

Ms Kris Peach
Chair
Australian Accounting Standards Board
PO Box 204
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West Victoria 8007

27 July 2015

Invitation to comment on AASB Exposure Draft Service Concession Arrangements: Grantor (ED 261)

Dear Ms Peach

Ernst & Young Australia ('EY') is pleased to provide comments on the AASB's Exposure Draft 261 *Service Concession Arrangements: Grantor* (the 'ED'). Our responses to the specific questions are set out in Appendix A to this cover letter.

Overall, Ernst & Young is supportive of the proposals set out in the ED in relation to grantor accounting for service concession arrangements ('SCAs'). Currently there is no specific Australian Accounting Standard that prescribes the accounting for such arrangements from a government grantor perspective and this has led to divergence in practice. While a number of jurisdictions have applied a risks and rewards model to accounting for such arrangements, we believe that the proposed standard will bring a more consistent approach to the accounting for SCAs from a public sector perspective.

While we acknowledge that the proposed control approach in the ED represents a more rules rather than a principles-based approach and hence may not be adequate to address all existing arrangements as well as emerging innovative service concession arrangements, the proposed Standard represents a positive way forward in addressing a gap that currently exists.

While we support the proposals, we encourage the Board to significantly expand the guidance and examples within the Standard to assist preparers in relation to its application similar to that which has been done with other standards such as AASB 10 *Consolidated Financial Statements*. Additional guidance would be of benefit particularly in relation to the definition of 'control' and 'public service', fair value of service concession assets and the transitional requirements upon first time adoption.

We would be pleased to discuss our comments further with you. Please contact Charles Feeney (charles.feeney@au.ey.com or (02) 9248 4665) or Georgina Dellaportas (georgina.dellaportas@au.ey.com or (03) 9288 8621) if you wish to discuss any of the matters in this response.

Yours sincerely



Ernst & Young

APPENDIX A

SPECIFIC MATTERS FOR COMMENT

1. The proposed application to all public sector entities is wider than IPSAS 32 *Service Concession Arrangements: Grantor*, upon which the [draft] Standard is based. IPSAS 32 applies to all public sector entities other than Government Business Enterprises (GBE). A GBE is akin to a for-profit public sector entity. The proposed approach is consistent with the AASB's policy of making Accounting Standards that require like transactions and events to be accounted for in a like manner for all types of entities, which is referred to as transaction neutrality. Do you agree with the proposed application to all public sector entities? Why or why not?

We agree with the proposed application to all public sector entities, consistent with the AASB's approach to transaction neutrality. While we note concerns that the application to for profit public sector entities (such as GBEs) might compromise their ability to make an 'explicit and unreserved statement' of compliance with International Financial Reporting Standards, we believe that the overarching principle of applying the same accounting principles to like transactions by all public sector entities is of greater importance.

2. The proposed scope in paragraph 5 applies to arrangements involving a 'service concession asset', which would include intangible assets and land. This is consistent with the scope of IPSAS 32 but broader than the scope of AASB Interpretation 12 *Service Concession Arrangements*. AASB Interpretation 12 applies to 'infrastructure' of a service concession arrangement, which would exclude intangible assets and land. AASB Interpretation 12 is applicable to infrastructure assets that the private sector operator constructed or acquired from a third-party, or to which it was given access by the grantor, for the purpose of the arrangement. Consequently, the intangible assets or land that has been granted by the grantor is outside the scope of AASB Interpretation 12. Do you agree with the proposed scope of the [draft] Standard? Why or why not?

We note that while AASB Interpretation 12 uses the term "infrastructure" this term has been interpreted broadly and it is accepted that 'the infrastructure' used to provide services can include moveable and other assets. Although Int. 12 uses the word 'infrastructure' and includes examples traditionally regarded as such (including roads, bridges, hospitals and airports [Int.12.1]), the Interpretation is based on the definition of an asset ('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' [Framework.4.4]), and therefore we have considered it to apply to all assets, including items such as buses or rolling stock that are made available by the grantor to the operator of the public service.

We therefore agree with the proposed scope of the ED to apply to 'service concession assets' which is broader than the term 'infrastructure' used in Int. 12.

In particular the proposals should apply to all intangible assets (for example, broadband networks), land as well as movable assets such as trams, trains, ferries and buses. We recommend that the Board add such examples into AG4.

3. The [draft] Standard proposes the specific control concept in paragraph 8(a) that a grantor controls the asset if the “grantor controls or regulates what services the operator must provide with the asset, to whom it must provide them and at what price”. This mirrors the control concept in AASB Interpretation 12. The AASB notes that a broader concept of control currently applies in other Australian Accounting Standards. An asset that does not meet the control and regulation definition of this [draft] Standard may still need to be recognised under other Accounting Standards. Do you agree with the proposed specific control concept in paragraph 8(a) of the [draft] Standard? That is, applying a narrower concept of control in the [draft] Standard than other accounting Standards. Why or why not?

We generally agree with the specific control concept in paragraph 8(a) that a grantor controls the asset if the “grantor controls or regulates what services the operator must provide with the asset, to whom it must provide them and at what price”.

However, we make the following comments:

- ▶ We have concerns in relation to the practical implementation of the above concept of control to certain arrangements for example, 99 year leases, privatisations and outsourcing type arrangements. We note that outsourcing-type or privatization arrangements are examples which have been most problematic in determining whether they meet the control criteria and therefore fall under Int12 or whether they are a form of a lease and therefore fall under Int 4 - *Determining whether an Arrangement contains a Lease* from an operator perspective.

In our view, a key distinction in outsourcing or privatization arrangements is the degree of control that the grantor vs the operator has over the use to which the asset is put. A 'right of use' conveys the right to control the use of the underlying asset. One of the conditions noted in Int 4 that confirms a right of use (and therefore a lease) is that the lessee has the ability or right to operate the asset or direct others to operate the asset in a manner it determines while obtaining or controlling more than an insignificant amount of the output or other utility of the asset. This feature is absent from a service concession arrangement that meets the control criteria.

In addition, there are many regulated public utilities (water, sewage, electricity supply etc.) that may fall within para 8(a) however these will only be within scope if there is also a contract between grantor and operator for the arrangement and any significant residual interest is also 'controlled' by the grantor under para 8(b).

While we note that para 6 alludes to outsourcing and privatisations not being within scope, we recommend that the Board provides additional guidance in this respect in the AG paras when providing guidance on control.

- ▶ As noted above, an asset that does not meet the control and regulation criteria of this [draft] Standard may still need to be recognised under other Accounting Standards. We recommend that the Board provide additional commentary in the AG paragraphs to this effect as well as guidance as on the application of the broader concept of control in other Australian Accounting Standards for an arrangement that does not meet the control and regulation criteria of the proposed Standard. A similar table to Information Note 2 in Int 12 which demonstrates how other standards apply to such arrangements could be considered for inclusion into this proposed Standard.
- ▶ We recommend that the Board provides guidance where the grantor's 'control' of the asset changes during the service concession arrangement. This should include guidance where there is a change in the third party regulation of the price and/or service during the term of the service concession arrangement.

- ▶ We also recommend that the Board include an example of the application of the concept of control to a particular fact set.

- 4. **The [draft] Standard proposes that the grantor initially measures the service concession asset at its fair value unless the service concession asset is an existing asset of the grantor. Do you agree that the proposed requirements and guidance appropriately explain the application of fair value to a service concession asset? Why or why not?**

Generally, we agree with the proposed measurement of a service concession asset at fair value in accordance with AASB 13 *Fair Value Measurement*. However, we have concerns about how fair value is determined from a market participant perspective for public sector assets under AASB 13, especially in a grant to the right of an operator model, since AASB 13 was not written from a public sector perspective.

We understand that the AASB is considering a broader project to address concerns related to fair value accounting in the public sector. We encourage the AASB to start this project as a matter of priority.

From a practical perspective, while fair value of a SCA at the end of construction could be determined using a qualified valuer, determining fair value of a partly constructed asset may prove more difficult, especially as the grantor may not necessarily be privy to the costs actually incurred by the operator during this phase. During the construction phase, it would be reasonable to assume that the fair value of asset could be estimated based on the percentage of completion of the project and its expected capital cost, which in practice, can be identified in the Base Case Financial Model ('BCFM'). In addition to these capital costs, there may be other upfront costs associated with the arrangement which would need to be considered as to whether these should be included in determining the fair value of the assets. Examples may include planning and design costs, insurance during construction, independent reviewer costs, and operator incurred interest during construction.

As broader project relating to fair value of public sector assets may not be finalised prior to the adoption of the proposals in this ED, we encourage the Board to provide additional guidance in ED 261 to assist grantors in determining which cash flows should be included in determining the fair value of service concession assets.

5. The [draft] Standard proposes that:

- a. where the grantor recognises a service concession asset, the grantor also recognises a liability measured at the same amount as the service concession asset adjusted for other consideration between the grantor and operator. Do you agree that the proposed requirements and guidance appropriately measure the consideration between the grantor and the operator of the service concession arrangement? Why or why not?
- b. the measurement of a service concession liability using the 'financial liability model' and/or the 'grant of a right to the operator model'. Do you agree with the proposed models? Why or why not? If you do not agree with the proposed models, what alternative model(s) would you recommend?

We agree with the proposed requirement to recognise the consideration between the grantor and the operator and hence the liability at the same amount as the service concession asset adjusted for other consideration between the grantor and operator.

However we make the following comments:

- ▶ Para 19 should also refer to AASB 9 for subsequent accounting of the financial liability
 - ▶ AG46, AG47 and AG48 - where a financial liability is recognised, the guidance paragraphs in the ED currently require the finance charge to be determined based on the operator's cost of capital specific to the service concession asset, if this is practicable to determine or otherwise, the rate implicit in the arrangement specific to the service concession asset, the grantor's incremental borrowing rate, or another rate appropriate to the terms and conditions of the arrangement. These requirements are not in compliance with AASB 139/AASB 9. As the liability under the financial liability model is a financial liability under AASB 9, it needs to be accounted for in accordance with this standard. Under AASB 9, the finance charge is required to be determined at the effective interest rate. Hence the operator's cost of capital or the grantors incremental borrowing rate or any other rate would be irrelevant.
 - ▶ AG49 - refers only to presentation of the finance charge- however we recommend that a reference to AASB 123 be made also in respect of how such finance charges are accounted for.
6. The [draft] Standard proposes that the grantor account separately for each part of the total liability recognised for the service concession arrangement where the arrangement involves the grantor both incurring a financial liability and granting a right to the operator. Do you agree that the [draft] Standard provides appropriate guidance for the separate recognition of the liability? Why or why not?

We do not believe that the proposed Standard provides enough guidance on the measurement of a liability for hybrid arrangements containing both the financial liability and grant of a right to the operator models. The proposed Standard currently requires each portion to be measured initially at the fair value of the consideration paid or payable. However no guidance is provided as to how this would be determined.

We also consider that the Standard would benefit from the addition of a more complex example in respect of a service concession arrangement involving both a financial liability and the grant of a right

to the operator, specifically illustrating how the apportionment of the fair value of the asset would be made under a hybrid model.

- 7. IPSAS 32 includes guidance in relation to other revenues in paragraphs AG55 - AG64. Other revenues relate to compensation by the operator to the grantor for access to the service concession asset by providing the grantor with a series of pre-determined inflows of resources. The [draft] Standard does not include this guidance, for the reasons outlined in paragraphs BC27 and BC28. Do you agree that guidance on the accounting treatment of other revenues from a service concession arrangement is not required? Why or why not?**

We believe that the guidance on the accounting treatment of other revenues from a service concession arrangement should be retained consistent with IPSAS 32 as it provides valuable insights into how such payments should be accounted for. In addition to the examples provided in IPSAS 32, common payments that we have seen in practice and which can be incorporated into the guidance include:

- ▶ Additional operator payments to the grantor where concessions are extended or tolling is increased
- ▶ Provision of construction by operator of state owned assets

In addition, we recommend that guidance be provided for accounting for variable payments in a service concession arrangement. Some contracted payments, particularly concession fees, vary with a measure of usage of the concession asset or with another feature of the arrangement. We note that while the IFRIC was able to reach a consensus on the treatment by operators of concession fees that do not depend on future activity, it has yet to reach a consensus on the issue of variable payments.

At present, the usual treatment for an operator in a service concession is to treat contingent payments that vary in relation to future activity as executory and expense them as incurred. We recommend that the Board consider including guidance for the treatment of such costs from a grantors perspective.

- 8. The [draft] Standard includes defined terms in Appendix A. Do you agree that the proposed defined terms in Appendix A appropriately explain the significant terms in the [draft] Standard? Why or why not?**

In particular, do you agree with the proposed definition of a 'public service' as a "service that is provided by government or one of its controlled entities, as part of the usual government function, to the community, either directly (through the public sector) or by financing the provision of services"? Why or why not?

Are there additional terms that should be defined in Appendix A to assist application of the [draft] Standard?

We agree with the choice of defined terms in Appendix A including the proposal to define 'public service' as this term has been the subject of much debate from an Int. 12 perspective. However we consider the proposed definition of 'public service' is unclear, in particular the use of the words 'usual' and 'community'. We therefore recommend amending the definition as follows:

'A service that is provided by government to the public, as a matter of public policy'

Under Int12, it is generally accepted that SCAs fall into two broad categories where a public service obligation can be identified:

- ▶ SCAs that where the operator provide services directly to the public (e.g. transport, water supply, prisons, sewage) and
- ▶ SCAs where the services related to the service concession assets continue to be provided by the grantor, e.g. the services provided by hospitals or schools, and the operator provides only construction, facilities management and maintenance services only. However these will fall in scope where the grantor controls the asset.

In other cases, it is far less clear that there is a public service obligation. Such an example is the provision of car parking which may or may not be considered a public service depending on the jurisdiction/grantor in question. For example, is car parking provided as part of a construction of new hospital a public service? Is the construction of a public car park by a local council a public service?

In addition, the services may be those that need to be provided to the public as a matter of policy (e.g. the provision of electricity) but the contractual arrangement itself may be unrelated to any public service obligation. There are no services in addition to the provision of power (a combination of assets and services is often thought as typical of SCAs) and the grantor pays for the fixed and variable costs of the power produced, as do many private purchasers of power. Similarly, a public sector water utility might engage a private contractor to build, maintain and operate a water treatment facility; but there are no services in addition to the provision of a functioning facility within the water network.

As discussed under our response to question 3 above, these outsourcing-type or privatization arrangements are examples which have been most problematic in determining whether they fall under Int12 or whether they are a form of a lease and therefore fall under Int 4 - *Determining whether an Arrangement contains a Lease*.

While we note that para 6 alludes to outsourcing and privatisations not being within scope, we recommend that the Board provides additional guidance in this respect in the AG paras when providing guidance on scope and the definition of public service.

- 9. The [draft] Standard includes examples on the accounting treatment of lifecycle costs of a service concession asset that might be a benefit to the grantor. Lifecycle costs are costs incurred by the operator to maintain the asset during the service concession period. An example of a lifecycle cost is the cost to periodically resurface a road during the operating and maintenance phase of the service concession arrangement. Do you agree that the examples in the [draft] Standard provide sufficient guidance on the accounting treatment of lifecycle costs of a service concession asset that might be a benefit to the grantor? Why or why not?**

The example in the ED in relation to the accounting treatment of lifecycle costs relating to a road resurfacing is useful but would be applicable only in a very simplistic scenario. In many arrangements including hospitals and schools, the number of assets that need to be replaced over the term of the arrangement can be significant.

Very often the operator and grantor agree to a series of lifecycle payments as part of the contract negotiations upfront and the subsequently the grantor has very little or no visibility as to when assets or components thereof are actually replaced and what the fair value of those assets is at the time of replacement. The Operator normally has a requirement to make replacements to the assets from time to time as required to ensure that they are able to be used for their intended purpose over the term of the agreement and to transfer to the grantor assets which are in good working order at the end of the agreement. The Operator bears the risk that the costs of replacement will be higher or that replacement may occur at shorter intervals than expected and will also benefit if the cost is lower or replacements are longer than expected.

The payments to the Operator could be structured to occur evenly over the term of the arrangement or on a lumpy basis to reflect the Operators' expectations of replacements. To the extent that the Lifecycle Payments reflect the cost of replacing an asset or parts of an asset, a grantor is required to recognise the fair value of the replacing parts of an asset when it occurs. From a grantor's perspective, there may be practical difficulties in identifying when particular assets or components thereof have been replaced and what their fair value is.

This can cause significant difficulties in accounting for such costs. We are therefore of the view that additional guidance and an example on accounting for such costs in more complex arrangements would be useful in the final standard.

10. Do you agree with the proposed disclosures for a service concession arrangement set out in paragraphs 30 to 32? Why or why not?

In particular, do you agree with the proposed disclosure of paragraph 31 applying individually for each material service concession arrangement or in aggregate for each class of service concession arrangements?

While we agree with the disclosure requirements in the ED, we have the following comments:

- ▶ Para 30 states "The grantor shall present information in accordance individually for each material service concession arrangement or in aggregate for **each class of** service concession arrangements. It is not clear as to whether material SCAs which are of the same class can be grouped or must be disclosed separately. For example, assume that a grantor has two hospital SCAs, both material, would the above imply that the grantor could group the disclosures for the two SCAs together or would it be required to disclose each one separately on the basis that they are each individually material? It is also unclear as to what is meant by a "class of service concession arrangements". We note that Int 129 addresses the term "class" by stating:

"A class is a grouping of service concession arrangements involving public services of a similar nature (e.g. toll roads, hospitals, telecommunications, water treatment services)."

We therefore recommend including the above as additional guidance.

- ▶ Para 31(c)(i) - refers to "rights to access specified assets" - what does this mean and how does it differ to (viii)?

11. In relation to the proposed application date and transitional requirements:

- a. Do you agree the proposed application date is appropriate, and if not, what further considerations should be taken into account to determine the application date of the [draft] Standard?
- b. Do you agree with the proposed transitional provisions set out in paragraph 33? Why or why not? The transitional provisions permit the grantor to apply the [draft] Standard retrospectively or elect to recognise and measure the service concession asset and liabilities at the beginning of earliest period for which comparative information is presented using deemed cost.

While we agree with the proposed application date of the ED, we would also have no concerns in extending this date if this provided preparers with more suitable time frames for implementation.

Generally, we also agree with the transitional provisions, however, we encourage the AASB to provide additional guidance in relation to the measurement of the liability when using deemed cost for the grant of a right to an operator model, in particular the measurement of liability in paragraph AG65. We recommend that AG65 contain a similar statement to AG64 that "Any difference between the value of the asset and the financial liability (as adjusted) is recognised directly in net assets/equity. If the entity chooses as its accounting policy the revaluation model in AASB 116 or AASB 138, this difference is included in equity".

Other matters:

Scope para 5

Para 5 states that the proposed standard applies to arrangements that involve an operator providing a public service related to a service concession asset on behalf of the grantor. Para 6 further states that arrangements are not in scope if they do not involve the delivery of a public service.

As noted in our response to question 3 above, there are SCA arrangements where:

- ▶ the operator provide services directly to the public (e.g. transport, water supply, prisons, sewage) and
- ▶ the services related to the service concession assets continue to be provided by the grantor, and the operator provides only construction, facilities management and maintenance services (eg hospitals and schools)

There is a risk based on the current wording of para 5 that it could be interpreted to mean that arrangements in (b) above would not be in scope, whereas it has generally been interpreted in applying Int 12 by operators that such arrangements do fall into scope. We therefore recommend that the Board add additional commentary in the AG1 to clarify the scope of the standard.