

29 May 2013

International Accounting Standards Board
30 Cannon Street
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Email: CommentLetters@ifrs.org

Dear Sirs/Madam

**SAICA SUBMISSION ON THE REQUEST FOR INFORMATION: RATE
REGULATION**

In response to your request for comments on the IASB's Request for Information on Rate Regulation, attached is the comment letter prepared by various industries which are subject to some degree of rate regulation. It was reviewed by the Accounting Practices Committee (APC) (which comprises members from reporting organisations, regulators, auditors, IFRS specialists and academics) of The South African Institute of Chartered Accountants (SAICA).

We thank you for the opportunity to provide comments on this document.

Please do not hesitate to contact us should you wish to discuss any of our comments.

Yours faithfully,

Sue Ludolph
Project Director – Financial Reporting

cc: Paul O'Flaherty (Chairman of the Accounting Practices Committee)

SAICA SUBMISSION ON THE REQUEST FOR INFORMATION ON RATE REGULATION

INTRODUCTION

The IASB has decided to restart the Rate-regulated Activities project, with the aim of developing a Discussion Paper that will identify and more clearly articulate:

- (a) the common features of rate regulation;
- (b) whether these common features create economic resources for, or claims against, a rate-regulated entity that should be recognised in IFRS financial statements; and
- (c) the information about the consequences of rate regulation that would be most useful for users of IFRS financial statements.

An early step in this process to develop the Discussion Paper is to identify the range of rate-regulatory schemes that stakeholders think should be included within the scope of the project. The IASB's Request for Information (RFI) is intended to assist in that process by obtaining high-level overviews of the types of rate regulation that are currently in force in order to provide factual evidence and examples on which to base the work. It would also indicate the extent to which IFRS reporting entities are subject to rate regulation. We have thus tried to include information regarding types of rate regulation, practical examples and actual regulatory mechanisms in the various jurisdictions (i.e. especially of the type that includes retrospective revenue adjustment clauses).

For the purpose of this response document we have covered five regulated sectors and regulatory regimes within South Africa, as set out in the table below:

Regulated sector	Enterprise	Ownership	Regulator
Electricity generation, transmission and distribution	Eskom Holdings SOC Limited	Public	National Energy Regulator of South Africa (NERSA)
Petroleum pipelines, loading and storage	Transnet SOC Limited; various others	Public and private	NERSA
Retail petrol supply	Various	Public and private	Department of Energy
Airports	Airports Company South Africa	Majority public	Regulating Committee (Dept. of Transport)
Ports	Transnet National Port Authority	Public	Ports Regulator of South Africa

In selecting these sectors and regulatory regimes we have used as one of the main criteria, a regulatory mechanism providing for adjustment of future allowed/regulated revenues due to outturn in predefined variables on which the original tariff determination of a prior period was based, in order to retrospectively compensate for such variances (it could also be described as retrospective adjustment of revenues of prior periods, achieved through adjustment of revenues of future periods).

A fair amount of information about the actual regulatory mechanisms in the various jurisdictions has been provided in this report to provide the background and details. The IASB might however find the general comments, principles and concepts to be

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more useful in determining the accounting implications/treatment/disclosure and assessing whether a specific accounting standard is needed for these activities. We have therefore provided reasonable detail in the General Comments section, of relevant principles and concepts.

GENERAL COMMENTS

It might be that the earlier debates on this issue struggled to reach consensus, not so much due to a difference of opinion regarding accounting principles but rather due to a difference in, or inadequate understanding regarding certain concepts and details of rate regulation. The IASB is thus commended that this process commences by specifically attempting to firstly develop a common and adequate understanding of rate regulation. In that context and as requested in the RFI, we provide below a general discussion of the matter of rate regulation, in addition to the direct responses to the specific questions raised by the IASB.

The RFI emphasises the matter of the common features, characteristics and objectives of rate regulation. In that regard it would be useful to consider the overall objectives of rate or economic regulation. The quotation below is representative of the typical description of the overall objective, which could be found in any number of textbooks on economic regulation:

“In economic theory, efficient prices are defined as prices that approach marginal cost, which is the level achieved under – perfectly – competitive conditions. Economic regulation is generally introduced when market failures prevent effective competition and is aimed at mimicking the competitive conditions to steer prices towards efficient levels”.

“ ...if well-implemented, economic regulation should lead to efficient prices...”¹

In the typical asset-intensive regulated industry, concepts such as Long Run Marginal / Incremental Cost (LRMC / LRIC) and Levelised Cost of Electricity (LCOE) are thus highly relevant and important, both in the process of investment decisions as well as in tariff setting – especially tariffs in terms of long term bi-lateral contracts (note: although bi-lateral contracts might seem outside of the scope of this discussion paper, it may well be that long-term bi-lateral contracts contain similar retrospective rate adjustment clauses as are encountered in rate regulated environments).

A Note on LCOE

In response to the request for where more detailed information could be obtained, this insert provides a source reference regarding the concept of LCOE:

“The calculation of the LCOE is based on the equivalence of the present value of the sum of discounted revenues and the present value of the sum of discounted costs. The LCOE is, in fact, equal to the present value of the sum of discounted costs divided by total production adjusted for its economic time value.

¹SOURCE: Storer, D. and Teljeur, E. (2003) Administered Prices: Executive Report: A Report for National Treasury. Page 1.

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Another way of looking at LCOE is that it is equal to the price for output (electricity in our case) that would equalise the two discounted cash-flows. In other words, if the electricity price is equal to the levelised average lifetime costs, an investor would precisely break even on the project.....undiscounted price stays the same throughout the operating lifetime of the plant.”

SOURCE: International Energy Agency, Nuclear Energy Agency, Organisation for Economic Co-Operation and Development (2010) Projected Costs of Generating Electricity, 2010 Edition. Pages 33-35.

Although marginal cost remains an important criterion, in practice regulators might not directly reference marginal cost as an integral part of the typical regulatory pricing methodology².

Nevertheless, even where marginal cost is not used directly as a pricing mechanism, in striving for ‘just and reasonable’ rates (i.e. rates that balance the interests of both the rate-regulated entity and the entity’s customers) regulators would generally have regard to the long term financial-economic sustainability of the regulated industries. Rates that are below the level required to ensure the long term financial-economic sustainability of the regulated entity would generally not be in the best interest of the entity’s customers (assuming an acceptable level of cost and technical efficiency by the regulated entity). As such it must at least imply that all of the regulated entity’s efficient costs over the full operational life of an asset are recovered through the prices of products and services supplied to its customers, including the original acquisition cost of the asset as well as the cost of the capital employed. From a theoretical perspective, in the long term this would apply as an overall criterion/characteristic/feature for any type of rate regulation (acknowledging that in practice, particular short term dynamics might cause the situation to appear as if this is not true³).

Therefore, in essence any of the typical regulatory approaches e.g. ‘cost-of-service’ would ultimately attempt to set regulated revenue to be equal to the efficient cost of fuel (in the case of electric utilities) and operations, plus annual depreciation of the assets (as a mechanism to amortise the original asset acquisition cost over the life cycle of the asset), plus a return on the un-depreciated / un-amortised asset balance. This could result in a somewhat ‘front-loaded’ life cycle tariff profile on an individual asset (which could be quite severe in a high-inflation environment, given the typical long asset lives), however the averaging effect of a fleet of assets could moderate this sufficiently (especially if assets are acquired at regular intervals, instead of in

²Noting however, that marginal and incremental cost *studies* do often provide the basis for determining prudent costs, Time Of Use (TOU) pricing, pricing of special services such as standby tariffs for customers with generation and interruptible tariffs, energy efficiency programs, procurement of renewable resources, etc. LCOE might be especially useful as a basis or reference point for long-term bi-lateral contracts.

³One dynamic that might appear to distort this norm could be if a particular product or service is provided at below-cost, subsidised rates/tariffs. However from the regulated entity’s perspective it would still require all of the costs elements to be covered through its income stream. Ultimately it would imply that taxpayers would be paying higher rates of tax (*ceteris paribus*) as the only other alternative to cost-reflective rates/tariffs.

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‘batches’ a decade or more apart) and in the process result in average rates quite close to LRMC / LCOE.

Another often-used mechanism to address the ‘front-loading’ is to reference the regulatory rate of return to the ‘real’ weighted average cost of capital (WACC), in combination with an annual inflation indexation of the assets. In all cases however, the discounted present value of the life cycle revenues would be equal to what it would have been had tariffs been set at LCOE, and also equal to the original acquisition cost of the asset (assuming that the regulatory rate of return is equal to the discount rate used in the LCOE calculation and equal to the true risk-adjusted weighted average cost of capital).

As mentioned, regulated industries often provide their products or services from an integrated network or fleet of assets rather than from a single asset. The assets might differ in terms of their age, technology, cost structures etc. As such the rates required for each asset in order to recover its efficient costs would also differ. In the typical approach described in the previous paragraph above, it would imply that regulated revenues and tariffs related to individual assets could be set to recover the respective assets’ full efficient costs whilst the end-customer tariff would reflect an averaging of the tariffs for all of the various assets. The outcome in terms of end-customer regulated rates is thus usually closer to a weighted average of the LRMC or LCOE of the fleet of assets employed. Such an outcome would ensure that rates / tariffs are at their sustainable minimum i.e. adequate only to allow the regulated entity to recover its efficient cost including its cost of capital (assuming again, that the regulatory rate of return is equal to the discount rate used in the LCOE calculation and equal to the true risk-adjusted weighted average cost of capital).

Irrespective of the type of rate regulation and the details thereof, the above criteria and objectives would apply in looking at economically sustainable outcomes. Where this is not the case i.e. where investors are faced with the prospect of not recovering their risk-adjusted cost of capital over the life cycle of the asset, it would obviously greatly dis-incentivise any investment in new capacity for these typically long-life infrastructure industries (this would apply to equity as well as debt capital). This would imply that the type of rate regulation would fail to serve the interests of the customers. For that reason one of the key objectives and criteria of sound rate regulation is ‘attraction of capital’ – and in order to achieve that there must be trust that the regulatory approach will enable the full recovery (through the prices of products and services supplied to its customers) of the regulated entity’s efficient costs over the full operational life of an asset, including the original acquisition cost of the asset as well as the cost of the capital employed.

In order for rates to move to levels lower than the levels conceptually described above, it would require further gains in cost and technical efficiency and perhaps the introduction of newer, lower-cost technologies. Hence, in combination with the regulatory methodology that attempts to allow full recovery of efficient costs, it is usually found that particular incentives apply that would encourage the regulated entity to continually strive for incremental efficiency gains in all aspects of the industry i.e. capital investment, operational and fuel cost, technical performance, asset utilisation etc.

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In practice, such incentives take various forms, and incentive mechanisms are often part of a 'cost-of-service' approach i.e. by designating some (or even, most) of the cost elements as not being subject to retrospective re-measurement. In such cases 'over-spending' relative to the assumptions made by the regulator in setting the rates and tariffs are for the account of the regulated entity and thus ultimately lead to a reduction in shareholder returns. Similarly, any 'under-spending' relative to the assumptions made by the regulator in setting the rates and tariffs would contribute to increased shareholder returns. The incentive mechanism functions on the expectation that the regulated entity would attempt to maximise its shareholder returns by making efficiency gains relative to the cost assumptions originally made by the regulator. In so doing, it provides the regulator with the opportunity to set the rates of all subsequent periods on such lower costs, thus benefitting customers.

This type of incentive is generally seen as appropriate to cost elements which management is able to adequately control and to accurately predict a number of years in advance. If the type of cost element is deemed to not be adequately controllable or predictable by management then the regulatory methodology usually would allow a retrospective re-measurement thereof, with concomitant adjustment to allowed/regulated revenues/rates/tariffs in future years in order to retrospectively recover/compensate for the variances between actual outcome (on predefined cost elements and other parameters and variables), and the assumptions originally made by the regulator in setting the allowed revenues/rates/tariffs of the particular prior year (with such recoverable variances often referred to as 'variance pass-through', 'claw back', regulatory assets/liabilities, clearing accounts, cost/revenue adjustments, regulatory deferral accounts etc.).

'Price-cap' and 'revenue-cap' types of regulation (often associated with 'incentive based regulation') are not entirely different to the 'cost-of-service' type as described above. Ultimately these methods should ensure that all of the regulated entity's efficient costs over the full operational life of its assets are recovered through the prices of products and services supplied to its customers, including the original acquisition cost of the assets and the cost of the capital employed. Price caps and revenue caps have other well understood characteristics:

- 'Price cap' regulation is generally more appropriate where there are mostly variable costs and not much fixed costs, and where the variable costs per unit of sales are deemed to be adequately controllable or predictable by management and where sales volumes are not as controllable or predictable.
- 'Revenue cap' regulation is seen as more appropriate where there are mostly fixed costs and not much variable costs, and where the fixed costs are deemed to be adequately controllable or predictable by management. It might also be utilised if there are material levels of variable cost, but where sales volumes are deemed to be quite stable, predictable and controllable and so too, variable costs per unit of sales.

In all cases however, the setting of the 'price cap' or 'revenue cap' would have regard to the same overall criteria and objectives as for 'cost-of-service' rate regulation. The 'capping' approach would however imply extensive incentives for further cost and technical efficiency i.e. gains achieved during the regulatory control cycle would

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contribute to increased shareholder returns (or conversely, imply a reduction in shareholder returns). The regulatory objective served by this approach would be to set the rates and tariffs of the subsequent regulatory control cycles on such improved level of costs and technical efficiency, which were achieved in response to the incentives.

In addition to these incentives, specific incentives might be incorporated in response to particular issues that are relevant to that industry or period, relating e.g. to environmental matters, service levels, etc.

In practice the distinctions between ‘cost-of-service’, ‘price cap’, ‘revenue cap’, ‘incentive based regulation’ etc. are not as clearly defined as might be thought. It would not be uncommon for ‘price cap’ or ‘revenue cap’ mechanisms to also incorporate ‘variance pass-through’ elements, or for ‘cost-of-service’ mechanisms to contain strong incentive elements. Thus, what are often found in practice are various forms of hybrids of the various approaches. However the basic underlying fundamentals, as mentioned, are not entirely dissimilar.

Regulators would often change or adapt the area of emphasis, in response to particular context or industry dynamics. If e.g. industry capacity is constrained and new capacity is quite urgently required, regulators might place less emphasis on further operational cost efficiency gains and rather emphasise capacity expansion incentives, during that period. In contrast, if there is surplus industry capacity, regulator might emphasise cost efficiency incentives. In terms of outcome this would not be incompatible with the overall objective of economic regulation as discussed at the start of this document, namely “.....*mimicking the competitive conditions*....” of a well-functioning market.

With regard to the ‘liquidation’ of the due amounts determined in terms of the various mechanisms for ‘variance pass-through’, ‘claw back’, regulatory assets/liabilities, clearing accounts, cost/revenue adjustments etc., some further common features, characteristics and objectives would also usually apply. In some cases the revenue adjustments are allowed to be made by the regulated entity during a financial year e.g. quarterly, by adjusting rates for the next quarter so as to take account of and retrospectively recover the due amount that had originated in a preceding quarter (even then, adjustments arising/pertaining to the final quarter of a financial year would fall into a following financial year). In other cases the due amounts might only be provisionally determinable at the end of a financial year and would require an assessment by the regulator prior to ‘liquidation’ in a following financial year.

There are often some elements of regulatory judgement involved e.g. the recovery of ‘over-spending’ might be subject to assessment to determine whether such overspending was due to originally inaccurate or unrealistic assumptions by the regulator, or due to events outside of management control, or due to management inefficiency (i.e., not prudent). Similarly, in the case of ‘under-spending’ the regulator might want to confirm that it did not arise due to not executing projects or programmes which the regulated entity were required to do – if the regulator concludes that such non-execution caused the ‘under spend’ it might ‘pass through’ such previous underspend to consumers by adjusting future rates lower, with the intention to factor such expenditure into the rates when the projects or programmes do take place.

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In all cases, the administration and application of these mechanisms are greatly facilitated if the regulatory methodology and detailed rules are sound, objective, sufficiently detailed, clear, transparent and predictable. The confidence, probability and accuracy with which amounts are determined for financial accounting and reporting purposes would to some degree be a function of whether the regulatory rules and regulatory environment meet these criteria.

National legislation and government policy are central aspects of the context within which regulatory decisions on matters such as methodologies, rules and rate determinations are made. Precise, sound and clear legislation and policy prescriptions function as a limit to regulatory judgement and discretion and further increase confidence in, and predictability of the creation of firm rights and obligations pertaining to regulatory assets and liabilities.

The debt/credit risk of a regulated entity is essentially a function of the risk assessment of the regulatory environment and regulatory methodology and rules, especially if all, or a material portion, of the entity's revenue is subject to rate regulation. As such, credit rating agencies analyse and assess the regulatory environment in depth, in performing credit rating assessments. The matters considered by the rating agencies for such assessment might have some relevance to the assessment and auditing of accounting transactions and financial reporting disclosure. Moody's, Standard & Poor, Fitch etc. have developed specific rating methodologies for regulated entities, which are available in the public domain. In addition, they perform regular credit risk updates which are also published. These additional resources might offer useful perspectives to consider.

Another often-found characteristic of regulatory revenue adjustment mechanisms (including regulatory assets/liabilities /variance / clearing / deferral accounts etc.) is that the balances are usually subject to interest charges, reflecting the actual or opportunity interest cost on balances whether positive or negative.

Regulatory revenue/rate/tariff determinations are typically set in advance, on the basis of forecasts and assumptions. In effect, the presence of regulatory revenue adjustment mechanisms is acknowledgement that the original regulatory revenue/rate/tariff determination is 'provisional' to some extent i.e. subject to retrospective re-measurement and adjustment/reconciliation. It thus implies that to some extent the original revenue/rate/tariff determination was not a final determination of the revenue/rate/tariff (although it might have been a final determination of e.g. the allowed percentage/percentage band for the return on assets, and of some other elements in the overall regulatory determination).

As discussed already, the usual recovery/'liquidation' mechanism for regulatory revenue adjustment mechanisms (positive or negative balances) in order to effect the retrospective re-measurement and adjustment/reconciliation of previous years' regulatory revenue, is to adjust future revenues/rates/tariffs, either higher or lower compared to what it would otherwise have been. In some cases the regulated entity might have the right to adjust tariffs on a quarterly basis (i.e. during the financial year) in order to retrospectively recover variances related to a previous quarter. In other cases tariffs might be firm (unchangeable) for a year and could only be adjusted in a following year, in order to retrospectively recover such variances related to a previous

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year – i.e. variances/adjustments that originate in one year are recovered by changing tariffs in a following year. Even on the quarterly adjustment basis it could of course happen that the adjustments related to the final quarter of a financial year would be recovered in the following financial year.

The question could be asked, even just from a theoretical perspective, what would happen to regulatory revenue adjustment mechanisms (on positive or negative balances) in the event that the regulated entity ceases functioning as a business or loses its regulatory licenses. The normal recovery mechanism (adjusting future rates) would not be available in this case.

One indication of the status of such balances would be if the regulatory methodology and rules, or the relevant legislation or government policy expressly addressed the matter. Another approach might be to consider the mandate of the regulator, namely *inter alia* to ‘safeguard the interests of customers’. In that context it would seem reasonable that the regulator would not merely ‘abandon’ the recovery of an amount which is due and owing to the broader customer base (which customers had previously by definition, ‘overpaid’), on the basis that the entity had ceased functioning. Considering that rate regulation is usually applied to large monopoly type infrastructure industries which often render ‘essential services’, it would seem hardly plausible that customers would also cease using the product or service. The likely scenario would be that the license to operate would have been transferred by the regulator to another operator, and with it probably the assets etc., of the previous operator. This would take place as a transaction between the previous and the new operators. It would be a simple matter for the transaction to account for the fact that the new operator / licensee would incur a known and quantified reduction in future revenues due to an earlier over-recovery of revenues by the previous operator. Similarly, with sound regulatory rules usually being applicable symmetrically, this would apply in the case of under-recovery by the previous operator. In this case it is likely that the previous operator could also if needed, enforce such recovery through litigation.

As a final observation, it should be noted that companies in recently established regulatory regimes (and in this case it could imply, less than “>15 years of being predictable and stable”⁴) often find themselves in the position that they inherit rates and tariffs that are below sustainable levels or below cost-reflectivity. The migration towards cost-reflectivity is then often phased-in over a prolonged period. If the regulatory methodology had been established on the normal principles e.g. on a cost-of-service basis, it then implies a prolonged period during which the full methodology is not implemented although there usually is an intention to achieve full implementation, sometimes by a certain date. In addition, newly established regulators as well as their governments often go through a period during which the regulatory legislation, policy, methodology and rules undergo some changes and developments, ostensibly on the road to and with the objective of achieving a sound, stable and predictable regulatory environment.

⁴ SOURCE: Moody’s Investors Services, Global Infrastructure Finance. Rating Methodology Regulated Electric and Gas Networks. August 2009. Page 11.

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SPECIFIC COMMENTS

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:

(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.

Rates and tariffs for essential services in South Africa (such as electricity generation, transmission and distribution; municipal electricity supply; gas and petroleum pipelines and storage; retail petrol supply; airport and aeronautical services, reserved postal services, and ports) are regulated (to various degrees) by reference to the cost of services provided.

Of these tariff regulated sectors, electricity generation, transmission and distribution; gas and petroleum pipelines and storage; retail petrol supply, ports; and aeronautical services have various regulatory mechanisms providing for adjustment of future allowed/regulated revenues in order to retrospectively recover/compensate for variances between actual outcome (on predefined cost elements and other parameters and variables), and the assumptions originally made by the regulator in setting the allowed revenues for prior periods. As such, the regulatory schemes in these sectors might, to various degrees, be seen as providing future financial rights and obligations by way of rules for adjusting tariffs to reconcile variance amounts. We have used this criterion (i.e. regulatory mechanism providing for ex post recovery/compensation of variances through adjustment of future allowed/regulated revenues) in selecting sectors and regulatory regimes within South Africa that could be considered in the IASB's forthcoming Discussion Paper⁵.

Reserved postal services are subject to revenue cap regulation by the Independent Communications Authority of South Africa (ICASA) in terms of the Regulations gazetted under section 30 of the Postal Services Act 124 of 1998. The revenue cap formula does not provide for any changes in volumes *ex post*. The regulations also do not provide for any mechanism to accommodate differences between the revenue allowed and the actual revenue earned. Other services such as telecommunications and financial services are covered by various forms of regulatory oversight in South Africa, but are not included in our comment letter as regulatory coverage is generally focused on matters such as competition and access (i.e. rather than the explicit

⁵ We have not covered gas pipelines and storage in this letter as the regulator's authority is similar regarding issuing of licenses and determining prices and tariff structures, although we note that there are some differences in legislation and regulatory methodology that one might wish to examine in a comprehensive study of these matters.

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setting/allowance of rates and tariffs as found in the sectors covered here). As such, South African experience in rate regulation of these sectors may not be as relevant to the forthcoming Discussion Paper.

With the above in mind we have focused our response on the following sectors and associated regulatory regimes that would appear to create some level of financial rights and obligations, and where the recognition of regulatory assets and liabilities may be of some relevance⁶:

Regulated sectors covered in our response

Regulated sector	Enterprise	Ownership	Regulator
Electricity generation, transmission and distribution	Eskom Holdings SOC Limited	Public	NERSA
Petroleum pipelines, loading and storage	Transnet SOC Limited; various others	Public and private	NERSA
Retail petrol supply	Various	Public and private	Department of Energy
Airports	Airports Company South Africa	Majority public	Regulating Committee (Dept. of Transport)
Ports	Transnet National Port Authority	Public	Ports Regulator of South Africa

Responses to questions 2-5 of the RFI are provided below for each of the regulated sectors covered in our response.

ELECTRICITY GENERATION, TRANSMISSION AND DISTRIBUTION

(Eskom Holdings SOC Ltd.)

(Response to questions 2-5)

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,

⁶ As an early adopter of IFRS, companies listed on the Johannesburg Stock Exchange have been required to comply with its requirements since 1 January 2005. As well, regulated State Owned Corporations (SOC) covered here (i.e. Eskom Holdings SOC Limited, Transnet SOC Limited, Airports Company South Africa) prepare their financial statements in accordance with IFRS.

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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?

The Electricity Regulation Act 4 of 2006 (section 2) sets out the fundamental objectives of regulation of the South African electricity supply industry in stating that the objects of the Act are to-

- “(a) achieve the efficient, effective, sustainable and orderly development and operation of electricity supply infrastructure in South Africa;*
- (b) ensure that the interests and needs of present and future electricity customers and end users are safeguarded and met, having regard to the governance, efficiency, effectiveness and long-term sustainability of the electricity supply industry within the broader context of economic energy regulation in the Republic;*
- (c) facilitate investment in the electricity supply industry;*
- (d) facilitate universal access to electricity;*
- (e) promote the use of diverse energy sources and energy efficiency;*
- (f) promote competitiveness and customer and end user choice; and*
- (g) facilitate a fair balance between the interests of customers and end users, licensees, investors in the electricity supply industry and the public.”*

In regard to the rate setting mechanism, the Act states that the setting or approval of prices, charges and tariffs, and the regulation of revenues:

- “(a) must enable an efficient licensee to recover the full cost of its licensed activities, including a reasonable margin or return;*
- (b) must provide for or prescribe incentives for continued improvement of the technical and economic efficiency with which services are to be provided;*
- (c) must give end users proper information regarding the costs that their consumption imposes on the licensee's business;*
- (d) must avoid undue discrimination between customer categories; and*
- (e) may permit the cross-subsidy of tariffs to certain classes of customers.”*

Of further relevance to this discussion point, the South African Government's *Electricity Pricing Policy* (Policy Position 1) states that:

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“The revenue requirement for a regulated licensee must be set at a level which covers the full cost of production, including a reasonable risk adjusted margin or return on appropriate asset values” ,,,

Having consideration of relevant legislation and government policy, the National Energy Regulator South Africa (NERSA) has promulgated a regulatory methodology pertaining to the activities of generation, transmission and distribution of electricity of Eskom Holdings SOC Limited (Eskom).

Eskom Holdings SOC Limited is South Africa’s primary electricity supplier. The company, which is wholly owned by the South African government, generates, transmits and distributes electricity to industrial, mining, commercial, agricultural and residential customers, and to municipalities, which in turn redistribute electricity to businesses and households.⁷

The regulatory methodology applying to Eskom has as its objectives:⁸

1. *“to ensure Eskom’s sustainability as a business and limit the risk of excess or inadequate returns; while providing incentives for new investment;*
2. *to ensure reasonable tariff stability and smoothed changes over time consistent with socio-economic objective of the Government;*
3. *to appropriately allocate commercial risk between Eskom and its customers;*
4. *to provide efficiency incentives without leading to unintended consequences of regulation on performance;*
5. *to provide a systematic basis for revenue/tariff setting; and*
6. *to ensure consistency between price control periods.”*

NERSA characterises the regulatory methodology as “a cost-of-service-based methodology with incentives for cost savings and efficient and prudent procurement by the licensee (Eskom)” However, in practice NERSA’s regulatory decisions appear to be based largely on reducing prices to consumers (noting that Eskom has not achieved benchmark returns under the current scheme of regulation).

Supplementary to the references provided above, we would add a few comments relevant to questions (a) and (b) (i to iv):

- a) This matter is also covered under General Comments. Although particular short term dynamics might cause the situation to appear different, ultimately the objective should be that the regulated entity’s efficient costs over the full operational life of an asset should be recovered through the prices of products

⁷ Eskom Holdings SOC Limited, Annual Financial Statements 2012. Page 6

⁸NERSA, *Multi – Year Price Determination Methodology*, Annexure 1, December 2012 p.5

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and services supplied to its customers, including the original acquisition cost of the asset as well as the cost of the capital employed, with the only alternative being that taxpayers would be paying higher rates of tax, *ceteris paribus* (for example, due to the transitional situation in South Africa with electricity rates migrating towards cost-reflectivity over a period, it might appear as if this objective does not apply in the short to medium term).

Regulators generally have two main functions namely controlling participation in the industry through licensing, and setting rates/tariffs/revenues. The licensing function is also a mechanism through which objectives such as competition or diverse ownership can be promoted.

- b) Electricity regulation in South Africa is relatively new (with economic regulation of electricity <15 years old) and very much in a transitional phase towards cost-reflective tariffs. Whilst cost-reflective tariffs remain a stated policy objective, the present focus is probably on gradual transition, by allowing the most time for customers to adjust to cost-reflective tariffs (i.e. through awarding the lowest possible tariffs that would balance the short and medium term cash requirements of the utility, in order to achieve the longest possible time for customers to adapt). Elements of 'rate of return' exist, combined with incentives (cost, technical, environmental etc.). Regulatory methodology and rules are very much under development and not as clear as in established jurisdictions. Some price setting flexibility exists, sometimes within existing rules and sometimes on the basis of further rule development.

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;
(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?

The rights and obligations of the service provider (i.e. Eskom) and regulator (i.e. NERSA) are set out in various legislative instruments. Relevant to the points of discussion, Eskom's right to operate in the market is established by licence to generate, transmit and distribute electricity. These licences do not provide market exclusivity, and official government policy is to allow competition. However in practice there is, with the exception of the procurement of a small amount of Independent Power Producers' (IPP) power by government, very little competition in the generation, transmission and distribution of power in South Africa.

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Under the Act, the regulator may make any licence subject to conditions relating to-

- “(a) the establishment of and compliance with directives to govern relations between a licensee and its or end users, including the establishment of or end user forums;*
- (b) the furnishing of information, documents and details that the Regulator may require for the purposes of this Act;*
- (c) the period of validity of the licence in accordance with section 20;*
- (d) the setting and approval of prices, charges, rates and tariffs charged by licensees;*
- (e) the methodology to be used in the determination of rates and tariffs which must be imposed by licensees;*
- (f) the format of and contents of agreements entered into by licensees;*
- (g) the regulation of the revenues of licensees;*
- (i) the setting, approving and meeting of performance improvement targets, including the monitoring thereof through certificates of performance;*
- (j) the quality of electricity supply and service;*
- (k) the cession, transfer or encumbrance of licences, including the compulsory transfer of a licence to another person under certain conditions, and terms and conditions relating thereto;*
- (l) the right to operate generation, transmission or distribution facilities, to import or export electricity, to trade or to perform prescribed activities relating thereto, including exclusive rights to do so, and conditions attached to or limiting such rights;*
- (m) the duty or obligation to trade, or to generate, transmit or distribute, electricity, and conditions attached to such duties or obligations;*
- (n) the termination of electricity supply to customers and end users under certain circumstances, the duty to reconnect without undue discrimination, and conditions relating thereto;*
- (o) the area of electricity supply to which a licensee is entitled or bound;*
- (p) the classes of customers and end users to whom electricity may or must be supplied;*
- (q) the persons from whom and to whom electricity must or may be bought or sold;*

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- (r) the types of energy sources from which electricity must or may be generated, bought or sold;*
- (s) compliance with health, safety and environmental standards and requirements;*
- (t) compliance with any regulation, rule or code made under this Act;*
- (u) compliance with energy efficiency standards and requirements, including demand-side management;*
- (w) the undertaking of customer or end user education programmes;*
- (x) the need to maintain facilities in a fully operational condition;*
- (y) the period within which licensed facilities must become operational; and*
- (z) any other condition prescribed by the Regulator.”*

As such, the conditions of license play a vital role in regard to the rights and obligations provided to the service provider and establish the means in which the regulator administers regulatory rules.

The right to operate and the exclusivity of that right are set out in the license conditions. There is not a cost to acquire a license from the electricity regulator, however for licensed generators there is an annual license fee. In regard to suspension, revocation and renewal of a licence:

The regulator may vary, suspend or remove any licence condition, or may include additional conditions—

- (a) on application by the licensee;*
- (b) with the permission of the licensee;*
- (c) upon non-compliance by a licensee with a licence condition;*
- (d) if it is necessary for the purposes of this Act; or*
- (e) on application by any affected party.*

The regulator may revoke a licence on the application of a licensee if—

- (a) the licensed facility or activity is no longer required;*
- (b) the licensed facility or activity is not economically viable;*
- (c) another person is willing and demonstrably able to assume the rights and obligations of that licensee in accordance with the requirements and objectives of this Act, and a new licence is issued to such a person; or*
- (d) conditions of a licence are not met.”*

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“Regarding renewal of a license –

- (1) Any generation or transmission licence issued in terms of this Act is valid for a period of 15 years or such longer period as the Regulator may determine.*
- (2) Any distribution or trading licence issued in terms of this Act is valid for the period determined by the Regulator.*
- (3) A licensee may apply for the renewal of his or her licence.*
- (4) An application for renewal must be granted, but the Regulator may set different licence conditions.*
- (5) A licensee may not assign a licence to another party.”*

A licence issued in terms of this Act empowers and obliges a licensee to exercise the powers and perform the duties set out in such licence and this Act, and no licensee may cede, transfer any such power or duty to any other person without the prior consent of the Regulator.

At present the right to recover revenue for the electricity utility is expressed as firstly the right to collect an ‘allowed revenue’ and based on that allowed revenue it is further expressed as an approved unit tariff (essentially being the allowed revenue divided by estimated sales volumes for different tariff categories). In addition, some of the assumptions regarding certain specified cost elements, volumes etc. are subject to ex-post re-measurement and retrospective revenue reconciliation / adjustment, within the parameters of the relevant regulatory rules. The net account balance (negative or positive) of such retrospective recoveries attracts interest at the prime rate, from the year during which the recoverable variance had arisen up to the year during which it is recovered through a change to that particular future years’ allowed revenue.

The General Comments section also discusses the situation of what would happen to regulatory revenue adjustment mechanisms (including regulatory assets/liabilities / variance / clearing / deferral accounts’ positive or negative balances), in the event that the regulated entity ceases functioning as a business or loses its regulatory licences – given that the normal recovery mechanism of adjustment to future rates would not be available in that case.

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 to provide the rate-regulated goods or services.*

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In regard to enforcing the rights of rate regulated entities (i.e. pertaining to the regulation of rates and tariffs) legislation sets out the conditions under which the service provider may appeal to the High Court for review of an administrative decision or action taken by the regulator. In terms of amendment bills which are going through the promulgation process at present, it is envisaged that a dedicated and separate energy regulation appeal authority would be established, with the rights to override and replace an original regulatory decision.

The regulator's powers of enforcement are set out in the Act whereby penalties may be imposed on the licensee for contravention of a condition of license of up to 10 per cent of the annual turnover of the licensee or R2 000 000,00 per day (whichever is the higher amount) as of the date of receiving notice from the regulator. In addition, as set out in response to Question 3 above, the regulator may vary, suspend or remove any licence condition, or may include additional conditions upon non-compliance by a licensee with a licence condition, and may revoke a licence on the application of a licensee if conditions of a licence are not met. In addition, non-performance or non-compliance with a licence condition might jeopardise a licensee's application for licence renewal.

In regard to the more specific issue of creation of regulatory assets and liabilities, the regulatory methodology applying to electricity generation, transmission and distribution provides for adjustment of future allowed/regulated revenues in order to retrospectively recover/compensate for variances between actual outcome (on predefined cost elements and other parameters and variables), and the assumptions originally made by the regulator in setting the allowed revenues for prior periods, by way of a regulatory clearing account (RCA) whereby debits and credits are applied to allowed tariffs in subsequent years. The details of this system of regulatory credits and debits are discussed in the section that follows. In general however, the rate regulation methodology provides for re-measurement of certain specified cost elements, volumes etc. and for retrospective compensation of variances through adjustment to end-user rates in subsequent years.

Whereas end-user rate adjustments are likely to be the only way in which customers could be affected, it might however happen (in the event that the regulated entity ceases functioning as a business) that the regulated entity could receive or make a cash-settlement of the regulatory asset/liability, or affect the settlement through other asset transfers. This issue is also discussed under General Comments.

In general the rights and obligations would be attached to the licensed activities. Rights related to 'regulatory assets/liabilities' would be separable upon transfer of licenses, i.e. from the previous licensee to the subsequent licensee.

Question 5

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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 debit 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)?

The regulatory methodology applying to electricity generation, transmission and distribution provides various adjustment mechanisms providing for adjustment of future allowed/regulated revenues in order to retrospectively recover/compensate for variances between actual outcome (on predefined cost elements and other parameters and variables), and the assumptions originally made by the regulator in setting the allowed revenues for prior periods.

The Regulatory Clearing Account (RCA) is the mechanism for tracking the recovery or reversal of such variance amounts. It includes adjustments related to variances between originally assumed/estimated sales volumes and final outcome. The main components are variances in externally-purchased fuel costs and in capital expenditure (with adjustment in the latter case relating to the interest components of the variance and not to the actual variance). Certain specified operational expenditure items are included, as well as changes in taxes and levies (excluding company income tax). In addition, sales volume variances and variances in inflation rates are accounted for. Finally, if the tariffs applied for a particular year fail to recover the allowed revenues (due e.g. to mix changes i.e. changes in the proportion that sales of the various different products constitute of the total volume of sales), the mechanisms would include that too.

While the rules for ex post revenue adjustments are codified in various regulatory instruments (such as the Methodology document referenced here) in practice the administration of such rules has been subject to considerable levels of regulatory discretion and is perhaps at present lacking in transparency and predictability. This issue is also discussed under General Comments (see final paragraph).

As a further general comment, in some methodologies it is also found that ‘overall’ risk mitigation mechanisms exist, e.g. if certain key financial metrics or credit ratings move outside of set parameters, it might trigger a ‘re-opening’ of the determination of allowed revenue. The outcome of such ‘re-opening’ is usually not specified in detail in advance although some broad parameters might be set out such as ‘to restore earnings to the acceptable range’.

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PETROLEUM PIPELINES, LOADING AND STORAGE FACILITIES

(Response to questions 2-5)

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?

The regulatory framework for economic regulation of petroleum pipelines, loading and storage facilities within South Africa is established in the Petroleum Pipelines Act No 60 of 2003. The objects of the Act are to:

- “ (a) promote competition in the construction and operation of petroleum pipelines, loading facilities and storage facilities;*
- (b) promote the efficient, effective, sustainable and orderly development, operation and use of petroleum pipelines, loading facilities and storage facilities;*
- (c) ensure the safe, efficient, economic and environmentally responsible transport, loading and storage of petroleum;*
- (d) promote equitable access to petroleum pipelines, loading facilities and storage facilities;*
- (e) facilitate investment in the petroleum pipeline industry;*
- (f) provide for the security of petroleum pipelines and related infrastructure;*
- (g) promote companies in the petroleum pipeline industry that are owned or controlled by historically disadvantaged South Africans, by means of licence conditions to enable them to become competitive;*

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- (h) promote the development of competitive markets for petroleum products;*
- (i) promote access to affordable petroleum products: and*
- (j) ensure an appropriate supply of petroleum to meet market requirements.”*

In regard to setting and approval of tariffs the Act requires that:

- (1) The Authority must set as a condition of a license the tariffs to be charged by a licensee in the operation of a petroleum pipeline and approve the tariffs for storage facilities and loading facilities.*
- (2) A tariff charged in terms of subsection (1)-*
 - (a) must be-*
 - (i) based on a systematic methodology applicable on a consistent and comparable basis;*
 - (ii) fair;*
 - (iii) non-discriminatory;*
 - (iv) simple and transparent;*
 - (v) predictable and stable;*
 - (vi) such as to promote access to affordable petroleum products;*
 - (b) becomes effective from the date set out in the licence;*
 - (c) must be reviewed by the Authority within the period set out in the licence; and*
 - (d) may be adjusted by the Authority on review.*
- (3) The tariffs set or approved by the Authority must enable the licensee to-*
 - (a) recover the investment;*
 - (b) operate and maintain the system; and*
 - (c) make a profit commensurate with the risk.*
- (4) The Authority must monitor the application of tariffs and take appropriate action when necessary to ensure that they are applied in a non-discriminatory manner and licensees must provide the information required by the Authority in this regard.*

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(5) *A licensee may request the Authority to review its tariff from time to time and may submit a proposal to the Authority in this regard, and-*

(a) *such proposed tariff, if set or approved, comes into effect from the date determined by the Authority;*

(b) *the existing tariff remains in force until a new tariff takes effect.*

(6) *A licensee may not charge a tariff for the licensed activity in question other than that set or approved by the Authority.*

The regulator (i.e. NERSA) has promulgated tariff methodologies for petroleum pipelines, and petroleum loading and storage facilities⁹. While administration and application of the two methodologies differ in various ways, the *rate setting mechanisms* are broadly equivalent in that they specify an annual Allowable Revenue amount on which tariffs are based. Allowable Revenue is defined as:

$$AR = (RAB \times WACC) + E + D + F \pm C + T$$

Where:

AR = Allowable revenue

RAB = Regulatory asset base

WACC = Weighted average cost of capital

E = Expenses: operating and maintenance expenses for the tariff period under review

D = Depreciation and amortisation of inflation write-up: the charge for the tariff period under review

F = Approved revenue addition to meet debt obligations for the tariff period under review (**NB** Not applicable to petroleum loading and storage facilities)

C = Clawback adjustment: to correct for differences between actuals and forecasts in formula elements from a preceding tariff period in relation to the actuals for that tariff period

T = Tax expense: estimated tax expense for the tariff period under review

Certain defined components making up Allowable Revenue are fixed so as to provide efficiency incentives; whereas other components are included in the “claw-back adjustment” to correct for differences between actual and forecasts in a preceding regulatory control period (This adjustment mechanism is described in our comments on question 4).

⁹See NERSA, *Tariff Methodology for the Setting of Tariffs in the Petroleum Pipelines Industry*, 5th Edition Approved: 31 March 2011; and *Tariff Methodology For The Approval Of Tariffs For Petroleum Loading Facilities And Petroleum Storage Facilities* 2nd Edition Approved: 31 March 2011

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For petroleum pipelines, the tariff is determined on a rolled-in volume-distance based tariff by dividing total allowable revenue by the total forecasted litre per kilometre throughput for the tariff period under review. As stated by NERSA, “The tariffs designed should generate sufficient revenue to recover approved costs, and at the same time fairly allocate charges to users in relation to the costs and benefits of different services.”

Operators of loading and storage facilities are given rather more flexibility in design of tariff structures, subject to the nature of the facility. There are numerous such facilities regulated by NERSA, and as such we will not go into the unique details associated with this sub-sector.

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;*
- (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?*

The right to operate in the market is established by licence which is issued by the relevant Authority (i.e. NERSA). As provided for under the section 15 of the Act:

(1) A person may not, without a licence issued by the Authority –

(a) construct a petroleum pipeline, a loading facility or a storage facility; or

(b) operate a petroleum pipeline, a loading facility or a storage facility.

(2) The Authority may-

(a) determine whether any person is engaged in any of the activities requiring a licence;

(b) direct any person engaged in any of the activities requiring a licence in terms of subsection (1) who is not in possession of the necessary licence to cease such activity.

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Any licence issued in terms of the Act is valid for a period of 25 years, and a licensee may apply to have his or her licence renewed.

- Every application for renewal must be granted if the licensee has complied with the licence conditions.
- A licensee may not sell or assign his or her licence.
- Any person taking over the business of a licensee must apply for a licence in his or her own right.

The Authority may revoke a licence on the application of a licensee if the service is no longer needed, economically justified, or if another person is willing to assume the rights and obligations of the licensee concerned.

The Authority may apply to the High Court for an order suspending or revoking a licence if there is any ground justifying such suspension or revocation (e.g. such as failure of the licensee to carry out the construction and operation activities for which the licence was granted).

In regulating rates and tariffs as a condition of license, the Act confers certain rights to the licensee in that the tariffs set or approved by the Authority must enable the licensee to-

- (a) recover the investment;*
- (b) operate and maintain the system; and*
- (c) make a profit commensurate with the risk.*

As well, Regulations promulgated by the Minister for Energy require that:¹⁰

- “(2) The tariffs set by the Authority must enable an efficient licensee to—*
 - (a) recover the reasonable operational and maintenance expenses of the pipeline in the year in which they are incurred;*
 - (b) recover capital investment and make profit thereon commensurate with the risk; and*
 - (c) rehabilitate land used in connection with a licensed activity.*
- (3) If the recovery of expenses contemplated in sub-section (2) (a) results in an increase of real tariffs by more than 10%, the Authority may direct that the recovery of such expenses be effected over a period of more than a year.”*

Question 4

¹⁰ Minister for Energy, “Regulations in Terms of the Petroleum Pipelines Act 2003” Government Gazette April 2008.

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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 to provide the rate-regulated goods or services?

Legislation sets out the conditions under which the service provider may approach the High Court for review of an administrative decision or action taken by the regulator.

The regulator's powers of enforcement are set out in the Act whereby penalties may be imposed on the licensee for contravention of a condition of license of up to R2 million per day as of the date of receiving notice from the regulator.

The regulatory methodology provides for retrospective recovery or reversal of under- or over-recoveries of specified allowable costs, whereby debits and credits are applied to allowable revenue in subsequent years. Further information on the adjustment mechanism is provided in the section that follows.

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 debit 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)?

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The regulatory methodologies applying to petroleum pipelines; and petroleum loading and storage facilities¹¹ provide a “clawback adjustment” mechanism in which defined variance amounts are recovered by way of an adjustment in allowable revenue applicable in the tariff period subsequent to the provision of audited financial statements of the applicable tariff period becoming available.

As set out in the tariff methodologies, the following formula must be used to determine the clawback adjustments:

$$\text{Clawback adjustment} = \text{VolA} + \text{DA} + \text{OeA} + \text{FA} + \text{KdA} + (\text{V-d})\text{A} + \text{CPIA} + \text{GA}$$

Where:

VolA = Volume adjustment

DA = Depreciation adjustment

OeA = Operating efficiency adjustment (only if more efficient)

FA = Revenue additions to meet debt obligations (F) adjustment

KdA = Cost of debt adjustment

(V-d)A = Value of operating property, plant, vehicles and equipment adjustment

CPIA = Consumer price index adjustment

GA = General adjustment for differences between projected and actual allowable revenue.

The components of the clawback formula are as described below (**NB.** as paraphrased by us from NERSA’s pipelines, and loading and storage tariff methodologies).

Volumes adjustment (VolA) - The volume adjustment compensates licensees and customers for differences between budgeted volume when the tariff is approved and the total actual volume throughput during the tariff period. Any adjustment in allowable revenue due to volume will be applicable in the tariff period subsequent to the licensee’s audited financial statements of the applicable tariff period becoming available. Projected volumes used in performing the calculation must be those used to determine the allowable revenue for the tariff period concerned. Any unexpected deviations from projected volumes and the factors that have led to such deviations must be explained by the licensee.

Depreciation adjustment (DA) - The depreciation adjustment provides for the differences between the projected depreciation made at the time the allowable revenue was determined and the actual depreciation for the specific tariff period (i.e. primarily due to variance in projected and actual assets).

¹¹See NERSA pipelines, and loading and storage *op cit*

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Operating efficiency adjustment (OeA) - NERSA characterises the OeA as “an incentive to licensees to increase operating efficiencies. It rewards licensees and customers for improvements in operating efficiency. This is determined as the difference between operating efficiency projections made when the tariff is set and the actual operating efficiency achieved during the tariff period.” 50% of the efficiency amount is clawed back from the licensee, allowing them to retain 50% of defined efficiency gains. Only improvements in efficiency are rewarded. Decreases in efficiency are not deducted.

Revenue additions to meet debt obligations adjustment (FA) - An adjustment factor is provided where allowable revenue does not enable the regulated activity to operate with a sufficient debt service cover ratio (as defined by the regulator). In such cases the regulator may allow for an increase in allowable revenues to meet projected debt obligations.

The FA is therefore a revenue adjustment mechanism that caters for differences between the debt obligations payments projections made when the allowable revenue was determined and the actual debt obligations payments made for that period.

Cost of Debt adjustment (KdA) - If there is a difference between the estimated cost of debt in the allowable revenue and the actual cost of debt for that tariff period then the allowable revenue must be recalculated using the actual cost of debt and the difference added to or subtracted from the clawback adjustment.

Value of new operating property, plant, vehicles and equipment adjustment (V-d)A - The operating asset adjustment compensates licensees and customers for differences in timing between the estimated date of a new asset becoming used and the actual date that the asset became used. (**NB.** Pertains to the return on assets that are to enter the regulatory asset base).

CPI Adjustment (CPIA) - The inflation adjustment compensates licensees and customers for differences between forecast and actual inflation rates.

General adjustment (GA) - The general adjustment is for any remaining differences between projected allowable revenue and actual allowable revenue not resulting from efficiency gains including tax.

NERSA has set out guidelines for regulatory reporting in which data is to be recorded to track relevant variance amounts.¹² The regulator and operators typically work through these reports, and other associated financial reports, to determine allowed adjustments to tariffs stemming from the clawback mechanisms.

RETAIL PETROL SUPPLY

(Response to questions 2-5)

Question 2

¹²See NERSA, *Regulating Reporting Manuals* Volumes 1-4, 2008

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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?

The petroleum industry is regulated by the South African government's Department of Energy which, in turn, is monitored by a Parliamentary Portfolio Committee.

The regulatory framework for petroleum-related activities in South Africa is established in the Petroleum Products Amendment Act (2006).

The objects of the Act are aimed at:

- a) promoting an efficient manufacturing, wholesaling and retailing petroleum industry;*
- b) facilitating an environment conducive to efficient and commercially justifiable investment;*
- c) the creation of employment opportunities and the development of small businesses in the petroleum sector;*
- d) ensuring countrywide availability of petroleum products at competitive prices; and*
- e) promoting access to affordable petroleum products by low-income consumers for household use.*

The Amendment Act entitles the Minister of Energy to regulate the prices, specifications and stock holding of petroleum products. The rate-setting mechanism is aimed at providing customers with affordable liquid fuels that fairly reflect the costs incurred to produce, including returns to the rate regulated entity.

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The petrol retail price is regulated by government, and changed every month on the first Wednesday of the month. The calculation of the new price is done by Central Energy Fund (CEF) on behalf of the Department of Energy (DOE). The price per unit is fixed for the period and does not provide flexibility to fuel retailers to change prices.

The petrol pump price is composed of a number of price elements and these can be divided into international and domestic elements as noted below:

- 1) Basic Fuel Price;
- 2) Slate levy;
- 3) Retail margin;
- 4) Customs and excise;
- 5) Fuel tax;
- 6) Delivery cost; and
- 7) Transport costs

1) Basic Fuel Price

The Basic Fuel Price (BFP) is based on what it would cost a South African importer to buy petrol from an international refinery and to transport the product onto South African shores.

The BFP formula replaced the In Bond Landed Cost (IBLC) formula on 2 April 2003. The IBLC was first introduced in the 1950s with the establishment of the first refinery in South Africa, and was previously revised in 1995, when a market spot price component was introduced. In a constantly changing world, the use of refinery gate prices posted by international refiners (known as postings) has become somewhat anachronistic in world trade as these no longer track international market prices consistently. This has resulted in the IBLC losing credibility as a reasonable proxy for international fuel prices and hence the BFP formula was introduced. This formula was negotiated with government and industry, African Minerals and Energy Forum (AMEF) and the South African Petroleum Industry Association (SAPIA) – agreeing on the new pricing formula, maintaining an import parity price structure.

The BFP formula reflects the realistic cost of importing a litre of product from international refineries with products of a similar quality compared to local South African specifications on a sustainable basis.

The BFP formula changes on the first Wednesday of every month based on the average daily international price movements and exchange rate fluctuations based on the “3-working day optimisation” mechanism. This means that the number of days between the first Wednesday of each month when fuel prices are adjusted and the last working day in which fuel price data is collected to determine price changes, will be restricted to 3 working days prior to the price change. For example, when fuel price was adjusted on 7 June 2012, the period used was from 26 April 2012 to 1 June 2012.

2) Slate levy

A levy paid by the motorists recovering money “owed” to the oil companies, due to the time delay in the adjustment of the petrol pump price.

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3) Retail margin

The retail margin is fixed by Department of Energy and is determined on the basis of actual costs incurred by the service station operator in distributing petrol such as rentals, interest, labour, overheads and profit. The way in which the margin is determined creates an incentive to service station operator to strive towards greater efficiency, to beat the average and to realise a net profit proportionate to their efficiency.

4) Customs and excise

A duty collected in terms of the Customs Union agreement.

5) Fuel tax

Tax levied by Government annually adjusted by the Minister of Finance in South Africa effective from the price change in April of each year, announced by the Minister of Finance in his annual budget speech.

6) Delivery cost

This element compensates marketers for actual depot related costs (storage and handling) and distribution costs from the depot to the end user at service stations. The value is calculated on actual historical costs of the previous year, averaged over the country and industry.

7) Transport costs

This element recovers the cost of transporting petroleum products from the nearest coastal harbour to the inland depot serving the area or zone.

The fuel price control system as administered by the Department of Energy and the CEF provides for monthly changes in the basic fuel price portion of petrol, diesel and illuminating paraffin prices, based on average over and under recoveries. Margins are usually changed by the Minister of Finance during the annual budget announcement and/or the Department of Energy.

The intention of the fuel pricing system is for the oil companies and retail service stations to earn a reasonable return, be unaffected by fuel taxes, and for the end consumer to bear the economic cost of, and taxes levied on fuels.

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;*
- (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*

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(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?

The Petroleum Products Amendment Act (2006) prescribes that a person may not be involved in the activities of manufacturing, wholesaling, holding or development of retail sites and retail sale of petroleum products without the appropriate licence having been issued in terms of the Amendment Act. The Amendment Act deems any person, who was, at the time of commencement of an act amending the Petroleum Products Act in 2003, involved in the aforementioned activities, to be a holder of a licence for that activity, provided such person has applied for such licence. Licences are controlled and issued by the Department of Energy.

Any licence issued in terms of the Act is valid for as long as the related business is a going concern and does not need to be renewed. A licensee may not sell or assign his or her licence. In addition, any person taking over the business of a licensee must apply for a licence in his or her own right.

The cost of acquiring a licence is set out below:

- a) R1 000 if entity has been operating before the Petroleum Products Amendment Act, No 58 of 2003.*
- b) R10 000 if entity has not been operating before the Petroleum Products Amendment Act, No 58 of 2003.*
- c) R5000 annual Manufacturing licence fee in respect of petroleum products manufactured from any hydrocarbon including petroleum, crude oil, natural gas, natural gas liquids, or coal or any combination thereof.*
- d) R500 annual Manufacturing licence fee in respect of petroleum products manufactured from other raw materials.*

In regulating the fuel price, the Act confers certain rights to the licensee in that the petrol price set by the Department of Energy is based on a fixed margin determined on the basis of actual costs incurred by a standardised service station operator in distributing petrol such as rentals, interest, labour, overheads and profit. The way in which the margin is determined creates an incentive to service station operators to strive towards greater efficiency, to beat the average and to realise a net profit proportionate to their efficiency.

Question 4

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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 to provide the rate-regulated goods or services?

The regulator's powers of enforcement are set out in the Act whereby penalties may be imposed on the licensee for contravention of a condition of license of up to R1 million or 10 years imprisonment as of the date of receiving notice from the regulator.

The regulatory methodology provides for retrospective recovery or reversal of under- or over-recoveries of specified allowable costs, whereby debits and credits are applied to tariffs in subsequent periods. Further information on the adjustment mechanism is provided in the section that follows.

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 debit 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)?

The slate levy is administered in terms of the Petroleum Products Act, 1977 (Act No 120 of 1977).

As the BFP is an import parity mechanism (calculated based on international final product prices (translated to rand) including the freight to bring the product to the nearest coastal harbour), the BFP of petrol and diesel is calculated on a daily basis.

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This daily calculated BFP is either higher or lower than the BFP reflected in the fuel price structures at that time.

If the daily BFP is higher than the BFP in the fuel prices, a unit under recovery is realised on that day. When the BFP is lower than the BFP in the price structures, an over recovery is realised on that day. An under recovery means that fuel consumers are paying too little for product on that day, whilst in an over recovery situation, consumers are paying too much for product on that day. These calculations are done for each day in the fuel price review period and an average for the fuel price review period is calculated. This monthly unit over/under recovery is multiplied by the volumes sold locally in that month and the cumulative over/under recovery is recorded by CEF on a cumulative over/under recovery account referred to as the "Slate".

With the introduction of the slate levy, the sole purpose was to manage the quantum of the slate when it is under-recovered. It is important to understand that the slate levy is paid to the CEF on production volumes at source, using the Duty At Source (DAS) rules. The claims against the fund that have been raised are then claimed on a sales basis, i.e. in proportion of a slate participant's portion of the slate.

The Minister of Energy implemented a self-adjusting slate levy mechanism on 24 August 2008. The slate levy element of the regulated fuel price is adjusted on the first Wednesday of every month and is based on the cumulative slate balance available at the time. In times when the cumulative slate account is under recovered, the CEF will make reimbursements to the oil companies (only if the balance is greater than R250 million).

In practice, oil companies do not make payments to the CEF when the cumulative slate account is over recovered. CEF, however, makes *ad hoc* payments to oil companies when the slate account is under recovered. Based on the self-adjusting mechanism referred to above, the Department of Energy and CEF adjust the slate levy element of the fuel price to either increase or decrease the cumulative slate account.

AIRPORTS COMPANY SOUTH AFRICA

(Response to questions 2-5)

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,

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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?

Airports Company South Africa (ACSA) is South Africa's predominant airport owner and operator. It was established under the Airports Company Act 44 of 1993 ("the Act") which transferred various airports which had previously been owned by the state and managed by the Department of Transport.

At the various airports, ACSA conducts both –

- activities which are directly related to the take-off and landing of aircraft at airports in South Africa, which are regarded as "aeronautical services"; and
- ancillary commercial activities and other services, which are regarded as "non-aeronautical activities".

The Act provides for the concept of "relevant activities" which are equivalent to the aeronautical services described above. For the purposes of the Act, a "relevant activity" is defined as the provision of any service or facility for the purposes of -

- “(a) the landing, parking or take-off of an aircraft;*
- (b) the handling or cleaning of an aircraft, the supply of provisions to an aircraft, including, but not limited to, food, or the emergency servicing of an aircraft on an apron, including the supply of fuel; or*
- (c) the handling of aircraft passengers or their baggage or of cargo at all stages while they are or it is on the premises of such airport, including the transfer of such passengers, their baggage or such cargo to and from an aircraft, but excludes the refreshment of passengers or the supply of consumer goods at such airport”.*

In terms of the Act, ACSA may levy "airport charges" on –

- the operators of aircraft in connection with the landing, parking or take-off of such aircraft at any of the Company's airports; and
- aircraft passengers in connection with their arrival at or departure from any of the Company's airports by means of an aircraft.

The Act requires that ACSA is in possession of a valid written permission in order to levy any “airport charges”. The process for obtaining a written permission is set out in the Act, whereby ACSA shall apply to the “Regulating Committee” for the issuing of a permission, and the Regulating Committee shall, after receipt of an application

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(including various conditions further set out in the Act) issue to ACSA a permission which shall be valid for a period of five years.

In regard to the level of permitted “airports charge”, under section 12(7) of the Act, the permission issued by the Regulating Committee may impose requirements in the form of conditions to the permission:

- (i) limiting the airport charges which the Company may charge aircraft operators and passengers and
- (ii) regarding service standards in respect of relevant activities conducted by the Company.

Under section 12(10) of the Act – which is of central importance to the matter of rate regulation - the Regulating Committee shall perform its duties and exercise its powers “*in such a manner as is best calculated to-*

- (a) restrain the company (i.e. ACSA) from abusing its monopoly position, in such a manner as not to place undue restrictions on the company’s commercial activities;*
- (b) promote the reasonable interests and needs of users of company airports;*
- (c) promote the safe, efficient, economical and profitable operation of company airports;*
- (d) encourage timely improvement of facilities at company airports so as to satisfy anticipated demands by the users of the airports; and*
- (e) in respect of relevant activities, ensure that the company after taking into consideration any compensation paid or to be paid to the company by the State in terms of the provisions of this Act or any other law, is able to finance its obligations and has a reasonable prospect of earning a commercial return for each financial year on capital employed.”*

The objectives of regulation referenced above are reflected in the regulator’s ‘Approach to Permission’ which sets out the general regulatory frameworks and methodology under which regulated charges are set, and specifically addresses its approach to a forthcoming permission cycle.¹³

The Act (section 12(9)) provides a considerable level of discretion to the regulator in terms of specific rate setting mechanisms that are to apply in that:

“the regulator may limit increases in the airport charges that may be levied –

¹³See Regulating Committee for ACSA and ATNS, *Approach to the 2010/11 to 2014/15 permissions*, April 2009.

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“(i) by means of a system of price regulation in which changes in airport charges are formally linked to the rate of inflation; or

(ii) in any other manner; ,,”

In practice, the rate setting mechanism employed is a combination of rate of return and incentive based regulatory methods. As described in the Approach to Permission,

“The Act requires the Committee to regulate both the Companies’ investments and its efficiencies. It is from these requirements that a combination of the price cap and the rate of return methodologies are utilised for setting tariffs. A combination methodology ensures that a reasonable rate of return is used as a base to ensure that the Companies obtain market related returns on their assets while requiring them to remain competitive by incentivising them to find more efficient ways of doing business.”

The combination of rate of return and price cap methods is reflected in the use of a cost based revenue allowance to determine initial base tariffs and a CPI – X mechanism applied to define allowed changes in tariffs (on a revenue weighted percentage basis) from year to year. The calculation of initial “base tariffs” and conversion to an annual revenue weighted percentage tariff increase document is provided below (as paraphrased by us from the Approach document (*op cit*)).

Calculation used to set initial (base) tariffs i.e. “building blocks approach”:

- (1) The regulatory asset base (RAB) is determined (within guidelines provided by the regulator) for each forecast year;
- (2) A reasonable rate of return is determined by the Committee for the Company;
- (3) The reasonable return is applied to the RAB and translates to a maximum return (annually) that is envisaged to be earned by the Company based on the RAB amount determined;
- (4) The costs of the company are then taken into account. These costs include operating costs, depreciation and tax on operating profit (but exclude interest and tax implications of interest);
- (5) The total revenue requirement is calculated using the costs above;
- (6) Forecast non-aeronautical revenue is deducted to arrive at aeronautical revenue;
- (7) Traffic forecasts are then used to translate aeronautical revenue into a price per unit;
 - The above is done annually for each period under review to balance the financial model.

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Annual revenue weighted percentage tariff increase

The price cap is referenced to a revenue weighted tariff basket. The revenue weighted percentage tariff increase for the period is less than or equal to:

$$(CPI_t - X_t + CF_t) + K_t$$

Where:

CPI_t is the CPI forecast at the beginning of period t for the period t

X_t is the subtractive balancing and efficiency factor

CF_t is the correction factor

K_t is the capital expenditure factor

The difference in tariffs between each period is then converted into a percentage increase or decrease from one year to the following year. The revenue weightings are typically set within guidelines provided by the regulator.

Company efficiencies are then taken into account and are factored in through the efficiency component of the X factor to further adjust the weighted tariff increase. This results in the weighted tariff increase being lower than the initial amount calculated in order to encourage efficiencies within the Company.

The combined X factors (being a combination of the balancing factor and the efficiency factor) are published for the five years of the permission period.

During the course of the permission further adjustments may be effected on the formula for correction and capital expenditure factors. The correction factor and capital expenditure factor are discussed in following sections.

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;*
- (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?*

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In terms of section 6(1)(a) of the Act, ACSA is responsible for the maintenance, management, control and operation of all the airports in South Africa which had been established or were in the process of being established as at 1 April 1993.

Moreover, the regulator may, as conditions of the permission to charge airports users:

- *“prescribe in respect of any relevant activity service standards which shall conform to internationally accepted and recommended practices.”*

ACSA’s rights to supply airports services are exclusive for the airports it owns and operates, but does not provide broad exclusivity to the market in general.

ACSA’s right to operate is predicated on compliance with a range of legislative instruments, but does not have an airports operating licence *per se* (i.e. the Act establishes the general condition, rights and obligations under which ACSA is to operate and maintain airport facilities.) As such, the issue of transfer and revocation of licence is not applicable, but the Act does set out conditions under which ACSA may close or sell facilities.

As noted in the previous section, the Act provides certain rights to ACSA in regard to the prospect of earning a commercial return for each financial year on capital employed, in that the Regulating Committee shall perform its duties and exercise its powers:

“in such a manner as is best calculated to- ...ensure that the company after taking into consideration any compensation paid or to be paid to the company by the State in terms of the provisions of this Act or any other law, is able to finance its obligations and has a reasonable prospect of earning a commercial return for each financial year on capital employed.”

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 to provide the rate-regulated goods or services?

Legislation sets out the conditions under which the service provider may approach the High Court for review of an administrative decision or action taken by the regulator.

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The Act confers certain powers to the regulator for non-compliance for rate related matters (i.e. section 14, 1-3 of the Act) -

- “(1) Any person who feels aggrieved by the failure of the company to comply with any provision of section 5 (2) or 12 (1) or (12), may lodge with the Committee a complaint, which shall be accompanied by proof of the failure.*
- (2) On receipt of any such complaint, or if the Committee on reasonable grounds suspects that the company fails so to comply, the Committee shall investigate such complaint or suspicion.*
- (3) If, after such an investigation, the Committee is satisfied that the company fails to comply with any provision mentioned in subsection (1), the Committee may in writing direct the company to comply with such provision within the reasonable period specified in such direction.*
- (3A) If, at the expiry of such period the company could have so complied but failed to do so, the Committee may -*
 - (a) by notice in the Gazette, prohibit any action of the company in relation to its non-compliance with such provision;*
 - (b) in writing direct the company to compensate for any loss sustained by or damage done to any person as a result of such action of the company; or*
 - (c) if such failure substantially prejudices the public interest, in writing, suspend or withdraw, on such conditions as may be determined by the Committee, any permission issued in terms of section 12.*
- (3B) In the event of a suspension or withdrawal under subsection (3A) (c), the company shall perform all relevant activities in a manner that -*
 - (a) is efficient and orderly; and*
 - (b) ensures the safety of aviation and security of people.*
- (3C) If the company fails to perform any relevant activity in accordance with subsection (3B), the Committee may take all reasonable steps to ensure such performance, including the performance of such activity by a person other than the company.”*

The regulatory approach provides an adjustment mechanism whereby tariff adjustments reflecting such variances specified components of the rate making formula. Further information on the adjustment mechanism is provided in the section that follows.

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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 debit 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)?

The regulatory approach established for setting allowable revenue and tariffs provides for a “Correction Factor Adjustment” and a “K Factor Adjustment whereby, under certain circumstances, under and over recovery of costs are reconciled via adjustment to permitted tariff increases. These adjustment mechanisms are described below.

The regulatory approach sets a cap on the permitted annual (revenue weighted) percentage tariff increase – inclusive forecast inflation. The **correction factor** is meant to account for variance in actual from forecast inflation, and is reconciled through an adjustment to permitted tariff increases on an annual basis.

As set out in the regulatory approach the correction factor in period t is equal to:¹⁴

$$[(CPI_{t-1} - X_{t-1} + CF_{t-1}) - (RWPTI_{t-1} - K_{t-1})] \times (1 + Prt_{t-1})$$

Where:

CPI_{t-1} = actual CPI for the year (t - 1)

$RWPTI_{t-1}$ = the sum of the permitted revenue weighted percentage tariff increases in year (t-1)

Prt_{t-1} = predominant prime overdraft rate in year (t - 1)

The formula calculates the difference between the actual tariff increases in a year ($RWPTI_{t-1} - K_{t-1}$) to the permitted tariff increase in that year ($CPI_{t-1} - X_{t-1} + CF_{t-1}$) taking into account actual inflationary movements. Due to unavoidable delays on implementation, this difference is then escalated by the prime interest rate ($1 + Prt_{t-1}$). This adjustment is applied when actual CPI data becomes available. The variance

¹⁴ Regulating Committee, Section B.9.4 op cit

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amount is therefore escalated by the prime interest rate($1 + \text{Prt}-1$) to account for the lag in reconciled amounts.

The **K factor** provides for extraordinary or especially lumpy once-off capital expenditures. As stated by the regulator:

“The K factor will thus be utilised where the Companies have convinced their clients and the Regulating Committee of the need to embark on a capital expenditure programme which is so extensive that it can neither be financed under the terms of the permission in place nor, for strategic reasons, delayed until the next permission.

Similarly, where a major capital expenditure programme is significantly curtailed or cancelled, a negative correction factor may be required. The Companies and the airline bodies in particular have the responsibility to jointly or individually timeously report any such event in writing to the Committee to enable the Committee the time to consider taking the required action.

The Regulating Committee believes that the K factor would only be effected in extraordinary circumstances and therefore does not envisage its application on a regular basis.”

Subject to various conditions placed by the regulator, where the actual capital expenditure incurred on a project or programme is less than / more than the forecast for the purposes of the permission (or nil, in the case of a project or programme not delivered) actual capital expenditure incurred is included in the RAB. Depreciation is adjusted consistent with the value of the asset included in the RAB. Implicit over-recovery / under-recovery of costs are reconciled by way of an adjustment to the permitted increase in tariffs.

For both correction factor and K factor adjustments, the primary onus to calculate the actual weighted tariff increase rests with the regulated companies (they are requested to submit an audit certificate annually) with the regulator retaining the right to audit the increases they report.

The granting of a correction factor adjustment and K factor adjustment is not an automatic process. The regulator has stated that it takes into consideration various factors, and that in fulfilling its statutory duties it will continue to exercise its discretion.

In practice, over the last several years once off adjustments to the RAB stemming from asset sales has lead to some of the more significant adjustments to permitted tariffs. Inflation variance is typically material and it is common to adjust tariffs on an annual basis to reconcile actual to forecast. Variance in traffic is not covered by the correction factor and therefore variance in demand is not explicitly addressed by the regulatory approach.

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TRANSNET NATIONAL PORTS AUTHORITY

(Response to questions 2-5)

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?

Transnet National Ports Authority (TNPA) - a division of state owned Transnet (SOC) Limited - was established under the National Ports Act 2005. As provided for in section 11(1) of the Act, the main function of the Authority is to own, manage, control and administer ports to ensure their efficient and economic functioning.

TNPA owns and manages the eight ports within South Africa namely: Saldanha Bay, Cape Town, Mossel Bay, East London, Port Elizabeth, Durban, Richards Bay and Port of Ngqura (which commenced operating on 10 October 2009). The business is divided into two service segments: the provision of port infrastructure and maritime services. Maritime services include dredging, navigation aids, ship repair and marine operations. TNPA's customers include terminal operators, shipping lines, ship agents, cargo owners and the clearing and forwarding industry.

Section 72 of the Act sets out Authority's obligations in relation to its tariffs in that:

“(1) (a) The Authority must, with the approval of the Ports Regulator, determine tariffs for services and facilities offered by the Authority and annually publish a tariff book containing those tariffs.

(b) The Authority may, with the approval of the Ports Regulator, amend the tariff book whenever it is necessary to do so.

(2) The Authority must, prior to any substantial alteration of a tariff, consult with the National Port Consultative Committee.

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- (3) *Subject to section 9 of the Competition Act, 1998 (Act No. 89 of 1998), the tariffs contemplated in subsection (1) may vary between ports.*
- (4) *Notwithstanding the provisions of this section, the Authority may enter into an agreement with a licensed operator or a party to an agreement or a port user for the variation of any tariff contemplated in subsection (1). “*

The Act also established the Ports Regulator whose main functions as provided for in section 30(1) of the Act are to-

- “(a) exercise economic regulation of the ports system in line with government’s strategic objectives;*
- (b) promote equity of access to ports and to facilities and services provided in ports;*
- (c) monitor the activities of the Authority to ensure that it performs its functions in accordance with this Act.”*

Section 30(2) of the Act further states that the Regulator must-

- “(a) hear appeals and complaints contemplated in sections 46 and 47, respectively, and investigate complaints contemplated in section 48;*
- (b) negotiate and conclude an agreement with the Competition Commission established by section 19 of the Competition Act, 1998 (Act No. 89 of 1998), to co-ordinate and harmonise the exercise of jurisdiction over competition matters, and to ensure consistent application of the principles of this Act;*
- (c) advise and receive advice from any other regulatory authority;*
- (d) consider proposed tariffs of the Authority, contemplated in section 72, in the prescribed manner;*
- (e) promote regulated competition;*
- (f) regulate the provision of adequate, affordable and efficient port services and facilities.”*

As authorised under section 30(3) of the Act, Directives were gazetted on 6 August 2009 and amended on 29 January 2010 relating to administration of the Regulator’s statutory duties.¹⁵

Relevant to the issue of tariff setting, Directive 23(1) requires the Regulator to consider whether the tariffs proposed by the Authority reflect and balance:

- “a) A systematic tariff that is applicable on a comparable basis;*
- b) Fairness;*

¹⁵Directives In Terms Of Section 30(3) National Ports Acts, Government Gazette, 6 August 2009 and

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- c) *The avoidance of discrimination save where discrimination is in the public interest;*
- d) *Simplicity and transparency;*
- e) *Predictability and stability*
- f) *The avoidance of cross subsidisations save where cross subsidisation is in the public interest; and*
- g) *The promotion of access to ports and efficient and effective management and operation in ports. “*

As provided in Directive 23(2) (as amended):

“In considering the Authority's proposed tariffs, and any subsequent proposed significant variations the Regulator must enable the Authority to –

- (a) recover its investment in owning, managing, controlling and administering ports and its investment in port services and facilities;*
- (b) recover its costs in maintaining, operating, managing, controlling and administering ports and its costs in providing port services and facilities; and*
- (c) make a profit commensurate with the risk of owning, managing, controlling and administering ports and of providing port services and facilities.”*

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;*
- (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?*

The Act (sec. 11(1)) states the main function of the Authority is to own, manage, control and administer ports to ensure their efficient and economic functioning, and in doing so the Authority must-

- “(a) plan, provide, maintain and improve port infrastructure;*
- (b) prepare and periodically update a port development framework plan for each port, which must reflect the Authority's policy for port development and land*

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use within such port;

- (c) control land use within ports, and has the power to lease land under such conditions as the Authority may determine;*
- (d) provide or arrange for road and rail access within ports;*
- (e) arrange for services such as water, light, power and sewerage and telecommunications within ports;*
- (f) maintain the sustainability of the ports and their surroundings;*
- (g) regulate and control-*
- (i) navigation within port limits and the approaches to ports;*
- (ii) the entry of vessels into ports, and their stay, movements or operations in and departures from ports;*
- (iii) the loading, unloading and storage of cargo and the embarkation and disembarkation of passengers;*
- (iv) the development of ports;*
- (v) off-shore cargo-handling facilities, including navigation in the vicinity of such facilities;*
- (vi) pollution and the protection of the environment within the port limits;*
- (vii) the enhancement of safety and security within the port limits;*
- (h) ensure that adequate, affordable and efficient port services and facilities are provided;*
- (i) exercise licensing and controlling functions in respect of port services and port facilities;*
- (i) ensure that any person who is required to render any port services and port facilities is able to provide those services and facilities efficiently;*
- (k) promote efficiency, reliability and economy on the part of the licensed operators in accordance with recognised international standards and public demand;*
- (l) promote the achievement of equality by measures designed to advance persons or categories of persons historically disadvantaged by unfair discrimination in the operation of facilities in the ports environment;*
- (m) prescribe the limits within which and the levels to which dredging may be carried out in the ports and the approaches thereto;*
- (n) provide or arrange for tugs, pilot boats and other facilities and services for the navigation and berthing of vessels in the ports;*
- (o) provide, control and maintain vessel traffic services;*

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- (p) promote the use, improvement and development of ports;*
- (q) advise on all matters relating to the port sector, port services and port facilities;*
- (r) promote greater representivity, in particular to increase the participation in 30 terminal port operations of historically disadvantaged persons;*
- (s) exercise the licensing of the erection and operation of off-shore cargo handling facilities and services relating thereto;*
- (t) discharge or facilitate the discharge of international obligations relevant to ports;*
- (u) facilitate the performance of any function of any organ of state in a port;*
- (v) promote research and development in the spheres of port services and facilities.”*

(2) The Authority may-

- “(a) undertake any other activities within a port that encourage and facilitate the development of trade and commerce for the economic benefit and interest of the national economy;*
 - (b) collaborate with educational institutions for the promotion of technical education regarding port services and facilities;*
 - (c) provide any service, including a port service or the operation of a port facility, which is required for the safe, efficient and orderly operation or management of a port;*
 - (d) perform such other functions as may be necessary in order to achieve the objects of this Act;*
 - (e) encourage and facilitate private and public sector investments and participation in the provision of port services and facilities;*
 - (f) enter into agreements in terms of this Act.*
- (3) The Authority may enter into any agreement with any other statutory body or organ of state in order to co-ordinate and harmonise the performance of functions similar or related to those of the Authority.*
- (4) The Authority as an operator of last resort must do everything reasonably necessary for the effective and economic management, planning, control and operation of ports.”*

The Authority’s rights and obligations with respect to operating are therefore derived from legislation rather than licence. In provision of ports services, the Act allows the Authority to charge fees in accordance with a tariff determined in terms of section 72, for-

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- “(a) the provision of port and other services, including-*
- (i) vessel traffic service charges;*
 - (ii) pilotage dues for the provision of pilotage;*
 - (iii) light dues for the provision of navigational aids along the coast of the Republic and within ports;*
 - (iv) towage dues for the provision of tug services;*
 - (v) berthing charges for the use of berthing facilities and services; and*
 - (vi) port and ship security;*
- (b) the provision and maintenance of port infrastructure, port terminals and port facilities, including-*
- (i) land rentals;*
 - (ii) port dues for the provision and maintenance of entrance channels, breakwaters, basins, navigational aids and maintenance dredging inside port limits;*
 - (iii) cargo dues for the provision and maintenance of port infrastructure-*
 - (iv) berth dues for vessels occupying quays or repair quays while not engaging in the loading or unloading of cargo;*
- (c) granting concessions and licences; and*
- (d) any other services provided by the Authority in the performance of its functions.”*

The Authority is the provider of last resort, and while it can enter commercial arrangements for third parties to provide ports services, the Authority remains ultimately responsible for provision of ports services. The Authority may only close a port which is non-viable and after Cabinet has issued a written directive authorising the closure of such port.

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

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(c) what happens to the rights or obligations when the entity ceases to provide the rate-regulated goods or services?

The regulator is currently developing a tariff methodology to be applied in assessing TNPA's tariff applications. In providing its comments to the Regulator, TNPA has noted that the Directive 23(2) (as amended) requires that:

“In considering the Authority's proposed tariffs, and any subsequent proposed significant variations the Regulator must enable the Authority to –

- (a) recover its investment in owning, managing, controlling and administering ports and its investment in port services and facilities;*
- (b) recover its costs in maintaining, operating, managing, controlling and administering ports and its costs in providing port services and facilities; and*
- (c) make a profit commensurate with the risk of owning, managing, controlling and administering ports and of providing port services and facilities.*

TNPA are of the view that “the Authority may in exceptional circumstances apply for an ex post adjustment to allowed revenues to deal with adverse outturns in forecast demand and/or costs in a preceding review period, which arise due to exogenous, unforeseen factors outside management control.”¹⁶

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 debit 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)?**

As reported by TNPA in their Position Paper on Tariff Methodology (*op cit*) the key purpose of applying claw-back is to ensure that the Authority or its customers do not gain or lose out from discrepancies between forecasts made at the time of the tariff

¹⁶TNPA, *Position Paper On Tariff Methodology For The Setting Of Tariffs By Ports Regulator*, Sept 2012.

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application and actual figures of capital expenditure, operating expenditure, depreciation, taxation, volume figures, volume mix and tariff structuring.

The effect of applying claw-back mechanism is that deviations from the revenue numbers approved by the Ports Regulator that are caused by reasonable forecasting differences are corrected through adjustments made on the allowed revenue.

TNPA has also proposed an F-factor, which as explained in their Position Paper:

“caters for differences between the revenue adjustment to meet debt obligation projections made when the allowable revenue was determined and the actual debt obligation payments made for that period. If the allowable revenue does not enable the Authority’s regulated activity to operate with debt service cover ratio (DSCR) acceptable, then additional revenue may be allowed.

In each period y, the Authority would repay to consumers any financing allowance granted in the previous period, y-1, compounded up one period by the WACC determined in that period to account for the time value of money.

If it is expected that the Authority will require a provision to finance its operations during period y, then the value would be added to allowed revenues for that period (and repaid with interest through a reduction in allowed revenue in period y+1).”

In recent regulatory tariff decisions the Ports Regulator has indeed implemented claw-back on this basis. Furthermore, in anticipation of a substantial increase in capital expenditure by the TNPA in the near future, the Ports Regulator has allowed the TNPA to retain a portion of the claw-back amount, to be used to off-set large expected future tariff increases. These amounts have been accounted for as an Excessive Tariff Increase Margin Credit (ETIMC) – with the ETIMC balance incremented by the WACC granted to the NPA in order to reflect the opportunity cost of capital¹⁷.

*** End of document ***

¹⁷ See Ports Regulator, Record of Decision: Tariff Application by the National Ports Authority for the Tariff Year 2012/2013, section 5.11, p13.