BDEW · Reinhardtstraße 32 · 10117 Berlin

International Accounting Standards Board
Columbus Building,
7 Westferry Circus, Canary Wharf
London E14 4HD
United Kingdom

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Martin Müller
Accounting | Finance | Concessions
Management, Taxation and Digitisation Department

Phone: +49 300199-1665
Fax: +49 300199-3665
Martin.Mueller@bdew.de
www.bdew.de

BDEW German Association of Energy and Water Industries
Reinhardtstraße 32
D - 10117 Berlin

Hauptgeschäftsführung
Kerstin Andreae (Vorsitzende)
Andrees Gentzsch
Dr.-Ing. Anke Tuschek
Martin Weyand

USt-IdNr: DE 814902527
Amtsgericht Charlottenburg
VR 26587 B

BDEW-Vertretung bei der EU
Avenue de Cortenbergh 52
1000 Brüssel
Belgien

Bankverbindung
Berliner Volksbank
IBAN: DE80 1009 0000 8848 0410 00
BIC: BEVODEBB

Comment letter
ED/2021/1 Regulatory Assets and Regulatory Liabilities

Dear Board members,

The **German Association of Energy and Water Industries (BDEW)** represents over 1,900 companies along the entire value chain of electricity and heat production and transmission as well as drinking water extraction and wastewater disposal. BDEW is responding to your invitation to comment on the Exposure Draft ED/2021/1 Regulatory Assets and Regulatory Liabilities.

In general, we support the new regulations on the IASB Exposure Draft ED/2021/1 “Regulatory Assets and Regulatory Liabilities”. BDEW agrees that the proposed standard establishes principles and requirements for the recognition, measurement, presentation, and disclosure of regulatory assets, liabilities, income, and expenses.

However, BDEW suggests some adjustments to the proposed regulations. Please take our remarks from the following comment letter.

Berlin, 7. Juli 2021

**BDEW Bundesverband
der Energie- und
Wasserwirtschaft e. V.**
Reinhardtstraße 32
10117 Berlin

www.bdew.de

Comment Letter on IASB Exposure Draft ED/2021/1 Regulatory Assets and Regulatory Liabilities

The **German Association of Energy and Water Industries (BDEW)** represents over 1,900 companies along the entire value chain of electricity and heat production and transmission as well as drinking water extraction and wastewater disposal. The BDEW represents around 90 percent of electricity and around 60 percent of local and district heating sales, 90 percent of natural gas sales, over 90 percent of energy networks and 80 percent of drinking water production and around a third of wastewater disposal in Germany.

In general, we support the new regulations on the IASB Exposure Draft ED/2021/1 "Regulatory Assets and Regulatory Liabilities". BDEW agrees that the proposed standard establishes principles and requirements for the recognition, measurement, presentation, and disclosure of regulatory assets, liabilities, income, and expenses.

However, BDEW suggests some adjustments to the proposed regulations. Here, the two main points of criticism are:

First, in frequently occurring situations where different factors vary simultaneously (e.g., volume variances combined with interest deviations and required recalculation of allowable costs from local regulatory accounting into IFRS as suggested by the ED), the ED does not provide decision-useful information. Revaluating the underlying financial information based on allowable costs to IFRS is impracticable to prepare and hardly understandable for users.

Second, based on the German system of incentive regulation, BDEW vehemently rejects the ED's proposal on shifting regulatory returns on assets under construction to subsequent periods when these assets are put into use. Within the German regulatory system, returns on assets not yet available for use are economically and legally earned. In consequence, grid operators do not have any present obligation regarding these returns and, thus, the recognition of a liability as suggested by the ED does not reflect the economic situation correctly. Instead, the recognition of a regulatory liability would not be in line with the definition and recognition criteria of the current IFRS framework: The recognition of a regulatory liability (as described in BC99) would imply (higher) future cash outflows or lower future cash inflows which is actually not the case as there is no repayment obligation for grid operators at all. As such, we believe that the ED's guidance is not in line with the future standard's objective. Finally, please take notice of the fact that the application of the guidance in paragraphs B15 and BC96–BC100 would cause high operational costs.

In particular: We have the following comments/remarks on the "questions for respondents" from the exposure draft:

Question 1 – Objective and scope

In general, BDEW agrees with the Objective and Scope of the Exposure Draft (ED), but in the current ED, guidance on distinction of regulatory agreements in scope of IFRIC 12 and in scope of ED is not sufficient.
The general concept seems to improve allocation of income/expenses to relevant reporting periods.
However, for BDEW the concept of an IFRS based Total Allowed Compensation as suggested by the ED does not increase comparability (both international and between different industries), but rather increases the risk of misunderstandings/ misstatements due to inadequate recognition and measurement of Regulatory Assets and Regulatory Liabilities and increases complexity for preparers and users. Under the current concept, the ED does not provide meaningful and practicable solutions for some real-life fact patterns.

Specific remarks to this question follow below:

a) As BDEW represents multiple companies operating in rate-regulated environments in the energy sector, we welcome the IASB's objective to create an accounting model that provides more relevant information about the financial performance of entities being subject to rate-regulation. Both, companies and users of financial statements, who are already provided with information on rate-regulated deferrals by some companies that publish such information on a voluntary basis as part of a segment reporting in an Integrated Annual Report, believe that financial reporting including such information is more relevant and helps to understand how financial performance and financial accounting are affected by rate-regulated activities. This view can be underlined by positive feedback being received by our members from banks, investors and rating agencies dealing with additional information about rate-regulation within published financials.
   However, the concept of reconciling or rather revaluating local regulatory allowable costs into IFRS and some aspects of the concept of total allowed compensation may distort the targeted improved insights into the company's cash flows intended according to paragraph 2(b) of the Exposure Draft. Please refer to our comments on question 3 for more details.
b) The BDEW agrees with the proposed scope of the Exposure Draft. We are clear on the activities within the utilities sector being in scope of the proposal.
c) Overall, BDEW is of the opinion that the proposals in the Exposure Draft are clear enough to enable an entity to determine whether a regulatory agreement gives rise to regulatory assets and regulatory liabilities. However, we identified certain aspects with regard to the definition of regulatory assets and regulatory liabilities where additional guidance by the Board would be appreciated:
   - The broad definition of a regulatory agreement which we fully support may also cause situations in which assets or liabilities that are already required to be recognized under current IFRS Standards might be considered as regulatory assets

or regulatory liabilities. In that case we suggest adding additional guidance that these assets are not in scope of the draft standard and are not considered as regulatory assets or regulatory liabilities.

- We would welcome some more guidance on paragraph 6 in connection with paragraph B9 of the Exposure Draft in accounting for chargeable income. Please refer to question 3 b) for further details.

d) We agree that the requirements proposed in the Exposure Draft should apply to all regulatory agreements and not only to those that have a particular legal form or those enforced by a regulator with attributes.

e) As noted in c) we would welcome a clarification that assets or liabilities that are already required to be recognized under current IFRS standards are not in scope of the draft standard and are not considered as regulatory assets or regulatory liabilities.

f) We agree that an entity should not recognize any assets or liabilities created by a regulatory agreement other than regulatory assets and regulatory liabilities and other assets and liabilities, if any, that are already required or permitted to be recognized under current IFRS Standards.

Question 2: Regulatory assets and regulatory liabilities

BDEW agrees with the proposed definition of regulatory assets and regulatory liabilities and that they are covered by the conceptual framework. BDEW does basically agree with the concept of total allowed compensation. However, BDEW rejects the proposed guidance on how an entity would determine/revalue the allowable expenses from local regulatory accounting into virtual IFRS (“3. GAAP-ledger). For specific remarks to this concept see question 3.

BDEW also agrees that a utility should account for regulatory assets and regulatory liabilities separately from other assets and liabilities that might arise from the regulatory agreement. Such assets and liabilities would be recognized under other IFRS.

BDEW has identified situations in which the proposed definitions would result in regulatory assets or regulatory liabilities being recognised when their recognition would provide information that is wrong, misleading or not useful to users of financial statements. In this regard, please also refer to our comments to question 3.

Further specific annotations to this question follow below:

a) Regarding the definition of regulatory assets and regulatory liabilities, we propose to extend the definition in the way that also "all" (as to local regulatory accounting) of the total allowed compensation might be included in revenue in the future and not only "part" of it. In Germany, incentive regulation in the Energy sector sometimes prescribes a “t+2” compensation mechanism for some costs (e.g., so-called “permanently non-influenceable costs”). In that case, the costs (e.g., permanently non-influenceable parts of personnel costs) were incurred when the goods or services were already supplied, but the regulatory regime stipulates that the total costs only become part of the revenue cap two years later. The proposed scope does not clarify if these costs (that are reimbursed with a t+2 offset) classify as regulatory asset in the year when the costs are incurred. According to the Exposure Draft, regulatory assets and regulatory liabilities are created by a regulatory agreement that determines the regulated rate in such a way that only "part" of total allowed compensation for goods or services supplied in one period is charged to customers in a different period. We propose to redefine the definitions in paragraph 4 and 6 c) as follows: "*part **or all** of total allowed compensation for goods and / or services […]*".

Furthermore, we don't agree with the Board's interpretation of what constitutes a "performance obligation", especially with regard to the regulatory liability for assets not yet available for use (as described in paragraph BC99). Please refer to question 3 a) (ii) for further details.

b) We support the focus on total allowed compensation (including both the recovery of allowable expenses and a profit margin) under the condition that the local regulatory costs are not revalued into IFRS. However, especially in applying the concept of total allowed compensation revalued into IFRS, permanent differences might arise due to falling back on IFRS standards as measurement basis for the total allowed compensation instead of using regulatory amounts. Even though we believe that these permanent differences should be out of scope of the future standard, we would appreciate a clarification in this Standard, despite of the fact that we disagree with the general concept of revaluating the local regulatory allowable costs into IFRS.
c) We agree that regulatory assets and regulatory liabilities meet the definitions of assets and liabilities within the Conceptual Framework for Financial Reporting.
d) We agree that an entity should account for regulatory assets and regulatory liabilities separately from the rest of the regulatory agreement.
e) With regards to the regulatory liability for assets not yet available for use as described in paragraph BC 99, please refer to our comments on question 3 a) (ii).

Furthermore, assets or liabilities that are already required to be recognized under current IFRS Standards should not be in scope of this future standard (refer to question 1 c)) to avoid information which is not useful to users of financial statements.

Question 3: Total allowed compensation

In its current version, BDEW disagrees with the proposed guidance on total allowed compensation. In general, the proposed concept of revaluating local regulatory allowable costs into IFRS requires the implementation of a "3rd GAAP", causing a virtual, artificial, non-existing reference data population as inadequate data set (mixing up regulatory and IFRS rules). In this regard, the ED does not provide decision-useful information since it deviates too much from the "real" compensation schemes based on relevant local regulatory rules. This can cause situ-

ations where the related recognition of regulatory assets and regulatory liabilities is inadequate because there will be actually no compensating inflow or outflow in subsequent years (giving rise to permanent differences, for which no such assets or liabilities should be recognized at all). Additionally, especially in the network business where multi-factor variance-based fact patterns typically occur (i.e., simultaneous, overlapping, multi-period deviations between planned and actual quantities and costs, change in interest rates, etc.), the underlying required financial information is impracticable to prepare. Additionally, this revaluation of allowable costs into IFRS is not meaningful for users.
Instead of linking local allowable costs to IFRS rules, we recommend a total allowed compensation concept which is based on local regulatory rules.

Furthermore, we harshly reject the proposed accounting treatment of regulatory returns on construction work in progress (CWIP):
Certain aspects of the definition of total allowed compensation will lead to a deviation from price regulation, causing economically unintended results. These concerns relate to the proposed treatment of regulatory returns on construction work in progress (CWIP) as their regulatory treatment deviates considerably from the proposed accounting treatment, which does not accurately reflect the economic underlying of these regulatory returns. To support long-term investments in national grids, German regulatory agreements allow grid operators to add calculated return on equity on assets under construction to the target profit already during their construction process. However, according to the proposed standard (B15), this proceeding does not meet the definition of the total allowed compensation. BDEW is also worried about the operational challenges of recognizing regulatory returns related to construction work in progress only when the asset is in use. It is usually not a single asset used to provide services, but a group of assets including such or some being still under construction. In these cases, the allocation of regulatory revenue/returns to individual assets can be rather impractical and difficult to achieve in practice.

Specific annotations to CWIP follow below:

a)
   i. Basically, we agree with the proposed guidance, except for the treatment of regulatory returns on assets not yet available for use (refer to (ii)).
   ii. BDEW does not agree with the Boards guidance on the treatment of regulatory returns on assets not yet available for use. We believe that this guidance is not in line with the standard's objective to provide relevant information that faithfully represents how regulatory income and regulatory expenses affect the entity's financial performance and how regulatory assets and regulatory liabilities affect its financial position. Further, we believe that this guidance is not in line with the standard's definition of regulatory assets and regulatory liabilities and would lead to high operational costs.

- <u>Not in line with the standard's objective</u>

Incentive regulation in the German energy sector allows regulated companies to receive a reimbursement for the capital invested, basically with a certain time lag through the revenue cap. In addition, for certain investments ("investment measure") a compensation for the invested capital without time-lag can be claimed. In that case, the regulated company is already entitled to get a reimbursement during the construction phase of the asset. There is no obligation for the regulated company to include this revenue in future tariffs even if the construction of the asset would never be completed. As a result, we think that the Board's guidance in paragraphs B15 and BC96–BC100 would lead to financial statements not providing the most relevant information. Moreover, the recognition of a regulatory liability as described in BC99 would even imply that there will be a cash outflow or lower cash inflow in future periods which is actually not the case. In consequence, we believe that the guidance is not in line with the future standard's objective.

We took note of the Board's considerations described in BC98, but we don't share that view. In our opinion, it does not contradict the model's principles in paragraph BC30 if those regulatory returns form part of total allowed compensation for goods or services supplied when the asset is not yet available for use. From a regulatory perspective (as described above), the investment as such and the provision of capital by the regulated company are the relevant services supplied to the customer. Further, we believe that comparability reasons don't justify the reduction of the relevance of information caused by the Board's guidance in paragraphs B15 and BC96–BC100.

- <u>No regulatory liability</u>

  According to paragraph 5 of the draft standard, a regulatory liability is an enforceable present obligation […] to deduct an amount in determining a regulated rate to be charged to customers in future periods […]. As already described above in German incentive regulation, the regulated company has no present obligation to reduce future tariffs when the regulatory return for the asset not yet available for use is received. Therefore, we vehemently doubt that under the German incentive regulation regime returns on assets under construction may give rise to a regulatory liability because the definition of a regulatory liability is not met in that case, different from what the Board suggests in paragraph BC99.
- <u>High operational costs</u>

  The application of the guidance in paragraphs B15 and BC96–BC100 would impose high operational costs on regulated companies because they would need to track for every asset (once under construction) what revenue has been received during its construction phase to recognize a related liability. The complexity of gathering the required information, also mentioned in paragraph BC100, should not be underestimated, especially with regard to the current situation in the Energy sector where grid operators face a huge investment program ahead. Since we believe that the relevance of financial information will decrease by applying that guidance, we expect the cost-benefit ratio to be rather negative.

  Based on our arguments above, we suggest reconsidering the guidance in paragraphs B15 and BC96–BC100. We are convinced that these paragraphs are misleading. We suggest a classification of the regulatory returns as target profit and thus a recognition as total allowed compensation during the construction phase of the asset.

iii. We agree with the proposed guidance.

b) We do not fully understand the proposed wording for the treatment of specified income which has to be deducted in determining the regulated rate as chargeable income (par. B9). In our understanding, the proposal does fit in the situation that the income is realized in the same accounting period.

Question 4: Recognition

BDEW agrees that an entity should recognize all its regulatory assets and regulatory liabilities under the condition that underlying total allowed compensation is based on local regulatory rules (not implying a revaluation into IFRS).

If IASB however insists on the currently proposed concept we see the risk of recognizing assets and liabilities for permanent differences or recognizing “assets”/”liabilities” (in the essence and in fact deferral items) which will not lead to future cash inflows/outflows.

BDEW recommends highlighting explicitly that regulatory assets and regulatory liabilities cannot result from permanent differences between total allowed compensation and the amount charged to customers for supplying goods or services in the same period. In the German regulatory setting, especially if local regulatory costs have to be accounted for applying IFRS standards, permanent differences arise in cases where expenses according to IFRS standards do not qualify as an allowable expense or in which allowable expenses are lower than the corresponding calculated amounts included in regulated rates.

BDEW also agrees that in case of uncertainty whether a regulatory asset or a regulatory liability exists, the regulatory asset or regulatory liability shall only be recognized if it is more likely than not that it exists.

However, the IASB should be aware that defining this kind of recognition threshold not only for liabilities, but also for assets, can have a radiating effect on quantifying probability thresholds within the context of other IFRS (like recognition of intangible assets according to IAS 38.21(a)).

Question 5: Measurement

BDEW agrees with the proposed guidance on measurement. A cash-flow based measurement methodology suits best to be applied to regulatory assets and regulatory liabilities.

BDEW also supports the proposal to estimate future cash flows incorporated in regulatory assets and regulatory liabilities using either the most likely amount or the expected value method, depending on which approach provides more relevant information.

In situations when single expenses are recoverable in future years, the actual recoverability of all expenses in future regulatory periods may be however doubtful and other important parameters for regulatory revenue in total may have not been stipulated by the respective regulatory agreement. In such cases, the measurement of a regulatory asset for this single expense component should take this into account.

Therefore, Illustrative Examples 2B/C ("Recovery period longer/shorter than an asset´s useful life") are too simple in assuming a useful life of only 4/5 years. Especially in the regulated network business, useful lives usually cover periods from 20 to 50 years. If those illustrative examples were applied literally and "mechanically" (not referring to the respective regulatory period), a 1:1 valuation of regulatory assets (Example 2B) or regulatory liabilities (Example 2C) would be economically inadequate since cash flows falling out of the regulatory period/boundary of the regulatory agreement are not yet stipulated/not yet reliably predictable. We see the need for supplemental additional wording in IE 2B and "C and IE 7A.4 to point out that in such fact patterns recognition/measurement of regulatory assets and regulatory liabilities should require additional analysis by the preparer as to recognition and measurement criteria provided in ED par. 25-through 44.

Question 6: Discount rate

BDEW agrees with the general guidance that discounting should be applied. However, BDEW recommends waiving discounting in cases where the effect is immaterial, which would be in line with other IFRS standards.

BDEW rejects the different discounting methods suggested, specifically the minimum discounting rate requirements.

Instead, on the one hand, BDEW supports using the same discounting approach for both regulatory assets and regulatory liabilities. On the other hand, BDEW suggests using the objective regulatory interest rate set by the regulator. For example, with regard to the regulatory accounts (comprising the deviation of volumes and allowable costs) the regulatory interest rate is legally defined. Accordingly, this interest rate should be used equally for discounting regulatory assets and liabilities. In consequence, the IFRS financial statements would reflect the regulatory accounts.

Additionally, in cases where a regulatory asset or liability forms part of the regulatory (net) asset base (e.g., the recovery period for an investment is longer/shorter than the corresponding asset's useful life), BDEW supports using the regulatory return rate applicable to this base as the relevant regulatory interest rate.

Furthermore, Example 5 of the Illustrative Examples describes a technique to compute a single interest rate in cases when different rates apply throughout the regulatory period. In this example, it is the effective interest rate used to measure regulated assets and liabilities. However, according to the core standard, the IASB requires an entity to "translate those uneven regulatory interest rates into a single discount rate that it shall use throughout the life of the regulatory asset or regulatory liability" (ED/2021/1, par. 54). In contrast to IFRS 9 and IFRS 16, the IASB does not define the concrete method for calculating this single discount rate. In consequence, the question remains whether there are other calculation techniques being in line with the standard requirements in paragraph 54. In particular, the IASB should clarify whether calculating the single discount rate requires the effective interest rate method in any case and, if not, which alternative calculation methods may be appropriate.

Question 7: Items affecting regulated rates only when related cash is paid or received

BDEW agrees with the measurement exception proposals in the ED.

However, BDEW suggests giving a more detailed description regarding the treatment of decommissioning costs to avoid conflicts (double recognition of assets) between the capitalization of the Asset Retirement Costs (ARC) and the recognition of a regulatory asset.

Question 8: Presentation in the statement(s) of financial performance

BDEW agrees with the guidance to present all regulatory income / all regulatory expenses as a separate line item immediately below revenue and to include regulatory interest income and regulatory interest expense within this line item.

BDEW wonders whether a net presentation in the balance sheet wouldn't make sense as well. The offsetting guidance seems to be unnecessarily complicated.

With respect to remeasurements of regulatory assets / regulatory liabilities applying ED par. 61, BDEW supports the idea of limiting the OCI entries to fact patterns described in ED par. 61 (cash paid or received). ED par. 69 requires companies to present these resulting effects in other comprehensive income (OCI) to the extent that the regulatory income or expense results from remeasuring the related liability or related asset through OCI.

Assuming that par. 69 is not limited to the cases covered by par. 61, this concept constitutes a highly impracticable burden for preparers who are required to set up complex IT solutions and processes in order to cope with the requirement of breaking down the single elements (recalculation of regulatory allowable costs as to timing and amount into IFRS ´, then split up the allowable costs in P&L and OCI elements, corrected for any quantity variances for the respective yearly / fact pattern based tranches).

Question 9: Disclosure

We agree with the proposed overall disclosure objective. The focus on the disclosures proposed in the Exposure Draft will provide more relevant information to users of financial statements. With respect to the specific disclosure requirements, there may be some judgement involved in determining the adequate level of disaggregation. A limitation to the most important positions and their changes would be desirable to reduce the administrative burden if the specific information is not readily available. In addition, preparers should be relieved from disclosing details about regulatory agreements if such information is already publicly available, also to avoid boilerplate information.

Question 10: Effective date and transition

BDEW supports the proposed transition requirements. Since a complete retrospective first-time application might be extremely difficult, the transition provisions should offer a choice for some modified, easened transition rule (avoiding a fully retrospective research work back to history). The effective date should be at least 24 months after the publication of the final IFRS to allow entities to adjust their accounting systems and to gather necessary information. However, an early adoption should be permitted.

Question 11: Other IFRS Standards

BDEW agrees with the guidance on interactions with other IFRSs. A specific observation is the interaction with IFRIC 12 where it is unclear how this would work in practice.

However, we would recommend further analysis/clarification of the impact of regulatory assets in the context of cash generating units (CGU) and their cash flows (when testing goodwill or long-lived assets for impairment).

In addition, the final Standard should also cover a comprehensive quantified example including taxes under IAS 12.

Question 12: Likely effects of the proposals

Specific annotations to this question follow below:

a) We agree with the IASB's analysis of the likely effects of the proposals on the quality of financial reporting (i.e., for entities currently recognizing regulatory assets and regulatory liabilities on a voluntary basis). We also want to highlight that presenting regulatory assets and regulatory liabilities prominently in the financial statements will reduce

Non-GAAP disclosures. However, in cases when the rate-regulated accounting model doesn't reflect the economic impact of rate-regulation adequately (e.g., recalculation of regulatory cost into IFRS, regulatory returns on construction work in progress), preparers and users will still fall back on Non-GAAP disclosures for reconciliation purposes.

b) If the IASB sticks to the current "3. GAAP-ledger"-approach (i.e., recalculating/revaluing local regulatory allowed compensation into IFRS standards), preparers will generally face high implementation and ongoing run/IT-costs. It will be necessary to establish highly sophisticated IT-solutions to implement the above mentioned "3. GAAP"-recalculation approach and to create the multidimensional data (volumes, Euro´s) required for recognition, measurement, remeasurement, presentation, and disclosures. Additionally, according to our experience, providing a breakdown of the positions considered as regulatory assets/liabilities and monitoring changes on this granular unit-of-account-level involves high ongoing administrative costs.

If the IASB changes the ED in the sense that local regulatory costs do not have to be recalculated in line with current IFRSs, the benefits for our stakeholders should outweigh the costs as long as the accounting for regulatory assets and regulatory liabilities provides better insights into the cash flows associated with the rate-regulated environment an entity is operating in.

Question 13: Other comments

No other comments.

For further questions or a clarifying conversation please do not hesitate to contact us.

Contact

Martin Müller
Business Administration, Taxation
and Digitalisation
Telefon: +49 30 300199-1665
martin.mueller@bdew.de