

EFRAG - European Financial Reporting  
Advisory Group  
AISBL-IVZW  
35 Square de Meeûs  
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Att.: Ms. Isabel Batista and Mr. Girogio Acunzo  
Submitted by e-mail

9 January 2015

Dear Isabel and Giorgio,

**Re.: EFRAG Draft Comment Letter on IASB Discussion Paper DP/2014/2,  
Reporting the Financial Effects of Rate Regulation**

We are hereby pleased to respond to your questions to constituents on behalf of "FSR – danske revisorer".

Because of limited time and resources, our answers below should be regarded as our initial reflections on this important issue.

We support the efforts to gather further information on this topic and – if it is deemed appropriate – eventually to issue a stand-alone standard for rate-regulated activities. We also support most comments in your Draft Comment Letter and appreciate the efforts you have undertaken in developing the comment letter.

There are two broad frameworks for Danish 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. The main purpose of the regulation is to limit prices and ensure fair consumer prices as well as ensuring continuous supply through efficiency and industry consolidation.

The answers to the questions below are mainly based on the following regulations:

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 licence 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.

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

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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.

Side 2

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.

We only reply to some of the questions raised in the EFRAG Draft Comment Letter. Our reply reflects **our** understanding of these arrangements in our capacity as auditors. Unfortunately, we have not been able to involve preparers of financial statements and other relevant stakeholders within the Danish utility sector.

### **EFRAG – Questions to constituents**

#### **Q17**

If the IASB were to introduce specific accounting and/or disclosures requirements to account for the effects of defined rate-regulation, do you believe that users would still use the Regulatory Asset Base as a valuation/analysis tool? Please explain.

#### **Answer:**

The below answer relates solely to Danish water supply and waste water disposal companies.

Most water supply companies have chosen to determine a value of their non-current assets in connection with their conversion into limited companies in accordance with guidance from the regulator. Certain companies chose to use this regulative value as carrying amount. The value of RAB is, thus, included in some companies as operating costs in the form of depreciation and, according to regulation, as an addition to the price cap to finance non-current assets by means of tariffs.

Due to the material impact on accounting and regulatory aspects, we would assume that this policy is to continue if IASB introduces specific accounting or disclosure requirements.

Side 3

**Q30**

Are you aware of other information regarding the entity's rate-regulated activities and the rate-regulatory environment that you think preparers of financial statements need to include in their financial statements or accompanying documents such as management commentary? Please explain how users would use this information.

**Answer:**

Although IASB's primary target regarding this project is to attract investors, it should be considered whether consumers should be able to obtain information on any coherence between the regulated entity's accounting profit and tariff development. Via IFRS 14 - IASB is planning reconciliation between opening and closing regarding recognised overabsorption/underabsorption. Reconciliation between financial and regulatory results seems, however, to provide more relevant information about the economic impact of the tariff regulation on the company. This reconciliation could be presented in continuation of the description of how the tariff is determined, see also IFRS 14.

**Q31**

Where would you prefer to find the information about the entity's rate-regulated activities, the rate-regulatory environment, and related financial effects on an entity's financial position, performance and cash flows? Which information would you rather find (1) in the primary financial statements and (2) disclosed in the notes or in the management commentary? Please explain your answer.

**Answer:**

The Management Commentary in annual reports presented in accordance with Danish accounting legislation is not subject to statutory audit, but it is reviewed for consistency with the financial statements. Therefore, it should be considered to require the information on rate-regulated activities, e.g. description of the regulation which affects the company's financial position and performance, to be stated in the notes to ensure correct and sufficient description thereof.

Reconciliation between the financial and regulatory results could also be required to be disclosed in the notes to ensure correct disclosure about the regulation.

Danish accounting legislation does not explicitly specify whether overabsorption/underabsorption should be recognised. However, according to a memorandum in which the Danish Business Authority has interpreted the legislation recognition should be made.

**Q36**

Are you familiar with using financial statements that recognise regulatory deferral account balances as regulatory assets or regulatory liabilities in accordance with your local GAAP? If so, what problems, if any, does the recognition of such balances cause users of financial statements when evaluating

investment or lending decisions in rate-regulated entities that recognise such balances compared to:

Side 5

- (a) non-rate-regulated entities; and
- (b) rate-regulated entities that do not recognise such balances?

**Answer:**

**A:**

Recognition of regulatory assets or liabilities in Danish rate-regulated companies is not required explicitly by law but specified in a memorandum issued recently by the Danish Business Authority as mentioned above under Q31. In practice, today most of the Danish utility companies recognise overabsorption or underabsorption.

In general, financial reporting does not sufficiently explain the regulation and overabsorption/underabsorption recognised to understand what is included in the item. Thus, it is generally required to increase the level of information regarding the rate regulation, which will increase comparability between an annual report of a rate-regulated and a non-rate-regulated company as it will be possible to understand the difference.

**B:**

Some, primarily minor rate-regulated companies, have not yet recognised overabsorption or underabsorption. This creates confusion and inconsistency in the financial reporting in the Danish utility sector. We are currently in dialogue with e.g. the Danish Business Authority on issuing a guideline on how to recognise overabsorption and underabsorption (regulatory assets and liabilities) in small water utilities.

**Q92**

Do you think that the regulation that you are aware of is scoped out of the description of defined rate regulation when it should be included? If so, why?  
How should the current description in the DP be improved to address this case?

**Answer:**

**Drinking water utilities, waste water utilities and heating utilities**

The regulation of these utilities primarily corresponds to the characteristics identified by IASB. Competition within the sectors is characterised by natural monopolies that supply essential goods to society. In continuation thereof, the sectors have an external regulator and a rate regulation, which substantially corresponds to IASB's allowable revenue.

**Q93**

Are there any additional features that you think are needed to establish the scope of defined rate regulation? Please specify and give reasons to support any features that you would add.

**Answer:**

There is one characteristic that relates to the problem regarding the accounting treatment of rate-financed assets (DP/2014/2, 5.87). In practice, many Danish heating utilities recognise so-called temporary differences in consumer payments.

Side 6

The Danish heating sector is generally covered by a prohibition against capitalisation. An exception to this is, however, that heating utilities, see the Danish Act on Heat Supply, can provide for savings for specific future investments. This provision means that for a period of up to five years prior to the investment is effected, the company may provide (pre-charge) up to 75% of the cost of the new facility. Maximum annual provision is 20% of the capital expenditure of budgeted investment. The provision will have to be deducted from the cost of the facility in the year in which the investment is made, and accordingly, the depreciation base will be reduced. The objective of a reduction of the depreciation base is that this portion of the investment is already financed/recognised in the rates via the provision and, thus, will not have to be recognised once again in the rates. According to guidance from the regulator, the company must compute the size of provisions for the year already at the date of budgeting; otherwise they will be classified as profits.

**Temporary differences in consumer payments**

Transactions attributable to the category "temporary differences in consumer payments" are to a certain degree subject to uncertainty when determining the exact timing for the reversal of temporary differences. As to depreciation, the period could be in the range 5 to 30 years, depending on the type of facility, whereas provisions, according to legislation, will be phased out after a period not exceeding five years. It is, however, certain that reversal in connection with future recognition of the price of heating will affect the entity's cash flows. It is, thus, very probable that future economic benefits will flow to/from the entity due to the temporary differences. Consequently, we assess that this item complies with the general recognition criteria of the framework.

**Recognition and measurement of temporary differences in consumer payments**

A temporary difference arises due to a difference between the date at which the transaction is recognised in the regulation accounts and the date at which the same transaction is recognised in the financial statements. Based on experience gained from the financial reporting of Danish heating utilities, in which temporary differences are recognised, we find that relevant information is already provided in the financial statements.

At present, IFRS do not include any guidance specifically on the recognition of regulatory-related temporary differences, but include many of the same characteristics as those relating to deferred tax according to IAS 12, which is why, in addition to assessing whether the general recognition criteria have been

met, this can also be used as basis for interpreting whether or not correct recognition and measurement thereof should be made. IAS 12 (paragraph 5) defines temporary differences as:

Side 7

*"The difference between an asset's or a liability's carrying amount in the statement of financial position and its tax value."*

Based on the definition, a corresponding interpretation could be made to the effect that the company will basically always have to recognise the value of a difference between the carrying amount of a transaction and the value of the transaction after the regulation (IAS 12, paragraphs 10, 15 and 16).

IAS 12 states that discounting of tax assets and liabilities is not required or permitted. According to paragraphs 53 and 54, IAS 12, such statement is attributable to the assessment that discounting "requires detailed scheduling of the timing of the reversal of each temporary difference". If examined in isolation, the underlying transactions are jointly characterised by the fact that the timing of the reversal of temporary differences does not to the extent required allow for scheduling.

By way of example, non-current assets are recognised in the financial statements at costs less systematic depreciation over the expected useful lives in order for the income statement to regularly reflect the use of the asset during the period. The regulation accounts apply costs as basis, but depreciation and provisions are deducted according to the Danish statutory order on depreciation and amortisation. The temporary difference thus arises as the difference between the booked residual value of the facility in the financial statements and the part of the asset that has not yet been included in the price of heating.

There might also be adjustment of interest rate swaps or currency swaps for which the adjustment of the swap regarding other payables/other receivables will be set off against "temporary differences".

Based on the above, we find that temporary differences can be recognised within the framework applicable. At the same time, there is a direct connection between the value adjustment of the temporary difference and the underlying transactions (depreciation and amortisation, provisions, swaps and tax expenses).

#### **Presentation of temporary differences in consumer payments**

In relation to the classification of the item "temporary differences in consumer payments" and when assessing underlying transactions, this item - just as overabsorption or underabsorption - also has to be presented separately from other balance sheet items. As the item, as previously mentioned, reflects a balance with the consumers, the item will represent an asset or a liability and, consequently, an assessment of the criteria for set-off is deemed not to be relevant, see IAS 32.

As the item is of a temporary nature, we assess that the item should be presented as a current item or a current liability, respectively. Paragraph 62 of

IAS 1 emphasises this order as expedient when an entity supplies goods or services within a clearly identifiable operating cycle based on the approach that working capital is distinguished from the assets that are used in the entity's long-term operations. As utilities are capital intensive entities, following considerable investments in infrastructure, such classification provides more useful information to the financial statement user than a classification ranked according to liquidity.

Side 8

IASB should, therefore, consider whether these characteristics should be included in the process going forward.

**Difference between overabsorption or underabsorption and temporary differences in consumer payments**

Overabsorption/underabsorption is an item that arises following e.g. the provisions in the Danish Act on Heat Supply and reflects the difference between profit on the sale of heating at the price approved and total operating costs inclusive of depreciation and provisions reported. Viz. the difference between the price charged and the price that should have been charged for the year.

Temporary differences in consumer payments arise as a result of the difference between regulating and accounting principles when these treat the same subject as is the case with deferred tax.

**Q119**

Are you aware of any operational difficulties in applying an accounting method based on deferring/accelerating the recognition of a combination of costs and revenue in your regulation?

**And**

**Q 120** Are there any other approaches that the IASB should consider? Please explain.

**Answer:**

The primary problem in relation to IAS 16 as described in DP/2014/2 relates to the solution applied by Danish heating utilities as "temporary differences". We refer to the description under Q 93.

Side 9

**Q122**

Are you aware of any other advantages and disadvantages on the accounting approaches that the IASB should consider? Please explain.

**Answer:**

IASB should focus on the level of information, in particular comparability and understandability according to presentation and disclosure requirements, see answer under Q30.

**Q131**

Does your organisation carry out activities that are subject to defined rate regulation? If so, what operational issues would you like EFRAG to consider in its response to the IASB? We would be particularly interested if you focus on a hybrid method that consists of a combination of deferring/accelerating the recognition of costs and revenue.

**Answer:**

No. We handle auditors' interests via FSR – danske revisorer, and we have obtained our understanding of rate regulation through audits of such entities. The problem in relation to self-produced facilities and IAS 16 could probably be solved by recognising a new item called "temporary differences" as described under Q93.

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Please do not hesitate to contact us if you need a clarification.  
We apologize for being late with our answers. Nevertheless, we hope that you still have time to consider them.

Yours sincerely

Søren Peter Nielsen  
Chairman of the Utility Sector Group  
of FSR – danske revisorer