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Sir David Tweedie, Chairman
International Accounting Standards Board
30 Cannon Street
London
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Email: commentletters@iasb.org

20 November 2009

Dear Sir David,

Re: Exposure Draft ED/2009/8 *Rate-regulated Activities*

Deloitte Touche Tohmatsu is pleased to respond to the International Accounting Standards Board's (the IASB's) Exposure Draft ED/2009/8 *Rate-regulated Activities,* (the "Exposure Draft" or "ED").

We support the Board's efforts to address differences in practice regarding the recognition of assets and liabilities arising from rate regulation. We agree that only the regulated entities proposed by the scope of the standard should be able to recognise regulatory assets and liabilities.

However, we believe the ED's current scope criteria, as currently worded, would create confusion for entities proposed to be outside the scope of the final standard. In our view, this may result in entities asserting they are within the scope and applying the principles contained in the ED by merely analogising to their particular situation even though technically they do not meet the established criteria. We would prefer the final Standard's scope include all entities' operating activities whose prices are subject to regulation, and then subject all such entities to established recognition criteria. Expanding the scope to all rate-regulated entities will help alleviate our concern as it becomes a question of whether an entity meets the recognition criteria for it to be able to recognise a regulatory asset or liability. Entities within the scope of the standard, but not meeting the recognition criteria would be prohibited from recognising regulatory assets and liabilities under this [draft] IFRS. The risk of entities the Board did not intend to recognise regulatory assets and liabilities doing so would therefore be lessened.

To apply our recommended approach, the final Standard would have to include specific recognition criteria. We believe the scope criteria in paragraph 3 of the ED would be appropriate recognition criteria to determine whether a regulatory asset or liability should be recognised if the core principles are elaborated upon such that constituents can more easily evaluate the wide range of regulatory frameworks that exist around the world while alleviating the need for a list of rules or exceptions that accommodates every possible example. We discuss this further in our response to Question 1.

We also believe that the use of a probability-weighted cash flow approach for measurement of regulatory assets and liabilities may not be practical and will be unduly complex and costly for preparers and not easily understood by users. Instead, we support a methodology that is consistent with IAS 37, *Provisions, Contingent Liabilities and Contingent Assets*, based on the individual more-likely-than-not outcome. Using this methodology, an entity would evaluate each potential scenario individually to determine the largest amount of cash flows that is more-likely-than-not to occur.

Additionally, we have concerns that certain of the disclosure requirements, particularly the requirement to provide a reconciliation from the beginning to the end of the period for each category of regulatory assets and liabilities, could be overly burdensome for financial statement preparers and may not be useful to users. We encourage the Board to reach out to financial statement preparers regarding the cost of this disclosure requirement. We also encourage the Board to reach out to financial statement users to understand if the additional information would be useful such that the benefits exceed the costs.

Finally, we would encourage the Board to further consider the transitional provisions in the new standard, especially for those entities that have acquired in the past a subsidiary operating under a rate-regulated system and for which any rate-regulated asset or liability was not recognised separately but as part of goodwill, since at such time there was no standard that specifically addressed the recognition of such assets and liabilities apart from goodwill. When those rate-regulated assets and liabilities will be recognised under the new standard, it may have consequential effect on the carrying amount of goodwill (possibly an impairment loss to be recognised). It would be appropriate that the standard clarifies where that consequential effect should be accounted.

These views are expressed in more detail in our responses to the invitation to comment questions, which are included in Appendix A to this letter.

If you have any questions concerning our comments, please contact Ken Wild in London at +44 (0) 207 007 0907.

Sincerely,

Ken Wild
Global IFRS Leader

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?

As discussed in our cover letter, we prefer that the final Standard's scope include all entities' operating activities that provide goods or services the prices of which are subject to regulation. Then, to determine whether regulatory assets or liabilities may be recorded, an entity should apply specific recognition criteria. We believe the scope criteria in paragraph 3 of the ED would be appropriate recognition criteria to determine whether a regulatory asset or liability should be recognised.

Notwithstanding our support of the scope criteria in the ED, we believe the final standard should further elaborate as to the core principles that lead to the recognition of regulatory assets and liabilities. Providing clear and concise principles will help constituents more easily evaluate the wide range of regulatory frameworks that exist around the world while alleviating the need for a list of rules or exceptions that accommodates every possible example. The principles and guidance in the final standard should be sufficiently robust, such that for the following examples of regulatory frameworks an entity should be able to determine whether recognising a regulatory asset or liability is appropriate.

(a) in some jurisdictions, entities use industry benchmarks for determining the costs that will be the basis of the price regulation. The benchmarks used are highly correlated to the costs of the specific entity which are used to develop the benchmark.

(b) certain industries (e.g., some nationally-regulated gas pipeline entities) are regulated under a maximum-rate philosophy. In these instances, a regulator sets only the maximum price that the entity can charge its customers based on the recovery of the entity's specific costs. These entities may provide discounts to the maximum regulated price (but cannot exceed that price) in order to increase throughput and maximise total revenues, at least for short periods of time. These discounted rates allow the entity to continue to recover their specific costs and a return on their investment (although perhaps lower than the maximum return set by the regulator).

(c) under some regulation, it is only some specific costs incurred that are considered by the regulator for adjustments of the regulated price (e.g. the regulator may allow through future tariff increases for the recovery of some additional pensions burden required from the entity whereas there is no other regulation enabling recovery for other excess costs incurred).

(d) in some jurisdictions, regulations are subject to periodic renewals (say that the regulation is revisited every four years, at which time the regulator reassesses what to include in the tariff). Based on past practice, there might be an expectation that the regulation will be renewed allowing recovery of prior costs incurred in future years, but may be not to the same extent as in the prior four years.

(e) there are electricity and natural gas distributors that are subject to regulation where tolls are established using a base year traditional cost of service toll filing that may be in place for 5 or more years. In each year, subsequent to the base year, the cost of service is estimated based on the previous year's rate adjusted for inflation and productivity factors with any over earnings either returned to the rate payers or shared on a pre-determined formula. In the event that the rate of return realized by the entity falls outside of the regulator specified range (higher or lower by a pre-determined threshold), the cost of service toll rate is immediately reset based on actual costs incurred. This method of setting rates avoids the inefficient process and the high cost of an annual cost of service filing yet still approximates the cost of service during the period.

(f) in some jurisdictions, regulators grant operators of a concession arrangement within the scope of IFRIC 12 (intangible asset model), an extension of the concession arrangement rather than an adjustment to tariff so as to recover prior costs incurred in excess of those initially budgeted when the original tariff was determined with the concession arrangement. If there is a difference in treatment between such a regulation and a regulation that would have granted a tariff increase, it should be understandable from the principles what makes a difference in treatment, as both regulations lead to the same effect, (i.e. recovery of prior costs incurred in excess of what was initially budgeted).

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 in Question 1, we do not agree with the proposed approach outlined in the ED. We believe all entities governed by rate regulation should be within the scope of the standard. The final Standard should include recognition criteria consistent with the scope criteria in paragraph 3 of the ED with further elaboration as to the core principles that result in the recognition of assets and liabilities in the context of rate regulated frameworks.

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 agree with the measurement approach proposed in the following respects:

Use of probability weighted cash flow approach

We do not agree with the use of a probability-weighted cash flow approach because it is costly and will be unduly complex for preparers and potentially confusing to users. Instead, we believe a preferable methodology is one that is consistent with IAS 37, *Provisions, Contingent Liabilities and Contingent Assets*, based on the individual more-likely-than-not outcome. Using this methodology, an entity would evaluate each potential scenario individually to determine the largest amount of cash flows that is more-likely-than-not to occur.

The following are some factors that we believe contribute to the complexity and cost of the currently proposed requirements in the Exposure Draft:

- It will often be difficult for financial statement preparers to develop the probabilities related to a range of possible outcomes of recovery or refund for each regulatory asset or liability. Since many regulatory assets are associated with property, plant, and equipment or other long-lived assets or liabilities, precise scheduling would be particularly complex and heavily reliant on entity-specific modeling considerations and potential outcomes. In addition, the return element of the future cash flows would change frequently over the recovery period by amounts that would be unknown at the measurement date. This will also result in an inconsistency between the measurement of regulatory assets and liabilities that are separately classified and those that are included as regulatory costs in property, plant, or equipment or intangible assets.

- In addition to the requirements of the proposed IFRS, many jurisdictions will still require the entity to report its regulatory assets and liabilities to the regulatory authorities using an undiscounted cash flow approach. This will result in a difference between regulatory accounting and financial accounting and will require entities to keep two sets of accounting records.

- We believe that the cost of remeasuring regulatory assets and liabilities every reporting period outweighs the benefits. We believe that remeasurement will be particularly costly and complex for entities that operate in multiple regulatory jurisdictions. We suggest that an entity should only be required to remeasure regulatory assets and liabilities when an indicator is present that indicates facts and circumstances have changed relating to various regulatory recovery scenarios and/or probabilities.

Discounting

In addition, we do not believe it is appropriate to discount regulatory assets and liabilities as they are not financial assets and liabilities to be measured at fair value. Because regulatory assets and liabilities cannot be monetized or settled at the balance sheet date we do not believe that application of an “exit price” or “present value” presumption results in an accurate or meaningful measurement. If the Board decides to retain the requirement to discount regulatory assets and liabilities (which we believe that the discounting of cash flows to measure the regulatory assets and liabilities is consistent with the requirements of certain existing IFRSs), we believe that the final Standard should acknowledge that often the rate of return that is included as part of the expected cash flows and the discount rate used to discount those cash flows will approximate each other in the calculation of the regulatory asset. In these situations, the final Standard should state that it is acceptable to ignore including a rate of return and discounting the expected cash flows. Because the expected return to be included in the estimated future cash flows would be subject to considerable judgment and would likely vary from period to period, and because the discount rate to be used is also somewhat arbitrary and subject to similar judgment, we believe such a change will greatly simplify the application of the final Standard without diminishing its recognition of the impacts of regulation.

However, if the discounting requirements are retained, we do not believe that the ED clearly and adequately describes how the discount rate (in addition to the risk-free time value of money) is to be determined.

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 believe that the exception is justified only in those situations where there would not be a material difference in the amounts reported on the income statement if an entity separated the costs out and recognized them as a separate regulatory asset rather than including those costs as part of property, plant and equipment or internally generated intangible assets. In these situations, we believe providing this exception would lessen the complexity and cost for preparers in applying the final Standard. We believe this exception is appropriate because these regulatory approved costs are not segregated by regulators and are recovered in a fashion and over periods identical to other costs of the property or intangibles that would be recognised under other IFRSs.

We also suggest that the IASB consider providing similar additional exceptions for certain other amounts already included as part of inventory and accumulated depreciation accounts under the requirements of certain regulators, such as costs of removal, accelerated depreciation, or other depreciation differences required or allowed by regulation as long as separating those amounts as separate regulatory assets or liabilities would not impact their amortisation periods. It would be complex and costly to capture and track certain of these amounts as separate regulatory assets and liabilities so would greatly reduce the cost and complexity of the proposed Standard.

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 are confused about the proposal relating to the impairment of the regulatory asset and liability. Because the regulatory asset is already a current measure, we do not understand why an entity would need to go to IAS 36 to determine whether a single regulatory asset is impaired and how an impairment loss can be allocated to such an asset where an impairment loss exists for the cash-generating unit to which the regulatory asset belongs (see paragraph 20 of the ED). A regulatory asset cannot have an IAS 36 value in use (as stated in B17 of the ED), because the asset cannot generate independent cash inflows from other assets. Therefore, for impairment purposes, the asset can only be tested with its cash-generating unit (refer to IAS 36.67).

In our view, regulatory assets and liabilities should be measured taking into account (through the cash flow projections) the consequence of demand and/or other areas of potential variability. Subsequently, the cash-generating unit to which those regulatory assets or liabilities belong should be tested for impairment under IAS 36 (i.e. consideration of the existence of indicators of impairment before determining the recoverable amount of the cash-generating unit). If there is an impairment loss at the cash-generating unit level, it should not be allocated to any regulatory asset (liability) as they are already measured on a current value (discounted cash flows, even if those cash flows are not independent from those generated by the assets to which the regulatory asset belongs). As a consequence, we believe that a decrease in the value of a regulatory asset would indicate that the other assets within the CGU may be impaired because of the interrelationship between the other assets and the regulatory asset. A decrease in value of the regulatory asset may indicate that entity may need to evaluate the CGU for impairment. Any resulting impairment would be allocated to the assets of the CGU (absent the regulatory asset because that is already at current value).

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 generally agree that the enhanced disclosure requirements provide decision-useful information. However, we have concerns that certain of the proposed disclosures, particularly the requirement to provide a reconciliation from the beginning to the end of the period for each category of regulatory assets and liabilities, could be overly burdensome for financial statement preparers and not useful to users. We encourage the Board to reach out to financial statement preparers regarding the cost of this disclosure requirement. We also encourage the Board to reach out to financial statement users to understand if the additional information would be useful such that the benefits exceed the costs.

In addition, the Board should consider an additional requirement that entities disclose the differences between costs incurred and the amount recorded as a regulatory asset, particularly if the proposed probability-weighted present value approach to measurement is retained. We believe this information may be useful to financial analysts and other financial statement users.

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 believe the Board should consider allowing entities to apply the proposed IFRS without providing comparative information. However, should the Board ultimately require comparative information be presented, we believe the Board should reach out to preparers to understand how much time it would take them to accumulate the necessary information to present comparative periods. The Board should also consider providing some relief to preparers if comparatives are required, such as allowing for the use of current assumptions regarding the probability-weighted present value of future cash flows because estimating the **past** probability and discounted amount of the expected cash flows would be difficult.

Question 8

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

The interaction between the requirements in paragraph 3(b) and B6 are not easy to understand. Among other things, it would need to be clarified whether the assessment of the specified return shall be made with respect to the specific costs incurred only or by looking at the effects of the regulation as a whole.

The interaction between the proposed requirements for the recognition and measurement of regulated assets and liabilities and an intangible asset recognised as a result of the application of IFRIC 12 to a concession arrangement should be clarified. In particular, where demand is not as expected, how does this affect the intangible asset recognised under IFRIC 12 and any regulatory asset that may have been recognised. Should some priority be given to one or the other asset in taking into account the accounting consequences of the decrease in demand?

Finally, we believe that the transition provisions in the new standard should consider entities that have acquired in the past a subsidiary operating under a rate-regulated system and for which any rate-regulated asset or liability was not recognised separately but as part of goodwill, since at such time there was no standard that supported the recognition of such assets and liabilities apart from goodwill. When those rate-regulated assets and liabilities will be recognised under the new standard, it may have consequential effect on the carrying amount of goodwill (possibly an impairment loss to be recognised). It would be appropriate that the standard clarifies where that consequential effect should be accounted.