



LESOTHO ELECTRICITY AUTHORITY

Regulatory Accounting Guidelines

REGULATORY ACCOUNTING GUIDELINES

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REGULATORY ACCOUNTING GUIDELINES

1. Abbreviations

AFUDC	Allowance for Funds Used During Construction
Authority	The Lesotho Electricity and Water Authority
CAM	Cost Allocation Manual
CAPM	Capital Asset Pricing Model
CWIP	Construction Works in Progress
DRC	Depreciated Replacement Cost
FDC	Fully Distributed Cost Allocation Approach
HC	Historical Cost
IFRS	International Financial Reporting Standards
IHC	Indexed Historical Cost
LEA	Lesotho Electricity Authority
LEWA	Lesotho Electricity and Water Authority
NBV	Net Book Value
RAB	Regulatory Asset Base
RAGs	Regulatory Accounting Guidelines
RAV	Regulatory Asset Valuation
RC	Replacement Cost
SLA	Service Level Agreement
WACC	Weighted Average Cost of Capital

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2. Definitions

Definitions provided in the LEA Act, amendments to the LEA Act, the LEWA Act and any rules and regulations issued pursuant to this legislation shall apply equally to the Regulatory Accounting Guidelines (RAGs). Unless otherwise stated, International Financial Reporting Standards (IFRS) definitions are presumed. Additional definitions used exclusively in the RAGs include:

Affiliate or Associate or Related Party

Include corporations or business enterprises where- (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 the ultimate shareholder excludes the Government) can exert significant influence, (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.

Asset Retirement Obligations

Provisions for costs related to future disposal of assets.

Cost allocation

The process of correctly assigning a single cost to more than one business unit, activity, process, product or service in a manner that prevents cross subsidisation

Cost Driver

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.

Cross- subsidy

When a firm, producing more than one product, uses the revenues from 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 cost are incurred.

Depreciation

The gradual and proportionate distribution of the cost of an asset to each of the benefiting periods spanning the service life of that asset.

Direct Costs

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.

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Fully Allocated Cost

The total of all direct and indirect costs including costs of capital incurred in providing goods or services.

Indirect Costs

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.

Joint costs

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. They are also referred to as common costs and include corporate costs.

Mothballed

The preservation of production facility without using it to produce. This is to enable quick restoration of production if needed.

Regulated Business

Any licensee, service or activity that is subject to regulation by LEA Act, 2002, as amended.

Regulatory Accounts

Financial records and statements to be prepared and submitted to the Authority by a regulated entity as prescribed by this RAGs.

Ring-fencing

Occurs when a portion of a company's assets or profits are financially separated without necessarily being operated as a separate entity. This might be for regulatory reasons, creating asset protection schemes with respect to financing arrangements, or segregating into separate income streams for taxation purposes.

Shared Services

Services that are corporate or general purpose in nature, and are used by various or all business units, but are not operations related.

Transfer Pricing

The pricing of products/services that one affiliate/business unit supplies to another affiliate/business unit of the same entity.

3. Introduction and Purpose

The Authority requires sufficient and accurate information from regulated entities in order to make well informed decisions in fulfilment of its mandate spelt out in the enabling legislation.

To gather that information, the Authority is issuing these Regulatory Accounting Guidelines (RAGs), for use by licensees in preparing and submitting to the Authority the required accounting financial information regularly in a systematic and consistent way.

The purpose of the RAGs is to provide guidance to the regulated entities in the electricity and water & sanitation sectors on the preparation and submission to the Authority of required accounting information to enable the Authority perform its regulatory functions.

4. Legal Basis for Regulatory Accounts – Legislation, Regulations and Rules

The RAGs are consistent with the primary and secondary legislation listed below. Additional rules and regulations may be issued from time to time and, if necessary, the RAGs will be amended for consistency with the new regulations or rules.

a. Primary legislation:

LEA Act 2002 (particularly Articles 61 to 63)

b. Regulations:

LEA (Electricity Price Review and Structure) Regulations 2009

Licenses issued by the Authority require licensees to comply with the RAGs. The Authority may, where appropriate, impose additional specific obligations on licensees.

5. Users of RAGs

The target users of the RAGs are:

- o The regulated entities in the electricity and water & sanitation sectors.
- o The Authority.
- o The Auditors of the regulated entities.
- o Other stakeholders of these regulated entities including consumers and Government.

6. Accounting Period

The accounting period (Financial Year) shall be one year in length. The Authority will not prescribe the licensees' regulatory accounting periods except that the one-year period chosen by licensees shall be the same for all ring-fenced businesses (if any) that form part of a company or group of companies with a single set of consolidated statutory accounts. However, unless there are good reasons approved by the Authority, the regulatory accounting period shall be the same as that used for statutory accounts.

7. Accounting Conventions

The accounting conventions used in IFRS will apply to the regulatory accounts unless otherwise specified in these RAGs. The only differences will be those necessitated by the specific requirements for regulatory purposes identified in the RAGs.

8. Reporting Currency and Language

The reporting currency shall be the Lesotho Maloti. Reports shall be submitted in the English language.

9. Regulatory Accounting Separation

Licence conditions may require accounting separation (also known as ring-fencing) of the regulated activities (Separate Businesses) within a regulated entity. This is intended to separate regulated from non-regulated activities and to prevent undesirable cross-subsidies and allow transparent pricing of services to third-parties.

Licensees shall maintain accounting and reporting arrangements which enable regulatory accounts to be prepared for each Separate Business – as defined in individual licences - and showing the financial affairs of each of such Separate Business.

Accounting separation shall be achieved by each licensee using Chart of Accounts through which it separates accounting transactions into traceable accounting entries attributed to the respective business that causes that transaction to occur or receive the benefit from the transaction.

Unless the Authority otherwise consents (such consent may be given in relation to some or all of the obligations in this condition and may be given subject to such conditions as the Authority considers appropriate), licensees shall be required to keep separate businesses as if they were carried on by separate companies. Each Separate Business shall be separately identifiable in the accounting records of the licensees. In respect of each business, revenues, costs, assets, liabilities, reserves and provisions shall be kept for the period referred to in the Companies Act and in the manner referred to in the accounting records.

10. Regulatory Information

Where no derogation has been received in relation to the obligation in the previous section, licensees shall prepare on a consistent basis from such accounting records in respect of:

- a) each regulatory accounting period, accounting statements comprising a statement of comprehensive income, a statement of financial position and a statement of cash flow, together with notes thereto, and showing separately in respect of each Separate Business and in appropriate detail the amounts of any revenue, cost, asset, liability, reserve or provision which has been charged from or to any other business (whether or not a Separate Business) as described in section **Error! Reference source not found.** of these RAGs;
- b) each regulatory accounting period, sufficient accounting information in respect of each Separate Business to allow the preparation of consolidated accounting statements for each Separate Business of licensees. Such information shall include a statement of comprehensive income, a statement of financial position, and a statement of cash flow together with notes thereto.

The Regulatory Accounts shall have at least two columns showing:-

- o Actual for the reporting period
- o Actual for the previous period

Regulatory accounting statements and information in respect of each regulatory accounting period shall, so far as reasonably practicable and unless otherwise approved by the Authority having regard to the purposes of this condition:

- a) have the same content and format (in relation to each Separate Business) as the statutory accounts of licensees prepared and conform to the best commercial accounting practices including all relevant accounting standards issued or currently in force;
- b) state the accounting policies adopted; and
- c) be published with the statutory accounts of licensees. Part of such statements and information which shows separately the amounts charged, apportioned or allocated and describes the bases of charge or apportionment or allocation respectively, will not be issued with the Regulatory Accounts.

Additional regulatory accounting information shall be provided to the Authority by licensees based on templates approved by the Authority.

11. Auditing of Regulatory Accounts

Licensees shall, if required by the Authority, procure, in respect of the accounting statements prepared in accordance with Auditing of Regulatory Accounts in respect of any Financial Year, a report by Auditors. It shall be addressed to the Authority, stating whether in their opinion those statements have been properly prepared in accordance and give a true and fair view of the revenues, costs, assets, liabilities,

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reserves and provisions of, or reasonably attributable to, the Separate Business to which the statements relate.

The Authority may at any time appoint a person to audit specific costs in Licensees' Regulatory Accounts. Licensees shall allow such a person so appointed by the Regulator to access the premises, records and all other information, and any management representatives that the person may require in order to conduct such an audit. The person so appointed may be independent experts or the Authority's own staff.

12. Frequency and Timing of Regulatory Accounting Submissions

Licensees shall deliver to the Authority the accounting statements, the accounting information, and the Auditors' report according to requirements specified in each licence. For annual submissions, the information shall be delivered as soon as reasonably practicable, and in any event not later than six months after the end of the Financial Year to which they relate.

13. Allocation of Costs

The methodologies for cost allocation within and between regulated businesses and between regulated and/or non-regulated businesses shall be prepared and documented by the licensee in a Cost Allocation Manual (CAM).

The CAM prepared by the licensee should be submitted to the Authority for approval in advance of that CAM being used by the licensee. Once approved, the CAM need not be re-submitted before subsequent tariff applications unless the licensee is proposing changes to the allocation rules/methodologies.

The licensee should prepare its CAM along the cost allocation guidelines outlined in this section of the RAGs. The Fully Distributed Cost (FDC) Allocation Methodology (also known as Fully Allocated Cost Approach) is the preferred methodology by the Authority.

Under the FDC approach the direct costs shall be assigned to the business, product, or service while indirect costs shall be traced to the activity centre or cost pool from where the primary cost driver must be identified and used to allocate the cost between the various regulated business units and/or between regulated and non-regulated businesses, products or services.

With a FDC approach, each business, product or service's cost will be the sum of assigned direct costs plus the share of indirect costs allocated by:

- o direct assignment
- o allocation based on a cost driver (cost allocator) *{for example, the cost of headquarters offices might be allocated based on the m² of office-space allocated to management staff of the different businesses}*

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Direct assignment should be applied when the portion of an activity used by a business unit, product or service can be reasonably established.

Allocation is used where more than one business unit, product or service uses an activity, but the portions of the activity that each uses cannot be directly established. In such cases, a cost driver must be identified and used to distribute the costs of the activity to the business units, products or services that cause the cost to be incurred.

The cost allocation methodology should adhere to the following principles:

- Causality – This means there is a causal relationship between the cost driver and the cost 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 easily be established, cost drivers should be selected based on benefits received.
- Objectivity – the allocation method should be objective, prevent cross-subsidisation and ensure equitable cost sharing among the entity's regulated businesses, non-regulated businesses, products or services and its affiliates without unduly benefiting any of them.
- Consistency – the allocation method should be consistent from year to year.
- Transparency – all direct and allocated costs, revenues, assets and liabilities be separately distinguishable from each other and traceable on the accounting records of the licensee.

Unless the Authority so specifies in directions issued for the purposes of this condition, or with the Authority's prior written approval, licensees shall not in relation to the accounting statements in respect of a regulatory accounting period change the bases of charge or apportionment or allocation from those applied in respect of the previous regulatory accounting period.

Where, in relation to the accounting statements in respect of a regulatory accounting period, licensees have changed such bases of charge or apportionment or allocation from those adopted for the immediately preceding regulatory accounting period, licensees shall, if so directed in directions issued by the Authority, in addition to preparing accounting statements on those bases which it has adopted, prepare such accounting statements on the bases which applied in respect of the immediately preceding regulatory accounting period.

14. Transactions with Related Parties/Affiliated Companies

The basic principle to govern transactions between a regulated entity and its affiliated businesses whether carrying out regulated activities or not, is that only costs relating to the operation of the licensed activity shall be allowed for tariff setting and other regulatory purposes. In addition, accounting separation is prescribed to avoid cross-subsidies and avoid preferential access to regulated services. To

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achieve these objectives, the following transfer pricing rules and affiliate transaction requirements must be adhered to:

- o Sale Price to Affiliate – Sale price to affiliate businesses should not be less than fair market value or cost-based price determined on an FDC basis. When a regulated product or service is provided, the sale price must be at the tariff/price approved by the Authority.
- o Purchase price from Affiliate – Purchase price from affiliate businesses should not be more than fair market value or cost-based price determined on an FDC basis. When a regulated product or service is procured from affiliate, the purchase price must be at the tariff/price approved by the Authority.
- o Asset Transfers – Regulated entity/business should sell assets to affiliate business at no less than Net Book Value (NBV) and should buy assets from affiliate at no more than NBV.
- o Shared Services - Shared services costs should be assigned directly to business/affiliate, product or service on the basis of causation or usage, and where causation cannot be established, then cost drivers should be selected based on benefits received.

Where shared services are provided internally, a key element is to ensure that services are competitively priced and the transactions are at arms length. Therefore these services should be contracted with Service Level Agreements (SLA) and marketing testing conducted every three years to ensure competitive inter-business/affiliates charging.

- o Affiliate business transactions shall be subject to the following disclosure requirements to the Authority:

Regulatory accounts shall show separately in respect of each Separate Business and in appropriate detail the amounts of any revenue, cost, asset, liability, reserve or provision which has been either:

- a) charged from or to any other business (whether or not a Separate Business) together with a description of the basis of that charge; or
- b) determined by apportionment or allocation between any Separate Business and any other business (whether or not a Separate Business) together with a description of the basis of the apportionment or allocation.

15. Assets

a. Regulatory Asset Base Valuation/Regulatory Asset Values

Except where the regulatory asset valuation (RAV) of the regulated asset base (RAB) used in the regulated activity is otherwise specified in licences issued by the Authority, the RAB for each Separate Business shall be the net re-valued fixed assets established as described below and depreciated as described below.

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b. Revaluation of RAB

RAB shall be re-valued annually on the basis of depreciated indexed historical cost (IHC). Periodically, assets may, if approved by the Authority, be re-valued on the basis of depreciated replacement cost (DRC) or other revaluation methodology approved by the Authority.

c. Depreciation Methods

The straight-line depreciation method shall be used.

d. Construction Work in Progress

Construction work in progress (CWIP) for an asset shall not be included in the RAB until the asset is in use. CWIP shall be reported separately.

CWIP shall not be re-valued while assets are still under construction.

e. Allowance for Funds Used During Construction (AFUDC)

When an asset is under construction, it is excluded from the RAB until construction is completed and that asset is in use. While the asset under construction is excluded from the RAB, a regulated entity may charge AFUDC to the capital cost on that part of the cost of the plant which has been built but not yet used. This charge may be accumulated until such time as the asset is placed in operation and ready for service.

The amount of such an allowance shall be based on a reasonable allowance for the use of funds (financing) expended during construction period, whether or not such funding (financing) used during construction have been borrowed.

The formula and elements for the computation of the allowance for funds (financing) used during construction shall be the approved weighted average cost of capital (WACC) in real terms described in the *Charging Principles* issued by the Authority from time-to-time multiplied by the sum of:

- o average of opening and closing balance of construction work in progress for a given year,
- o plus the average of opening and closing capital inventory balance for a given year,
- o less construction accounts payable,
- o less asset retirement costs (if any are included in construction work in progress).

i. e, $AFUDC = WACC \times [(Average\ CWIP + Average\ Capital\ Inventory - Construction\ Accounts\ Payable - Asset\ Retirement\ Costs\ in\ CWIP)]$

f. Weighted Average Cost of Capital

The actual proportionate financing of the project (debt and equity, subject to a minimum of an optimal debt ratio in the regulatory methodology) in question will be used for the weighting in determining WACC for the AFUDC calculation.

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Construction Works in Progress balances in the financial reporting period are not indexed for inflation hence the nominal WACC is used in the formula to calculate the AFUDC.

g. Asset Retirement Obligations

Asset retirement obligations liabilities should be disclosed but, unless otherwise directed by the Authority, these amounts will not be included in the RAB. The cost of such retirement obligations not included in the RAB shall be recognised as an operating cost in the period in which the obligation is realised.

16. Infrequent Events and Deferral Accounts

Regulatory accounting treatment of events that are unusual/infrequent, including asset impairment charges, must be approved by the Authority. Mothballed assets do not qualify as impairments for the regulatory accounts.

In approving the amounts of unusual/infrequent events the Authority will at the same time make a decision on how these amounts will be apportioned into the allowable revenue and tariffs and over what time period.

The Authority will issue specific guidance on how to use deferral accounts at the time that the decision is made.

17. Review and modification of RAGs

The RAGs will be reviewed at intervals of three to five years but may be amended or updated by the Authority as necessary as circumstances change.

18. Confidentiality

Regulatory accounting information provided by licensees shall normally be made available to stakeholders by the Authority as part of the review and public consultation process. Should licensees wish to maintain some information as confidential then such information should be clearly marked as confidential and the licensee should provide reasons why they wish the information to be kept confidential. The Authority may accept reasons for confidentiality that relate to the disclosure of information that may give unfair competitive advantage to a competitor.

19. Implementation

New licensees who had not been issued with licences by the Authority before 31 December 2009, other than the Water and Sewerage Company, shall implement the provisions of these RAGs with effect from the date on which submissions for approval of tariffs are made, and all accounting reports submitted by newly licensed entities, other than the Water and Sewerage Company, shall comply with these RAGs.

The Lesotho Electricity Company and the Lesotho Highlands Development Authority shall introduce systems to implement these RAGs in full by 31 March 2013 for regulatory accounting information prepared for the financial year commencing April

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2014. Regulatory accounting information submitted by the Lesotho Electricity Company and the Lesotho Highlands Development Authority to the Authority relating to the financial year April 2012 to March 2013 shall, to the reasonable extent possible, be based on provisional accounting separation prescribed in these RAGs. Regulatory accounting information relating to the financial year April 2013 to March 2014 that is presented in tariff applications relating to tariffs or contracts to be implemented after 1 April 2013 shall be based, to the reasonable extent possible, on provisional accounting separation contained in these RAGs.

The Water and Sewerage Company (WASCO) shall be allowed up to 12 months to introduce systems to implement these RAGs in full for regulatory accounting information prepared for the first financial year commencing after the first anniversary of the issuance of the licence. Regulatory accounting information submitted by WASCO to the Authority relating to financial years before full implementation of the RAGs shall, to the reasonable extent possible, be based on provisional accounting separation described in these RAGs.

20. Clarifications

Clarifications on these RAGs may be issued by the Authority to licensees from time to time and should be read in conjunction with these RAGs. Such clarification notices will be provided on the Authority's website together with these RAGs.