



REGULATORY  
AUTHORITY

**Bermuda**

## **2<sup>nd</sup> Round Consultation Document:**

### **Regulatory Accounting Instructions General Determination for Electricity Sector**

Consultation Document Matter: [            ]

Date: May 4, 2018

Responses Due: June 21, 2018 (extended deadline)

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## **I. INTRODUCTION**

1. The Electricity Act 2016 (“EA”) received Royal Assent on 27th February 2016. The EA came into operation on 28th October 2016 pursuant to the Electricity Act 2016 Commencement Day Notice 2016 (BR 101/2016). The EA repealed the Energy Act 2009.
2. The Regulatory Authority of Bermuda (“the Authority”) is responsible for the regulation of the electricity sector. Its overarching responsibilities are to:
  - a. regulate tariffs and the quality of service provision to end-users;
  - b. ensure that access to electricity infrastructure by current and prospective generators is transparent, fair, reasonable, and non-discriminatory;
  - c. investigate and respond to complaints from end-users as regards the provision of electricity.
3. On 2nd August 2017, the Authority issued General Determinations (“GDs”) to establish the form of the transmission, distribution and retail (“TD&R”) and bulk generation licences. In accordance with condition 11 of the TD&R licence and condition 22 of the bulk generation licence, a vertically integrated electric utility holding these licences (“the licensee”) is required to submit separate regulatory financial accounts to the Authority.<sup>1</sup>
4. After the consultation process is completed, the Authority will enact a GD setting forth the Regulatory Accounting Instructions (the “Instructions”) for the electricity sector. The Instructions will provide guidance to the licensee in relation to the preparation of the separate regulatory financial accounts that the licensee will need to submit to the Authority. The same Instructions apply to all other bulk generation or TD&R licence holders in the electricity sector of Bermuda that are required to submit regulatory accounts to the Authority.
5. To consult on the Instructions, the Authority issued a Consultation Document on 23rd February 2018 (the “1st round of consultation”). Two interested parties provided their comments on the Instructions after the 1st round of consultation. This Consultation Document provides the discussion of the responses and invites interested parties to comment on the updated text of the Instructions, as proposed by the Authority.

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<sup>1</sup> An electric utility is a company that engages in the generation, transmission, distribution, and sale (retailing) of electricity. An electric utility may perform any combination of these functions. See Government of Bermuda (2015), ‘The National Electricity Sector Policy of Bermuda’, 26 May.

## II. CONSULTATION PROCEDURE

6. This consultation is being undertaken in accordance with Sections 69 to 73 of the Regulatory Authority Act 2011 ("RAA"). The procedure and accompanying timelines (as set out in Section 70 of the RAA), under which this consultation is taking place have been set out below.
7. Written comments should be submitted before 5:00 PM (Bermuda time) on June 21, 2018.
8. The Authority invites comments from members of the public, electricity sectoral participants and sectoral providers, and other interested parties. The Authority requests that commenting parties, in their responses, reference the numbers of the relevant questions, as set forth in this Consultation Document, to which they are responding. A complete list of questions presented by this Consultation Document appears in Section VIII.
9. Responses to this Consultation Document should be filed electronically in MS Word or Adobe Acrobat format. From the Authority's website, [www.rab.bm](http://www.rab.bm), parties wishing to file comments should click on the "Consultations" tab in the top menu, and select the fourth option in the drop-down list: "Submit a response". All comments should be clearly marked "Response to Consultation Document: Comments on Regulatory Accounting Instructions for Electricity Sector" and should otherwise comply with Rules 18 and 30 of the Authority's [Interim Administrative Rules](#), which are posted on the Authority's website.
10. The Authority intends to make responses to this Consultation Document available on its website. If a commenting party's response contains any information that is confidential in nature, a clearly marked "Non-Confidential Version", redacted to delete the confidential information, should be provided together with a complete version that is clearly marked as the "Confidential Version". Redactions should be strictly limited to "confidential information", meaning a trade secret, information whose commercial value would be diminished or destroyed by public disclosure, information whose disclosure would have an adverse effect on the commercial interests of the commenting party, or information that is legally subject to confidential treatment. The "Confidential Version" should highlight the information that has been redacted. Any person claiming confidentiality in respect of the information submitted must provide a full justification for the claim. Requests for confidentiality will be treated in the manner provided for in Rule 30 of the Authority's [Interim Administrative Rules](#).
11. In accordance with section 73 of the RAA, any interested person may make an *ex parte* communication during this consultation process, subject to the requirements set forth in this paragraph 11. An *ex parte* communication is defined as any communication to a Commissioner or member of staff of the Authority regarding the matter being consulted on in this Consultation Document, other than a written submission made pursuant to this Section 2. Within 2 business days after making an *ex parte* communication, the person

who made the *ex parte* communication shall submit the following to the Authority: (i) a written description of the issues discussed, and positions espoused; and (ii) a copy of any written materials provided. This will be posted on the Authority's website, along with a notice of the *ex parte* communication.

12. The principal point of contact at the Authority for interested persons for this Consultation Document is Jozelle Escolastica, Head of Regulatory Finance. She may be contacted by email, referencing "Comments on Regulatory Accounting Instructions for Electricity Sector" at [electricity@RAB.bm](mailto:electricity@RAB.bm) or by mail at:

Jozelle Escolastica  
Regulatory Authority  
1st Floor, Craig Appin House  
8 Wesley Street  
Hamilton, Bermuda

13. In this Consultation Document, except insofar as the context otherwise requires, words or expressions shall have the meaning assigned to them by the EA, the RAA and the Interpretation Act 1951.
14. This Consultation Document is not a binding legal document and does not contain legal, commercial, financial, technical or other advice. The Authority is not bound by this Consultation Document, nor does it necessarily set out the Authority's final or definitive position on particular matters. To the extent that there might be any inconsistency between the contents of this Consultation Document and the due exercise by the Authority of its functions and powers, and the carrying out of its duties and the achievement of relevant objectives under law, such contents are without prejudice to the legal position of the Authority.

### III. LEGISLATIVE CONTEXT

15. The RAA established a cross-sectoral independent and accountable regulatory authority “to protect the rights of consumers, encourage the deployment of innovative and affordable services, promote sustainable competition, foster investment, promote Bermudian ownership and employment and enhance Bermuda’s position in the global market”.<sup>2</sup>
16. In June 2015, the Minister of Economic Development of Bermuda published the National Electricity Sector Policy (the “Policy Document”). The Policy Document set out the groundwork for the institution of the subsequent EA and the desired structure of the Bermudian electricity sector.
17. The EA received Royal Assent on 27th February 2016 and came into operation on 28th October 2016 pursuant to the Electricity Act 2016 Commencement Day Notice 2016 (BR 101/2016). The EA repealed the Energy Act 2009.
18. The Minister responsible for electricity is currently the Minister of Transport and Regulatory Affairs (the “Minister”). The Minister can issue Ministerial declarations that establish policies for the electricity sector,<sup>3</sup> and can also issue Ministerial directions to the Authority regarding any matter within his/her authority as regards the electricity sector.<sup>4</sup> In formulating Ministerial directions, the Minister shall set priorities and resolve trade-offs or conflicts that arise from the purposes of the EA in a way that he/she thinks best serves the public interest.<sup>5</sup>
19. The EA grants various functions to the Authority. Section 14 of the EA provides that the function of the Authority is generally to monitor and regulate the electricity sector. Section 14 (2) (c) provides that the functions of the Authority shall include the making of Administrative Determinations<sup>6</sup> to provide for the control and conduct of the provision of electricity services, including the grant, renewal, modification, suspension or revocation of licences for the provision of electricity. On 2nd August 2017, the Authority issued General

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<sup>2</sup> Regulatory Authority Act 2011, p. 5.

<sup>3</sup> Electricity Act 2016, Section 7(2).

<sup>4</sup> Electricity Act 2016, Section 8(3).

<sup>5</sup> Electricity Act 2016, Section 9.

<sup>6</sup> Defined in the RAA as including a General Determination, order, direction, decision or other written determination by which the Authority establishes the legal rights and obligations of one or more Sectoral Participants (i.e. person who provides, uses or seeks to use a good or service in the energy sector but does not include the Authority) but does not include an advisory guideline (i.e. written statement issued by Authority that provides Authority’s views regarding a specific matter but is not legally binding) or an adjudicative decision and order (which means a decision or order following an adjudication conducted in accordance with Sections 74 to 83 of the RAA). General Determination is defined as a statutory instrument made pursuant to Section 62 of the RAA that is applicable to all Sectoral Participants or categories of Sectoral Participants as fall within the scope of the Statutory Instrument.

Determinations to establish the form of the TD&R and bulk generation licences pursuant to Section 24 (1) of the EA.

20. In accordance with condition 11 of the TD&R licence and condition 22 of the bulk generation licence, licensees are required to submit separate regulatory financial accounts to the Authority.
21. Separate regulatory financial accounts will enable the Authority to fulfil its functions pursuant to the EA. In particular, accounting separation is required in order to provide information in relation to the performance of licensees, which enables the Authority to pursue its duties in relation to:
  - a. protecting the interests of end-users with respect to affordability of the electricity service;
  - b. promoting economic efficiency and sustainability in the generation, transmission, distribution and sale of electricity; and
  - c. promoting competition among electricity generators.
22. The preparation of separate regulatory financial accounts also helps the Authority to determine electricity retail tariffs in Bermuda.
23. The Authority notes that were any irreconcilable differences between licences and the Instructions to arise, then the Instructions, would take precedence.

#### **IV. DESCRIPTION OF METHODOLOGY PROPOSED IN THE 1ST ROUND OF CONSULTATION**

25. The Authority requires the licensee to report, separately for the bulk generation and TD&R licensed business units, the elements of the balance sheet and income statement (the “accounts”), with corresponding accounting disclosures and notes.
26. The Instructions require the accounts of the bulk generation and TD&R licensed business units to be separated from:
  - a. each other;
  - b. the accounts of the unregulated business units of the licensee (if applicable);
  - c. the accounts of related parties, as per the definition in the international accounting standards (“IAS”).
27. The elements that need to be reported include operating costs, revenues, assets and liabilities. In particular, the following information is required for each licensed business unit:
  - a. A breakdown of operating costs and revenues by type of activity; and of allocation rules by type of cost and revenue.
  - b. A breakdown of fixed assets (“the fixed assets register”), including the disclosure of asset life assumptions, depreciation methods, other relevant details on asset valuation policies, and whether an asset is used as collateral for a liability.
  - c. A breakdown of current assets and liabilities; and of allocation rules by type of current asset and liability.
  - d. A breakdown of long-term liabilities if they are directly associated with a particular business unit, or are collateralised with assets that are associated with particular business units; and disclosure of the details of long-term liabilities.
  - e. The split of operating costs and revenues between: internal transactions; external transactions with related parties; and external transactions with independent parties; and the pricing mechanisms used for internal and external transactions with related parties by type of activity.
  - f. Disclosure of third-party transactions that relate to activities that are not core activities for bulk generation or TD&R business units.
28. The licensee should demonstrate how the separate business units’ regulatory accounts reconcile with the consolidated statutory financial statements.



29. The methodologies that are envisaged to be used to prepare regulatory accounts must be submitted to, and approved by, the Authority. This includes the accounting separation principles, capitalisation and asset valuation policies, and pricing mechanisms behind transfer charges and related parties' transactions. Where the licensee changes a methodology, the licensee is required to justify and disclose the change and demonstrate its financial impact by showing how it reconciles with the previous methodology. The Authority retains the right to request more information about the disclosed change to the methodology, and to disagree with the change.

## **V. SUMMARY OF RESPONSES TO THE 1ST ROUND OF CONSULTATION**

30. The Authority has received two responses to the 1st round of consultation.

### **A. RESPONSE 1—MR ROBERT THOMSON**

31. The first response was submitted by Mr Robert Thomson. Mr Thomson made a number of suggestions in relation to market structure and the form of the regulatory control to which the licensee should be subject. In relation to the regulatory financial accounts, the Authority has identified two suggestions from Mr Thomson that are discussed below.

#### **a. Separate presentation of fixed and variable costs**

32. Mr Thomson suggested that the regulatory financial accounts should present fixed and variable costs separately.
33. The Authority does not consider it necessary to require the licensee to present its fixed and variable costs separately. The Authority notes that the International Financial Reporting Standards (“IFRS”) propose two different ways of classifying expenditure: by nature and by function, and do not require the explicit separation of fixed and variable costs. The Authority considers it sufficient for the licensee to be compliant with the IFRS, in this regard. In any case, if the regulatory allowance for fixed and variable costs differs in the implementation of the retail tariffs methodology, or in estimating the allowed feed-in tariff, then the relevant distinction in the fixed and variable expenditure will be reviewed as part of the tariff reviews.

#### **b. Benchmarking analysis**

34. According to Mr Thomson, the licensee should perform and present cost benchmarking analysis, whereby the costs of the licensee should be compared with the costs of companies providing similar services in other countries.
35. The Authority acknowledges the usefulness of cost benchmarking analysis in monitoring whether the least-cost provision has been achieved. However, the Authority considers that requiring the licensee to undertake cost benchmarking analysis would be outside the scope of the Instructions. The purpose of the Instructions is to provide transparent information about the past costs of the licensee. Therefore, the Authority does not propose any changes to the Instructions related to this suggestion.

### **B. RESPONSE 2—BERMUDA ELECTRIC LIGHT COMPANY (“BELCO”)**

36. The second response to the 1st round of consultation was submitted by BELCO. Notable aspects of the response are discussed below.

**a. Impact of the Instructions on the promotion of competition**

37. BELCO provided the following comment:

...BELCO believes the public understanding of the cost of alternative sources of generation units built under a vertically integrated, regulated cost-of-service model with a strict obligation to serve is not comparable to the cost structure of one generating unit selling energy through a power purchase agreement. As such, we believe the information gleaned from compliance with the Instructions will need to be disseminated by the Authority with care.

38. The Authority appreciates BELCO's opinion on the comparability, or lack thereof, between the cost structure of the licensee's bulk generation business unit and an independent power producer. The Authority considers that the regulatory accounts increase the transparency in reviewing the extent to which the costs are comparable.
39. In fact, transparency in relation to costs, and the access to information by sectoral participants would be compatible with the purposes of the Electricity Act 2016. The Act envisages that sectoral participants would have non-discriminatory interconnection to transmission and distribution systems, as per section 6 (d) of the Electricity Act 2016. Access to information in relation to the costs of the bulk generation licensee therefore provides a basis for cost comparisons to sectoral participants.
40. Separately, the Authority considers that it would be consistent with good procedural practice to make the submitted regulatory accounts publicly available. This is because the regulatory accounts would be an input into regulatory allowed tariffs.

**b. Auditor's Assurance**

41. BELCO's auditor, PricewaterhouseCoopers Ltd. ("PWC") has suggested the following alternative language for the assurance statement sought in paragraph 7 of the Instructions:

In our opinion, the financial statements of Bermuda Electric Light Company Limited are prepared, in all material respects, in accordance with the regulatory accounting instructions for the electricity sector of Bermuda issued by the Regulatory Authority of Bermuda.

42. The Authority does not object to the language suggested by PWC and, therefore, proposes to incorporate the change to paragraph 7 of the Instructions.

**c. Response to Consultation Question 4**

Do you agree that assets should be allocated to the regulatory accounts of their main user, where the main user should make a transfer charge to any other business unit that also uses that asset?

43. BELCO has provided the following response to Consultation Question 4:

BELCO believes that assets should be allocated to the regulatory accounts of their main user and that shared assets should either be allocated on the basis of shared usage or that the main user should charge a market-based levy for such usage depending on which approach is more practical. The Authority ought to be cautious about the potential for market-based costs to destroy the existing synergies inherent in a vertically integrated utility that benefit ratepayers.

44. First, the Authority wishes to comment on BELCO's response in relation to the allocation of the shared assets.
45. BELCO specified that it believes that "shared assets should either be allocated on the basis of shared usage or that the main user should charge a market-based levy for such usage depending on which approach is more practical".
46. As proposed in the Instructions, the Authority believes that the latter approach to assets allocation would be preferable for the following reasons:
- a. If multiple independent parties used the same asset, typically, the asset would not be proportionally allocated to both parties. Instead, a single entity (one of the parties or a third party) would own the asset. To the extent that principles of asset allocation between the licensee's business units mimic asset allocation between independent parties, the Authority considers it appropriate to allocate each asset to a single business unit.
  - b. If shared assets were to be proportionally allocated to multiple business units, each business unit will have a part of an asset on its balance sheet. To the extent that assets are not divisible (e.g. half of a computer), the Authority considers that allocating whole assets to their main users would be more readily comprehensible.
47. The above, however, is not related to asset classes that consist of separate small units, e.g. IT equipment—separate small units can be individually allocated to particular business units (e.g. amongst 5 computers, 2 can be allocated to one business unit and 3 to another based on their main usage).
48. Second, the Authority wishes to comment on BELCO's response in relation to market-based costs and the synergies inherent in a vertically integrated utility.
49. BELCO flagged that "the Authority ought to be cautious about the potential for market-based costs to destroy the existing synergies inherent in a vertically integrated utility that benefit ratepayers".

50. The Authority wishes to provide assurance that it has no intention of ignoring the synergies inherent in a vertically integrated utility and that they should benefit ratepayers. Where one business unit charges the other, the transfer charges are offset such that, there is no net impact on customer bills. In addition, the Authority notes that the existing synergies within the vertically integrated utility would not necessarily preclude the valuation of transfer charges and transactions with related parties from being considered as valued at arm's length—for example, a cost-based approach is generally allowable within arm's-length pricing (see paragraph 34 of Instructions).

**d. Response to Consultation Question 6**

Do you agree that long-term liabilities should be allocated to business units only if they are directly associated with a particular business unit, or are collateralised with assets that are associated with particular business units?

51. In relation to the Consultation Question 6, BELCO made the following note:

... legacy costs related to environmental remediation and post-retirement benefits should either be left unallocated or allocated to the TD&R accounts to avoid distorting the generation cost structure for liabilities and costs that relate to periods prior to 1 January 2018.

52. This comment relates to the treatment of specific cost items rather than the methodology in relation to a broad category of costs.

**e. Response to Consultation Question 7**

Do you agree that the licensee should comply with the IFRS in relation to the capitalisation policy in everything but capitalisation of interest—i.e. that the licensee should not capitalise interest?

53. BELCO made the following comment in relation to the capitalisation of interest:

In relation to capitalized interest, BELCO believes that a return on capital ought to be earned for assets under construction and that this can be achieved either by including assets under construction in tariffs or through an allowance for funds used during construction (i.e. capitalized interest). We believe that the treatment of interest for accounting separation should follow the tariff methodology for assets under construction.

54. The Authority will ensure that the treatment of interest for accounting separation is consistent with the retail tariff methodology.

**f. Response to Consultation Question 9**

Do you agree that only pre-agreed economic asset life assumptions should be used?

55. BELCO provided the following response to Consultation Question 9:

Rather than agreeing economic asset life assumptions on an arbitrary basis, BELCO believes that the asset life assumptions should be based on IFRS. IFRS provides the appropriate standard for determining asset lives because it requires management to base asset lives on fundamental economic and technical considerations as they change from time to time. We do not object to advising the Authority when circumstances change.

56. The asset life assumptions should not be determined on an arbitrary basis. Instead, the Authority considers it appropriate for the licensee to use asset life assumptions that are justified by fundamental economic and technical considerations. Where the Authority considers that the proposed asset life assumptions are economically or technically unreasonable, even if they are consistent with the IFRS (e.g. if IFRS allows for a wide range and the selected point estimate is implausible with reference to economic or technical considerations), then the Authority may require more reasonable asset life assumptions to be used for regulatory accounting purposes. Therefore, for the avoidance of doubt, the Authority suggests adding the following footnote to paragraph 29 of the Instructions:

The Authority allows the licensee to use asset life assumptions that are consistent with the IFRS as long as the assumptions are pre-agreed with the Authority and are considered economically and technically reasonable.

**g. Response to Consultation Question 10**

Do you agree that, as far as is practical and proportionate, transfer charges and transactions with related parties should be valued at arm's length?

57. BELCO has noted the following in relation to Consultation Question 10:

BELCO believes that a cost-based approach, rather than competitive tendering, from which market rates would be gleaned, is the most appropriate approach in relation to corporate services.

58. The Authority has no objections to the cost-based approach, as described in the Instructions. However, where the cost-based approach is used, the licensee should provide a justification as to why other approaches were not considered suitable.

**h. Response to Consultation Question 11**

Do you agree that, for every licensed business unit, the licensee should provide a breakdown of operating costs and revenues by internal transactions, external transactions with related parties, and external transactions with independent parties?

59. BELCO provided the following comment in relation to Consultation Question 11:

BELCO does not object to providing details of internal and related-party transactions where material but questions the value of this information if all transactions are undertaken on an arm's-length basis.

60. To clarify, paragraph 37 of the Instructions does not require the licensee to provide the details of every material transaction. Instead, it asks for a breakdown of operating costs and revenues by three aggregate categories—namely, internal transactions, external transactions with related parties, and external transactions with independent parties. This measure is introduced by the Authority for transparency purposes.

## **VI. SUMMARY OF THE PROPOSED CHANGES TO THE INSTRUCTIONS AS A RESULT OF THE 1ST ROUND OF CONSULTATION**

61. To summarise, in response to BELCO's comments on the Instructions, the Authority proposes two changes to the text of the Instructions.

62. First, the Authority proposes to amend paragraph 7 of the Instructions as follows:

The accounts must be assured by an independent auditor, who, together with the provision of the audit report, must issue the following assurance statement:

"In our opinion, the financial statements of [the licensee] are prepared, in all material respects, in accordance with the regulatory accounting instructions for the electricity sector of Bermuda issued by the Regulatory Authority of Bermuda."

63. Second, the Authority proposes to add a footnote to paragraph 29 of the Instructions, which would read as follows:

The Authority allows the licensee to use asset life assumptions that are consistent with the IFRS as long as the assumptions are pre-agreed with the Authority and are considered economically and technically reasonable.

64. With the exception of the two changes described in paragraphs 62 and 63 of this Consultation Document, the Authority proposes that the text of the Instructions remains unchanged.

## **VII. PROPOSED DECISION**

65. The Authority proposes to adopt the methodology set out in Annex 1.

## **VIII. CONSULTATION QUESTIONS**

66. Interested parties are invited to comment on the Regulatory Accounting Instructions for the electricity sector.

67. In particular, the Authority welcomes responses in relation to the questions outlined in the table below.

68. For ease of reference, the Authority has also inserted the consultation questions throughout the proposed decision in Annex 1.



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**Scope of regulatory accounts**

1. Do you agree that the accounts of the bulk generation and TD&R licensed business units should be separated from each other, from the accounts of the unregulated business units of the licensee (if applicable), and from the accounts of related parties?
2. Do you agree that, for every licensed business unit, the elements that need to be reported include operating costs, revenues, current assets and current liabilities, and fixed assets?

**Operating cost and revenue allocation**

3. Do you agree with the three-tier approach to allocating all operating costs and revenues to the individual business unit?

**Assets and liabilities allocation**

4. Do you agree that assets should be allocated to the regulatory accounts of their main user, where the main user should make a transfer charge to any other business unit that also uses that asset?
5. Do you agree that current assets and current liabilities should be allocated to the business units in line with the principles of cost and revenue allocation?
6. Do you agree that long-term liabilities should be allocated to business units only if they are directly associated with a particular business unit, or are collateralised with assets that are associated with particular business units?

**Capitalisation and asset valuation policy**

7. Do you agree that the licensee should comply with the IFRS in relation to the capitalisation policy in everything but capitalisation of interest—i.e. that the licensee should not capitalise interest?
8. Do you agree that the cost model of asset valuation is an appropriate methodology to use in the preparation of regulatory accounts?
9. Do you agree that only pre-agreed economic asset life assumptions should be used?

**Transfer charges and related party transactions**

10. Do you agree that, as far as is practical and proportionate, transfer charges and transactions with related parties should be valued at arm's length?
11. Do you agree that, for every licensed business unit, the licensee should provide a breakdown of operating costs and revenues by internal transactions, external transactions with related parties, and external transactions with independent parties?

**Third-party transactions disclosure**

12. Do you agree that third-party transactions need to be disclosed in the notes to the regulatory accounts?
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# **ANNEX 1: PROPOSED METHODOLOGY**



REGULATORY  
AUTHORITY

**Bermuda**

**Regulatory Accounting  
Instructions General  
Determination for Electricity  
Sector**

Draft General Determination

Date: [     ]

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## I. INTRODUCTION

1. The Regulatory Authority of Bermuda (“Authority”) is issuing this General Determination to set these instructions (“the instructions”) to govern the regulatory accounting standards for the vertically integrated electric utility holding licences for bulk generation and transmission, distribution and retail (“TD&R”) (“the licensee”).<sup>1</sup> The same instructions apply to all other bulk generation or TD&R licence holders in the electricity sector of Bermuda that are required to submit regulatory accounts to the Authority.
2. The licensee is required to provide separated regulatory accounts to enable the Authority to fulfil its functions in accordance with the Electricity Act 2016.<sup>2</sup> In particular, accounting separation is required in order to:
  - a. **protect the interests of end-users** with respect to affordability of the electricity service. Specifically, separated regulatory accounts are essential to inform the level of electricity tariffs to end-users;
  - b. **promote economic efficiency and sustainability** in the generation, transmission, distribution and sale of electricity. Separated regulatory accounts inform the requirements for what constitutes an adequate tariff, such that the tariff incentivises efficiency and allows for the sustainable functioning of the licensee;
  - c. **promote competition** among electricity generators. Accounting separation, insofar as it increases the transparency of costs and profitability levels, enhances the ability of independent power producers to compete with vertically integrated utilities. It also allows the Authority to target regulatory controls at the natural monopoly elements of the sector, such as transmission and distribution networks, while reducing the regulatory burden on bulk generation, for which the Electricity Act 2016 suggests that competitive bidding in procurement of resources may be a possibility.<sup>3</sup>

## II. SUMMARY

3. The licensee is required to submit audited statutory financial statements to the Authority. These may be prepared on a consolidated group basis, in accordance with the International Financial Reporting Standards (“IFRS”). In addition, the Authority requires the licensee to report, separately for the bulk generation and TD&R licensed business units, the elements of the balance sheet and income statement (the “accounts”), with corresponding accounting disclosures and notes.<sup>4</sup>

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<sup>1</sup> An electric utility is a company that engages in the generation, transmission, distribution, and sale (retailing) of electricity. An electric utility may perform any combination of these functions. See Government of Bermuda (2015), ‘The National Electricity Sector Policy of Bermuda’, 26 May.

<sup>2</sup> Government of Bermuda (2016), Electricity Act 2016, p. 3 and section 6.

<sup>3</sup> Government of Bermuda (2016), Electricity Act 2016, section 40.

<sup>4</sup> The notes should include the methodology of accounting separation, capitalisation and asset valuation policies, pricing mechanisms behind transfer charges and related parties’ transactions, and disclosure of third-party transactions. However, replication or duplication of all the notes that accompany IFRS-compliant accounting and that are prepared for consolidated accounts is not required. Maintaining separated regulatory accounts for transmission and distribution relative to the retail business would be considered best practice, but is not required by these instructions.

4. The elements that need to be reported include operating costs, revenues, assets and liabilities. In particular, the following information is required for each licensed business unit.
  - a. A breakdown of operating costs and revenues by type of activity; and of allocation rules by type of cost and revenue.
  - b. A breakdown of fixed assets (“the fixed assets register”), including the disclosure of asset life assumptions, depreciation methods, other relevant details on asset valuation policies, and whether an asset is used as collateral for a liability.
  - c. A breakdown of current assets and liabilities; and of allocation rules by type of current asset and liability.
  - d. A breakdown of long-term liabilities if they are directly associated with a particular business unit or are collateralised with assets that are associated with particular business units; and disclosure of the details of long-term liabilities.
  - e. The split of operating costs and revenues between: internal transactions; external transactions with related parties; and external transactions with independent parties; and the pricing mechanisms used for internal and external transactions with related parties by type of activity.
  - f. Disclosure of third-party transactions that relate to activities that are not core activities for bulk generation or TD&R business units.
5. The licensee should demonstrate how the separate business units’ regulatory accounts reconcile with the consolidated statutory financial statements.<sup>5</sup>
6. The methodologies that are envisaged to be used to prepare regulatory accounts must be submitted to, and approved by, the Authority. This includes the accounting separation principles, capitalisation and asset valuation policies, and pricing mechanisms behind transfer charges and related parties’ transactions. Where the licensee changes a methodology, the licensee is required to justify and disclose the change, and demonstrate its financial impact by showing how it reconciles with the previous methodology. The Authority secures the right to request more information about the disclosed change to the methodology, and to disagree with the change.
7. The accounts must be assured by an independent auditor, who, together with the provision of the audit report, must issue the following assurance statement:

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<sup>5</sup> The reconciliation includes separate licensed business units’ regulatory accounts, unregulated business units’ regulatory accounts, and items reflecting methodological differences between regulatory and statutory accounts. Methodological differences may arise in the balance sheet, for example due to differences in asset life assumptions between regulatory and statutory accounts. Or, for example, methodological differences may arise in the income statement due to differences between actual and efficiently incurred costs.

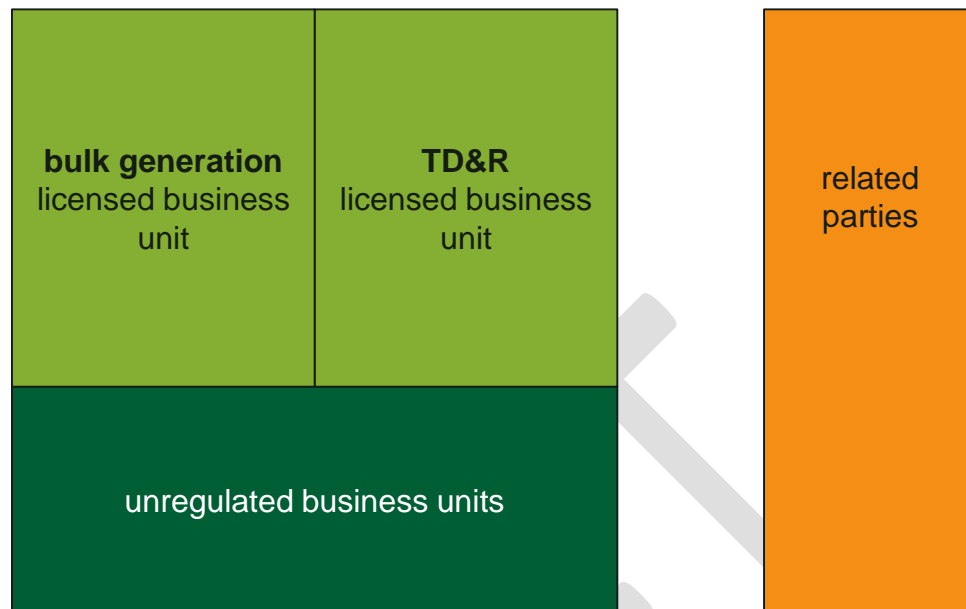
“In our opinion, the financial statements of [the licensee] are prepared, in all material respects, in accordance with the regulatory accounting instructions for the electricity sector of Bermuda issued by the Regulatory Authority of Bermuda.”

8. In line with the Electricity Act 2016 and the functions of the Authority, these instructions promote the following principles of regulatory accounts reporting:
  - a. **causality**: all the costs (and revenues) should be allocated to the activities that caused the costs (and revenues);
  - b. **practicality**: all the methods used to prepare regulatory accounts should be practical to implement;
  - c. **objectivity**: the regulatory accounts should be prepared on an objective basis;
  - d. **transparency**: all the methods used to prepare regulatory accounts should be disclosed in the notes to the accounts;
  - e. **consistency**: where practical, the regulatory accounts should be prepared on a consistent basis from year to year. If a change to the methodology is necessary, the licensee is required to justify and disclose the change and demonstrate its financial impact by showing how it reconciles with the previous methodology.
9. As illustrated in Figure 1, the instructions require the accounts of the bulk generation and TD&R licensed business units to be separated from:
  - a. each other;
  - b. the accounts of the unregulated business units of the licensee (if applicable);
  - c. the accounts of related parties, as per the definition in the international accounting standards (IAS).<sup>6</sup>

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<sup>6</sup> For example, related parties might be a parent company, other companies in the group, or associate companies. For further details, see IFRS (2001), 'IAS 24 Related Party Disclosures', para. 9.

*Figure 1 Separated accounting segments*



Source: The Regulatory Authority of Bermuda.

10. Where a licensee combines more than one business unit, its costs and revenues are likely to arise from a variety of functions relating to TD&R, bulk generation, and other business units. Similarly, assets and liabilities can belong to more than one business unit. To be able to determine adequate tariffs and monitor the licensee's profitability, the Authority requires operating costs, revenues, assets and (where relevant) liabilities of the licensee to be allocated to one of its business units, in accordance with the principles of the instructions. Allocation of the costs and revenues, and of the assets and liabilities, is discussed in sections III and IV of these instructions respectively.
11. In addition to the appropriate separation of accounts, the licensee is required to follow consistent capitalisation and asset valuation policies. Section V outlines the requirements for these policies.
12. With its duties to protect the interests of the end-users and promote competition, the Authority needs to put measures in place to prohibit cross-subsidy. This is important in order to sustain a level playing field for all competing firms, and to ensure that end-users are not disadvantaged. Therefore, the Authority requires the licensee to demonstrate that any transfer charges and transactions with related parties are undertaken on market terms. This is discussed in section VI of these instructions.
13. Finally, section VII outlines the requirements for the disclosure of third-party transactions.



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#### Consultation questions

1. Do you agree that the accounts of the bulk generation and TD&R licensed business units should be separated from each other, from the accounts of the unregulated business units of the licensee (if applicable), and from the accounts of related parties?
  2. Do you agree that, for every licensed business unit, the elements that need to be reported include operating costs, revenues, current assets and current liabilities, and fixed assets?
- 

### III. OPERATING COST AND REVENUE ALLOCATION

#### A. OPERATING COSTS

14. Operating costs can be classified in one of three categories: direct costs, indirect attributable costs, and indirect non-attributable costs.
  - a. **Direct costs:** costs that are exclusively associated with generation, TD&R or a function of an unregulated business unit belong in this category. These costs should be allocated to the accounts of the corresponding business units.
  - b. **Indirect attributable costs:** costs that are not exclusively associated with a single business unit and are likely to be considered joint or common costs, belong in an indirect costs category. If the costs are indirect, but it is possible to identify factors that drive them to increase, and those factors are exclusively associated with individual business units, the instructions refer to these costs as indirect attributable costs.
  - c. **Indirect non-attributable costs:** where it is not practical to identify the cost drivers and, therefore, not possible to estimate their proportions caused by the functions of one or another business unit, the instructions refer to these costs as indirect non-attributable costs.
15. The Authority expects the licensee to follow a three-tiered approach to allocating all operating costs to the individual business units.
  - a. Where reasonable, an entity should allocate direct costs to the corresponding individual business unit. For example, fuel costs that are directly associated with bulk generation, and network maintenance costs that are directly associated with TD&R functions, should be attributed to these business units respectively.
  - b. Where such reasonable direct allocation is not possible, the licensee should allocate indirect attributable costs to more than one individual business unit based on the underlying drivers of these costs within each unit. This approach to indirect cost allocation is referred to as “activity-based costing” (ABC). The cost drivers should reasonably reflect the factors that drive costs to increase. For example, for a given set of costs, the Authority recommends using cost drivers such as those specified in Table 1.

*Table 1 Cost drivers for indirect attributable costs—examples*

<b>Cost type</b>	<b>Cost driver to be used<sup>1</sup></b>
Finance, HR, general management	Time spent by staff on the individual business units based on timesheets
Motor vehicle costs	Number of vehicles
Facilities, building/grounds maintenance/rent	Floor space (m <sup>3</sup> )
Employee/employer liability insurance	Number of full-time equivalent employees

Note: <sup>1</sup> Only where costs cannot be directly attributed.

Source: The Regulatory Authority of Bermuda.

- c. Where identification of cost drivers is not practical, the licensee should allocate indirect non-attributable costs to more than one business unit in line with the proportion of direct costs associated with each of the business units. This approach to indirect cost allocation is referred to as “equi-proportionate mark-up” (EPMU). For example, the Authority considers it appropriate to categorise indirect management costs as non-attributable if management is unable to estimate the proportion of the time they spend on the functions of one business unit or another. In this case, the licensee can allocate management costs to multiple business units in line with the proportion of the corresponding direct costs. Fuel costs are not included in the estimate of direct costs associated with the bulk generation business unit, for the purpose of allocating indirect non-attributable costs.

16. For the avoidance of doubt, no costs should be allocated on the basis of revenue shares.

## **B. REVENUES**

17. The Authority expects most of the licensee’s revenues to be directly attributable to its business units. However, where revenues are common to multiple business units, the principles for allocating revenues should be consistent with those for costs, as specified in this section of the instructions. In particular, revenues need to be allocated to business units that drive them to increase.
18. The licensee is required to disclose, in the notes to the regulatory accounts, the allocation method applied to every type of cost. Where a cost is classified as non-attributable, the licensee is required to justify why identification of that cost driver is not practical. Where the licensee changes the allocation methodology for any cost, it is required to justify, disclose, and demonstrate the financial impact of the change, by reconciling with the prior methodology.

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**Consultation questions**

3. Do you agree with the three-tier approach to allocating all operating costs and revenues to the individual business unit?
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**IV. ASSETS AND LIABILITIES ALLOCATION****A. FIXED ASSETS**

19. The Authority considers that it is likely that most fixed assets are used within the individual business units, and therefore, most fixed assets and the corresponding depreciation are expected to be directly allocated to individual business units.
20. Where more than one business unit uses the same asset, the asset should be allocated to the regulatory accounts of its main user. This main user should make a transfer charge to any other business unit that also uses that asset. The main user would report the income as a negative operating cost under 'recharges to other units'. The other business units would report a corresponding positive operating cost in their accounts.
21. The amount of the recharge should be proportionate to the use of the assets and be determined in line with the principles outlined in section VI of these instructions. If an asset is transferred from one business unit to another, the principles outlined in section VI apply to the transfer price.

**B. CURRENT ASSETS AND CURRENT LIABILITIES**

22. Current assets and liabilities should be allocated to business units in line with the principles of cost and revenue allocation. For example, where current assets and liabilities relate to accruals or pre-payments, these should be allocated on the same basis as the costs or revenues to which they relate.

**C. LONG-TERM LIABILITIES**

23. The licensee is required to provide a breakdown of the long-term liabilities in two instances:
  - a. where they are directly associated with a particular business unit;
  - b. where they are collateralised with assets associated with a particular business unit.
24. If a liability is not directly associated with a particular business unit, and is not collateralised with assets that belong to a particular business unit, the liability does not have to be allocated to individual business units.
25. In addition, the licensee is required to disclose the terms of long-term liabilities, including the principal amount, issuance date, repayment date, interest rate, and intended use of proceeds.

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**Consultation questions**

4. Do you agree that assets should be allocated to the regulatory accounts of their main user, where the main user should make a transfer charge to any other business unit that also uses that asset?
  5. Do you agree that current assets and current liabilities should be allocated to the business units in line with the principles of cost and revenue allocation?
  6. Do you agree that long-term liabilities should be allocated to business units only if they are directly associated with a particular business unit, or are collateralised with assets that are associated with particular business units?
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**V. CAPITALISATION AND ASSET VALUATION POLICY****A. CAPITALISATION POLICY**

26. A capitalisation policy refers to the set of principles used by a company to decide whether to expense a cost—i.e. to record it as a cost in the income statement in the period in which it is incurred; or to capitalise the cost—i.e. to record it in the balance sheet as an increase in the value of the assets, and record a corresponding cost as a depreciation and amortisation expense in the income statement over the asset life.
27. The licensee is required to comply with the IFRS in relation to the capitalisation policy in everything but capitalisation of interest—the licensee should not capitalise interest. In addition, the licensee is required to disclose the details of its capitalisation policy for individual cost and asset types.

**B. ASSET VALUATION**

28. The Authority requires the licensee to comply with the IFRS in relation to the valuation of fixed assets unless stated otherwise in these instructions.<sup>7</sup> Only a cost model is allowed. The licensee is required to disclose in the accounts the following elements of the asset valuation policy:
  - a. asset life assumptions;
  - b. methods of depreciation.
29. The licensee is required to use pre-agreed economic asset life assumptions.<sup>8</sup>
30. Where the IFRS provides multiple options for any of these disclosures, the Authority requires the licensee to explain, in notes to the accounts, the rationale for its choice.

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<sup>7</sup> To the extent that the Authority considers that revision to the asset valuation policy may be required for regulatory tariff setting (e.g. to smooth the profile of allowed revenues via the use of accelerated depreciation), then, any such potential changes to asset valuation policy would be appropriately signalled, consulted, and agreed with the licensee.

<sup>8</sup> The Authority allows the licensee to use asset life assumptions that are consistent with the IFRS as long as the assumptions are pre-agreed with the Authority and are considered economically and technically reasonable.

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**Consultation questions**

7. Do you agree that the licensee should comply with the IFRS in relation to the capitalisation policy in everything but capitalisation of interest—i.e. that the licensee should not capitalise interest?
  8. Do you agree that the cost model of asset valuation is an appropriate methodology to use in the preparation of regulatory accounts?
  9. Do you agree that only pre-agreed economic asset life assumptions should be used?
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**VI. TRANSFER CHARGES AND RELATED PARTY TRANSACTIONS**

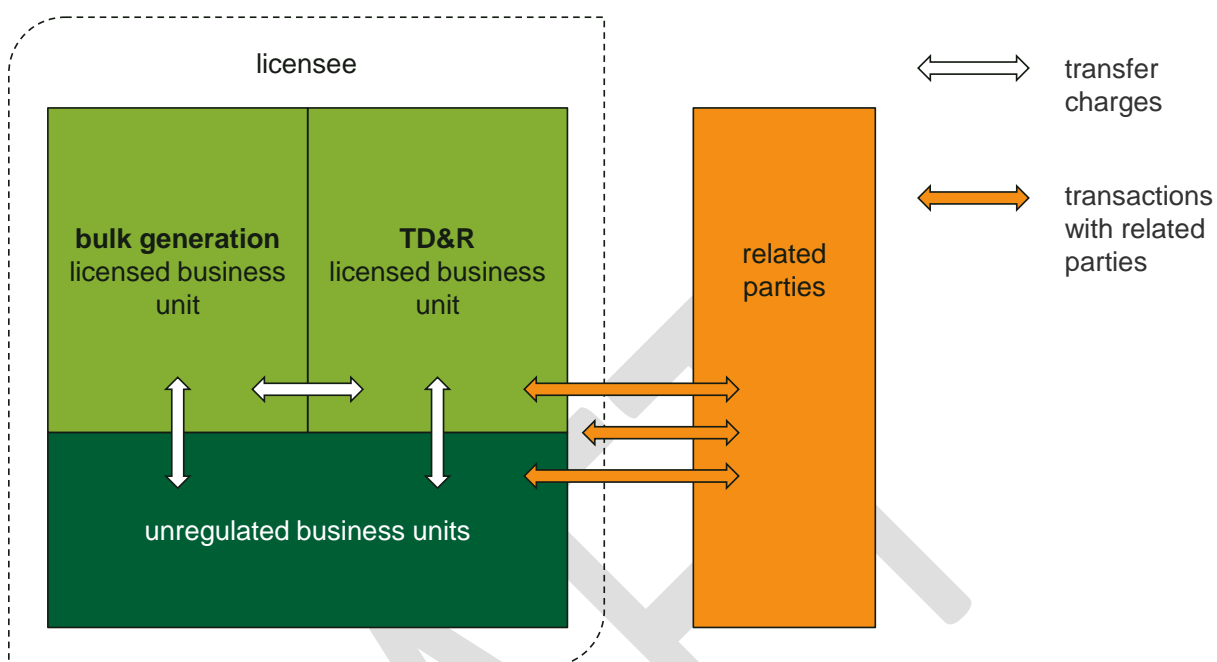
31. It is the licensee's duty to ensure that all transfer charges and transactions with related parties ("regulated transactions") are valued at arm's length—i.e. on the same terms as would apply between independent parties. As far as is practical and proportionate, the pricing principles should be consistent across regulated transactions.
32. A transfer charge is the charge or price that is applied, or deemed to be applied, by one business unit within the licensee to another for the use of assets, provision of services or transfer of goods.<sup>9</sup> In the context of these instructions, the related party is defined in accordance with IAS 24.<sup>10</sup>
33. Figure 2 illustrates the regulated transactions.

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<sup>9</sup> Transfer charges include recharges that arise through multiple business units sharing the same assets. As specified in section IV of the instructions, a shared asset should be allocated to the accounts of its main user, which would require a recharge to the other business units sharing the asset.

<sup>10</sup> For example, related parties might be a parent company, other companies in the group, or associate companies. For further details, see IFRS (2001), 'IAS 24 Related Party Disclosures', para. 9.

**Figure 2** Transactions subject to the Authority's regulation



Note: The instructions apply to all transactions specified in the figure.

Source: The Regulatory Authority of Bermuda.

34. The Authority considers the following approaches to be appropriate for demonstrating that a regulated transaction has been undertaken at arm's length:
  - a. competitive tendering;
  - b. comparison against published list prices;
  - c. third-party evaluation;
  - d. benchmarking;
  - e. a cost-based approach.<sup>11</sup>
35. The Authority considers the first of these—competitive tendering—to be the most robust approach for demonstrating that a regulated transaction has been undertaken at arm's length. If the licensee uses this approach, it should invite independent contractors to tender a price for a given good or service. Where such competitive tendering is not possible, or is impractical or disproportionate, other approaches can be applied. Upon request, the licensee needs to be able to provide evidence showing why competitive tendering was not considered suitable.

<sup>11</sup> Under a cost-based approach, the price is driven by cost, including the cost of capital. In practice, this means that a mark-up at the market level may be added to the cost base.

36. The transfer price for electricity that the TD&R business unit purchases from the bulk generation business unit should be set in line with the retail tariffs regime, once effective.
37. For every licensed business unit, the licensee is required to provide a breakdown of operating costs and revenues by internal transactions, external transactions with related parties, and external transactions with independent parties.

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**Consultation questions**

10. Do you agree that, as far as is practical and proportionate, transfer charges and transactions with related parties should be valued at arm's length?
11. Do you agree that, for every licensed business unit, the licensee should provide a breakdown of operating costs and revenues by internal transactions, external transactions with related parties, and external transactions with independent parties?

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**VII. THIRD-PARTY TRANSACTIONS DISCLOSURE**

38. If a third-party transaction refers to an activity that is not a core activity of the bulk generation or TD&R business units, but is attributable to them, a transaction needs to be disclosed in the notes to the regulatory accounts.

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**Consultation questions**

12. Do you agree that third-party transactions need to be disclosed in the notes to the regulatory accounts?
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