

IASB  
Submitted by web

and

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Dear Sirs

We are pleased hereby to accept the invitation by IASB and EFRAG to respond to the Request for Information ('RFI') 'Rate regulation' on behalf of "FSR – danske revisorer".

We support the efforts to gather information on this topic, which should enhance the analysis in the Discussion Paper phase of the project.

There are two broad frameworks for price regulation: cost of service-based regulation and incentive-based regulation. The distinction between them is not always clear. Both frameworks apply to the Danish utility sector.

It might be helpful to consider the different forms of rate regulation, but focus should remain on the rights and obligations and the accounting consequences that might arise from price regulation, rather than how the overall framework might be categorised.

We have replied briefly to the questions. Our reply reflects our understanding of these arrangements in our capacity as auditors and accountants. Regulation in practice is quite detailed and it could be valuable to discuss issues arising from practical regulatory examples. By our participation in the Rate Regulation Activities Working Group of EFRAG we will be happy to provide further details on Danish regulatory regimes. We are not aware of any existing detailed description of Danish regulatory regimes in English.

**Question 1. Types of rate regulations**

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(a) + (b)

We represent the Danish auditors and our views cover legislation in Denmark.

(c)

IFRS has been applied for some time in Denmark, mainly since 2005 as a result of the IAS Regulation. While some unlisted companies have chosen to apply IFRS, only a few utilities publish financial statements under IFRS. The Danish Financial Statements Act (DFSA, the accounting law in Denmark) is based on EU directives and on a framework similar to that of IASB (as it was before the September 2010 revisions).

The general types of rate regulation we see in Denmark are:

Cost-of-service regulation:	Water supply (in reality a price cap)
	Sewage (in reality a price cap)
	District heating (cost plus combined with price cap)
	Waste (cost plus)
	Electricity and gas TSO and PSO (cost plus)
	Gas distribution (cost plus)
Incentive-based regulation	Electricity distribution (in reality a price cap)
	Electricity and gas supply

The company structure is divided into two main groups. One group is owned and controlled by consumer organisations and companies owned by local governments. In addition, there are a few private and government-owned commercial companies.

## **Question 2. The objectives of rate regulation**

(a)

The main purpose of the regulation is to limit prices and encourage consumer prices through efficiency and industry consolidation.

(b)

In respect of **water, sewage and waste** it is currently not possible to earn a profit or have a return on invested capital. In respect of water and sewage a price cap has been set based on an industry benchmarking in order to ensure reasonable prices by reducing costs. A utility may lose its license if it does not

meet the requirements. Immediate losses must be offset by subsequent efficiency gains. The utility has no volume risk in its return. A utility may earn a profit through efficiency but there is a requirement to either reduce tariffs or invest in regulated assets.

Side 3

In respect of **district heating** it is possible to earn a profit on invested capital though interest is moderate. The regulator may lower the price in the event it becomes unreasonable. Pricing is flexible as depreciation of fixed assets goes into the price based on annually evaluated depreciation principles. Some CHPs (combined heat and power plants) also operate under a price ceiling. Consequently, they can be limited in their recovery of variation in their heat prices. For waste burning plants the heat loss may be recovered in waste prices – just to illustrate complexity.

Taxes are not viewed as an owner expense as current taxes go into the basis of future tariffs.

Imbalances may be carried forward as there is an obligation to reduce tariffs if variances are to the benefit of the customers.

Incentive-based models set a revenue cap and a return on equity ceiling. Imbalances may be carried forward or set off (electricity distribution and others). The utility will have the volume risk as the cap is defined per kWh.

Regulation of gas distribution, electricity distribution, water and sewage included price caps set from benchmarking, which in principle implies a risk and the necessity to reduce future costs.

### **Question 3. Rights and obligations established by rate regulation**

(a)

For most utilities there is a monopoly right to operate within a geographic area or with a specific group of customers. The regulation of gas and electricity retail is more like factual monopoly since it is possible for the customers to change supplier but they rarely do so in practice. Offsetting variances can create price differences to competing companies. However, in practice this has not led to any unfortunate developments in the market.

(b) + (e)

Natural monopolies have long-term licenses that are often renewed. Licenses may be transferred but this will often require regulators' approval. The obligation to offset variances follows the business.

Side 4

(d)

The variance is an explicit number that comes out of each year's regulatory accounts. Electricity distribution has a cap on rate of return combined with a general cap on the price set for each individual company. A variance to the benefit of the company may be recovered within two years. Variances to the benefit of the customers will be repaid by a reduction in the price cap and not in the cap on rate of return.

#### **Question 4. The enforcement of rights and obligations**

In general, the variances are specified in annual regulatory accounts and are settled in subsequent prices. The variances become part of the basis of subsequent regulated prices. In practice, it will not be the exact same customers as customers who have moved house will not have earned a right or claim to be settled with the supplier.

Prices are not always explicitly approved by the regulator. The regulator sets the overall cap and the utility files the explicit price structure with the regulator or local government. A follow-up on historic variances is included in the regulatory accounts. These regulatory accounts are subject to an audit.

In the event that a regulated business is sold, the regulatory position follows the business, and the rights and obligations will be transferred with the regulated business sold.

#### **Question 5. The recovery or reversal of variances**

(a)

As we see the accounting issues, there are two types of differences. There is an immediate variance that comes out of the regulatory accounts and there is a variance relating to different accounting policies in the regulatory accounts and the external financial statements prepared under either DFSA or IFRS.

The variances in the regulatory accounts are in general required to be settled with customers within a short period of time (1-3 years). This is monitored by the regulator – and in some sectors quite meticulously controlled.

The variances relating to different accounting policies have a more unclear time frame. The accounting challenge here has many similarities to the distinction between current taxes and deferred taxes.

We encourage that both current and deferred variances are covered by the DP.

(b) + (c)

In practice, this has not been an issue in Denmark. Some of the largest differences are seen in respect of district heating relating to changes in oil and gas prices and with the System Operator relating to PSO-tariffs. It is possible for the companies to change their on-account charges during the year or in the event a variance becomes unrealistically large, it is possible to offset the variance over a longer period of time in which case the utility needs a specific agreement with the regulator. There have been a few examples of zero charges for network services in connection with repayment of previous overcharges which in theory could lead to unexpected consumer behaviour, but it has not really been the case.

(d)

We have not experienced a general trend in variances except with the district heating and System Operators mentioned above.

Kind regards

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of FSR – danske revisorer