Organismo Italiano di Contabilità – OIC
(The Italian Standards Setter)
Italy, 00187 Roma, Via Poli 29
Tel. 0039/06/6976681 fax 0039/06/69766830
e-mail: presidenza@fondazioneoic.it

EFRAG
35 Square de Meeûs
B-1000 Brussels
BELGIUM
commentletter@efrag.org

24 November 2009

Re: ***EFRAG draft comment letter on Exposure Draft Rate-Regulated Activities***

Dear Sir/Madam

We are pleased to provide EFRAG with our comments in order to contribute to the finalization of the EFRAG comment letter on the IASB Exposure Draft *"Rate-Regulated Activities"*.

In general, there are different views on the recognition of regulatory assets/liabilities (especially for regulatory assets) based on the current Framework[1].
Many believe that a regulatory asset (liability) does not meet the definition of asset (liability) in the current Framework, because the regulatory asset does not represent a resource controlled by the entity since the regulator cannot ensure the demand. In this case a regulatory asset should be considered as a contingent asset and recognised in accordance with the requirements of IAS 37.
The ED requires that an entity shall recognise a regulatory asset for its right to increase rates in future periods to recover higher previously incurred costs or lower previously collected amounts. Those who do not support the recognition of a regulatory asset believe that the presumption of inclusion of the incurred costs in the future rates does not necessarily imply that the future economic benefits will flow to the entity. In substance, there is no guarantee that customers will request the service provided. Indeed, the recognition of the asset would be based solely and exclusively on a generic right (obligation) to increase (reduce) the future rates applied for the customers that are considered in an abstract and aggregate sense.
As a consequence of stabling the economic results, it is noted that the recognition of a regulatory asset could, in some circumstances, contribute to hide situations of economic imbalance that could remain unexpressed in the financial statements for a long time.

---

[1] "*An asset is a resource controlled by the entity as a result of past events and from which future economic benefits are expected to flow to the entity. A liability is a present obligation of the entity arising from past events, the settlement of which is expected to result in an outflow from the entity of resources embodying economic benefits*" (Framework para 49 a) and b)).

On the other hand, some agree with the IASB's view on the consistency between the Framework and the recognition of regulatory assets/liabilities. They believe that the new standard can improve the information given by the financial statements, matching the period of recognition of costs with the related increase or decrease on revenues. This will happen because the application of this standard leads to a representation in the financial statements consistent with the logics of rate remuneration of the entity.

On the basis of those considerations, it does not clearly appear that the proposed standard put forward by the Board is necessarily consistent with the current Framework,. Moreover, we are aware that the definition of regulatory asset/liability may be consistent with the "tentative" definition of asset/liability provided in the ED of phase B of Conceptual Framework project, but as that project has not yet been completed, this does not represent a sound basis.
We believe that this new standard should be issued only when it is clearly consistent with a stable Framework , to avoid the risk of having to intervene again in the same area with other changes. Each subsequent change on a standard means further administrative costs and also makes adopted rules less credible, and thus less useful for users. Hence, in terms of the amendment process, it is, in our view, more appropriate to complete the project on the framework first and then the rate-regulated activities one.

However, bearing this in mind and not agreeing with the approach proposed by the IASB, we provide our comments on the specific questions asked in the ED below, with the aim of giving our contribute to the IASB effort on this area.

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?

We agree with the IASB proposal. In fact, we believe that the regulatory assets and liabilities should be recognised only if there is a cause-and-effect relationship between an entity's costs and its rate-based revenues. Moreover, we agree that these relationships exist only when the rate revision is based on actually incurred costs and collected revenues by the entity. We agree that the extension to situations in which the rates are based on targeted or assumed costs, for example industry averages, should involve the recognition of assets or liabilities that are not connected with the dynamics of costs actually incurred, and this will create a further factor of uncertainty about the capacity of the entity to obtain expected future economic benefits.
However, we think that should be clarified if entities that operate in a regulated industry in which the rates are based on industry average costs and hold almost the totality of market share, could fall within the scope of this standard. In this case, the specific costs incurred by the entity approximate the industry average costs.
It should also be clarified if regulations in which the rate is determined by the regulator in part recovering the specific costs incurred by the entity and the other part of the rate is based on targeted costs or industry average costs could fall within the scope of the proposed Standard. Based on a literal interpretation, it would seem that such systems do not fall within

the scope of the standard in question. However, if they did, it would be still necessary to clarify whether the recognition of regulatory assets must be limited only to the part that covers the specific costs incurred.

Moreover, the ED requires that the standard does not apply to financial assets/liabilities. We agree with the IASB proposal, but we believe that it would be necessary to clarify that the standard does not apply when the entity comes under the financial model as per IFRIC 12.

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?

With respect to additional recognition criteria, we have already given our comments in the introduction part of this comment letter. There are different views on the recognition of regulatory assets/liabilities (especially for regulatory assets) based on the current Framework, but generally we believe that before developing a new Standard the IASB should define a stable Framework.

Other comments on recognition regard the following.

In the ED view, to support the existence of a right for the entity to recover the higher past costs is a consequence of the concept of "customer base", but it should be noted that the ED omits to define the concept of "customer base". The fact that in situations of monopoly or oligopoly there exists a relationship between the regulatory asset and the future economic benefits (customer base) is not a good reason to not describe in a positive fashion, in the standard, the nature and the features (primarily governed by operating conditions of the market) of the customer base that should guarantee the future flow of economic benefits.

Moreover, from the ED it would appear that a regulatory asset (liability) could be recognised every time that an entity-specific element of the rate based on actual data is different compared with the estimated value. Usually the elements that affect the rates are the investments, the operating costs (included amortisations) and the sales volumes. However, from reading para 10 of ED it might be interpreted that the level of investments might be excluded. This is an aspect that should be clarified. Some believe considering the "investment component" of the rates would be inconsistent with the objectives set by the Board that excludes items accounted for directly in the balance sheet from the application of the standard. However, the recovery of different levels of investments compared with the initial forecasts will be represented by the recognition of a regulatory asset/liability for the difference in the amortisation charged to profit or loss.

Others believe that such a possible exclusion would be a significant shortcoming, because some regulations place considerable emphasis on the remuneration of the level of investments, ie yield on the net investments, and especially in the case of plans that require lengthy investments over a significant number of years before they begin operating. This is a frequent situation, especially in the case of major projects or plans.
In their opinion, this approach is consistent with the rationale of the standard because:

- it enables the correlation between the bearing of the costs relating to the investments and the remuneration of the capital invested;
- it is more consistent with the rate decisions made by the regulator intended to encourage the entity to make investments that will increase the efficiency and security of the transmission system by increasing the remuneration rate recognised;
- it meets the criterion of the margin on the costs incurred, explicitly provide from the ED (in particular, see para 8 a) and para B8 of Appendix B of the ED), as the return on the capital invested, having covered all costs, is an indicative parameter of the real remuneration of the entity.

In any case, it seems that the application of paragraphs 8 and 10 do not appear sufficiently clear and consistent concerning this issue[2], thus it would be appropriate for the IASB to provide clarifications in the illustrative examples of the accounting treatment for recognition of the return on investments.

In this regard, we also would point out that the ED does not provide sufficient clarifications concerning its application in the presence of changes in sales volumes and amortisations. Therefore, it could be useful if the example wants to provide a case where changes stem from sales volumes or amortisations. So, we suggest issuing in the final standard also the example n. 8 proposed in the ED and, moreover, to require some changes in which it shows the application of the standard in cases in which the components of the rate that change are the variations in sales volumes and amortisations. This example should be completed by explaining the methods of rate-making.

It would also be appropriate to clarify the accounting treatment of the margins on costs incurred by the entity, that will be included in future rates. In such cases, it should be explained whether an entity recognises both the reductions in costs, and the increase in revenues.

Question 3

The exposure draft proposes that an entity should measure regulatory assets and regulatory liabilities on initial recognition and subsequently at their expected present value, which is the estimated probability-weighted average of the present value of the expected cash flows (see paragraphs 12–16 of the draft IFRS and paragraphs BC44–BC46 of the Basis for Conclusions). Is this measurement approach appropriate? Why or why not?

We do not support an approach that requires the measurement of an asset or a liability taking into account the probabilities of all possible outcomes, because we believe that such an approach entails a high degree of detailed work, thus imposing an additional burden on preparers without producing information that is more relevant for users. Moreover, the probability-weighted average of all possible outcome criteria could lead to a volatile and perhaps unrealistic estimate of regulatory assets and liabilities.

We believe that an entity should base the measurement of regulatory assets and liabilities on management's best estimate of the amount expected to be recovered. The emphasis in

---

[2] Para 8 states that "*An entity shall recognise a regulatory asset for its right to recover specific previously incurred costs and to earn a specified return when it has the right to increase or the obligation to decrease rates in future periods as a result of the actual or expected actions of the regulator*.", so believing that also the differences of margins resulted from differences on investments can give rise to a regulatory asset, instead para 10 states that *"this [draft] IFRS is not applicable when items related to regulated operating activities have been recognised as assets or liabilities in accordance with other IFRSs".*

relation to measurement should be on the expected future cash flows, which are a central focus for users of financial statements.

Question 4

The exposure draft proposes that an entity should include in the cost of self-constructed property, plant and equipment or internally generated intangible assets used in regulated activities all the amounts included by the regulator even if those amounts would not be included in the assets' cost in accordance with other IFRSs (see paragraph 16 of the draft IFRS and paragraphs BC49–BC52 of the Basis for Conclusions). The Board concluded that this exception to the requirements of the proposed IFRS was justified on cost-benefit grounds. Is this exception justified? Why or why not?

We agree with the IASB proposals.

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 believe that the regulatory assets and liabilities have to be tested for impairment individually and they should not be included in a cash generating unit. In fact, para 22 of IAS 36 states that *"recoverable amount is determined for an individual asset, unless the asset does not generate cash inflows that are largely independent of those from other assets or groups of assets"*. As the measurement basis for regulatory assets and liabilities is their expected present value, which implies that these assets and liabilities are measured based on their cash flows, we believe that these items might be tested for impairment separately, from other CGUs because it is easily possible to allocate cash flows to them.

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.

We agree with the IASB proposal on disclosure requirements.

It does not seem appropriate to require additional disclosures based on information that the regulatory entities give to the regulator and on the analysis of the rates in their different components. In this regard, without going deeply into the usefulness of the information, it underlines the fact that as usual in Italy relationships with the regulator are marked by privacy.

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?

We agree with the IASB proposal on transition requirements. When there are changes or issues of new accounting standards the entities might modify their systems. Obviously these costs will be less burdensome when the method to determine the rates is clearer.

Other comments
Question 8

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

We believe that it would be appropriate to analyse thoroughly the boundaries between the ED and IFRIC 12, as the relationship between this draft standard and IFRIC 12 is only mentioned (see para BC21 and para BC39).
With this ED only one amendment to IFRIC 12 is expressly provided for, which suggests that entities within the scope of IFRIC 12 check if the activities provided using the infrastructure in accordance with the concession arrangement are also within the scope of the ED.
It seems that the draft standard and IFRIC 12 (intangible model) both could be applied by an entity that operates in a service concession arrangement. In order to clarify how those two standards might be applied we suggest inserting in the standard an example on the joint application of this standard and IFRIC 12.

If you have any questions concerning our comments, please do not hesitate to contact us.

Yours sincerely,

Angelo Casò
(Chairman)