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TRANSPOWER

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26 August 2010

Alex Sim
Chief Advisor
Commerce Commission
P O Box 2351
WELLINGTON

Dear Alex

CALCULATION OF THE YEAR END REVENUE REQUIREMENT

In the determination of the 2009/10 year end revenue requirement (Economic Value Statements) we propose to make certain adjustments to which we would like to draw your attention. These are items that we have previously raised with you informally.

Non Part F overspend in 2010/11

During the 2009/10 assessment period we incurred actual non Part F expenditure of $203.0m. This is $13.4m more than the allowance of $189.6m. As we noted during the 2009 Strata Review, we incurred expenditure on two major programmes of work that were not included in the original plan of threshold work for the year.

- Marsden substation redevelopment project (actual expenditure $11.6m). This expenditure was initially, incorrectly categorised at Part F expenditure; and
- Procurement of strategic spare transformers (actual expenditure $4.8). This expenditure was inadvertently omitted from the original plan, although the spend was part of the programme of strategic investment in spare transformers reviewed by Strata and the Commission.

Total expenditure for these two programmes in 2009/10 was $16.4m. We propose to exclude this amount from the regulatory asset base (RAB) for the purposes of the year end revenue, pending ex post approval from the Commission, which we will seek as part of the annual compliance assessment process (in accordance with clause 4(1)(e) of Schedule 1 of Transpower's Threshold Gazette Notice). As a result of the exclusion, the total non part F capital expenditure for 2009/10 included in the RAB is $186.5m (compared to the allowance of $189.6m).

Accounting treatment for North Island Grid Upgrade (NIGU) properties

As part of the EC approved NIGU programme, we have purchased freehold properties along the route between Whakamaru and Otahuhu to facilitate the construction of a new 400kV transmission line. Property purchases and their proposed regulatory treatment can be broken down as follows:

A: Properties purchased and held long-term for the location and construction of substations and the cable route ($12m purchase price).

These property values are included in the RAB.

B1: Properties purchased and held for the short/medium term, on which easements have yet to be established ($34m purchase price). These properties are awaiting easements to be registered and preliminary construction works to be completed. Sale clearance also needs to be obtained from LINZ. Our intention is to sell these properties as soon as is practical.

These property values are excluded from the regulated asset base

B2: Properties purchased on which easements have been established and are now being marketed for sale ($36m purchase price).

These property values are excluded from the RAB.

B3: Properties purchased on which easements have been established but which are not yet being actively marketed and/or are unlikely to be sold within 12 months ($107m purchase price). These are properties which, for example, are being held due to leasing commitments or because market conditions are not considered conducive to sale.

These property values are excluded from the RAB.

C: Properties purchased and being held for the medium term due to ongoing project construction requirements/disturbance ($6m purchase price). These are properties that are either strategic sites from an engineering perspective and/or they are heavily impacted by temporary or permanent disturbance as a result of construction. Examples include major traffic movements close to dwellings, major disruption to quiet enjoyment or farming operations, and demolition of dwellings or farm infrastructure that precludes ongoing farming operations. There are currently seven properties in this category.

These property values are included in the RAB at their cost - until their eventual sale after project construction and/or any disturbance has concluded.

D: Properties purchased and subsequently sold (purchase price $11m).

These property values were always excluded from the RAB i.e. losses on sale have been attributed to the shareholder account.

Accounting treatment for NIGU easement costs

Schedule 1 (paragraph 4 (4)) of the Gazette Notice provides that the capital value of easements over land held for resale together with any injurious affection payments and all other costs of establishing the easements can be included in the RAB subject to approval of the costs (as part of the associated project) by the Electricity Commission. There are two specific payments for the 2009/10 assessment period to which we would like to draw to the Commission's attention.

[redacted]

[redacted]

[redacted]

The [redacted] *<u>included</u> in the RAB base as a cost of establishing the easement.*

[redacted]

We purchased this dairy farm rather than seeking to negotiate an easement because of: a) the cost that would be involved in demolishing and rebuilding a number of the owner's buildings, including a milking shed; and b) the need to relocate an existing residence. The milking shed and residence were both within the curtilage of the planned easement. In this instance, the most efficient course of action is to remove the milking shed and other buildings and not to replace them. Consequently there will be a reduction in value as the farm will be downgraded to a grazing property. An independent valuation of the reinstatement costs is [redacted].

[redacted] *in the RAB as a cost of establishing the easement.*

The rationale for these treatments is to proxy the outcome if we were to have acquired an easement through third-party negotiation (rather than through purchase of the underlying freehold). If Transpower had negotiated easements, we would have had to make these payments to the landowners (in addition to the easement value) to compensate for the associated diminution of land value.

We expect more examples of these payments during the remainder of the project i.e. where there is diminution of the property value as a result of constructing the assets. In further such cases, we also intend to capitalise these additional costs to the project (i.e. include them in the RAB).

The capitalisation of these costs is in accordance with GAAP and will be subject to independent audit. The auditors are required to confirm the basis and justification for any valuation reduction.

Easement Valuation Issues

Under the terms of the settlement, we are entitled to include in the RAB[1]

> *…the capital value of the easements over land held for resale, together with any injurious affection payments and all other costs of establishing the easements;*
>
> *…the capital value of the easements and injurious affection payments is to be valued by independent valuations;*

We do not believe, the independent valuations for easements established on land we have purchased reflect the full costs that we would incur if we had negotiated an easement with a third party. There is an "avoided" cost of third-party negotiation which we believe should be included in the full costs of establishing the easement. We are currently investigating this issue further in conjunction with independent valuers. Similarly, we are considering whether the valuations of easements on Transpower land accurately reflect what would have been paid in the open market. In the event that we believe it is consistent with the terms of the Administrative Settlement and is supported by independent valuers' opinions, we will look to

[1] Commerce Act (Transpower Thresholds) Notice 2008, Schedule 1, (4), (b) and (c)

include these costs in the RAB. We may not have resolved this satisfactorily in time for compiling the 2010 EV statements but ask the Commission to note these issues.

Foreign Exchange Gains or Losses

As we discussed at a previous meeting in June, and have summarised in our Part 4 submission, appropriate incentives are required such that Transpower undertakes prudent hedging of foreign exchange and commodity price risks efficiently and in the best interests of consumers.

The Electricity Commission approves project capital expenditure in NZ$, but the cost impact of foreign exchange rate and commodity price movements (including the cost associated with hedges) and the impact of accounting treatments is not specifically catered for. This is an area which requires clarification under the new Part 4 arrangements.

One particular complication arises from the contrasting accounting treatments depending on whether or not a foreign exchange hedging undertaken meets the effectiveness test necessary to qualify for hedge accounting. In particular, the final project value, established in accordance with IFRS, will depend on whether or not hedge accounting is achieved.

If hedge accounting is not achieved, the economic costs of a project will be represented by separate accounting entries: the project capital value calculated at the spot exchange rate and a Profit and Loss statement adjustment for the cost difference due to the variance between the spot and hedged exchange rates. The hedge margin (the difference between the spot and the hedged rate) remains on the P&L and is not assigned to the project, despite it being part of the overall project cost. If only the capital value of the project is included in the RAB and charged to customers, the full economic cost of the project (including the outcomes of any hedging) is not borne by customers.

If a foreign exchange hedge contract can be hedge accounted, the project value will include the "mark to market value" of the hedge contract and the commercial impact of the foreign exchange hedge contract is represented fully by the capitalised value of the project on the balance sheet calculated using the hedged foreign exchange rate (i.e. the true cost of the project will be reflected in the RAB).

For certain transactions Transpower is unable to obtain hedge accounting[2].

The economic recovery of the project costs including the impact of any hedging should not be determined by accounting treatment.

To date, we have reflected gains or losses on hedge contracts taken to the P&L as a Shareholder gain or loss. However, we believe this is not the appropriate treatment and that such gains or losses should flow to the customer account.

There have been net shareholder losses of $5.4m[3]. We propose to make the adjustment to reverse this treatment in the 2010 year-end revenue.

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[2] For example, the specific hedge of a non financial asset, such as a Copper hedge as part of the NAaN project.

[3] To reduce the future incidence of non-hedge accounted transactions, we have amended our hedging policy to preclude the use of so-called weighted average hedging which typically will not qualify for hedge accounting. In weighted average hedging, a single hedge is put in place to provide an approximate hedge for a larger number of (small) payments which it would otherwise be inefficient to hedge individually.

In all cases, the total cost charged to customers is capped at the project value approved by the Electricity Commission, irrespective of the accounting treatment and the attainment or otherwise of hedge accounting. In the circumstance where the total costs exceed the capital value of the project; our intention would be to make a one-off adjustment via the EV statements (i.e. a credit to the customer account). This approach allows the final accounting (book) value of the project to be held in the RAB without charging customers more than the maximum amount approved by the EC.

Conclusion

We would be happy to meet with Commission staff to discuss these items in more detail. In the first instance please contact either Richard Fletcher or John Coulter.

Yours sincerely

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Howard Cattermole,
General Manager Corporate Services

Appendix 1

[redacted]

[redacted]

[redacted]

[redacted]

[redacted]

[redacted]

[redacted]

[redacted]