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## GENERAL NOTICES

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### NOTICE 1115 OF 2008



**Title: Regulatory Reporting Manual Volume 1:**

General Regulatory Reporting Procedures and Administrative Matters

**Purpose:** To prescribe and provide guidance to the regulated entities in the Energy Sector on the format, content, preparation and submission to the Energy Regulator of required information to perform its functions.

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## **Introduction**

### **1.1. List of Acronyms**

1. ABC – Activity Based Costing
2. CAM – Cost Allocation Manual
3. ERP – Enterprise Resource Planning
4. FAQ - Frequently Asked Questions
5. GRAP - Generally Recognised Accounting Practice
6. IFRS – International Financial Reporting Standards
7. IRBA – Independent Regulatory Board for Auditors
8. NBV – Net Book Value
9. PFMA – Public Finance Management Act
10. RRM – Regulatory Reporting Manual
11. RA – Registered Auditor
12. RAV – Regulatory Asset Value
13. RV – Regulatory Value
14. SA GAAP – South African Generally Accepted Accounting Practice
15. SLA – Service Level Agreement

### **1.2. Terminology**

1. Affiliate or Associate or Related Party- include corporations or business enterprises that are: - [1] members of the same group of companies as the Corporate Entity, including subsidiaries, joint venture partners, joint venture companies and other similar arrangements, and the group's associated companies over which the Corporate Entity's ultimate shareholder (where ultimate shareholder excludes the Government) can exert significant influence; and [2] companies outside the group of companies of which the Corporate Entity is a member, over which the Corporate Entity's ultimate shareholder (where the ultimate shareholder excludes the Government) can exert significant influence.
2. Cost Allocation – is the process of correctly assigning a single cost to more than one business unit, activity, process, product or service, based on the cost allocator, in a manner that prevents cross subsidization.
3. Cost Allocator - is a formula or ratio for sharing the cost of an activity among those which cause the cost to be incurred.
4. Cost Driver – is a measurable event or quantity which influences the level of costs incurred and which can be directly traced to the origin of the costs themselves.
5. Cross subsidisation – is when a firm, producing more than one product, uses the revenues from the sale of one product to cover the costs of producing another product or, the process of assigning costs between divisions/services/products in a manner that does not objectively reflect the manner in which the costs are incurred.

6. Direct Costs – are costs that are specifically incurred on behalf of a specific entity with an identifiable causal relationship with a business unit, activity, process, product or service. Direct assignment is applied in case of direct costs.
7. DME or Department – Department of Minerals and Energy of the Republic of South Africa.
8. Electricity Regulation Act - Electricity Regulation Act, 2006 (Act No 4 of 2006).
9. Energy Regulator – National Energy Regulator of South Africa (NERSA) established in terms of section 3 of the National Energy Regulator Act, 2004 (Act No 40 of 2004).
10. Fully Allocated Cost – is the total of all direct and indirect costs including cost of capital incurred in providing both regulated and non-regulated goods and/or services.
11. Gas Act - Gas Act, 2001 (Act No 48 of 2001).
12. Government – Government of the Republic in South Africa.
13. Historical Cost – “actual cost” or “original cost” or “purchase price” of the asset. Where no historical costs information exists, RAV is the deemed historical cost at the commencement of economic regulation.
14. Incremental Costing or Marginal Costing – is a pricing approach based on only the additional cost of producing a product/service while the pre-existing products/services support the fixed costs.
15. Indirect Costs - are those costs which are not directly assignable to a product or service, but incurred by an entity or business unit in producing the regulated product or service. This includes, but is not limited to, overhead costs, administrative and general costs, and taxes. Indirect costs are allocated based upon a methodology as set forth in this Manual.
16. Joint Costs – are those costs which do not have a specific, identifiable causal relationship with a particular entity or affiliate, but which benefit all affiliates/business units, or more than one. Joint costs are also referred to as common costs, and include corporate costs.
17. Licensee – a holder of a licence granted or deemed to have been granted by the Energy Regulator under the National Energy Regulator Act, 2004 (Act No 40 of 2004), Electricity Regulation Act, 2006 (Act No 4 of 2006), Gas Act, 2001 (Act No 48 of 2001), Petroleum Pipelines Act, 2003 (Act No 60 of 2003). Licensee and Regulated Entity shall be used interchangeably
18. Long-lived asset – Asset with economic (service) life that spans over several years
19. Manual – Regulatory Reporting Manual.
20. Minister – Minister of Minerals and Energy.
21. Modified Historical Cost - is historical cost indexed by inflation.
22. National Energy Regulator Act – National Energy Regulator Act, 2004 (Act No 40 of 2004).
23. National Treasury – Department of National Treasury of the Republic of South Africa
24. NERSA – National Energy Regulator of South Africa.

25. Petroleum Pipelines Act - Petroleum Pipelines Act, 2003 (Act No 60 of 2003).
26. Registered Auditor – means an individual or firm registered as an auditor with the IRBA.
27. Regulated Business - any licensee, service or activity that is subject to regulation by the NERSA in terms of the National Energy Regulator Act No 40 of 2004, the Electricity Regulation Act No 4 of 2006, the Gas Act No 48 of 2001, or the Petroleum Pipelines Act No 60 of 2003.
28. Regulated Entity – Regulated Business.
29. Regulatory Reporting Manual (RRM) – Detailed regulatory reporting procedures, requirements and guidelines to be implemented by the regulated entities.
30. Regulatory Financial Reports or Regulatory Financial Statements – financial records and reports or statements to be prepared and submitted to the Energy Regulator by a regulated entity as prescribed by this Regulatory Reporting Manual.
31. Service Life of Asset - estimated economically useful life of depreciable property as supported by engineering, economic, or other depreciation studies.
32. Shared Services – are services that are corporate or general purpose in nature, are used by various or all business units, but are not operations related.
33. Transfer Pricing – the pricing of products/services that one affiliate/business unit supplies to another affiliate/business unit of the same organization.
34. Unregulated Business - entity, service or activity that is not subject to regulation by the Energy Regulator.
35. ***Other accounting terminologies used herein, unless defined otherwise in the RRM, will take the same meaning as that given in the IFRS and/or South African SA GAAP/GRAP.***

### **1.3. Preamble**

The Energy Regulator requires sufficient and accurate information from regulated entities in order to make well informed decisions on issues of market demand, competition development, service quality/availability, financial health of the regulated entities and setting/approval of fair and reasonable tariffs aligned with the public interest.

To gather that information, the Energy Regulator is issuing this Regulatory Reporting Manual (RRM), for implementation by licensees for purposes of recording and submitting to the Energy Regulator, its financial information, both regularly in a systematic and consistent way. The goal is to have focused financial information relevant to economic regulation, which may at times differ from what is contained in statutory financial statements, to enhance efficiency and transparency of the regulatory process.

RRM not only provides a uniform system of regulatory financial reporting by regulated entities, but also requires accounting separation (also known as ring-fencing) when the regulated entity has other businesses that the Energy Regulator does not regulate or as the Energy Regulator may require separating different activities within a regulated entity.

RRM is in two sections. Section 1 (or Volume 1) contains general administrative issues and instructions that apply to all entities in the regulated the energy industry. Section 2 (or Volume 2, Volume 3 and Volume 4) contains industry specific charts of accounts, activity analysis and reporting templates.

### **1.4. NERSA Legislative Mandate to Prescribe Reporting Requirements**

Section 15 of Electricity Regulation Act, Section 21 of the Gas Act, and Section 20 of the Petroleum Pipelines Act, allows NERSA to prescribe licence conditions to regulated entities that may include, among other considerations, providing the Energy Regulator with required information to perform its functions. Section 21(1)(u) of the Gas Act and Section 20(1) (u) of the Petroleum Pipelines Act provide that, as a condition of licence "licensees must provide information necessary for the Regulator to perform its functions". Section 15(1)(b) of Electricity Regulation Act provides that "The Regulator may make any licence subject to conditions relating to the furnishing of information, documents and details that the Regulator may require for the purposes of this Act". Section 20(1)(e) of the Petroleum Pipelines Act also provides that, as a condition of licence, "the petroleum loading, pipeline and storage activities of vertically integrated companies may be required to be managed separately with separate accounts and data with no cross-subsidisation". In addition, as a licence condition, the Energy Regulator can prescribe tariff determination methodology. A tariff making methodology can have implications for account structure.

Pursuant to Section 47 of the Electricity Regulation Act, the Energy Regulator may, after consultation, make rules by notice in the *Gazette* that may relate to the keeping of information, the rendering of returns and the period for and format in which information must be kept, as well as the persons or institutions it must be rendered to.

Pursuant to Section 34 of the Gas Act, after consultation and duly considering public comments, the Minister may by notice in the *Gazette* make regulations regarding, among others, the rendering of information to the Energy Regulator.

Pursuant to Gas Regulation 17(1)(a), a licensee must submit to the Gas Regulator, in addition to any other information required, detailed audited annual accounts consisting of a balance sheet, income statement and cash flow statement for each licensed gas facility and activity.

Pursuant to Paragraph 16.5 of "The Regulatory Agreement Between the Minister of Minerals and Energy, the Minister of Trade and Industry and Sasol Limited in Terms of Section 36 of the Gas Bill with Regard to a Project to Import Natural Gas from Mozambique", the Energy Regulator will be responsible for the administration of this agreement. It is therefore implied that the Energy Regulator must be provided with the requisite information to fulfil its functions as envisaged in this agreement.

Pursuant to Section 33 of the Petroleum Pipelines Act, after consultation and duly considering public comments, the Minister must, as appropriate, by notice in the *Gazette* make regulations regarding, among others, the rendering of information to the Energy Regulator.

Section 45 of the Electricity Regulation Act and Sections 29 of both the Gas and Petroleum Pipelines Acts grants any person authorised by the Energy Regulator in writing right of entry to inspect, among others, books, accounts or other documents relating to the regulated entity. Furthermore, the Energy Regulator may require any person to furnish to the Energy Regulator such information, returns or other particulars as may be necessary for the proper application of these Acts. The Energy Regulator may require the accuracy of that information, return or furnished particular to be verified by way of oath/solemn declaration.

#### **1.5. Regulatory Functions of NERSA**

The role of NERSA is to regulate the electricity, piped gas, and petroleum pipelines industries. The powers and duties/functions of NERSA in terms of Sections 4 of all three enabling Acts include, among others, the following:

- ✓ Regulate electricity prices and tariffs; set tariffs for petroleum pipeline operation and approve tariffs for petroleum storage and loading facilities; regulate prices in terms of Section 21 (1) (p) of the Gas Act in the prescribed manner, monitor and approve and if necessary regulate gas transmission and storage tariffs and take appropriate action when

necessary to ensure that they are applied in a non-discriminatory manner as contemplated in section 22, and administer the agreement concerning the Mozambique Gas pipeline.

- ✓ Promote competition in the petroleum pipelines and gas industries as well as competitiveness and customer and end user choice in electricity.
- ✓ In electricity, establish and manage monitoring and information systems and a national information system, and co-ordinate the integration thereof with other relevant information systems; Gather and store information relating to construction, conversion and operation of petroleum pipelines, loading facilities, and storage facilities; Gather information relating to gas production, transmission, storage, distribution, trading, liquefaction, and re-gasification.
- ✓ Licensing in the electricity, piped gas, and petroleum pipelines industries.
- ✓ Compliance
- ✓ Dispute resolution

To fulfil these functions NERSA employs a range of regulatory tools, one being Regulatory Financial Reporting.

#### **1.6. Purpose of Regulatory Reporting Manual (RRM)**

The purpose of this Regulatory Reporting Manual (RRM) is to prescribe reporting procedures and requirements in order to achieve uniformity and consistent reporting of elements that are required for tariff setting, monitoring and/or tariff approval like: operating and maintenance expenses, capex/asset values, depreciation, taxes, return on investment as well as profit commensurate with risk.

Regulatory Financial Reports as set out in this Manual [1] accommodate financial segregation between regulated activities/products/services in a vertically integrated business [2] accommodate financial segregation of regulated business from non-regulated businesses, [3] incorporate current legislative requirements, [4] support the adopted regulatory methodologies in the regulated businesses, [5] provide guidance necessary for unbundling cost allocation and rate design, and [6] provide consistency of format in regulatory financial reports in the energy sector.

Implementation of the RRM will assist in bringing certainty to regulatory reporting requirements, providing an adequate information base for future price/tariff setting, monitoring financial health of the regulated entity, monitoring performance and improving transparency in the regulatory process and enhancing regulatory efficiency.

Expected Benefits from RRM implementation are:-

- a. Consistency of reported regulatory information which provides for easier understanding and submitting of tariff applications. The RRM also ensures the information requested for



regulatory purposes is submitted correctly and should reduce further information requests. There is value in reporting in a consistent basis from year to year.

b. Comparability of information over time both within and between regulated entities

It is much easier to compare information when it has been recorded on a consistent basis thereby improving the Energy Regulator's ability to test whether applications and budgets are reasonable. Standardization allows the development and calculation of metrics and performance measures that can be used for comparison purposes and starting point to understanding variations.

c. More complete and comprehensive applications

To a great extent, it will help resolve the issue of how much and what type of information to include in a regulatory application which in turn will result in reduced information requests. Both the regulated entity and the Energy Regulator will have greater certainty on regulatory reporting requirements.

d. Regulatory efficiencies

It will engender high standards, quality applications on a consistent basis, better understanding of applications, reduce information requests and hence lead to more regulatory efficiency. The RRM will save time spent in hearings by shifting focus from "what is contained in the application" to "why".

e. Monitoring compliance with Energy Regulator conditions/requirements

The regulatory financial reports will allow the Energy Regulator to detect whether the full intentions of their decision have been complied with and that license conditions have been complied with.

f. Informing tariff reviews and setting/approving of tariffs

g. Detection of cross-subsidisation and discrimination within businesses, all or part of which are regulated.

### 1.7. Applicability of Regulatory Reporting Manual (RRM)

RRM applies to all entities regulated by NERSA and has implications for the regulated entity's affiliates to the extent that there are transactions with the affiliate(s), allocation of cost to/from/between these affiliates and the regulated entity. In this regard, the RRM has been designed for use by:-

- a. each regulated entity's accounting, financial and regulatory personnel
- b. the regulated entity's auditors
- c. NERSA regulatory staff

### 1.8. Disclaimer

Inclusion of any item or account in the prescribed RRM does not necessarily imply NERSA's acceptance for tariff setting/approval purposes of any expenditure, revenue, or procedure suggested by the use of such account.

Although, implementation of RRM is expected to lead to more complete/comprehensive application filings and thereby reduce information requests, there will still be certain well justified circumstances when additional information would be required in order to fully clarify a specific aspect of a requested revenue requirement in an application.

## **2. General Preparation and Reporting Guidelines**

### **2.1. Reporting Currency**

The regulatory financial reports must be presented in South African Rand.

### **2.2. Basis of Preparation of Regulatory Financial Reports**

The Energy Regulator requires information to perform its functions such as, tariff setting/tariff approval and performance monitoring. This information shall be prepared by a regulated entity/licensee and provided to the Energy Regulator, and may differ from that prepared for the statutory financial statements. The purpose of the RRM is to provide guidance on additional details, calculations, content, structure and format of regulatory reporting needed specifically for energy regulation. The Regulatory Financial Reports should therefore be prepared in accordance with these RRM in order to fulfil these information requirements.

### **2.3. Reporting Convention – Historical Cost**

The Regulatory Financial Reports should be prepared under the historical cost convention and as specified in the RRM. Where no historical cost information exists, RAV is the deemed historical cost at the commencement of economic regulation as explained in the following paragraph.

Use of historical costs requires information dating back to when the oldest assets in service were first commissioned. For long-lived pipeline assets, this may be some time ago, and the relevant information may not be readily available. In the same vein, some electricity lines businesses' asset registers may be incomplete or/and incorporate inconsistent assumptions about depreciation. To address these limitations, the Energy Regulator may make specific decisions in this regard to determine a vesting regulatory asset valuation (RAV) of the assets in question. This is expected to be a once-off valuation at the start of economic regulation. A form of modified historical cost valuation approach, taking into account the estimated remaining useful life, will be applied to determine vesting RAV of the affected long lived assets. The so determined vesting RAVs become the proxy for historical cost going forward.

### **2.4. Reporting Convention – Accrual Basis**

The regulatory financial reports should be prepared on an accrual basis.

## **3. Cost Allocation and Separation Principles**

The allocation (assignment and attribution) of costs should ensure that separation and no cross-subsidization occurs between regulated and non-regulated lines of business and

between regulated businesses themselves, products or services. The cost of each activity should be distributed among the business units based on direct assignment when possible, and based on cost drivers when not. The allocation methodology should adhere to the following principles:-

### **3.1. Causality**

This means there is a causal relationship between the cost driver and the costs incurred in performing the activity. Revenues, costs, assets and liabilities must be attributed in accordance with the activities which cause the revenues to be earned or costs and liabilities to be incurred or the assets to be acquired.

Where cost causation cannot be easily ascertained or established cost drivers should be selected based on benefits received.

### **3.2. Objectivity**

The attribution methods should be objective, prevent cross-subsidization and ensure equitable cost sharing among the entity's regulated businesses, non regulated business and its affiliates without unduly benefiting any of them.

### **3.3. Consistency**

The attribution/allocation methods should be consistent from year to year. Where there are changes to the methodology, the regulated entity should restate the previous year's (or any other applicable comparative figures) regulatory financial reports to reflect the impact of the changes.

### **3.4. Transparency**

The attribution method should be transparent. All direct and allocated costs, revenues, assets and liabilities separately distinguishable from each other should be traceable on the accounting records of the regulated entity to the applicable regulatory financial reports submitted by the entity.

## **4. Cost Allocation and Separation Methodology**

### **4.1. Methodology Overview**

The regulated entities should adopt the fully allocated cost approach (sum of direct cost plus a share of indirect costs) whereby direct costs are assigned directly to the product/services while indirect costs are traced to an activity centre or cost pool from where the primary cost driver or relevant proxy must be identified and used to allocate the costs between regulated and non-regulated lines of business, products or services.

One of the fundamentals behind the fully allocated cost approach is to eliminate arbitrary cost allocations and instead use cost drivers, work orders and other such instruments to ensure to the maximum extent possible direct assignment.

#### **4.2. Fully Allocated Cost Approach**

The fully allocated cost approach entails two steps to distribute costs among business units: –

1. Direct Assignment
2. Allocation based on a Cost Allocator

##### **Direct Assignment**

Direct Assignment should be applied when the portion of an activity used by a business unit can be reasonably established. Direct assignment is preferable to Allocation because it is based on a more direct relationship.

##### **Allocation**

Allocation will apply where more than one business unit uses an activity, but the portions of the activity that each uses cannot be directly established. In this case, a cost driver must be identified and a cost allocator assigned to distribute the costs of the activity. A cost allocator is a formula for sharing the cost of an activity among those who cause the cost to be incurred according to causality principle mentioned above.

It is acknowledged that some amount of cost allocation is unavoidable. However best practice suggests that when it comes to cost allocations, less is better. Therefore allocations will only be allowed when there is no other feasible alternative for direct assignment.

Clearing accounts may be used for indirect costs that are to be allocated to more than one account - from which they are then allocated on a determined cost-drivers basis. The clearing accounts must be zeroed at end of each month of the regulated entity.

The cost allocation method, affiliate transactions and transfer pricing policies should be documented in the form of a Cost Allocation Manual (CAM) and reviewed regularly to reflect any changes in cost relationships and cost allocators/cost drivers. The CAM should be approved by the Energy Regulator as specified in this Manual.

Discussions of activity analysis for each of the three regulated businesses are found in the respective industry specific manuals. (see Volume 2, Volume 3 and Volume 4)

### **5. Affiliate Transactions and Transfer Pricing Policies**

#### **5.1. Overview**

The basic principle to govern transactions between regulated entity and affiliates and/or between business divisions whether carrying out regulated activities or not, is that only costs relating to the operation of the licensed activity are allowed for tariff-setting/approval and other regulatory purposes. Vertically integrated businesses shall, where required, keep separate accounts for separate business units and shall separate these between regulated and non-regulated businesses. The principal objectives of this separation are:-

1. Minimize the potential for a utility to cross-subsidize these activities.
2. Ensure there is no preferential access to regulated entity services.

#### **5.2. Affiliate Transactions - Sale price to affiliate**

Sale price to affiliate/division should not be less than fair market value. Where no market value exists, charge no less than cost-based price. Cost-based price should follow the RRM cost allocation guidelines. When a regulated product or service is provided, the transaction should be recorded in the regulated revenue accounts at the prevailing approved tariff rate.

#### **5.3. Affiliate Transactions- Purchase price from affiliate**

Purchases from affiliate/division should not exceed fair market value. Where no market value exists, payment reflected should be no more than the cost-based price. Cost-based price should follow RRM cost allocation guidelines. When a regulated product or service is received the transaction should be recorded in the regulated expense accounts at the prevailing approved tariff rate.

#### **5.4. Asset transfers**

Regulated entity should sell assets to affiliate/division at no less than Net Book Value (NBV), and

Regulated entity should buy assets from affiliate/division at no more than NBV.

For public entities, there may be cases where the National Treasury may prescribe the values at which a regulated public entity should buy, sell or transfer assets. If such values prescribed by National Treasury are derived on an historical cost basis or, where original cost are not available, on a modified historical cost basis, then those values may become the Regulatory Asset Value (RAV) at the commencement of economic regulation.

#### **5.5. Shared Services Joint Costs**

To the maximum extent possible, shared costs should be assigned directly to licensee/affiliates on the basis of causation or usage, and where cost causation cannot be easily ascertained or established cost drivers should be selected based on benefits received.

A key element is to ensure that transactions are at arms-length. Market testing is usually used to determine that an arms-length transaction is taking place. An arms-length contract like a Service Level Agreement (SLA) should be entered into. Wide market tendering (every three years or as specified by the Public Finance Management Act (PFMA), Municipal Finance Management Act (MFMA) or industry best practice) should be used to ensure competitive inter-business/division charging. Where no market exists, allocation of shared costs should use a reasonable method for a fair and equitable split as envisaged in the RRM on cost allocation and transfer pricing.

**5.6. Loans**

The interest charges between a regulated entity and its affiliate should be based on the regulated entity's fully allocated cost of debt derived as the sum of actual cost plus an allocated treasury function cost, using a cost driver selected on the basis of "benefit received". However, where the regulated entity's fully allocated cost of debt is lower than the prevailing interest rate that the affiliate can obtain elsewhere, the higher rate should be used by the regulated entity to calculate interest charges to the affiliate.

**5.7. Disclosure requirements for Affiliate Transactions**

The regulated entity should keep its accounts and records so as to be able to furnish accurately and expeditiously reports of all transactions with affiliates. The reports are required to show:-

1. Explanation of affiliate relationship, detailed description of nature and purpose of transactions with affiliate entity.
2. The total amounts involved.
3. A breakdown of the charges to and from each affiliate clearly split between opex (excluding depreciation), depreciation, capex, revenues etc – this breakdown should clearly indicate the amounts included in each account prescribed in RRM with respect to such transactions.
4. Any other info about affiliate transactions necessary for an understanding of the financial statements. e.g., disclose those affiliate transactions valued at fair market value, tariff rates, and those valued using fully allocated cost-based recovery.

However there are instances the Energy Regulator may waive disclosure of information about transactions between public/government entities where the transactions are consistent with normal operating relationships between the entities, and are undertaken on terms and conditions that are normal for such transactions in these circumstances

**6. Audit of Regulatory Financial Reports****6.1. Role of the Auditor in Regulatory Financial Reports**

An independent audit of regulatory financial reports enhances the quality, objectivity, and credibility of the regulatory financial reports for the Energy Regulator and other stakeholders' use.

**6.2. Appointment of Auditors for Regulatory Financial Reports**

Section 45 of the Electricity Regulation Act and Sections 29 of both the Gas and Petroleum Pipelines Acts grants any person authorised by the Energy Regulator in writing right of entry to inspect, among others, books, account or other document relating to the regulated entity found thereat. Furthermore, the Energy Regulator may require any person to furnish to the Regulator such information, returns or other particulars as may be necessary for the proper

application of these Acts. The Energy Regulator may require the accuracy of that information, return or furnished particular be verified by way or oath/solemn declaration. Such an oath/solemn declaration shall be done by a responsible official that would normally sign the audited statutory accounts for the entity or, in the case of a Municipality, by the Municipal Manager, and shall constitute part of the regulatory financial statements being audited.

Regulatory Financial Reports must be audited in the same frequency as, and by the same auditors that are auditing, the regulated entity's statutory accounts. Using the same auditors will be more cost-effective as the auditors already has knowledge of the regulated entity's business and would avoid duplicating some of the work performed for statutory audits. Using the same auditors may also enhance the timeliness of regulatory reporting. However, this would not preclude the Energy Regulator from appointing an auditor, in terms of Section 45 of the Electricity Regulation Act and Sections 29 of both the Gas and Petroleum Pipelines Acts to audit the Regulatory Financial Reports, where the Energy Regulator deems it appropriate to use a different auditor from the regulated entity's incumbent auditors.

#### **6.3. Form and Content of Auditor's Engagement Letter**

The existing Engagement Letter would deal with the relationship between the regulated entity and the auditor. There will be a separate Engagement Letter between the Energy Regulator and the auditor as contemplated in Section 45 of the Electricity Regulation Act and Sections 29 of both the Gas and Petroleum Pipelines Acts.

The Engagement Letter between the Energy Regulator and the auditor may specify the duty of care the auditor owes the Energy Regulator and require the auditor to carry out the audit with due consideration of the objectives of the Energy Regulator as contemplated in the enabling Acts. The Engagement Letter may also clarify the position on issues related to unique needs for economic regulation in line with the RRM, and the communication process between the auditor, the regulated entity being audited and the Energy Regulator.

#### **6.4. Scope of the Audit**

The audit of regulatory financial reports is to be performed in accordance with the International Standards on Auditing or, in the case of public entities and municipalities, as prescribed by the Auditor General. The regulatory reports audited would have been prepared in accordance with the RRM.

The licensee must grant the auditor unlimited access to the accounting and other records, any such information and explanations required for the purposes of the regulatory financial reports audit.

#### **6.5. Materiality and Audit Framework of Specialized Areas**

In a situation where the materiality level used for the audit of group level statutory accounts may be significantly larger than its individually licensed activities to the extent that transaction tests will not sufficiently test regulatory financial reports items, the auditor should conduct further transaction testing for the regulatory financial reports beyond that already performed for statutory accounts. The transaction testing on regulatory financial reports should, as a minimum, be equivalent to that performed on statutory accounts as if the auditor were only engaged to audit the regulatory financial reports.

Some of the specialized areas that may constitute part of the scope of audit for regulatory financial reports are attached as an Appendix to this RRM.

#### **6.6. Audit Opinion**

The regulatory financial reports audit report will be addressed to the Energy Regulator. The auditors will express an opinion on whether the annual Regulatory Financial Report has been prepared in all material respects in accordance with the RRM.

#### **6.7. Cost of the Audit**

The regulated entity being audited will bear all the audit costs with provision that such costs may be recovered from tariffs.

### **7. Administrative Issues**

#### **7.1. Required Regulatory Financial Reports**

##### ***Half-year Regulatory Financial Reports***

The half year Regulatory Financial Report should only provide data on those specific items used in the determination of Revenue Requirement or setting/approval of tariffs to enable NERSA to monitor the results for each licensee over time. This information should be in columns accompanied by explanatory notes showing:-

- a. Actual performance for reporting period, compared to
- b. Estimates (projections) used to set/approve tariffs
- c. A Declaration that the information presented is complete and accurate and complies with the RRM signed by responsible person as indicated in 7.1 (f) below.

These half-year regulatory financial reports need not be audited.

##### ***Annual Regulatory Financial Reports***

The annual (full year) Regulatory Financial Reports should provide annualized comparatives in columns of: [a] current year actual against; [b] immediate previous year actual, and [c] estimates used in tariffs setting/approval applications. The annual (full year) Regulatory Financial Reports shall include the following:-

- a. Balance sheet (statement of financial position)
- b. Statement of retained earnings (statement of changes in net assets)
- c. Income statement (statement of financial performance/comprehensive income)



- d. Statement of changes in financial position (statement of cash flow)
- e. Commentary explaining the financial statements. The commentary should include:-
  - i. A comparison between actual current period results and assumption made during tariff application/approval
  - ii. An explanation of variances between current period actual results, the results of previous year and the assumptions made in setting/approving tariffs
  - iii. A discussion of the results against plan and an outline of the forward plans for key business drivers such as capex, financing arrangements, organizational shape, operational performance, etc
  - iv. A formal statement from the directors of the licensee that the licensee has complied with licence obligations and that licensee has not cross-subsidized or discriminated
  - v. Detailed disclosure of basis of preparation of regulatory financial reports
  - vi. A discussion of asset valuation basis and depreciation
  - vii. Detailed cost attribution, cost allocation and inter-affiliate business charges
  - viii. Reconciliation between information in the regulatory financial reports and statutory accounts
  - ix. The entity's statutory accounts with their supporting documents or/and notes.
- f. A signed declaration to the effect that the information presented is complete and accurate and complies with the RRM. This declaration shall be signed by a suitable official that normally signs the statutory accounts for entity, or Municipal Manager in the case of a Municipality.
- g. Other surveillance/monitoring reports that NERSA may specifically request for ongoing evaluation of performance, tariffs, revenues, etc

The annual regulatory financial reports shall be audited. Estimates used in tariff setting/approval should be included in the Regulatory Financial Reports but would not be subject to audit. However, the Energy Regulator may specify in the Engagement Letter for the auditor to verify that the same estimates that would have been used during the tariff setting/approval application are replicated in the comparative column for estimates of the Regulatory Financial Reports.

## **7.2. Cost Allocation Manual (CAM)**

Unless otherwise exempted by the Energy Regulator, each licensee is also required to submit to the Energy Regulator a Cost Allocation Manual (CAM), for approval, as soon as the RRM is approved for implementation and before the licensee makes its first filing to the Energy Regulator under the RRM. Regulated entities so exempted from submitting their own Cost Allocation Manual will be required to adopt a standardized CAM provided by the Energy Regulator. Thereafter, a licensee is only required to submit an updated CAM with the Energy Regulator whenever the licensee reviews and updates the CAM.

**7.3. Accounting Period**

Each regulated entity shall maintain its accounting records on an ongoing basis and, at least, on a monthly basis so that for each month all transactions applicable thereto shall be entered in the accounting records of the regulated entity. Amounts applicable or assignable to specific business divisions shall be segregated monthly. Each regulated entity shall close its accounting records at the end of each financial year. This financial year end date should align with annual dates used in tariffs application for ease of analysis and monitoring.

The Energy Regulator may specify other allowed accounting periods to cater to specific dispensations and as deemed appropriate to ensure the regulatory reporting burden is not unnecessarily onerous.

**7.4. Records**

Each regulated entity must keep its books of accounts, and all other records supported by detailed information as will permit ready identification, examination, analysis and verification of all facts thereto. All amounts included in the accounts for capex and opex as well as any payments disallowed by the Energy Regulator shall be tracked separately within each account prescribed by RRM. The records shall be filed in such a manner as to be readily accessible for examination by authorised representatives of the Energy Regulator. These records must be retained by the licensee for at least 5 years.

**7.5. Account Numbering System**

Regulated entities should use account numbers and descriptions provided in this RRM. Where it is not possible to use the account numbering system prescribed in RRM, the regulated entities may opt to use a different system of account numbers for its own purposes provided that there shall be kept a readily available list of such account numbers and a reconciliation of such account numbers with the numbers provided in this RRM. In this context, all submissions/applications/correspondence to the Energy Regulator must be referenced to the account numbering provided in this RRM.

**7.6. Reporting Timeframe**

Half-Year Regulatory Financial Reports (for monitoring) – Should be submitted within sixty (60) days of end of licensee's half year reporting period.

Annual Regulatory Financial Reports – Should be submitted within 4 months of financial year end of the licensee.

All submissions of Regulatory Financial Reports must be in an electronic format for all documents. Electronic copies must include PDF and MS Excel files for materials which will form a permanent record, with the Excel files being for all financials. Any MS Word files made available to the Energy Regulator will function as working copies for all parties to readily

extract and analyse information. A hard copy should also be provided that will serve as a master copy.

#### **7.7. Prior Period Restatement**

An important tool that the Energy Regulator uses in assessing a licensee's application is the comparison of actual results to prior year and/or forecasts. In order to permit this comparison, it is imperative that the forecasts, prior year and current period actual figures be recorded and reported on a similar basis. If licensees find themselves in a situation where the forecasts/prior year and actuals are prepared on a different basis, the licensee must restate, on an account by account basis, the forecasts/prior year in order to provide meaningful comparisons.

#### **7.8. Publication and Confidentiality**

Section 8(9)(a), Section 10(2) of the National Energy Regulator Act, Section 29 of the Gas Act and Section 29 of Petroleum Pipelines Act contain specific provisions on confidentiality of information.

The regulatory financial reports will be published on the Energy Regulator's website, but would exclude certain information contemplated in Sections 8(9)(a) and 10(2) of the National Energy Regulator Act, Section 29 of the Gas Act and Section 29 of the Petroleum Pipelines Act, determined to be confidential by Energy Regulator. It is the responsibility of the regulated entity to promptly notify the Energy Regulator of information that should not be in the public domain by clearly marking the relevant information as such. Regulated entities are also encouraged to publish the regulatory financial reports on their respective websites.

#### **7.9. Implementation Costs and Timetable (Effective Date) of RRM**

RRM will become effective from the date it is gazetted. Immediately following the RRM being gazetted, all entities regulated by the National Energy Regulator are required to start making appropriate arrangements to implement RRM and complete the implementation by 1 January 2009.

Regulated entities will be required to report according to the RRM for all the submissions made to NERSA from June 2009, although NERSA also will encourage those regulated entities that are able to comply with and report in accordance with RRM to do so immediately.

Within three months of the RRM being *Gazetted*, each licensee will be required to submit to the Energy Regulator a "*RRM Implementation Cost Estimates and Implementation Plan*" for approval and also to enable the regulated entity to claim the approved Implementation Costs from tariffs. In approving the submitted Cost Estimates and Implementation Plan the Energy Regulator will take into consideration, among others, [1] the Overall Approach, [2] Project/Work Plan, [3] Feasibility of the Solution Proposed, [4] Compliance with RRM (and

especially demonstrate more direct cost assignments and minimize cost allocations), [5] Budget/Cost Containment, [6] Risk Management, and [7] Whether it is a new implementation or customization.

NERSA may consider categorizing regulated entities and set staggered compliance dates according to regulated entities' implementation capacity. Such a categorization will take into account licensees' different starting points including; licensees with experience in regulatory reporting vs new or future licensees, the learning period for both the Energy Regulator and Licensees, different ERP systems whereby some can easily get on with it, different costing systems like ABC vs traditional, time to amend licence conditions if necessary, entities that have multi-year filing applications/dispensations.

#### **7.10. Review and Modification of the RRM**

The Energy Regulator will consult with regulated entities on an ongoing basis to ensure the objectives and requirements of RRM are being met. To maintain uniformity of Reporting, the licensee should submit questions of doubtful interpretation to the Energy Regulator for consideration and decision. The Energy Regulator will be responsible for advising licensees on the interpretation and application of the RRM. All interpretations issued by the Energy Regulator will be posted on the frequently asked questions (FAQ) section of the Energy Regulator's website. The Energy Regulator will also entertain detailed annual feedback from the regulated entities on aspects of RRM that are working well and areas that need amendment, with suggested amendments. The Energy Regulator will publish these feedback/comments with its response on the FAQ section of its website.

The Energy Regulator will conduct an initial formal review of the content of this RRM within 3 years after implementation. Subsequent reviews will be done every 3 years to ensure that the contents of RRM reflect the regulatory circumstances existing at the time of the review. The Energy Regulator also recognizes that special circumstances may arise that may necessitate ongoing changes, perhaps more frequent than the envisaged 3 years formal review cycle. This provision would therefore not preclude on-going incorporation by the Energy Regulator of justifiable changes that are considered necessary to immediately capture clarity, transparency and regulatory efficiency benefits.

The Energy Regulator will give decisions on the interpretation of the various clauses of RRM, but any party will be entitled at any stage to take decisions of the Energy Regulator on review or appeal as contemplated in the enabling legislations.

## 8. Appendix: Scope of Audit for Specialized Areas

### 1 AUDIT – TEST YEAR

- Defined:
  - ✓ Period of Measurement for a recent, consecutive 12 month period consisting of a full year of operations where data is readily available
- Historic or Future?
  - ✓ Current or past?
  - ✓ Representative of period in which rates will be in effect?

### 2 AUDIT - TEST YEAR ADJUSTMENTS

- Correcting
  - ✓ Removal of Prior Period Items from the Test Year
- Normalizing
  - ✓ Adjusting Revenues for Normalized Conditions e.g. normalized weather
- Pro Forma
  - ✓ Reflection of Authorized Salary Increases
  - ✓ General purpose is to transform the relationship that exists between the revenue requirement elements to make it reflective of what is expected to take place during the time the rates are expected to be in effect

### 3 AUDIT - RATE BASE

- Rate base is the investment base to which a fair rate of return is applied to arrive at the Allowable Revenue (or Revenue Requirement) to be set or approved
- Original Cost is the cost of the item at the time that asset was first put into service and it is the cost that remains with that asset throughout its life.

#### 3.1 Audit of Rate Base – Regulated Plant in Service: Used and Useful

- Plant should be functioning and necessary to be included in rate computation
- Matching in-service date with timing included in rates – Regulator Policy
- Look at major additions since last rate case or review – Type, need, cost, date in service.

#### 3.2 Audit of Rate Base –Plant Held for Future Use

- Plan for Use
  - ✓ Is there a definite plan to use this plant in the future?
- Date of Use
  - ✓ When will this plant be used?

#### 3.3 Audit of Rate Base - Construction Work in Progress (CWIP):

- What is the Policy of the Regulator?
  - ✓ Allow/Disallow Plant in rates prior to being in service.

#### 3.4 Audit of Rate Base - Acquisition Adjustments

- Represents the difference between the original cost of plant and purchase price
- What is the Policy?
  - ✓ Allow or Disallow - Return on and Return of the Investment.

#### 3.5 Audit of Rate Base – Customer Deposits

- Source of non-investor supplied capital
- Reduction to rate base. How should interest on these deposits be treated?
- Deposit policies – are they consistent with the Regulator's rules?
- Is the regulated entity doing what it can to minimize uncollectibles (bad debts)?

#### 3.6 Audit of Rate Base – Cash Working Capital

- Measure of funding the daily expenditures to sustain on-going operations of the utility until those expenditures can be recovered through revenues

- Methods used to measure Cash Working Capital include:-
  - ✓ Formula Method – most popular 45-days
  - ✓ Balance Sheet Method
  - ✓ Lead Lag Study

### **3.7 Audit of Rate Base – Customer Advances**

- Source of non-investor supplied capital
- Accounting treatment different for different industries
  - ✓ Energy Industry– this is usually netted against costs in plant account
- Consistent with tariff
- Tax treatment

### **3.8 Audit of Rate Base**

- Prepayments:-
  - ✓ Type of payment: Related to Service?
- Materials and Supplies
  - ✓ Level of inventory: Reasonable or Excessive?
  - ✓ Use of 13 month average