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15 December 2014

The Chair
Australian Accounting Standards Board
P.O Box 204
Collins Street West Victoria 8007
AUSTRALIA

Dear Sir

ITC32 Reporting the Financial Effects of Rate Regulation

Please find attached Ergon Energy Corporation Limited's (Ergon Energy) response to the invitation to comment referred to above.

Ergon Energy is subject to regulation of revenue generated from its electricity distribution network. This regulation is overseen by the Australian Energy Regulator (AER) and takes the form of a fixed revenue cap. The views expressed in this submission represent those of Ergon Energy.

Overall, Ergon Energy is supportive of the AASB to issue a new accounting standard with specific guidance on the accounting treatment for rights and obligations arising from rate regulation. Specifically, the accounting standard should allow for the alignment of the recognition of revenue with the regulated revenue cap, where revenue regulation requires any under or over recovery to be returned to customers in future periods. Attached are the views on specific matters for comment.

The opportunity for comment is appreciated and I trust you will find the attached comments useful.

Yours sincerely

Gary Gaffel
Acting Group Manager Finance Operations

Comments on the IASB Discussion Paper

1(a). Information about rate regulated activities and regulatory environment which preparers of financial statements need to include in their financial statements or accompanying documents.

(i) Statement of financial position

- Receivable - for under recovery of regulated revenue (asset) which the entity is entitled to recover from its customers in the form of increases to future year revenue caps: OR
- Provision for over recovery of regulated revenue (liability) which the entity is required to return to its customers in the form of decreases in future year revenue caps

(ii)The statements of profit or loss and other comprehensive income

- Revenue equivalent to the entity's regulated revenue cap for the financial year, excluding adjustments for prior year or current year under or over revenue recoveries.

(iii) Statement of cash flows

- Cash flows from regulated revenue during the financial year.

(iii)Note disclosures

- Nature of the rate regulation i.e. revenue/price cap, governing body etc.
- Critical accounting estimates and judgements and any assumptions used, for example forecasted demand.
- Assessment for the recoverability of regulated revenue under recoveries.
- Sensitivity analysis on changes in regulated revenue as a result of changes in forecasted demand.

(iii) Management commentary

Ergon Energy is of the view that no additional disclosures are required.

1(b). How the above information will be used by investors and lenders in making investment and lending decisions.

Investors

Potential investors would be interested in the impact of regulated revenue over recoveries on key financial ratios such as gearing.

Lenders

As lenders are interested in the net asset position of the entity, they will be interested in knowing the impact of regulated revenue under or over recoveries on revenue. The balance of any under or over recovery assets or liabilities will impact balance sheet ratios.

Lenders may also be interested in knowing management's assessment for recoverability of regulated revenue under recoveries.

Question 2 – no comment

Question 3 – no comment

Question 4 – no comment

5(a). Whether the description of defined rate regulation captures an appropriate population of rate-regulated schemes within its scope.

The description captures the rate regulated scheme that governs Ergon Energy's revenue.

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6(a). Rights and obligations arising from the features of defined rate regulation

Under the rules set out by the Australian Energy Regulator, Ergon Energy is allowed to earn a fixed amount of electricity distribution revenue per annum. At the start of each financial year Ergon Energy determines a set of tariffs which, based on forecast demand, it believes will achieve its revenue cap. Any difference between the revenue cap and actual revenue collected is either returned to, or recovered from, its customers. This adjustment to revenue is effected by adjusting the tariffs in future financial years.

The adjustments to revenue are enforceable under Coordination Agreements between Ergon Energy and electricity retailers. These Coordination Agreements detail the respective rights and obligations of electricity distributors and retailers. The clauses concerning billing stipulate that the prices charged by distributors to retailers must be those set by the Australian Energy Regulator.

Rights

The accounting framework defines an asset as:

(a) a resource controlled by an entity as a result of past events; and

(b) from which future economic benefits are expected to flow to the entity.

The right to collect revenue from the rendering of a service creates a gross inflow and economic benefits can be quantified and measured in monetary terms. Accordingly, management believes that the right to collect revenue (in the event of collecting less revenue than allowed under the AER revenue cap) meets the definition of an asset and it is appropriate to recognise this on the balance sheet as a receivable at fair value.

There is a view that an asset does not exist because the past under billing is reversed by increasing the rate that is charged for future sales, hence recoverability is dependent on the entity's future actions. Ergon Energy believes that the AER regulatory framework ensures that the inflow of economic benefit will occur in the future. Thus, under the substance of AER regulation and the Coordination Agreements, the shortfall represents a receivable, as Ergon Energy is permitted to recover this shortfall from customers through its revised tariffs and the retailers are required to adhere to the revised tariffs approved by the AER.

Obligations

AASB137 *Provisions, Contingent liabilities and Contingent Assets*, defines a liability as follows:

> "*…..a present obligation of the entity arising from past events, the settlement of which is expected to result in an outflow from the entity of resources embodying economic benefits*".

In instances where Ergon Energy has collected regulated revenue in excess of the cap set by the AER, it has a legally enforceable obligation to reduce tariffs in the future financial years. This liability results in reduced future economic benefits.

It can be argued that a liability does not exist because the reversal of the regulatory deferral account credit balance depends on the entity's future actions; that is it depends on the entity making sales to customers in the future. Management believe that although the AER regulatory regime means that the outflow of economic benefit occurs in the future; the substance of AER regulation and the Coordination Agreements represents a current obligation, as Ergon Energy would not be permitted to operate unless it returns the over recovery to customers.

AASB 137 paragraph 14 states that *a provision shall be recognised when:*

- *(a) an entity has a present obligation (legal or constructive) as a result of a past event;*
- *(b) it is probable that an outflow of resources embodying economic benefits will be required to settle the obligation; and*
- (c) *a reliable estimate can be made of the amount of the obligation.*

Each element of the *provisions* definition is considered below:

Present obligation

A present obligation to reduce tariffs for the new financial year arises when Ergon Energy exceeds its revenue cap.

Past event

The past event is Ergon Energy earning more than the revenue cap set by the AER for the regulatory year.

Probable outflow of economic benefits

Given the application of the revenue cap for the regulatory year, Ergon Energy is able to calculate whether it has exceeded the cap set by the AER and, in turn, will be required to return excess revenue to its customers. Therefore, at the conclusion of a regulatory year, Ergon Energy is able to confirm whether there will be an outflow of economic benefits.

Furthermore, the AER regulatory regime is enforced by the National Electricity Law and the National Electricity Rules which provides the mechanism under which this liability is enforced.

Reliable estimate

As Ergon Energy accurately accounts for revenue earned, Ergon Energy can readily calculate by how much it has exceeded the cap set by the AER and determine the required adjustment to future tariffs.

Ergon Energy's position is that the collection of revenue in excess of the AER revenue cap meets the definition of a liability and should be accounted as a provision as opposed to a trade payable or accrual.

6(b). Whether the IASB should develop specific accounting guidance or requirements to account for the combination of rights and obligations described.

Ergon Energy supports the IASB's proposal to issue a new accounting standard with specific guidance on the accounting treatment for rights and obligations arising from rate regulation. This would eliminate ambiguity in accounting for the effect of rate regulation and enable comparability of the financial performance of rate regulated entities.

7(a). The approach which will best portray the financial effects of defined rate regulation in IFRS financial statements and is most likely to provide information that investors and lenders consider is most relevant to help them make their investing and lending decisions.

Ergon Energy supports the development of specific IFRS requirements to align the recognition of revenue with allowable regulated revenue cap due to the following reasons:

- To a great extent this approach will use the already existing accounting standards and require a few modifications to reflect the consequences of rate regulation.
- Deferral accounts will be disclosed separately, making it to easier to compare the financial performance for regulated entities with non-regulated entities.
- Approach gives more decision making information to potential investors and lenders.
- The approach better reflects the effects of the transactions and events which have occurred in the period, even if the recovery of under or over recoveries occurs in future periods.
- Although IFRS14 is a temporary standard, the current guidance in the accounting standard is in line with this proposed approach to regulatory accounting.

The above comments reflect the existing definitions of an asset and a liability in the Conceptual Framework. However, it would be helpful for the IASB to adopt the proposed definitions of an asset and a liability in order to eliminate any ambiguities.

7(b). Any other approach that the IASB should consider.

None noted.

7(c). Additional advantages or disadvantages for each of the approaches which the IASB should consider.

No additional advantages or disadvantages were noted.

8. Whether Ergon Energy carries out activities which are subject to defined rate regulation.

Ergon Energy is subject to regulation over the revenue generated from its electricity distribution network. This regulation is administered by the Australian Energy Regulator.

Under the rules set out by the Australian Energy Regulator, Ergon Energy is allowed to earn a fixed amount of electricity distribution revenue per annum. At the start of each financial year Ergon Energy determines a set of tariffs which, based on forecast demand, it believes will achieve its revenue cap. Any difference between the revenue cap and actual revenue collected is either returned to, or recovered from, its customers. This adjustment to revenue is effected by adjusting the tariffs in future financial years.

The adjustments to revenue are enforceable under Coordination Agreements between Ergon Energy and electricity retailers. These Coordination Agreements detail the respective rights and obligations of electricity distributors and retailers. The clauses concerning billing stipulate that the prices charged by distributors to retailers must be those set by the Australian Energy Regulator.

If the IASB releases a new accounting standard that does not allow recognition of regulatory deferral account balances, this may cause Ergon Energy to write off significant under recovery assets recorded on our balance sheet.

9. Whether there is need to develop specific disclosure only requirements if the IASB decides to prohibit the recognition of regulatory deferral account balances.

If the IASB determines that the rights and obligations do not meet the definition of an asset and liability to be recognised on the balance sheet, the balances are still significant to Ergon Energy operations, and hence it would be appropriate to make additional disclosures.

10(a). Extent to which the requirements of IFRIS 14 meet the information needs of investors and lenders for entities that are subject to defined rate regulation.

Ergon Energy considers the presentation and disclosure requirements contained in IFRS 14 to be sufficient and appropriate for rate regulated entities.

10(b). Whether any of the disclosure requirements of IFRS14 could be omitted or modified in order to reduce the cost of compliance, without omitting information that help users of financial statements make investment and lending decisions.

No disclosures in IFRS14 were noted which could be omitted or modified in order to reduce the cost of compliance, without omitting information that help users of financial statements make investment and lending decisions.

11. Advantages and disadvantages if the separate presentation required by IFRS 14 was to be applied.

Advantages of reporting rate regulated assets and liabilities on a gross basis

- Gives a true and fair view of the rights and obligations arising from the rate regulation.
- Makes it easier to assess the entity's future cash flows.
- Reporting gross figures in line with AASB101, para 32, which states that assets and liabilities, and income and expenses, shall not be offset unless required or permitted by an Australian Accounting Standard. The only exception is when offsetting reflects the substance of the transaction.

Disadvantages of reporting rate regulated assets and liabilities on a gross basis

- None noted.

12. Whether the existence of a rate regulator whose role and authority is established in legislation or other formal regulation is an important feature of a defined rate regulation.

Ergon Energy supports the notion that the existence of a rate regulator whose role and authority is established in legislation or other formal regulations is an important feature to consider when analysing what rights and obligations established by the rate regulation are enforceable. This is because, in order for there to be a substantive right or obligation, there has to be an enforcement mechanism outside the entity.

The presence of a rate regulator also indicates that customers have little or no choice but to purchase the essential rate regulated goods or services from the entity at the regulated prices. On the other hand the entity will have no practical ability to avoid reversing the regulatory deferral credit balance by providing the rate-regulated goods or services at the reduced rate per unit.

Co-operatives or similar entities, which operate under self-imposed rate regulation should not be included within the scope of defined rate regulation as there is greater flexibility in decision making, making it difficult to predict the outcome of the rate setting mechanism or enforce it. Self-imposed rate regulation will also mean that there will be no sanctions if the regulated entity fails to satisfy any of its obligations.

Entities subject to formal oversight from a government department or other authorised body should be included within the scope of defined rate regulation, provided there is a sufficiently predictable and enforceable rate-setting mechanism in place.

13. Whether there are any comments or suggestions on issues which may or may not have been raised in the Discussion Paper which the IASB should consider if it decides to develop proposals for any specific accounting requirements for rate-regulated activities.

No further issues for consideration have come to our attention at the time of submitting this request for comments.