

November 20, 2009

Submitted electronically via www.iasb.org

International Accounting Standards Board
30 Cannon Street, 1st Floor
London, EC4M 6XH
United Kingdom

Dear Sirs

Re: Exposure Draft, *Rate-regulated Activities*

The following is the response of the Canadian Accounting Standards Board (AcSB) to the IASB's invitation to comment on its July 2009 Exposure Draft, *Rate-regulated Activities*.

Is the project needed?

The AcSB feels strongly that the issues addressed by the IASB's Rate-regulated Activities project are important ones requiring resolution sooner rather than later. This is especially the case for Canada and other countries preparing to adopt IFRSs in 2011. We commend the Board for adding the project to its already crowded agenda. The question of whether rate regulation can create assets and liabilities meeting the *Framework* definitions, and if so under what circumstances, tests fundamental financial reporting concepts. In our view, it is far better for the IASB to answer this question itself, than to allow others to do so in practice.

Can rate regulation create assets and liabilities?

The AcSB supports the Board's conclusions on this threshold question. We find particularly compelling the analogies to both cost-plus contracts and service concession arrangements. We

agree with the Board that the right the operator of a service concession obtains to charge users of the public service in the intangible asset model in IFRIC 12 *Service Concession Arrangements*, is the same as the right the regulator provides to a rate-regulated entity to charge users of the regulated service. Unlike a rate-regulated entity, the operator pays to acquire the license providing it this right and, therefore, recognizes the license in its statement of financial position.

Such a license may or may not also include a condition providing assurance that the operator/entity will recover its costs and earn a specified return. Different mechanisms can be used to implement such a condition. In situations such as service concession arrangements in which the license intangible is recognized in the financial statements, it would be possible to recognize the effects of the mechanism as a component of the carrying amount of the license. However, if no license is recognized, any assets and liabilities arising as a result of the chosen mechanism would be recognized separately.

The AcSB does not agree with those who argue that cost-of-service regulation cannot result in the recognition of assets because they are internally developed intangibles that simply affect the value of the license. We think that the right granted by regulation is a contractual/legal identifiable intangible with a third party and assets and liabilities arising as a result of the right must be recognized.

In our view, if the Board concludes that assets and liabilities arising from the form of regulation described in the Exposure Draft should not be recognized, it must also reconsider the conclusion in IFRIC 12 resulting in the recognition of an asset for the license in the intangible asset model. An entity with license to charge a price (which may be capped) for use of a public service when it bears the demand risk and has no assurance that it will earn any return at that price cannot have an asset if an entity with a right to charge a price that will recover its costs and earn a specified return does not.

Is the scope definition appropriate? (Question 1)

If the Board affirms its conclusion that no additional recognition criteria are necessary (see our response to Question 2), the proposed scope criteria are especially important. The AcSB agrees with the concepts underlying these criteria. However, we are concerned that the Exposure Draft may be causing some confusion about the Board's intentions in this area. Already, we are aware of extremely literal readings of paragraph 3 that appear to ignore both the application guidance that is part of the standard, and the illustrative examples and Basis for Conclusions that are intended to assist constituents to understand and apply it. We support the Board's commitment to principle-based standards, but clarity with respect to the scope criteria is essential to consistent application of this standard.

In the type of cost-of-service regulatory regime illustrated in Example 7 of the Draft Illustrative Examples, all of an entity's costs are included in the regulator-approved revenue requirement for rate-making purposes. Those costs, including interest on debt, are recognized in profit or loss for financial reporting purposes. The single exception to this one-for-one correspondence between amounts included in rates and amounts eventually flowing through profit or loss is the regulator-approved return on equity referenced in paragraph 3(b) of the Exposure Draft and illustrated in Example 7. The regulator treats this return as a cost for rate-making purposes and includes it in the entity's revenue requirement, but it is clearly not a cost for financial reporting purposes. In such a regime, an entity's profit equals the regulator-approved return, calculated as the allowed rate base times the specified equity return; operating cash flow essentially equals the approved return plus depreciation.

The AcSB thinks that understanding these relationships is vital for users to appreciate the economic reality of entities operating in a cost-of-service regulatory regime. Further, we think the recognition of regulatory assets and regulatory liabilities is necessary to provide a faithful representation of this economic reality. Canada's analyst community appears to agree. In the past, these users have told us that financial statements including regulatory assets and regulatory liabilities provide a useful starting point for their assessment of both an entity's current financial position, and the risks of a change in its economic circumstances due to possible new behavior

on the part of the regulator. This is because the financial statements incorporating those assets and liabilities closely reflect expected future cash flows.

The AcSB thinks it is evident that the Board had the regulatory model in Example 7 in mind when it developed the scope criteria. Given the importance of this model to an understanding of the proposals, we recommend moving Example 7 into the application guidance for the proposed IFRS. We also think that additional explanations in Appendix B are necessary to produce the results the Board intended in terms of an entity's assessment of whether it is in or out of the scope of the standard. Our specific suggestions are included in Section 1 of the Appendix to this letter.

Are recognition criteria needed? (Question 2)

The AcSB supports the proposal not to include a separate, probability-based recognition criterion for regulatory assets and regulatory liabilities. By definition, the reasonable assurance provided by a regulator's actions for activities meeting the proposed scope criteria meets the requirement set out in paragraph 83(a) of the *Framework*. The inclusion of a probability-based recognition hurdle is therefore redundant.

More importantly, we note that a probability-based recognition criterion would postpone the recognition of items that do not immediately meet the hurdle but do so at some point in the future (when the regulator approves the particular item for inclusion in customer rates). The result would be a more complex standard and increased volatility in the statement of comprehensive income that is unrepresentative of any underlying economic phenomenon. For example, if it was only 60% probable that an entity's regulator would permit it to recover a cost, the entire cost would be included in current period comprehensive income. However, in the period that probability rose to 85%, the entire regulatory asset would be recognized and comprehensive income would be increased.

In contrast, the proposed IFRS recognizes assets and liabilities meeting the *Framework* definitions when they exist and factors any uncertainty about their recovery/repayment into their measurement. Changes in expectations about future cash flows are appropriately reflected in the

financial statements when they occur. This separation of the recognition and measurement of financial statement elements is consistent with the approach taken by the Board in other projects and standards and results in financial statements that are more representationally faithful. We recommend that the Basis for Conclusions be expanded to explain more fully why this is so.

Is the measurement approach appropriate? (Question 3)

The AcSB agrees with the proposal to measure regulatory assets and regulatory liabilities at their expected present value. As noted in our comments in response to Question 2 on the need for recognition criteria, we think that any uncertainty about the cash flows associated with these items should be reflected in their measurement. In our view, an expected present value model best reflects this uncertainty. We note that, in any case, the expected present value model produces the same result as the so-called cost model when it is certain that an entity's regulator will permit it to recover a cost, and the market-based rate used to discount estimated cash flows is also the regulator-approved rate of return. We understand that such circumstances would not be unusual.

Is the exception in respect of self-constructed property, plant and equipment or internally generated intangible assets justified? (Question 4)

The AcSB thinks the proposed exception is justified on a cost-benefit basis. However, we note that an argument can be made for extending the exception to address other aspects of accounting for an item of property, plant and equipment or an intangible asset, whether self-constructed/internally developed or acquired. Section 2 of the Appendix provides further explanation.

We also think exceptions to the measurement requirements of the proposed IFRS are warranted for regulatory assets and regulatory liabilities relating to employee future benefit costs and deferred income taxes. Further details are provided in Section 3 of the Appendix.

Is the approach to recoverability appropriate? (Question 5)

We agree with the proposed approach for assessing recoverability for the reasons stated in the Basis for Conclusions.

Do the proposed disclosure requirements provide decision-useful information? (Question 6)

The AcSB agrees with the proposed disclosure requirements. Canadian GAAP contains very similar requirements for entities subject to rate regulation. Financial statement preparers have not found them burdensome, and users find the disclosures useful. We also agree with the enhancements made to the Canadian requirements, in particular the requirement to provide a tabular reconciliation of regulatory assets and regulatory liabilities from the beginning to the end of the period. The reconciliation explains to the reader what has changed and why, and makes clear how the recognition of regulatory items has affected an entity's reported profit or loss. Consequently, it is possible for users to compare the results of an entity subject to cost-of-service regulation to the results of one that is not.

Is the transition approach proposed appropriate? (Question 7)

Yes, the transition approach proposed is appropriate. We note that, in the event the project is significantly delayed or discontinued, the Board nonetheless needs to issue promptly the amendment to IFRS 1 *First-time Adoption of International Financial Reporting Standards*, set out in Appendix C. That amendment is essential for the transition to IFRSs for entities in Canada and other countries. The Board has already redeliberated and finalized the amendment, and included it in the Exposure Draft simply for completeness.

Other comments (Question 8)

The Exposure Draft proposes an amendment to the scope discussion of IFRIC 12. We suggest a similar amendment to IFRIC 18 *Transfers of Assets from Customers*.

We would be pleased to elaborate on our comments in more detail if you require. If so, please contact me, Peter Martin, Director, Accounting Standards (+1 416 204-3276 or email peter.martin@cica.ca) or Karen Jones, Principal, Accounting Standards (+1 416 204-3463 or email karen.jones@cica.ca).

A handwritten signature in black ink that reads "Patricia O'Malley". The signature is written in a cursive style with a large initial 'P'.

Patricia L. O'Malley
Chair, Accounting Standards Board
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Appendix

This Appendix provides additional background and discussion of issues identified in our comment letter.

1. Scope

We think it unnecessary to change the scope criteria set out in paragraph 3 of the proposed IFRS. However, we recommend adding a few paragraphs of application guidance to clarify how the Board intends those criteria to be applied.

(a) Scope criteria

As noted, the AcSB is concerned that some entities with regulated operating activities are misinterpreting the scope criteria. Consequently, they are drawing conclusions about the applicability of the proposed IFRS that do not necessarily reflect the Board's intentions. For example, we are aware of the following two situations that, based on a literal reading of the criteria, do not appear to be within the scope even though they fit logically within the regulatory model underlying the proposed IFRS.

The first situation is when entities are permitted to charge customers less than the maximum rates specified by their regulator. In some circumstances, the costs of providing the regulated service are essentially fixed. Therefore, estimated volumes are the major variable in establishing rates. When an entity otherwise satisfies the scope criteria in paragraph 3, its regulator may permit it to charge less than the maximum permitted rates so they can "self-manage" their results. Thus, an entity might charge a lower price in order not to exceed its approved rate of return when sales volumes are higher than the ones assumed when rates were set.

Such entities technically do not appear to meet paragraph 3(a) of the proposed IFRS, which states that the entity "must" charge the price established by the regulator. However, similar to entities clearly meeting this criterion, their overall results are constrained by an approved rate of return they are working to achieve. We suggest adding a paragraph to Appendix B explaining that: (i) although, in the vast majority of cases, entities with regulated operating activities cannot

charge customers anything other than the regulator-approved rates, there are exceptions; and (ii) an entity charging less than the approved rates is not precluded from applying the proposed IFRS solely because of this pricing decision, provided the overall focus of its regulation is on the approved rate of return, i.e. provided that the requirements of paragraph 3(b) are met.

The second situation is distribution utilities that also sell the commodity they deliver to customers. In some jurisdictions, these entities are permitted to recover their commodity purchase costs on the basis of a one-for-one pass through to the customers, but are prohibited from earning an equity return on the commodity costs. Such entities might interpret paragraph 3(b) as disqualifying them from applying the proposed standard. The AcSB thinks this was not the Board's intention. This is evidenced by the inclusion of Example 3 (on supply of energy in a rate-regulated environment) and Example 8 (on balancing accounts) in the Draft Illustrative Examples. In both examples it is clear that the entity is permitted/required to earn/pay a debt return due to the late or early collection of the commodity purchase costs. If the Board agrees with our analysis, we recommend expanding on the discussion in paragraph B5 of the application guidance. The new guidance would clarify that a regulator may permit an entity to earn an adequate overall return on its shareholder's investment even if it prescribes different returns for different activities or even disallows a return on particular components of the entity's costs.

(b) What is an "activity"?

Some Canadian constituents (and others) have asked for clarification on what constitutes an operating "activity" for purposes of applying the scope criteria. For example, must all of an entity's regulated operating activities meet the scope requirements? Is it possible for an entity to apply the proposed IFRS to just one of its regulated operating activities (for example, the supply of fuel) if that is the only activity meeting the scope criteria?

The AcSB thinks the answer is implicit in the proposed IFRS. We think that, simply put, an "activity" for purposes of applying paragraph 3 is the activity or group of activities incurring the costs included by the regulator in determining a rate or rates that provide(s) the specified return on the assets used to generate the revenue. Further, we think that the rate and return specified by

the regulator can be different for different costs and activities (see the discussion on the second situation above).

Although we think constituents should be able to reach a logical conclusion from the existing proposals, we recommend that the Board add a paragraph to Appendix B making these points explicit. The Board might also consider changing Example 3 slightly to assume that the entity's distribution activities do not meet the scope criteria. This would illustrate the application of the proposed scope criteria to just one activity (that is, the supply of energy) and further help constituents to understand the Board's intentions on this issue.

(c) "True-up" to actual costs

The proposed indicators of cost-of-service regulation included in the application guidance refer to this type of regulation providing for a "true-up" to the entity's actual costs, when rates are by necessity established using estimates. Some Canadian constituents have interpreted this to mean that each of an entity's individual costs must be trued up dollar for dollar in order for the entity to apply the proposed IFRS. The AcSB thinks this level of precision is unnecessary and was not the Board's intention. Rather, we think the adjustment for differences between estimated and actual costs need only be performed at a level intended to ensure that the entity's approved rate of return is not exceeded. This may or may not be at an individual cost level, depending on the regulatory methodology in place and the particular circumstances. The AcSB recommends that a paragraph be added to Appendix B to clarify this point.

2. Proposed exception for self-constructed property, plant and equipment or internally-generated intangible assets

The proposed IFRS requires amounts included in the cost of self-constructed property, plant and equipment or internally generated intangible assets for rate-making purposes also to be included in their cost for financial reporting purposes, even if IAS 16 *Property, Plant and Equipment*, IAS 23 *Borrowing Costs*, or IAS 38 *Intangible Assets* would not permit those amounts to be included. It could be argued that this exception should be extended to: (i) include other differences between the accounting for property, plant and equipment and internally generated intangible assets specified by the regulator and IFRS requirements; and (ii) apply to all items of property,

plant and equipment or intangible assets, whether self-constructed/internally generated or acquired.

In North America, examples of other differences between the carrying amount of an item of property, plant and equipment for rate-making purposes and its carrying amount in accordance with IAS 16 are those resulting from an entity's use of the composite depreciation methodology as permitted or specified by the regulator. Under composite depreciation, depreciation is determined by grouping items of property, plant and equipment with similar life expectancies, and no gain or loss on disposal of individual items of property, plant and equipment is included in profit or loss until the last item in a group is disposed of. Neither of these treatments meets the requirements of IAS 16. In total, these differences typically are far larger than differences relating to costs permitted to be capitalized.

The rationale for such an extension would be the one noted in paragraph BC51 in the Basis for Conclusions — that the regulatory assets that would otherwise result from the application of the proposed IFRS and assets recognized in accordance with other IFRSs are so closely related that they should be accounted for as single assets. We do not think that the cost-benefit rationale expressed in paragraph BC52 is equally applicable to these other differences between regulatory accounting and IFRSs. In our view, the differences are of such magnitude that the benefit to users of accounting for them separately outweighs the cost to preparers of doing so.

If the Board decides against this extension it could conclude it should remove the proposed exception altogether. The AcSB does not prefer one of these alternatives over the other. Nor do we object to the Board proceeding with the proposed exception as is on a cost-benefit basis.

3. Proposed exceptions from the measurement requirements

The AcSB thinks that two exceptions from the general requirement to discount the estimated cash flows associated with regulatory assets and regulatory liabilities are warranted — one for regulatory items relating to employee future benefit costs and the other for items relating to deferred income taxes.

Regulators often permit the recovery of employee future benefit costs and income tax expense through rates on a cash basis only. Obviously, differences between the accrual amounts recognized in an entity's financial statements in respect of these costs and the cash payments recognized for rate-making purposes eventually reverse. However, the exact timing is unknown. Entities recognize a regulatory asset or regulatory liability for these costs on the basis that they will be permitted to increase or decrease rates in future periods when cash payments are made.

Income Taxes

IAS 12 *Income Taxes* specifically prohibits discounting of deferred tax assets and liabilities because of the difficulty in determining the timing of the reversal of each temporary difference and the incomparability between entities that would result if discounting were permitted but not required. Accordingly, the AcSB recommends that regulatory items relating to deferred income taxes be exempted from the discounting requirement in paragraph 13(c) of the proposed IFRS for the same reason (and that the rationale provided in paragraph 54 of IAS 12 be added to the Basis for Conclusions). Otherwise, the regulatory item and the financial statement item to which it relates will be measured inconsistently.

Employee future benefit costs

We recommend the same exception for regulatory items relating to employee future benefit costs to ensure that the regulatory item and the financial statement item to which it relates are not measured inconsistently. For many pension plans and for all unfunded long-term employee future benefits, expenses are recognized in the financial statements before cash payments are made. Some question whether an expense recognized for financial reporting purposes that will not result in a cash outflow for many years can be considered a "specific previously incurred cost" in accordance with paragraph 8 of the proposed IFRS. The AcSB thinks these expenses are clearly specific costs incurred in providing the regulated service in the current period. However, they will be included in the operating expenses permitted for rate-making purposes only when paid in cash.

If IFRSs required the entity to recognize the employee future benefit obligation on the statement of financial position, a regulatory asset of the same amount would be stated at its expected

present value. In accordance with IAS 19 *Employee Benefits*, the obligation would reflect the present value of the entity's best estimates of the amount and timing of the expected future cash flows for the employee future benefits. In this case, discounting the regulatory asset amount would double count the time value of money.

However, existing IAS 19 is such that the amount recognized in the financial statements as the asset or liability for employee benefit plans is not necessarily the same as the present value of expected future cash flows for a variety of reasons. We note that the Board's existing agenda project on Post-employment Benefits (including Pensions) proposes to require all entities to recognize the entire asset or obligation in the statement of financial position. To avoid unnecessary complexity until that project is completed, the AcSB recommends the following (temporary) exception to the measurement requirements of the proposed IFRS. When the regulator requires employee future benefit costs to be included in regulated operating expenses on a cash basis, the entity should recognize the related regulatory asset or regulatory liability at the same liability or asset amount the entity recognizes in accordance with IAS 19 no matter what accounting policy the entity has adopted to apply IAS 19.