



**International Accounting Standards Board**  
**30 Cannon Street**  
**London**  
**To: [commentletters@iasb.org](mailto:commentletters@iasb.org)**

**19 November, 2009.**

**Discussion Paper: Rate-regulated Activities**  
**Deadline: 20 November 2009**

Dear Sir,

Brazilian Accounting Pronouncements Committee (CPC)<sup>1</sup> is pleased to offer our comments on International Accounting Standards Board (IASB) in respect Exposure Draft: Rate-regulated Activities.

Please see our comments and responses to the Invitation to Comment questions in the Appendix.

If you have any question on our comments, please contact our Board Member, **Geraldo Toffanello** ([geraldoffanello@gerdau.com.br](mailto:geraldoffanello@gerdau.com.br)).

Yours sincerely,

**Edison Arisa Pereira**

Technical Coordinator

Brazilian Accounting Pronouncements Committee (CPC)

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<sup>1</sup> The CPC was founded by ABRASCA (Brazilian Listed Companies Association), APIMEC (National Capital Market Investment Professionals and Analysts Association), BMFBOVESPA (São Paulo Stock Exchange), CFC (Federal Accounting Council), FIPECAFI (Financial and Accounting Research Institute Foundation) and IBRACON (Brazilian Institute of Independent Auditors), with the objective of the study, preparation, and issuance of Technical Pronouncements on Accounting procedures.

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**Re.: “Exposure Draft ED/2009/8 Rate-regulated Activities”**

The new Brazilian Corporate Law enacted in December 2007 permitted the convergence of Brazilian accounting standards with the International Financial Reporting Standards (IFRS) and the issuance by CVM (Brazilian SEC) of new standards consistent with IFRSs. This process was started in 2008 and should be completed by 2010.

Specifically for the Power Industry, with Brazil’s decision to pursue the convergence of these standards with IFRSs and not the US GAAP, a concern raised as to whether, under IFRS, regulatory assets and liabilities could continue to be recognised as they have been recognised in Brazil. Brazil started to officially adopt the accounting of rate-regulated activities based on the US accounting principles (FAS 71) in 2001.

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During the public hearing process of the Exposure Draft (“ED”), we studied the contents thereof and wish to, through this comment letter, express our main concerns regarding such document and request its review so it would cover certain specific issues that we experience in our regulatory environment, which are not included in the ED, mainly the regulatory assets arising from Alternative Revenue Programs, similar to those included in the US GAAP, in particular EITF 92-7 (Accounting by Regulated Utilities for the Effects of Certain Alternative Revenue Program), which allows that amounts resulting from legal rights approved by regulators or supported by specific law be recorded as regulatory assets.

Our comments are detailed in Appendix I.

The following appendixes were also included:

Appendix II - Summary of the Main Aspects of the Tariff Mechanism, Tariff Revision and Regulatory Accounting in Brazil

Appendix III - Practical Example of the Issue Addressed in Appendix I - item 1.2

Appendix IV - IBRACON Technical Bulletin - General Agreement of the Electric Power Industry - that Supported the Adoption of the Regulatory Accounting in Brazil

We remain at your disposal for any additional clarifications on our comments. In case of doubt, please contact us.

Yours truly,

**Brazilian Accounting Pronouncements Committee (CPC)**

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## INVITATION FOR COMMENTS

### SCOPE

#### QUESTION 1

**The exposure draft proposes two criteria that must be met for rate-regulated activities to be within the scope of the proposed IFRS (see paragraphs 3-7 of the IFRS draft and paragraphs BC13-BC39 of the Basis for Conclusions).**

**Is the scope definition appropriate? Why or why not?**

In general, we agree that the criteria established in IFRS paragraphs 3-7 as the minimum requirements to allow recognition of regulatory assets and liabilities generated by regulatory activities.

In addition, we point out to the IASB Board unusual situations in Brazil in which regulatory assets and liabilities have been recorded, which are part of the US GAAP literature, in particular the EITF 92-7 (Accounting by Regulated Utilities for the Effects of Certain Alternative Revenue Program). We report below specific Brazilian situations for which our understanding is that the final pronouncement should address as an additional guidance in the application of the regulatory accounting. We describe below the main features of the revenues programs which are currently recognized as regulatory assets and liabilities in Brazil.

#### 1.1. Margin losses generated in Rationing Programs

In the period from June 2001 to February 2002, the Brazilian Government created the Electric Energy Consumption Reduction Emergency Program (“Rationing Program”) generating a margin loss in all distribution companies (“distributors”) located in the rationing area. As a result of the negotiation with the Federal Government, the distributors signed the Overall Agreement for the Electric Energy Industry, under which the Government recognised that distributors would be entitled to charge consumers over a period of time (seven years on average) an amount equivalent to the margin loss incurred at the time (balance adjusted for inflation and interest). This agreement was formalised through a Provisional Act of 2001, converted into a Law in 2002, that ensured the recognition of receivables - regulatory assets as a contra entry to the “Operating revenue - unbilled” account. This situation may happen again in the future, and according to the criteria set out in the ED it would no longer be possible to recognise a regulatory asset arising from such situation. What concerns us most is that in Brazil a law was enacted to guarantee the right to receive the amount equivalent to the margin loss, and other regulatory assets have been recognised for other matters arising from the execution of such agreement. Considering that the electric Power system in Brazil is heavily dependent upon hydroelectric power plants, unusual fluctuations in the level of rain over Brazil may significantly affect the industry entities’ activities. Therefore, the lack of specific guidance on this matter may result in inconsistent information on assets that would be highly probable to be included in the rate-making process.

We understand that the Board should analyze whether the legal right supported by the law, in this case, may result in the recognition of regulatory assets. We suggest that the Board

analyse the possibility of including at least one additional example to the standard to explain whether or not this situation would result in the recognition of regulatory assets.

The **Appendix IV** - Technical Bulletin issued by IBRACON in 2002 - supports the establishment of the regulatory accounting in Brazil.

## 1.2. Approval of Portion B<sup>2</sup> Tariff Increase in Parcels

There is a situation, in the case of the “periodic tariff revision of Portion B” that arises every four years in which ANEEL (regulator) officially approves a tariff increase percentage to be used for the next four years by a certain distributor, but such increase is granted in parcels, i.e., it is gradually stepped up and not on a straight-line basis. As the annual tariff adjustment of Portion A costs is granted simultaneously with the result of the periodic tariff revision of the items integrating Portion B, every four years, whose result can be a tariff increase or decrease, ANEEL uses this procedure to minimise the impact on consumer tariffs when the addition of the adjustments of Portion A and Portion B is much higher than annual inflation. For example:

- A distributor obtains the legal right to charge consumers a 12 percent increase equal to the Portion B tariff increase for the next four years, officially approved by ANEEL, but this percentage is stepped up as follows: 7 percent in year 1, 9 percent in year 2, 11 percent in year 3, and 13 percent in year 4, so that at the end of the four years the distributor receives the tariff rate increase approved by ANEEL. If at the end of the four years it is not possible to pass through to tariffs the entire amount approved by ANEEL, the excess or deficit is passed through in the next ordinary tariff revision. We point out that there is no market risk linked to the receipt of this amount, as the regulatory agency approves the total amount to be received, and not only the percentage of increase applied.

Please, refer to Appendix II for a summary of some aspects of the tariff mechanism, tariff revision and regulatory accounting in Brazil, and Appendix III for the practical example of this situation.

The Brazilian accounting practices permitted recording as a regulatory asset the difference between the amount corresponding to the tariff increase approved by ANEEL recorded on a straight-line basis, and the increase actually charged (in parcels), based on the following:

- a) Legally, the tariff increase approved by ANEEL, through a specific resolution for each distributor, is a legal, unconditional right of each distributor to charge consumers; and
- b) The realisation of the amounts recorded as regulatory assets is considered probable.

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<sup>2</sup> See definition of Portion A and B in attachment II

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We point out that the items discussed above are based on laws that support the recognition of such assets. We understand, therefore, that the recognition of this type of regulatory assets and liabilities also meet the definitions stated in paragraph 83 of the Framework, as discussed in BC40 of ED.

## RECOGNITION AND MEASUREMENT

### QUESTION 2

**The exposure draft proposes no additional recognition criteria. Once an activity is within the scope of the proposed IFRS, regulatory assets and regulatory liabilities should be recognised in the entity's financial statements (see paragraphs BC40-BC42 of the Basis for Conclusions).**

**Is this approach appropriate? Why or why not?**

In general, we agree with the contents of the Exposure Draft, i.e., as the rate-regulated activity is within the proposed scope of IFRS, no additional criteria is required. If the criteria are met, regulatory assets and liabilities should be recorded in the entity's financial statements. We would like the IASB Board to take into consideration the matters addressed in Question 1, on the additional recognition of regulatory assets when approved by regulators or guarantees by law, similar to the matters included in EITF 92-7 in the US GAAP.

### QUESTION 3

**The exposure draft proposes that an entity should measure regulatory assets and regulatory liabilities on initial recognition and subsequently at their expected present value, which is the estimated probability-weighted average of the present value of the expected cash flows (see paragraphs 12-16 of the draft IFRS and paragraphs BC44-BC46 of the Basis for Conclusions).**

**Is this measurement approach appropriate? Why or why not?**

Regulatory assets and regulatory liabilities recorded in Brazil are already discounted to present value as specific costs are accrued monthly in a specific account and to be passed through on the tariff annual increase. These costs are monthly adjusted for inflation and market interest.

Had we not use this system, we would have not agreed to use the method proposed in the Exposure Draft, i.e., the expected present value method, which is the probability-weighted cash flow approach, as this method is complex and may be confusing for users of financial statements. We understand that there would be a great level of judgment involved in the determination of the range of possible outcomes and, consequently, could cause financial statements of peer entities not to be comparable. We recommend that the Board use, when applicable, the discounted cash flow method considering only the most probable scenario.

## QUESTION 4

**The exposure draft proposes that an entity should include in the cost of selfconstructed property, plant and equipment or internally generated intangible assets used in regulated activities all the amounts included by the regulator even if those amounts would not be included in the assets' cost in accordance with other IFRSs (see paragraph 16 of the IFRS draft and paragraphs BC49-BC52 of the Basis for Conclusions). The Board concluded that this exception to the requirements of the proposed IFRS was justified on cost-benefit grounds.**

**Is this exception justified? Why or why not?**

No further comments. The requirement is in accordance with that applied already in Brazil. Brazilian regulators determine which costs will be considered and allowed to record the cost of property, plant and equipment items, which are transferred to tariffs through regulatory depreciation. For this reason, we understand that it is highly probable that these costs will be included in the rate-making process. However, we recommend that the Board request specific disclosures of the amounts recognized in property, plant and equipment related to regulatory assets. This information may be relevant to enable the financial statement users to understand the possible impact that may arise if an entity fails to meet the criteria in paragraph 3.

## QUESTION 5

**The exposure draft proposes that at each reporting date an entity should consider the effect on its rates of its net regulatory assets and regulatory liabilities arising from the actions of each different regulator. If the entity concludes that it is not reasonable to assume that it will be able to collect sufficient revenues from its customers to recover its costs, it tests the cash-generating unit in which the regulatory assets and regulatory liabilities are included for impairment in accordance with IAS 36 Impairment of Assets. Any impairment determined in accordance with IAS 36 is recognised and allocated to the assets of the cash-generating unit in accordance with that standard (see paragraphs 17-20 of the draft IFRS and paragraphs BC53 and BC54 of the Basis for Conclusions).**

**Is this impairment testing approach appropriate? Why or why not?**

We agree with the Board's proposal. However, we understand that additional guidance on how an impairment loss should be allocated to the assets of a cash-generating unit which include regulatory assets. IAS 36-104 prescribes the following:

*An impairment loss shall be recognised for a cash-generating unit (the smallest group of cash-generating units to which goodwill or a corporate asset has been allocated) if, and only if, the recoverable amount of the unit (group of units) is less than the carrying amount of the unit (group of units). The impairment loss shall be allocated to reduce the carrying amount of the assets of the unit (group of units) in the following order:*

*(a) first, to reduce the carrying amount of any goodwill allocated to the cash-generating unit (group of units); and*

*(b) then, to the other assets of the unit (group of units) pro rata on the basis of the carrying amount of each asset in the unit (group of units).*

*These reductions in carrying amounts shall be treated as impairment losses on individual assets and recognised in accordance with paragraph 60.*

As the recognition of regulatory assets reflects directly future cash flows that an entity expects to receive through the tariff set by the regulator, we understand that the Board should consider revising IAS 36-104 to include regulatory assets in the order of impairment expense recognition under this standard.

## DISCLOSURES

### QUESTION 6

**The Exposure Draft proposes disclosure requirements to enable users of financial statements to understand the nature and the financial effects of rate regulation on the entity's activities and to identify and explain the amounts of regulatory assets and regulatory liabilities recognised in the financial statements (see paragraphs 24-30 of the draft IFRS and paragraphs BC59 and BC60 of the Basis for Conclusions).**

**Do the proposed disclosure requirements provide decision-useful information?**

**Why or why not? Please identify any disclosure requirements that you think should be removed from, or added to, the draft IFRS.**

In general we agree with the disclosure requirements in the Exposure Draft and we suggest further disclosure on property, plant and equipment, as commented in the reply to question 4. In Brazil regulators have require the disclosure of amount reconciliation (principal, inflation adjustment and interest), by type of regulatory assets and regulatory liabilities and by formation year, i.e., an entity is required to include a specific explanatory note to the financial statements.

We would, however, suggest the following to the Board:

1. The tabular reconciliation described in paragraph 27 (a) should also include amounts related to (i) impairment losses recognized in the period and (ii) amounts of regulatory assets and liabilities derecognized in accordance with paragraph 21.
2. There could be a significant level of subjectivity in the entity's assessment of the expected future regulatory actions. We would suggest that the Board includes additional guidance as to how such assessment should be performed by the entity.

## TRANSITION

### QUESTION 7

**The Exposure Draft proposes that an entity should apply its requirements to regulatory assets and regulatory liabilities existing at the beginning of the earliest comparative period presented in the period in which it is adopted (see paragraph 32 of the draft IFRS and paragraphs BC62 and BC63 of the Basis for Conclusions).**

**Any adjustments arising from the application of the draft IFRS are recognised in the opening balance of retained earnings.**

**Is this approach appropriate? Why or why not?**

We agree with the Exposure Draft requirement. As in Brazil accounting for regulatory assets and regulatory liabilities is required since December 31, 2001, we would not have problems to apply the standard as proposed in the ED.

## OTHER COMMENTS

### QUESTION 8

**Do you have any other comments on the proposals in the Exposure Draft?**

Yes. We highlight below some of issues that may be relevant for the Brazilian economic environment:

#### 8.1. Definition of regulator

We believe that the definition of regulator presented under Defined Terms should be more restrictive. The possibility prescribed by the Board that a regulator could be a governing body of an entity could lead to entities structuring themselves to comply with the scope of the standard, and consequently record assets and liabilities that otherwise would not be recognized. This possibility cannot be overlooked in situations where an entity holds the monopoly of certain products and services. If the Board believes that it is appropriate that an entity with a self-governing body designated as regulator be within the scope of the standard, we understand that there should be more guidance to reduce the possibility of structuring.

#### 8.2. Valuation of regulatory assets and regulatory liabilities in business combinations

We did not identify any amendments to IFRS 3 in Appendix C. As the Exposure Draft does not prescribe the use of fair value concepts in the measurement of such assets and liabilities, we recommend that the Board provide guidance on how such assets and liabilities should be measured in a business combination involving entities within the scope of this ED.

8.3. Voluntary Discounts Granted by a Distributor After Approval of Tariff Increase by the Regulatory Agency - Portion A - Cost Recovery

One of our most recent concerns is how to address the recording, or not, of an allowance for impairment of regulatory assets, if a regulator grants an tariff increase, specifically related to specific Portion A costs, but due to a decision taken by the entity's management (e.g., for political reasons) the increase is not passed through to consumers in full or partially.

We understand that the objective of creating regulatory accounting was to account for specific costs, not prescribed in the tariffs for a certain period of time to straight line a company's contribution margin, in our case those of distributors. Therefore, it is assumed that to recover such costs (there is no margin in Portion A), a distributor would have to pass through to tariffs the full increase approved by regulators (full tariff criterion). Any discount granted on the deferred margin should result in the derecognition of any regulatory assets.

We understand that the ED should address how these situations should be accounted for in relation to regulatory assets when similar events occur, as well as certain impairment aspects.

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SUMMARY OF SOME ASPECTS OF THE TARIFF MECHANISM  
TARIFF REVISION AND REGULATORY ACCOUNTING IN BRAZIL

1. BACKGROUND

1.1. Accounting aspects in Brazil

The Brazilian accounting practices are prescribed by Corporate Law, the Brazilian Securities and Exchange Commission (CVM), through the Accounting Standards Committee (CPC), created in 2007 (for publicly-traded company), the Federal Accounting Council (CFC), and regulators, in the case of rate-regulated activities. The accounting standards that officially allow the recognition of regulatory assets and liabilities by energy distributors in Brazil starting December 2001 were prepared by the National Electric Power Agency (ANEEL), through a specific Accounting Resolution, agreed with CVM and IBRACON, through the issue of a special Technical Bulletin.

1.2. Tariff mechanism of distributors

The tariff mechanism applicable to distribution companies in Brazil is the mixed or hybrid system, which encompasses the concept of “service cost” for the cost items called Portion A, and the price-cap concept for other cost and capital return items called Portion B, both part of the of the parametric formula included in the concessions agreements.

1.3. Determination of Portion A

Portion A includes the so-called “non-manageable” costs of a distributor, i.e., costs whose amount and variance are not managed by the distributor. These costs encompass purchased energy, industry charges, and energy transportation costs. Portion A should be neutral for tariff determination purposes, i.e. it is acknowledged that a distributor should not earn profits on nor incur losses from events that it cannot control. Thus, the costs of Portion A are specific costs fully and annually passed through to tariffs.

Portion A costs can fluctuate significantly because electricity consumed in Brazil is predominantly generated by hydro-electric plants, which depend on external factors (rainfall rate) to maintain the reservoirs at adequate water levels. When the water level in reservoirs is insufficient, electricity is generated by thermal power plants and other energy sources, usually at higher costs.

#### 1.4. Determination of Portion B

The primary objective of economic regulation is to introduce in the performance of a regulated, monopoly company, the effects of competitive pressures (actual and potential) that are typical of otherwise competitive markets. Consistently with this objective, the current electric public utility concession model establishes a tariff system for Portion B of the tariff mechanism called price-cap regime, under which services are regulated by price, according to innovative economic rules, the purpose of which is remodelling public utility services based on the characteristics of private sector activities, which include the service efficiency and tariff reasonableness principles.

#### 1.5. Tariff revisions prescribed by the concession agreements

Most of the Brazilian distributors were privatised from 1995 to 2000. The electric public utility concession agreements entered into with all the distributors starting 1995 establish the initial tariffs and prescribe the tariff revision mechanisms:

- Annual tariff adjustment - pass-through of fluctuation of Portion A cost and Portion B inflation - factor X.
- Extraordinary tariff revision - at any time when there is an economic and financial unbalance of the concession agreement.
- Periodic tariff revision - Portion B, every four or five years

Under the concession agreement, the initial revenue of a distributor is divided into two portions, as follows:

- a) Portion A encompasses the so-called “non-manageable” costs of the distributor, related to the electricity distribution operation and expressly stated in the agreement. These are costs whose amount and variance escape the control or influence of the distributor.
- b) Portion B encompasses the remaining revenue, and thus includes the so-called “manageable costs”. These are costs inherent to distribution operations and customer management activities, which are subject to the control or influence of the management practices adopted by the concessionaire, i.e., the costs of the operation (personnel, supplies, and outside services). Portion B also includes the return on capital.

The periodic tariff revision process applicable to Portion B of the tariff mechanism is conducted in two stages. The first stage, called tariff repositioning, serves to define tariffs consistent with efficient operating costs--for a certain service quality level--and fair return on prudently made investments. The second stage consists of the calculation of Factor X, which consists of setting efficiency goals for the second tariff period that will reflect in the tariff.

At the time of the periodic tariff revision new tariffs are defined based on efficient costs, so that consumers are benefited by the cost reduction and the gains on increased efficiency earned by the distributor. Therefore, the return on the capital invested in the service provision is not predefined (as under the service cost regime), but can be increased as result of the reduction in operation costs, as the concession agreements set out mechanisms that have the objective of obtaining tariffs that remain constant in real terms. The current legal and economic statutes on the tariff regime of electric public utility service concession agreements in Brazil are one side of the incentive-based regulation regime. Its primary purpose is to increase service efficiency and quality, in conformity with the tariff reasonableness principle.

Each portion is broken down as follows:

Breakdown of a Distributor's Revenue - required	
Portion A and Financial Components (non-manageable costs)	Portion B (manageable costs)
Industry charges: Overall Reversal Reserve Fuel Consumption Account Service Inspection Fee Alternative Electric Energy Sources Incentives Program Energy Development Accounts Research and Development and Energy Efficiency National System Operator	Operation and maintenance expenses Personnel Supplies Outside services General and other expenses  Capital expenditure: Regulatory depreciation Return on capital
Energy transportation cost: Use of transmission facilities Use of connection facilities Use of distribution facilities Transportation of Electric Energy from Itaipu	
Electricity purchased for resale: Bilateral agreements Energy from Itaipu Auction contracts	
Financial components	

The concession agreements comprise a specific procedure for the adjustment of these portions in each year of the tariff period. Each distributor has included in the tariff revision amount a tariff structure considering its own initial amounts, which when applied to its marketplace defines the annual revenue for the first year of the subsequent tariff period.

At each annual adjustment within the tariff period, the amount of Portion A is obtained based on the effective conditions of each one of the items that form said portion (energy purchased and other). The amount of Portion B is adjusted based on the IGP-M (inflation index) for the twelve months prior to the revision date. These rules encourage concessionaires to reduce operating costs (covered by Portion B of revenue) during the period prior to the next tariff revision, as lower costs for a constant real level of tariffs means higher benefits for the distributor, as higher return of capital.

Thus, the return on invested capital, which should be included in tariffs, is obtained by applying a return rate appropriate to distribution operations in Brazil on the investment made, or return basis.

This repositioning ensures the economic and financial balance of the concession agreement of a distributor at the time of the periodic tariff revision. By applying annual tariff adjustment rules, this balance should be maintained until the next revision, which is made every four years.

#### 1.6. Recognition of regulatory assets and liabilities

Under normal conditions in Brazil, entities can only recognise regulatory assets and regulatory liabilities related to the costs part of Portion A, i.e., specific costs, non-manageable by a distributor's management, whose tariff mechanism ensure the pass-through of annual costs to the corresponding tariffs. There are exceptions that we report above.

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## Example:

## Tariff increase of Portion B

Year	Actual figures			Legal right - increase in tariff					% of the tariff increase in parcels					Regulatory asset unbilled (amortized) R\$
	Actual market Consumption	Tariff before increase	Actual net revenue	Actual market Consumption	Tariff increase	Net revenue	Incremental revenue		Actual market Consumption	% tariff increase	Tariff increase	Net revenue	Incremental revenue	
	KWh	R\$	R\$	KWh	R\$	R\$	R\$	R\$	KWh	%	R\$	R\$	R\$	
	(estimated)			(estimated)	12%				(estimated)					
1	1.000	10,00	10.000	1.000	11,20	11.200	1.200		1.000	7%	10,90	10.900	900	300
2	1.000	10,00	10.000	1.000	11,20	11.200	1.200		1.000	11%	11,10	11.100	1.100	100
3	1.000	10,00	10.000	1.000	11,20	11.200	1.200		1.000	13%	11,30	11.300	1.300	-100
4	1.000	10,00	10.000	1.000	11,20	11.200	1.200		1.000	15%	11,50	11.500	1.500	-300
Total			40.000			44.800	4.800					44.800	4.800	0

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## **IBRACON Release No. xx/02**

### **General Settlement of the Power Sector**

This Release is issued to discuss and communicate the conclusions reached by the Brazilian Institute of Independent Auditors (IBRACON) about the effects on the financial statements of the electric distribution and generation companies of the "General Settlement of the Power Sector", which was regulated by Executive Order No. 14 of December 21, 2001 issued by the Brazilian government (published in the official gazette of December 21, 2001) and Resolution No. 91 of December 21, 2001 issued by the Energy Crisis Management Commission. These legal instruments deal primarily with the extraordinary rate adjustment, its calculation method, requirements for the National Bank for Economic and Social Development's (BNDES) emergency support program for electric utilities.

This Release also provides guidance to independent auditors, IBRACON's members, on necessary procedures to be applied for ensuring the validity of the accounting records of the said extraordinary rate adjustment.

### **BACKGROUND**

#### Brazilian accounting environment

The accounting profession and the Brazilian regulatory agencies establish the rules for certain business segments, such as financial institutions (Central Bank of Brazil), insurance companies (Superintendency of Private Insurances - SUSEP), private pension entities (Supplementary Pension Department - SPC), consortiums (Central Bank of Brazil), etc., as well as for particular situations, like downstream mergers, etc.

Since the electric utilities were controlled by the government a short time ago (most electric generation companies still are government-owned), the National Electricity Agency (ANEEL), in addition to fulfilling its role as regulator of the electricity market, assumed the responsibility for dealing with the accounting matters and establishing standard chart of accounts, accounting procedures, etc. for these companies.

After the privatization process or the execution of new concession agreements, primarily of electric distribution companies, new situations have arisen from the relationship between the government (through ANEEL) and the private enterprise.

New situations arose which have not been timely resolved due to the little experience of the parties involved (private enterprise and government - ANEEL) and specific economic aspects. There are presently several claims not yet decided by ANEEL or law courts.

The utilities, on their own initiative or based on discussions with their independent auditors, will not account for such claims related to costs classified as Parcel A until they obtain a definitive, favorable decision from ANEEL.

The effect of the exchange rate variation on the energy supply by Itaipu in 1999 is an example of a matter for which a solution was found.

In the first months of 1999 the Brazilian currency (Real - R\$) devalued sharply in relation to the U.S. dollar, which caused an imbalance between the electric distribution companies' revenues and costs as the Itaipu rate was denominated in U.S. dollar. Recognizing that the change of economic policy (floating exchange rate) caused an economic imbalance to the concession agreements, ANEEL authorized a rate increase designed to recover the electric distribution companies' extraordinary exchange rate difference within 12 months. After the recovery period expired or the difference was recovered in a shorter period, the rate returned to the prior level.

For accounting purposes, such exchange rate difference was considered as prepaid cost in current assets and was amortized as recovered through the approved rate increase. However, it should be noted that this treatment has not been applied by all companies, as it was an unusual situation in which there are no standards or policies in the Brazilian accounting literature. Several companies recognized the difference as cost in the month of occurrence and as revenue as billed at the special rate.

### **Regulated activity**

According to the terms of the concession agreements in Brazil and the Electricity Distribution Agreements, the three categories of rate review follow:

- a) Annual rate adjustment on the agreement anniversary  
According to Technical Note No. 18/1999-SRF/ANEEL - Concepts of rate adjustment and review processes of September 21, 1999, "within the concept of price guarantee as provided for in these agreements, the rate adjustment index (IRT) is designed to recover, upon every adjustment, the purchasing power of the rate.

The adjustment is effected in a separate and distinct way for revenues: the total variation of the concessionaire's non-manageable costs (Parcel A), which are defined by the concession authority, is passed on to rates, while manageable costs (Parcel B) are adjusted using the General Market Price Index (IGPM).

- b) Extraordinary rate adjustment  
If there are significant changes in the concessionaires' costs, like change in rates of purchase and sale of energy, change in rates for use of electric distribution and generation systems, etc., the concessionaires can apply to ANEEL for an extraordinary rate adjustment.
- c) Ordinary rate review  
ANEEL can authorize rate increases or reductions taking into consideration changes in the concessionaires' market and cost structure, rate levels of similar companies operating locally or abroad, efficiency improvement and reasonable rates. The first ordinary rate review is expected to take place in four, five or six years from the signature date of the agreements.

Based on the foregoing, the concession agreements guarantee recovery of certain costs through the automatic adjustment of rates and keeping of economic balance.

### **Emergency Energy Rationing Plan (government's interference in the business activity)**

An Emergency Energy Rationing Plan was created by Executive Order No. 2198 of August 24, 2001 to reduce energy consumption and avoid unplanned interruption in power supply. Average

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reduction in consumption levels by this plan was estimated at 20% for the months of May, June and July 2000. The energy rationing plan will be effective June 2001 through the date the government considers the reservoir levels normal. This plan has been suspended in January 2002 in the North and is expected to be suspended in March 2002 in the other regions.

As a result of the mandatory energy rationing implemented by the Brazilian government, the electric generation and distribution companies experienced a reduction in their profit margins, as their physical and personnel structures could not be reduced in line with the consumption reduction quotas imposed by the rationing plan. Thus, the electric utilities continued incurring fixed costs and financial charges (very significant in this business segment) without earning corresponding revenue.

In addition to the energy rationing plan, the electric utilities have filed various claims with the National Electricity Agency (ANEEL) to resolve the financial imbalance of the concession agreements that, according to them, has resulted from several events – for example, the increase in the costs of energy acquired from Itaipu because of the significant devaluation of the Brazilian real in 1999. Only a Parcel of such unexpected increased costs has been offset by raising rates as authorized by ANEEL; no rate adjustment was authorized with respect to the other Parcel, which resulted in the companies putting in claims for rate increase.

These and other costs are part of non-manageable costs that compose "Parcel A" of annual rate adjustments.

#### EXTRAORDINARY RATE ADJUSTMENT

After six months of discussions, the Brazilian government and the electric utilities reached a settlement known as the General Settlement of the Power Sector to regain the financial balance of the existing agreements and to offset losses from the Energy Rationing Plan relating to the period the plan is effective.

Such Settlement covers the margin losses incurred by the electric distribution and generation companies during the period the Energy Rationing is effective, additional costs of Parcel A for the period from January 1, 2001 to October 25, 2001, and costs of energy purchased on the Wholesale Electricity Market (MAE), referred to as "free energy", until December 2002.

#### Electric distribution companies:

A – Losses incurred in the rationing period (revenue x costs)

1. The revenue of the electric distribution companies during the rationing will be recovered through an “extraordinary rate adjustment” (rate increase of 2.9% for residential consumers (except for low-income consumers) and 7.9% for the other consumers);

2. Such rate adjustment applies only to consumers that are served by the Interconnected Systems in the Southeast, Midwest and Northeast regions (from June 1, 2001 to the discontinuance of the Rationing Plan) and Pará and Tocantins states, and in the areas of Maranhão state that are served by the Northern Inter connected System (from July 1 to December 31, 2001);

3. The extraordinary rate adjustment will be effective for the time needed to offset the amount of losses determined, which is subject to ANEEL's homologation; (our underline)

4. The sector expects that losses will be recovered in three years;

5. The amount of the extraordinary rate adjustment will correspond, for each interested company, to the difference between the electric distribution company's estimated revenue, if the Emergency Rationing were not effective, and actual revenue during the Rationing Plan, considering the GDP growth rate and the expected consumption increase. (our underline).

The estimated revenue will be computed from the expected consumption at the projected average rate, which will be based on the average rate calculated by the rate adjustment index (IRT) of 2000 and adjusted at the IRT of 2001 in the months of annual rate adjustment; and

6. The electric distribution companies, to which the extraordinary rate adjustment applies, shall pay the electric generation companies over the period the Energy Rationing Plan is effective the amounts of the initial contracts and equivalent instruments, with the same reduction as for the electric distribution companies. Such reduction is estimated at 3%, i.e., the electric generation companies shall bill the electric distribution companies for the total energy contracted as if it had been produced and delivered.

#### Requirements for extraordinary rate adjustment

To permit the implementation of the extraordinary rate adjustment, the Energy Crisis Management Commission issued on December 21, 2001 Resolution No. 91 establishing the following standards:

I. the extraordinary rate adjustment must eliminate potential current legal controversies over the topics discussed in the above-mentioned Resolution;

II. the electric distribution and generation companies shall not claim from each other and from the concession authority any amounts relating to excess of initial contracts and equivalent instruments or compensation for reduction in energy supply by plants pertaining to the Energy Reallocation System (MRE), for the period from June 2001 through the discontinuance of the Rationing Plan;

III. the electric distribution and generation companies shall not file court or out-of-court claims for any type of compensation related to revenues during the Energy Rationing Plan;

IV. to resolve the controversy over repurchase of excess energy of initial contracts and equivalent instruments, including the Repurchase Agreement, and application of ANNEX V of initial contracts, the electric distribution and generation companies shall amend the initial contracts and equivalent instruments by including a formula to substitute for ANNEX V, which is a requirement for ANEEL's homologation of the extraordinary rate adjustment;

V. the extraordinary rate adjustment is not applicable, as stated in article 1 of the said resolution, in cases of energy rationing;

VI. by the date of the first partial homologation by ANEEL of the extraordinary rate adjustment, the electric distribution and generation companies will have formalized, with the concession authority and among themselves, the settlement, relinquishment and waiver of any potential claim, right, court or out-of-court disputes associated with the Energy Rationing Plan, the said excess of initial contracts and equivalent instruments, expenses set out in article 2 and costs referred to in article 6, especially in paragraph 1, both of Executive Order No. 14 of 2001, as well as other legal acts, including representations, transactions, amendments and commitments set forth in paragraph 5, article 1 of Resolution No. 91 and in Executive Order No. 14 of 2001;

VII. without detriment to their other obligations and representations, the electric distribution and generation companies recognize that no rule, order, duty, act or circumstances that have been addressed in Resolution No. 91 and in Executive Order No. 14 of 2001 is cause for economic imbalance and waive any claim to rate review based on facts and rules which are provided for in the same regulation.

#### B - Additional costs of Parcel A (cost recovery)

The mechanism provided for in Executive Order No. 2.227 of September 4, 2001, shall apply to all variations which occurred in items of "Parcel A" set out in the electric distribution concession agreements, excluding variations of those items that may have occurred until December 31, 2000. The application of this provision requires the interested party to apply for it. The interested party shall then have to:

1. waive rights, claims, lawsuits, court or out-of-court claims and withdraw any administrative or judicial demands under way relating to variations in items of Parcel A from the date the respective concession agreement was executed through October 26, 2001;

2. make a declaration stating that it will not demand extraordinary rate review based on facts that took place between the execution of the concession agreement and December 31, 2001;

3. sign acts, transactions, waivers, representations and relinquishments regulated by an ANEEL resolution.

i. The application of the provisions of the paragraph above is subject to the principle of reasonable rates. These provisions will be implemented only after verification of supporting documentation and homologation of the amount by ANEEL over a flexible period of time.

ii. The provision of the paragraph above shall not, in any circumstance, apply to variations of items of "Parcel A" which occurred in fiscal years prior to 2001.

#### C - Free energy

The expenses incurred for the purchase of energy on the Wholesale Electricity Market (MAE) until December 2002, as a result of the reduction in the energy volume generated by the power plants belonging to the Energy Reallocation System (MRE) and that are signatories to the initial contracts and equivalent instruments, shall be passed on to the consumers who are served by the National Interconnected Electric System.

##### Electric generation companies:

1. As previously stated, the electric distribution companies, to which the extraordinary rate adjustment applies, shall pay to the electric generation companies, over the period the Energy

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Rationing Plan is effective, the amounts of the initial contracts and equivalent instruments, with the same reduction as that applicable to the electric distribution companies. Such reduction is estimated at 3%.

2. To resolve the controversy over repurchase of excess energy of initial contracts and equivalent instruments, including the Repurchase Agreement, the expenses incurred for the purchase of energy on the Wholesale Electricity Market (MAE) until December 2002, as a result of the reduction in power supply by the plants belonging to the Energy Reallocation System (MRE) and that are signatories to the initial contracts and equivalent instruments, shall be passed on to the consumers who are served by the National Interconnected Electric System. With respect to the application of ANNEX V of initial contracts, to meet the requirement for the ANEEL homologation of the extraordinary rate adjustment, the electric distribution and generation companies shall amend the initial contracts and equivalent instruments by including a formula to substitute for ANNEX V.

3. The expenses incurred for the purchase of energy on the MAE until December 2002, as a result of the reduction in power supply by the power plants belonging to the MRE and that are signatories to the initial contracts and equivalent instruments, shall be passed on to the consumers who are served by the National Interconnected Electric System.

#### BASIS OF ACCOUNTING

As aforementioned, unusual events have evolved in the electricity sector primarily from the Emergency Energy Rationing Plan, and there are no standards or policies in the Brazilian accounting literature for the effects of these significant events and the solution encountered with the release of Executive Order No. 14 and GCE Resolution No. 91.

To address this topic, initially we referred to IBRACON's pronouncement NPC 14 – Revenues and Expenses - Income, which sets forth the standards for identifying the conditions and recognizing revenues and expenses.

Some criteria in such pronouncement are as follows:

*Revenue is recognized only if it is probable that the economic benefits of the transaction will be received by the company (revenue was "earned" by the company).*

*Sales revenue must be recognized if all of the following conditions are met:*

- a. the company has assigned to the buyer significant risks and benefits associated with the title to the products;*
- b. the company no longer has a continuous management involvement that is usually associated with the ownership nor has effective control over goods sold;*
- c. the amount of revenue is objectively determinable;*
- d. it is probable that the economic benefits of the transaction will be received by the company; and*
- e. the costs incurred or to be incurred in the transaction are objectively determinable.*

At first sight it seems that the rate adjustment and the Parcel A (non-manageable) cost recovery could not be recognized as revenue and cost reduction, respectively, in fiscal 2001. However, the characteristics of the product in question - electric power – should be analyzed.

Differently from any other product (except those having similar characteristics, like production and supply of gas, water, etc.), the electric power has its own characteristics, related to production or commercialization. Currently the power consumers do not have supplier options open, except for large consumers that decided to exercise the right to choose their supplier, thus becoming free consumers. There are few substitutes for electric power (the consumers can reduce consumption levels, but they probably will not cease consumption). In light of the current electricity market conditions (lack of competition due to short supply), we can say that the consumers are slaves.

For analysis purposes, it should be noted that there is a group of consumers and not individual consumers, i.e., the concessionaires have a mass of clients whose individual consumption will vary but consumption tends in the aggregate to be steady.

In the topics discussed in this Release we could see that both the rate adjustment and the additional costs of Parcel A have been derived in fiscal 2001, i.e., the rate adjustment is being computed by the difference between the energy that would be sold if the Energy Rationing Plan were not effective and the non-manageable costs of Parcel A are being computed by the excess of costs in fiscal 2001.

Therefore, both the decrease in revenue and the increase in costs pertain to the year ended December 31, 2001, and the rate adjustment will extend to the next years until the aforementioned Energy Rationing Plan is extinguished.

We can say that the product was delivered at a lower price than that assured for the concessionaires to obtain a necessary margin or recover non-manageable costs. Thus, the government established a mechanism of offsetting such difference by raising prices (2.9% for residential consumers and 7.9% for the other consumers). The rates will return to the original level as soon as the electric distribution companies recover the costs of Parcel A and additional costs of free energy.

We repeat that such differences of 2001 will be borne by the group of consumers because if the calculation is based on the individual consumption of each consumer in 2001, the amount to be paid by the consumers will vary. The settlement of accounts is not individual.

The only remaining question to discuss is the collectability of such differences. As exhaustively discussed, the Brazilian government, through Executive Order No. 14 and other instruments, guaranteed recovery by the electric distribution companies of such differences by means of a special rate increase (2.9% and 7.9%) until the differences are fully recovered. Thus, in view of the history of energy consumption in the country, its indispensability, its sale method, the realization of the differences is assured.

In addition to the concepts and conclusions discussed in this topic, please find at the end of this Release a summary of the main topics addressed in the U.S. literature that was applicable when U.S. electricity market had similar characteristics to those presently found in Brazil.

## IBRACON's understanding

Based on the information summarized above (Executive Order No. 14 and Resolution No. 91) and what was discussed in the preceding topic "Basis of Accounting", the Brazilian Institute of Independent Auditors concluded that the amount of the extraordinary rate adjustment allowed by the Brazilian government, for the recovery of costs of Parcel A and additional costs of free energy, can be regarded as an asset and it should therefore be recorded by the electric utilities in the income for the year ended December 31, 2001 and that this accounting complies with the accounting principles set forth in CFC Resolution No. 750 of December 29, 1993, primarily those relating to the fact: principle of opportunity (timing and integrity of the recording of net equity and its changes); principle of accrual basis (revenues and expenses must be included in income for the period in which they are earned/incurred, always simultaneously if related, regardless of receipt or payment); and principle of conservatism (adopt the lowest amount for assets and the highest amount for liabilities).

It is important to note that this understanding is based on the current situation of the Brazilian electricity market. Therefore, any future change in situation implies review of the conclusions set forth in this Release.

The way accounting entries must be performed will be regulated by ANEEL.

## SIGNIFICANT ASPECTS FOR AUDIT PURPOSES

For audit purposes too, this topic has special characteristics and demands a lot of attention prior to expressing an opinion.

### Determination of the amounts of the extraordinary rate adjustment

#### a) Rationing losses

The calculation method for this item was regulated by several instruments released by the government and ANEEL.

#### b) Parcel A costs

With regard to costs of Parcel A, there is a clear definition in the legislation of the nature of items to be considered and the period covered.

#### c) Additional costs of free energy

The Wholesale Electricity Market Administration (ASMAE) has responsibility for calculating and disclosing the individual amount per concessionaire for accounting purposes.

#### d) Tax aspects

In accounting for the items enumerated above tax aspects shall be considered, especially indirect taxes (PIS, COFINS) levied at the time of recording or in the future at the time of billing to consumers.

### Requirements for homologation of the extraordinary rate adjustment

Executive Order No. 14 established the requirements for the extraordinary rate adjustment and the recovery of costs of Parcel A (non-manageable), as set forth in the topics "Requirements for Extraordinary Rate Adjustment" and "Additional Costs of Parcel A (Cost Recovery)".

With regard to rationing loss:

“by the date of the first partial homologation by ANEEL of the extraordinary rate adjustment, the electric distribution and generation companies will have formalized, with the concession authority and among themselves, the settlement, waiver and relinquishment of any potential claim, right, court or out-of-court dispute related to the Emergency Energy Rationing Plan, excess energy of initial contracts and equivalent instruments, expenses set out in article 2 and costs referred to in article 6, especially paragraph 1, both of Executive Order No. 14 of 2001, as well as other legal acts, including representations, transactions, amendments and commitments set forth in paragraph 5 of article 1 of Resolution No. 91 and in Executive Order No. 14 of 2001”

With regard to additional costs of Parcel A:

- “waiver of any claim, right, court or out-of-court dispute, as well as withdrawal from any administrative or judicial dispute in progress relating to variations of items of Parcel A, from the date the respective concession agreement is signed to October 26, 2001;
- interested party's declaration stating that it will not demand extraordinary rate review based on facts which occurred between the signature of the concession agreement and December 31, 2001; and
- interested party's signing of acts, transactions, waivers, representations and relinquishments regulated by ANEEL's resolution”.

## AUDIT PROCEDURES

As there are conditions for the fulfillment of provisions set forth in the legal documents, prior to expressing an opinion on the financial statements of these companies, the auditor should examine all the documents mentioned above. For this process ANEEL established requirements and procedures for the request for and homologation of the rate adjustment and other provisions and is preparing other rules to complete the process. Thus, concessionaires may have difficulty in submitting their requests to ANEEL or ANEEL may have difficulty in giving a prompt response.

As many concessionaires need to publish their financial statements prior to completing the process mentioned above, the IBRACON's understands that minimum requirements for issuance of auditors' opinion are:

- a) test calculations made by the company and conform them to established rules;
- b) examine supporting documentation of costs classified as Parcel A;
- c) compare the amounts recorded as additional costs of free energy with the amounts disclosed by the ASMAE. In the event of differences between the amounts disclosed by the ASMAE and the estimate previously made by management of the company, request management to discuss the matter with the ASMAE and ANEEL to resolve the differences. The auditor shall not issue his/her opinion prior to resolving the difference;

- d) check accounting record against rules established by ANEEL;
- e) check amounts of assets and liabilities classified under current and long-term to ensure that they comply with the time of recovery estimated by the company;
- f) check the company's commitment to the General Settlement of the Power Sector to ensure that the company's representative who signed the commitment had the legal power to sign it in conformity with legal requirements.
- g) examine minutes of meetings of the executive committee and/or board of directors that provide any waiver or relinquishment of any claim, right, court or out-of-court dispute, as well as withdrawal from any administrative or judicial dispute in progress, as set forth in Executive Order No. 14.
- h) review the explanatory note prepared by the company regarding the effects on the December 31, 2001 financial statements of the General Settlement of the Power Sector.
- i) obtain a written representation from management acknowledging responsibility for the financial statements, under the terms of CFC Resolution No. 752. In addition to the requirements set forth in the said resolution, this representation letter should indicate waiver by the company related to the matters discussed in item "g" above.

The suggested wording of this representation is:

"With regard to meeting the requirements for the homologation of the extraordinary rate adjustment under Executive Order No. 14 and CGC Resolution No. 91, we confirm our decision to make representations, sign amendment and enter into agreement, as follows:

I. representation on the full settlement of rights related to variations in items of Parcel A that occurred from the date of signature of the respective concession agreement to October 26, 2001 and on waiver of any right, claim, future or current administrative or judicial dispute over these facts;

II. representation on the waiver or withdrawal from any future or in progress administrative or judicial dispute over extraordinary rate reviews resulting from facts and rules which occurred from the signature of the respective concession agreement to December 31, 2001, as well as representation confirming that no extraordinary rate review will be requested based on facts which occurred in the same period;

III. representation on the waiver or withdrawal from any future or in progress court or out-of-court dispute with the concession grantor or regulators of the power sector related to facts concerning the Emergency Energy Rationing Plan, extraordinary rate adjustment, and provisions set forth in CGC Resolution No. 91 of December 21, 2001 and in Executive Order No. 14 of December 21, 2001;

IV. representation on the waiver or withdrawal from future or in progress court or out-of-court claims for any type of compensation related to revenues and costs during the Energy Rationing Plan;

V. representation on the waiver of any claim to the electric generation companies or the concession grantor for any amounts relating to excess of initial contracts and equivalent

instruments or compensation for reduction in energy supply by plants belonging to the Energy Reallocation System (MRE), for the period from June 2001 through the discontinuance of the Rationing Plan, as per article 20 of Decree No. 2655 of 1998, with wording from Decree No. 3656 of November 7, 2000;

VI. representation acknowledging that no rule, order, duty, act or circumstances referred to in Executive Order No. 14 of December 21, 2001, in CGC Resolution No. 91 of December 21, 2001, and in ANEEL Resolution No. 31 of January 24, 2002 is cause for economic imbalance;

VII. signature of an amendment to the initial contracts and equivalent instruments, including a substitute formula for Annex V, so as to resolve controversies over the application of the said annex, repurchase of excess of initial contracts and equivalent instruments, including the Repurchase Agreement, and expenses addressed in article 2 of Executive Order No. 14 of December 21, 2001;

VIII. signature of an amendment to the initial contracts and equivalent instruments providing a compulsory formula for controversy resolution, for adoption *ex officio* by ANEEL in case the parties fail to do so within the set time, at no detriment to ANEEL's subsidiary role in controversy arbitration procedures;

IX. making of an agreement for reimbursement of free energy costs with the electric generation companies that are signatories to the initial contracts and equivalent instruments, indicating the full settlement of expenses addressed in the sole paragraph of article 2 of Executive Order No. 14 of December 21, 2001, under the terms of ANEEL Resolution to be issued upon accounting for operations on the Wholesale Electricity Market (MAE) relating to the period the Emergency Energy Rationing Plan is effective."

#### EXPLANATORY NOTE ON THE GENERAL SETTLEMENT OF THE POWER SECTOR

In light of the significant subjects addressed in the General Settlement of the Power Sector and their impacts on the financial position and results of operations of the electric utilities, there is the need for adequate disclosure in financial statements of the content of the settlement and its effects for reader understanding.

The note on this topic must disclose the following information:

- Brief outline of the settlement
- Provisions of the settlement that are applicable to the utility
- Commitments assumed by utility management for the effectiveness of the settlement and current status of commitments (see "Requirements for Extraordinary Rate Adjustment" in this Release)
- If Executive Order No. 14 is under voting by Congress at the time of publishing the financial statements of the utility, this fact must be disclosed in the explanatory note
- Disclosure of the effects by nature of amounts, such as:

Electric distribution companies

1. Amount of the reversal of effects of Annex V, if applicable;
2. Amount of the extraordinary rate adjustment recorded as Consumers and Distributors (current and long-term), relating to the recovery of margin losses on energy rationing and the recovery of costs of free energy that will be passed on to the electric generation companies;

3. Amount of the extraordinary rate adjustment relating to the recovery of Parcel A costs, for the period January 1 to October 25, 2001, recorded as Prepaid Expenses (current and long-term) and Cost of Energy Purchased;
4. Parcel of expenses for the purchase of free energy in the Wholesale Electricity Market (MAE), recorded as Cost of Energy Purchased and Suppliers (current and long-term);
5. Total of effects on net income.

Electric generation companies

1. Amount of the reversal of effects of Annex V, if applicable;
2. Amount of the complement to revenue from initial contracts (difference between contracted amounts, net of reduction factor, and amounts billed through the balance sheet date);
3. Amount of the cost of free energy purchased in the MAE during the period May to December 2001;
4. Amount of the contract excess repurchase in the MAE in May, if applicable;
5. Amount of the reduction in revenue resulting from the application of Annex V in May, if applicable;
6. Amount of the recovery of the cost of free energy purchased in the MAE (MAE price less cost to be allocated to the electric generation companies, R\$ 49.26). This amount will be recovered through the electric distribution companies, as per item 4 of the note related to the electric distribution companies;
7. Total of effects on net income.

If the utility will use the special line of credit made available by the National Bank for Economic and Social Development (BNDES), this fact must be disclosed in the note.

The estimated time of recovery of the amounts recorded in assets must also be disclosed in the explanatory note.

ISSUANCE OF OPINION

Due to the importance of the topics addressed herein, doubts that may still exist and audit aspects involved, the auditor should evaluate each case carefully for the modifications necessary in the independent auditors' report.

Because of the large number of companies involved in the whole process, discussions in progress with the regulators and the MAE, and requirements for calculating the amounts to be recorded, there may be events or situations involving uncertainty that the auditor should consider in assessing the sufficiency of his/her work, potential uncertainties or aspects that the auditor should emphasize in his/her report.

The IBRACON will be attentive to the development of this process and, if needed, will issue a technical interpretation or other instrument providing guidance to auditors.

**São Paulo, March 9, 2002**

**Marcio Martins Villas  
President**

**Francisco Papellás Filho  
Director for Technical Matters**

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## Appendix

To assist us with the resolution of the matter discussed in this Release we referred to the international literature, primarily that applied to regulated enterprises in the United States - FAS-71, Accounting for Regulated Operations.

The following is a summary of the main points of this FASB pronouncement:

*“The Addendum to APB-2 (Accounting Principles for Regulated Industries) required that financial statements of a regulated business intended for public use be based on existing GAAP, with appropriate recognition given to the rate-making process established by the regulatory agency. Under GAAS, an independent auditor must comply with the reporting standard that financial statements be presented in accordance with GAAP.*

*Different methods are used by regulatory agencies to set rates for regulated enterprises. The many different methods can be classified into (a) individual cost-of-service, (b) group rate-setting, and (c) a combination of both individual cost-of-service and group rate-setting.*

*Under the individual cost-of-service method of rate setting, the allowable costs that an enterprise usually is permitted to recover are all actual and/or estimated costs that are required to provide the service to the public, including a return on investment to compensate sources of long-term debt and equity capital. The rate or rates charged to different classes of customers are designed, but not guaranteed, to produce total revenue for the enterprise equal to the allowable costs. The individual cost-of-service method usually is used in setting rates for public utilities. An enterprise is more ensured of cost recovery under the individual cost-of-service method than any other method.*

*Under the group rate-setting method, the allowable costs that an enterprise may recover are based on rates established on an industry-wide, area-wide, or some other aggregate basis. Group rate-setting usually is utilized in more competitive industries, such as airlines, motor carriers, railroads, and insurance companies, than those in which the individual cost-of-service method is used.*

*Under the combination of individual cost-of-service and group rate-setting methods, the allowable costs that an enterprise can recover are based on some combination of both methods. Under the combination method, however, allowable costs usually do not include a provision for a return on investment, but may include an allowance for inflation or working capital.*

*Through the regulatory process, an enterprise is substantially assured of recovering its allowable costs by the collection of revenue from its customers. It must be noted that under some methods of rate-setting, allowable costs include a return on investment for the regulated enterprise. The economic effect of regulation is the substantiation that an asset exists or does not exist. As allowable costs are incurred by a regulated enterprise, they should be capitalized as assets. Costs that are not allowable under the regulatory process, however, are not substantially assured of being recovered and should be expensed as incurred.*

*FAS-71 establishes GAAP for enterprises whose regulators have the power to approve and/or regulate the rates that enterprises may charge customers for services or products. It contains the criteria that an enterprise must meet to be classified as a regulated enterprise and also establishes GAAP for the capitalization of allowable costs. FAS-90 amends FAS- 71 to specify*

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*the appropriate accounting for abandonments of plants and the disallowances of costs of recently completed plants.*

### **CRITERIA FOR REGULATED OPERATIONS**

*FAS-71 applies to financial statements issued for general purposes by an enterprise that has regulated operations and meets all of the following criteria (FAS-71, par. 5):*

- 1. An independent third-party regulator or a governing board of the regulated enterprise that has been empowered by statute or contract establishes or approves the rates the enterprise can charge its customers for its services or products.*
- 2. The established or approved rates of the independent third-party regulator or governing board of the regulated enterprise are intended to recover the specific costs of the regulated services or products.*
- 3. The rates set by the independent third-party regulator or governing board of the regulated enterprise to recover the costs of the regulated enterprise are reasonable and likely to be collected. (In applying this criterion, consideration must be given to the demand for the services or products and the level of direct and indirect competition.)*

*The thrust of FAS-71 is that the regulatory process can provide a basis for the regulated enterprise to recognize a specific asset. In this respect, FAS-71 requires that the following conditions be met for a regulated enterprise to recognize an incurred cost as a regulatory asset (FAS-71, par. 9):*

- 1. The regulator's intent to provide recovery of a specific incurred cost must be clear.*
- 2. Based on available evidence, it is expected that the regulated rates will produce revenue about equal to the specific incurred cost.*

*If at any time the above conditions are not met, the incurred cost should be charged to earnings (FAS-121, par. 32a).*

*An enterprise must first qualify as a regulated enterprise by meeting the specified criteria of FAS-71, and then both of the above conditions must be met before an incurred cost can be capitalized as an asset.*

*The essence of the first criterion in FAS-71 is the existence of a regulator that can approve and/or regulate the rates that the enterprise can charge its customers for its services or products. The regulator may be an independent third party or a governing board of the enterprise empowered by statute or contract. A contractual arrangement between an enterprise and its sole or principal customer may create the appearance of regulation. However, the sole or principal customer of the enterprise is also responsible for payment of the services or products and thus is not, in a strict sense, an independent third-party regulator or governing board empowered by statute or contract. Therefore, Medicare, Medicaid, and similar contractual arrangements are excluded from the scope of FAS-71.*

*The principal economic effect of the regulatory process covered by FAS-71 is that it can provide substantiation that an asset does or does not exist at the time a regulated enterprise incurs costs to provide services or products.*

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*Under the provisions of FAS-71 the regulated rates must be designed to recover the specific costs of the regulated services or products. This usually is best accomplished by the individual cost-of-service method of rate-setting. Thus, the second criterion of FAS-71 requires that there be a cause-and-effect relationship between costs and revenues.*

*A cause-and-effect relationship usually does not exist if regulated rates are based on industry-wide costs. The cause-and-effect relationship is intended to be applied to the substance and not the form of the regulation. If regulated rates are based on the costs of a particular group of companies and there is a dominant company within the group, the costs of the dominant company may represent the costs of the entire group. Here, the second criterion of FAS-71 would be met.*

*The third criterion requires that the rates sufficient to recover incurred costs be reasonable to the ultimate consumer and likely to be collected.*

*If the regulatory process is based on the recovery of future costs and not specific incurred costs, the provisions of FAS-71 are not met. If a rate order authorizing regulated rates for an enterprise does not specify clearly the recovery of specific incurred costs, the provisions of FAS-71 are not met. The rate order must indicate clearly the specific incurred costs that are designated for recovery. These specific incurred costs are referred to as allowable costs, in accordance with FAS-121 and consistent with GAAP applicable to other enterprises in general.*

*In addition, if a regulator subsequently allows recovery through rates of costs previously excluded from allowable costs and written off, that action shall result in recognition of a new asset. The classification of that asset shall be consistent with the classification that would have resulted if those costs had been included initially in allowable costs (FAS-121, par 32c). This provision to reinstate costs previously written off under FAS-121 is unique to rate-regulated industries.*

*Sometimes the nature of an incurred cost, such as the abandonment of part or all of a particular facility, cannot be anticipated by the regulated enterprise or the regulator. Under these circumstances, the intent of the regulator may be inferred based on available evidence or regulatory precedent, and, as a result, it may be probable that the future rate increases will be provided by the regulator for the specific recovery of the unanticipated future cost.*

*On the other hand, the regulatory process may indicate the reduction or elimination of an existing asset or substantiate the existence of a new liability. If a cost or related asset is not classified as an allowable cost by the regulator, it will not produce future revenue through the regulatory process (FAS-71, par. 10). Here, the cost or related asset must be accounted for under existing GAAP, which are applied to other enterprises in general.*

***OBSERVATION:** If the regulatory process can create an asset, it appears that deregulation may result in the permanent impairment of an asset that owes its existence to regulation. Additionally, as competition becomes more pervasive in the rate-regulated industries, costs (particularly plant costs) may become “stranded” in that the utility is unable to recover its cost or plant investment because the customer has changed the nature of the services it has historically received from the utility.*

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*A regulated enterprise may be required by the regulator to refund revenue that was collected in prior periods; or the regulator may include in its regulated rates amounts that are intended to recover specific costs that may be incurred in the future, with the understanding that if the costs are not incurred, an adjustment will be made to future regulated rates. In either instance, the regulator has substantiated the existence of a liability (FAS-71, par. 11). In the event of customer refunds, FAS-71 requires that they be recorded as liabilities if they can be estimated reasonably and either (a) were ordered by the regulator and are unpaid or (b) are likely to occur and are not yet recorded.*

*If the regulator includes amounts in its rates that are intended to recover expected future costs that must be accounted for, a liability is created equal to the amount of revenue collected for the expected future costs.*

*The amount of revenue collected for the expected future costs is recorded as unearned revenue until those costs are actually incurred or an adjustment is made by the regulator. For example, a regulator may include in its regulated rates an amount for expected future uninsured storm damage. In this respect, the regulator may require that any amounts not actually incurred in the future for storm damages must be refunded to customers in the form of a future adjustment in the regulated rates. As the revenue attributable to the future storm damage is collected, FAS-71 requires that it be recorded as a liability and included in income only when the actual storm damage costs are incurred.*

*A regulator can substantiate the existence of another type of liability by requiring the regulated enterprise to credit customers over a future period for gains or other reductions of net allowable costs. The gains or other reductions in net allowable costs usually are amortized over the related future periods by a corresponding reduction in the approved regulated rates. In this event, FAS-71 requires that a liability be recorded in the amount of the future amortization (FAS-71, par. 11c). If a liability is recorded because of the regulatory process, it can only be reduced or eliminated by the regulatory process (FAS-71, par. 12).*

*An enterprise subject to FAS-71 must comply with all of its provisions. If there is a conflict between FAS-71 and existing GAAP, the provisions of FAS-71 must be applied (FAS-71, par. 4). In all other circumstances, however, existing GAAP must be followed and applied by a regulated enterprise. If a regulated enterprise is required by court order (affirmative injunction) to capitalize and amortize a particular cost and the cost does not qualify for capitalization under existing GAAP or FAS-71, the regulated enterprise cannot capitalize the cost in financial statements purported to be presented in accordance with GAAP.*

#### *Accounting for Alternative Revenue Programs (EITF 92-7)*

*Regulated enterprises, whose rates are set under the cost-of-service method, charge their customers the approved base rates (that are designed to recover the utility's allowable costs, including a return on shareholders' investment). Some regulators of the electric utilities have also authorized the use of alternative revenue programs. The following two categories of alternative revenue programs are discussed herein:*

- *Type A - Adjust billings for the effects of weather abnormalities or broad external factors or to compensate the utility for demand-side management initiatives. Demand-side management programs are measures or programs undertaken by a regulated utility to reduce or otherwise influence the level of its customers' usage.*

- *Type B - Increase billings if the utility achieves certain objectives, such as reducing costs or reaching specified milestones or proven improvement in customer services.*

*Both types of programs permit the adjustment of future rates (usually a surcharge on future billings) in response to prior activities or completed events. Such adjustments may result in refunds to consumers (for example, if actual sales to consumers are greater than expected or if established performance targets are not achieved).*

*Regulated entities to recognize the additional revenues if all of the following conditions are met:*

- *The regulator has approved an alternative program through an order that allows for the automatic adjustment of future rates;*
- *The amount of additional revenue for the period is objectively determinable and is probable of recovery; and*
- *The additional revenues will be collected within 24 months following the end of the annual period in which they are recognized.*

#### *Going off FAS-71*

*The rate-regulated industry continues to undergo significant changes. Competition, deregulation, regulatory disallowances, and market-sensitive rate structures are driving these changes. Most of the regional telephone holding companies created upon the breakup of AT&T in 1984 no longer follow FAS-71. Many other companies in rate-regulated industries are evaluating the applicability of FAS-71 as these changes evolve.*