



Accounting Standards Board

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5 November 2009

Dear Stig

EFRAG's Draft Comment Letter (DCL) on the IASB's Exposure Draft 'Rate-regulated Activities'

This letter sets out the UK Accounting Standards Board's (ASB) comments on the EFRAG DCL to the IASB on the above IASB Exposure Draft (ED). The ASB has already responded to the IASB and I attach a copy of our letter. You will see from our letter that, unlike EFRAG, the ASB views expressed below are based on a strong consensus.

We do not agree with the EFRAG DCL that rate-regulated activities (RRA) create assets and liabilities that should be recognised in the financial statements. Our reasons for this are outlined in the cover letter of our attached response to the IASB. The DCL's analysis of whether RRA give rise to assets and liabilities does not convince us that the right to charge a price in the future is significantly different for a regulated entity than for any other entity that is not significantly constrained by competition.

We also do not agree with the DCL suggestion that the scope should be widened to include regulation that is economically similar to cost-of-service regulation. We think it will be impossible for the IASB to write a scope that is wide enough to balance the need to capture regulation that is economically similar to cost-of-service regulation whilst simultaneously scoping out regulation that is not, due to the vast number of different regulatory regimes in force worldwide. We are also not convinced this exercise is even necessary since the right to charge customers a price for services in the future is common amongst all entities, as is the need to consider cost structure when setting prices.

We understand that guidance has been requested in this area in the past but given there is no diversity in practice within jurisdictions currently applying IFRS, we do not agree with the DCL that this ED is necessary. We consider that the unique nature of RRA is best communicated through note disclosure. Jurisdictions moving to IFRS should look to the established practice in this area.

Finally, we agree with the DCL that changes to recognition thresholds should be addressed at the Framework level and that we do not see the justification for using a 'best estimate' approach in IAS 37 and a probability-weighted approach in this instance.

We have responded to the questions for constituents in the Appendix to this letter.

Should you have any queries regarding our response please contact Melanie Kerr (+44 20 7492 2428, m.kerr@frc-asb.org.uk) or me.

Yours sincerely



Ian Mackintosh

Chairman

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Appendix

Responses to EFRAG's Question to constituents

Paragraph 24 of Appendix 1 to the DCL

As the paragraphs above show, EFRAG members are divided on whether rate-regulation creates assets and liabilities as defined by the Framework. We would therefore particularly welcome your views on the issue. Do you agree with the IASB that some forms of rate-regulated activities (operating within cost-of-service regulation) give rise to assets and liabilities under the existing Framework? If not what are your major concerns? And what view would you favour instead?

In the cover letter to our response to the IASB we note the following:

We do not support the proposals in the ED because we do not believe that RRA give rise to assets and liabilities – instead we support the 'Alternative Views on the ED'. Further, we do not consider that publishing this ED is a good use of the IASB's resources.

We consider that regulatory assets meet neither the 'resource controlled by the entity' nor the 'past event' elements of current Framework definition of an asset. We do not support the view that the incurring of costs is a 'past event' given that the 'future benefits' are actually caused by future sales to customers. We also do not consider that an entity 'controls' the ability to make future sales to its customers.

On the liability side, we do not believe the 'past event' or 'outflow from the entity of resources' criteria are met since we have difficulty concluding that a reduced selling price in the future is actually an outflow of resources from the entity.

Further, we consider that the ED has not been sufficiently persuasive in explaining why regulator controlled prices give rise to an asset in the form of a right to increase or decrease prices in the future when other entities have this same right but it does not give rise to an asset or liability. We consider that the risk of non-recovery of costs for rate-regulated entities may typically be lower than for other entities because many are monopoly providers of an essential service – in some instances the risk may be lowered to practically nil – but we do not believe lowered business risk in itself gives rise to an asset or liability.

Paragraph 45 of Appendix 2 to the DCL

We would particularly welcome your views on this issue. Do you think that there are other rate regulatory methodologies that could be addressed by the proposed IFRS? And if so, could you provide examples of these and explain why you think that they should be included in the scope of the proposed future IFRS?

We agree with EFRAG that the scope is too narrow to ensure that rate regulation that is economically similar to cost-of-service regulation is within scope. However, in our response to the IASB, question one, we note the following:

We think it will be impossible for the IASB to write a scope that is wide enough to balance the need to capture regulation that is economically similar to cost-of-service regulation whilst simultaneously scoping out regulation that is not, due to the vast number of different regulatory regimes in force worldwide. We are also not convinced this exercise is even

necessary since the right to charge customers a price for services in the future is common amongst all entities, as is the need to consider cost structure when setting prices.

Paragraph 71 of Appendix 2 to the DCL

Again we would welcome your views on this issue. Which of the above two views for the determination of the discount rate do you support and why do you think it is preferable?

We do not support the proposals in the ED that regulatory assets and liabilities be recognised and measured in the financial statements. If we did, we see no reason for using a discount rate that is different from that used for liabilities under IAS 37 and therefore support view one.

We agree with paragraph 70 that using an asset/liability specific discount rate instead of the regulatory rate may result in circumstances whereby the asset/liability recognised for future recovery/refund may differ from the actual amount of costs/revenues in the period. However, if this ED proposes the existence of regulatory assets and liabilities (and not some type of scheme to match revenues and expenses with future periods) we do not consider that the goal of selecting the discount rate should be offsetting revenues and expenses of the current period.

Paragraph 83 of Appendix 2 to the DCL

As the above paragraphs explain, EFRAG has more than one view on <the issue of whether regulatory assets should be included in the cost of self-constructed property>. We would welcome your views on this issue and in particular which of the views described above you prefer and why?

In our response to the IASB, question 4, we note the following:

We agree with AV13 that mixing regulatory assets and liabilities with those recognised in accordance with other IFRS reduces the transparency of the financial statements. As such, we think the cost of this proposal to users of the financial statements exceeds any record keeping benefit to the entity.

We do not support this proposal but if the IASB does decide to push ahead with this we note the following: since the goal of this proposal appears to be alignment of the regulatory and general purpose accounting for self constructed assets, we wonder why the ED addresses costs the regulator has allowed that would not be allowed under other IFRS but not costs the regulator has disallowed that would be allowed under other IFRS; and the ED is unclear how this proposal would apply in the case that an entity does not continue to meet the scope criteria in paragraph 3 and must derecognise its regulatory assets and liabilities. We assume these amounts are regulatory assets (since they are not assets under other IFRS) and should therefore be derecognised, but the ED is not explicit on this point. If our assumption is correct, then these amounts have a different derecognition threshold from other assets and would need to be tracked separately, thus negating any record keeping benefit.

Paragraph 97 of Appendix 2 to the DCL

What disclosures do you think could adequately address rate-regulated activities?

In our response to the IASB, question 6, we noted the following:

We consider the disclosure requirements in the ED provide the necessary information to users of financial statements to enable them to understand the nature of the regulatory assets. In particular, we support the proposed reconciliation of opening and closing regulatory asset balances as critical to transparency.

As noted in our response to question 4, we do not support mixing regulatory assets with internally generated capital assets, however, if the IASB does push ahead with this requirement, disclosure requirements for this should be specifically addressed. In particular, the requirement to disclose finance costs in paragraph 27(c) should cover other costs as well.



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International Accounting Standards Board
30 Cannon Street
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15 October 2009

Dear Sirs

Exposure Draft 'Rate-regulated Activities (RRA)'

This letter sets out the comments of the UK Accounting Standards Board (ASB) on the above IASB Exposure Draft (ED).

We do not support the proposals in the ED because we do not believe that RRA give rise to assets and liabilities – instead we support the 'Alternative Views on the ED'. Further, we do not consider that publishing this ED is a good use of the IASB's resources.

We consider that regulatory assets meet neither the 'resource controlled by the entity' nor the 'past event' elements of current Framework definition of an asset. We do not support the view that the incurring of costs is a 'past event' given that the 'future benefits' are actually caused by future sales to customers. We also do not consider that an entity 'controls' the ability to make future sales to its customers.

On the liability side, we do not believe the 'past event' or 'outflow from the entity of resources' criteria are met since we have difficulty concluding that a reduced selling price in the future is actually an outflow of resources from the entity.

Further, we consider that the ED has not been sufficiently persuasive in explaining why regulator controlled prices give rise to an asset in the form of a right to increase or decrease prices in the future when other entities have this same right but it does not give rise to an asset or liability. We consider that the risk of non-recovery of costs for rate-regulated entities may typically be lower than for other entities because many are monopoly providers of an essential service – in some instances the risk may be lowered to practically nil – but we do not believe lowered business risk in itself gives rise to an asset or liability.

ASB Response: Exposure Draft Rate-regulated Activities

We are also concerned that the ED introduces substantially new principles into IFRS. We do not consider that a standard on RRA is the appropriate place to introduce such principles that may be applied by analogy or have knock-on implications for other IFRS. For example, removing the 'reliable measurement' recognition hurdle and instead addressing uncertainty entirely through measurement differs from the recognition requirements in the Framework. We do not consider that there is any argument for presuming assets and liabilities arising from rate-regulation are reliably measurable given the vast number of different methods of rate regulation and the often-lengthy regulatory lag between the incurrence of costs and the change in rates. If the IASB wishes to change this criterion, it should be done via Phase B of the Conceptual Framework project.

We have answered the specific questions posed by the ED in the attached Appendix but note that this does not imply agreement with the issuance of the ED in the first instance. We consider that the unique nature of RRA is best communicated through note disclosure. We understand that guidance has been requested in this area in the past but given there is no diversity in practice within jurisdictions currently applying IFRS, we do not agree that this ED is necessary. Jurisdictions moving to IFRS should look to the established practice in this area.

If you would like to discuss these comments, please contact Melanie Kerr (020 7492 2428, m.kerr@frc-asb.org.uk) or me.

Yours sincerely



Ian Mackintosh

Chairman

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Appendix

Response to the Invitation to Comment

We have answered the specific questions posed in the ED, but as the covering letter makes clear, we do not support the publication of the ED and the proposals contained in it.

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?

We think it will be impossible for the IASB to write a scope that is wide enough to balance the need to capture regulation that is economically similar to cost-of-service regulation whilst simultaneously scoping out regulation that is not, due to the vast number of different regulatory regimes in force worldwide. We are also not convinced this exercise is even necessary since the right to charge customers a price for services in the future is common amongst all entities, as is the need to consider cost structure when setting prices.

If the IASB does decide to proceed with these proposals we have a number of suggestions for improving the scope:

1. We do not think that the existing mention of cost-of-service regulation is helpful for three reasons. First, the term may not be as meaningful worldwide as it is in the North American market. Second, it is difficult to define. The ED's definition of 'cost-of-service' regulation as a 'cause-and-effect' relationship between specific costs and revenues is unclear. Perhaps terms like 'pass-through costs' or 'cost plus a percentage return' would make the relationship more clear. Third, use of the specific term may result in scoping out economically similar types of regulation.
2. We do not support the proposal that uncertainty in future demand be addressed entirely through measurement. If customers in a particular market have substantial ability to increase or decrease demand through use of substitutes or conservation, it could be an indicator that the market does not support a price based on an entity's costs and call to question whether the rates are really controlled by the regulator or the market. We therefore consider that market demand should form part of the recognition criteria as reliable demand at a variety of price levels is integral to the notion that the regulator rather than the market controls the prices and the recovery of costs.
3. The scope paragraph 3(b) requires a 'specified' return but the application guidance requires an 'adequate' and 'sufficient' return and the Basis for Conclusions mentions a 'fair' return. We suggest the type of return required be clarified through use of a single word.

4. We find the indicators in paragraph B4 somewhat conflicting when considered in the context of UK regulation. Consider for example, the possibility that a regulated company can request a rate increase if an unexpected event affects turnover by 20%. In the event that a company suffers an adverse effect that does not meet the 20% materiality threshold then the company and its shareholders meet the full cost of this effect.¹ To us, if the 20% threshold is reached this could be considered a 'true-up' as described in paragraph B4(b) but it is clearly vastly different from regulation designed to recover an entity's costs and provide a fair return as described in B4(a) as in the above example the shareholders are bearing substantial risk for unexpected costs.
5. The requirement that the regulator establishes the price an entity 'must' charge its customers may unintentionally scope out economically similar arrangements whereby an entity is given a maximum allowable price increase but the entity has the discretion to hold back that increase in any given year and instead apply it to future years.

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?

As noted above, we consider that market demand should form part of the recognition criteria as reliable demand at a variety of price levels is integral to the notion that the regulator rather than the market controls the prices.

We also consider that there should be 'reliable measurement' and 'probable future economic benefit' recognition criteria in accordance with the current Framework. If the IASB wishes to change the recognition threshold, it should do it through Phase B of the Conceptual Framework project.

Given the substantial uncertainty inherent in recovery/refund of costs in instances when there is a lengthy regulatory lag, we do not see a justification for presuming reliable measurement or having a lower recognition hurdle than other intangible assets recognised under IAS 38 and other provisions recognised under IAS 37.

In relation to removal of the 'probable future economic benefit' criteria, we noted the following in our response dated 28 October 2005 to the *ED of proposed amendments to IAS 37 Provisions, Contingent Liabilities and Contingent Assets and IAS 19 Employee Benefits*:

In our opinion the elimination of the probability criterion (ie the removal of the threshold) from the Standard results in the Standard not adequately addressing element uncertainty. In a business environment, uncertainty exists on a continuum, so that the recognition process involves selecting the point on the continuum at which uncertainly becomes acceptable. The

¹ Note to example: This example is based on Ofwat regulation in the UK which allows 'Substantial Effect Determinations' in these circumstances.

exact location on the continuum will vary depending on circumstances. The probability criterion in IAS 37 previously provided a pragmatic approach to recognition of contingent liabilities and provisions.

The elimination of the probability criterion, in our opinion, fails to leave adequate guidance as to the amount and quality of evidence required to recognise liabilities. Whilst accepting that sufficient evidence is a matter of judgement, it is unsatisfactory for the Standard to fail to provide any guidance; whilst we accept the proposed amendments provide greater guidance on meeting the definition of a liability, we believe this does not specifically address element uncertainty.

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?

We do not support expected present value as an initial measurement basis for regulatory assets as we note that no other assets in IFRS are initially measured on this basis.

We note that the measurement basis for rate-regulated provisions differs from that of other provisions recognised under IAS 37. We do not see the justification for using a ‘best estimate’ approach in IAS 37 and a probability weighted approach in this instance. We are aware the IASB is considering revision to IAS 37 but we do not consider it appropriate that this specialised ED leads the way in finalising new principles for dealing with measurement uncertainty.

After consideration of illustrative example 6, we also wonder whether this measurement basis might result in misleading results in some instances. In this example, if an entity derecognised the damaged towers and expensed the carrying value in the profit and loss but recognised the regulatory asset based on recovery of replacement costs incurred, it would be possible to make a profit on the transaction beyond the rate of return, assuming that the cost incurred to build new towers exceeded the carrying value of the old towers. We do not consider that this profit reflects the economics of a transaction whereby the entity ends up in substantially the same position they started in.

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?

We agree with AV13 that mixing regulatory assets and liabilities with those recognised in accordance with other IFRS reduces the transparency of the financial

statements. As such, we think the cost of this proposal to users of the financial statements exceeds any record keeping benefit to the entity.

We do not support this proposal but if the IASB does decide to push ahead with this we note the following:

- since the goal of this proposal appears to be alignment of the regulatory and general purpose accounting for self constructed assets, we wonder why the ED addresses costs the regulator has allowed that would not be allowed under other IFRS but not costs the regulator has disallowed that would be allowed under other IFRS; and
- the ED is unclear how this proposal would apply in the case that an entity does not continue to meet the scope criteria in paragraph 3 and must derecognise its regulatory assets and liabilities. We assume these amounts are regulatory assets (since they are not assets under other IFRS) and should therefore be derecognised, but the ED is not explicit on this point. If our assumption is correct, then these amounts have a different derecognition threshold from other assets and would need to be tracked separately, thus negating any record keeping benefit.

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?

We do not support the measurement basis proposed in this ED, however, we do wonder whether impairment testing as described in paragraphs 17 and 18 is necessary in the circumstances described in the ED since the asset is re-measured at its expected present value each reporting period and demand uncertainty/declines should be reflected in this measurement.

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.

We consider the disclosure requirements in the ED provide the necessary information to users of financial statements to enable them to understand the nature

of the regulatory assets. In particular, we support the proposed reconciliation of opening and closing regulatory asset balances as critical to transparency.

As noted in our response to question 4, we do not support mixing regulatory assets with internally generated capital assets, however, if the IASB does push ahead with this requirement, disclosure requirements for this should be specifically addressed. In particular, the requirement to disclose finance costs in paragraph 27(c) should cover other costs as well.

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 do not support the proposals in the ED but if we did, the transition provisions would not give us cause for concern.

Question 8

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

As noted in our covering letter, we do not believe RRA give rise to assets and liabilities and consider the IASB should have solicited views on this issue as part of the ED, particularly in light of the fact that two IASB members dissented on this basis.

We are also concerned about the implications of illustrative example 6. Consider the following example:

Scenario A:

A utility company builds its first power plant and the regulator allows the company to include the cost of building the plant in the its rate base.

Scenario B:

A utility company's existing plant is destroyed in a storm and written-off through the profit and loss. The utility builds a new plant, and is allowed to recover the costs.

According to paragraph 10, the ED is not applicable when items related to regulated activities are already recognised as assets and liabilities in accordance with other IFRS. Therefore, in Scenario A the right to recover the cost of building the plant is not recognised as an intangible regulatory asset.

According to illustrative example 6, Scenario B would result in an intangible asset representing the right to recover the costs of building a new plant due to the write-off of the destroyed plant being expensed in the profit and loss.

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The right to recover the costs of building a plant is the same in both instances, so we do not believe the existence of a write-off of a destroyed plant justifies different treatment in the two scenarios.