

23 September 2004

Paul Melville
Gas Pipeline Inquiry
Commerce Commission
Level 6, 44-52 The Terrace
PO Box 2351
WELLINGTON

Dear Paul

GAS PIPELINES INQUIRY – COMMISSION’S PROPOSED TAX TREATMENT

- 1 NGC welcomes the opportunity to comment on the Commission’s proposed treatment of tax as outlined in the documents "*Gas Control Inquiry: Tax Treatment in the Commerce Commission’s Cost Benefit Analysis*", "*The Treatment of Gains on the Sale of Assets*", and "*The Interest Tax Deduction and the Calculation of Excess Earnings*" released on 8 September. This submission addresses issues raised in the three documents as a package rather than commenting on each separately.

Forecast Tax Information for NGCD

- 2 As the Commission is aware, NGC was unable to confirm the forecast tax information for its distribution business until 10 September. The forecast information with distribution and gas metering combined from different businesses took some time to reconcile accurately with the historic information. Rather than repeat that information in this submission, NGC presumes that the information provided on 10 September will replace that presented in the consultation documents. NGC would appreciate confirmation of this and is happy to discuss the information should the Commission have any further queries.

Regulatory Asset Value and Depreciation

- 3 NGC agrees with the Commission’s adoption of the ODV valuation as the regulatory asset base. It is important that there is a consistent approach to information in the Inquiry’s cost benefit analysis. At the Conference on the Draft Report, NGC raised the issue of the asset base and depreciation being consistent with the treatment of changes in optimisation. The Commission proposes to use ODV to calculate regulatory depreciation. The use of ODV for valuation and depreciation requires the business to carry the risk of asset stranding, which is consistent with industry practice. To maintain a consistent approach, it is necessary for any changes in the level of asset stranding to be excluded from the calculation of regulatory revenue in contrast to revaluations due to replacement cost inflation which are included.
- 4 It is not proven in the Commission’s documents that acquisition prices above ODV are capitalisations of monopoly rents, as implied by the Commission¹ rather than a

¹ "*Gas Control Inquiry: Tax Treatment in the Commerce Commission’s Cost Benefit Analysis*", paragraph 27.

reflection of other elements of the transaction, for example intangible assets or expected efficiency gains. In NGC's view, the Commission's concern that such acquisitions will adversely affect consumers can only be tested by examining the pricing behaviour of the acquirer of the assets.

- 5 NGC maintains its view that only its forecast information, prepared for internal board decision-making purposes, should be used in the cost benefit analysis of price control. However, given that the Commission has presented tax information for 12 years, NGC presumes the analysis will average historic and future data. If this is the case, NGC stresses that the net present value analysis should be cast on a forward looking basis as outlined in paragraph 39 of our cross-submission following the Conference on the Draft Report. In NGC's view, a different approach to determining the net present value would result in an inaccurate cost-benefit analysis.

NPV may not equal zero

- 6 NGC believes that the NPV=0 principle should not be expected to hold in a study period that is short relative to the asset's life. NGC has previously submitted that this requirement does not reflect accepted business practice or practical issues, for example:

- Ex ante pricing;
- Unpredictable variations in costs and revenues;
- Option values in investment; and
- Timing of cost recovery.

- 7 Dr Lally acknowledges the problem of choice of study period giving rise to misleading conclusions in his discussion of the principle of neutrality in relation to the gain on the sale of assets².

- 8 NGC remains concerned that the Commission may misdiagnose excess earnings due to a strict adherence to the NPV=0 principle over a short study period. NGC is encouraged by the Commission's recognition that its choice of tax loss treatment may result in the overstatement of excess returns³. NGC believes similar consideration should be given to other aspects of the cost-benefit analysis which may result in NPV>0 when a short study period is used, for example the de-optimisation of the Kapuni North Line.

- 9 It is unlikely that this pipeline would have been brought back into service under price control, if such revaluations were to be treated as income that must be passed to consumers via lower prices. As occurs in heavily regulated jurisdictions overseas,

² "The Treatment of Gains on the Sale of Assets", page 7.

³ "Gas Control Inquiry: Tax Treatment in the Commerce Commission's Cost Benefit Analysis", paragraph 35.

NGC would have placed issues such as this before the regulator for prior approval. Specifically, it would have obtained an agreement from the regulator that deoptimisation is not regulatory revenue before agreeing with shippers to transport gas on the pipeline.

- 10 In NGC's view the factual and counterfactual need to be carefully and explicitly defined, so the behaviours under each can be robustly modelled and assessed.

Gains on Sale of Assets

- 11 As previously submitted, NGC agrees the gains on the sale of assets should be disregarded.

- 12 NGC is concerned that the definitions of inter-sector and intra-sector sales may lead to the unintended consequence of ad hoc treatment of issues elsewhere in the cost-benefit analysis. For example, NGC would expect the Commission's market definitions to apply to the particular services irrespective of who owned the asset used to provide those services. Consequently, whoever purchased those assets would become part of the sector. Asset sales can therefore only be intra-sector. If another owner of the asset can be considered to be outside the market definition, then the asset is not central to the provision of the service under investigation. If this is so, all such assets should be outside the scope of the Inquiry.

Concluding Remarks

- 13 It is clearly important that data used in the Inquiry is based on sound underpinnings and the models applied to the data applied on a consistent basis. Ad hoc adjustments should not be made to individual data without considering how this would have impacted on, for example, price setting behaviour. NGC seeks to continue its positive engagement with the Commission and is happy to comment on any other aspects the Commission may propose with a view to minimising errors or areas of unnecessary dispute.

Yours sincerely

Paul Hodgson
Manager Regulatory Affairs