



December 14, 2010

The International Accounting Standards Board  
30 Cannon Street  
London, United Kingdom  
EC4M 6XH

Electronically via [www.ifrs.org](http://www.ifrs.org)

Re: Exposure Draft ED/2010/9 – Leases

Dear Sirs:

We appreciate the opportunity to comment on the exposure draft ED/2010/9 – Leases (ED). This letter is written on behalf of Canadian airport authorities, in particular those operating airports in Toronto, Montreal, Ottawa, Winnipeg, Edmonton and Calgary. These six airport authorities are among 8 airport authorities that operate the 8 major airports of the 26 airports in Canada's National Airport System. Five of these airport authorities will be subject to International Financial Reporting Standards starting in 2011 and one is considering voluntary adoption of IFRS at a future date. Approximately 70 percent of air passenger traffic in Canada is handled by these 6 airport authorities.

#### Background information

Canadian airport authorities lease their airport lands from the Government of Canada under an 80 year Ground Lease/governance model (60 year terms plus 20 year extensions) that we understand to be unique among airports around the world. In Australia the Government of Australia has also leased airport lands to the private sector under 99-year leases. However, these leases were structured with up-front single lump-sum pre-payments of rent that were fixed in amount, unlike the annual rents paid by Canadian airport authorities. Under the Canadian airport leases, rent is calculated and payable solely on a contingent basis as a percentage of the lessee's annual revenues. This contingent rent model may be unique among airports around the world, but it is likely that there are other very-long-term leases of other asset types around the world where rents are totally (or substantially) contingent on the lessee's revenues.

In addition to being lessees, Canadian airport authorities are also lessors and rent space in their terminal buildings and sublease land under very long-term arrangements to businesses that service the aviation industry and other related tenants. These tenants include concession-type arrangements with tenants paying base and contingent rents, much like those seen in shopping malls.

We support the theoretical arguments for capitalizing certain lease obligations. However, we disagree with several aspects of the approach taken by the IASB in the exposure draft, most particularly those that relate to accounting by lessees for contingent rentals. The lessor accounting will also cost Canadian airport authorities significant amounts in additional rent payments. In addition, we are concerned that the accounting and administration of leases will have a significant impact on operations that may only be justified by benefits to users that may be marginal at best.

### Specific airport authority comments and concerns

As lessees, we have 2 main comments with regards to the exposure draft on leases:

1. The exposure draft is silent as to the accounting treatment for leases that do not fit the definition of leases to which the accounting prescribed under the exposure draft applies. We assume that the existing “operating lease” model would apply to these situations. These leases should be included as exceptions in the scope section of the final standard (paragraph 5 of the ED).
2. For those situations where the lion’s share of rent paid is contingent rent, we disagree with the inclusion of contingent rent in the measurement of the assets and liabilities arising from a lease.

#### Item 1. Treatment for leases that do not fit the definition of leases

The Exposure Draft is silent as to the accounting treatment for leases that do not fit into its definition of leases. See Appendix A for a more thorough analysis of Canadian airport authority Ground Leases. We believe that Canadian airport authority Ground Leases do not fit the definition of leases to which the accounting proposed in the Exposure Draft should apply, mainly because these Ground Leases do not give an unconditional right to use the asset over the lease term. Furthermore, rents under these Ground Leases were not established based on market rates. Accordingly, the net present value of rent payments bears no resemblance to the value of the underlying asset. Informally, rating agencies comment that, in their view, the rents that airports pay in Canada are more in the nature of taxes. In our view, they are more like royalties or franchise fees calculated as a percentage of revenues. Similar to franchising agreements, the standard Canadian airport ground lease contains more than the usual matters found in leases – it also includes matters of governance, disclosure, public accountability, competition by the landlord, rights of foreign dignitaries, purchases of other land, approvals of master-plan updates, noise abatement, and various other operating matters.

#### Item 2. Contingent rent

For other long-term arrangements that are similar to Canadian airport Ground Leases, we believe that contingent rent payments should not be included in the measurement of the lease assets and liabilities arising from the lease as prescribed by the ED. See Appendix B for a more thorough analysis using the example of contingent rents paid by Canadian airport authorities. This is



primarily because of the difficulties in measurement of future rents based on forecast revenues 60 to 80 years hence, and also because of the resulting peculiarities in the financial statements. These peculiarities are driven by the reasonable expectation that rents will escalate into the future based on revenues or other determining factors in the calculation of contingent rent. Contingent rentals are extremely difficult to forecast with any degree of reliability given the long-term nature of these lease arrangements and the complexity of the business activities and related revenues. Providing leased asset and liability information to users that is based on estimates that cannot be reliably measured, or subsequently verified, diminishes the usefulness of that financial information. We note that the ED has proposed that lessors should only include contingent rentals if they can be reliably measured.

In addition, we believe that contingent rents do not meet the definition of liability at commencement of the lease because they are dependent on future events (revenues). Normally liabilities arise when goods are received or services are rendered. For example, the execution of a supply contract does not in itself create an obligation until goods are ordered and received under that agreement.

As lessors, under the proposed accounting, Canadian airport authorities will be required to pay higher amounts of rent to the Government of Canada because higher revenues will be recorded under the performance model for lessors.

The Basis for Conclusions to the ED acknowledges that the proposed model for lessees will result in recognition of expenses greater than the lease payments in the early years of a lease and lower than the lease payments in later years. Similarly, because of discounting and the accretion of interest, the lessor model will result in recognition of revenues that are greater in the early years and lower in the later years. Canadian airport authorities pay rent that is calculated as a percentage of revenues based on how these revenues are recorded in accordance with GAAP (IFRS). We are very concerned because this added cash cost for rent will be very significant in the early years of adoption. It will add to the lesser, but not insignificant, administrative costs of tracking and accruing interest on a large portfolio of leases.

Without proper analysis, the simplest and most significant item in Canadian airport authority financial statements, rent, could become the most complex item in these financial statements if the ED were to apply to Canadian airport authority ground leases and if contingent rents were included in the calculations. If applied to Canadian airport authority ground leases, the ED will have sacrificed clarity in financial statement presentation for theoretical purity, and the financial statements will be rendered less relevant to the user. Rent is a significant and relevant item for all current users of Canadian airport authority financial statements. These users include the landlord and regulator (the Government of Canada), airline stakeholders, bondholders, bank lenders, rating agencies, and the general public.

We appreciate the opportunity to comment on the exposure draft. If you would like to further discuss any of our comments, please do not hesitate to contact me at 1-613-248-2000 ext 1107 or at [john.weerdenburg@ottawa-airport.ca](mailto:john.weerdenburg@ottawa-airport.ca).

Sincerely,



John G. Weerdenburg, CA  
Vice-President and Chief Financial Officer  
Ottawa International Airport Authority

Attachments:

Appendix A: A situation where the definition of leases in the ED does not apply

Appendix B: Contingent rentals example

Appendix C: Rent payable under Canadian airport authority Ground Leases

Appendix D: Example calculation; the Ottawa International Airport Authority

Appendix E: Purpose and nature of Canadian airport authorities

## Appendix A

### Situations where the definition of leases in the ED does not apply

Airport Ground Leases in Canada are an example where the definition under the ED (Appendix B, B1 (b)) does not apply, and so should be considered as operating leases under the existing requirements of IAS 17.

### **Situation analysis – Canadian airport authorities**

IFRS are applicable to several, but not all, Canadian airport authorities

On February 13, 2008, the Canadian Accounting Standards Board (AcSB) confirmed that use of International Financial Reporting Standards (IFRSs) will be required in 2011 for publicly accountable enterprises. IFRSs will replace Canada's current Generally Accepted Accounting Principles for those enterprises. In April 2008, the AcSB addressed a number of transition issues, including the definition of "publicly accountable enterprises": An enterprise is a Publicly Accountable Enterprise unless, among other exceptions, "it has not issued, or is not in the process of issuing, debt or equity instruments in a public market". This definition is important since it determines which Canadian enterprises would be required to apply IFRSs.

Because five of the airport authorities noted above have issued bond debt that is publicly listed or traded over-the-counter (a public market), these airport authorities believe that they are publicly accountable enterprises and that their financial statements will need to be prepared in accordance with IFRS.

Canadian airport authorities "lease" their lands from the Government of Canada

Prior to 1992, all airports in Canada were generally operated by the Government of Canada (Transport Canada) or by municipalities. Since 1992, Transport Canada has transferred the management, operations, and development of airports that make up Canada's National Airports System to airport authorities and other organizations in the private sector. Canada's National Airports System consists of 26 airports (8 major airports and 18 much smaller airports) of which the 8 major airports collectively handle over 82 percent of air passenger traffic in Canada.

The Government of Canada continues to own all of the lands occupied by these airports - it has treated its ownership and control of airport lands as a strategic decision and has never offered them up for sale. All of the airports owned by the Government of Canada are operated and developed by locally managed airport authorities under Ground Lease arrangements with the Government of Canada. All of these airport authorities have historically accounted for their ground leases as operating leases under Canadian Generally Accepted Accounting Principles. For several reasons, these leases do not fit the criteria for accounting as service concession agreements under IFRIC 12.

The Ground Lease contract does not “convey the right to control the use” of these lands. The Government of Canada has insisted on the leasing model so as to maintain control of existing airport lands, primarily to ensure that they continue to be used as airports. In addition, Canadian airport authorities have had no choice but to operate their airports under Ground Leases granted by the Government of Canada. Purchasing these lands is not, and has never been, an option. These airport authorities did not enter into these leases in order to finance the purchase of airport lands, but rather as a means to access and better manage their community airports for their communities.

As part of the Ground Lease, any change in the official “land use plan” of the leased lands must be approved by the Minister of Transport for the Government of Canada. Although each airport has some excess lands that may be designated for commercial (non-aviation) development, the bulk of the land under the Ground Lease must be used as an airport in accordance with the airport’s land use plan for airport operations. Because of this control, the airport authority has no discretion to change the use of the bulk of the land to its highest and best use.

Section 8.09 of the Ground Lease expressly prohibits competition within a given radius of the airport. However, even if the airport authority, or indirectly another entity not subject to the Ground Lease, were to purchase land or lease land at an alternative site to develop this as a new airport, because the Government of Canada grants an Aerodrome Operating Certificate to allow the operation of lands as an airport, it ensures that the existing airport lands continue to be used as airports by issuing or withholding such certificates.

All land purchased (and paid for) by the airport authority immediately upon development or commencement of use becomes the property of the Government of Canada without recovery of cost (section 3.15 of the Ground Lease). Toronto Pearson and Calgary International Airports have purchased land for operational and development purposes (extensions to runways and logistics parks) and title to this land was immediately transferred to the Government of Canada under the Lease. There is no change or credit to the quantum of rent payable as a result of land purchases, and in fact any income from the transferred land is immediately subject to rent payable to the Government of Canada.

To further complicate these lease arrangements, Canadian airport authorities have title to the buildings and other assets of the airport during the life of the Ground Lease, but must surrender a first class facility back to the government of Canada at the end of the lease.

Rent payable by Canadian airport authorities is completely contingent on revenues

The rent paid by Canadian airport authorities to the Government of Canada is completely and totally contingent and based on a percentage of revenues on a graduated scale (Appendix C). With few exceptions, revenues include all revenues earned by the airport authority, even if those revenues are not derived from the operation of the airport.

The rent paid by Canadian airport authorities is not based on market rates and is not comparable to market rates on equivalent or adjacent properties (see Appendix C for the history of determination of rent). In a recent transaction by the Ottawa International Airport Authority, it leased a substantial un-serviced 11.5 hectare parcel of land for a 47-year term to a subtenant. The rent in the first year of this sublease was the equivalent of ten times the calculated rate per hectare that the Authority itself pays to the Government of Canada under the Ground Lease. As the rent payable by airports is not based on market rates, so too the NPV calculation to determine the right to use asset has no significance in terms of cost or market value.

Changes to lease terms to increase or decrease rent would not occur in normal leasing situations. The Government of Canada has established a track record of changing lease terms, in fact there were 4 lease payment amendments in the first 14 years at Calgary. In the interests of fairness to airports, in 2005 the Government of Canada changed the terms of the Ground Lease (with concurrence of the industry) to change the rent formula – decreasing the rent for some airports, and increasing rent for others.

Rating agencies' methodologies retain and rely upon operating lease accounting for Canadian airport authorities

The opening paragraph of the Introduction to the Exposure Draft indicates 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”. It is interesting to note that internationally recognized rating agencies, in their newsletters and commentaries on IFRS, have commented that their rating methodologies already include capitalizing leases that have been accounted for as operating leases. The methodologies of Moody's, Standard & Poors, and Dominion Bond Rating Service, the three rating agencies that rate Canadian airport authority bond issues, generally make such adjustments for operating leases. However, in the case of airport authority financial statements, they do not make these adjustments. The standard Canadian airport authority ground lease is sufficiently different, and the rating metrics are sufficiently different for Canadian airport authorities, that adjusting their financial statements to capitalize the Ground Lease does not matter to the credit metrics and makes no sense based on the underlying economics.

These same rating agencies have informally indicated that, should Canadian airport authorities be required to change their accounting based on the ED to capitalize their Ground Leases and establish right-of-use assets on their balance sheets, they would adjust the financial statements back to operating lease accounting to establish the appropriate credit rating metrics based on rent payable for the year.

## Appendix B

### Contingent rent payments should not be included in the measurement of lease assets and liabilities

The contingent rent model under which Canadian airport authorities calculate and pay rent to the Government of Canada may be unique among airports around the world, but it is likely that there are other very-long-term leases of other asset types around the world where rents are totally (or substantially) contingent on the lessee's revenues.

The difficulties of calculating the NPV of lease payments

Rent payable by Canadian airport authorities is totally contingent and based on a percentage of revenues on a graduated scale (Appendix C). Revenues include all revenues earned by the airport authority, even if those revenues are not derived from their airport – “all Gross Revenues derived by the Tenant from any business that does not form part of the Airport Undertaking of the Tenant and that is carried on in whole or in part directly by the Tenant outside of the Demised Premises” (section 4.02.01 “Airport Revenue” (h)).

Airport authorities have “an unfettered ability to set rates” as they see fit. By virtue of their status as the tenants under their Ground Leases and in accordance with the National Airport Policy, Canadian airport authorities may independently set and collect airline rates and charges, negotiate and issue leases, licenses and permits and establish other fees as they see fit. There is no requirement to seek approval from the Government of Canada (Transport Canada) or any other party on the rates charged for services.

Airport authorities have complete discretion to set rates (revenues) to recover operating costs and costs of infrastructure.

One of the largest sources of revenue is the airport improvement fee (AIF), a usage fee charged to all departing passengers. The fee is collected by airlines on behalf of each airport authority on the ticket and remitted to airport authorities based on enplanement. The fee is collected primarily to pay for infrastructure improvements to the airport and for the debt service costs related to borrowing to pay for that infrastructure. In Canada, the AIF ranges from \$15 to \$25 per enplaned passenger; the average rate is \$20. This rate is set totally at the discretion of each airport authority, which may decide to keep the fee low and pay for infrastructure and related debt over a very long time horizon, or to raise the fee and pay for infrastructure and related debt over a shorter time horizon, and then, discontinue collection of the AIF. Obviously, the latter case will yield a lower amount of rent over the long term (revenues will be higher and allow the authority to reduce debt service costs by paying off debt sooner), and will affect the timing of rent payments, which are contingent on revenue.

The AIF rate and resulting revenue is impacted by the cost of borrowing, inflation impacts on the cost of construction, the passenger throughput through the airport, and the

decisions of the airport authority in how to best recover its infrastructure and debt service costs over time.

#### The peculiar results of applying the ED accounting to contingent rentals

The Ottawa International Airport Authority has calculated amounts under the ED as if these amounts were to be established at the end of its calendar 2009 fiscal year, and these are included in Appendix D. The resulting figures would not be relevant to any of the users of the financial statements for the Ottawa International Airport Authority, users which include bond holders, rating agencies, bank lenders, the Airport Authority's landlord and regulator (the Government of Canada), the airline community, and the general public.

The results, assuming that the projection used to produce these results proves to be accurate, are summarized as follows:

- For 2010, the charge to the profit and loss under the revised accounting model would be:
  - \$ 3,760K amortization of right to use asset
  - \$ 9,937K interest on the lease asset (calculated at 5.80%)
  - \$13,697K total
- For 2010, the charge to the profit and loss under the existing accounting model would be:
  - \$5,411K rent
- Rent would not be sufficient to cover the computed interest on the liability until the year 2031. Accordingly until this date
  - the liability will continue to accumulate in value and reach \$240,238K at that date.
  - the asset will continue to decline in carrying value to reflect amortization and would be on the balance sheet at \$97,781K.
- The actual revenues for 2010 are proving to be different from the projection:
  - based on a new calculation of NPV based on rent in 2010 of \$6,041 and a revised projection for future years, the NPV of the lease obligation at the end of 2010 is \$178,125K versus \$181,268K.
  - How is this to be reflected in the financial statements?

## Appendix C

Rent Payable under the Canadian airport authority Ground Lease

Prior to 2006, there were slight variations between airports on the calculation of rent. For most airports, rent was based on a fixed charge per passenger, adjusted annually for inflation, to a maximum threshold number of passengers. This rent per passenger for each airport was originally calculated with reference to the amount of cash that the Government of Canada (Transport Canada) expected to generate from its own operation of each airport based on its own projections and plans. Accordingly, it was not calculated based on market rates for comparable lands.

As this formula yielded inequities between airports with some paying excessive rents and others paying very little, on May 9, 2005, the Government of Canada announced that it would adopt a new rent policy that would result in reduced rent for airport authorities and increased rent for others. This new formula was established after “consultation” with the authorities, and effectively spread the existing rent more equitably among airport authorities. The revised rent was phased in gradually over a transition period for the years 2006 to 2009.

Starting in 2010, ground rent for all Canadian airport authorities is calculated on a graduated basis as a percentage of gross annual revenues, with revenues as defined in the lease, with no rent payable on the Authority’s first \$5 million in annual revenue and an increasing rent percentage payable as revenues increase, on a cumulative basis as follows:

Gross revenues	Rent payable	Cumulative ground rent
On the first \$5 million of revenues	0%	\$0
On the next \$5 million	1%	\$50 thousand
On the next \$15 million	5%	\$800 thousand
On the next \$75 million	8%	\$6,800 thousand
On the next \$150 million	10%	\$21,800 thousand
On revenues over \$250 million	12%	

Examples (There is no minimum annual guaranteed rent).

On total revenues of \$25M:

On the first \$5M,	=	0
On the next \$5M, \$5M X 1%	=	\$ 50 thousand
On the last \$15M, \$15M X 5%	=	<u>\$ 750 thousand</u>
Total		<u>\$ 800 thousand</u>

On total revenues of \$80M:

On the first \$5M,	=	0
On the next \$5M, \$5M X 1%	=	\$ 50 thousand
On the next \$15M, \$15M X 5%	=	\$ 750 thousand
On the last \$55M, \$55M X 8%	=	<u>\$ 4,400 thousand</u>
Total		<u>\$ 5,200 thousand</u>

## Appendix D

Example calculations of assets and liability arising from the Ground Lease for  
Ottawa International Airport Authority

## Assumptions:

- Revenue projection based on 2 ½ % growth
- Airport Improvement Fee assumed to continue into perpetuity at the existing rate of \$15 per enplaned passenger
- 47 years to the end of the lease term (assumes, for purposes of this exercise, it is more likely that not that the authority will not exercise its renewal option)
- 5.80% average cost of debt capital used to discount to NPV
- Rent paid at the beginning of each year based on revenues for that year

		Right to Use Asset \$000	Lease Liability \$000
December 31, 2009		\$176,741	\$176,741
Transactions contemplated in 2010:			
Amortization of right to use asset		(3,760)	
Interest on liability			9,937
Rent payment			(5,411)
December 31, 2010		172,981	181,268
Transactions contemplated in 2011			
Amortization of right to use asset		(3,760)	
Interest on liability			10,168
Rent payment			(5,952)
December 31, 2011		169,221	185,484

## Appendix E

### Purpose and nature of Canadian Airport Authorities

1. Until the early 1990's, airports in Canada were managed and operated by Transport Canada, a department of the Government of Canada.
2. In 1987, the Government of Canada issued a policy that considered reforming the management and operation of airports called *A Future Framework for Airports in Canada*. This policy (which was amended and issued in 1994 as the *National Airports Policy*), allowed the transfer of airports to independent local authorities who assumed financial responsibility for airports in their communities, and undertook their direct management and operation by virtue of long-term ground leases. 4 airports transferred under the Framework prior to publication and implementation of NAP.
3. Under these quasi-permanent leases (60 year terms plus 20 year extensions), these independently operated, community-based authorities must manage, operate and maintain their airports in an up to date and reputable manner befitting a first class facility and a major international airport, and in a condition and at a level of service to meet the capacity demands at the airports.
4. The purposes of an airport authority are to:
  - Manage, operate and develop the airport in a safe, secure, efficient, cost effective and financially viable manner with reasonable airport user charges and equitable access to all air carriers;
  - Undertake and promote the development of the airport lands for which it is responsible for users compatible with air transportation activities;
  - Expand transportation facilities and generate economic activity in ways which are compatible with air transportation activities.
5. During the term of the lease, each airport authority has complete discretion as to how it will maintain its airport in an up-to-date manner befitting a first class airport:
  - At some airports, it is likely that during the 60 plus 20 year lease term, the passenger processing facilities will be torn down and rebuilt 2 or 3 times over;
  - At other locations, local authority management may decide to continuously renovate and update their facilities.
6. The authorities have been incorporated without share capital under Part II of the *Canada Corporations Act* or comparable provincial legislation. As such, all earnings of the authorities are retained and reinvested in airport operations and development.
7. Under the lease, at the expiry of the lease, the airport facility is to be returned to the Government of Canada. The authorities may continue to exist after the expiry of the lease.

Under the bylaws of these authorities, in the event of dissolution or winding up of the authority, all remaining assets, after payment of the authority's liabilities, are to be distributed to the Government of Canada or, alternatively, to a successor organization to the authority, acceptable to the government of Canada.

8. Airport authorities have an unfettered ability to set rates as they see fit. By virtue of their status as the tenants under their Ground Leases and in accordance with the National Airport Policy, airport authorities may independently set and collect airline rates and charges, negotiate and issue leases, licenses and permits and establish other fees as they see fit. There is no requirement to seek approval from Transport Canada or any other party on the rates charged for services.
9. The first airports to be commercialized and transferred to private sector management and control paved new ground and established themselves as commercially oriented operations. In preparing their financial statements, they adopted accounting practices generally accepted for commercial enterprises, and these accounting practices became generally accepted in the industry.