May 31st, 2005
Elizabeth Hickey
Chairman IFRIC
30 Cannon Street
London EC4M 6XH
UK

Re: IFRIC Draft interpretations on Service Concessions Arrangements

Dear Mrs. Hickey,

Following the publication by IFRIC of the draft interpretations "D12 - Service Concessions Arrangements - Determining the Accounting Model", "D13 – Service Concessions Arrangements - The Financial Asset Model" and "D14 – Service Concessions Arrangements - The Intangible Asset Model", please find herewith FIEC (European Construction Industry Federation) comments to these draft interpretations in the framework of the consultation process initiated by IFRIC.

We remain at your disposal for any further information or clarification you may need on the various issues addressed in our comments.

Introduction

FIEC very much appreciated the efforts devoted by IFRIC to the "concession project". IFRIC has undertaken significant efforts in order understand the main features of the business and to provide a practical solution fitting with these features as well as with the current IASB standards and framework.

In this sense, FIEC considers the qualification of the asset as an intangible rather than a tangible one a consistent approach with the substance of the business and with the current IASB rules, taking in mind that the operator doesn't control the physical asset. FIEC also welcomes, as something consistent with the substance of the business, the separation made in terms of profit and loss account, between construction and operation activities.

Notwithstanding the above, FIEC has some concerns regarding the final interpretations and their impact in particular during initial years of the business. These concerns are explained in paragraphs below.

The complexity of the accounting issues involved with concession arrangements and the absence of IFRS/IAS literature on these types of arrangements certainly explain the difficulties encountered by IFRIC in addressing this matter. Furthermore, with hindsight, it would presumably have been better for the IASB Board to develop a comprehensive standard on recognition, measurement and disclosures of concession arrangements.
In this sense, as the current draft interpretations are not completely satisfactory, FIEC believes that the development of a new standard should be the final objective. FIEC also believes that from a technical point of view it is possible to blend the present draft proposed interpretations into a specific standard.

Such standard would avoid the problems explained hereafter in our comments and would guarantee that the accounting issues of the businesses are treated in a more realistic manner, in particular during the initial periods of the business, and would avoid the application of different accounting methods for concession contracts that are economically very similar.

Notwithstanding the above and despite FIEC’s preference for a new specific standard on concessions, the comments hereafter have been elaborated under the assumption that the adoption of such a specific standard will not be accepted and that ultimately the accounting treatment given to the concession industry under IFRS will be addressed in a first stage through IFRIC interpretations.

**A) FIEC main concerns**

FIEC main concerns in relation with the draft interpretations are the following:

1. **The need for two accounting models and the criteria for determining the accounting model**

The idea of having two different accounting models for service concession arrangements could be welcomed. However, if this approach is chosen, the financial asset model must include not only the cases where the grantor is paying but also those cases in which the grantor is offering a substantial guarantee of revenues, even if the users are paying.

Therefore, FIEC expresses its concerns about the fact that the criterion for determining the accounting model chosen by the IFRIC is based only on whether the grantor or the users have the primary responsibility for the payments to the operator. Although FIEC recognizes the simplicity of the method chosen for the determination of the appropriate accounting model, there is a concern that this method is based on the form of the contracts rather than on the substance of the underlying transactions.

FIEC is concerned about this different accounting treatment even when the economic substance of the contracts is essentially the same, particularly considering the significant different outcome from the application of both models, as explained in the next point.

2. **Mismatch of revenues and expenses in the "intangible asset model"**

When the operator receives the payments directly from the users (which is likely to be more frequent in the future), under the "intangible asset model" significant losses should be recognized in the early years of certain types of concession projects, since there is usually a mismatch of revenues and expenses in these early years (especially in transport...
infrastructure concessions). This mismatch is due to the following features of service concessions:

- this type of concession usually requires a high volume of capital expenditure, generating negative cash flows in the early years of operation and making it necessary for shareholders and lenders to contribute significant funds during the early stages of the concession, giving rise to high levels of financial leverage at the outset of the project; this generates significant differences in the timing of costs, especially financial costs incurred (which decrease over the life of the concession as the level of borrowing declines) and in operating revenues (which normally increase over the life of the concession);

- the public-service nature of the activities conducted by concession companies and the long-term nature of concession projects often mean that tariffs are not directly related to the costs incurred in each period; rather, the regulator normally sets the tariffs at a level that permits the recovery of the operator's expenses not on a yearly basis but over the duration of the concession.

FIEC is of the opinion that the draft interpretations fail to give a reasonable response to this mismatch of revenues and expenses.

According to FIEC, when a concession project is profitable as a whole and the tariffs set by the grantor have been defined with the aim of recovering the operator's costs over the concession term, recognizing significant losses during the first years of operation of projects of this kind (as would be the case under the "intangible asset model") that will be offset by significant profits in the latter years, does not faithfully represent the economic situation of companies.

Therefore, for FIEC a comprehensive solution is required for the mismatch of revenues and expenses, since according to the current draft interpretations this issue has only been resolved for the "financial asset model".

3. Amortization method under the "intangible asset model"

FIEC believes that the unit of production amortization method would best reflect the pattern in which the asset’s future economic benefits are expected to be consumed by the operator and it should systematically be applied to most concession contracts.

B) Transitional period

The draft interpretations on service concessions would apply from 1. January 2006, although earlier adoption is encouraged. However, the final interpretations have not been published by 1. January 2005 and probably will not be approved by the IASB and endorsed by the EU until late 2005.

The accounting for service concessions during 2005 is a practical issue for preparers and, in the absence of a standard or an interpretation, IAS 8 establishes that the management should use its judgment in developing and applying an accounting policy that meets a number of criteria specified in such standard. In making this judgment, the management may
also consider the most recent pronouncements of other standard-setting bodies that use a similar conceptual framework to develop accounting standards, other accounting literature and accepted industry practices, to the extent that these do not conflict with current IFRS. A number of EU Member States already have guidance on accounting in this area, which they could continue to apply if this respects the IAS 8 hierarchy.

FIEC believes that from the preparer's point of view the best solution would be a temporary relief from the IAS 8 hierarchy for 2005, as it has already been the case for other standards. This would give, on the one hand, to the preparers an option to temporarily continue applying the existing accounting practice and, on the other hand, the users would benefit from this approach, as otherwise they risk to be confronted with financial reports that are not homogeneous (since it is very difficult to make an interpretation of the existing standards themselves, as IFRIC long deliberations have demonstrated) and that differ in consecutive reporting periods as a result of changes between adjustments made and a final IFRIC interpretation (that could differ from the current drafts) to be applied in 2006.

From 2006 onwards, all existing arrangements would need to be restated in accordance with the final interpretations (i.e. the temporary relief would only be applicable for the first IFRS financial statements and does not mean that the interpretations would only be applied prospectively to any new arrangement entered into on or after 1 January 2006).

**Conclusions**

Although IFRIC has progressed significantly on some important issues, FIEC is of the opinion that the above mentioned concerns call into question whether the draft interpretations effectively address the problems relating to the accounting for service concession arrangements in a practicable manner.

FIEC's main concerns are that the current draft interpretations are likely to lead to inaccurate representations of the economic of transport infrastructure concessions, as similar concession contracts (in terms of the distribution of risks and rewards) could be accounted for under two different models that give radically different outcomes, which would show many concessions incurring, even in the case of overall profitable projects, in significant losses in the early years of the concession contract. This would not only fail to represent faithfully the economics underlying the concession contracts, but could also result in lower solvency and profitability of the companies involved in transport infrastructure concessions, therefore reducing companies' ability and interest in undertaking infrastructure projects.

As already mentioned, we remain at your disposal for any further information or clarification you may need on the various issues addressed in our comments.

Yours sincerely,

<original signed>
Domenico Campogrande
Technical papers attached herewith:

Appendix I: FIEC answers to the specific questions raised by IFRIC on the draft interpretations as they are currently drafted, assuming that IFRIC will maintain the two models approach.

Appendix II: additional comments in order to facilitate the application of the interpretations during the transitory period, assuming that a new standard is to be developed.
APPENDIX I: DETAILED COMMENTS ON THE DRAFT INTERPRETATIONS

In this appendix FIEC answered the specific questions raised by IFRIC on the draft interpretations D12, D13 and D14 as they are currently drafted, assuming that IFRIC will maintain the two model approach.

Draft Interpretation D12: Determining the accounting model

Question 1:  
The proposal in paragraph 5 of the draft Interpretation reflects the IFRIC’s decision that whether an operator recognizes service concession infrastructure as its property, plant and equipment should depend on whether it controls the use of that infrastructure. The IFRIC selected this approach instead of one based on the extent to which the risks and rewards of ownership lie with the operator. The rationale for selecting this approach is explained in paragraphs BC9-BC11 of the Basis for Conclusions. Do you support the approach selected?

FIEC supports the approach adopted by IFRIC from a technical point of view, as the control approach is something that should be addressed previously to any risk and rewards analysis.

According to FIEC, the answer to the question of whether the operator controls the infrastructure is quite clear in the majority of the contracts, as there are features in these contracts that led to the conclusion that the asset is controlled by the grantor, the operator only retaining a right to charge a toll or to collect revenues from the users. The contractual features that lead to this conclusion are as follows:

- the infrastructure is built according to the design and requirements established by the grantor offering the concession;
- during the construction period, agents representing the grantor check and control the construction work in order to ascertain that the asset is being built in accordance with the contractual requirements; when the construction work is completed, the grantor and the operator sign a document (certificate of completion or other) stating that the work has been performed in accordance with the stipulated requirements;
- after the construction work is completed, the only right that the concession operator retains is the right to charge for the use or for the availability of the asset; this right can be exercised only in accordance with the conditions established by the grantor (level of tolls, way of collecting tolls, definition of users, etc.); this right is linked in many cases to a maintenance obligation;
- in order to charge the tolls and to maintain the infrastructure, the operator controls certain assets (other than the infrastructure), such as the toll systems, maintenance equipment, etc. that are actually the only tangible assets of the operator;
- as a consequence, the operator in some cases could sell or pledge the right to charge a toll, (concession right) but never the tangible assets, namely the infrastructures themselves;
- the operator cannot restrict the use of the asset to any user who pays and furthermore cannot use the asset for any purpose other than that established by the grantor;
- in many cases the operator undertakes to build one or several infrastructures, but only has the right to charge a toll to recover the investment in relation to a portion of the infrastructure built (e.g. it undertakes to build 100 km of roads and accepts the right to charge a toll only over 20 km);
- the useful life of the infrastructure is normally significantly longer than that of the concession period. In this regard, the main costs of infrastructures such as roads relate to earthworks and structures such as tunnels or bridges that have a very long life and which, it could be argued, would be infinite provided proper maintenance work is undertaken; a similar conclusion could be used for other types of infrastructures (water distribution networks, etc);
- upon termination of the concession period, all the rights of the operator over the assets and related installations revert to the grantor at no cost to the latter.

Question 2:

Paragraph 11 of the draft Interpretation proposes that the operator should apply the financial asset model only if the grantor has primary responsibility to pay for the concession services. The rationale is explained in paragraphs BC24-BC43 of the Basis for Conclusions. Do you agree with this proposal? If not, what criteria would you use to determine whether the financial asset model should apply? How would you reconcile those criteria to the definition of a financial asset set out in IAS 32 Financial Instruments: Disclosure and Presentation?

FIEC believes that the determination of the accounting model as formulated in the current drafts simplifies the choice of the model. However, FIEC is highly concerned that drawing the line on the basis of who has the primary responsibility to pay puts too much emphasis on the form rather than on the substance of the arrangements. FIEC considers that not only the primary responsibility to pay, but also the demand risk should be taken into account in determining whether there is a financial asset.

In this respect, FIEC is of the opinion that, although the operator is entitled to be paid by users, if the effect of the contractual arrangements is that the majority of the demand risk associated with the service concession is retained by the grantor, the "financial asset model" should apply. This position and its reconciliation with IAS 32 are explained in detail in Appendix II.

Question 3:

As explained in paragraph BC44 of the Basis for Conclusions, paragraph 13 of the draft Interpretation proposes that the identity of the party or parties with primary responsibility to pay for the concession services should be determined by reference to the substance of the contractual arrangements (which would not be affected by, for example, changing the parties through whom payment is routed). Do you agree with this proposal?

FIEC agrees with this proposal. However, in practice there are "borderline situations", for example where the operator is partly paid by both the grantor and the users.

There may be practical difficulties in applying the test and splitting the contract into two components, a receivable one (the part paid by the grantor) and an intangible one (the remainder part paid by the users), could be complex for financial statements preparers and difficult to understand for users. FIEC would prefer a solution which would analyze the substance of the arrangements, in order to decide what model better fits with the underlying economics of the contract and to apply the selected model to the whole contract.
Question 4:
The IFRIC aims to issue this and the two other proposed Interpretations on service concessions (D13 and D14) in final form before the end of 2005. It proposes that, subject to it achieving this aim, the three Interpretations should be applied for annual periods beginning on or after 1 January 2006. Do you agree with this proposal?

FIEC has previously expressed its concerns on the transitional issue. From the preparers' point of view, the best thing would be a temporary relief from the IAS 8 hierarchy for 2005, as it has already been the case for other standards. This would give preparers an option to temporarily continue applying the existing accounting practice and the users will benefit from this approach, as otherwise they risk to be confronted with financial reports that differ in consecutive reporting periods as a result of changes between adjustments made and a final IFRIC interpretation to be applied in 2006.

Draft Interpretation D13 – The Financial Asset Model

Question 1:
As discussed in paragraphs BC3-BC5, the proposals in the draft Interpretation are based on a conclusion by the IFRIC that the discharge of each contractual obligation (including obligations to repair and maintain the infrastructure) gives rise to revenue for the operator. Do you agree with this conclusion? (Question 3 in the Invitation to Comment on draft Interpretation D14 Service Concession Arrangements—the Intangible Asset Model poses a similar question in relation to the intangible asset model.)

FIEC agrees with the conclusion.

Question 2:
As explained in paragraphs BC6 and BC7, the IFRIC has concluded that, applying IAS 11 Construction Contracts, operators might recognize different profit margins on different activities undertaken within a single service concession contract. Do you agree with this conclusion?

FIEC agrees with this conclusion. This would be the only proper application of IAS 11 (which states that percentage of completion should be applied separately to identifiable components of a single contract), due to the following features of this type of contract:

- in public tenders for service concessions, the different bidding groups are usually consortia consisting of several members that create Special Purpose Vehicles for the tender; the members of these consortia can be banks, financial investors, construction and service companies, or companies specializing in infrastructure operations and maintenance;
- in order to prepare the tender, these consortia request from several construction companies (one of them can be a sister company of one of the members of the consortium) proposals to build the infrastructure;
- the price of the construction contract must be fixed between the SPV and the constructor before the bid is submitted to the state authority, because one of the conditions established by banks for the grant of project financing to the SPV (the
operator) is that the construction price must be fixed at no risk for the SPV arising from overruns in the construction phase;
- this process provides a market price for the construction work, established on an arm's-length basis; this price has to be included in the bid submitted by the consortium and in the business plan to be included in the bid, since it is the main reference of the cost of the project for the granting authority; the construction price is not a matter of negotiation with the state authority as neither are the level of tolls or the period of the contract;
- normally, for the entire construction period the construction company has to provide a guarantee to the banks securing completion of the construction work at a fixed price;
- the construction activity is different from the operation and maintenance activity; it requires different skills and carries very different margins;
- in some cases service concessions do not entail a construction obligation; in these cases, the concession operator pays an amount to the grantor in exchange for the right to charge a toll.

Considering the foregoing, FIEC agrees with the conclusion that operators might recognize different profit margins on different activities

**Draft Interpretation D14 - Intangible Asset Model**

**Question 1:**

*In the intangible asset model on which this draft Interpretation is based, the service concession operator is regarded as receiving an intangible asset from the grantor in exchange for the construction or other services it provides to the grantor. Paragraph 7 of the draft Interpretation proposes that the operator should recognize revenue and profit or loss on that exchange. The rationale for this proposal and for an alternative view—i.e. that no revenue or profit should be recognized on the exchange—is set out in paragraphs BC7-BC14 of the Basis for Conclusions. Do you agree with the proposal? If not, how would you reconcile non-recognition of revenue and profit to the requirements of existing IFRSs?*

FIEC agrees with this conclusion. According to IAS 18 p. 12, when goods are sold or services are rendered in exchange for dissimilar goods or services, the exchange is regarded as a transaction which generates revenue. This revenue is measured at the fair value of the goods or services received, adjusted by the amount of any cash or cash equivalents transferred. When the fair value of the goods or services received cannot be measured reliably, the revenue is measured at the fair value of the goods or services given up, adjusted by the amount of any cash or cash equivalents transferred. In this sense IASB has never subordinated recognition of revenue or expenses to the revenue or expenses materializing in cash in- or out-flows.

For example, in transport infrastructure concession contracts, the operator performs construction work (including repair and maintenance obligations) for the grantor and in exchange and in consideration for this construction activity receives a financial or an intangible asset. The revenue on the non-monetary exchange cannot be eliminated unless the exchange itself is eliminated.

The rules regarding the “exchange of assets” established in IAS 38 paragraphs 45 to 47 are not an argument against the recognition of income in construction activity, as the exchange
transaction does not lack commercial substance (in the case at hand, it is clear that the configuration of the cash flows of a construction contract is completely different in terms of risk and timing to the right to charge a toll for the use of an infrastructure over a long period) and the fair value of the asset received and of the asset given up are reliably measurable (in the specific example of a toll road, it is evidently easier to estimate the value of the construction contract than that of the right to charge a toll).

Question 2:

As explained in paragraph BC6 of the Basis for Conclusions, the draft Interpretation does not specify the timing of recognition of the intangible asset. The IFRIC identified three possible approaches. Do you agree that the proposed Interpretation should remain silent on this matter? If not, which of the three approaches do you think should be specified and in what circumstances?

FIEC agrees with IFRIC proposal.

Question 3:

As explained in paragraph BC16 of the Basis for Conclusions, the proposed requirements for maintenance and repair obligations in this draft Interpretation are different from those in D13 Service Concession Arrangements—The Financial Asset Model. Do you agree that the IFRIC has interpreted existing IFRSs correctly in respect of these proposals?

Assuming that the two accounting models would be designed to produce different accounting treatments (a solution which we do not favor), FIEC agrees with the draft interpretations and the resulting difference in treatment between them.

Under the intangible asset model, a repair obligation is recognized and measured in accordance with IAS 37, i.e. at the best estimate of the expenditure required to settle the present obligation at the balance sheet date, being this best estimate in most cases proportional to the usage of the asset over time.

Under the financial asset model, all contractual obligations are obligations in respect of which revenue is recognized as costs are incurred.

However, FIEC is of the opinion that IFRIC should consider whether hand-over costs require a separate treatment than periodic maintenance and repair obligations. Hand-over costs are costs that the operator expects to incur at the end of the concession in order to restore the road to a specified condition at the point of handing it back. Although in most concessions it is normal that the periodic maintenance plans of the infrastructure, the cost of which is expensed currently, are sufficient to ensure the delivery of the revertible assets in good working order at the end of the concession period, and, accordingly, no significant expenses arise at the end of the concession, if this is not the case and there are significant hand-over costs, under the financial asset model the proposed treatment would lead to recognize in full expenses and revenues in the last year.

Other comments on the Draft Interpretations D12, D13 and D14
Comment 1: Definition of a concession

In reviewing the scope of the interpretations (D12), there are two concepts missing, which FIEC has always considered in the definition of a concession contract:

1. The tariff regulation scheme defined in the concession contract is normally designed to recover the investment in infrastructure over the term of the concession rather than on a year-by-year basis.
2. Normally the concession contract exhaustively regulates the risks and rewards of the grantor and the operator. Government guarantees (balance of the Financial Plan, regulated prices, maximum and minimum returns for the concession holder, etc.) co-exist with the principle that the risks and the business venture pertain to the concession holder. The manner in which such Government guarantees are instrumented may at times cause significant changes in the structure and term of projects in order to maintain and underpin an appropriate economic and financial balance.

FIEC considers that these features should be included in the definition of a concession contract.

Comment 2: Depreciation method under the intangible asset model

The IFRIC current draft interpretations are considering that the asset of the concession operator, when the operator receives payment from the users, should be considered as an intangible asset. In relation with the depreciation of this type of assets, IFRIC draft interpretations are silent, although a specific mention of paragraph 98 of IAS 38 has been included in the basis for conclusions.

According to FIEC, most intangible assets arising from service concession arrangements could be deemed to involve cases in which there is persuasive evidence to support an amortization method other than the straight-line method. The conditions for qualifying for this amortization method should be the following:

- that initially the volume or expected quantity of demand to be satisfied or of production units to be used by the intangible assets may be reliably determined;
- that such demand or units to be produced are the most reliable and representative measure of the economic use of this asset.

If these two conditions are met, even if the useful life of the assets is also limited to a determined period, the application of the demand or production units method, from the date on which the intangible asset was able to become operational, would be more representative (although it would give rise to progressive amortization) than the straight-line amortization method.

In reaching this conclusion, the nature of these intangible assets should be borne in mind, which consists of the right to charge a toll to the users for using an infrastructure during a limited period of time. It can be concluded that in most concessions a key driver to determine the consumption of the economics benefits of the asset is the number of users of the
infrastructure, as the economics benefits of the asset will be consumed charging a toll per user during the life of the contract.

In this sense, for FIEC the only faithful way of calculating the pattern in which the asset's economic benefits are consumed is the level of use of the asset (i.e. number of cars in case of a toll road). This would result in applying the units of production method for the depreciation of the intangible asset, and the impact would be an increasing amortization of the intangible asset, as the number of users is also increasing during the life of the contract. This method could only be applied if it is possible to make reliable estimations about the level of use of the asset during the life of the concession.

For FIEC the following features of this type of contracts are a strong arguments in favor of applying this depreciation method:

1. The activities of concession operators are in essence regulated activities. This means that the conditions of the operations are established by the government or by a public body, and that tariffs or tolls are fixed with the intention of recovering the costs incurred by the concession operator over the entire concession period and not on a year-by-year basis. This is a key issue in order to consider the contract as a whole when discussing the recognition of amortization expenses, which is by far the most significant cost in infrastructure projects.

2. In this type of project it is possible to make accurate estimates of future level of use (i.e. traffic in case of a toll road), revenues related with this traffic, investments and expenses. These estimates are normally performed by independent experts, and financial institutions base their decisions to finance these projects on the estimates of independent experts. The reliability of the estimates is the reason why these types of projects are financed with project finance borrowing without recourse to the project's shareholders.

3. The estimate made by the operator is normally presented to and approved by the government, in the form of a Business Plan of the project.

4. Normally projects of this kind can be considered to be a natural monopoly, i.e., bearing in mind the nature of the service (i.e. toll road or water supply), there is no competition for the service rendered (if you have to travel by car between two cities you will have to use the road). This restriction of competition is normally guaranteed in the contract (i.e., if governments decide to open a parallel road, they will have to compensate the Concession Operator accordingly). This feature represents a key difference between these activities and other regulated activities such as electricity supply or telecommunications, in which current technological progress has given rise to a competitive market using the same infrastructure.

5. Infrastructure and service concessions are contracts with complex and specific characteristics and regulations. The contract clauses normally have the effect of reducing the risk borne by the concession operator or sharing risks with governments by means of traffic or minimum revenues guarantees (provided by the concession granting authority), the right to the economic balance of the concession, etc.

In short, it can be concluded that, if we analyze the consumption of the benefits of assets which consist of the possibility of charging users for a limited period of time, it is clear that the only faithful means of calculating the pattern in which the asset's economic benefits are consumed by the enterprise is the level of usage. This method will be based on the units-of-production method that it is accepted under IASB rules, and could be accepted by IAS 38 as is possible to make reliable estimations of future usage.
Another argument in favor of applying this method would be that if the infrastructure should be considered as a tangible asset of the operator, it could clearly be depreciated under IFRS by applying the units-of-production method. Therefore, it is not logical from an economic point of view that the same asset with the same pattern of use should be amortized using a different method depending on whether it is classified as an intangible or as a tangible asset. Also, it is necessary to point out that an amortization method for intangible assets other than the straight-line method, is accepted internationally in several jurisdictions (US, Canadian and Spanish GAAP).

Comment 3: Change of accounting model
The draft interpretations do not indicate in which cases the accounting model could, or would, be required to change due to a change in the arrangement or in the facts and circumstances, or how to account for a change of model during a concession.

Comment 4: Accounting treatment of enhancements under the intangible model
Paragraph 9 of D 14 establishes that obligations to construct new infrastructures or to enhance either new of existing infrastructures shall be included in the consideration given for the intangible asset. FIEC understands that the corresponding accounting treatment would be to recognize an asset for the current value of the obligations, the balancing entry of which would be a liability for the same amount. The asset should be amortized over the term of the concession and the liability should be annually revalued. According to FIEC, in concessions in which the enhancement would give rise to greater revenues in the future (new sections or widening of road lanes, for example), the application of this method would not involve the appropriate matching of revenues and expenses, since the asset would begin to be amortized prior to the generation of revenues for the operator.
Appendix II: Additional comments in order to facilitate the application of the interpretations during the transitory period, assuming that a new standard is to be developed

Broadening of the financial asset model

FIEC understands that the broadening of the financial asset model, if differentiation is focused on reflecting the sharing of risks and rewards between grantor and operator, could be an acceptable solution for the industry and would also be compatible with existing IFRS.

It is usual that the concession arrangements include clauses to limit the operator’s benefits and risks – upward or downward. For example, the grantor may guarantee a minimum return or the operator’s maximum return may be capped. Usually, the effect of these arrangements is that the operator has not substantially all of the demand risk. The following are examples of other contracts that FIEC’s understand could be covered by the financial asset model, even though the operator is paid by users:

- if the grantor guarantees a specified return and claims for any excess return, such that the operator’s return is substantially fixed;
- if the price charged by the operator is modified by regulation designed to ensure that the operator gets a substantially fixed return, and the risk of demand being insufficient to provide that fixed return is remote;
- if the operator collects revenues from users until it achieves a specified return on its investment, at which point the concession comes to an end and the infrastructure reverts to the grantor, and the risk of demand being insufficient to provide the specified return is remote.

In each of these examples, the commercial effect of the arrangements is similar to a loan by the operator to the grantor, repaid wholly or partly out of income collected by the operator on the grantor’s behalf.

However, the draft interpretations restricts the financial asset model to concession arrangements where the grantor is primarily responsible for paying the operator, since IFRIC concluded that, although the operator’s asset might have characteristics that are very similar to those of a financial asset, it does not meet the definition of a financial asset included within IAS 32, as the operator does not have a contractual right to receive cash from another entity at the balance sheet date. In reaching this conclusion, IFRIC noted that in contracts where users have the primary responsibility, this other entity (the user) still has the ability to avoid any obligation (by means of not using the infrastructure). IFRIC also applied this reasoning to service concession contracts where users pay but contractual arrangements eliminate substantially all variability in the operator’s return and to service concessions where users pay but grantor guarantees payments.

In these cases, IFRIC noted that, as a result of such contractual arrangements, the operator faces very little demand risk, and only if usage were extremely low -likelihood of usage being that low could be remote- would the contractual mechanisms fail to give the operator a fixed return. However, IFRIC concluded that the fact that the operator’s asset was very low risk did not influence its classification. IAS 32 does not define financial assets by reference to the
amount of risk in the return—it defines them purely by reference to the existence or absence of a contractual right to receive cash.

In this situation, it could be argued that the operator has a contractual right to receive, and hence a financial asset for, the full amount of cash guaranteed by the grantor, for the following reasons:

- The grantor has no discretion to avoid making payments to the operator. The grantor's liability might be reduced by amounts received by the operator directly from users. The concession contracts usually include clauses obliging the grantor to make additional payments in case the grantor's acts cause a decrease in the concession revenues (i.e. changes in taxes, opening of an alternative infrastructure, etc).
- The grantor is not acting on its own behalf when it enters into a service concession; it is acting on behalf of the public in order to provide a public service. One way or another, the grantor will raise the funds to pay for the concession from the public. It may use its general tax revenues or it may charge specific users. If it charges users, it may allow the operator to collect amounts owed to it from the users directly, but the method of payment is a matter of form only.

In each case, the operator has, in substance, a contract with the public on whose behalf the grantor is acting, which is guaranteed by the grantor in case of users default or in case of a change in the conditions of the concessions due to grantor's decisions.

Despite the foregoing, IFRIC's arguments against the application of the financial asset model in these cases were the following:

- IAS 32 seeks to recognize separately each of an entity's rights to receive cash. IFRIC acknowledges that a guarantee would give rise to a financial asset in its own right, the fair value of which would depend greatly on the likelihood of the guarantee being called upon, but it regards guarantees as separate assets from the assets they guarantee. The concession operator should recognize its right to collect payments from users and the guarantee from the guarantor as two separate assets.
- IFRIC considers that the suggestion that the grantor and users are, in effect, one and the same, makes fundamental assumptions about the nature of transactions involving the public sector, as it views the public sector indistinguishable from, rather than a supplier to, the public. This assumption may set a precedent that has wider, perhaps inappropriate, ramifications.
- Allowing the operator to treat the right to collect user payments as a financial asset if they are guaranteed by the grantor does not eliminate the need for two different accounting models being applied to similar commercial arrangements—it would merely change the position of the dividing line.

In FIEC's opinion, IFRIC arguments against the application of the financial asset model to concession arrangements where substantially all of the demand risk associated with the service concession is retained by the grantor are largely offset by the fact that the dividing line between both models is based on a formal requisite that has little to do with the economics of the contracts, thus making two contracts with similar demand risks for the operator to be accounted for differently depending on a formal aspect without considering the substance of the contracts.
FIEC's view could be reconciled with IAS 32, as according to IAS 32.AG 8, the ability to exercise a contractual right may be contingent on the occurrence of a future event. Following that logic and the similarities in certain concession arrangements between a guarantee of the grantor to pay and a financial guarantee, FIEC thinks that the borderline between a financial asset and an intangible asset should be drawn in a different place, because we think there might be a contractual right to receive cash—and thus a financial asset—to be recognized by the operator as a result of past transactions, even though the operator's ability to exercise its right is contingent on a future eventual use of the guarantee.

According to FIEC, if, although the operator is entitled to be paid by users, the effect of the contractual arrangements is that the grantor retains substantially all of the demand risk associated with the service concession, the financial asset model should apply.

**Application of percentage-of-completion accounting methods**

The intangible asset model does not solve the revenue and expense mismatching in the early years of transport infrastructure concessions, which arises because of the significant differences in the timing of costs (including financial expenses) and operating revenues over the concession term.

According to FIEC, the application of percentage-of-completion accounting methods to the recognition of income and expenses (established in IAS 11 and IAS 18) in concession contracts that meet certain restrictive criteria could be acceptable from a IFRS technical point of view and would provide a solution to the above-mentioned mismatch in the statements of income of concession operators over the term of the concession. In this connection, most concessions contracts, especially transport infrastructure concessions, comply with the requirements established by IAS 11 and IAS 18 for the application of percentage of completion rules:

- Most concession contracts involve the construction of new infrastructure by the operator. This infrastructure is transferred to the grantor authority (the government) when the construction work is finished and in exchange for this commitment the operator receives a payment in kind consisting of the right to charge a toll or a tariff during a certain period for the use of the infrastructure and related services, subject to certain conditions established by the grantor. Contracts of this kind can be classified as construction contracts in accordance with IAS 11. In this connection, the objective of IAS 11 is to specify the accounting treatment of revenues and expenses associated with construction contracts because, due to the nature of these contracts, the dates of commencement and completion of the construction work that is the subject matter of the contract usually fall in different accounting periods, the main issue in accounting for construction contracts being the allocation of contract revenue and contract costs to the accounting periods in which the related construction work is performed. As explained before, this is also the key issue in connection with some types of concession contract, mainly when there is a large initial investment at the beginning of the concession, as there is a regulator trend to mitigate the impact and smooth the payments and guarantees over the term of the concession. Accordingly, there are significant differences in the timing of financial expenses and operating revenues.
- Also, it should be noted that, in general, most concessions meet the criteria established under the existing IAS to qualify for a percentage of completion type accounting; since the outcome of the contract can generally be estimated reliably (IAS 11.23, IAS 18.20), it is probable that the economic benefits associated with the contract will flow to the enterprise (IAS 11.28, IAS 18.20), the degree of completion of the transaction at each
balance sheet date can be measured reliably (IAS 11.23, IAS 18.20), the costs incurred in relation to the transaction and the costs of completion of the transaction can be measured reliably (IAS 18.20) and the contract costs attributable to the contract can be clearly identified and measured reliably so that the actual contract costs incurred can be compared with prior estimates (IAS 11.23).

FIEC is aware that percentage-of-completion accounting – an accounting treatment recommended by the IWG\(^1\) provided that certain conditions are met - seems to be inadvisable for the IFRIC for the following reasons:

- Agenda papers for the IFRIC meetings suggest that IASB members are reluctant to accept the application of the percentage of completion method for service concession contracts because "the distant future is uncertain and so cost estimates relating to very long periods can rarely if ever be reliable". FIEC believes that the main costs of these projects (initial investment and related financial costs) have a significant degree of certainty when the asset becomes operational and that many countries have decades of experience in infrastructure projects with independent experts giving very accurate income projections. In this connection, it should be clarified why the financial asset model, which is based on a reliable estimate of the expected future cash flows, is included in the interpretation, whereas the percentage-of-completion method, which is based on similar estimates, is ruled out.

IASB staff is reluctant to apply these rules to this type of contract because they consider that in these contracts there will usually be much more uncertainty regarding the cost to be incurred over the concession period and regarding the likelihood that the economic benefit associated with the contract will flow to the enterprise. They also consider that cost estimates relating to very long periods can rarely, if ever, be reliable. FIEC considers that this reluctance is unfounded due to the special features of this type of contract:

- projects of this kind (i.e. toll roads) are low-risk, i.e. it is possible to make accurate estimates of future revenues, investment and expenses; these estimates are usually made or reviewed by independent experts;
- the low level of risk is the reason why projects of this type are financed with project finance borrowing without the need to obtain funds from the project's shareholders; banks use the estimates of independent experts as a basis for their decisions on the financing of these projects;
- the operator's estimates are normally presented to the government and serve as a business plan for the project, which is usually approved by the government;
- concession operators' activities are considered to be regulated activities; this means that the conditions of the operations are established by the government, especially tariffs or tolls, which are set by the governments with the intention - in most cases due to political reasons - of recovering the expenses and investments incurred during the entire concession period rather than on a year-by-year basis;
- the features and regulation of concessions contracts are specific and complex, and generally have the effect of reducing the risk borne by the concession operator or sharing risks with governments such as traffic or revenue guarantees (by the authority granting the concession), the Balance of the Economic and

\(^1\) International Working Group created by the IASB with the participation of the accounting setters from Australia, France, Spain, UK with the aim of proposing solutions for service concession accounting in accordance with present IFRS rules.
Financial Plan right granted to the concession operator and/or competition is restricted to the benefit of the concession-holder, etc.

- IFRIC also argues that the percentage-of-completion approach "provides no basis for deferring or capitalizing costs, unless they qualify as contract costs of future activity and will probably be recovered". However, FIEC believes that the existing IFRS literature provides a sound basis to apply percentage-of-completion accounting to service concession arrangements. The percentage-of-completion solution is not a means of capitalizing costs, but rather a means of recognizing a right to revenues. The argument that services concessions do not qualify for percentage of completion accounting because this accounting provides no basis for deferring or capitalizing costs, unless they qualify as contract costs of future activity and will probably be recovered could also be rebutted. FIEC believes that upfront expenses (including financial expenses) would qualify for recognition as costs of future activity, as far as they relate to the procurement of the resources that are necessary for the project considered as a whole (financing, construction and operation), so it can be stated that these costs are "used up" during the concession period. Provided that there is sufficient evidence that future revenues will permit the recovery of the upfront costs incurred, there would be sufficient basis for recognizing these costs as an asset.

In any case, determining whether any specific project complies with the necessary conditions for application of the percentage-of-completion method is a matter of professional judgment to be made by companies and auditors on a project-by-project basis, but as a rule it can be concluded that the conditions are met in most contracts of this type.

FIEC is of the opinion that the application of the percentage-of-completion method to concession arrangements that meet certain specific criteria would not be an obstacle to providing fair information about the financial position of a concession operator as requested by the IASB framework, but would in fact improve the quality of the information provided. Also, according to IAS 11.36, if it is probable that the total contract cost will exceed the total contract revenues, the expected loss should be recognized as a loss immediately and, according to IAS 11.32 and IAS 18.28, when it is concluded that the outcome of the contract cannot be estimated reliably the contract costs should be recognized as an expense in the period in which they are incurred.

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