To: Mr. Robert Herz, Chairman, FASB.

Sir David Tweedie, Chairman, IASB.

9 December 2010

Dear Sirs

Exposure Draft ED/2010/9 Leases

Porterbrook wishes to thank the Boards for the opportunity to comment on the above Exposure Draft ("ED"). Whilst we support the Boards' intention that lease accounting should provide users of financial statements with a complete and understandable picture of an entity's leasing activities we have some concerns regarding the impact of the ED on lessor accounting. These concerns relate to the assessment of the benefits and costs of the proposals, whether they achieve the stated objective and their potential impact on business.

Background

Porterbrook is one of the three Rolling Stock Leasing Companies ("ROSCOs") created on rail privatisation and owns approximately one third of the UK's passenger rolling stock along with a substantial fleet of freight vehicles which it leases to its customers, the operators. Leases are classified as operating leases, with terms of generally up to 10 years compared to the average asset lives in the region of 30 years.

The three ROSCOs were previously owned by banks (Santander, RBS and HSBC) but at various points since 2008 they have transferred into new ownership. Similar to the other ROSCOs, Porterbrook is now owned by a consortium of financial institutions, including infrastructure funds and pension schemes. In addition to its equity, Porterbrook is funded via a mix of bank facilities and corporate bonds and is independently rated by Standard and Poor's (S&P).

Benefits and Costs

As a private company, the key users of our accounts are our owners, bank lenders, current and potential bondholders, rating agencies and suppliers.

The Boards recognise that, "many users of financial statements adjust the amounts presented in the statement of financial position to reflect the assets and liabilities arising
from operating leases." This is particularly true of credit rating agencies, such as S&P, who use their own methodology when assessing financial information for the purpose of their rating. We note however, that in S&P's recent paper they said "... we believe the proposed model differs from our own estimate of operating lease liabilities that we add to debt in three significant respects: incorporation of renewal options and contingent rent, and discount used."

If the information arising from the proposals is not aligned with the current methodology of a user such as S&P, then the principal benefit may not have been achieved. The Boards should clearly explain how they reached the conclusion that this key benefit will be achieved and that the differences to users' current practices will be valued by them.

Even if a benefit to users is achieved it should still be measured against the cost of achieving it. Unlike some high-volume lessors, we have a small number (fewer than 500) of lease agreements. Despite this, the proposals will still increase the complexity and costs of results preparation. Reporting is likely to take up much more management time as the increased earnings volatility will need to be explained to key investors and other users.

We encourage the Boards to share their assessment of an overall net benefit (e.g. that the benefits to users outweigh the costs to preparers) arising from the proposals, in supporting their final conclusions.

ED Objective

We understand that the Boards' objective is to provide a new approach to lease accounting that would ensure that assets and liabilities arising under leases are recognised in the statement of financial position. We also note the IASB's comment that, "There are greater deficiencies in the quality of information in relation to lessees than lessors. However, many believe that it is important to have consistent accounting for lessees and lessors. The exposure draft therefore proposes a consistent accounting model for both lessees and lessors."\(^2\)

Given the above, we believe that the choice between the performance obligation approach and the derecognition approach in the ED will increase complexity, costs of preparation and potentially reduce comparability between lessor accounting. Since one of the key criticisms of the current accounting is the classification between operating and finance leases we do not believe that the Boards have clearly explained their rationale for introducing a different set of choices into the proposed lessor accounting.

The ED talks of the current lack of comparability and undue complexity because of the sharp "bright-line" distinction between finance leases and operating leases. We are not aware of any such bright-line tests within IAS 17, particularly given the definition of a finance lease as "a lease that transfers substantially all the risks and rewards incidental to ownership of an asset."\(^3\) We are therefore concerned that the proposals are seeking to address issues outside of IFRS by changing IFRS. The stated objectives may be achieved with a better cost: benefit ratio by retaining IAS17 and instead focussing on the current disclosures to ensure users have the information they require.

1 "Proposed Lease-Accounting Requirements Likely to Affect Our Analysis" – November 2010
2 IASB's "Snapshot: Leases" – August 2010
3 IAS 17 Leases – paragraph 4
It has not been made clear how in a consistent accounting model for both lessees and lessors there can be a choice of accounting on one side of a transaction and not on the other. Considering the lack of detail in March 2009’s discussion paper, the lessor accounting proposals in the ED appear to be more consistent with those expected at a discussion paper stage. It seems that the lessor accounting proposals have been rushed through in order to meet the 2011 deadline. We believe that convergence should be based on the best of US and IFRS GAAP, rather than following a technical compromise that is the path of least resistance.

We urge the Boards to take the time to develop the lessee and lessor models together in one standard. We do not believe that the Boards should proceed with lessee accounting on its own. Within the Porterbrook group there are entities that are both lessees and lessors, with some who participate in sub-lease. The Boards would need to consider in depth the implications on such entities if they were to pursue a lessee only model.

The ED neither clearly explains the logic underpinning the creation of an extra asset when a lease is signed, nor how the lease cashflows will support the value in use calculation for both the right to receive lease payments asset and the underlying physical asset. Similarly we find it difficult to understand the recognition of a right to receive asset in respect of rentals arising in a future option period, when until the option has been exercised, we do not have an unconditional right to receive those lease payments.

**Business impact**

Some financial entities that we, and our owners, have spoken to over recent years have found it difficult to view Porterbrook as comparable to other infrastructure businesses, such as utilities. Whilst Porterbrook has a number of features common to infrastructure investments, in particular the group’s ability to generate long term stable cashflows and profits, this could be impacted by the ED proposals. This in turn could limit the attractiveness of the industry to other potential equity infrastructure investors.

Our principal concern is that the proposals are likely to lead to a significant reduction in Earnings Before Interest, Tax, Depreciation and Amortisation (“EBITDA”), and increase the volatility in Profits Before Tax (“PBT”). Whilst EBITDA is not a defined term within IFRS and does not appear on the Income Statement, it is an important measure used by investors, rating agencies and lending covenants.

The decrease in EBITDA and increased volatility in PBT could ultimately affect the ability to attract investment into the ROSCO sector. Porterbrook has long term assets and associated cashflows and therefore would expect to be able to raise debt with matching tenors. The volatility could led to increased financing costs, or reduce the tenor of future debt issuances, if investors perceive there to be volatility risk concerns. These cost increases would flow to higher lease prices at a time when the UK Government has announced plans to increase the rolling stock fleet by over a 1,000 vehicles to alleviate overcrowding and accommodate growth.

EBITDA is a key constituent of our bank and bond covenants. The ED proposals will impact on these covenants and require Porterbrook to either renegotiate the definitions of EBITDA in its agreements or prepare separate reporting for the covenants in line with IAS17 (with the extra compliance costs that this would bring). We believe that these costs are likely to be
significant for ourselves and many other preparers and should be included in the assessment of benefits and costs discussed earlier.

We are pleased to note that S&P do not expect ratings to change as a result of the ED proposals. However, as noted previously there will be an increased burden on companies to explain the changes and the ongoing volatility.

Our assessment of lessee accounting indicates that the profile of profits for our customers is likely to be affected. Due to the interest charges arising on the lease payment liability, with all other things being equal, their profits are likely to be lower at the start of a lease than at the end. Since many of our customers form material parts of publicly traded transport groups, the changes could have a significant impact on group measures such as Earning Per Share etc. Over the long term this could ultimately affect the attractiveness of our leases despite there being no changes to the commercial terms.

Conclusion

We hope that the Boards take these views into account in their development of a new standard for leases.

Yours faithfully

Will Day  
Finance Director