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Brasília, Distrito Federal – Brazil
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May 29, 2013

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

RE: Request for Information – Rate Regulation

Dear Board Members,

The Comitê de Pronunciamentos Contábeis - CPC (Brazilian Accounting Pronouncements Committee)¹ welcomes the opportunity to respond the Request for Information – Rate Regulation.

We are a standard-setting body engaged in the study, development and issuance of accounting standards, interpretations and guidance for Brazilian companies.

1. The regulated industry and why it should be considered

Rate regulation is widespread and affects industries across many jurisdictions. It would be helpful if respondents indicate whether they think that recognising, in IFRS financial statements, the effects of the rate-regulatory scheme being described would provide relevant information about the consequences of rate regulation to users of financial statements. It is easier for us to understand the information that you give us if we know what industry the rate regulation relates to.

Question 1

For the types of rate regulation that you think would be useful for us to consider in the Discussion Paper (or would not be useful to consider, if applicable), what types of goods or services are subject to the rate regulation being described?

In providing this information, please also tell us:

¹ The Brazilian Accounting Pronouncements Committee (CPC) is a standard-setting body engaged in the study, development and issuance of accounting standards, interpretations and guidances for Brazilian companies. Our members are nominated by the following entities: ABRASCA (Brazilian Listed Companies Association), APIMEC (National Association of Capital Market Investment Professionals and Analysts), BMFBOVESPA (Brazilian Stock Exchange and Mercantile & Future Exchange), CFC (Federal Accounting Council), FIPECAFI (Financial and Accounting Research Institute Foundation) and IBRACON (Brazilian Institute of Independent Auditors).



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- (a) **whether you are a rate-regulator, a financial statements preparer, auditor, user or other (please specify);**
- (b) **what jurisdiction the rate regulation that you are describing is in;**
- (c) **whether that jurisdiction is a recent adopter of IFRS; and**
- (d) **whether the main suppliers of the rate-regulated goods or services (ie the rate-regulated entities), including your company if applicable, are predominantly private-sector entities, government entities or closely related to the rate regulator.**

There are many rate regulated activities in Brazil, including energy, gas distribution, water supply and treatment and road concessions. Airports concessions are starting to become more common as well. We believe that the most relevant aspects in the Brazilian regulatory environment are those related to the energy distribution industry and, therefore, we are going to focus our discussions and comments on this sector. We understand that other regulated activities in Brazil are simplified versions of the regulations around energy distribution or may be analogized with the regulations for this industry.

Additional information:

- (a) We are representatives of CPC as defined above.
- (b) We are describing the rate regulation in Brazil, specifically the regulatory environment of the energy distribution industry.
- (c) Brazil adopted fully IFRS in 2010 (opening balance as of January 1st 2009) as your local GAAP, including IFRS for SME for smaller entities. This process was implemented via issuing national standards with the wording equivalent to the relevant IFRS. There are few exceptions for some segments, but this is not the case for rate regulated activities. Before adopting IFRS, the Brazilian energy distribution companies recognized regulatory assets and/or liabilities in accordance with SFAS 71 “Accounting for the Effects of Certain Types of Regulation” (codified in ASC 980).
- (d) The main suppliers of the rate-regulated services are predominantly owned by:
- Energy distribution – entities are mostly privately controlled with some entities still owned by the government.
 - Gas distribution – state controlled with minority interests owned by private investors and few is private owned.
 - Water supply and treatment – state controlled. Many of them are listed companies with minority interests owned by private investors.
 - Road concession – private owned.



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2. The objectives of the rate regulation

The objectives of rate regulation are influenced by many factors, such as the nature of the goods or services that are being provided, the economic climate, environmental factors, etc. It is useful to know the high-level objectives of the rate regulation under review because those objectives will influence the nature of the rate-setting mechanism employed by the rate regulator.

The objectives of rate regulation may change over time. We are most interested in your current situation but it would be helpful if you could indicate whether there has been a recent change or a trend towards alternative objectives.

Question 2

What are the objectives of the rate regulation and how do they influence the interaction between the rate regulator, the rate-regulated entity and customers?

In providing this information, please tell us:

- (a) what are the high-level objectives of the rate regulation (for example, to restrict prices or to influence the levels of supply and demand or to restrict or encourage competition); and**
- (b) how these objectives are reflected in the nature of the rate-setting mechanism? For example, to what extent:**
 - (i) is the rate-setting mechanism designed to give the rate-regulated entity a ‘fair rate of return’ (for example, a cost-plus mechanism) or is the focus more on reducing the cost to customers (for example, a price-cap or other incentive-based mechanism);**
 - (ii) are there incentives to meet targets that are not directly related to the cost-rate relationship (for example, efficiency, service levels, infrastructure investment, increased supply capacity or reliability, use of alternative resources or reduction in customer demand or usage);**
 - (iii) does the rate regulation fix the price per unit or does it provide some flexibility for the entity to set prices (for example, through price ranges or caps, based on either unit prices or total revenue or total profitability); and**
 - (iv) are there other aspects of the rate-setting mechanism that reflect any specific objectives not envisaged above?**

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| <p>a) The primary objective of the rate regulation on energy distribution industry is to provide a “fair return” on the distribution grid investments and on respective operating expenses to maintain it and also to promote efficiency and high quality services to customers. With limited exceptions, concessions for energy distribution are assigned to a concession area, which may comprise a region or state. Customers located in concession area has energy distribution provided only by concessionary assigned to that specific area, except for larger consumers (load higher than 3.000 kW) whose can choose its energy supplier.</p> |
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As result of this monopoly, rate-regulation for energy distribution services aim to introduce target levels of efficiency and quality of services in order to determine tariff charged to customers. This rate-setting mechanism may reduce or increase the rate, as further explained in item b.II) bellow.

- b) (i) Tariff mechanism applicable to distribution companies in Brazil is a mixed or hybrid system, which encompasses the concept of “service cost” for the so-called non-manageable items or Portion A, and the price-cap concept for manageable cost and capital return items called Portion B, both part of the parametric formula included in the concessions agreements.

Portion A includes costs whose amount and variance not managed by the distribution company. These costs encompass purchased energy, industry regulatory charges, energy transmission costs among others. Portion A should be neutral for tariff determination purposes, i.e. it is acknowledged that a distribution company should not earn profits neither incur losses from events that it cannot control. Thus, Portion A costs are fully and annually considered in tariff determination and passed through to consumers. Any variation is passed through to customers in the following years by increasing or decreasing future rate adjustments. This mechanism is designed to avoid any margin or mark-up over those Portion A costs. In some cases these costs may reach 80% of the costs structure of an energy distribution company. For example, the purchase of energy is currently conducted through auctions managed by the federal government and, therefore, the contractual price is not directly managed by the concessionaries who are only responsible for providing inputs regarding future demand fluctuations.

Given the current energy matrix in Brazil, Portion A costs can fluctuate significantly because electricity consumed in Brazil is predominantly generated by hydro-electric plants, which depend on external factors (such as rainfall volume) to maintain the reservoirs at adequate water levels. When the water level in reservoirs is close or low than a minimum limit established by regulator, electricity is generated by thermal power plants and other energy sources, usually at much higher costs.

Portion B encompasses the so-called “manageable costs”. These are costs inherent to distribution company operations and customer management activities, which are subject to the control or influence of practices adopted by the concessionaire management, i.e., the costs of the operation (personnel, supplies, and outsourced services). In line with the objectives of providing a fair return and promote efficiency by concessionaries, the current model establishes a price-cap regime for Portion B that aims to provide fair return on the electricity grid investments made and on operating activities, subject to adjustments associated with the X Factor, discussed on item b.II) bellow..

- (ii) Brazilian Energy Regulator (ANEEL) establish an X Factor for energy distribution companies applied on periodic tariff revision. X Factor is defined based on quality of services provided and productivity gains as defined by ANEEL, that can improve the remuneration if met, or reduce the allowed rates if not met.



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(iii) The rate regulation is basically fixed per unit, with no flexibility.

(iv) Tariff revisions and adjustments prescribed by the concession agreements may be summarized as follows:

- Annual tariff adjustment - pass-through of variation in Portion A costs and adjustments for inflation in Portion B, plus or minus X Factor.
- Extraordinary tariff revision - at any time when there is an economic and financial unbalance of the concession agreement.
- Periodic tariff revision - Portion B, every three to five years

At each annual adjustment within the tariff period, the amount of Portion A is obtained based on the effective conditions of each one of the items that form said portion (energy purchased, regulatory charges and other). The amount of Portion B is adjusted based on the IGP-M (inflation index) variation in the twelve months period prior to the annual tariff adjustment date, adjusted by X Factor. These rules encourage concessionaires to optimize operating costs (covered by Portion B of revenue) during the period prior to the next periodic tariff revision, as actual costs lower than costs considered in determination of level of tariffs means higher returns for investors.

3. The rights and obligations established by the rate regulation

Information about the nature and amounts of a reporting entity's economic resources and claims can help users to identify the reporting entity's financial strengths and weaknesses. It is important for us to understand what rights and obligations are commonly established by rate regulation so that we can identify more clearly the types of economic resources and claims that might arise. At this stage, we are looking for a factual summary of the rights and obligations created by the rate regulation. We are not asking respondents to analyse whether those rights and obligations should be recognised as assets and liabilities in IFRS financial statements. That analysis will be done when developing the Discussion Paper.

Question 3

What sort of rights or obligations does the regulation create?

In providing this information, please consider:

- (a) whether the rate-regulated entity has an exclusive right to operate in the market;**
- (b) if the entity's right to operate in the market is established by licence:**
 - (i) is there a cost to acquire the licence; and**
 - (ii) can the licence be revoked, renewed or transferred;**



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- (c) how competition is excluded or encouraged;
- (d) how the rights and obligations are expressed, for example, as a cap on the rate of return, as the right to recover entity-specific costs, as a right to recover an allowed level of costs (whether or not incurred by the entity), or as a right to recover specific types of costs without limit if and when incurred; and
- (e) whether the entity can choose to stop providing the goods or services that are subject to rate regulation and, if so:
- (i) how is this achieved; and
 - (ii) what are the consequences for the entity?

(a) As mentioned before, except for limited exceptions, the energy distribution rate-regulated entity has an exclusive right to operate in its concession area (which is established as an area, state or region).

(b) (i) In general there is no cost to acquire the license energy distribution concession. Obviously, during the privatisation process (given that all distribution companies were originally owned by the government) or any subsequent business combination, part of the price paid refers to the concession right over the concession area assigned to the acquired entity. Therefore, the price paid to purchase distribution companies included concession in the business as a whole during the privatisation or other form of transfer of control - there is no specific payment to obtain the license in the energy distribution industry. In other regulated activities the concessionary may be required to make payments regarding the right of use concession assets, for using natural resources or other assets associated with the concession. For example: fixed and variable fees are paid by energy generation companies, concession road, concession airports and others.

(ii) Concessions grant rights in the relevant concession area for a specified period. For example, in the energy distribution sector, this period is usually 30 years for new distribution concessions. An existing concession may be renewed once at the granting authority's discretion.

The Concession Law establishes, among other things, the conditions that the concessionaire must comply with when providing services, the rights of consumers, and the obligations of the concessionaire and the granting authority. Furthermore, the concessionaire must comply with regulations governing its sector. The main provisions of the Concession Law are summarized below:

Adequate service. The concessionaire must render adequate service with respect to regularity, continuity, efficiency, safety and accessibility.

Use of land. The concessionaire may use public land or request the granting authority to expropriate necessary private land for the benefit of the concessionaire.



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In such case, the concessionaire shall compensate the affected private landowners.

Strict liability. The concessionaire is strictly liable for all damages arising from the provision of its services.

Changes in controlling interest. The granting authority must approve any direct or indirect change in controlling interests in the concessionaire.

Intervention by the granting authority. The granting authority may intervene in the concession, by means of a presidential decree, to ensure the adequate performance of services, as well as full compliance with applicable contractual and regulatory provisions. The concession returns to the concessionaire if the granting authority's representative decides not to terminate the concession and the concession term has not yet expired.

Termination of the concession. The termination of the concession agreement may be accelerated by means of expropriation and/or forfeiture. Expropriation is the early termination of a concession for reasons related to the public interest that must be expressly declared by law. Forfeiture must be declared by the granting authority after the regulatory agency or the government has made a final administrative ruling that the concessionaire, among other things, (i) has failed to render adequate service or to comply with applicable law or regulation, (ii) no longer has the technical, financial or economic capacity to provide adequate service, or (iii) has not taken remediated actions in responses to the penalties assessed by the granting authority. The concessionaire may contest any expropriation or forfeiture in the courts. The concessionaire is entitled to indemnification for its investments in expropriated assets that have not been fully amortized or depreciated, after deduction of any fines and damages due by the concessionaire.

Expiration. When the concession expires, all assets, rights and privileges that are materially related to the rendering of the services revert to the Brazilian government. Following the expiration, the concessionaire is entitled to indemnification for its investments in assets that have not been fully amortized or depreciated as of the expiration.

Penalties. The regulatory agency or the government may impose sanctions against the participants in the sector and classify the appropriate penalties based on the nature and importance of the breach (including warnings, fines and forfeiture).

- (c) As mentioned before, energy distribution concessions are basically monopolies. There are no mechanisms to stimulate competition even though rate-regulation is a mechanism to promote efficiency.
- (d) In energy distribution industry there is unlimited right to recover "Portion A" costs. "Portion B" costs in general are not subject to any reimbursement or compensation mechanism.



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(e) No. Concession agreement establishes that a grantee may enter in a legal process to require agreement annulment, when grantor does not comply with concession agreement terms. In fact, we do not have history of contracts early terminated by grantees in the concession sectors.

4. The enforcement of rights and obligations

To help us to identify what features of the rate regulation might create economic resources for or claims against the rate-regulated entity, it is important for us to understand how the rights and obligations established by the rate regulation are enforced or settled respectively.

Question 4

For the rights and obligations identified in response to Question 3, how does the rate-regulated entity enforce its rights, or how does the rate regulator enforce the settlement of the rate-regulated entity's obligations?

In providing this information, please tell us:

- (a) does the rate regulation provide for retrospective recovery or reversal of under- or over-recoveries of allowable costs? If so, how is this achieved, for example through cash payments or other asset transfers to or from parties outside the rate-regulated entity (such as individual customers or groups of customers, the rate regulator or the government);**
- (b) are the rights and obligations separable from the business; and**
- (c) what happens to the rights or obligations when the entity ceases provide the rate-regulated goods or services?**

(a) Rate regulation does provide a retrospectively recovery or reversal of under-or-over recoveries of allowable costs, specifically "Portion A" costs. All compensation shall occur through future billings via tariff increases.

(b) No, rights and obligations are not separable from the business.

(c) When the entity ceases providing the rate-regulated services the infrastructure shall return to the grantor (federal government). At this point, the concessionary has the right to receive an indemnification related to non-amortized investments (infrastructure) and, by analogy, Portion A balances will be part of this indemnification. This understanding is widely accepted in the industry.



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5. The recovery or reversal of cost and income variances

We understand that, in many rate-regulatory schemes, the rate-setting mechanism uses estimates of future costs and income as well as actual costs incurred. In such circumstances, the rate regulator usually requires that the rate-regulated entity must keep records of variances between the estimated and actual amounts. These variance amounts are then recovered or reversed over an agreed period of time through inclusion in the calculation of future rates, either automatically or with the approval of the rate regulator.

Irrespective of whether these variance amounts are recognised in general purpose financial statements, we want to learn more about the effectiveness of the rate regulation in ensuring their recovery or reversal, particularly when there have been shifts in demand for the regulated goods or services.

Question 5

How does the rate regulation ensure the recovery or reversal of under- or over-recoveries of allowable costs (ie variance amounts) (if applicable)? Are these mechanisms effective in recovering or reversing those amounts within the targeted time frame?

In providing this information, please tell us:

- (a) what is the mechanism for tracking the recovery or reversal of such variance amounts;**
- (b) how does the rate-setting mechanism adjust for unexpected changes in demand for the rate-regulated goods or services;**
- (c) has there been a recent trend whereby the balances of the variance amounts have been increasing? If so:
 - (i) is this caused by an increase or a decrease in the demand of the rate-regulated goods or services;**
 - (ii) has the trend resulted in a net debt position (ie under-recovery of costs) or a net credit position (ie over-recovery of costs); and**
 - (iii) what are the main components of the variance amounts (ie what are the main categories of cost or income variances)?****

(a) There are specific rules issued by the regulator that establish the mechanism to ensure the recovery or reversal of under- or over-recoveries of allowable costs (i.e. variance amounts) and these mechanisms are usually effective in recovering or reversing those amounts within the targeted time frame (usually in 12 months). Especially for the energy distribution sector, the mechanism for tracking the recovery or reversal of such variance is based on “regulatory financial statements” and other reports prepared by regulated distributors and audited by the regulator. The “regulatory financial statements” are required to be filed annually based on the



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regulatory rules with the Brazilian energy regulator (ANEEL). In this report and in accordance with the rules established by ANEEL, Portion A excess or deficit are currently reported as assets or liabilities and the PP&E is adjusted based on tariff basis (valued using replacement cost method established by the industry regulators).

(b) Changes in expected demand are uncommon but given that Portion A variances amounts have to be recovered via future billings, any change in demand that impacts this offsetting mechanism are carried over the following 12-months-period until the Portion A items are fully recovered.

(c) Yes, especially in the energy distribution sector.

(i) No. The trend is mostly related to the proportion of hydro versus thermal generation (increased tariffs in dry years).

(ii) The current trend (drought season) has resulted in a net debt position.

(iii) Main components of the variance amounts are composed by: acquisition of energy from thermal plants, which has higher costs when compared with the hydro generated energy that is the standard in Brazil. Recently, the Federal Government has provided temporary cost relief reimbursement to cover the additional costs generated by the acquisition of thermal energy, since the hydro plants were temporarily unavailable to supply all energy demanded by the distributors. This mechanism aims to provide a temporary cash relief to the concessionaries (as a "Portion A" extraordinary reimbursement) because in accordance with the current regulations Portion A costs only start to be compensated after the next tariff increase.



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If you have any questions about our comments, please contact us at operacoes@cpc.org.br.

Yours sincerely,

A handwritten signature in black ink, appearing to read 'Idésio da Silva Coelho Júnior', written in a cursive style.

Idésio da Silva Coelho Júnior
Chair of International Affairs
Comitê de Pronunciamentos Contábeis (CPC)