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29 October 2010

Alex Sim  
Chief Adviser  
Regulation Branch  
Commerce Commission  
Level 6, 44 The Terrace  
**WELLINGTON**

Dear Alex

## **REGULATORY TREATMENT OF LAND RELATED TRANSACTIONS**

Thank you for your letter of 27 September in which you set out a formal response to the issues raised in Transpower's letter of 26 August 2010 regarding the calculation of the year end revenue requirement for 2009/10.

Our recently submitted compliance statement for the 2009/10 assessment period confirms that we have complied with the Commission's view on how the issues, raised by Transpower, should be accounted for to determine the year end revenue requirement. However, we believe the Commission's interpretation of the requirements set out in the administrative settlement, leading to the disallowance of prudently incurred costs from the regulatory asset base, is not consistent with ensuring Transpower is able to recover its full economic costs of approved investments nor is it consistent with our interpretation of the terms of the Administrative Settlement.

We set out the issues below.

### **Land held due to medium term disturbance**

We accept that, under the terms of the settlement with the Commission, the value of land under example C, on page 2 of our letter of 26 September, should not be included in the Regulatory Asset Base (RAB) as this situation falls within Schedule 1, clause 4(4)(a) of the settlement. We note that the Commission intends to consider whether or not excluding land held for resale continues to be appropriate under the new input methodology framework but we also believe that some estimate of the "cost" of holding properties due to ongoing project construction requirements / disturbance (example C) should be considered part of the cost of constructing the line under the administrative settlement. It would seem to be a perverse (and unintended) outcome that had we rented these properties from a third party these costs would (ultimately) be included in the RAB, but because Transpower determined that it was a least cost option to purchase the property no costs associated with holding these properties can enter the RAB.

Transpower proposes to seek an independent estimate of the “rental” costs of these properties and include this as part of the cost of the line.

**Easements, Injurious Affection and all other costs.**

The Commission notes that in relation to land purchased with the intention of gaining an easement, any reasonable costs in establishing the easement may be entered into the RAB as part of the cost of that easement, provided the value of the easement and any injurious affections payment is supported by an independent valuation.

Specifically, the Commerce Act (Transpower thresholds) notice 2008 states;

*s 4(b): The capital value of easements over land held for resale, together with any injurious affection payments, **and all other costs of establishing the easements** are to part of the regulatory asset base, subject to the approval of the purchase costs by the Electricity Commission;*

*s 4(c): the capital value of those easements and any injurious affection payments is to be valued by independent valuations;*

*s 4 (d): The inclusion within the regulatory asset base of the full costs of establishing those easements is to occur at the date of the next valuation of the regulatory asset base following either purchase of the land or the approval of the purchase by the Electricity Commission, whichever is the later.*

*While s5 (c) states: GAAP is to be used to determine the date on which assets are commissioned and their capital costs....*

The settlement terms specifically make a distinction between:

- a) the capital value of the easement,
- b) the injurious affection payments and
- c) all other costs necessary to establish the easement.

In the case of (c) above, under the terms of the settlement, “all other costs” necessary to establish the easement are not required to be independently valued as these costs are appropriately and deliberately excluded from s4 (c). Although we note that the Commission has assumed a slightly different interpretation.

Our view is that providing these “other” costs are capitalised in accordance with GAAP then they should form part of the transmission corridor cost.

We note that capitalisation of any project costs are only permitted up to an approved maximum allowed cost which is determined by the Electricity Commission.

### **Easement Valuation**

We have provided some examples of independent valuation reports for easements and injurious affection, under separate cover.<sup>1</sup> The valuers' opinion confirms the easement value and the injurious affection costs only.

The scope of the valuation does not extend to an assessment of other costs such as:

- Staff time
- Legal fees
- Valuation costs
- Costs associated with ensuring the easement could be established

One of the most significant cost items is where Transpower changes the underlying use of the land for example by removing a building<sup>2</sup>. While the building write-off would be based on valuation, other dismantling costs would also be capitalised to the project.

All of the above items are legitimate costs of the project which are accounted for in accordance with GAAP and should therefore be included in the costs of the easement. It is questionable whether land valuation experts would in fact be suitably qualified to provide comment on the appropriateness or otherwise of these "other costs". At best they would be able to indicate that these costs were not unreasonable – it seems counterintuitive and somewhat circular that Transpower should on behalf of consumers pay for these items.

We are unsure why the Commission is seeking to make a special case in relation these specific components of project expenditure by seeking independent validation of the costs incurred by Transpower. Forecast project expenditure (and any associated property / easement requirements) is subject to scrutiny as part of the project approval process and a maximum allowed expenditure is established. Taken to its extreme the same argument for requiring independent valuation / validation of these specific transmission corridor development costs (the "other" cost) could be extended to any and all projects costs.

### **Avoided Costs**

The Commission's position in relation to any 'avoided costs' that may result from third party negotiation is that these costs should not be included as a cost of establishing an easement. The Commission has not provided any rationale for this decision. We believe that, provided this is supported by an independent opinion, any clearly avoided costs should be included as part of the cost of establishing an easement. It would create a perverse outcome if an easement which Transpower negotiated on a third party's property is valued higher (under the regulatory framework) than an identical easement on Transpower land.

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<sup>1</sup> Email from Richard Fletcher to Alex Sim – 14 October 2010 (Sexton / Haunui)

<sup>2</sup> Where a property is destroyed or damaged to facilitate the construction of the line - such as the Sexton situation - then the basis for the value transfer would normally be on a valuers report.

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## **REGULATORY TREATMENT OF LAND RELATED TRANSACTIONS UNDER THE INPUT METHODOLOGIES**

We note that as a part of the input methodology consultation process we have proposed a different treatment of land and easements related costs to that currently prescribed under the administrative settlement. Having realised the cost, complexity and vexatious nature of the current regulatory treatment we believe that it would be more appropriate for the net costs of any prudently incurred land transactions are included as part of the regulated asset base (i.e. including the net gain or loss on land held for resale). Attempting a separation of items between regulated and unregulated adds significant complexity, and is not something that we believe is in the long term interests of consumers or Transpower.

### **Foreign Exchange**

We note the Commission's position on the treatment (and recovery) of foreign exchange hedging losses and we will write to you separately on this issue.

We would be happy to meet and discuss this further with you, please contact either John Coulter, Finance Manager on 494 7360 or Richard Fletcher, Regulatory Strategy Manager on 494 7337 in the first instance.

Yours sincerely



Richard Fletcher  
Regulatory Strategy Manager