
Default Price- Quality Path for Gas Pipeline Businesses

17 June 2011

Review of Draft Section 53ZD
Information Request for the Purpose
of Setting Starting Prices

Report for Vector and Powerco



1. Introduction

The Commerce Commission (the Commission) has released a Consultation Paper (Default Price-Quality Path for Gas Pipeline Businesses Draft Information Requests and Process Update, 3 June 2011) which includes:

- A draft section 53ZD Notice to supply information to the Commission for the purpose of informing decisions on starting prices for default price-quality paths (DPPs) under Part 4 of the Commerce Act;
- Schedules A and B to be supplied in electronic form which comprise a Microsoft Excel workbook of templates to be populated with financial information for each gas pipeline business (GPB);
- Schedule C which sets out information requirements for an independent engineer's report on Initial Regulatory Asset Base (RAB) adjustments, also to be provided;
- Schedule D which sets out the form of the Directors' certificate to accompany the information to be provided; and
- Schedule E which sets out the form of the independent assurance report, also to accompany the information to be provided.

PwC has been commissioned by Vector Limited and Powerco Limited to review and comment on Schedules A, B and C. Our review has been informed by our earlier review of the draft templates for Electricity Distribution Businesses (EDBs) and our experience in assisting EDBs and auditors in compiling and reviewing the information recently submitted by EDBs in response to the section 53ZD notice for the EDB DPP.

2. Proposed approach to collecting financial information

Design of templates

We support the use of spreadsheet templates to collect the data required by the Commission for its analysis. This approach facilitates both the compilation and audit tasks. However the information to be included in the templates does not provide a complete picture of the financial performance of the regulated service (ie: either the regulatory profit or the regulatory investment value (RIV)) or the derivation of these key outputs. The templates include a number of variables relevant to regulatory profit and RIV which are to be used by the Commission in its analysis of starting prices for the DPP. The templates therefore appear to be primarily designed in a way which meets the needs of the Commission's own analysis, however in so doing the templates create unnecessary complexity for GPBs and auditors. This is because it is not possible for users to reconcile the information fully to regulatory methodologies and measures, as the information to be provided is not a complete representation of those methodologies and measures.

In our view, the templates could be improved to assist regulated suppliers and their auditors, while fully meeting the Commission's information needs. The key improvement would be the redesign of the templates to provide:

- a full regulatory profit statement (including depreciation, tax, term credit spread allowance and revaluation);
- a full (allocated) RAB roll forward, starting with the Initial RAB at 1 July 2009;
- a full regulatory tax calculation inclusive of its various components including the deferred tax balance and tax loss balance rolled forward from 1 July 2009;
- the derivation of the RIV.

We note that the Commission has recently published draft information disclosure (ID) templates consistent with the IMs which were discussed at the Commission's workshop on 10 June 2011. Although a number of refinements were suggested at the workshop, these drafts provide a useful basis from which the Commission could design more complete templates for the DPP information request. The draft ID templates were not available at the time the EDB information request templates were issued. However as they are now available, we suggest the Commission could greatly improve the DPP information request by incorporating them into the design of the templates to address the information listed above. This would have the added advantage of reducing the compliance costs for GPBs when implementing the new ID requirements once finalised.

Regulatory period

We note the information request is designed to capture financial information for the 12 month period ending 30 June 2011 for all GPBs with the exception of Maui Development Limited (MDL), for which the data is required for the 12 month period ending 31 December 2010. These dates are collectively referred to in the Consultation Paper as the "2010 Disclosure Years".¹ The audited information is to be supplied to the Commission by 30 September 2011 which is three months after the end of the 2010 Disclosure Year for all GPBs with the exception of MDL). We question whether it will be possible for GPBs (with the exception of MDL) to meet this deadline.

¹ We note this definition is contrary to the Input Methodologies which define disclosure year as a 12 month period ending on the date specified. This causes confusion in the template Schedules which use the terms Disclosure Year 2010 and Disclosure Year 2011 consistent with the IMs.

The EDB information request required information pertaining to the period ending 31 March 2010, which was submitted on 27 May 2011 and was derived from information which had already been disclosed and audited as part of the 2010 IDs. Despite this head start, this deadline was tight for EDBs given the:

- opportunity to adjust initial RABs;
- requirement to implement the new IMs for the first time with only limited guidance; and
- coincidence with other financial year end processes.

Most GPBs will be facing the same issues (although Powerco and Vector have now had some experience with implementing the input methodologies (IMs)) However GPBs (with the exception of MDL) do not yet have audited data to work with. Each Company will be unable to commence their work on Schedules A and B of the information request until they have completed their own year end processes for the underlying financial information (revenue, expenses, assets, tax differences etc). At the same time, it will not be possible for the Company to populate the Schedules until the auditors have finished their work on the underlying source information. The Schedules still must be audited for compliance with the IMs, once this task is completed.

As the Commission worked with disclosure data which was over twelve months out of date at the time of the information request for EDBs, it seems possible that data for the period ending 30 June 2010 could also be used for GPBs (with MDL's data at 31 December 2010 as proposed). This would alleviate some of the pressure if the Commission is unable to move its 30 September deadline.

Guidance

The information request is to be completed consistent with the IM determinations. There is very little guidance offered in the draft Notice or templates to assist GPBs and auditors to interpret the IMs. The Commission's technical guidance notes in response to questions from EDBs proved useful and should be offered again. However as discussed at the information disclosure workshop last week, the IMs themselves are very difficult documents to use in isolation when applying these methods, particularly for the first time. We urge the Commission to consider including additional guidance in support of the templates to address areas of particular difficulty identified during the EDB information gathering process.

3. Schedules A, B and C

In the remainder of this report we identify a number of ways in which the templates could be improved to ensure they are more consistent with the GPB IMs and previous regulatory disclosures for GPBs. In addition we identify a number of specific corrections required to the Schedules.

Opex categories

The opex categories included in the templates are the same as those used for EDBs. GPBs have never had to report opex on this basis, and we note that EDBs were permitted to transition to these categories over a number of years when the categories were introduced into the 2008 IDRs.

Grouping opex into common categories may not be important for the starting price analysis. We are not aware that it is for EDBs. Accordingly the best approach may be to allow GPBs to include opex categories which they each use for their own reporting purposes. This would have the lowest compliance cost. An alternative would be to group opex by direct and indirect costs (in addition to pass through and recoverable costs), as this is currently required for performance measures under the gas disclosures. We would recommend an “other” category be included as well if this approach were adopted to allow for abnormal items.

These proposed amendments to opex impact on Schedule A1 and A2 (non-public and public versions). By allowing more flexibility in A2, the Schedules are greatly improved from the user’s perspective as they are able to be tailored to the way in which each supplier structures its business and its cost accounting. It also makes them more consistent with A5 which allows users to enter their own categories of assets.

Cost and asset allocations

Once GPBs have determined whether they apply ACAM or ABAA for allocating costs the allocation method will apply to all costs. The same principle applies to assets, although a different method may be used to that used for costs. The only variation on this is under ABAA where OVABAA may apply in some instances. The design of A2 and A5 (non public and public versions) does not reflect this reality and hence is somewhat confusing for the user. Accordingly we suggest that the templates are modified as follows:

- the ‘allocation methodology’ column in the non public version and the ‘percentage allocation by method’ columns in the public version are removed as they are confusing. Sufficient information exists elsewhere in the Schedules to demonstrate how the method has been applied;
- the method applied is selected from a (new) drop down box to be included above the table which contains the following three options (ACAM, ABAA or ABAA with OVABAA); and
- the ‘line item’ column is removed from both versions. This is unnecessary as the category of operating costs or assets is already entered in the first column of each Schedule.

These changes are in addition to the modification suggested above to allow more flexibility for GPBs to enter cost categories relevant to their business processes.

In addition, the requirement to roll asset information forward across two regulatory periods raises the issue of how the cost allocation IM is to be applied. The definition of causal relationship in the cost allocation IM refers to an 18 month period prior to the end of a disclosure year. As allocations must be made for the Initial RAB (at 1 July 2009), the end of the disclosure year 2010 (30 June 2010) and the end of the disclosure year (30 June 2011), the 18 month period is exceeded (assuming the Commission persists with its requirements to provide information for the 2011 disclosure year). This suggests a different set of metrics may need to be used for the Initial RAB, than those for the 2010 and 2011 year ends, or alternatively, the same metrics may be used for the Initial RAB, and the 2010 year end, but a revised set for the 2011 year end. The same issue applies to the tax book value required for the regulatory tax allowance.

Some guidance on how the Commission expects this aspect of the cost allocation IM to the RAB and tax book value would be useful. A simple solution would be to apply metrics relevant for the 18 month period to 30 June 2011 to all of the information contained in the section 53ZD Notice.

Regulatory asset base

Schedule A3 sets out a range of information to be provided in relation to the RAB. The information pertaining to establishing the Initial RAB at 30 June 2009 is reasonable and consistent with the IMs and Schedule C. RAB information is also requested for the disclosure years 2010 and 2011. We assume these are consistent with the IM definitions, ie: periods ending 30 June 2010 and 30 June 2011.² We note that it appears that the definition of Disclosure Year 2010 in the templates is different to that which is in the Consultation Paper. These anomalies need to be resolved.

The current information request is confusing because:

- it focuses heavily on unallocated RAB information, without including equivalent allocated RAB information; and
- it includes a mix of 2010 and 2011 data, which does not provide a complete RAB picture for either year.

The confusion arises partly because the templates do not set out a comprehensive RAB roll forward. We suggest the RAB template should be modified to reflect a standard RAB roll forward. This would commence at 1 July 2009 with the Initial RAB as the opening value, with annual adjustments for commissioned assets, found assets, acquired assets, depreciation, revaluation, disposals and lost assets, leading to a closing RAB. The existing AV1 schedule in the EDB ID templates is a useful example of a meaningful RAB roll forward.

The RAB IM presents the RAB roll forward process on an unallocated RAB basis, modifying the closing RAB by the asset allocation adjustments to obtain closing allocated RAB. However the unallocated RAB is only an interim step in determining the allocated RAB. In addition suppliers are required to calculate allocated values for depreciation and revaluations (for regulatory profit purposes) and commissioned assets for the RIV. It is therefore reasonable to present the information as an allocated RAB roll forward, with any necessary allocation adjustments disclosed as adjustments between the prior year closing allocated RAB and the opening allocated RAB.

Asset adjustment process

Schedule A4 sets out the information required which pertains to the asset adjustment process. It is largely based on the EDB template, but excludes the specific references in the EDB IM to ODV adjustments. As Vector's non Auckland gas assets were last revalued for ID purposes in 2003, it would greatly assist Vector if the template were extended to include the 2003 year. In addition, it would be useful if the template were expanded to accommodate additional entry rows for more classes of correction.

Regulatory tax

The information required for regulatory tax is set out in Schedule A6. It represents a selection of variables relevant to the regulatory tax allowance calculation for 2010 and 2011 (although not all of the variables are requested for both years). We also note that some of the date information is incomplete. It is not clear from the information request how the Commission's plans to use this information.

The design of Schedule A6 is not particularly helpful for users, as it does not set out the derivation of the regulatory tax allowance for the disclosure periods, nor the roll forward of the relevant tax balances (assets, deferred tax, amortisation of opening differences in asset values, tax losses). Since the EDB section 53ZD information request was finalised, the Commission has developed a set of draft regulatory tax templates for ID purposes. Although these are not yet final, we suggest that the Commission adopts these for the purpose of the

² Although it is not clear what is intended in relation to MDL.

information request as they generate all of the information the Commission is seeking, but in a manner which is significantly more logical for those required to prepare the information.

Engineer's report

Schedule C sets out the minimum information requirements to be included in the independent engineer's report which is to accompany any adjustments made to the Initial RAB. It is largely based on the EDB version. We have noted the following drafting errors which require correction:

- Schedule C, 2(e)(i) refers to ODV rules. ODVs do not form part of the Gas IM for establishing the Initial RAB. Instead the Gas IM refers to either the '2005 authorisation value' (which is not relevant for Schedule C as no adjustments are able to be made to these valuations) or '2009 disclosed assets'. For the purpose of adjusting 2009 disclosed assets, reference is made in Clause 2.2.1 to the Gas (Information Disclosure) Regulations 1997 and the most recent revaluations made under these regulations. Accordingly all references to ODV in Schedule C should be changed to refer to the most recent revaluations made in accordance with the Gas IDs.
- Schedule C, Table 1, 2.2.1(2)(b) refers to how assets to be 'included' in the Initial RAB are to be valued. Table 1 defines this as depreciated historic cost consistent with GAAP. This is consistent with Clause 2.2.1(5) of the IMs. Clause 2.2.1(5) also provides for included assets to be valued at depreciated carrying value where sufficient records do not exist to establish depreciated historic cost. Table 1 should be modified to reflect this.

Please do not hesitate to contact either of the undersigned if you have any queries about this report.

Yours faithfully



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