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**DP2014/2 Discussion Paper:  
Reporting the Financial Effects of Rate Regulation**


Dear Sir or Madam,

In answering the IASB's invitation to comment on the Discussion Paper "Reporting the Financial Effects of Rate Regulation" we would like to draw your attention to the remarks on the discussion paper on rate-regulated activities enclosed in the following pages.


We also refer to our comments on the IASB's request for information regarding rate-regulated activities which was filed to the IASB in May 2013.

Yours sincerely

50Hertz Transmission GmbH



Giegerich



Schröder

**50Hertz Transmission GmbH**

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Date  
08.01.2015

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## DP 2014/2: Defined rate-regulation

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### Question 1

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#### General remarks

Effects of rate regulation usually have a significant impact on a company operating in a regulated business. Therefore our understanding is that financial statements of such a company have to include these effects to allow interpretation and analysis of the core business and its financial effects.

It should be kept in mind, that comparison of financial performance of each company is enabled only, if all major business transactions and factors of influence are shown within its financials. Comparability – even of entities of the same category – requires in our opinion the visibility of all major financial effects. Thus, the effects of rate regulation shall be included in the IFRS financial statements to submit a clear and comparable set of financial information about the underlying business.

The very general principle of the IASB to provide relevant and decision-useful financial information is not met. IFRS shall represent “financial statements for general purpose” but given the fact, that significant financial information about the core business is missing, the very general principle of the IASB is in our reflection not applicable for regulated entities. As long as such significant financial effects are being excluded from any financial reporting under IFRS we believe the aforementioned statement is not valid in any case. We would appreciate taking into consideration the fact, that financial effects of rate-regulation arise and reflect a significant part of the core business and also have significant volume for entities operating in regulated markets.

Depending on the overall impact of rate regulation on the regulated entity, it can be argued, that a fair presentation of financial statements can be reached in different ways. If a massive impact is given, then a lot of information shall be presented to allow a best possible interpretation of the financial effects arising from the regulation scheme. In that case, it is fairly clear to provide as many and relevant information about the content and the nature of the financial effects, as the true and fair view allows. It is also possible, that for certain entities effects of rate regulation are of minor interest. Even then the entity might have an opinion or interest to state some more detailed information in its financial statements.

The type of information as well as the level of detail should be generally in line with conclusions about relevance, usefulness and materiality on a company's level. This should be clarified by the management within the management commentary as well as within sufficient notes about the regulatory regime, effects and any other important aspects of the economic environment of the regulated company.

## Information to be provided within financial statements

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... within the statement of financial position

If rate regulation has a significant impact on the entity, then a total **balance sheet** position covering the total number of rights and obligations resulting from the rate setting mechanism in accordance to DP 4.72 seems necessary. These positions reflect the total volume of Euros to be considered in future periods as adjustments of cost or revenue and also regarding the fact that with some certainty respective cash flows will arise out of these positions.

The fact of regulation itself supports our opinion, that the recognition of rights and obligations based on or resulting from the regulatory regime are relatively sure and predictable. Such a high degree of certainty is caused by the legal framework and the corresponding rules and regulations as well as by the existence of a regulator. Additional enforcement mechanisms make sure, that regulated companies are on the one hand able to measure the respective figures and information reliably and on the other hand willing to provide a true and fair view about their business operations.

Even if – based on current discussions – the definition criteria of assets and liabilities cannot be met by the rights and obligations arising from the regulation scheme, the creation of a new position within the statement of financial position seems logical. We therefore support the idea of IFRS 14 to show effects of regulation separately within the statement of financial position, but in our view this must be done within the statement and the other positions. This way of presentation allows either to interpret its volume and importance in comparison to other elements or it easily enables everybody to eliminate the figures if they are not important for specific purposes. This is one major supportive aspect for the benefit of rate regulation under IFRS.

Besides other positions of the balance sheet it is important to understand, how the regulatory framework would affect the overall financial position. Furthermore a separate recognition within the statement of financial position allows interpreting how impacts of the regulation affect the entity in terms of working capital management. Separation of various effects can be important to determine and also to proof cost of debt towards the regulator.

... within the statement of profit or loss and other comprehensive income

In our opinion effects of rate regulation have to be presented also within the net result as their variances show significant movement between calendar years.

Several financial effects are a result of the regulation scheme and have an impact on regulated entities' figures. Various effects often were caused by past events and lead to compensation via tariffs in the future. Due to the fact that a lot of forecast information is used for the tariff calculation it is necessary to wrap up with the actuals after closing of the calendar year. This true-up mechanism results in vari-

ances, which lead to the financial effects that impact the profit or loss in following periods. In accordance to the regulatory framework these effects are sometimes realized long term, some are quite of short term, but all are following a strict and binding system set out by law and/ or the regulator. A variety of different schemes exists in various regulated systems; therefore it has to be paid attention to the respective financial effects and also their occurrence regarding the specific share within the result of a period.

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Taking into consideration the regulatory framework and its basic function it is necessary to understand the impact it will have on the results of a regulated company. Due to very long underlying periods (lifetime of assets up to 50 years, amortization periods under the regulatory regime between 1 and 10 years) a lot of effects spread over more than just one or two reporting periods. The mismatch caused by not taking into account the effects of regulation is significant for certain companies within a regulated environment. Useful financial information which enables proper decision-making is in need of consideration of the respective regulatory effects consequently.

Our intention does not at all mean eliminating every source of seasonal influence to the performance of the period of a regulated company, but to allocate certain effects of regulation to periods where they belong, where they were initiated or where they can be measured in comparison to the underlying transaction. Seasonal effects are also seen on the face of the statement of profit or loss of a regulated company (e.g. due to weather conditions and influencing of energy costs).

In our opinion it seems difficult to argue, that any financial statements are for general purpose, if effects of rate regulation (if significant) are not shown and therefore not visible to any external party. As long as IFRS intend to be the standards fitting and supporting the most entities in the world, it should be considered allowing at least the recognition of certain amounts of rate regulation under a specific and separated area in the statement of financial position and also within profit or loss.

... within the statement of cash flows

The type of information presented within the statement of **cash flows** should allow evaluating how the financial flows of regulation occur and if they have also a significant impact (compared or in relation to financing and investing activities) to the entity. As the regulation scheme also sets the frame for investing activities for infrastructure-dominated entities, the occurrence and the volume of financial flows gives a better understanding about the economic surroundings of regulation.

Investors usually evaluate the ability of possible investment targets under strong analysis of the financial flows, which are caused by its framework of business operations. The core businesses are affected by regulation massively. As regulated companies gain significant portions of cash flow based on their regulation scheme, the visibility of effects is important for an investor's view. Investors having a very long term interest are strongly interested in monitoring the company's performance besides the various effects of regulation that are not representing

the current performance of the period. It is in that context important to submit detailed information about the ability to gain and recover funds from business operations.

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Any information provided by the regulated entity shall allow the evaluation of the financial performance and ability to finance own business activities. A big advantage is given to the fact, that if regulatory positions were allowed to become accounted under IFRS, then they would also benefit the investor's information, as all the information would be subject to an audit/ review of the auditors. The benefit indeed would arise from the fact, that an auditor runs several audit work throughout the numbers of regulatory positions and the supporting information as well. Depending on the will of investors the supported information can easily be eliminated from the financial statements if they were presented and disclosed in a transparent and informative way.

... to note disclosures

A pure approach of **disclosures** on regulated activities seems helpful in comparison to the current situation of non-recognition and non-disclosure under IFRS, but without making any quantitative effects visible within the key elements of financial statements, a pure disclosure approach seems not to make sense and also does not allow interpretation of the financial development.

Any disclosures on rate regulation should give additional information about financial figures and effects that are shown within the financial statements together with a good explanation of the regulatory framework and its basic functionality. Disclosures shall also support the needs of investors with split ups and useful information and finally give more useful details as well as some forecast information about future financial outflows caused by the regulatory scheme.

The specific level of information presented within the financial statements or the notes might be subject to a management decision, as not all information is allowed or relevant to be distributed in public. Local laws might be applicable and some information also can be classified by law, by the regulator or by other obligation.

... the management commentary

Consequently the management commentary should cover the main effects and influences on the financial statement of the reporting period. The management commentary itself in our view cannot be the first choice to submit information about the regulatory framework and its respective effects on the company. As the level of detail within the commentary is more reduced and on a high level generally, the usefulness is not that high compared to the other ways of presentation (see above).

... how will information be used by investors and lenders?

In addition to our remarks above we would like to state, that detailed information on the regulatory scheme is highly relevant and important for long term investment decisions of investors and that any support of useful information on the kind of framework a regulated entity is located in, will in general improve the financial reporting and the view on the entity and its performance drivers besides the pure rendering of essential goods and services.

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One major aspect of stakeholders in regulated companies is the evaluation of recoverability of variances which arise from the rate setting mechanism. Based on the stability and level of certainty as well as the track record of past periods it can be measured quite reliably if certain amounts will be reimbursed via tariffs in the future or how excess income will be dealt with.

## **Question 2**

Elia group and also 50Hertz are very familiar with the use of financial statements, which consider the recognition of balances arising from regulatory operations.

Under Local Gaap in Germany the recognition of regulatory liabilities is without any exemption a mandatory obligation. Also for German tax purposes the recognition is an obligation.

For the purposes of internal group reporting within Elia as well as for the consolidated financial statements of Eurogrid GmbH it was decided by the management to fully recognise regulatory claims and obligations within the consolidated financial statements under IFRS. The main part of Eurogrid Therefore we fully apply the recognition and measurement of such balances on regular basis. We are of the opinion, that financial information is incomplete if such balances were not included in our financial statements.

Eurogrid is rated "Baa1" by Moody's Investors Service.

Despite the fact, that IFRS does not allow the recognition of regulatory balances we have made very positive observations throughout the presentation of our consolidated financial statements to banks, investors and rating agencies. The information submitted was helpful to support the needs of external stakeholders and enabled a better interpretation of our net results than without the additional financial information.

Internally we made the observation, that after processes and existing information were brought together, the processing of regulatory information to figures within the financial statements is quite easy. Information about regulatory transactions is usually available anyway within the company and also subject to detailed management reporting. Thus and also due to the fact that the regulator requires the specific reporting of various facts and figures, the use of such information for external reporting is not a significant issue for regulated companies.

In our view complexity is no proper argument against the recognition of regulatory balances within financial statements, as any regulated company will be forced to

challenge itself and its processes to make any information about regulatory effects available for internal steering purposes as well as for reporting requirements of the regulator.

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### Question 3

Defined rate regulation seems to be a good initial point to start. Due to the fact, that regulation shows so many different aspects within Europe and abroad it seems logic to have a wide scope to start and to further evaluate the specific requirements, which might be useful.

Generally it should be possible to include as many regulatory regimes in most countries of the world into the defined rate regulation, as the characteristics of a rate setting mechanism and its financial effects will be in a certain way similar in various regulatory regimes.

### Question 4

In our understanding we do not see any market rate regulation within the scope of a new standard.

But given the fact, that also market rate regulation is a way of regulation which might have impact on regulated entities under their regime, we would support to further evaluate whether specific IFRS guidance can be useful for such companies. Furthermore we see the possibility to allow and engage disclosures on specific regulatory transactions that lead to financial effects in a reporting period for such entities.

### Question 5

We agree with the scope and description of defined rate-regulation.

#### Scope of defined rate-regulation

In our view the focus of defined rate-regulation should be on regulated systems and transactions instead of regulated entities. We would appreciate having a new standard that covers the wide range of regulated businesses independently from the legal setup of companies and / or groups of companies.

We are of the opinion that regulatory mechanisms are to be considered by the IASB irrespectively of the fact whether they are significant for the entity or not. Regulatory activities are not comparable to other competitive activities in business; therefore in terms of comparability and transparent financial reporting under IFRS we absolutely support the evaluation and development of new reporting requirements caused by a new standard.



### Features of defined rate-regulation

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We generally support the idea of enforceable rights and obligations that arise from a rate setting mechanism as described in DP 4.72. The revenue requirement is a good basis for argumentation regarding the existence of rights and obligations out of the rate setting mechanism.

But, instead of focussing on the pure existence of enforceable rights and obligations we would like to point out, that not always strict and binding claims can be made within a regulatory framework to recover certain amounts of money. We see the risk, that by using "enforceable" together with rights and obligations it could be argued, that only legally existent claims and obligations are in scope, whether all others were out-scoped by definition. This would not be of benefit, as the regulatory frameworks not always create standalone legal claims by themselves. But usually regulated entities can proof a certain track record of past periods and also a certain degree of experience with the regulator which is outflow of the rate setting mechanism and the legal regulatory framework. Therefore it should paid attention to the fact that a reasonable level of certainty of the rights and obligations can be drawn out of the experience with the regulator. In that constellation it would be useful not setting a fixed requirement in the existence of enforceable rights and obligations, but instead allow to proof whether rights and obligations will be recovered in future periods.

The existence of a specific rate regulator can vary in different jurisdictions. Therefore we support the idea of making use of indicators, which can be used to assess the existence and the function of a regulated system and a regulator. As a result of the existence a regulated entity will be forced to fulfil several duties and follow certain obligations. All of these represent the regulatory framework which sets the frame for its business environment.

In terms of the unit of account it should be allowed to not only focus on the relationship to individual customers, but instead also to the customer base as a whole, if the regulatory environment does not foresee any recoverability of claims for individuals but for all customers as a group. Given that, it is also important to know, that regulation is not always based on individual customer's contracts, but instead directly based on laws and other regulation.

### Additional features

We currently do not see any additional features to be included.

## **Question 6**

### Additional things to consider

Rights and obligations are a result of the rate setting mechanism. As long as the existence and occurrence of such will be allowed to be taken into account under IFRS, this will enhance the quality and comparability of the financial reporting at



all. In saying that we do not believe that more than the true up mechanism for rights and obligations will be necessary to consider by the IASB.

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### Specific accounting guidance

As noted above already we think that IFRS do not fully support decision useful financial information as long as regulatory positions are not included in the key elements of financial statements under IFRS. For us it is important to include such balances into our financial statements.

Taking into consideration the long timeline for implementation of new IFRS standards we would also suggest taking again into consideration the following aspects, which can be helpful to analyse whether or not other possible solutions than developing a new IFRS standard for rate-regulation may lead to similar or better results. We still believe that a new IFRS standard for rate regulation best fits the needs of the industries and also of the various stakeholders, but for further discussion we would also like to raise the public attention to the following aspects:

- **Conceptual framework project: allow recognition of assets and liabilities arising from defined rate-regulation**

We understood that rights and obligations arising from regulatory activities currently do not meet the definition criteria of assets and liabilities under existing IFRS. A change of definitions together with some additional guidance – as now presented within the discussion paper on defined rate-regulation – might be also helpful to finally allow the recognition of regulatory balances under IFRS. We are aware of the current IFRS project, but also know that good reasons are to be seen to support such an initiative.

- **IFRS 14 application to all IFRS users and allowance to fully recognise rights and obligations**

If IFRS 14 would be applicable not only to first-time-adopters, then recognition of regulatory liabilities in Germany was allowed. If then also regulatory claims would be allowed, a solution for recognition could be not that far away from realization. In our opinion IFRS 14 has some acceptance in Europe, but unfortunately it was only created for the benefits of first-time-applicants. A change could be an alternative.

- **IFRS 15 modification**

IFRS 15 deals with performance obligations and therefore could be utilized to make use of in terms of rate-regulation. As long as the regulatory true up mechanism is based on past events any future change in tariffs arising from the rate setting mechanism can be also seen as sort of performance obligation. In dependence of the identified contract and/ or the group of customers an application of a slightly modified IFRS 15 seems possible.

## Question 7

### Best approach to follow

Following our arguments above on where the effects of defined rate-regulation shall be shown in the best way we are of the opinion that a helpful approach enables regulated companies to account for variances in cost or revenue in a proper way. The total position of future increases or decreases in tariffs, which arose from past periods shall be shown in the balance sheet representing the overall quantity of regulatory deferrals. In addition some helpful disclosures underline and further explain the figures shown in the statements of financial position as well as profit or loss and cash flow.

We would not support an approach that ends up in recognizing an intangible asset, as the underlying regulatory mechanisms are varying and also using a lot of different assumptions on amortization periods. The valuation of such an intangible would be highly insecure and volatile as so many influencing factors would determine its total value.

We would not support disclosure-only-approaches and any solution that were based on regulatory accounting requirements. Such solutions would not benefit the users of financial statements. Our company would finally never support any solution which ends up in a prohibition of recognition of regulatory balances, as we are of the strong opinion that for regulated entities a true and fair presentation of financial statements is required to show regulatory balances and corresponding information and disclosures.

### Other approaches to consider

The current stage of discussion does not expand on the implementation of any solution that consists of the use of the other comprehensive income (OCI). In our view it could be worth to further analyse the results and possible benefits of an accounting approach that affects the OCI. Changes in tariffs cause variances of profit and loss but do not necessarily belong to the period they were incurred. Using the OCI to allocate certain amounts to equity when incurred and to be released from the equity when the amounts shall be recovered would allow a better performance measurement for the reporting period.

## Question 8

Yes, 50Hertz does carry out regulated activities.

50Hertz is a German high-voltage electricity network operator being regulated under an incentive-based regulation scheme ("Anreizregulierung") since 1<sup>st</sup> January 2009. This scheme is incentive-based and provides so called revenue-cap-regulation over regulation-periods of five years.

### Question 9

The prohibition of recognition of regulatory balances under IFRS would in our opinion decrease the acceptance of IFRS within the utilities industry massively. The current project shows that good reasons can be named to include regulatory balances into IFRS financial statements and therefore we strongly believe that the IASB will decide wisely and in a supportive way ... and in benefit for financial reporting purposes. The allowance of recognitions clears out a significant accounting mismatch in our industry and we hope to have given transparent insight into our arguments and the underlying assumptions.

As noted above we would not support disclosure-only-approaches. We are not convinced, that pure disclosures would allow a good and fair presentation under IFRS.

### Question 10

In our opinion IFRS 14 can only function as a starting point, but will not be the role model for future regulatory accounting models. Based on the information gained by the current rate-regulation project we assume that the IASB will have good insight and proper knowledge to develop further guidance on the need of preparers, investors and analysts, banks and other stakeholders.

### Question 11

We do not believe that a presentation separated from assets and liabilities enables good interpretation of the respective financial effects. Therefore our suggestion is to fully include regulatory balances into the statements of financial position and profit or loss as well as into the statement of cash flows.

In our opinion there is no reason for separation. Given the fact, that uncertainty is much bigger in recognition of other elements (IAS 12, deferred tax assets) under IFRS we strongly recommend to include regulatory balances into the key elements of IFRS financial statements. Comparison and good understanding is only enabled, when all information about financial effects is presented in a common way without separation of single elements.

### Question 12

In our view it is not important whether specific arrangements fall into the scope of rate regulation or not. We would strongly encourage further evaluating and defining the facts and circumstances set out by the discussion paper regarding the fact whether defined rate-regulation exists or not.

The existence and the kind of regulation is to be evaluated in dependence of laws, regulatory framework and local specifications. Regional specifications might also be relevant to consider. The indicators regarding essential goods or services, no or just limited level of competition and a specific or required level of quality of supply and availability are helpful to assess the existence of a regulated framework.

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If the regulator is a separate legal entity authorized by the government, a separate unit of the government or which legal form else does not materially matter. The fact, that regulation is performed by an authorized legal body is in our view the relevant fact pattern to be recognized.

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### Question 13

At the current stage of discussion we do not see a specific field of discussion or attention here. In the further development process and based on a more clear view of the IASB regarding possible next steps it will be necessary to analyse more in depth which constellations are worth to evaluate and elaborate more deeply.

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