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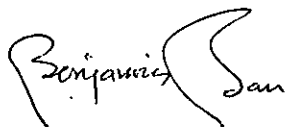
Dear Mr Riley,

IASB Discussion Paper of *Reporting the Financial Effects of Rate Regulation*

I refer to your letter of 24 September 2014 to invite comments on the Discussion Paper of Reporting the Financial Effects of Rate Regulation issued by International Accounting Standards Board (IASB) in September 2014.

As the Discussion Paper will have a profound effect on the financial reporting of our rate-regulated activities, we consider that it is more appropriate to express our view and submit our comments on the Discussion Paper directly to the IASB. We would like to give you a copy of our letter to the IASB. Hopefully, the Institute can also consider our view in developing your response to the IASB.

Yours sincerely,



Benjamin Lau
Director – Group Financial Control

9 December 2014

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Dear Sirs,

Discussion Paper - *Reporting the Financial Effects of Rate Regulation*

We are pleased to note the IASB's decision to start a new comprehensive research project on rate-regulated activities. We believe that the recognition of the regulatory assets and liabilities together with appropriate disclosures can reflect the financial effects of rate regulation on the entity's activities. In brief, we support the proposals of focusing the discussion on defined rate regulation and developing specific accounting guidance for such rate regulation. Our detailed responses to certain questions set out in the Discussion Paper are shown below.

Background

CLP Holdings Limited is a company listed on the Hong Kong Stock Exchange and has invested in energy businesses in Hong Kong, Australia, the Chinese mainland, India and Southeast Asia and Taiwan. CLP Holdings Limited owns 100% stake in CLP Power Hong Kong Limited ("CLP Power") and 70% stake in Castle Peak Power Company Limited ("CAPCO") (together the "Companies"). CAPCO is a generating company while CLP Power is the sole customer for CAPCO's electricity. CLP Power owns the transmission and distribution network and provides electricity supply and customer service to 5.8 million people in Hong Kong.

The Companies are one of the two rate-regulated entities engaging in the generation and supply of electricity to the customers in Hong Kong. Electricity supply in Hong Kong has all along been provided by the private sector.

The Companies are regulated by a Scheme of Control Agreement ("SCA"). The first SCA was signed in 1963. The current SCA covers the period from 2008 to 2018. The SCA is a bilateral contract entered into between the rate regulator (the Government of Hong Kong) and the Companies. It sets out the rights and obligations of the Companies and provides a framework for the Government to monitor the operations and financial affairs of the Companies during the tenure of the agreement.

The main objective of the SCA is to ensure the reliability of power supply so that there are sufficient facilities to meet the demand for electricity while the service to the customers is provided at the lowest cost which is reasonable in light of financial and other considerations.

Question 3

Do you agree that, to progress this project, the IASB should focus on a defined type of rate regulation (see Section 4) in order to provide a common starting point for a more focused discussion about whether rate regulation creates a combination of rights and obligations for which specific accounting guidance or requirements might need to be developed (see paragraphs 3.6 - 3.7)? If not, how do you suggest that the IASB should address the diversity in the types of rate regulation summarised in Section 3?

As rate-regulated entities under the SCA, we would like to draw your attention to the many aspects of the SCA which have impacts on the financial position, performance and cash flows of CLP Power and CAPCO. We realise the advantages of developing specific accounting guidance under IFRS for rate-regulated activities which may help the stakeholders understand the financial effects of rate regulation. We note that there is a diverse view whether rate regulation creates assets and liabilities that should be recognised for IFRS financial reporting purposes. There will have endless debates if the scope of the project is not properly defined. Therefore, we believe it is a sensible approach to focus the discussion on defined rate regulation.

Question 5

Paragraphs 4.4 – 4.6 summarise the key features of defined rate regulation. These features have been the focus of the IASB's exploration of whether defined rate regulation creates a combination of rights and obligations for which specific accounting guidance or requirements might be developed in order to provide relevant information to users of general purpose financial statements.

(a) Do you think that the description of defined rate regulation captures an appropriate population of rate-regulatory schemes within its scope? If so, why? If not, why not?

We think defined rate regulation should contain the following elements which create a combination of rights and obligations that supports the recognition of the entity's right to recover, or obligation to reverse, the specified differences as assets or liabilities in the statement of financial position.

- 1) A legally enforceable framework which governs the operations and financial affairs of the rate-regulated entity for a certain long period of time.

Electricity supply is an essential service in Hong Kong. The SCA does not establish or involve franchise for the supply of electricity. Therefore, the Companies do not have an exclusive right to supply electricity in Hong Kong. While interested parties are at liberty to enter the electricity market, there are latent constraints in the electricity supply industry for new suppliers to emerge such as intensive capital investment with long payback periods, the relatively small size of Hong Kong's electricity market, and the availability of suitable land for infrastructure development.

The Government executes the SCA with the Companies in order to ensure safe, reliable and cost effective electricity supply to the customers and provides incentive for our continuous investment in new electricity infrastructure to meet demand.

- 2) An independent rate regulator who has the responsibility and authority to administer the terms and conditions of rate regulation.

Under the SCA, the Government of Hong Kong has the responsibility and authority of overseeing our operations, capital investment plan and financial affairs. The Government also approves our tariffs under the rate-setting mechanism stipulated in the SCA. Through this monitoring role, the Government acts to balance the needs of the customers with those of the Companies.

- 3) A rate-setting mechanism which allows the recovery of costs and required rate of return.

Under the SCA, the Companies are entitled to receive tariff revenue sufficient to earn the permitted return (profit) on their investments through the planning, design and charging of annual basic tariff rates during the tenure of the agreement. The Companies have the right of full recovery of the actual costs of fuels consumed for the generation of electricity. There is no explicit provision for

the recovery of operating costs but the rate-setting mechanism of the SCA normally ensures their recovery.

The SCA requires the set-up of a number of reserve accounts to capture the surpluses or, in relation to fuel costs, deficits arising from over-billings or under-billings to the customers respectively. The rate-setting mechanism of the SCA incorporates the balances in these reserve accounts into the calculation of the future tariffs to be charged to the customers. This is the process for the Companies to recover, or reverse, the amounts in these reserve accounts through future bills to the customers.

In case of unforeseen circumstances, the basic tariff rates can be increased by up to a certain percentage (as provided in the SCA) above the approved level for a particular year.

(b) Do you think that any of the features described should be modified in order to include or exclude particular types of rate-regulatory schemes or rate-regulated activities included within the scope of defined rate regulation? Please specify and give reasons to support any modifications to the features that you suggest, with particular reference to why the features may or may not give rise to circumstances that result in particular information needs for users of the financial statements.

Depending on local regulation and circumstances, we realise that rate regulation may come with many different forms and features. As the Discussion Paper has indicated, "almost all of the schemes described as cost-of-service contained some incentive mechanisms and almost all schemes described as incentive-based incorporated some cost-recovery mechanisms". To come up with a defined type of rate regulation, IASB should focus on the key features of rate regulation which create the rights and obligations of the entity for recovering or reversing any under-billings or over-billings.

Give an example under the SCA. There is no explicit provision for the recovery of operating costs and the entitlement of the full permitted return. In fact, the permitted return is a cap and is not a guaranteed profit. However, the rate-setting mechanism of the SCA takes into account the projected operating costs and permitted return for future annual tariff adjustments. Together with the discretionary right to increase annual tariffs above the approved level and the set-up of reserve accounts, the recovery of operating costs incurred and the entitlement of the full permitted return for a year are normally ensured. Nevertheless, under exceptional circumstances such as catastrophic disaster with significant damage, it is possible that permitted return or even operating costs may not be able to recover for that year. But this kind of incidence should not preclude the rights and obligations stipulated in the SCA. Therefore, we believe that "to recover no more and no less than its revenue requirement" should not be a conclusive criterion for the effectiveness of defined rate regulation.

Similarly, we think whether defined rate regulation applies interest to any price increase that is deferred should not be the key features of defined rate regulation.

(c) Are there any additional features that you think should be included to establish the scope of defined rate regulation or would you omit any of the features described? Please specify and give reasons to support any features that you would add or omit.

Rate regulation is common in industries that are capital-intensive and require significant investment in long-life infrastructure assets in order to allow investors to earn their risk-adjusted cost of capital by investing in new capacity. We agree to the Discussion Paper that this is one of the key objectives of effective defined rate regulation.

However, it should be noted that rate regulation in whatever form would have a defined regulatory period. To allow for periodic review and the corresponding changes to the regulatory framework, the regulatory period is usually shorter than the useful lives of assets invested by the rate-regulated entity. To cater for any major changes to rate regulation, the entity would like to ensure that any capital investment and contractual commitment made will not become stranded or there is a mechanism in rate regulation to ensure the recovery of any stranded costs/assets together with reasonable return in case rate regulation no more exists.

Under the SCA, there is a provision to govern this situation. In the event of a change implemented by the Government of Hong Kong to the electricity supply market structure that causes material impact to the Companies, the Companies are entitled to recover from the market stranded costs (including costs of investments, fuel and power purchase agreements and may include a fair and reasonable return on the costs) that cannot be mitigated by measures required by the Government. The amount of stranded costs and recovery mechanism are to be agreed between the Government and the Companies.

This is a very important provision for defined rate regulation which ensures the recovery of investment and return beyond the regulatory period. This also supports the argument that a combination of rights and obligations are created under defined rate regulation which should be recognised in the financial statements.

Question 6

Paragraphs 4.62 - 4.72 contain an analysis of the rights and obligations that arise from the features of defined rate regulation.

(a) Are there any additional rights or obligations that you think the IASB should consider? Please specify and give reasons.

No

(b) Do you think that the IASB should develop specific accounting guidance or requirements to account for the combination of rights and obligations described? Why or why not?

The regulatory pricing framework and rate-setting mechanism would create rights or obligations to recover or reverse the amounts under-billed or over-billed but could not be recognised under the IFRS financial statements. These rights and obligations should be recognised in financial statements to reflect the underlying financial effects of rate regulation.

In our case, there are certain areas that the accounting policies of the SCA are different from the requirements of IFRS which include the treatment/recognition of costs incurred and funds collected by the Companies. The reserve accounts are one of the examples. Under IFRS, we treat these reserve accounts as financial liabilities which imply our contractual obligation to settle the amounts with the customers after the expiry of the SCA. However, we realise the uncertainty for any arrangement to settle the amounts with our two million customers directly. On the contrary if these reserve accounts together have deficits, we are not allowed to book a financial asset as the recovery of which is contingent upon future sales. This asymmetric treatment does not reflect the substance of the arrangement under the SCA.

We support the IASB in developing specific accounting guidance or requirements to account for a combination of rights and obligations arising from defined rate regulation.

Question 7

Section 5 outlines a number of possible approaches that the IASB could consider developing further, depending on the feedback received from this Discussion Paper. It highlights some advantages and disadvantages of each approach.

(a) Which approach, if any, do you think would best portray the financial effects of defined rate regulation in IFRS financial statements and is most likely to provide the information that investors and lenders consider is most relevant to help them make their investing and lending decisions? Please give reasons for your answer?

We consider that the 2nd approach set out in paragraph 5.34, i.e. adopting the accounting requirements established by defined rate regulation in the general purpose IFRS financial statements, would be the most appropriate option. If the purpose of this project is to align the financial information to the financial effects of rate regulation, the most appropriate mean is to prepare the financial statements in accordance with the accounting requirements established by rate regulation. In order to apply this approach, the IASB would need to consider certain exemptions from applying existing IFRS for the rate-regulated entity. This allows the entity to present the 'regulatory financial statements' as their general purpose financial statements.

Based on our experience in relation to the preparation of IFRS financial statements for the SCA business, we can demonstrate with the following examples why the 2nd approach is more appropriate.

Application of IFRIC 4 and IAS 17

Under an Electricity Supply Contract, all the electricity output of CAPCO is sold exclusively to CLP Power at the price paid by CLP Power to CAPCO sufficient to cover all of CAPCO's operating expenses (including fuel, depreciation, interest expenses, taxes), as well as CAPCO's share of the return permitted under the SCA. The Electricity Supply Contract entered between CLP Power and CAPCO is considered as a lease arrangement under IFRIC 4. CLP Power accounts for the contract as a lessee and CAPCO as a lessor under the finance lease accounting in accordance with IAS 17. As a result, CAPCO's power generating facilities are recorded on CLP Power's balance sheet as part of the leased fixed assets with a corresponding finance lease liability. CAPCO on the other hand is viewed as the financier of the finance lease arrangement and recognise a finance lease receivable. The payments made by CLP Power to CAPCO are therefore split into (1) interest payments (expenses) on the outstanding finance lease liability and (2) repayment of the outstanding finance lease liability. Corresponding treatments are adopted in CAPCO's financial statements as a lessor.

Under the SCA, CLP Power and CAPCO's returns are based on an annual permitted rate of return of 9.99% on the average net fixed assets. Under the IFRS lease accounting rules, the stakeholders would have the difficulty in finding the average net fixed assets of CLP Power and CAPCO individually, which are the critical information in understanding the financial results of the Companies. Also the rate regulator will not recognise the lease interest revenue/expense as SCA allowable items. As a result, separate SCA regulatory accounts have to be prepared.

Application of IAS 39

IAS 39 can lead to more volatile earnings, particularly when the Companies entered into derivatives for hedging purposes. Although the Companies can apply hedging accounting, unfortunately hedging accounting comes with significant conditions and is far from a free choice. Sometimes, those derivatives which cannot satisfy all the conditions will have been taken out as part of an economic hedge. Changes in the fair values of these derivatives are recognised immediately in profit or loss.

Under the SCA, in order to achieve the objective of maintaining stable tariff adjustments, fair value gains or losses of these derivatives are deferred but will be taken into account in the rate-setting mechanism of the SCA upon settlement. As a result, the IFRS financial results of the Companies are more volatile than the SCA's.

(b) Is there any other approach that the IASB should consider? If so, please specify and explain how such an approach could provide investors and lenders with relevant information about the financial effects of rate regulation.

We consider that the 3rd approach of developing specific IFRS requirements to defer/accelerate the recognition of costs and/or revenue could be a feasible alternative. As this approach focuses on profit or loss items and thus the recognition of regulatory assets and liabilities, certain regulatory differences from IFRS as specified in our response to Question 7(a) above would not be reflected in the general purpose financial statements. Separate regulatory accounts may still need to be prepared to address these accounting differences.

(c) Are there any additional advantages or disadvantages that the IASB should consider before it decides whether to develop any of these approaches further? If so, please describe them.

The major advantage of specific accounting guidance is to reflect the underlying performance and financial position of the rate-regulated entity. It facilitates the interpretation and understanding by the investors/shareholders, lenders, customers and other stakeholders of the financial effects of defined rate regulation. It also reduces the efforts in preparing two set of accounts, i.e. IFRS financial statements and regulatory accounts, by the preparers and assist the rate regulator in monitoring the financial affairs of the rate-regulated entity.

Question 8

Does your organisation carry out activities that are subject to defined rate regulation? If so, what operational issues should the IASB consider if it decides to develop any specific accounting guidance or requirements?

The Companies are rate-regulated entities under the framework of the SCA. The SCA itself has specified accounting rules which are applicable to certain transactions and their corresponding accounting treatments during the regulatory period. For transactions not covered by the SCA accounting rules, they are subject to the prevailing generally accepted accounting principle (i.e. IFRS). The relevant provisions are quoted below:

“The accounting policies to be applied in the interpretation of this Agreement (SCA) in general follow the prevailing generally accepted accounting principles in Hong Kong as applicable to the Companies at the time this Agreement is made. Specific accounting policies which will be applied in the interpretation of this Agreement are set out hereunder. For items not specifically listed below, the generally accepted accounting principles prevailing in Hong Kong and applicable to the Companies at the time this Agreement is made will be applied“

The SCA disallows the mechanical application of any new or revised IFRSs to the regulatory accounts which are issued subsequently after the execution of the SCA. This is understandable as these new standards or changes are unpredictable by the rate regulator and may increase the volatility of revenue requirements under the SCA. It will jeopardise one of the objectives of the rate-setting mechanism of the SCA to ensure stability in tariff adjustments.

Any specific accounting guidance or requirements for rate regulation should consider the effects of changes in future IFRS.

Question 9

If, after considering the feedback from this Discussion Paper and the *Conceptual Framework* project, the IASB decides to prohibit the recognition of regulatory deferral account balances in IFRS financial statements, do you think that the IASB should consider developing specific disclosure-only requirements? If not, why not? If so, please specify what type of information you think would be relevant to investors and lenders in making their investing or lending decisions and why.

We believe that in the absence of specific accounting guidance or requirements for rate regulation, disclosure alone can provide limited and even confusing financial information to the stakeholders and lead to tedious preparation efforts.

- 1) If defined rate regulation gives rise to rights and obligations, we have to explain and the stakeholders have to appreciate why these financial effects have not been recorded in the financial statements.
- 2) By not recording assets/liabilities arising from these rights and obligations in the financial statements, IASB must assess whether the financial statements of the rate-regulated entity still present a true and fair view of the financial performance and position of the business.
- 3) As a Group company with regulated and non-regulated businesses, additional disclosures for rate regulation will add to the complexity of the already-overloaded financial disclosures.
- 4) Results announcement usually contains limited disclosures which may not be sufficient for the stakeholders to comprehend the underlying financial performance and position of the entity.
- 5) If a disclosure approach is adopted, we are shifting the burden to interpret the financial statements in the perspective of rate regulation to the stakeholders. For the less sophisticated stakeholders, they may not have the capability and resources in analysing and interpreting the financial effects of rate regulation.
- 6) Disclosure alone will not satisfy the rate regulator in performing their monitoring role. We still need to maintain and prepare separate regulatory accounts to discharge our reporting obligation under the SCA. Reconciliations are likely to be provided for certain items in the IFRS financial statements and regulatory accounts.

Question 10

Sections 2 and 6 discuss some of the information needs of users of general purpose financial statements. The IASB will seek to balance the needs of users of financial statements for information about the financial effects of rate regulation on an entity's operations with concerns about obscuring the understandability of financial statements and the high preparation costs that can result from lengthy disclosures (see paragraph 2.27).

(a) If the IASB decides to develop specific accounting requirements for all entities that are subject to defined rate regulation, to what extent do you think the requirements of IFRS 14 meet the information needs of investors and lenders? Is there any additional information that you think should be required? If so, please specify and explain how investors or lenders are likely to use that information.

(b) Do you think that any of the disclosure requirements of IFRS 14 could be omitted or modified in order to reduce the cost of compliance with the requirements, without omitting information that helps users of financial statements to make informed investing or lending decisions? If so, please specify and explain the reasons for your answer.

AND

Question 11

IFRS 14 requires any regulatory deferral account balances that have been recognised to be presented separately from the assets and liabilities recognised in the statement of financial position in accordance with other Standards. Similarly, the net movements in regulatory deferral account balances are required to be presented separately from the items of income and expense recognised in the statement(s) of profit or loss and other comprehensive income.

If the IASB develops specific accounting requirements that would apply to both existing IFRS preparers and first-time adopters of IFRS, and those requirements resulted in the recognition of regulatory balances in the statement of financial position, what advantages or disadvantages do you envisage if the separate presentation required by IFRS 14 was to be applied?

We would like to set out our high-level responses to Question 10 and Question 11 in relation to the presentation and disclosure requirements of IFRS 14.

Presentation in financial statements

If specific accounting requirements are developed and their application has resulted in the recognition of regulatory deferral account balances in the statement of financial position, these regulatory deferral account balances should have met the definition of assets and liabilities under IFRS. Instead of disclosing a separate line item as required under paragraphs 20 and 21 of IFRS 14, these balances in the regulatory deferral accounts should be included in the respective line items of assets and liabilities of the same nature (e.g. property, plant and equipment, deferred tax etc.). "Other Regulatory Assets" and "Other Regulatory Liabilities" are still needed for the

remaining regulatory balances. They should be presented under non-current assets and non-current liabilities respectively. Such presentation for regulatory deferral account balances can provide users of financial statements with a complete picture of respective asset and liability items in the statement of financial position. This is particularly important as the return of most rate regulation is based on fixed assets as the rate base for the computation of required return.

Correspondingly, the effects of recognising regulatory deferral accounts to statement of profit and loss and other comprehensive income should be included in the respective revenue and expenses line items. There is no need to separate the net movements as required under paragraphs 22 and 23 of IFRS 14.

Separate presentation as required under paragraphs 24 to 26 in relation to deferred tax, discontinued operation and earning per share is not necessary. On the other hand, additional information about the impact of rate regulation should be provided in the notes to the accounts.

Disclosures in financial statements

We consider that it would be helpful if the qualitative disclosures, as required by IFRS 14, are shown in a note to the financial statements, which should include (i) explanation of activities subject to rate regulation including the nature and extent of the rate-regulated activities, (ii) rate-setting mechanism and (iii) specific risks in particular the regulatory risks associated with the recovery of regulatory balances. There should be cross-reference to other notes of those line items with regulatory balances included.

Additional information on the impact of rate regulation can be further elaborated in those notes where related regulatory balances are included. Such additional information would include relevant information on the nature of regulatory deferral accounts, regulatory balances and their recovery / reversal mechanism and expected period for recovery.

For those line items such as "Other Regulatory Assets" and "Other Regulatory Liabilities", reconciliation on the carrying amounts at the beginning and end of period with relevant details as set out in paragraph 33(a) of IFRS 14 would be useful to users on understanding the nature and impact of those deferred costs and incomes.

We also support the disclosure of some classes of regulatory assets / liabilities under the same rate-regulated activities that can be offset against each other.

Question 12

Section 4 describes the distinguishing features of defined rate regulation. This description is intended to provide a common starting point for a more focused discussion about whether this type of rate regulation creates a combination of rights and obligations for which specific accounting guidance or requirements should be developed.

Paragraph 4.73 suggests that the existence of a rate regulator whose role and authority is established in legislation or other formal regulations is an important feature of defined rate regulation. Do you think that this is a necessary condition in order to create enforceable rights or obligations, or do you think that co-operatives or similar entities, which operate under self-imposed rate regulation with the same features as defined rate regulation (see paragraphs 7.6 – 7.9), should also be included within defined rate regulation? If not, why not? If so, do you think that such co-operatives should be included within the scope of defined rate regulation only if they are subject to formal oversight from a government department or other authorised body?

We believe that the existence of a rate regulator is one of the key elements of defined rate regulation. We do not agree that co-operatives or similar entities, which operate under self-imposed rate regulation with the same features as defined rate regulation should be included within defined rate regulation because

- they are just a kind of economic activities similar to partnership; and
- defined rate regulation is imposed on essential goods or services with limited competition in order to balance the interests of the suppliers and the customers. The existence of an independent rate regulator with delegated authority from legislation or other formal regulations provides certainty on the enforcement of rights and obligations arising from rate regulation. Such certainty does not exist under self-imposed scheme.

Question 13

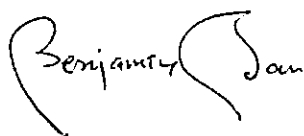
Paragraphs 7.11 – 7.22 highlight some of the issues that the IASB may consider if it continues to progress this project. Do you have any comments or suggestions on these or any other issues that may or may not have been raised in this Discussion Paper that you think the IASB should consider if it decides to develop proposals for any specific accounting requirements for rate-regulated activities?

The following issues are raised for your consideration:

- 1) The transition arrangement for the accounting of rate regulation when the entity moves from rate regulation to non-rate regulation or vice versa;
- 2) The application of rate-regulated accounting on the consolidated financial statements if only one of the subsidiaries is rate-regulated;
- 3) Should specific guidelines be developed for the income tax accounting to regulatory deferral accounts;
- 4) The application of rate-regulated accounting on business combination; and
- 5) The application of rate-regulated accounting when dealing with certain arrangements such as service concession arrangement (IFRIC 12) or lease arrangement (IFRIC 4)

We hope our comments are helpful. Please do not hesitate to contact us for any clarification needed.

Yours sincerely,

A handwritten signature in black ink that reads "Benjamin Lau". The signature is written in a cursive style with a large, sweeping initial 'B'.

Benjamin Lau

Director – Group Financial Control