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Rate-regulated Activities Interaction between IFRIC 12 *Service Concession Arrangements* and defined rate regulation

Purpose of the paper

- 1 This paper provides an initial analysis of the interaction between IFRIC 12 *Service Concession Arrangements* and defined rate regulation and examines the effects on the enforceability of rights and obligations, arising from the rate regulation, created by this interaction.
- 2 This paper refers to defined rate regulation as the type of regulation described in the IASB Discussion Paper *Reporting Effects of Rate Regulation* (“DP”).

Introduction

- 3 At its meeting in November 2016, EFRAG TEG considered a paper that reported the findings of research on the effects of defined rate regulation reported by Portuguese companies in their IFRS consolidated financial statements. The research found that the major Portuguese utility companies¹ subject to defined rate regulation recognise tariff adjustments² in their IFRS financial statements. All four companies account for the rate-regulated activity infrastructure under IFRIC 12.
- 4 EFRAG TEG asked the EFRAG Secretariat to examine the interaction between IFRIC 12 with the rate regulation system in Portugal to determine what might be the effects, if any, on the enforceability of the rights and obligations arising from the rate regulation applicable under the Portuguese legislation. This paper addresses this request.
- 5 As background material, Appendix 1 provides a summary of the requirements under IFRIC 12.

Scope of the analysis

- 6 For this analysis the EFRAG Secretariat reviewed the relevant sections of the IFRS financial statements of a few entities in other European jurisdictions (including the Portuguese utility companies), with activities subject to defined rate regulation, to determine whether these entities recognise tariff adjustments and whether they recognise the infrastructure assets under IFRIC 12 or under IAS 16 *Property, Plant and Equipment*. Some of these entities are represented in EFRAG’s Rate-regulated Activities Working Group. The EFRAG Secretariat also contacted some of the

¹ The research was based on the four main utility companies in Portugal.

² **Tariff adjustments** are the differences between an entities’ allowed revenue (as established by the rate regulator) and the amount the entity has invoiced to its customers for the goods or services it has delivered.

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selected entities to obtain more insight on the information reported in the financial statements.

- 7 The EFRAG Secretariat analysis is based on limited research and therefore we are not able to draw any firm conclusions. However, we believe the analysis provides some initial insights into the interaction between activities subject to defined rate regulation which are accounted for under IFRIC 12 and the potential effects of this relationship on the accounting for such activities.

Interaction between IFRIC 12 and defined rate regulation

- 8 In some jurisdictions, Governments have introduced contractual service arrangements to attract private sector participation in the development, financing, operation and maintenance of certain infrastructure. Some of these arrangements involve activities subject to defined rate regulation (for example, the utilities sector).
- 9 The EFRAG Secretariat understand that there are a number of similarities between activities subject to defined rate regulation and activities accounted for under IFRIC 12 (which might or might not be subject to defined rate regulation). For example, both activities are generally public services governed by a public authority (a regulator under defined rate regulation and a grantor under a concession agreement) that is empowered to determine processes that bind the entity and its customers under a statute or otherwise. Furthermore, the terms of the regulatory frameworks (either through the concession agreement or through statutes/laws governing defined rate regulation) generally have long-term durations and require high levels of capital investment.
- 10 The following table illustrates, at a very high level of generalisation, the main similarities and differences between the activities accounted for under an IFRIC 12 arrangement and defined rate regulation:

Topic	Similarities	
	<i>IFRIC 12</i>	<i>Defined rate regulation</i>
Regulation	Provision of a public service activity by an operator (an entity).	In general a provision of a public service activity by an entity.
Regulatory framework	Regulatory environment (governed by a contract that sets performance standards).	Regulatory environment (parameters to maintain the availability and quality of the supply).
Grantor/rate regulator	Grantor regulates what services the operator must provide, and at what price, under the terms of the arrangement.	Rate regulator regulates the goods or services the entity must provide, and at what price, under the terms of the regulatory regime.
Rate-setting mechanism	Mechanism for adjusting prices charged to customers.	Mechanism for adjusting prices charged to customers to ensure entity receives an agreed level of return.
Topic	Differences	
	<i>IFRIC 12</i>	<i>Defined rate regulation</i>
Customer (responsible for payments)	The Grantor.	The Customer base.
Recognition	Regulatory adjustments may be recognised.	Regulatory adjustments are recognised.
Enforceability	Contractual arrangement/agreement between grantor and operator.	Does not depend on a contract, it depends on the enforceability of the rights and obligations under the regulation.
Control of infrastructure	No control over the infrastructure.	Can have or not have control over the infrastructure.

Table 1: Similarities and differences (IFRIC 12 and Defined rate regulation)

- 11 The EFRAG Secretariat notes that in some cases activities subject to defined rate regulation could also give rise to a service concession arrangement accounted for under IFRIC 12. As highlighted in the table above, there are a number of similarities between these activities which, in our view, create a natural interaction between IFRS 12 and defined rate regulation, which could affect the accounting for activities subject to defined rate regulation.
- 12 In the EFRAG Secretariat's view, an important element of this interaction is that the application of IFRIC 12 by an entity subject to defined rate regulation **reinforces**, at least in some way, the enforceability of the rights and obligations granted to the entity (operator) under the concession agreement and strengthens the support for recognition of regulatory assets and liabilities as these are likely to meet the definitions under the IASB's Conceptual Framework.

Portuguese utility entities

- 13 As mentioned previously, the main Portuguese utility entities subject to defined rate regulation recognise 'tariff adjustments' in their IFRS financial statements. These entities also operate under a service concession arrangement with the Portuguese State, accounted for under IFRIC 12.
- 14 The tariff adjustments are recognised as revenue (either income or expense) either within total revenue or as a separate line item 'tariff adjustment' revenue. On the balance sheet, the tariff adjustments are recognised as receivables (debtors) or payables (creditors) or other receivables (payables).
- 15 The main reason, mentioned in the notes to the financial statements of the Portuguese entities, to justify recognition of tariff adjustments and the corresponding regulatory assets and liabilities, **is the enforceability and recoverability of the tariff adjustment mechanism** under the Portuguese Regulatory framework.
- 16 The Portuguese Regulatory framework includes a 'Package of legislation' that combines (i) the Concession arrangement; (ii) Regulatory framework (including a rate-setting mechanism); and (iii) Supplementary legislation. This package of legislation strengthens the enforceability of the tariff adjustments as assets and liabilities.
- 17 Appendix 2 to this paper provides an overview of the Regulatory framework in Portugal governing defined rate regulation. In summary, the factors that strengthen the enforceability in the Portuguese jurisdiction are as follows:
 - (a) the Concession agreement and the Regulatory framework guarantee the recoverability of the adjustment through a rate-setting mechanism;
 - (b) the requirements of the revenue and remuneration criteria are public information - the tariff adjustments approved by the rate regulator are published within a short period after the reporting date;
 - (c) the two-year period for recovery/return the tariff adjustments, as far as was possible to understand, is effectively fulfilled; and
 - (d) the supplementary legislation reinforces the right of these companies in the persecution of a stability market and establishes the **possibility to transfer** the tariff adjustments to third parties.
- 18 Furthermore, the EFRAG Secretariat notes that the Portuguese legislation seems to suggest there are *two different customers* that need to be considered (i) the individual customer and (ii) the grantor. The grantor is responsible for regulating the tariff adjustments, but because of the link to the user-payer mechanism, the operator

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typically obtains compensation from the customer base, instead of a Government grant or subsidy, which would happen in the case of failure of the customer base³.

- 19 In the Portuguese case, regardless of the recoverability through future tariffs for goods or services rendered in present or past periods, the regulatory adjustments approved by the rate regulator are legally considered as an enforceable right of the Portuguese rate-regulated entities.
- 20 The EFRAG Secretariat understands that recognition of regulatory assets and liabilities as either Receivables or Payables could arise from two factors:
 - (a) analogy with IFRIC 12's financial asset model; or/and
 - (b) the unconditional right to receive cash or other assets or obligation to pay cash or other assets.
- 21 In other words, when the tariff adjustments are approved by the rate regulator, the company **has already performed** for a certain period/year (thus, the right to charge (intangible) decreases through depreciation) and that the amount is confirmed (**public published**) and not subject to change. The decreases in the right to charge the customer represents a receivable or payable. The fact that, under the supplementary legislation in Portugal, **the rights to regulatory adjustments are transferable** to a third party reinforces this rationale.
- 22 Additionally, the EFRAG Secretariat notes that IAS 32 *Financial Instruments: Presentation* defines a financial asset by reference to the existence or absence of an unconditional contractual right to receive cash/consideration.

Other jurisdictions under IFRIC 12 or/and rate regulation

- 23 The EFRAG Secretariat reviewed the relevant sections of the IFRS financial statements of four entities in other European jurisdictions, with activities subject to defined rate regulation, to determine whether these entities recognise tariff adjustments and whether they recognise the infrastructure assets under IFRIC 12 or under IAS 16. Three of these entities are represented in EFRAG's Rate-regulated Activities Working Group. The EFRAG Secretariat also contacted some of the selected entities to obtain more insights on the information reported in the financial statements.
- 24 The EFRAG Secretariat noted that there is diversity in practice in terms of recognition of tariff adjustments amongst European entities, both when the activities are accounted for under IFRIC 12 or not. However, the findings from this limited research highlight that the approach taken by the Portuguese utility entities is not unique and there are other entities that recognise tariff adjustments in the IFRS financial statements. Although our research was not exhaustive, the following table provides a summary of our findings:

³ Similarly, the FASB has recently issued a proposal to amend the Topic 853 *Service Concession Arrangement* stating that "*an operating entity shall consider the grantor to be the customer of its operation services in all cases for service concession arrangements within the scope of this Topic.*"

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Regulated jurisdiction	Entity's Headquarters				
	Portugal	Spain entity 1	Spain entity 2	Belgium	Scotland
Belgium	-	-	-	D	-
Portugal	A	-	E	-	-
Brazil	B	B	-	-	-
Spain	C	D	E	-	-
Germany	-	-	-	D	-
UK	-	C	E	-	-
Scotland	-	-	-	-	D

Table 2: Recognition of tariff adjustments in the IFRS financial statements

A: IFRIC 12 (Intangible asset model) / Recognition of tariff adjustments

B: IFRIC 12 (Financial asset model) / Recognition of tariff adjustments

C: Owner of the assets / No recognition of tariff adjustments

D: Owner of the assets / Recognition of tariff adjustments

E: Depends on the IFRIC 12 model (with the Financial asset model the tariff adjustments are recognised and with the Intangible asset model the tariff adjustments are not recognised).

EFRAG Secretariat observations

- 25 The EFRAG Secretariat observed that entities that apply the **financial asset** model under IFRIC 12 recognise the tariff adjustments as part of receivables due by the grantor.
- 26 However, *some entities* that apply the **intangible asset** model under IFRIC 12 recognise the tariff adjustments. Also, *some entities* that “own” the infrastructure under IAS 16 recognise the tariff adjustments.
- 27 The table below provides a summary of our observations for the selected entities.

Rate (tariff) regulation subject to an allowed revenue requirement			
	IFRIC 12		Own asset
	Financial asset model	Intangible asset model	
Regulatory adjustments			
Revenue adjustment	✓	Mixed ⁽¹⁾	Mixed ⁽¹⁾
Regulatory assets (receivables)	n/a	Mixed ⁽¹⁾	Mixed ⁽¹⁾
Regulatory liabilities (payables)	n/a	Mixed ⁽¹⁾	Mixed ⁽¹⁾
Balance sheet (Infrastructure)			
PPE (IAS 16 Infrastructure)	n/a	n/a	✓
Intangible (IAS 38-IFRIC 12 Infrastructure)	n/a	✓	n/a
Financial (IAS 39-IFRIC 12 Infrastructure)	✓	n/a	n/a

(1) EFRAG Secretariat could not find a pattern. Some entities recognise the regulatory adjustments and others do not.

Table 3: Other jurisdictions – Summary of recognition method

EFRAG Secretariat preliminary conclusions

- 28 Based on our research, the EFRAG Secretariat notes that it was not possible to identify a clear and consistent fact pattern between the application of IFRIC 12 and the recognition of tariff adjustments.
- 29 IFRIC 12 applies when certain conditions are met. Based on our research, we observe that for some entities, with activities subject to defined rate regulation, these conditions are met. The presence of a concession agreement within a defined rate regulation environment appears to depend on the particular Regulatory regime, with some frameworks, like the one in Portugal, keeping the infrastructure assets within a government authority, rather than under the control of the rate-regulated entity. In these cases, the differences in practice, in terms of recognition of tariff adjustments, might arise from differences in the regulation rather than pure accounting diversity.
- 30 In terms of interactions between IFRIC 12 and defined rate regulation, the EFRAG Secretariat considers that the most significant difference that arises in defined rate regulation within an IFRIC 12 environment, is the existence of a concession agreement. In our view, the existence of an agreement under IFRIC 12, and depending on the terms and conditions set out in the concession agreement, can reinforce the enforceability of the rights and obligations that stem from defined rate regulation.
- 31 The EFRAG Secretariat also considers that in the Portuguese jurisdiction there is another source of enforceability which is the supplementary legislation that, together with the elements referred in paragraph 17, creates the conditions for recognition. Hence, the key factors enhancing enforceability are the **concession agreement** and the **supplementary legislation**.

Next steps

- 32 At the December 2016 Accounting Standards Advisory Forum (ASAF) meeting, some members indicated that the implications of IFRIC 12 on rate-regulated activities would need to be considered as the IASB project progressed.
- 33 The EFRAG Secretariat will monitor future IASB discussions and inform EFRAG TEG of relevant developments.

Questions for EFRAG TEG

- 34 Does EFRAG TEG agree that a service concession arrangement within the scope of IFRIC 12 reinforces the enforceability of the rights and obligations arising from defined rate regulation? And if so, in this specific context, do you agree with the recognition of those rights and obligations in the financial statements? If not, please explain why.
- 35 At this stage, does EFRAG TEG have any other comments or suggestions on the interaction between IFRIC 12 and defined rate regulation?

Appendix 1 – IFRIC 12 Service Concession Arrangements

- 1 This appendix summarises the requirements under IFRIC 12 *Service Concessions Arrangements*.
- 2 IFRIC 12 addresses arrangements in which a private sector entity (the operator) builds or upgrades public service infrastructure – such as roads, bridges, tunnels, prisons, hospitals, airports, water distribution facilities, energy supply and telecommunication networks.
- 3 IFRIC 12 is restricted to public-to-private service concession arrangements undertaken by the operator. The service arrangement contractually obliges the operator to provide the services to the public on behalf of the public sector entity. The operator is paid for its services over the period of the arrangement. The arrangement is governed by a contract that sets performance standards, mechanisms for adjusting prices and arrangements for arbitrating disputes.
- 4 IFRIC 12 gives guidance on the accounting by operators for public-to-private service concession arrangements when the grantor controls the following:
 - (a) What **services** the operator must provide with the **infrastructure**;
 - (b) To **whom** it must provide;
 - (c) What **price** the operator can charge; and
 - (d) Controls – through ownership, beneficial entitlement or otherwise – any **significant residual interest** in the **infrastructure** at the end of the term of the arrangement.
- 5 Within an IFRIC 12 arrangement, entities operate under the terms of the concession agreement and typically have little or no freedom on the management of their activity.
- 6 Determining whether an arrangement is in the scope of IFRIC 12 affects the recognition and measurement of assets by the operator, notably whether the operator recognises the public service infrastructure as property, plant and equipment under IAS 16 *Property, Plant and Equipment* or as a financial asset, an intangible asset or both under IFRIC 12. IFRIC 12 draws a distinction between two types of service concession arrangements – financial asset model and intangible asset model.
 - (a) Financial asset model⁴: An entity (operator) shall recognise a financial asset to the extent that it has an unconditional right to receive cash or another financial asset from or at the discretion of the grantor (for example from users of the public service). The definition of a financial asset is met even if the contractual right to receive cash is contingent on the operator meeting specified quality or efficiency requirements or targets.
 - (b) Intangible asset model⁵: An entity (operator) shall recognise an intangible asset to the extent that it receives a right (a licence) to charge users of the public service. When developing IFRIC 12, the IFRS Interpretations Committee considered whether a right to charge users unsupported by any shortfall guarantee from the grantor could be regarded as an indirect right to receive cash arising from the contract with the grantor. It concluded that although the operator's asset might have characteristics of a financial asset in IAS 32 *Financial Instruments: Presentation*, the operator would not at the balance sheet date have a contractual right to receive cash from another

⁴ Paragraph 16 of IFRIC 12

⁵ Paragraph 16 of IFRIC 12 and Basis for Conclusions paragraph BC49

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entity. That other entity (i.e. the user) would still have the ability to avoid any obligation. The grantor would be passing to the operator an opportunity to charge users in future, not a present right to receive cash.

- 7 IFRIC 12 provides a summary of the typical arrangements operated by the private sector to provide public sector services and how existing IFRS apply to these arrangements. The table below is provided in the Implementation Guidance to IFRIC 12 to illustrate this interaction:

Category	Lessee	Service provider			Owner	
Typical arrangement types	Lease (eg Operator leases assets from grantor)	Service and/or maintenance contract (specific tasks eg debt collection)	Rehabilitate-operate-transfer	Build-operate-transfer	Build-own-operate	100% Divestment/Privatisation/Corporation
Asset ownership	Grantor			Operator		
Capital investment	Grantor		Operator			
Demand risk	Shared	Grantor	Operator and/or Grantor		Operator	
Typical duration	8–20 years	1–5 years	25–30 years			Indefinite (or may be limited by licence)
Residual interest	Grantor			Operator		
Relevant IFRSs	IFRS 16	IFRS 15	IFRIC 12		IAS 16	

Figure 1: IFRIC 12 – Implementation guidance

Appendix 2 - Regulatory framework in Portugal governing defined rate regulation

- 1 This appendix includes an extract of the **relevant section in agenda paper 07-01** discussed at the EFRAG TEG November meeting that considered the regulatory framework in Portugal that governs activities subject to defined rate regulation and how Portuguese entities subject to this type of regulation report tariff adjustments.

Key observations

- Legislation forms the basis of the regulatory framework which governs the relationship between the rate-regulated entity and the rate regulator.
- Entities that provide goods or services subject to rate regulation operate under a service concession agreement ('concession agreement'), between the Portuguese State (the grantor) and the rate-regulated entity (the operator), in which the operator has access to and operates the infrastructure to deliver a public service on behalf of the grantor.
- The regulatory framework establishes a rate-setting mechanism in which the tariffs charged to customers are approved by the rate regulator. Any differences between the amount charged and the amount allowed is considered a recoverable/payable tariff adjustment.
- The regulatory framework states that rate-regulated entities have an unconditional right to recover tariff adjustments and related interest expenses, notwithstanding the form of the future payment or situations of insolvency and cessation of operations. The recovery of tariff adjustments is strengthened by supplementary legislation⁶.
- It appears there is a two-year period over which the rate-regulated entity recovers the tariff adjustments.
- The regulatory framework allows rate-regulated entities to transfer to third parties, in total or in part, the tariff adjustments.

- 2 In Portugal, entities that provide goods or services in the electricity, gas and water supply/wastewater sector that are subject to defined rate regulation operate within a regulatory framework that is governed by Portuguese law.
- 3 These entities operate under a service concession agreement ('concession agreement'), between the Portuguese State (the grantor) and the rate-regulated entity (the operator), in which the operator has access to and operates the infrastructure to deliver a rate-regulated good or service on behalf of the grantor.
- 4 Rate-regulated tariffs charged to users (or customers) are approved by a regulator and are generally not subject to any intervention by the grantor. This ensures segregation between the 'Legislative State' and 'Regulator State', with the rate regulator being responsible for acting independently on behalf of the State in a specific sector, namely, for setting up the prices (or "rates" or "tariffs"), on a yearly basis, under the terms of the regulatory framework. The recovery mechanism is strengthened by supplementary legislation that supports the recoverability of tariff

⁶ Supplementary legislation:

- Electricity: Decree-Law 165/2008;
- Natural gas: Decree-Law 87/2011; and
- Water supply: Decree-Laws 92/2015, 93/2015 and 94/2015

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adjustments. There are different regulators responsible for the different rate-regulated goods or services.

- 5 The rate regulators are: (i) Entidade Reguladora dos Serviços Energéticos (“ERSE”) for energy and gas sector; and (ii) Entidade Reguladora dos Serviços de Água e Resíduos (“ERSAR”) for water supply sector.
- 6 The following activities are subject to defined rate regulation:
 - (a) Electricity – distribution and transmission
 - (b) Natural gas – distribution, transport, storage and regasification
 - (c) Water – water supply and water waste treatment.

Concession agreement

- 7 The concession agreement is an agreement signed between the Portuguese State (the grantor) and the rate-regulated entity (the operator).
- 8 Under the concession agreement, the operator has access to and operates the infrastructure to deliver a public service on behalf of the grantor in accordance with the terms of the agreement. It is the responsibility of the operator to build and maintain the infrastructure used to provide the goods or services and operates over a specified period of time, under the terms of the concession agreement.
- 9 In general, the concession agreement states that the ultimate owner of the infrastructure and equipment is the grantor, and the operator has the right to collect from the customers a price set by the rate regulator.
- 10 The concession agreement, typically, includes a clause that guarantees economic and financial viability to the operator, which is based on the assumption that the (i) investment costs, (ii) O&M costs, and (iii) adequate compensation of the concession assets, are reflected in the tariff of the regulated activity through a tariff adjustment.
- 11 Moreover, the concession agreement usually states that when necessary (need for recovery of economic and financial viability), the recovery of the tariff adjustment should proceed as follows: (i) Extension of the concession period; (ii) Reduction of the investments previously approved; (iii) Allocation of a direct compensation; or (iv) Mix of all or other type of compensation agreed.
- 12 The entities recognise the concession agreement as an intangible asset under IFRIC 12 *Service Concession Agreement* and amortise the intangible in accordance with its economic useful life. (for example, amortisation the infrastructure network over the concession period or of the exploration licence).

Rate-setting mechanism

- 13 The regulatory framework governs the relationship between the rate-regulated entity and the rate regulator and is designed to balance a fair remuneration for the rate-regulated entity and a reasonable price for customers through a rate-setting mechanism in which the tariffs charged to customers are approved by a rate regulator.
- 14 The tariff setting process begins with the rate regulator examining the budgets in respect to investments and operating costs submitted by the rate-regulated entities, quantitative predictions of consumption for the particular good or service and comparing these to the overall strategic plan established by the Portuguese State.
- 15 Generally, the established tariff (“Allowed revenue”) is as follows: (i) Capex, compound by a return over Regulated Asset Base (“RAB”) and amortisation of the relevant assets; and (ii) Opex, all the operating expenditures accepted by the regulator. The established tariff is designed to remunerate the rate-regulated entities for the construction and maintenance (whether self-built or outsourced to a third

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party) of the infrastructure, strategic for the country that customers have access to and are allowed to use.

- 16 At the end of the rate-setting process, there are two outputs from the rate regulator:
 - (a) the first output is the total amount (based on the budgets) that the rate-regulated entity (holder of a concession agreement) has the right to receive; and
 - (b) the second output, is the rate per unit to be applied in each activity (and each entity) in that year.
- 17 At the reporting date, rate-regulated entities have to recalculate, using the same regulatory requirements but with actual amounts of the variables (Regulated Asset Base, depreciation/amortization and costs incurred), the amount of allowed revenue and a comparison with the amount already invoiced (based on the rate established ex-ante).
- 18 The allowed revenue is almost always different from the invoiced revenue, consequently a difference, whether positive or negative, arises which is adjusted in future tariffs, even though this difference is related to the provision of goods or services in that period rather in future periods. These differences are referred to as 'tariff adjustments' or 'tariff deviations' when reported in the financial statements.

Enforceability and recoverability of the tariff adjustment mechanism

- 19 EFRAG Secretariat understands that the governing regulatory framework together with the applicable law (for example Decree-Law 237-B/2006 of 19 December, and Decree-Law 165/2008 of 21 August) provides an unconditional right to the operators to recover tariff adjustments approved by the rate regulator.
- 20 Furthermore, at least in some sectors (for example electricity and natural gas), the Portuguese law allows the transfer of the right to recover the tariff adjustment to third parties, in whole or in part, through future tariffs.
- 21 Even though the relationship between the rate regulator and the rate-regulated entity may not be contractual, the rate regulator acts on behalf of the Portuguese State, and has the ability to affect the entity's financial performance and future cash flows through its regulatory decisions.
- 22 The regulatory framework encompasses supplementary legislation governing the recovery of tariff adjustments, aiming to mitigate the economic effect generated by these adjustments and ensure that rate-regulated entities are entitled to recover these adjustments.
- 23 Overall, the Portuguese "package of legislation" for rate regulation contributes to the strength of the underlying regulatory framework, its enforceability and tariff recovery mechanism.