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Our ref LT101MPP.Powerco

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Dear Elanga

Tax treatment in the Commerce Commission's Cost Benefit Analysis

You have asked us to review the Commerce Commission's (the "Commission") proposed treatment of taxation in their analysis of pricing in the gas services industry from an accounting viewpoint.

This letter addresses two issues from the perspective of Generally Accepted Accounting Practice in New Zealand ("GAAP"):

- Whether the proposed treatment of tax depreciation of network assets in the preparation of the regulatory accounts complies with GAAP; and
- The likely flow-on effect of pricing restrictions in the statutory financial statements of entities who have purchased and recorded network assets at a value above their Optimised Deprival Value ("ODV").

New Zealand's Accounting Standards Review Board announced in December 2002 that New Zealand would adopt International Financial Reporting Standards from 2007, with early adoption available in 2005. In this letter, we have made reference to NZIFRS as GAAP on the basis that it is likely that any regulation would apply to periods where NZIFRS had been introduced in New Zealand.

Our analysis is based on our review of material provided by you, including:

- A report by the Commission entitled: "Gas Control Enquiry, Tax Treatment in the Commerce Commission's Cost Benefit Analysis, Powerco Version" dated 8 September 2004.
- A paper by Martin Lally entitled: "The Treatment of Gains on the Sale of Assets" dated 2 September 2004.



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1. Executive Summary

The Commission's analysis fails to reflect the temporary difference caused by the difference between the tax base and the recorded value of the network assets and therefore does not comply with GAAP.

The likely impact of regulation to impose pricing controls on entities who have purchased and recorded assets at a value above their ODV is to require those entities to write-down the value of their network assets and record a deferred tax asset in their statutory financial statements.

2. Compliance with GAAP

You have asked us to comment on whether the Commission's proposals comply with GAAP.

Relevant extracts from the Commission's paper

Paragraph 5 of the Commission's 8 September paper notes that financial information is prepared for various purposes:

"Businesses are required under the Financial Reporting Act 1993 to prepare financial accounts based on generally accepted accounting principles (GAAP). These accounts form the basis of reporting to shareholders and the financial community. Businesses also prepare separate tax reconciliations based on the requirements of the Income Tax Act 1994. The Commission has also constructed a set of regulatory accounts for each of the gas businesses based on the information provided by the businesses under the s70E notices served by the Commission."

The same paragraph goes on to discuss the proposed calculation of tax expense for regulatory purposes:

"The tax expense calculated using the regulatory accounts is described in this paper as prima facie tax and is based on net profit derived according to accounting rules. Tax payable is the tax obligation calculated in accordance with the Income Tax Act. Differences between these two tax numbers arise because of permanent differences and timing differences as explained in more detail in Section 3."

In paragraphs 8-10, the Commission outlines important principles relevant to its approach to calculating tax expense for the purposes of the regulatory accounts:

"In using tax payable rather than prima facie tax, the Commission assumes that businesses should pass on any benefits of lower tax payable (relative to prima facie tax) to customers and recover the costs of higher tax payable as these arise. The circumstances in which tax payable deviates from prima facie tax, and the adjustments that the Commission has taken into account in its modelling are discussed in the sections below."

An alternative approach would be for the Commission to use prima facie tax in assessing excess returns rather than tax payable. This would mean that businesses would keep the benefits of lower tax payable, and would bear the costs when these were reversed. Businesses would earn higher returns earlier on and lower ones in the future. However, such an approach deviates from the NPV = 0 principle because of the timing of the tax benefits and the possibility that when a business is growing, taxes benefits may be retained for an extended period.

A further principle adopted by the Commission is that impacts outside the period of analysis are not taken into account in the analysis. Thus revaluation gains prior to the analysis period are ignored, as are opening deferred tax balances.”

Relevant sources of GAAP

Both accounting and statutory tax models require an entity to spread the cost of an asset over its useful life to the entity. NZIAS-16, *Accounting for Property Plant and Equipment* defines depreciation as:

“...the systematic allocation of the depreciable amount of an asset over its useful life.”

In NZIAS-12, *Accounting for Income Tax*, temporary differences are defined as follows:

Temporary Differences are differences between the carrying amount of an asset in the balance sheet and its tax base. Temporary differences may be either deductible or taxable.

Deductible temporary differences are temporary differences that will result in amounts that are deductible in determining taxable profit of future periods when the carrying amount of the asset is recovered and taxable temporary differences are temporary differences that will result in amounts that are taxable in determining taxable profit of future periods when the carrying amount of the asset is recovered.”

Under GAAP as set out above, temporary differences arise where:

- A transaction such as a business combination establishes an initial accounting base for the asset that is different from its initial tax base; or
- The application of a different rate or pattern of depreciation to an asset creates an accounting base that is different from its tax base in subsequent periods; or
- Assets are revalued (upwards or downwards) and no equivalent adjustment is made for tax purposes.



In recording a deferred tax asset or liability for a difference between the tax base and recorded accounting value, the accounting rules are acknowledging:

- That the accounting value is based on the present value of the expected future cashflows to be generated from the asset, and that those cashflows will be taxable (hence the difference is taxable/deductible); and
- Over the full economic life of the asset, both the accounting and tax depreciation rates will reduce the depreciable amount of the asset to zero (hence the difference is temporary).

Comparison of GAAP to the Commission's proposals

As set out above, GAAP contains specific guidance on the appropriate treatment of differences between the depreciable tax base and depreciable accounting base that arise from either:

- A transaction, such as a business combination, that establishes an accounting base for the asset that is different from its tax base; or
- The application of a different rate or pattern of depreciation to an asset that creates an accounting base that is different from its tax base in subsequent periods.

The Commission's proposals correctly recognise the temporary difference that arises from the latter, by recording the deferred tax impact of the different depreciation rate or pattern used for tax and accounting purposes.

However, the Commission's proposals fail to reflect the temporary difference caused by the recognition of the network assets at a cost for accounting purposes (e.g. at the fair value paid in a business combination or ODV for regulatory purposes) that is different to the cost for tax purposes.

The position is further exacerbated by the Commission's principle in paragraph 10 (refer above) that impacts outside their period of analysis are ignored. Inherently GAAP financial statements aim to appropriately allocate income and expenses to reporting periods to which they relate. By arbitrarily ignoring temporary tax differences that have arisen in prior periods and will reverse during the analysed period, the Commission appears to be building an explicit flaw into the regulatory reporting.

Conclusion

- GAAP specifically covers the situation where the tax base of an asset is different to the base being used for financial reporting (in this case, regulatory financial reporting), including as a result of a business combination.
- GAAP requires the impact of this different base to be recognised as a temporary difference in calculating the tax expense in each period.

- The effect of recording this temporary difference is to record a tax expense in each period that reflects the depreciation being recognised in the financial statements (rather than the depreciation deductible that period in the tax return)
- The Commission's proposals fail to reflect all temporary differences as required by GAAP, and therefore do not comply with GAAP.
- Given the materiality of the non-compliance, we expect this to cause some difficulty for auditors of regulatory financial statements if this approach is adopted.

3. Likely flow-on impact of the Commission's proposals

We understand that the Commission's current analysis of Powerco indicates excess earnings on Powerco's network assets (using an ODV asset base, taxes payable as opposed to prima facie tax and ignoring impacts outside the period of analysis). In this section, we discuss the likely impact of any regulation that reduced the future income from network assets relative to the current and forecast earnings.

Our analysis in this section is focused on the impact in the statutory financial statements prepared by Powerco under the Financial Reporting Act, 1993.

Relevant sources of GAAP

NZIAS-36, *Impairment of Assets* sets out the requirements under GAAP for:

- Establishing at each reporting date whether there are indications that an asset (or group of assets) may be impaired.
- Calculating the recoverable amount of the asset (or group of assets) as the higher of its net market value or value in use.
- Calculating value in use for the asset (or group of assets) as the present value of the future cashflows expected to be earned by continuing use of the asset in its current state.
- Where the carrying value of the asset (or group of assets) exceeds its recoverable amount, the carrying value is required to be written down immediately by recognising an expense in the income statement.

Likely impact of regulation to reduce future income

The impact of new regulation that reduced future income from the network assets would depend on the current position of the carrying value of the assets versus their recoverable amount, and the extent of the regulatory impact on future revenues.

Prima facie, the regulation would be an indicator of impairment in the period in which it was introduced, forcing Powerco to test for impairment. The regulation could be expected to have an equally negative effect on both the net market value Powerco could obtain from selling the assets



and their value in use to Powerco. Assuming that the assets' carrying value was equal to their recoverable amount immediately prior to the introduction of the regulations, the result of the impairment test would be to write-down the value of the network assets by an amount equal to the present value of the reduced future income caused by the introduction of regulation.

It is unlikely that any write-down of the network assets would be treated as an allowable deduction for tax purposes, hence the write-down would create a new temporary difference between the accounting base value of the asset and its tax base. The effect of this temporary difference would be to record a deferred tax asset at the point of the write-down. The deferred tax asset would be released over the remaining useful life of the network assets, resulting in an accounting tax charge that was higher than the tax payable in each period. However, in the year of write down, the tax payable would be disproportionately higher than the accounting tax charge.

Conclusion

The introduction of price regulation that reduced future earnings from the network assets would be likely to result in:

- The network assets being written-down in the statutory financial statements; and
- A deferred tax asset being created and released over the remaining useful life of the network assets (increasing the accounting tax expense in each period accordingly).

The combination of the write-down in the value of the asset but no reduction in the tax base therefore has a "double negative" impact on the company's statutory financial statements.

Our advice is subject to the terms and conditions set out in our engagement letter dated 22 September 2004. We would be happy to discuss any aspect of our advice with you.

Yours sincerely

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