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50 Clark Street
Khandallah
Wellington 6035

The Commissioners
Commerce Commission
44-52 The Terrace
Wellington

Transpower alignment of fixed asset registers

Dear Commissioners

I have read Transpower's internal memorandum dated 12 April 2007 concerning proposals for the alignment of their regulatory and financial asset registers and how this may assist in the Administration settlement negotiations in which they are engaged with the Commerce Commission.

I was a partner with PricewaterhouseCoopers for over 20 years until 31 March 2002 and the partner responsible on behalf of the Controller and Auditor-General for the audit of Transpower. Hence I am familiar with the underlying issues being raised by Transpower in their internal memorandum.

I have provided some general observations primarily based on my prior knowledge in the Appendix, in responding to the proposals contained in the Transpower internal memorandum.

I comment on four aspects below, namely:

- Will Transpower's proposal, as explained in its internal memorandum dated 12 April 2007, achieve its intended purposes of aligning its regulatory and financial accounting books?
- Is Transpower's proposal able to be effectively implemented under IFRS?
- Is Transpower's proposal the most effective means to achieve the intended purpose?
- Will Transpower's proposals relating to aligning its regulatory books and adoption of Depreciated Historical Cost (DHC) valuations financially advantage or disadvantage it relative to its customers, and if so, by approximately how much and over what timeframe?

1) Will Transpower's proposal, as explained in its internal memorandum dated 12 April 2007, achieve its intended purposes of aligning its regulatory and financial accounting books?

The two key areas that need to be demonstrated by Transpower to the Commission in the alignment of their fixed asset registers, are:

- physical assets alignment; and
- asset valuation alignment.

Physical assets alignment

In the 12 April 2007 internal memorandum Transpower provided a very useful example of

physical assets alignment. The Addington to Islington line is one asset for regulatory reporting purposes but is 380 assets for financial reporting purposes.

From my past experience as auditor on behalf of the Auditor-General of Transpower, the Addington to Islington line is also most likely one asset for income tax reporting purposes and 380 assets for asset management purposes. As a consequence it is probable that Transpower have at least three fixed asset registers, one for regulatory reporting purposes (Regulatory register), one for income tax reporting purposes (Tax register) and one for financial reporting and asset management purposes (F& AM register). I have no doubt that the scope for misalignment of the physical assets in the three registers is significant.

Transpower will need to demonstrate to the Commission that the assets in the Regulatory register are the same assets that are in the F& AM register. Using the Addington to Islington example, that the same 380 assets are recorded in both registers.

Because of the optimisation process required for regulatory reporting purposes there will be a number of instances where the Regulatory register will comprise assets that are not included in the F & AM register. In such cases Transpower will need to demonstrate to the Commission that these regulatory (optimised) assets are providing the same services as the equivalent F & AM register assets.

As Transpower propose adopting a single register based on the F & AM register from 1 July 2006 for financial reporting and regulatory purposes, the unregulated assets from the F & AM register will be included in this register. In addition the detail of the assets contained in the F & AM register will also be included in this single register. For example the Addington to Islington line will now become 380 assets in the register where previously it was one asset in the Regulatory register.

Asset valuation alignment

In achieving asset valuation alignment at 1 July 2006, Transpower have highlighted in their 12 April 2007 internal memorandum that there is a \$112m difference between the Regulatory and F & AM registers. The Regulatory assets have a value of approximately \$2bn whereas the Financial assets have a value of approximately \$1.9bn at 1 July 2006. In determining the \$112m difference I am assuming Transpower has adjusted for the unregulated assets in the F & AM register.

Transpower's preferred option for alignment of asset values is to create four extra (pseudo) assets totaling \$112m, being \$38m of HVDC assets, \$(4)m of HVDC line, \$14m of substations assets and \$64m of AC Transmission line. Transpower's internal memorandum recommends that the asset register to be used for regulatory and financial reporting purposes from 1 July 2006 onwards will comprise these four pseudo assets plus the existing detailed F & AM register assets, ie the Addington to Islington line as 380 assets.

This would also mean that there was a detailed register that could meet (subject to comments below) both IFRS reporting and Transpower's asset management needs. In assessing the likely success of this proposed asset valuation alignment, Transpower will need to get IFRS sign-off on the 1 July 2006 opening balance from their auditors, useful lives/depreciation sign-off from the Commission; and, asset management sign-off from their asset maintenance personnel in confirming the assumptions and policies underlying both future maintenance and capital additions.

These matters are commented on further below.

2) *Is Transpower's proposal able to be effectively implemented under IFRS?*

NZIAS 16 "Property, Plant & Equipment" is the same in all significant respects to the existing FRS 3 "Property, Plant & Equipment". Choice is permitted in both these financial reporting standards by allowing the use of historical cost, a valuation (modified historical cost) or a combination of both valuation bases. I understand from 1 July 2006 Transpower intend that all their fixed asset registers will be on an historical cost basis, including the Regulatory register.

The start point at 1 July 2006 for Transpower's Regulatory register will be their detailed F & AM register plus four pseudo assets totaling \$112m. Transpower's first hurdle will be for their Board of Directors to satisfy themselves that their Regulatory register at 1 July 2006 meets NZIAS 16 requirements.

This may require some consultation with their auditors, especially as to the most appropriate treatment of the \$112m. The \$112m would be permitted under NZIAS 16 as a valuation, provided the \$112m was seen to be recording assets at their fair value. Which means the directors and auditors would need to be satisfied that ODV values of the assets at 1 July 2006 met the fair value tests of NZIAS 16.

NZIAS 16 requires that fixed assets are differentiated according to their asset management programmes, ie, each asset or groups of similar assets are recorded together, according to the planned maintenance over their useful life. This serves to distinguish maintenance costs from other costs that are capitalised into the cost of the asset which are incurred where it is "*probable that future economic benefits associated with the (asset) will flow to (Transpower)*". A consequence of this asset management approach is that the useful lives of the asset or groups of similar assets is established.

The Commission would need to be satisfied that the useful lives (hence depreciation) being applied to assets recorded on an historical cost basis in accordance with NZIAS 16 asset management-based principles are acceptable.

Transpower identify in their internal memorandum that they may construct or acquire assets in future for a value greater than the Electricity Commission (EC) will allow a full recovery from their customers. In such cases I agree with Transpower's conclusion that such assets could be dealt with under the asset impairment principles in NZIAS 16.

3) *Is Transpower's proposal the most effective means to achieve the intended purpose?*

Transpower's proposal deals with two key elements:

- (a) The desire to create increased transparency and simplicity around their various fixed asset registers; and,
- (b) An efficient means of dealing with the difference in value of the assets in their Regulatory and F & AM register.

Transpower should be able to have one fixed asset register recording all assets on a detailed basis, which would be able to meet financial reporting, asset management, regulatory and income taxation needs. Transpower's internal memorandum addresses aspects of its financial reporting and regulatory needs, but makes no mention of its asset management and taxation needs.

Hence without further information from Transpower I cannot confirm whether their proposal will increase the transparency and simplicity they are seeking.

The \$112m difference between the Regulatory and F & AM registers could be approached in two ways. The first is as suggested by Transpower by the creation of pseudo assets to bring the F & AM register balance up to the 1 July 2006 balance of the Regulatory register. The other way would be to adopt the F & AM register balance at 1 July 2006 for regulatory purposes which would avoid the need to consider how the \$112m difference could be accommodated under NZ IFRS.

This latter basis may not be acceptable to Transpower depending on its materiality to the projected future revenue recoveries from their customers. However this latter basis could also present an opportunity for Transpower and the Commission to agree on a new basis for the calculation of revenue requirements from 1 July 2006 with the change from ODV accounting to the historical cost basis of accounting.

4) *Will Transpower's proposals relating to aligning its regulatory books and adoption of Depreciated Historical Cost (DHC) valuations financially advantage or disadvantage it relative to its customers, and if so, by approximately how much and over what timeframe?*

With the increased transparency and simplicity afforded by having (potentially) one detailed fixed asset register that meets asset management, regulatory, financial reporting and income tax needs, comes the increased ability to scrutinise the underlying assumptions as to the maintenance programmes and useful lives of the underlying assets. There will now be 380 such assumptions that can be reviewed for the Addington to Islington line for regulatory purposes, whereas there is currently only one item for analysis of assumptions by the Commission and Transpower's customers.

There is now going to be much more information available for regulatory monitoring purposes than is available from asset information that is currently significantly summarised.

Subject to an external audit continuing of the Regulatory financial statements and disclosures, Transpower's stated intent of achieving greater *"simplicity, transparency and robustness in calculating the revenue requirement"*, and getting satisfactory responses to the issues I have discussed above (including a question I have not addressed concerning how Transpower intend to deal with the balances in the customer EV accounts), I can see no reason to suspect that Transpower's proposals are intended to financially advantage or disadvantage it relative to its customers.

Other information

I would be pleased to provide clarification of any of the matters I have raised above in assisting you and the Commissioners in determining a way forward with the Transpower proposals.

Yours sincerely

T J Fairhall
Financial Adviser

APPENDIX

Transpower fixed asset registers

From my previous involvement with Transpower, which is highlighted in the internal memorandum, Transpower need to maintain a number of fixed asset registers for financial reporting, asset management, regulatory and taxation purposes. These registers are maintained on both a detailed and summarised basis depending whether they are for financial reporting and asset management purposes or regulatory and taxation purposes respectively. The registers also have assets recorded on both historical cost and valuation bases.

The maintenance of these various registers creates significant reconciliation challenges, especially in ensuring the same assets are recorded in all of them.

Alignment of the fixed asset registers

The purpose of the 12 April 2007 memorandum is to explore ways of aligning the financial reporting and regulatory asset registers. Given the complexities that exist with the various registers I can understand why Transpower is endeavouring to simplify and make more transparent their asset registers. And, to minimise and/or eliminate the need for costly reconciliation processes.

However, the introduction of some pseudo assets as suggested in the internal memorandum does not appear to be addressing the underlying purpose of the alignment process which is to achieve more simplicity, transparency and usefulness to Transpower of the asset information.

NZIAS 16 and FRS 3

The introduction of FRS 3 in 2001 and the recent introduction of NZIAS 16 has provided Transpower and other asset-intensive entities the opportunity to provide more robust and useful information both for asset management and financial reporting purposes. The reason being is that these financial reporting standards require assets to be broken down into their component elements where those elements have differing useful lives. It also requires a plan for that asset to be developed which clearly distinguishes between maintenance and capital additions to the asset over its useful life.

What this means for Transpower, as illustrated in their internal memorandum with the Addington to Islington line, is that one asset acceptable for regulatory and taxation purposes needs to be broken down into (380) its component elements for financial reporting purposes, which is also useful and relevant for asset management purposes.

The financial reporting standards permit assets to be recorded at either historical cost or their fair value. Fair value may or may not be materially equivalent to their regulatory value.

It does not appear this valuation issue has been addressed in the formulation of the internal memorandum, but it will need to be considered as a first stage in Transpower's alignment of their asset registers for financial and regulatory reporting purposes. Transpower may need to consult their auditors in confirming that the regulatory basis of valuation will be acceptable for financial reporting purposes in all material respects.

However, I am sure that Transpower will also be concerned to ensure that the move to align the valuation bases for regulatory and financial reporting purposes does not diminish the usefulness of the asset information for asset management and taxation purposes.

Achieving greater transparency and usefulness

In achieving greater transparency for reporting purposes and usefulness for asset management purposes, I believe Transpower should first be focussing on ensuring they have one asset register which records all assets right down to their component elements. These component elements will each be assigned a useful life for depreciation (both for tax and accounting) purposes and (as appropriate) will each have a maintenance programme assigned, so that future maintenance can be clearly distinguished from capital additions. Finally each component element will either be recorded at historical cost or at a valuation, depending on for which reporting purpose it is required.