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## **Exposure Draft ED/2009/8 Rate-regulated activities**

Dear Sir/Madam,

I am writing on behalf of the CNC to give you our comments on the above-mentioned Exposure Draft (ED). Our detailed comments are set out in the attached Appendix.

We agree that rate regulation is widespread, significantly affects the economic environment of many entities and raises accounting issues. However the draft IFRS only deals with cost of service regulation which is common in North America but not in other jurisdictions where other forms of rate-regulation are far more widespread.

### **Scope**

In addition, because cost of service regulation involves a cause-and-effect relationship between an entity's specific costs and its revenue, we believe that the draft IFRS will only be applicable in very specific circumstances. However, these circumstances are not set out explicitly in the draft IFRS. As a result the scope of the draft IFRS is likely to be interpreted in an inconsistent manner.

We understand that the cost of service model can only apply to activities in a monopoly-type situation where the regulated service is not subject to significant fluctuations of customer demand and there is effectively no limitation in the duration of the entity's contract.

We also understand that hybrid activities where the cost recovery model of the draft IFRS is only applicable to certain types of cost or where regulated entities enjoy a degree of liberty in the application of regulated tariffs are outside the scope of the draft IFRS.

Those activities where the nature and the amount of costs to be recovered are subject to negotiation with the regulator or the tariffs are subject to government intervention are also presumed to be outside of the scope of the draft standard.

Because the draft IFRS appears to apply only to certain specific cases, a large number of rate-regulated activities will be left without principles-based guidance even though the title of the ED suggests that it applies to rate-regulated activities in general.

We believe that it would be more appropriate to develop principles-based guidance to deal with the overall rate-regulation issue and address the accounting impact of regulations or contracts that subject revenue to capping and flooring mechanisms. Because such a project raises issues relating to the definition of assets and liabilities and revenue recognition this could be done in conjunction with the Conceptual framework project Phase B and in the future revenue recognition standard.

However, if the Board intended to provide guidance on certain specific cases within the existing Framework and standards then an interpretation would have been the appropriate response.

### **Recognition and measurement**

In addition to not being in favour of the issuance of the draft standard, we also want to stress that we consider the recognition, measurement and presentation principles of the draft unacceptable for the reasons explained further in our answers to the detailed questions:

- The recognition criteria are not in accordance with the existing Framework.

We disagree with the proposed lack of separate recognition requirements for regulatory assets and liabilities and consider that the proposals in the ED could lead to the recognition of assets and liabilities which do not comply with the present Framework.

In particular, we do not believe that the Board has demonstrated that “the actions of a regulator provide reasonable assurance that the economic benefit will flow to or from the entity”. For example, the regulator cannot provide reasonable assurance that customer demand will be sufficient to enable an entity to recover its prior costs plus a specified return, as well as the costs of future periods plus a specified return on the future delivery of goods or services.

- The recognition and measurement principles will create a complete lack of comparability for activities within the scope and activities outside the scope even if the economic characteristics of those activities are not materially different.
- We regret that the Board introduces a new valuation method for such a specific type of asset.

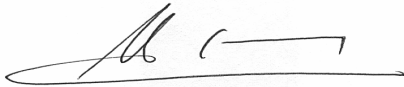
We disagree with the expected present value approach for measuring regulated assets and liabilities as set out in the draft IFRS. We do not think that probability-weighted averages based on all possible outcomes provide decision-useful information. We consider that measurement based on the management’s best estimate provides a better indication of expected cash flows. Moreover, we would expect that the cash flows of activities within the scope of the draft IFRS would not be subject to such uncertainties that would require the use of mathematical probability calculations.

## **Conclusion**

In conclusion, the draft IFRS in its present form is likely to reduce the comparability of financial reporting and should not therefore be issued as a full standard. We recommend that the Board should clarify the scope and reconsider whether cost of service regulation could be dealt with by an interpretation within the current Framework. Our principle recommendation would, however, be to develop a standard for rate-regulated activities in general and appropriate principles for recognizing regulatory assets, liabilities and revenue in conjunction with Phase B of the Conceptual framework project and the future revenue recognition standard.

We hope you find these comments useful and would be pleased to provide any further information you might require.

Yours sincerely,

A handwritten signature in black ink, appearing to read 'J. Lepetit', with a long horizontal flourish extending to the right.

Jean-François Lepetit

# APPENDIX

## Exposure Draft ED/2009/8 Rate-regulated activities

### Scope

#### 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?

1.1. Although we agree with the IASB that rate regulation is widespread and significantly affects the economic environment of many entities, we regret that the scope of the proposed standard is limited to activities subject to the “cost of service” regulation model. We understand that such model is largely spread in North America but other models (regulations based at least partially on cost incentives, on targeted costs, on average industry costs) are also more and more prevalent outside North America. The proposed standard therefore leaves all regulated activities other than “cost of service regulation” without principle based guidance when its title seems to indicate that it deals with all rate regulated activities.

1.2. In addition, we consider that such limited scope is not adequately defined in the exposure draft as it is very unclear which conditions need to be met for an activity to be considered within the scope of the standard. We understand from the Basis of Conclusion (BC16) that, for its activity to be in the scope of the standard, regulation must provide the entity with a promise that the costs it has incurred will result in future cash flows. This can only be the case in very specific regulations for which the entity has the ability to determine precisely which cash flows it can expect based on its incurred costs. As indicated in the application guidance (B11) this implies very strict conditions which would need to be further clarified. For example:

- it would be necessary to meet the scope definition, for a contractual formula to exist, which is agreed in advance with the regulator leaving very little room for subsequent negotiation with the regulator and no room for politicians to override the agreed formula. Only such a mechanism could enable the entity to determine itself the price increase/decrease to be applied ;
- the cost of service model can usually only apply to activities in a monopoly-type situation with no major uncertainties in relation to the future volume of activity such as material changes in customer demand, for example changes in demand linked to weather conditions. One of the fundamental issues is whether prices increases authorized by the regulator will have a significant impact on customers’ demand for services: where demand is sensitive to price increases it seems unlikely that the activity is within the scope of the proposed standard ;
- there is effectively no limitation in the duration of the entity’s contract e.g. where renewal is considered to be automatic ;

- there is no cost-incentive component in the regulation i.e. “hybrid” activities with regulation based both on actual and target costs are outside the scope of the draft IFRS ;
- regulated activities where entities enjoy a degree of liberty in the application of regulated tariffs are outside the scope of the draft IFRS.

1.3. Because the draft IFRS appears to apply only to certain specific cases, a large number of rate-regulated activities will be left without principles-based guidance even though the title of the ED suggests that it applies to rate-regulated activities in general.

We therefore believe that it would be more appropriate to provide guidance for rate-regulated activities in general and since the draft IFRS is unsuitable for this purpose it should not be issued as a standard.

It would be preferable to develop principles-based guidance to deal with the overall rate-regulation issue and address the accounting impact of regulations or contracts that subject revenue to capping and flooring mechanisms. Because such a project raises issues relating to the definition of assets and liabilities and revenue recognition this could be done in conjunction with the Conceptual framework project Phase B and in the future revenue recognition standard.

However, if the Board intended to provide guidance on certain specific cases within the existing Framework and standards then an interpretation would have been the appropriate response.

## 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 (see paragraphs BC40–BC42 of the Basis for Conclusions). Is this approach appropriate? Why or why not?

2.1. We disagree with the proposals in the ED because they allow recognition of regulatory assets and liabilities which may not meet the recognition criteria applicable under the current Framework, which requires that an asset or a liability should be recognized if:

- (a) it is probable that any future economic benefit associated with the item will flow to or from the entity; and
- (b) the item has a cost or value that can be measured reliably.

2.2. As a general principle, we do not support deviations from the requirements of the Framework introduced by a standard. Where changes to the Framework are required they should be based on the full due process and standards should only reflect these changes once they have been adopted in the Framework.

2.3. The ED asserts that if rate-regulated activities satisfy the scope criteria of the draft standard then the actions of a regulator provide reasonable assurance that the economic benefit will flow to or from the entity. In our view the ED does not provide sufficient evidence to support this assertion.

In addition, as already discussed above, such assertion is only right if the criteria to define the scope are very strict and more adequately defined.

2.4. Moreover, we do not understand why entities whose activities are rate-regulated but have no guarantee of customer demand by the regulator could record assets/liabilities in relation to future price increases or decreases when other entities whose activities are not subject to rate regulation cannot recognize such assets liabilities even when they have the right to increase/decrease their prices and may have a dominant market share enabling them to pass on their costs through price increases. We believe that the proposed standard creates a lack of comparability in this respect.

2.5. As stated above, we are in favour of a standard dealing with all rate-regulated activities and recommend that appropriate principles-based recognition criteria should be determined for regulatory assets and liabilities.

**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?

3.1. We believe the Board should clarify which of the following two approaches the draft IFRS sets out to represent and apply them consistently for the purposes of recognition, measurement and presentation in the statement of comprehensive income:

1. A deferred cost approach (as in SFAS 71)
2. An accrued revenue approach

We understand from §8 of the draft IFRS that the recognition of an asset is justified as the deferral of incurred costs for which revenues are expected in the future. Such an asset should therefore be measured at its cost, limited to the present value of expected cash flows in accordance with other cases of deferred costs such as costs of inventories, or tangible and intangibles assets.

However, the draft IFRS proposes measurement of the right to increase rates in future periods at the expected present value of future cash flows i.e. at selling price including a profit margin instead of cost.

There would therefore appear to be an inconsistency between recognition and measurement principles that requires clarification.

Under the accrued revenue approach the objective would be to accrue revenue for future price increases to which the regulated entity has a right in respect of past costs. This approach is consistent with measurement based on future cash flows at selling price.

Moreover, it is not clear, in particular from the illustrative examples, whether the other side of the entry for regulatory assets and liabilities is intended to be presented in cost of sales or in revenue. If the deferred cost approach is adopted then the other side of the entry should be in cost of sales whereas accrued revenue would impact revenue.

3.2. We do not support the expected present value approach.

In our view, the estimated probability-weighted average of the present value of the expected cash flows does not produce relevant information for users of financial statements. The management's best estimate of the most likely outcome would better reflect expected cash flows and be more relevant for users.

In addition, as the proposed approach requires assessing the probability of all possible outcomes, it could prove burdensome for preparers.

3.3. We are also concerned that the IASB introduces substantially new principles into IFRS as expected value was never used before the issue of the draft standard in IFRS to measure assets. We do not consider that such a specific standard is a proper way to introduce new principles that may be applied by analogy.

**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.

4.1. We disagree with the proposal.

The ED provides no conceptual basis for overriding IFRS requirements.

In addition, by introducing non IFRS measurement principles for self-constructed property, plant and equipment or internally generated intangible assets the proposals reduce the comparability of the financial statements.

4.2. We note that the Board justifies this exception to IFRS measurement principles on cost-benefit grounds. In effect, the proposals would avoid keeping two sets of accounts, one for regulatory purposes and one for IFRS reporting. However, we do not think that the benefit of avoiding double accounting compensates for a loss of comparability. Moreover, we do not believe that measurement principles used for setting tariffs are necessarily relevant for financial reporting purposes.

4.3. We would therefore be in favour of maintaining IFRS measurement principles for all assets and liabilities including self-constructed property, plant and equipment or internally generated intangible assets. Any regulatory assets that meet the Framework definition would be presented separately.



**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?

5.1. As stated above we disagree with the measurement approach adopted in the ED. We are in favour of a “probability of recovery” threshold for recognizing regulatory assets as well as a “best estimate” approach to measurement. On this basis, a regulatory asset value would only be recognized to the extent that it is more likely than not that it will generate equivalent additional cash flows and there would, therefore, be no need for impairment.

5.2. As the ED proposes that regulatory assets should be measured on a current basis at each balance sheet date, based on expectations for future cash flows, it would be inappropriate to submit them to a further impairment test. Instead, an impairment test would apply to the cash-generating unit to which the regulatory asset belongs (as it does not generate cash-inflows separate from the other assets) and the recoverable amount under IAS 36 should be determined if there is an indicator of impairment. If there is an impairment loss to be recognised for the cash-generating unit, as the regulatory asset is already measured using a current value, that loss should only be allocated to the other assets of the cash-generating unit, in accordance with the requirements in IAS 36.

5.3. We note that according to BC 53 and 54 the risk of impairment occurs when price increases authorized by the regulator give rise to decreases in the customer’s demand for regulated services. As stated in 1 above, where the demand for an activity is sensitive to price increases, we assume the activity to be outside of the scope of the draft IFRS because under such circumstances the cost recovery model will not operate. We therefore think the ED should clarify the circumstances in which an activity that is sensitive to price increases would be in the scope of the draft standard and subject to possible impairment.

**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.

6.1. Although we are not in favour of the Draft IFRS in its present form we believe the proposed disclosures provide decision-useful information.

## 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?

7.1. We think a clarification of transitional requirements is necessary in the following circumstances. An entity applying this draft IFRS for the first time may have carried out business combinations in prior periods and recognized corresponding goodwill. Where the recognition of regulatory assets would have had an effect on the opening balance of goodwill the ED should provide guidance on what adjustments would be necessary to goodwill in these circumstances.

### Other comments

### Question 8

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

8.1. We suggest that the Board should provide clarification on the inter-action between IFRIC 12 and the draft IFRS. We suggest that this clarification should set out to illustrate under which circumstances regulated assets should be recognized in addition to those under service concession arrangements.

It is our understanding that under the intangible asset model of IFRIC 12 rate-regulation would provide an additional right to the operator who otherwise has no form of guarantee from the grantor in respect of its revenue. This right would be recognized as an asset according to the draft IFRS.

Under the financial asset model of IFRIC 12, the operator has a contractual right to receive cash guaranteed by the grantor. This right covers the cost of the operator's investment in infrastructure under the concession arrangement. It would not therefore be possible to recognize a regulatory asset in respect of that investment. However we suggest the Board should clarify whether other operating costs might be eligible for recognition as regulatory assets.