BUSINESSEUROPE

IASB
International Accounting Standards
Board
30 Cannon Street
London, EC4M 6XH
United Kinddom

23 November 2009

BUSINESSEUROPE's response to the Exposure Draft ED/2009/8 *Rate-regulated Activities*

Dear Sir/Madam,

BUSINESSEUROPE values very positively the Board's efforts to address differences in practice regarding the recognition of assets and liabilities arising from rate regulation. However, we do not agree with the **proposed scope** (which we consider too narrow) and the criteria for application of the final Standard, in particular with regard to the following aspects:

- From the current wording of the standard it can be interpreted that regulatory assets may only be recognised for the costs incurred that exceed the initially budgeted costs and which give rise to the right to increase future rates. Strict application of the asset recognition criteria solely to budget deviations would give rise to an accounting mismatch with other expenses / costs meeting the same conditions as the assets generated by deviations.
- We also believe that any regulation agreement that sets up prices on a basis of a formula, and that sets those prices first on a forecast basis and then regulates future prices in order to amortize any amounts invoiced in excess or by default, should be included in the scope of any future standard. Average costs in a particular industry or whatever the basis for setting prices can be would create similar assets or liabilities in our view.
- Additionally, broadening the scope to include price cap or incentive based forms of regulation could well be argued as appropriate, since these mechanisms permit the recovery of the expenses and meet the general definitions of a regulated-activity asset included in the exposure draft.

Another relevant matter is that we consider that the wording of the standard should consider the **interactions existing with the IFRIC 12** currently in force in relation to some concession arrangements (which are a regulated activity and, so, they should be expressly included in the standard). The joint application of the two standards gives rise to significant inconsistencies, especially as regards the treatment of the costs incurred.

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This suggestion is consistent with the provisions of certain standards that specifically regulate concession arrangements, such as US GAAP (FAS 71). This treatment had already been recommended in March 2004 by the staff of the IASB in their analysis of the preparation of IFRIC 12. The IFRIC's argument to dismiss this recommendation was the non-existence at that time, within the IFRS framework, of regulatory assets, and that the IFRIC did not have sufficient competence to consider such a matter. This restriction should be reviewed since it does not apply in the context of the creation of a specific standard on regulatory assets.

In relation to the **recognition criteria**, we disagree with the approach of the ED, as we understand that the likelihood of future cashflows does not lie only in the regulator willingness to comply with the regulation, but also in the competition position of the regulated industry, as it is not the same a regulated activity open to free competition (e.g a telecommunications regulated activity), or a regulated activity with no competition (e.g a natural monopoly as a toll road).

In relation to the **measurement criteria**, we have constantly opposed the use of expected value for single-risk items. We believe that estimates of future prices, necessary in the valuation process of regulatory assets and liabilities, should be based on management's best estimate, with appropriate disclosures provided in the notes.

In relation to **transition**, an exception should be included to the retrospective application of the standard in those cases in which such application is impracticable or excessively costly. In addition, with regard to the transition to the new standard, the standard should specifically address the recognition of regulatory assets and liabilities that previously had not been recognised as a result of a business combination, but rather had been treated as part of the total amount of the goodwill arising on the acquisition.

This view, together with other additional issues, is expressed in more detail in our responses to the invitation to comment questions, which are included in Appendix A to this letter. We remain at your disposal, should you wish to discuss these comments in more detail.

Yours sincerely,

J. Chauvin

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APPENDIX A: Invitation to comment

<u>SCOPE</u>

<u>QUESTION 1:</u> *The exposure draft proposes two criteria that must be met for rate-regulated activities to be within the scope of the proposed IFRS. Is the scope definition appropriate? Why or why not?*

<u>Recognition criteria – capitalisation of costs:</u>

Based on paragraphs BC15 to BC22 of the Basis for Conclusions, it seems reasonable to consider that the costs incurred should be capitalised if they meet the basic criteria defined in the standard on rate-regulated activities, i.e. to the extent that the price setting system envisages the recovery of the costs and that such recovery is probable.

However, the wording of paragraph 8 of the standard establishes that an entity will recognise a regulatory asset as a result of the existence of a right to recover specific previously incurred costs and to earn a specified return, when it has the right to ***increase*** the rates in future periods as a consequence of the actual or expected actions of the regulator.

This wording appears to imply that only the costs incurred in excess of those initially budgeted and which give rise a right to increase future rates should be recognised as regulatory assets, which would also imply that a regulatory asset never exists at the commencement of the arrangement. There is a clear inconsistency between this situation and the points regulated by sections 13-16 of the exposure draft, on the basis of which it seems reasonable to assume that the recognition criteria should apply to the recoverable initial costs and not only to deviations. In fact, paragraph 16 of the standard even permits the capitalisation of types of costs in internally generated assets which it would not be permitted to recognise in accordance with other IFRSs in force.

Accordingly, it could also be argued that it does not appear reasonable to include the recognition of an asset for unapproved cost deviations or even costs not permitted by other IFRSs and, by contrast, not expressly regulate the recognition of an asset for the initial costs incurred, included in the initial approved plan, which have a lower level of associated uncertainty than the deviations.

For the reasons explained above, we believe clarifications by the Board of what is meant to be reflected in the statement of financial position are needed.

<u>Recognition criteria – specific costs:</u>

One of the criteria established in the scope of the standard (paragraph 3b) refers to the requirement that the price established by regulation be designed to recover the specific costs incurred by the entity providing the service and to earn a specified return *(cost-of-service-regulation)*.

The establishment of a direct link between specific costs and rate regulation must be interpreted in a broadly basis in the context of some regulated activities, such as infrastructure concessions, since in arrangements of this type it is not possible to make analyses of individual costs but rather the costs required to construct, start up and operate the infrastructure must be considered taken as a whole over the entire life of the concession.

Recognition criteria – Price Cap and others:

Narrowing down the scope to cost-of-service regulations excludes other forms of price "catch up" regulations that, although not necessarily based on the costs the entity incurs, do create similar regulatory assets or liabilities, i.e. amounts due from – or to - the customer base taken as a whole. Whilst the later details of the standard set out some principles which may relate far more broadly across the sector and encompass other forms of regulation, it is inconsistent, in our view, that the scope is limited, ruling out, for example, price cap or incentive based forms of regulation. However, companies with these forms of regulation could have many comparable elements within their regulatory structure; certain specific costs may be recoverable in future periods, under the regulatory regime, for example via explicit guidance from the regulator. No matter when the costs are recoverable in future periods, differences between cost of service and price-cap regulations are not significant. As a result, broadening the scope to include such incentive based mechanisms could well be argued as appropriate.

Furthermore, paragraph 4 could be interpreted as suggesting that entities within the scope do not have any freedom to grant any discount from regulated prices. We do not believe that such interpretation would be correct. Assets and liabilities represent rights and obligations substantiated by the regulation. We believe that those assets and liabilities are generated, even though the entity has full discretion in granting rebates, i.e. re-distributing part of the asset granted by the regulation or increasing its obligation towards its customer base. We would appreciate if clarification was provided in that area, if our recommendation to limit requirements to appropriate disclosures was not followed.

Interactions with IFRIC 12:

The current exposure draft directly regulates the recognition of "regulatory assets", permitting the entity to capitalise previously incurred costs to the extent that they will be recovered through future rate increases established by the regulator. Although the draft appears to be aimed primarily at the energy market, it is evident that the criteria established in the definition of the scope can be applied to a significant number of diverse arrangements, i.e. infrastructure concession arrangements. The concessions business is essentially a regulated industry and, so, it should be expressly included in the standard.

Accordingly, on the basis of its current wording, certain concession arrangements could be required to be accounted for by applying both IFRIC 12 and the standard on rate-regulated activities. This premise is reflected in paragraph BC39 of the Basis for Conclusions where it states: *"In another service concession arrangement, the grantor* *may give the operator the right to recover the operator's costs and earn a specified return as well as the right to charge customers to use the public service. If it does, the entity would apply both IFRIC 12 and the proposed IFRS on rate-regulated activities",* as well as in Appendix C7 of the standard: *"An entity that operates a public-to-private service concession arrangement that is within the scope of this Interpretation should also consider whether its operating activities provided using the infrastructure in accordance with the concession arrangement are within the scope of IFRS Rate-regulated activities".*

We consider that, in practice, a large number of concessions meet the criteria, established in paragraph 3 of the standard on rate-regulated activities, to be considered within the scope of the standard. The criteria are as follows:

1. *An authorised body is empowered to establish rates that bind customers.*

2. *The price established by regulation (the rate) is designed to recover the specific costs the entity incurs in providing the regulated goods or services and to earn a specific return (cost-of-service regulation).*

This could be the case, for example, of certain concession arrangements included in the IFRIC 12 intangible asset model in which the rates are set by the regulator and, although there is no unconditional right to receive a financial asset, the public rates are calculated to recover the costs incurred by the entity and there is sufficient evidence that these rates will enable the entity to recover the aforementioned costs. In our opinion these conditions can be interpreted in many cases as the establishment of a direct cause-and-effect relationship between the costs incurred for the provision of the service and the revenue to be received. It should therefore be concluded that in these cases the rate setting system is aimed at recovering the entity's costs (through rate increases or, as the case may be, increases in the term of the concession).

On the basis of all the foregoing, the existence of significant interactions between IFRIC 12 and the current exposure draft on rate-regulated activities is established, although this interaction and its implications are not made sufficiently clear in the current draft. Therefore, as indicated earlier, the fact that an entity applies the intangible asset model for a concession arrangement in accordance with IFRIC 12 does not prevent the application of the standard on rate-regulated activities to that arrangement (BC39, Appendix C C7); however, the joint application of the two standards gives rise to significant inconsistencies.

Treatment in other accounting standards and IFRIC recommendations from 2004:

The adequate deferral of costs in order to correct for the timing mismatch between annual revenue and expenses, is considered in certain legislations, such as US GAAP (through FAS 71 "Accounting for the Effects of Certain Types of Regulation"), which already included, with a significant degree of similarity, mechanisms to eliminate the aforementioned timing mismatches which arise in relation to revenue and expenses of a concession arrangement over the life thereof, through the deferral of the initial costs/losses that will be recovered over the term of the concession. The standard consider the recognition of a regulatory asset for the right to recover *all of the costs incurred (including finance costs)* when:

- It is reasonable to assume that the rates will be set at such levels that enable the costs capitalised by the entity to be recovered.

- It is probable that the prices will be set at the aforementioned levels, i.e. it is probable that the future revenue will be generated in an amount sufficient to at least equal the total capitalised costs, through the inclusion of such costs as part of the costs “permitted” in the setting of rates.

- There is sufficient evidence that the future revenue will enable the recovery of the previously incurred costs.

Accordingly, US GAAP establish that it is reasonable to consider the deferral of the initial costs if it is probable that they will be recovered, since they conclude that these costs relate to the *future activities*, because they are necessary for the overall execution of the project (financing, construction and commercial operation) and, therefore, they should be considered, taken as a whole, to be costs “used” over the entire term of the project. If there is sufficient evidence that the future revenue will enable the initial costs to be recovered, there are sufficient arguments to capitalise such costs.

Also, it should be recalled that in 2004, when IFRIC 12 on Service Concession Agreements was being prepared, the IFRIC analysed the circumstances in which the concession operator could recognise an asset for the right of recovery of finance or other costs incurred (see Agenda Papers of March 2004 and the IFRIC Update of March 2004), with a particular analysis from the standpoint of the aforementioned FAS 71. The staff of the IASB concluded that an accounting treatment similar to the one established in the two jurisdictions for finance and other costs incurred could also be appropriate under IFRSs. The provisional recommendations of the IASB staff established that a regulatory asset for the right of recovery of the costs incurred should be recognised when it is reasonable and probable to consider that the costs incurred will be recovered through future rates, if certain conditions ware also met.

The staff of the IASB also concluded that this criterion was consistent with both the Framework of the standards and with the IFRSs already issued. However, these recommendations were dismissed by the IFRIC, which rejected the creation of an asset of this type by arguing that any asset that did not meet the recognition criteria established in the Framework and in certain relevant IASs (IAS 11-Construction Contracts, IAS 16–Property, Plant and Equipment, IAS 18-Revenue or IAS 38-Intangible Assets) could not be recognised in an entity’s financial statements. *In this regard,* ***the fundamental reason for dismissing the recommended creation of a regulatory asset was primarily that the IFRIC is a body that merely interprets IFRSs and that the creation of the aforementioned asset was outside the scope of its competences.*** **This restriction therefore no longer applies, to the extent that the IASB is developing a specific standard on regulatory assets** concluding on the existence of sufficient reasons to determine the need to recognise, in this context, the regulatory assets that meet the recognition criteria of the Framework.

The inconsistency arises because of the analysis in the standard that incurring costs is the past event creating regulatory assets. As we have explained in our comments on scope in question 1, we do not believe that this analysis is correct. It indeed would lead to deal differently with very similar economic transactions.

RECOGNITION AND MEASUREMENT

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. Is this approach appropriate? Why or why not?*

We disagree with the approach of the ED, as we understand that the likelihood of future cashflows does not lie only in the regulator willingness to comply with the regulation, but also in the competition position of the regulated industry, as it is not the same a regulated activity open to free competition (e.g. a telecommunications regulated activity), or a regulated activity with no competition (e.g. a natural monopoly as a toll road).

We consider that it would be better to introduce and additional recognition criteria as requested in FAS 71 or in IFRIC 2004 discussion on concessions saying that the regulated asset will be recognized when it is reasonable and probable to consider that the costs incurred will be recovered through future rates.

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. Is this measurement approach appropriate? Why or why not?*

As we have already expressed in the past, we oppose to the use of expected value approach to measurement of single-risk assets or liabilities. The search for increased precision in areas where assumptions are quite subjective and do not stem from any observable factors is in our view hopeless and therefore irrelevant. (Please refer to our series of comments and letters related to Amendments to IAS 37).
Furthermore, we object to such a new measurement attribute to be introduced for a very narrow category of assets and liabilities. We believe that regulatory assets and liabilities should be measured consistently with other assets and liabilities of the same nature (Amounts due from – due to – customers as in IAS 11).
Basically, the complexity of the calculation arises from the capacity to identify objective values that provide reliable information on the following variables or parameters:

a) The calculation of the discount rate
b) The estimate of the range of probabilities
c) The estimate of the cash flows over long periods

Measurement at expected present value can give rise to certain inconsistencies; for example it would be necessary to recognise discounted regulatory assets but if the tax base of the assets differed from their carrying amount, a deferred tax asset or liability should be recognised which, however, is measured at the nominal value of the temporary difference.

Also, we believe that regulatory assets and liabilities should be valued as other similar assets and liabilities are according to IFRS. As stated, we believe that regulatory assets and liabilities are akin to IAS 11 amounts due from – due to – customers. They therefore should be value similarly..

Finally it should be noted that measuring regulatory assets at their expected present value, understood to be the estimated weighted average of the present value of the expected cash flows, taking into consideration the various probability scenarios, would raise significant costs in the preparation of financial statements.

We therefore believe that regulatory assets and liabilities should be, if accounted for, measured on the basis of management's best estimate, with appropriate disclosures provided in the notes.

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?

In a regulated activity, it appears appropriate to capitalise certain costs included by the regulator, even though such costs do not form part of the general cost of the assets permitted by other IFRSs, insofar as these costs will be recovered through the setting of future rates, in the same way that the recognition of the other costs which do meet the general recognition criteria established in the IFRS Framework is envisaged. Therefore, we consider the establishment of the exception included in paragraphs BC49-BC52 and paragraph 6 of the Exposure Draft to be reasonable.

Nevertheless, once again, in line with our answer to Question 1, we would like to point out that where finance costs an entity incurs are identified in a cost-of-service regulation as part of the costs that regulated prices ought to ensure the entity recovers, those costs would be encapsulated in the application of the standard as regulatory assets. We believe this would, we believe, create inconsistencies with IFRIC 12 requirements.

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 agree that regulatory assets, if recognized, should be tested for impairment within the cash generating unit to which they belong, whenever it is not reasonable to assume that sufficient revenue can be collected from its customers. We believe that IAS 36 requirements are appropriate for that purpose.

DISCLOSURES

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.

In the context of rate regulated activities being reflected in accrual accounting, we believe that the principle set in paragraph 24 is appropriate. We believe however that disclosures required in subsequent paragraphs are excessive. Where regulations are similar, develop similarly and stem nonetheless from different regulators, we believe that aggregate disclosures should be allowed. The description of each specific approval process (26 b) is not necessary in our view. Whenever significant judgment is involved, as suggested in 26 (c), such descriptions may be helpful in explaining the conclusion reached. Furthermore, 26 (e) suggests providing forward looking information on customer base demand. We do not believe that such information should either be required or provided in the notes.
Even if the proposed disclosures were adequately reduced, accounting for individual regulatory assets and liabilities, and providing disclosures would still be quite burdensome, both in terms of preparation and financial analysis costs. We believe that users should be provided with a set of more meaningful disclosures instead.
Such disclosures would include for each group of similar regulatory agreements:

- a description of the regulations, including the frequency of regulatory decisions and approvals,
- an estimate, based on facts and circumstances, of the possible increase or decrease in future prices that the entity expects to be decided, the timing of those decisions and the periods in which they are expected to apply,
- appropriate comments and explanations, if and when those estimates change or do not materialize as expected.

TRANSITION

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?*

The current wording of the draft indicates that the effects of the standard must be applied retrospectively, with an impact on the reserves of the earliest comparative period presented.

Bearing in mind the complexity associated with certain regulatory assets an exception should be included that envisages prospective application if the obtainment of the historical information required for retrospective application is impracticable or excessively costly.

OTHER COMMENTS
QUESTION 8:

There are no additional significant comments.