
Consultative Group for Rate Regulation

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Purpose of the paper

- The purpose of the paper is:
 - to discuss feedback on the proposals dealing with discounting estimated future cash flows in the Exposure Draft *Regulatory Assets and Regulatory Liabilities* (Exposure Draft)—that is, paragraphs 46–58 of the Exposure Draft; and
 - to gather input from members of the IASB Consultative Group for Rate Regulation (Consultative Group) to help develop staff recommendations for the IASB.

Structure of the paper

- The paper is divided into the following sections:
 - regulatory interest rate as the discount rate (slides 3–8);
 - minimum interest rate (slides 9–14); and
 - uneven regulatory interest rate (slides 15–18).
- Each of these sections includes:
 - a summary of the proposed requirements and the feedback; and
 - questions for the members of the Consultative Group.

Regulatory interest rate as the discount rate



Regulatory interest rate as the discount rate (1/5)

Table 1

Proposed requirements

The Exposure Draft proposes to measure regulatory assets and regulatory liabilities using a cash-flow-based measurement technique that involves:

- a) estimating future cash flows and updating them at the end of each reporting period to reflect conditions existing at that date; and
- b) discounting those estimates of future cash flows.

In discounting the estimates of future cash flows, paragraphs 46–49 and 55 of the Exposure Draft propose that an entity:

- a) uses the regulatory interest rate for a regulatory asset or regulatory liability as the discount rate, unless the regulatory interest rate for a regulatory asset is insufficient;¹ and
- b) continues to use the discount rate at initial recognition, except when the regulatory agreement changes the regulatory interest rate subsequently. In that case, the entity would use the new regulatory interest rate as the new discount rate.

The Exposure Draft defines **regulatory interest rate** as 'the interest rate provided by a regulatory agreement to compensate an entity for the time lag until recovery of a regulatory asset or to charge the entity for the time lag until fulfilment of a regulatory liability'.

¹ Table 2 describes the proposals for determining the discount rate when the regulatory interest rate for a regulatory asset is insufficient.

Regulatory interest rate as the discount rate (2/5)

Table 1

Feedback

- Most respondents agreed with the proposed requirement to use the regulatory interest rate for a regulatory asset or regulatory liability as the discount rate for that regulatory asset or regulatory liability.
- A few respondents disagreed with discounting estimates of future cash flows when:
 - a) the regulatory assets and regulatory liabilities attract regulatory interest because discounting would result in similar measurements to those that would be obtained using an approach that does not discount estimates of future cash flows; and
 - b) the regulatory agreement does not provide a regulatory interest rate. These respondents said determining the discount rate for these cases would be challenging. Other respondents said it is unclear whether the regulatory interest rate in those cases is nil and if so, what factors should be considered in determining the discount rate.
- A few respondents asked for clarification about how an entity determines the regulatory interest rate when that rate has not been set for the full life of a regulatory asset or regulatory liability.

Regulatory interest rate as the discount rate (3/5)

Table 1

Feedback (*continued*)

- Many respondents said that the final Standard should provide an exemption from discounting the estimates of future cash flows arising from a regulatory asset or regulatory liability when:
 - a) the effect of discounting is not significant, similar to the exemption in IFRS 16 *Leases* or to the practical expedient in IFRS 15 *Revenue from Contracts with Customers*; or
 - b) the regulatory asset or regulatory liability is expected to be recovered or fulfilled within a specified period, for example one year.
- A few respondents said that an entity should be exempted from discounting when:
 - a) the regulatory agreement does not specify a timeframe over which the estimated future cash flows arising from a regulatory asset or regulatory liability would be included in determining future regulated rates;
 - b) a difference in timing changes frequently from being a regulatory asset to becoming a regulatory liability and vice versa; or
 - c) a regulatory asset or regulatory liability arises from an item of expense or income that is measured using discounted cash flows applying IFRS Accounting Standards.

Regulatory interest rate as the discount rate (4/5)

Table A—Questions for the Consultative Group

1. In some cases, the regulatory agreement **does not** provide (charge) a regulatory interest rate for a regulatory asset (regulatory liability)—the regulatory agreement either provides (charges) an explicit 0% interest rate or does not specify any interest rate.
 - a) How common and significant are these regulatory assets (regulatory liabilities)?
 - b) Which components of the regulatory compensation typically give rise to these regulatory assets (regulatory liabilities)—for example, specific items of allowable expenses or performance incentives?
 - c) What are the regulator’s main reasons for not providing (charging) a regulatory interest rate?
 - d) How long are the recovery (fulfilment) periods of these regulatory assets (regulatory liabilities)?
2. A few respondents said that discounting would be challenging when the regulatory agreement does not specify a timeframe over which a regulatory asset (regulatory liability) would be recovered (fulfilled). How common is this situation and how significant are these regulatory assets (regulatory liabilities)?

Regulatory interest rate as the discount rate (5/5)

Table A—Questions for the Consultative Group (*continued*)

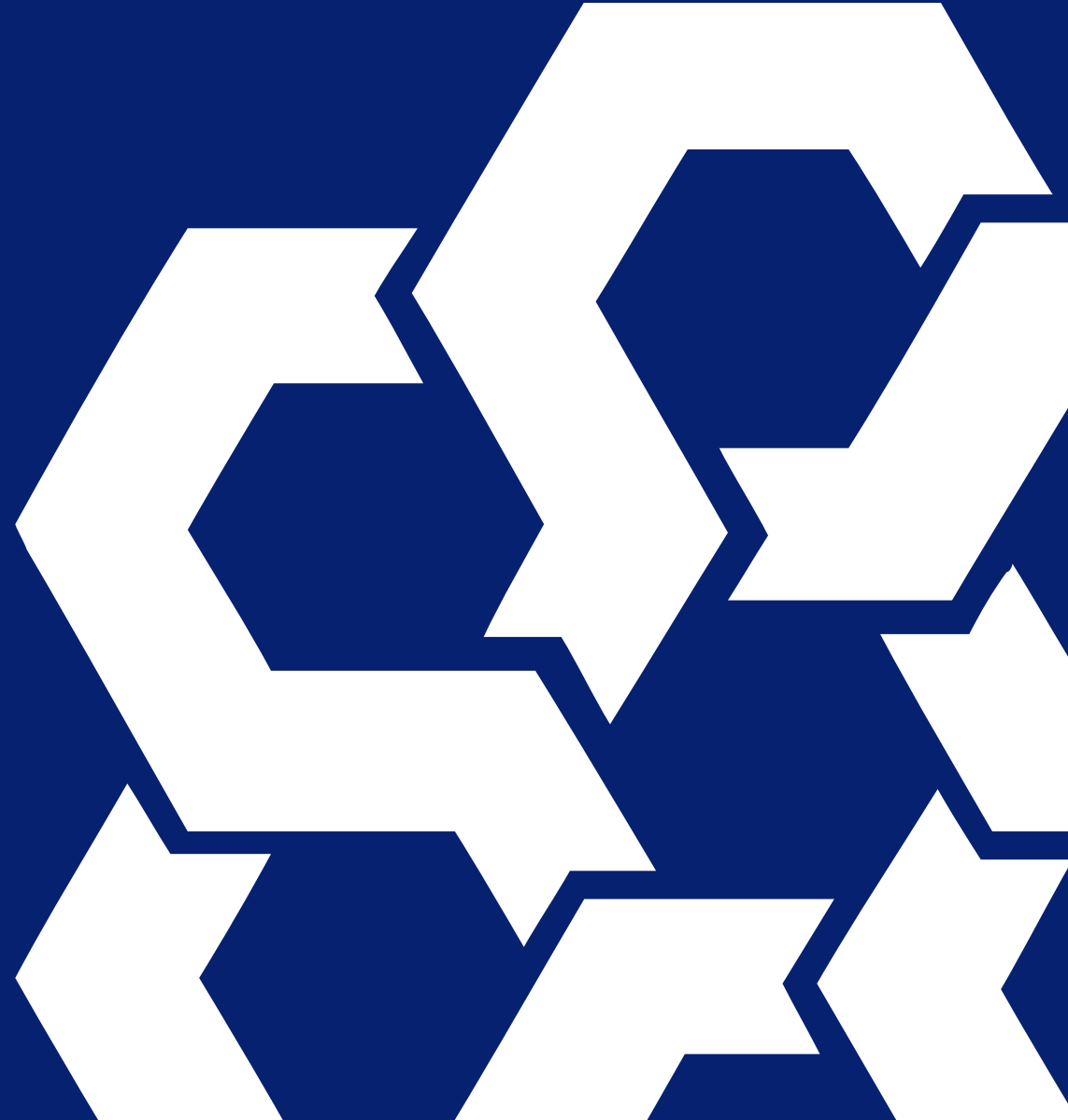
3. Appendix A includes an example in which a difference in timing arises from an item of expense relating to a provision measured using discounted cash flows in accordance with IFRS Accounting Standards. The regulator allows the entity to receive compensation for both the present value of the cash flows arising from the provision and the unwinding of the related discount with a two-year time lag.

Appendix A illustrates how the measurement proposals in the Exposure Draft would be applied to such differences in timing (Alternative 1) and an alternative approach that uses the measurement basis applied to the provision (Alternative 2).

Considering this example:

- a) Would applying the proposed cash-flow-based measurement technique to those regulatory assets (regulatory liabilities) provide useful information (Alternative 1)? Why or why not?
 - b) If your answer to (a) is no, how would you define those differences in timing for which you think using the measurement basis applied to the related liability (asset) might provide more useful information (Alternative 2)?
4. What are your views on a possible exemption from discounting regulatory assets (regulatory liabilities) that:
- a) are recovered or fulfilled within a specified period? What would be an appropriate length for such a period and why?
 - b) meet other specified conditions? If so, what would be those conditions and why?

Minimum interest rate



Minimum interest rate (1/5)

Table 2

Proposed requirements

Paragraphs 50–51 of the Exposure Draft propose that, on the initial recognition of a regulatory asset and then subsequently if the regulatory agreement changes the regulatory interest rate:

- a) an entity assesses whether there is **any indication** that the regulatory interest rate for a regulatory asset may be **insufficient** to compensate the entity for the time value of money and for uncertainty in the amount and timing of the future cash flows arising from the regulatory asset; and
- b) if **such an indication exists**, the entity estimates the minimum interest rate that is sufficient to provide that compensation. In such cases, the entity would use, as the discount rate, the higher of:
 - the regulatory interest rate; and
 - that minimum interest rate.

Paragraph 53 of the Exposure Draft proposes that for a regulatory liability, an entity uses the regulatory interest rate as the discount rate in all circumstances.

Appendix B illustrates how the proposals would apply if the regulatory interest rate for a regulatory asset is insufficient.

Minimum interest rate (2/5)

Table 2

Feedback

- Some respondents agreed with the proposals in the Exposure Draft for cases when the regulatory interest rate provided for a regulatory asset is insufficient. However, most respondents did not support the proposals. Their concerns were mainly:
 - a) the complexity and costs of applying the proposals would outweigh any benefits; and
 - b) the asymmetric treatment of regulatory assets and regulatory liabilities.
- Respondents provided examples of why the costs of the proposal might outweigh the benefits:
 - a) the minimum interest rate is not used in the rate-setting process and regulatory assets have a different nature and risk profile from other assets, which may make it difficult for entities to find relevant interest rates.
 - b) in some cases, the regulatory interest rate is revised frequently. Entities would be required to reassess frequently whether the new regulatory interest rate is sufficient, and if not, determine the new minimum interest rate.
 - c) some differences in timing may give rise to a regulatory asset in some periods and a regulatory liability in other periods. Using different discount rates in those cases would result in gains or losses that do not reflect a change in economics.

Minimum interest rate (3/5)

Table 2

Feedback (*continued*)

- d) using the minimum interest rate as the discount rate would not result in more useful information than using the regulatory interest rate as the discount rate. This is because:
 - the minimum interest rate does not reflect the regulatory interest provided by the regulatory agreement.
 - discounting the regulatory asset using the minimum interest rate would result in an entity measuring the asset at a lower amount than the related item of expense. The entity would reflect a loss in profit or loss even if the regulatory agreement provides the entity with an overall adequate compensation.
 - significant estimation uncertainty involved in determining the minimum interest rate may reduce comparability of the resulting information provided by different entities.
- Many respondents said that the asymmetric treatment of regulatory assets and regulatory liabilities produces outcomes that can undermine the understandability and neutrality of the resulting information. It also makes the requirements more complex to apply. Those respondents suggested using the regulatory interest rate as the discount rate for all regulatory assets and regulatory liabilities.
- Most of the users of financial statements that provided feedback said that the proposals would reduce comparability among entities and would be confusing for users.

Minimum interest rate (4/5)

Table B—Questions for the Consultative Group

1. In some cases, the regulatory interest rate provided by a regulatory agreement to some regulatory assets may be insufficient to compensate an entity for the time value of money and for uncertainty in the amount and timing of the future cash flows arising from the regulatory assets. For the purpose of the questions below, please consider only cases in which the regulatory agreement provides a regulatory interest rate—that is, exclude cases discussed in question 1 in Table A.
 - a) What are the main reasons a regulatory agreement would provide an insufficient regulatory interest rate for these regulatory assets? What factors might indicate that the regulatory interest rate is insufficient?
 - b) How common and significant are regulatory assets with an insufficient regulatory interest rate?
 - c) What guidance do you think entities would need to determine:
 - (i) whether the regulatory interest rate for a regulatory asset is insufficient?
 - (ii) the minimum interest rate if the regulatory interest rate is insufficient?
2. If differences in timing give rise to a regulatory asset in some periods and a regulatory liability in other periods (see feedback (c) in Table 2):
 - a) In what circumstances do such regulatory assets and regulatory liabilities arise?
 - b) How significant are those regulatory assets and regulatory liabilities?
 - c) How long is the period between when a regulatory asset (regulatory liability) arises and when it becomes a regulatory liability (regulatory asset)? What is the timeframe over which these types of differences in timing exist?

Minimum interest rate (5/5)

Table B—Questions for the Consultative Group (*continued*)

3. What are the views of Consultative Group members who are users of financial statements on the concerns raised about the usefulness of information provided by applying the proposals (see feedback (d) in Table 2)?
4. What are your views on these possible alternatives:
 - Alternative 1—Retain the proposals
 - Alternative 2—Remove the proposals
 - Alternative 3—Restrict the proposals to regulatory assets with specified features (for example, long-term regulatory assets)
 - Alternative 4—Extend the proposals to regulatory liabilities

Uneven regulatory interest rate



Uneven regulatory interest rate (1/3)

Table 3

Proposed requirements

Paragraph 54 of the Exposure Draft explains that a regulatory agreement may specify at initial recognition of a regulatory asset or regulatory liability a series of different regulatory interest rates for successive periods over the life of that regulatory asset or regulatory liability. In such cases, the Exposure Draft proposes that an entity:

- a) translates those uneven regulatory interest rates into a single discount rate at initial recognition and uses that rate throughout the life of the regulatory asset or regulatory liability.
- b) continues to use the discount rate determined at initial recognition, unless the regulatory agreement changes the regulatory interest rate.

Feedback

Fewer respondents commented on this proposal than on other aspects of the discount rate proposals. Many respondents who commented agreed with the proposed approach. However, many respondents did not support the proposal because according to them the proposal adds complexity to the proposed measurement requirements with no obvious benefits. For example:

- a) in some cases, there is a time lag between when an entity recognised a regulatory asset or regulatory liability and when that regulatory asset or regulatory liability is recovered or fulfilled. The regulatory agreement may provide or charge a regulatory interest rate only when that regulatory asset or regulatory liability starts being recovered or fulfilled through the regulated rates charged. Respondents thought that the costs of applying the proposal in this case would be high.
- b) the proposal would create an additional difference between the regulatory assets and regulatory liabilities reported in financial statements and the regulatory balances determined in accordance with the regulatory agreement.

Uneven regulatory interest rate (2/3)

Table C—Questions for the Consultative Group

1. Some regulatory agreements may not provide (charge) a regulatory interest rate for a regulatory asset (regulatory liability) between when an entity recognises the regulatory asset (regulatory liability) and when the regulator allows the entity to start recovering (fulfilling) the regulatory asset (regulatory liability).

The diagram below illustrates the case of a regulatory asset (regulatory liability) that originates in T0 and the regulator allows the entity to recover (fulfil) that regulatory asset (regulatory liability) during the period T2–T4. The regulator provides (charges) regulatory interest during the period T2–T4 on the outstanding balances of the regulatory asset (regulatory liability).

T0	T1	T2	T3	T4
Regulatory asset (regulatory liability) originates		Regulatory asset (regulatory liability) is recovered (fullfilled)		
No regulatory interest		Regulatory interest		

Uneven regulatory interest rate (3/3)

Table C—Questions for the Consultative Group (*continued*)

- a) How common and significant are these regulatory assets (regulatory liabilities)?
 - b) Which components of the regulatory compensation typically give rise to these regulatory assets (regulatory liabilities)—for example, specific items of allowable expenses or performance incentives?
 - c) How long, typically, is the period between when the entity recognises those regulatory assets (regulatory liabilities) and when the regulator starts providing (charging) regulatory interest?
2. Do you think the proposals would result in useful information about regulatory assets (regulatory liabilities) and their related income (expense) that outweigh the costs of applying those proposals? Why or why not?
 3. If your answer to question (2) is no, what are your views on how an entity should discount the estimates of future cash flows arising from regulatory assets (regulatory liabilities) that have uneven regulatory interest rate? Why?

Appendix A—Differences in timing arising from items of expense or income measured using discounted cash flows



Differences in timing arising from items of expense or income measured using discounted cash flows (1/5)

Fact pattern

Entity A estimates that it will pay environmental clean-up costs of CU100 at the end of Year 5. Applying IFRS Accounting Standards, Entity A recognises at the beginning of Year 1 a provision of CU78 determined using a discount rate of 5%.

Table 1—Provision

In CU / Years	1	2	3	4	5
Opening balance	78.35	82.27	86.38	90.70	95.24
Unwinding of discount	3.92	4.11	4.32	4.54	4.76
Payment					(100.00)
Closing balance	82.27	86.38	90.70	95.24	0.00

The regulatory agreement allows the entity to recover the environmental clean-up costs on an accrual basis with a two-year time lag. This is illustrated in Table 2.

Table 2—Regulatory compensation

In CU / Years	1	2	3	4	5	6	7
Opening balance	0.00	82.27	86.38	8.43	8.85	9.30	4.76
Addition	78.35						
Unwinding of discount	3.92	4.11	4.32	4.54	4.76		
Recovery			(82.27)	(4.11)	(4.32)	(4.54)	(4.76)
Closing balance	82.27	86.38	8.43	8.85	9.30	4.76	0.00

Differences in timing arising from items of expense or income measured using discounted cash flows (2/5)

Alternative 1—Regulatory asset measured applying the cash-flow measurement technique

Entity A measures the regulatory asset applying the cash-flow-based measurement technique. Entity A determines that a discount rate of 3% is a rate that appropriately reflects the time value of money and the uncertainty in the amount and timing of the cash flows arising from the regulatory asset.

Table 3 shows a reconciliation of the regulatory asset.

In CU / Years	1	2	3	4	5	6	7
Opening balance	0.00	77.55	83.75	8.06	8.47	8.89	4.62
Amount recognised (*)	77.55						
Regulatory interest income		6.20	6.58	4.52	4.74	0.27	0.14
Recovery			(82.27)	(4.11)	(4.32)	(4.54)	(4.76)
Closing balance	77.55	83.75	8.06	8.47	8.89	4.62	0.00

(*): This is the present value of the amount of provision recognised in Year 1 (that is, CU82.27 in Table 1) discounted at 3%.

Differences in timing arising from items of expense or income measured using discounted cash flows (3/5)

Entity A's statement of financial performance (Table 4) and statement of financial position (Table 5) would be as follows:

In CU / Years	1	2	3	4	5	6	7	TOTAL
Revenue			82.27	4.11	4.32	4.54	4.76	100.00
Regulatory income / (regulatory expense)	77.55	6.20	(75.69)	0.40	0.42	(4.27)	(4.62)	0.00
Provision expense	(78.35)							(78.35)
Finance costs	(3.92)	(4.11)	(4.32)	(4.54)	(4.76)			(21.65)
Profit or loss	(4.72)	2.09	2.26	(0.02)	(0.02)	0.27	0.14	0.00

In CU / Years	1	2	3	4	5	6	7
Regulatory asset	77.55	83.75	8.06	8.47	8.89	4.62	0.00
Provision	82.27	86.38	90.70	95.24	0.00	0.00	0.00

Differences in timing arising from items of expense or income measured using discounted cash flows (4/5)

Alternative 2—Regulatory asset measured using the measurement basis applied to the provision

Entity A considers that the cash flows of its regulatory asset are related to the discounted cash flows of the provision. Entity A is of the view that it should measure the regulatory asset using the measurement basis used in measuring the provision.² As a result, Entity A does not apply discounting to the future cash flows arising from the regulatory asset.

Table 6 shows a reconciliation of the regulatory asset.

In CU / Years	1	2	3	4	5	6	7
Opening balance	0.00	82.27	86.38	8.43	8.85	9.30	4.76
Amount recognised	82.27	4.11	4.32	4.54	4.76		
Recovery			(82.27)	(4.11)	(4.32)	(4.54)	(4.76)
Closing balance	82.27	86.38	8.43	8.85	9.30	4.76	0.00

² The Exposure Draft proposes that an entity measures a regulatory asset (regulatory liability) using the measurement basis used in measuring the related liability (asset) if amounts are included in regulated rates only once cash is paid (received) on the related liability (asset) (paragraph 61 of the Exposure Draft).

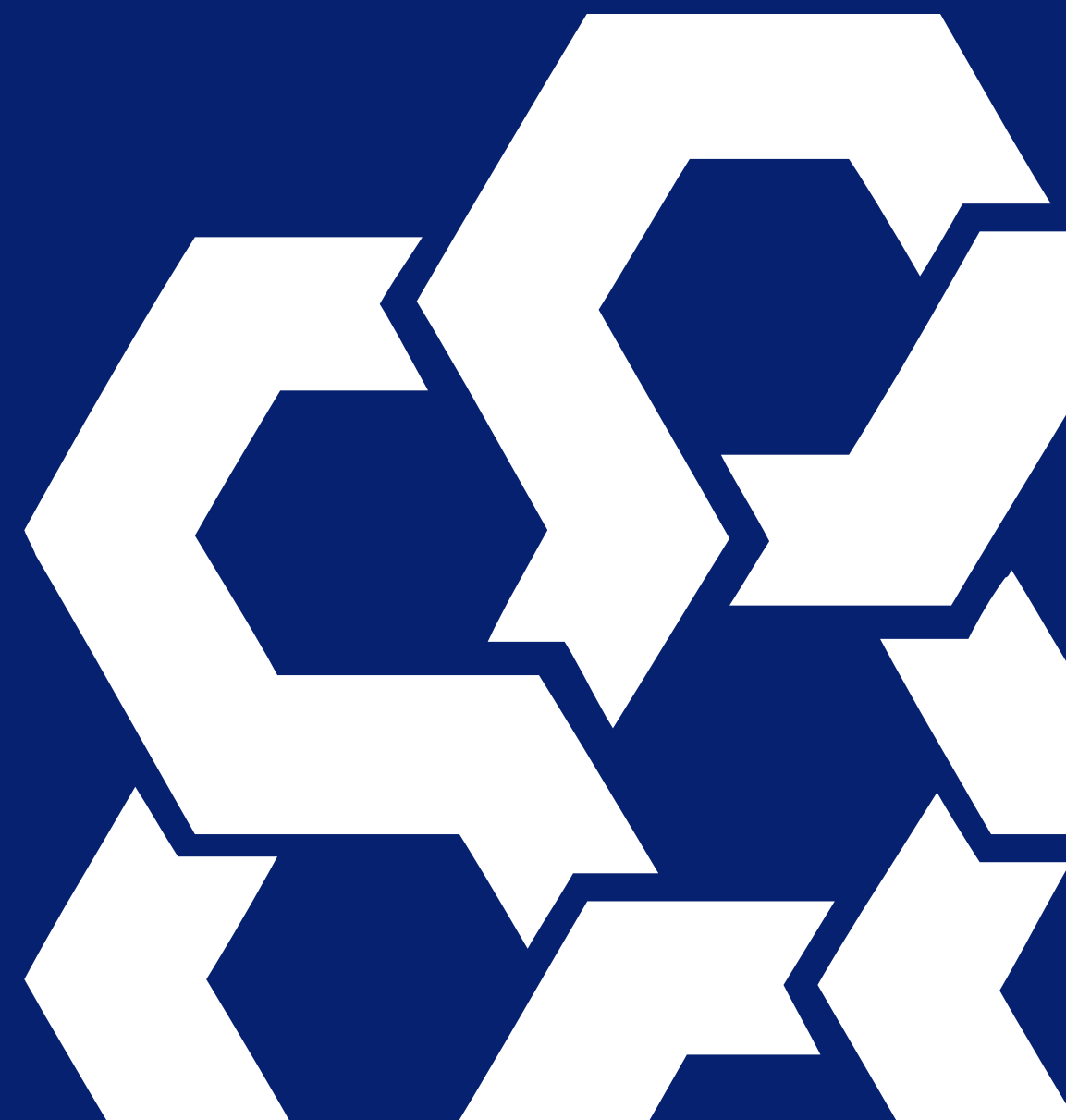
Differences in timing arising from items of expense or income measured using discounted cash flows (5/5)

Entity A's statement of financial performance (Table 7) and statement of financial position (Table 8) would be as follows:

In CU / Years	1	2	3	4	5	6	7
Revenue			82.27	4.11	4.32	4.54	4.76
Regulatory income / (regulatory expense)	82.27	4.11	(77.95)	0.42	0.44	(4.54)	(4.76)
Provision expense	(78.35)						
Finance costs	(3.92)	(4.11)	(4.32)	(4.54)	(4.76)		
Profit or loss	0.00	0.00	0.00	0.00	0.00	0.00	0.00

In CU / Years	1	2	3	4	5	6	7
Regulatory asset	82.27	86.38	8.43	8.85	9.30	4.76	0.00
Provision	82.27	86.38	90.70	95.24	0.00	0.00	0.00

Appendix B—Minimum interest rate



Minimum interest rate (1/2)

Fact pattern

Entity B incurs an expense of CU100 in Year 0. The regulatory agreement allows the entity to recover the expense evenly over Years 1–4. The regulatory agreement does not provide a regulatory interest rate for the regulatory asset.

The entity determines that a minimum interest rate of 3% would be sufficient to compensate it for the time value of money and for uncertainty in the amount and timing of the future cash flows arising from that regulatory asset.

In Year 0, the entity recognises a regulatory asset at CU92.93, representing the present value of the future cash flows measured using the minimum interest rate.

In CU	Year 0	Year 1	Year 2	Year 3	Year 4
Cash flows	100	(25.00)	(25.00)	(25.00)	(25.00)
Net present value at 3%	(92.93)				
Partial disallowance	7.07				

Minimum interest rate (2/2)

During Years 1–4, the entity recognises regulatory interest income at an aggregated amount of CU7.07, determined by applying the minimum interest rate to the outstanding amount of the regulatory asset. Table 2 shows a reconciliation of the regulatory asset.

In CU	Year 0	Year 1	Year 2	Year 3	Year 4
Opening balance		92.93	70.72	47.84	24.27
Amount recognised	92.93				
Regulatory interest income		2.79	2.12	1.44	0.73
Recovery		(25.00)	(25.00)	(25.00)	(25.00)
Closing balance	92.93	70.72	47.84	24.27	0.00

Table 3 illustrates the effects of the proposals on the statement of financial performance:

In CU	Year 0	Year 1	Year 2	Year 3	Year 4	TOTAL
Revenue		25.00	25.00	25.00	25.00	100.00
Regulatory income / (regulatory expense)	92.93	(22.21)	(22.88)	(23.56)	(24.27)	0.00
Expenses	(100.00)					(100.00)
Profit or loss	(7.07)	2.79	2.12	1.44	0.73	(0.00)

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