bdew
Energie. Wasser. Leben.

20 November 2009
Kd/Mie

Thomas Kunde
Legal Affairs and Business Management Division
phone +49 30 300199 1665
fax +49 30 300199 3665
Thomas.Kunde@bdew.de
www.bdew.de

German Association of Energy and Water Industries (BDEW)
Reinhardtstraße 32
10117 Berlin · Germany

Member of the Board of Directors
General Executive Manager:
Hildegard Müller (Chairwoman)

VAT Reg. No.: DE 814902527
Charlottenburg local court
Associations' Registry 26587 B

BDEW Representation to the EU
Avenue de Cortenbergh 52
B-1000 Brussels
Belgium

Banking details
Berliner Volksbank
bank account no: 8 848 041 000
bank code: 100 900 00
SWIFT: BEVODEBB
IBAN: DE80 1009 0000 8848 0410 00

German Association of Energy and Water Industries (BDEW)
Reinhardtstraße 32 · 10117 Berlin · Germany

International Accounting Standards Board
First Floor
30 Cannon Street
London EC4M 6XH

UNITED KINGDOM

BDEW Comment Letter on IASB's Exposure Draft „Rate-Regulated Activities“

Ladies and Gentlemen,

We hereby wish to accept IASB's invitation to comment on the above Exposure Draft and would like to thank IASB for this opportunity to express our opinion.

The German Association of Energy and Water Industries (Bundesverband der Energie- und Wasserwirtschaft - BDEW), Berlin, represents the interests of approximately 1,800 companies. The spectrum of its members ranges from local and municipal to regional and international companies. They represent about 90 percent of electricity sales, more than 60 percent of local and district heat supply, 90 percent of natural gas sales as well as 80 percent of drinking water abstraction and approximately one third of wastewater disposal in Germany.

A major part of BDEW's member companies operate energy supply networks in Germany or are holding stakes in network operating companies. According to the German Energy Industry Act, the approximately 870 German electricity network operators and about 720 gas network operators have been subjected since 2005 to regulation by the German Federal Network Agency and the regulatory authorities of the German Länder.

In the following, we would like to comment on the exposure draft from the point of view of the companies of the German energy and water industries:

bdew
Energie. Wasser. Leben.

General remarks on the Exposure Draft

We appreciate that IASB intends to establish binding rules on the accounting treatment of regulatory assets and liabilities. We believe that recording of „regulatory assets“ and „regulatory liabilities“ in the financial statements provides the user of financial statements with decision-useful information as future cash flows can be better assessed. Furthermore, „regulatory assets“ and „regulatory liabilities“ provide important financial information to the majority of member companies for purposes of management control. Against this background, we consider that comprehensive „on-balance“ recording of this kind of (regulatory) assets and liabilities should be achieved if a company is working in a regulated environment. We are of the opinion that taking account of regulatory assets only in the form of notes to the financial statements (disclosures) would not represent an appropriate alternative to on-balance recording.

Basically, we take the view that the development of rules for accounting of regulatory assets must be carried out in a principle-oriented manner. Accordingly, regulatory assets are to be recognized if the principles in terms of assets and liabilities codified in the Framework are met. Specific recognition rules in a standard which are not coherent with these general principles are however to be rejected. In the present case, this means in particular that the design of the respective national regulatory regime (here the „cost-of-service“ regime) cannot represent the crucial recognition criterion for accounting of regulatory assets. Even where regulatory frameworks exist which do not directly fulfill the prerequisites of cost-of-service regulation, the general criteria for the recognition of assets and liabilities can nevertheless be met and regulatory items be recognized in the financial statement.

The statements of the Board in BC[1] 19, BC 20 and BC 25 that it is the aggregate situation and the customer base as a whole which must be taken into consideration enforcement are suited, in our opinion, as a generally valid and principle-based interpretation of criteria for the recognition of assets and liabilities in order to arrive at an appropriate classification of all

[1] Basis for Conclusion

circumstances occurring under the various regulatory regimes. For this reason we take the view that according to the Basis of Conclusion, assets and liabilities which exist within the scope of regulation, meet the criteria for recognition set out in the Framework (in its interpretation presented by the Board in the Basis for Conclusion) and can thus be recognized.

We are of the opinion that claims for pricing of costs incurred in future rates (or the obligation of repatriation through future reduced rates) meet the requirements of being recorded as asset or liability ("cause-and-effect relationship"). The argument occasionally put forward that the realization of regulatory assets and liabilities would depend on future events is not relevant from our point of view as network operators cannot easily back out of their obligation (resulting from the German Energy Industry Act - EnWG) to operate the network.

However, for the purposes of assessment and statement of regulatory items, an independent standard is imperative in any case because these items represent categories of assets and liabilities for which there have no regulations existed to date. In particular regulatory assets are neither (classical) financial instruments nor intangible assets. Though in substance we see a certain nearness to financial instruments particularly since regulatory items imply the right or the obligation to realize additional or reduced cash flows in the future.

Besides, when assessing a standard for accounting of regulatory items, it is important to make sure that no inconsistencies with current IASB projects on „revenue recognition" and „liabilities" arise as we consider that there are essential logical interactions here with rate-regulated activities. Furthermore, it is absolutely necessary to make sure that also US-GAAP specifications about the recognition and assessment of regulatory assets and liabilities are altogether reflected in the regulations of the new standard so that there will not arise any further differences between IFRS and US-GAAP.

Responses to the different questions asked in the exposure draft:

Question 1: The exposure draft proposes two criteria that must be met for rate-regulated activities to be within the scope of the proposed IFRS (see paragraphs 3–7 of the draft IFRS and paragraphs BC13–BC39 of the Basis for Conclusions). Is the scope definition appropriate? Why or why not?

The criteria formulated are neither in line with the principle-oriented determination of recognition rules, nor do they meet the objective of clarifying under what conditions regulatory items are to be recorded or not.

We believe that the first criterion of recognition („an authorized body") is not clear-cut enough and thus needs further clarification. In our opinion, the second criterion of recognition restricts the standard's scope of application too much.

This view shall be explained in the following:

The exposure draft mentions as a first prerequisite for the recognition of regulatory assets that „an authorized body is empowered to establish rates that bind customers". However, it remains unclear what is to be understood by an „authorized body". Though it is a common practice in many regulatory regimes that a special (public) authority is established which approves or determines rates, this must not necessarily be the case. It should be sufficient to have a law comprising binding rules for the calculation of rates (e.g. based on the costs incurred in the past or according to any other method). Especially a statutory provision which provides binding force to the future consideration of regulatory facts can result in the fulfillment of general criteria for the recognition of assets or liabilities. Therefore, an „authorized body" in the sense of a regulatory authority cannot represent an appropriate criterion. The only important thing is that there exists an enforceable claim or a binding obligation. In case of doubt, the legitimacy of claims or obligations resulting from a law or from a regulation can be clarified before ordinary courts of law. But there is no difference as compared to other accounting facts so that the criterion of an „authorized body" is neither appropriate nor necessary. The only decisive fact for the existence of an asset in this context is that a claim is within the company's power of control and that this claim is expected to yield economic benefit

to the entity in future (in the form of increased rates). We consider that the only requirement for the existence of an obligation must be that a present obligation exists the discharge of which is associated with an expected outflow of resources yielding an economic benefit (in the form of reduced rates).

Apart from the aforementioned preconditions for the recognition of assets and liabilities, an additional requirement that must be satisfied in both cases is that a past event took place which gave rise to the resource or to the obligation. The requirement that „the price established by regulation (the rate) is designed to recover the specific costs the entity incurs in providing the regulated goods or services and to earn a specified return (cost-of-service regulation)“, can only be explained by the fact that the Board thereby tries to operationalize the requirement of a past event. Basically, this idea is to be approved as there must be a connection between past activities and future claims or obligations to arrive at a recognition of assets or liabilities according to the Framework. However, the requirement of „cost-of-service regulation“ is falling much too short or limits the scope to an inadmissible extent.

In many cases, other regulatory regimes such as incentive regulation, comprise elements of cost-of-service regulations („hybrid regulation systems“). So if the Scope is already focusing exclusively on regulation systems which only take the cost-of-service idea into account, the exposure draft falls inadmissibly too short. After all, the question remains open in the exposure draft whether regulatory items shall generally not be recognized if the regulation system as a whole does not represent a „cost-of-service regulation“ even though different elements take account of the „cost-of-service“ idea (alternative 1), or whether in such cases every single component of the regulation system must be separately analyzed (alternative 2). But in our opinion, neither of the two alternatives are expedient: alternative 1 would lead to an accounting method only based on higher regulatory schemes while possibly disregarding essential facts with the nature of claims or liabilities. On the other hand, alternative 2 would lead to a fragmentating accounting method which only partly represents the actual regulation system. Besides, the demand for the existence of „cost-of-service“ regulation raised in the exposure draft would at least be misleading.

Due to the interpretation of BC 17, it might be argued that regulation systems subject to an „incentive-based system“ have no recognizable assets and liabilities. We cannot agree with this conclusion.

With regard to the respective facts and irrespective of the designation of the regulatory environment, we consider that an investigation should be made into the question of whether there exists a past event which gave rise to a resource (right to generate future cash flows) or to an obligation (to reduce future cash flows). Concerning the recognition issue, it is sufficient to resort to the Framework as well as to the views of the Board expressed in BC 19, 20 and 25.

In the following, we will state our view in the light of the current regulation practice in Germany:

Since early 2009, network operators in Germany are generally subject to incentive regulation. Only supra-regional wide-area gas network operators with competitive pricing were exempted from this regime. Incentive regulation will be applicable to them from early 2010. According to this regulatory regime, a cap is determined for admissible total revenues from network rates and fixed in advance for several years by the regulator (revenue cap). Efficiency requirements to be met by network operators will be taken into consideration when determining the revenue cap. The revenue cap essentially consists of a controllable costs component and a non-controllable costs component (hybrid system).

The revenue component for controllable costs is determined for several years on the basis of the costs really incurred during a base year of the past. Thus, this component does not depend on the specific costs incurred by the company during the reporting period under review (and thus also during the period of service provision) and shall provide an incentive to minimize controllable costs (incentive regulation).

The determination of the revenue component for non-controllable costs is based on a cost-of-service idea. Basically, the non-controllable costs really incurred by the company are reimbursed with a time delay of usually 2 years.

As the regulator does not define rates but revenues, the company must divide the total revenue cap by the expected delivery quantities and determine a rate per volume of delivery. Should the real delivery quantity be

below the expected quantity, the company's real revenue will be below the approved revenue cap. This difference is recorded by the regulatory authority on a „regulatory account"[2] (regulatory account) and leveled out with interest paid during future periods by adjustments of the revenue cap. Should the real delivery quantity be above the expected quantity, the regulatory account implies the company's obligation to reimburse the excess sales revenues with interest payment during future periods to the customer base through reduced revenues.

We are of the opinion that claims or obligations taken into consideration on the regulatory account are to be recognized as regulatory items in the balance sheet. The criteria for the recognition of an asset or a liability according to the Framework are met, as has been shown. This applies even though the regulatory regime does not formally represent cost-of-service regulation (though it contains certain components of such a regulation) but incentive regulation. This suggests that the criterion of cost-of-service regulation per se does not lead to appropriate accounting in line with the principles codified in the Framework. Against this backdrop, this criterion should not be adhered to in the final standard. It is important to have a clear reference to the past, i.e. that the "past event" criterion is met. This criterion is definitely complied with in the present case: The service agreed with the regulator was rendered (network transfer/network operation) so that the company is entitled to the full revenue cap approved. The two other criteria for the recognition of an asset or a liability result immediately from the costing regulation. Hence, a clear "cause-and-effect relationship" also exists in a regime called "incentive regulation". Therefore, we take the view that a reduction of the scope of application to "cost-of-service" regulation is to be rejected.

To sum up it can be said that the scope of application mentioned in the exposure draft needs to be fundamentally revised. However, an important basis for decision on whether a company is within the scope of the future standard should be whether "an entity is able to determine, without a prior intervention of the authorized body and within the limits of the closing period, the precise amount it must recover/pay for the past accounting pe-

---

[2] The regulatory account is kept by the regulatory authority.

riod. The regulation rules must be sufficiently clear and stabilized to allow the entity to calculate the amounts (in case of the existence of a regulator: to recognise, on its own, the adjustments that the regulator will employ). In this case, and only in this case, the entity should enter in the scope of the future standard."

Just as important is the enforceability of the relevant claims/obligations. Only if it is certain that this enforceability exists, corresponding accounting can take place. To this end, it is necessary that there exist clear-cut legal bases. Where competencies are delegated to a regulator, the latter must be capable of ensuring enforceability.

Question 2: The exposure draft proposes no additional recognition criteria. Once an activity is within the scope of the proposed IFRS, regulatory assets and regulatory liabilities should be recognised in the entity's financial statements (see paragraphs BC40–BC42 of the Basis for Conclusions). Is this approach appropriate? Why or why not?

We suppose that the general recognition criteria will be applied. In practice, the entity will have to use the different kinds of information exchange with the regulator (e.g. information letters) in order to see whether the criteria have been met, since the entity can only to a limited extent resort to legally binding administrative decisions.

As for the rest we refer to our comments under Question 1.

However, attention should also be paid to the fact that regulatory systems are not rigid but are subject to certain dynamics. Therefore, the standard that is to be developed should contain provisions on how to handle changes within the regulatory system. This also applies to cases where regulation is completely terminated or will be significantly changed in the foreseeable future. This kind of systematic changes particularly occurred in Europe due to Directives of the European Union which have to be obligatorily implemented in all Member States. It is uncertain whether regulatory items should actually be recognized in the financial statements if it can be anticipated that regulation will be terminated and that it will not be possible to take these items into consideration in competitive pricing in the

ensuing competitive market. Consequently, the rule on de-recognition suggested by the Board in paragraph 21 is not sufficient.

Question 3: The exposure draft proposes that an entity should measure regulatory assets and regulatory liabilities on initial recognition and subsequently at their expected present value, which is the estimated probability-weighted average of the present value of the expected cash flows (see paragraphs 12–16 of the draft IFRS and paragraphs BC44–BC46 of the Basis for Conclusions). Is this measurement approach appropriate? Why or why not?

As already mentioned above, we establish that there is a certain nearness between regulatory items and financial instruments. We consider the proposed assessment standard to be a way of determining the Fair Value of the asset or of the liability. As regulatory claims of regulatory obligations are not marketable, the use of the Net Present Value (NPV) might represent an appropriate method for determining the Fair Value. Against this backdrop, we are open to the utilization of the NPV. Nevertheless, the NPV should not be introduced as an assessment category of its own kind but, as described before, as operationalization of the Fair Value in the case of regulatory facts.

Nevertheless, we suggest to include the best-estimate approach as there may arise problems in the practical implementation of the NPV. However, it has to be ensured that there are no differences induced between US GAAP and IFRS. We consider that there is a need for further consultation in this respect.

Question 4: The exposure draft proposes that an entity should include in the cost of self-constructed property, plant and equipment or internally generated intangible assets used in regulated activities all the amounts included by the regulator even if those amounts would not be included in the assets' cost in accordance with other IFRSs (see paragraph 16 of the draft IFRS and paragraphs BC49–BC52 of the Basis for Conclusions). The Board concluded that this exception to the requirements of the proposed IFRS was justified on cost-benefit grounds. Is this exception justified? Why or why not?

What is important are the regulations existing in the respective regulatory environment. If the cost of self-constructed property, plant and equipment or internally generated intangible assets can be included in future rates and thus increase future cash flows, we consider that they have to be taken into consideration for the assessment of regulatory items. Consequently, there is no reason for dealing with these facts in a different manner as compared to other components to be included in regulatory items.

Furthermore, we believe however that it is questionable whether imputed profits should be decisive for the determination of the acquisition costs of self-constructed assets. We take the view that only those items should be taken into consideration which are compared to true (cash-outlay) costs of the past.

In our opinion, paragraph 16 of the exposure draft can be forgone as the generally accepted principles (already mentioned several times in this letter) are sufficient for dealing with the issue of integration of cost components. Paragraph 13 is not opposed to these generally accepted principles.

Question 5: The exposure draft proposes that at each reporting date an entity should consider the effect on its rates of its net regulatory assets and regulatory liabilities arising from the actions of each different regulator. If the entity concludes that it is not reasonable to assume that it will be able to collect sufficient revenues from its customers to recover its costs, it tests the cash-generating unit in which the regulatory assets and regulatory liabilities are included for impairment in accordance with IAS 36 Impairment of Assets. Any impairment determined in accordance with IAS 36 is recognised and allocated to the assets of the cash-generating unit in accordance with that standard (see paragraphs 17–20 of the draft IFRS and paragraphs BC53 and BC54 of the Basis for Conclusions). Is this approach to recoverability appropriate? Why or why not?

In our opinion it is not clear whether a regulatory asset rather represents a right or a financial instrument. If it does not constitute a right we believe that IAS 36 should not be applied. Therefore, we recommend deleting the regulation.

Question 6: The exposure draft proposes disclosure requirements to enable users of financial statements to understand the nature and the financial effects of rate regulation on the entity's activities and to identify and explain the amounts of regulatory assets and regulatory liabilities recognised in the financial statements (see paragraphs 24–30 of the draft IFRS and paragraphs BC59 and BC60 of the Basis for Conclusions). Do the proposed disclosure requirements provide decision-useful information? Why or why not? Please identify any disclosure requirements that you think should be removed from, or added to, the draft IFRS.

An explanation of the respective regulation systems within which an entity is active cannot be given in a financial statement. Regulation systems are partly very complex and can therefore not be concisely described so as to serve as decision-useful information to a user of financial statements. Moreover, a user of financial information must be expected to have a "reasonable knowledge of business and economic activities" or at least to be able to procure this information from elsewhere. Against this backdrop, too, an explanation of the regulatory system does not seem to be necessary.

Whether the regulatory system is designed in such a way that that a resource capable of being capitalized or an obligation to carry as liability on the balance sheet exists, results already from the entity's financial statement. Besides, we refer to our comments made under Question 1 according to which the regulatory system's design is not relevant to accounting as long as the described criteria for recognition, which we consider to be appropriate, are complied with.

In our opinion it is not necessary to include four new lines in the financial statement for the representation of regulatory assets and regulatory liabilities as these can be recorded already under the existing balance-sheet items. Information about the amount of price-regulated activities is to be given in the Annex.

The information required by the ED in paragraph 26c on indicators that management considered in concluding that such operating activities are within the scope of this standard can likewise be foregone as existing legal provisions clearly stipulate whether there is regulation or not. Due to the

bdew
Energie. Wasser. Leben.

legal provisions on the regulation of specific business activities, a decision of the management in this regard is neither necessary nor possible.

Question 7: The exposure draft proposes that an entity should apply its requirements to regulatory assets and regulatory liabilities existing at the beginning of the earliest comparative period presented in the period in which it is adopted (see paragraph 32 of the draft IFRS and paragraphs BC62 and BC63 of the Basis for Conclusions). Any adjustments arising from the application of the draft IFRS are recognised in the opening balance of retained earnings. Is this approach appropriate? Why or why not?

We consider that these statements are unnecessary as they coincide with the general principles of IAS 8.22.

Question 8: Do you have any other comments on the proposals in the exposure draft?

We refer to our preliminary remarks. Accordingly, it is necessary to fundamentally revise the exposure draft and, in particular, to considerably extend and define in a clear-cut manner the scope of application of the final standard.

You are kindly requested to take account of the aspects we have addressed in this letter for the further standard-setting process. We shall be glad to discuss the different issues in detail and are at your disposal for any further questions you may have in this matter.

Yours faithfully,

Thomas Kunde
Unit Manager

In autumn 2007, BGW, VDEW, VDN and VRE merged in the German Association of Energy and Water Industries (BDEW). The association represents the interests of approx. 1,800 companies working in the energy and water sectors. The spectrum of its members ranges from local and municipal to regional and international companies.