Transpower House, 96 The Terrace,
PO Box 1021, Wellington,
New Zealand
Telephone +64-4-495 7000
Facsimile: +64-4-495 7100
www.transpower.co.nz

31 March 2014

Brett Woods
Senior Analyst
Regulation Branch
Commerce Commission
WELLINGTON

By email: regulation.branch@comcom.govt.nz

Dear Brett

Proposed amendments to input methodologies for Transpower

Thank you for the opportunity to comment on the paper "*Proposed amendments to input methodologies for Transpower",* published 11 March 2014 (the consultation paper). No part of our submission is confidential.

We understand the Commission's approach to consider our IM amendment proposals in three phases[1]:

- phase 1 being those amendment proposals necessary to be addressed prior to an RCP2 decision, for example depreciation in year of commissioning and which are the subject of the 11 March consultation paper
- phase 2 being those amendment proposals best addressed through the individual price-quality (IPP) for RCP2 process and which were canvased in the recent RCP2 'issues paper' consultation
- phase 3 being amendment proposals that are more suited to consideration in the 7 year review of IMs and or not necessary to give effect to the IPP determination for RCP2.

We commented on the 'phase 2' amendment proposals in our response to the RCP2 issues paper consultation. This submission responds to the three proposals under phase 1. While we would prefer that the amendment proposals were dealt with at this point we recognise that some changes may best be considered in context of the broader 7 year review. We address the three phase 2 amendment proposals below.

Proposals one and two

Proposal one: removing the requirement to spread depreciation for 'end-of-life' assets. Our rationale for this amendment proposal was that the current rule creates additional complexity and compliance costs (because of the departure from GAAP) for no obvious benefit. We outlined in our amendment proposal that the rationale for the current requirement, which we supported at the time, is invalid as the inefficient incentive it seeks to address does not exist in practice.

[1] As explained in 14 March letter from the Commission to Transpower: Input methodologies amendment requests

We appreciate the attention given to the issue and support the Commission's proposal to remove the rule.

Proposal two: strategic land acquisition. We agree that from RCP2 the issue that strategic land could not be added to our RAB will be resolved (because we will have had approval under the Capex IM).

We consider that clarification may be needed on the drafting (to be certain that individual strategic land acquisitions may enter the RAB at acquisition). It would be helpful and low cost and therefore worth doing.

Proposal three: Depreciation in Year of Commissioning (DIYOC).

Our amendment proposal is to remove the current non-GAAP treatment of depreciation in the year an asset is commissioned. In its consultation paper the Commission has put forward two possible reasons for opposing or delaying our amendment request:

- the effect of the amendment on other deliberately established GAAP departures
- the cross-sector implications of changing one supplier's IM.

We discuss these aspects below (we respond to the specific questions in appendix B).

Departures from GAAP

In December 2009 the Commission released its first discussion paper on input methodologies. The Commission stated its reasoning for departures from GAAP as the following:

> "Although it may reduce compliance costs to be able to rely on generally accepted accounting practice (GAAP), it is axiomatic that regulatory financial disclosure requirements may need to differ from statutory financial reporting requirements to appropriately reflect regulatory principles and objectives"

We agree that it may be appropriate to depart from GAAP where necessary to reflect regulatory principles and objectives. However, as indicated in our IM change request (reproduced as attachment 3) we have not been able to retrieve or identify any such principles or objective that would justify the current departure from GAAP and no substantive reasons are raised in the paper. The current situation is also inconsistent with the policy for MAR adjustments (which takes into account the timing difference between forecast and actual capital additions), and the use of GAAP to value our assets on commissioning.

The consultation paper explains that an input methodology that specifies a GAAP calculation (as proposed by Transpower) would:

> "also have the effect of removing a number of other differences established deliberately by the input methodologies between GAAP and the regulatory rule – such as requirements to use regulatory depreciation lives prescribed in Schedule A of the determination".

Our principal concern is that the substantive issue is addressed - not necessarily that the specific drafting that we proposed is adopted. We agree is too blunt as it may preclude non-GAAP treatment, which is not our intention. We would be happy to work with Commission staff on drafting that addresses the substantive issue without unintended consequences.

The table in Appendix A summarises the current diversions from GAAP. If depreciation in year of commission (DIYOC) adjustment was removed as we have requested and proposal one (above) was adopted then only one adjustment to the GAAP depreciation calculation. We have requested an IM change to remove this adjustment as well (to be considered under the CC's 7-year review). We also note that the asset lives we use for regulatory purposes are the same as the GAAP values used in our audited financial statements. So while standard asset lives are described by Schedule A of the IM, we apply the provisions of clause 2.2.6 (1) (h) (iii) and use an engineer's report to establish the lives instead.

The objective should be overall efficiency

We support efficient administration as an appropriate objective for the Commission and have no objection to the Commission's comment at paragraph 38:

> "we consider that consistency in input methodologies across the sectors is important and having the same approach makes it easier for us to administer the Part 4 regime[2] (paragraph 38) and suggest this is the case for regulator and the regulated parties."

However, we consider it appropriate that any view of administrative efficiency is focused on overall efficiency and nets off the costs imposed on other parties. This is particularly relevant where costs essentially flow through to the consumer, as is the case with the Commission and Transpower. In this instance, however, it is not obvious that the proposed chance would impose additional costs on the Commission (and we would be surprised any costs to the Commission were comparable to costs imposed by the current rules).

Cross-sector consistency desirable for 'generic' regulatory matters

As a matter of good practice we also support a consistent approach to (regulatory) policy and rule making by Commission between comparable sectors. This can help interested parties understand the Commission's likely approach on process and policy and consequently enhance regulatory stability and predictability.

It is critical, however, that the Commission delineate between consistency that enhances efficiency and consistency *for the sake of consistency* which can reduce efficiency. Where there is a good reason for differential treatment then the Commission should be comfortable doing so. In this case it seems unlikely that mandating consistency will enhance efficiency and, while we agree that some IM changes are best dealt with through the 7 year IM reviews it is not obvious to us why that would be the case for DIYOC.

More generally the question of consistency between sectors seems likely to become more salient as the final pricing principle reviews crystallise linkages between telecommunications and Part 4 services and as the 7 year IM reviews approach. We encourage the Commission to consult on its views in this area including delineating between consistency for statutory (e.g. section 5(T) (c)) and other reasons.

Please let me know if you would like clarify or discuss any of the points made in this submission.

Yours sincerely

Jeremy Cain
Chief Regulatory Advisor

[2] Paragraph 38

Appendix A

Table 1 Depreciation building block as reported in 2012/2013 Annual Regulatory Report

Depreciation in the 2012/13 ARR	**$m**	**Comment on adjustment term**
Total depreciation for 2013 financial year per GAAP	**167.9**	**Calculated in accordance with GAAP**
plus pseudo asset depreciation	6.4	Legacy adjustment that is a very simple addition to our depreciation, causing no issues
less depreciation in commissioning year	(25.3)	"DIYOC": the third of the proposed amendments (see paragraphs 27 - 32 of consultation paper, and attachment 3)
less depreciation on assets which will be fully depreciated in RCP1	(17.9)	The first of the proposed amendments, see paragraphs 9 - 15 of consultation paper. The commission states that it favours removing these two adjustments.
plus allocated depreciation from assets fully depreciated in RCP1	17.7	
plus dismantling costs	8.8	n/a (A GAAP figure, included in this calculation to simplify the revenue building blocks)
plus net asset write-offs	9.0	n/a (A GAAP figure, included in this calculation to simplify the revenue building blocks)
Capitalised interest adjustment for the difference between GAAP and WACC	(4.3)	If the DIYOC adjustment was to be removed this would be the only adjustment to depreciation that would remain. We have requested an IM change to remove this adjustment as well (to be considered under the CC's 7-year review).
Regulatory depreciation and write-offs	**162.4**	

The shaded cells represent regulatory requirements not currently consistent with GAAP that we have asked the Commission to align with GAAP.

Appendix B: responses to questions regarding proposal 3 (Allowing for part-year depreciation for assets in the year of commissioning)

Commission question	Transpower response
1. Whether an amendment should be made to reduce Transpower's compliance costs.	Yes. This adjustment term appears to serve no identifiable regulatory objective and creates unnecessary administrative cost and risk.
2. Whether the drafting suggested by Transpower should be adopted, or whether the existing depreciation formula in the input methodology should be modified to account just for the part-year depreciation aspect.	Our principal concern is that the substantive issue is addressed - not necessarily that the specific drafting that we proposed is adopted[3]. If the Commission intends to adopt alternative drafting we request the opportunity to comment on this before the change is made.
3. What your views are on the effects of the proposed change on advancing future cash flows from maximum allowable revenues under the individual price-quality path.	The effect on our price path is very small and the change is neutral, in NPV terms.
4. Whether a transitional 'catch-up' adjustment should be made, so as to reverse the cumulative effect of the differences as at 2015, and how this transitional adjustment is best implemented.	We agree. The effects of our proposed approach on our RCP2 and RCP3 price path are relatively minor (less than 1% of revenue).
5. Whether the issue should be deferred for wider consultation in order to ensure consistency across sectors, for instance as part of a programme for the 7 year review of input methodologies.	We see no reason why the Commission should defer this issue to the 7 year IM review. We consider it seems unlikely that mandating consistency in this instance will enhance efficiency and that, while we agree that some IM changes are best dealt with through the 7 year IM reviews, it is not obvious why that would be the case for DIYOC.

[3] The Commission's IM amendment template requires suggested drafting