



Our Ref.: C/FRSC

Sent electronically through the IASB Website (www.ifrs.org)

30 May 2013

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

Dear Sirs,

IASB Request for Information on Rate Regulation

The Hong Kong Institute of Certified Public Accountants is the only body authorised by law to promulgate financial reporting, auditing and ethical standards for professional accountants in Hong Kong. We welcome the opportunity to provide you with our comments on this Request for Information. Our responses to the questions raised in your Request for Information are set out in the Appendix for your consideration.

We appreciate the effort of the IASB in seeking examples of rate-regulatory schemes to help identify the common features of rate regulation, with a view to developing specific guidance for accounting for the consequences of rate regulation. Amongst different types of rate regulation, electricity distribution in Hong Kong is considered as a type of industry which is subject to rate regulation that we might consider as relevant.

In this connection, we provide examples of rate-regulatory schemes by extracting relevant information available from the government of Hong Kong and the two power generation, distribution and supply companies which operate in Hong Kong. In this fact-finding exercise, publicly-available information can be obtained via the following sources:

- CLP Holdings Limited 2012 Annual Report¹;
- Power Assets Holding Limited 2012 Annual Report²; and
- Government of the Hong Kong Special Administrative Region – Environment Bureau³

If you have any questions regarding the matters raised in this letter, please contact Ben Lo, our Associate Director of Standard Setting at ben@hkiipa.org.hk.

Yours faithfully,

Simon Riley
Director, Standard Setting

SR/BL
Encl.

¹ CLP Holdings Limited 2012 Annual Report
(<http://www.hkexnews.hk/listedco/listconews/SEHK/2013/0318/LTN20130318320.PDF>)

² Power Assets Holding Limited 2012 Annual Report
(<http://www.hkexnews.hk/listedco/listconews/SEHK/2013/0403/LTN20130403266.HTM>)

³ Government of the HKSAR – Environment Bureau
(http://www.enb.gov.hk/en/about_us/policy_responsibilities/financial_monitoring.html)

Hong Kong Institute of CPAs

Response to IASB Request for Information on Rate Regulation

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.**

HKICPA is the only body authorised by law to promulgate financial reporting standards for professional accountants in Hong Kong. Hong Kong has been fully converged with IFRS since 2005.

Electricity generation, distribution and supply in Hong Kong is considered as a type of industry which is subject to rate regulation by means of a Scheme of Control Agreement (SCA) between the government of Hong Kong and the two power companies which are both listed on the Hong Kong Stock Exchange (ie private-sector entities).

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 objectives of an SCA are to ensure the power companies provide a reliable, safe and efficient electricity supply to the consuming public at a reasonable price and that the shareholders of the companies obtain a reasonable return on their investment.

Reasonable return means the net return allowed to shareholders each year. This "net return" is calculated by first determining the "permitted return", which is currently set at 9.99% of the company's average net fixed assets (save for average renewables net fixed assets to which a 11% permitted rate of return will apply). Deductions/adjustments (which include interest and excess capacity adjustments and incentive/penalty adjustments in respect of emissions performance, supply reliability, operational efficiency, customer services, energy efficiency and the use of renewable energy) are then made from the "permitted return" to give the "net return".

The power companies are allowed to charge tariffs designed to recover the operating costs (including tax) and allowed net return.

The SCAs also provide the framework for the government of Hong Kong to regulate the power companies and monitor their corporate affairs to protect the interests of consumers. Pursuant to the SCAs, the power companies are required to seek the approval of the relevant government authorities for certain aspects of their development plans, including projected basic tariff levels, and the agreement of the government of Hong Kong to their annual tariff adjustments. Meanwhile, technical, environmental and financial performance of the power companies are subject to annual auditing review conducted jointly by the government of Hong Kong and the power companies.

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 SCAs do not offer the power companies any exclusive rights. They are not franchises per se, nor do they define a supply area for either company (although, effectively, the two companies do operate in distinct geographical locations), or exclude newcomers to the market. Rather, they set out their obligations and rights. By signing the SCAs, the power companies undertake to provide sufficient facilities to meet present and future electricity demand of their respective supply areas, in return for a permitted rate of return on their fixed assets.

For details of rights and obligations created, please see our response to Question 2.

The SCAs are typically of a fixed term, with an option exercisable by the government of Hong Kong to extend for an additional period.

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?

In an SCA signed between the government of Hong Kong and a power company, there is contained a provision with respect to Tariff Stabilisation Fund, which states that any excess or deficiency of the gross tariff revenue over the sum of total operating costs, Scheme of Control Net Return and Scheme of Control taxation charges is transferred to/(from) a Tariff Stabilisation Fund from/(to) the income statement of respective power company.

When a transfer from the Tariff Stabilisation Fund to the income statement is required, the amount transferred shall not exceed the balance of the Tariff Stabilisation Fund. In addition, each year a charge calculated by applying the average of the one-month Hong Kong Interbank Offered Rate on the average balance of the Tariff Stabilisation Fund is transferred from the income statement of the respective power company to a Rate Reduction Reserve, the purpose of which is to rebate electricity charges to customers.

The Tariff Stabilisation Fund and the Rate Reduction Reserve do not form part of distributable shareholders' funds and represents a liability in the accounts of the respective power company.

After the expiry of the respective SCAs and in the absence of any agreement to the contrary, the power companies shall discharge those liabilities in respect of the balances in the Tariff Stabilisation Fund and the Rate Reduction Reserve. The government of Hong Kong and the respective power companies shall at least twelve months before the expiry of the term of respective SCAs institute specific discussions regarding the way the respective power companies shall discharge those liabilities.

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)?****



For details of mechanisms for tracking the recovery or reversal of such variance amounts, please see our response to Question 4.

As provided in the financial statements of the respective power companies, the Tariff Stabilisation Fund for both power companies are in a net credit position in recent years (although it does not appear to be specifically provided for in the SCA, it is our understanding that the Tariff Stabilisation Fund may only be in credit).

Moreover, the variations between the actual cost of fuel and the fuel cost billed are captured in the fuel clause recovery account. The balance of the account (inclusive of interest) represents amounts over-recovered or under-recovered and is treated as an amount due to or from customers. In this connection, net debit balances have been maintained in the financial statements of the two power companies.

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