern

A regulatory asset arises in X0 related to expenses of CU100 incurred by the entity which will be recovered through the rates charged to customers evenly over the 4 years X1-X4 (ie CU25 per year). However, the regulatory agreement provides no return or interest to the entity on the outstanding amount of the regulatory asset.

Application of the measurement principles

The entity determines that the return of zero inadequately compensates the entity for the time and risks. The entity therefore determines the minimum adequate rate to compensate it for the time and risks specific to this regulatory asset—this is determined to be 3.0%.

The entity has experienced a partial disallowance as the minimum adequate rate is higher than the rate of interest provided by the regulatory agreement. The entity recognises the regulatory asset at its present value as measured using the minimum adequate rate in X0, as shown below:

DETERMINATION OF PRESENT VALUE		X0	X1	X2	X3	X4
CASH FLOWS		100.00	(25.00)	(25.00)	(25.00)	(25.00)
NPV @	3%	92.93				
PARTIAL DISALLOWANCE:		(7.07)				

Thereafter, the entity records interest at the minimum adequate rate throughout the period of recovery:

ACCOUNTING OUTCOME						
Regulatory asset	X0	X1	X2	X3	X4	Total
Opening balance	-	**92.93**	**70.72**	**47.84**	**24.27**	**(0.00)**
Origination	92.93	-	-	-	-	92.93
Interest at **3%**	-	2.79	2.12	1.44	0.73	7.07
Recovery through the rate(s)	-	(25.00)	(25.00)	(25.00)	(25.00)	(100.00)
Closing balance	**92.93**	**70.72**	**47.84**	**24.27**	**(0.00)**	**(0.00)**

This would result in the following summarised statement of financial performance:

Profit & Loss Account	X0	X1	X2	X3	X4	Total
Revenue	-	25.00	25.00	25.00	25.00	100.00
Regulatory income / (expense)	92.93	(22.21)	(22.88)	(23.56)	(24.27)	-
Expenses	(100.00)	-	-	-	-	(100.00)
Profit or loss	**(7.07)**	**2.79**	**2.12**	**1.44**	**0.73**	-

26 Paragraphs 50-52 of the ED, explain that the assessment of whether the regulatory interest rate is sufficient, is based on an indicator-based approach. There may be such indications if, for example, the **regulatory interest rate provided for a regulatory asset is lower than**:

(a) the regulatory interest rate provided for other regulatory assets in the same currency and having a similar maturity profile and subject to similar uncertainties; or

(b) the interest rate on loans in the same currency and having a maturity profile, credit risk, and terms and conditions similar to those of the regulatory asset, after deducting any part of that interest rate intended to recover the cost of servicing the loans and any estimated credit losses already included in the estimated cash flows. Such loans could be loans that the entity itself provides or other loans for which the interest rate is readily observable.

27 Paragraph 168 of the Basis for Conclusions explains that:

*"'if the minimum interest rate is higher than the regulatory interest rate, the entity would use the minimum interest rate as the discount rate, thus reducing the carrying amount of the regulatory asset. In some circumstances, that reduced carrying amount would be less than the amount of the related allowable expenses. The difference in amounts arises because the regulatory agreement does not provide the entity with sufficient compensation for the time lag until recovery of the regulatory asset—**in effect, disallowing part of the related expenses**. When the minimum interest rate is used as the discount rate, subsequent regulatory interest income would be accrued at that rate."*

Reasons to justify the IASB proposal

Usefulness of information

28 The IASB considers that the proposal to estimate a minimum interest rate for a regulatory asset will allow an entity to more appropriately reflect the time value until recovery of the regulatory asset.

29 In cases when the regulatory interest rate is <u>lower</u> than the interest rate an entity should have received on a similar asset, the entity will recognise a loss in profit in loss. The IASB considers that this loss represents the disallowed (or partially disallowed) expense that the entity is unable to recover from its customers through future rates.

Conceptual basis

30 One could argue that from a conceptual point of view, the loss represents the fact that the entity will not fully recover the regulatory asset and so should recognise an expense immediately in profit or loss for the partial disallowance of the related expenses. In a way, this treatment is similar to an immediate impairment of the regulatory asset, for the disallowed portion. This ''impairment'' would reverse if in future periods the regulatory interest rate increases and becomes higher than the ''minimum'' interest rate that was previously determined.

31 However, the ED does not propose a symmetrical accounting approach for regulatory liabilities and recognise a loss in cases when the regulatory interest rate on a regulatory liability is higher than the rate an entity would pay on a similar liability (see paragraphs below).

Costs of applying the proposal

32 In AP9D (paragraphs 11 and 15) of the June 2019 IASB meeting, the IASB staff noted that situations when the regulatory interest rate is insufficient are likely to be limited. The staff expect the interest or return rate provided by the regulatory agreement will adequately compensate an entity for the time value and risks inherent in the cash flows in most cases, and consequently, that in most cases it will be appropriate to use that rate as the discount rate.

Discounting a regulatory liability

33 For regulatory liabilities, the ED requires an entity to always use the regulatory interest rate to discount those liabilities and does not propose an entity to calculate a "minimum'' interest rate when the regulatory interest rate is higher than what an entity would pay on a similar liability of a similar duration.

34 In AP9D (paragraphs 50-54) of the June 2019 IASB meeting, the IASB staff noted that in some cases, the regulatory interest rate or return rate applied to a regulatory liability may be higher than the interest rate or return rate that the entity might have to pay if it obtained funding elsewhere in the form of a financial liability for the same amount and duration.

35 However, in the IASB staff's view, this does not automatically make a regulatory liability onerous. This is because:

(a) The IASB staff expect the regulatory interest rate in the regulatory agreement will apply to all items (regulatory assets and regulatory liabilities) within the same time band.

(b) An excessive regulatory interest rate on a regulatory liability may merely offset an excessive regulatory interest rate on a larger regulatory asset, so that the regulatory interest rate sufficiently compensates the entity for an overall net regulatory asset position.

(c) If there were no identifiable events or transactions that would explain the difference in the return rate applied to the regulatory liability and the rate that the entity might have paid if it had obtained similar financing elsewhere.

36 Furthermore, the IASB staff consider an excess charge on a net regulatory liability position to be rare because regulatory interest rates and return rates are set with the aim of achieving the regulatory objective of making it financially viable for the entity to fulfil its requirements for the supply of the goods or services. They explain that research conducted by the Accounting Standards Board of Canada supports this view. [2]

37 In the view of the IASB staff, an excess interest or return charged on a regulatory liability or net regulatory liability position could be an indication that the regulator is imposing a penalty on the entity. The imposition of such a penalty would represent an identifiable transaction or event and would result in an entity immediately recognising the penalty charge as an expense, rather than recognising the whole of the regulatory interest or return over time.

38 In AP9D of the June 2019 IASB meeting, the IASB staff do not discuss situations when the interest rate is lower than what an entity would pay on a similar liability of the same duration.

39 Paragraphs 169 and 170 of the Basis for Conclusions explains the IASB reasoning which is in line with the IASB staff analysis discussed above in paragraphs 34 - 37.

"To avoid introducing unnecessary cost and complexity, the Board proposes not to require an entity to assess whether the regulatory interest rate for a regulatory liability is excessive—in other words, more than is needed to charge the entity for the time value of money and uncertainty.

[2] A research paper titled Rate-regulated Activities: Exploring the decision-usefulness of financial information that reflects the economics of rate-regulated activities, published in November 2018 by the Accounting Standards Board of Canada, highlights that for a sample of Canadian electric utilities over 2011-2015, credit balances totalled less than 10% of debit balances arising from rate regulation. (see https://www.frascanada.ca/en/acsb/news-listings/2018-rra-update for research paper).

*Because any such excess would not be excluded from the discount rate, **the excess would be reflected by higher regulatory interest expense over time**, rather than by higher regulatory expense at initial recognition of the regulatory liability. In some cases, an excessive regulatory interest rate on a regulatory liability may merely offset an excessive regulatory interest rate on a larger regulatory asset, so that the regulatory interest rate sufficiently compensates the entity for an overall net regulatory asset position. In the Board's view, an entity is unlikely to be subject to an excessive regulatory interest rate on a large overall net regulatory liability position."*

For similar reasons, the Board also proposes not to require an entity to use a discount rate that is sufficient to charge the entity for the time value of money and uncertainty if the regulatory interest rate for a regulatory liability is lower than that rate. Thus, any insufficiency in the regulatory interest rate would be reflected by lower regulatory interest expense over time, rather than by lower regulatory expense at initial recognition of the regulatory liability."

Reasons to justify the IASB proposal

Usefulness of information

40 Refer to paragraph 39 above. The IASB reasoning on the resulting information of the proposal, seems to be because it considers that, any such excess in the interest rate for a regulatory liability, would not be excluded from the discount rate; **the excess would be reflected by higher regulatory interest expense over time**, rather than by higher regulatory expense at initial recognition of the regulatory liability.

41 The IASB also consider that in some cases, an excessive regulatory interest rate on a regulatory liability may merely offset an excessive regulatory interest rate on a larger regulatory asset, so that the regulatory interest rate sufficiently compensates the entity for an overall net regulatory asset position. In the IASB's view, an entity is unlikely to be subject to an excessive regulatory interest rate on a large overall net regulatory liability position."

Conceptual basis

42 The IASB decision does not seem to be conceptually justified, as one could argue that similar reasoning as in paragraph 40, could apply when the regulatory interest rate on a regulatory asset is lower than what an entity would expect to get. In other words, instead of recognising an immediate loss, that loss could be recognised over time.

Costs of applying the proposal

43 The IASB explains it is trying to avoid introducing unnecessary costs and complexity.

Summary of EFRAG and EFRAG TEG discussions on discounting

EFRAG RRAWG

44 EFRAG RRAWG discussed discounting of regulatory assets and regulatory liabilities at its meetings in October 2019, June 2020 and February 2021.

45 At the October 2019 meeting, some members suggested that it would be more practical for entities to apply a 'reasonable' discount rate at each balance sheet date instead of keeping track of different discount rates established at initial recognition of regulatory items. Another alternative was to use the WACC at each balance sheet date. some EFRAG RRAWG members commented that the concept of discounting when measuring regulatory items was not very relevant to those items as the

amounts to be recognised as regulatory assets and regulatory liabilities were initially negotiated with the regulator.

46 EFRAG RRAWG members also commented on the asymmetrical accounting being developed by the IASB on discounting:

(a) when the regulatory interest rate is lower than the minimum adequate rate, then the entity should use minimum adequate rate to discount estimated future cash flows – consequently, the entity should recognise a Day 1 loss, however;

(b) when the regulatory interest rate provides an excess compensation, which does not relate to an identifiable transaction or event, then the entity should use the regulatory interest rate to discount estimated future cash flows and there is no recognition of a Day 1 gain.

47 At the June 2020 meeting, EFRAG RRAWG discussed the key messages to be included in EFRAG's draft comment letter. The following comments were made:

(a) RRAWG members confirmed their disagreement with the IASB tentative decision that when the regulatory discount rate (regulatory interest rate) is inadequate to compensate the entity for the time value of money and uncertainty inherent in the cash flows, the entity should determine a minimum adequate rate to use as the discount rate.

(b) EFRAG RRAWG members pointed out that the regulatory agreement does not use the concept of a minimum adequate rate and introducing such a rate in the model would be a highly subjective and complex exercise for preparers. Some EFRAG RRAWG members referred to the complexities associated with discounting of deferred tax assets and liabilities, which is why IAS 12 does not require discounting.

(c) The RRAWG members identified the following additional concerns:

(i) Regulatory rate of interest or return –. A suggestion was made that it would be more practical for entities to apply a 'reasonable' discount rate at each balance sheet date instead of keeping track of different discount rates established at initial recognition of regulatory items. Another alternative was to use the weighted average cost of capital (WACC) at each balance sheet date.

(ii) Implicit rate of interest or return usually refers to return on capital invested and the proposed terminology might create created confusion when used to discount regulatory assets and regulatory liabilities under the model.

(d) Some EFRAG RRAWG members commented that the concept of discounting when measuring regulatory items was not very relevant to regulatory assets and regulatory liabilities as the amounts to be recovered (settled) were initially negotiated with the regulator. It was therefore questionable why they should be discounted. EFRAG RRAWG members expressed views that the application of a minimum adequate rate would not bring value to users to understand regulatory assets and regulatory liabilities. What mattered was the discount rate agreed with the regulator.

(e) The EFRAG RRAWG members that supported discounting said that it should be based on the regulatory discount rate (regulatory interest) which is used to compensate the entity for the time lag until recovery of a regulatory asset or fulfilment of a regulatory liability.

48 In February 2021, EFRAG RRAWG discussed its initial position on the EFRAG draft comment letter. Summary of the comments provided were as follows:

(a) EFRAG RRAWG members did not support the proposal to determine a minimum adequate discount rate when the regulatory interest was considered insufficient and thus agreed with EFRAG's draft response. The proposal would be highly judgemental, subjective and likely result in lengthy discussions to justify whether the rate was sufficient.

(b) One EFRAG RRAWG member highlighted that the definition of regulatory interest rate in Appendix A of the ED was inconsistent with the capital asset pricing model used in many regulatory agreements, which not only compensated an entity for time lag before regulatory assets (liabilities) are recovered (fulfilled) but also for business risk.

EFRAG TEG

49 EFRAG TEG discussed the topic at its meetings in November 2019, September 2020 and in March 2021.

50 At the November 2019 EFRAG TEG meeting, some EFRAG TEG members disagreed with the discounting approach being developed by the IASB. They referred either to the general principle of adjusting the rate to reflect the risks or to the IAS 12 approach as a possible way forward. They suggested to assess in practice which rate was applied by the members of the RRAWG working group.

51 At the September 2020 EFRAG TEG meeting, EFRAG TEG members reiterated the concern about the uncertainty regarding the discount rates to be used in the accounting model. The EFRAG project team discussed this with EFRAG RRAWG members (summarised in above paragraphs). RRAWG members did not support the IASB proposal on applying a minimum interest rate for regulatory assets when the regulatory interest is deemed to be insufficient. EFRAG RRAWG also did not support applying the general discounting principles in IFRS Standards to regulatory assets and regulatory liabilities. In their view, what matters is the regulatory interest rate as that is the agreed interest rate which is enforceable and needs to be applied when determining the rates charged to customers.

52 At the 26 March 2021 EFRAG TEG meeting, EFRAG TEG discussed an initial draft comment letter. Regarding the proposal on discounting, EFRAG TEG disagreed with the proposal to have different discounting approaches for regulatory assets and regulatory liabilities. EFRAG TEG also expressed mixed views on how regulatory assets and regulatory liabilities should be discounted. The two views expressed in the EFRAG draft comment letter.

What the EFRAG project staff has heard so far during outreach?

53 So far, our outreach has informed that some entities see discounting of regulatory assets and regulatory liabilities as being highly complex or operationally challenging. Some have suggested that the complexity is comparable to discounting deferred tax assets (liabilities) under IAS 12 *Income Taxes*, which is why IAS 12 does not require discounting.

54 A stakeholder mentioned the need for clarity on the objective of discounting taking into account that the regulatory interest rate can have varying objectives.

55 Those that accept discounting, suggest using the regulatory interest rate for both regulatory liabilities and regulatory assets.

56 Furthermore, we have heard that if the minimum interest rate is higher than the regulatory interest rate on a regulatory asset, the resulting loss (expense) recognised in profit or loss is seen as counterintuitive.

57 The EFRAG project staff have not heard any support for discounting regulatory assets and regulatory liabilities using the general discounting principles in IFRS Standards (EFRAG's View 2).

Questions for EFRAG RRAWG-TEG members

<u>EFRAG position on discounting</u>

58 As noted, in the DCL, EFRAG disagrees with the use of a minimum adequate rate as the discount rate for regulatory assets. After considering the points for further consideration (conceptual basis, usefulness of information and operational challenges) and the context of the reasoning underpinning the requirements from past IASB meetings, which of the following views do EFRAG RRAWG-TEG members support? And why?

(a) Discounting regulatory assets and regulatory liabilities only using the regulatory interest rate

(b) Discounting regulatory assets and regulatory liabilities using the general discounting principles in IFRS Standards as an alternative to the ED proposal

<u>Application of ED proposals</u>

59 Please explain the operational complexities that discounting would represent in general? Specific examples can also help.

60 How often would you conclude that the regulatory rate of interest being provided by the regulator is insufficient?

61 What would be the reasons why the regulatory interest rate on a regulatory asset would be lower than what your company could get on a similar asset?

62 How complex would it be to estimate a minimum interest rate for regulatory assets?

63 If the minimum interest rate is higher than the regulatory interest rate for a regulatory asset, would you consider the resulting loss to be counterintuitive? If so, why?