

Proposed amendments to input methodologies for Transpower

Consultation paper

Amendments proposed to be made under s 52X of the Commerce Act 1986 to the input methodologies for electricity lines services supplied by Transpower New Zealand Limited.

Date: 11 March 2014

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Chapter 1: Introduction

Purpose of this paper

1. The purpose of this paper is to consult with interested persons on proposed amendments to the input methodologies for electricity lines services supplied by Transpower New Zealand Limited.

Determinations affected by the amendments

2. We are consulting on proposed amendments to the following determinations:
 - 2.1 *Transpower Input Methodologies Determination [2012] NZCC 17*
 - 2.2 *Transpower Capital Expenditure Input Methodology Determination [2012] NZCC 2.*
3. The amendments relate to changes to input methodologies we consider may be necessary or appropriate to make prior to setting Transpower's individual price-quality path for the second regulatory control period, to commence on 1 April 2015.
4. We consider that some changes to input methodologies which have been suggested by Transpower can be more effectively addressed through the individual price-quality path determination process. We have asked for separate feedback on those issues from interested persons.¹

Overview of proposed amendments

5. We propose to amend the input methodologies relating to asset valuation to remove the requirement to spread regulatory depreciation for assets that become fully depreciated in a regulatory period across the whole of that period.
6. We are also seeking feedback from interested persons as to whether:
 - 6.1 an amendment is necessary to clarify that land purchases which are base capex enter the regulatory asset base at their time of acquisition rather than at the time of commissioning; and
 - 6.2 part-year depreciation of newly-commissioned assets should apply in the year in which those assets are commissioned.
7. Chapter 2 explains each of these matters in further detail. Chapter 3 outlines how you can provide your views. Additional technical material is contained in the Attachments to this paper.

¹ See Chapter 2 of the Commerce Commission, *Invitation to have your say on Transpower's individual price-quality path and proposal for the next regulatory control period, Issues Paper*, 10 February 2014. If changes are required to input methodologies to address these matters then we intend to undertake a second round of input methodologies consultation after we release our draft decision on the individual price-quality path – see Commerce Commission, *Notice of Intention: Proposed Amendments to Input Methodologies for Transpower*, 10 February 2014.

Chapter 2: Proposed amendments

8. This chapter discusses the amendments we are proposing, including the draft methodologies required to implement the changes where relevant.

Removing the requirement to spread depreciation for 'end-of-life' assets

9. The input methodologies require that an asset which will become fully depreciated within a regulatory period must have its remaining useful life for depreciation purposes extended to the end of the regulatory period. This requirement applies for information disclosure purposes and in setting the individual price-quality path.
10. The effect of this rule is to spread the remaining depreciation for an asset that is near to the end of its scheduled life over the whole of a regulatory period when setting an individual price-quality path.
11. In our reasons paper explaining our decision on the input methodologies applicable to Transpower we stated:²

In some cases assets may be depreciated too quickly, to the extent that they are fully depreciated before the end of their economic lives. As a result, the value to the business of any additional service would not be recognised, and the business may even have little incentive to keep the assets in service rather than replacing them.

System fixed assets tend to be long-lived and so, if they are in service at the beginning of a regulatory period, the majority are likely to continue in use throughout the period. Where an asset is due to become fully depreciated during a regulatory period, Transpower should continue to be entitled to earn a return on that asset throughout the regulatory period, to recognise the value it provides.

12. Transpower has requested that this rule be removed because it does not create an incentive and adds compliance costs given that the input methodology treatment diverges from its generally accepted accounting practice (GAAP) treatment and therefore requires accounting 'workarounds' (see Attachment 1).
13. We note that Transpower's asset replacement plans are now subject to scrutiny and approval by the Commission through the input methodologies introduced under s 54S of the Commerce Act in relation to capital expenditure proposals. On this basis, the removal of the spreading rule for end-of-life assets should not detract from any incentives relating to capital expenditure (eg, by prematurely replacing assets).
14. We therefore consider that the rule should be removed for Transpower.

Proposed amendment

15. The proposed amendment is to delete clause 2.2.6(2) of the Transpower input methodologies, which provides:³

² Commerce Commission, *Input Methodologies (Transpower) Reasons Paper*, 22 December 2010, paragraphs 4.4.142 to 4.4.143.

³ *Transpower Input Methodologies Determination* [2012] NZCC 17.

For the purpose of subclause (1), the physical asset life at the start of a **regulatory period** of an asset that would, in accordance with subclause (1), become fully depreciated during that **regulatory period**, is equal to the duration of the **regulatory period**.

16. Consequential re-numbering of the subclauses in clause 2.2.6 will be required.

Strategic land purchases as base capex – “commissioned” when acquired

17. Land or easements should enter Transpower’s regulatory asset base in the year in which they are acquired, provided they are “approved by the Commission” under the capex input methodology. Where there is no approval then the assets will enter the asset base only once they are used to provide electricity transmission services.
18. Transpower acquires land for strategic purposes where the land:
- 18.1 relates to potential future grid upgrades and is acquired after a need is identified but before project funding has secured regulatory approval; or
- 18.2 mitigates environmental effects such as noise complaints from landowners around substations, prevents inappropriate third party development, or secures land containing strategic grid assets.
19. The first type of these strategic land purchases can provide option value to consumers when acquired in advance of actually being used in a project to provide electricity transmission services (ie, prior to the “commissioning” of a project). The second type can provide a least cost solution when compared to alternatives.
20. The allowance for minor capital expenditure which has been set for the current regulatory period under the individual price-quality path excludes strategic land,⁴ and only strategic land with a cost of greater than \$5 million can be approved as a major capex project or programme during the period.
21. This means that low cost strategic land (ie, less than \$5 million) acquired during the current regulatory period cannot enter the regulatory asset base when acquired because it has not been “approved by the Commission” as required by the definition of “commissioned” in the Transpower input methodologies:⁵

“commissioned” means used by Transpower to provide electricity transmission services, save that in relation to-

- (a) land that is not easement land; or
(b) an easement;

whose acquisition was approved by the-

- (c) Electricity Commission under Part F of the Electricity Governance Rules 2003;
(d) Commission under s 54R(3)(b) of the Act; or

⁴ See definition of “minor capital expenditure” in Commerce Commission “Individual price-quality path determination applicable to Transpower pursuant to Part 4 of the Commerce Act 1986” Decision No. 714.

⁵ *Transpower Input Methodologies Determination* [2012] NZCC 17, cl. 1.1.4(2).

(e) Commission in accordance with any input methodology determined pursuant to s 54S of the Act;

'commissioned' means acquired by Transpower”.

22. However, for the next regulatory control period commencing on 1 April 2015, Transpower is eligible to apply for the determination of a “base capex allowance”, which includes strategic land, for each year of the individual price-quality path.⁶ In this period the base capex threshold will also increase from \$5m to \$20m.
23. For this period, our interpretation of the definition of “commissioned” above is that strategic land with a cost below \$20m (ie, which meets the “base capex” definition) will be eligible to enter the regulatory asset base in the year it is acquired if a base capex allowance for Transpower is determined by the Commission for that year.⁷
24. We consider this treatment to be appropriate given the overall intent of the capex input methodologies relating to base capex, and note that strategic land will be subject to the same requirements and checks as other types of base capex.⁸
25. It could be argued, however, that a base capex allowance determination does not extend to approving *particular* strategic land assets as base capex for a regulatory period and on this basis the requirements of the “commissioned” definition would not be met. We acknowledge that the definition of “commissioned” might therefore need to be more clearly expressed to address this situation.

Feedback from interested persons

26. We seek your feedback as to whether the existing definition of “commissioned” is sufficient, or whether an amendment to clarify that land or easements that are base capex should be treated as “commissioned” when acquired is necessary.

Allowing for part-year depreciation for assets in the year of commissioning

27. Transpower has requested that the input methodology governing asset valuation be amended so that newly-commissioned assets receive a part-year depreciation allowance for regulatory purposes in their year of commissioning.

⁶ The term “base capex” which is defined in *Transpower Capital Expenditure Input Methodology Determination* [2012] NZCC 2 will replace “minor capital expenditure” in the individual price-quality path determination for the forthcoming regulatory period.

⁷ Although Transpower provides a forecast of its base capex for the purposes of determining a base capex allowance, the Commission’s determination does not specify the particular asset purchases that should be made and Transpower is able to effectively substitute types of base capex (including strategic land) for that included in the forecast as it considers appropriate during the regulatory period.

⁸ Similar to other base capex, the purchase of strategic land must be consistent with Transpower’s policies, and Transpower is subject to a base capex annual policies and processes adjustment if it has not acted accordingly – see *Transpower Capital Expenditure Input Methodology Determination* [2012] NZCC 2, Schedule B. Transpower has confirmed that a management-approved policy applies to strategic land purchases which includes a requirement to undertake a cost-benefit analysis.

28. To implement this change, Transpower suggests that depreciation is calculated in accordance with GAAP, instead of the formula in the input methodologies which commences depreciation in the year following commissioning (see Attachment 2).⁹
29. Transpower considers that this change would reduce the costs and risks involved in manually reconciling its regulatory reports to its accounting asset books under GAAP.
30. Transpower estimates the difference between its regulatory asset base value and its accounting asset book value would be in the order of \$50 million by the end of the current regulatory period in 2015 (see calculations in Attachment 3).
31. The draft methodology that Transpower has suggested in order to introduce part-year depreciation specifies a GAAP calculation of depreciation in place of the existing input methodology depreciation formula. However, this would also have the effect of removing a number of other differences established deliberately by the input methodologies between GAAP and the regulatory rules – such as requirements to use the regulatory depreciation lives prescribed in Schedule A of the determination.
32. If we proceed to consult on a draft amendment following feedback from interested persons (as outlined below) then we propose to consult on alternative drafting to achieve only the part-year depreciation change that has been requested.

Effect on revenue cash flows

33. The change would bring forward the permitted cash flows from maximum allowable revenues under the individual price-quality path as Transpower's depreciation allowance building block would increase in the year of commissioning. However, the treatment would be NPV-neutral because it would have the compensating effect of reducing the return on the regulatory asset base over the life of the relevant asset.
34. The input methodologies already provide for an unindexed asset roll forward approach to Transpower's regulatory asset base, meaning that Transpower's revenue cash flows are advanced compared to other sectors. This treatment was concessionary and was intended to aid Transpower with financing its investment needs over the short to medium term. We have previously signalled that we may review this position once Transpower's investment needs abate.¹⁰

Transitional arrangements

35. In order to completely eliminate the discrepancy between regulatory and accounting records for the part-year depreciation difference, Transpower has asked that the change be implemented so as to reverse the cumulative effect of the differences as at the end of its current regulatory control period in 2015 (see Attachment 3).

⁹ The rule that prevents depreciation for assets in their year of acquisition is implicit in cl. 2.2.4 of *Transpower Input Methodologies Determination* [2012] NZCC 17, which bases the calculation of the regulatory depreciation on an asset's opening RAB value. Newly-commissioned assets do not have an opening RAB value in their year of acquisition and are therefore not eligible for depreciation in that year. The rule applies for information disclosure purposes and in setting the individual price-quality path.

¹⁰ *Input Methodologies (Transpower) Reasons Paper*, 22 December 2010, paragraph 4.3.15.

36. To achieve this, Transpower has suggested a transitional mechanism be applied over the two forthcoming regulatory periods. This would have the effect of increasing its maximum allowable revenue over those two periods. If this 'catch-up' feature were not implemented then Transpower would be required to maintain records of past differences on a forward-looking basis.

Cross-sector implications

37. None of the sectors regulated under Part 4 currently have input methodologies that allow for a part-year depreciation allowance in the year of asset commissioning.
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.
39. We are interested in your views as to whether the change that Transpower suggests should also be considered for other sectors.

Feedback from interested persons

40. We seek your views on whether this change should be made, specifically:
- 40.1 Whether the amendment should be made to reduce Transpower's compliance costs;
- 40.2 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;
- 40.3 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;
- 40.4 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;
- 40.5 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.¹¹

¹¹ Section 52Y of the Commerce Act 1986.

Chapter 3: How you can provide your views and next steps

41. This chapter sets out the process for making submissions on this paper and provides details on the next steps in the amendments process.

How you can provide your views

42. Submissions on the proposed draft methodology are due by 5pm, Monday 31 March 2014. Cross-submissions are due by 5pm, Monday 7 April 2014.
43. These dates differ from those in our notice of intention. This is because we now consider a shorter consultation period to be more appropriate given the small number of proposed changes.

Address for responses

44. You should address your responses to:

Brett Woods (Senior Analyst, Regulation Branch)
c/o regulation.branch@comcom.govt.nz

45. It would be helpful to include in the subject heading Submission (or Cross-submission) on Proposed Transpower IM Amendments February 2014.
46. We would appreciate receiving responses in both MS Word and PDF file formats.

Requests for confidentiality

47. While we discourage requests for non-disclosure of submissions, we recognise that there may be cases where parties that make submissions wish to provide information in confidence. We offer the following guidance.
48. If it is necessary to include confidential material in a submission, the information should be clearly marked. Both confidential and public versions of the submission should be provided.
49. The responsibility for ensuring that confidential information is not included in a public version of a submission rests entirely with the party making the submission.
50. We request that you provide multiple versions of your submission if it contains confidential information or if you wish for the published electronic copies to be 'locked'. This is because we intend to publish all submissions and cross-submissions on our website. Where relevant, please provide both an 'unlocked' electronic copy of your submission, and a clearly labelled 'public version'.

Next steps

51. Following receipt of submission and cross-submissions, we intend to make final decisions on any amendments by 16 May 2014. At this stage, we do not intend to hold a technical consultation prior to our final decisions. We will review this position after considering submissions, and notify parties of any change.

Attachment 1: Transpower's amendment request for removing requirement to spread depreciation for 'end-of-life' assets

Transpower issue reference	IM_02 – (Treatment of fully depreciated assets within a regulatory period updated)
Date of request	First submitted 29 March 2011 by letter. Update submitted 14 June 2013
Party requesting clarification or amendment	Transpower New Zealand Limited
Relevant determination (Decision number)	IM – NZCC 17
Clause reference	IM 2.2.6 (2)
Description of clarification or amendment sought. If an amendment is proposed, provide the suggested wording of the determination	<p>Clause 2.2.6(2) of the IM requires that when an asset becomes fully depreciated during a regulatory period, the physical life of that asset must be set to equal the duration of the regulatory period, which means that depreciation of the asset is spread evenly over the regulatory period. This provision is inconsistent with GAAP (under GAAP the asset would be depreciated for its remaining life).</p> <p>We recommend deletion of clause 2.2.6(2) from the Transpower IM</p>
Reason why clarification or amendment is required	<p>The IM currently requires depreciation to be spread evenly over each year of the control period in which the asset is fully depreciated. Unlike first year depreciation spreading, this is an explicit and clearly intentional feature of the Transpower IMs. There is limited discussion of the rationale for spreading in the reasons paper, however the basis appears to be to prevent Transpower having an incentive to bring asset retirement forward into the early years of a control period. At the time the IMs were in development, Transpower supported this approach.</p> <p>On further reflection, we believe there is no such incentive and, accordingly, no reason for the spreading rule. This is because, unlike in Australia, we have an annual wash-up for capital, depreciation and tax building blocks. As such, there is no depreciation-linked incentive to bring forward or defer retirement of an asset.</p> <p>Depreciation spreading has similar resource demands and other practical challenges to non-GAAP treatment of first year depreciation (refer to IM_01). As with IM_01 we can see no benefit to the current drafting but obvious disbenefit in terms of complexity, transparency and additional cost.</p> <p>The proposed amendment, which is NPV neutral, is consistent with provisions elsewhere in the IM that refer to GAAP, such as the "value of commissioned assets"</p>
Reasons Paper reference (if applicable)	Paragraph 4.4.140 to 4.5.1

Date amendment is required to be made by and why (if applicable)	The amendment should be made to apply from the beginning of RCP2
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Attachment 2: Transpower's amendment request for part-year depreciation of assets in the year of commissioning

Transpower issue reference	IM_01 – (No Depreciation allowance in the year the asset is commissioned)
Date of request	First submitted 29 March 2011 by letter. Resubmitted 14 June 2013
Party requesting clarification or amendment	Transpower New Zealand Limited
Relevant determination (Decision number)	IM – NZCC 17
Clause reference	IM 2.2.4 (1) & (2)
Description of clarification or amendment sought. If an amendment is proposed, provide the suggested wording of the determination	<p>The depreciation formulae in IM paragraphs 2.2.4 (1) and (2) require assets to have an opening balance in order for a depreciation amount to be applied in the year ahead.</p> <p>That means assets capitalised during any particular year will have a zero opening balance and no depreciation will be calculated. Under GAAP, as applied during the settlement period and consistent with Transpower's current accounting policies, depreciation is applied in the year in which an asset is commissioned. For example, if an asset were commissioned half way through the year it would receive six months' worth of depreciation.</p> <p>We recommend amendment of clauses 2.2.4 (1) and (2) to allow depreciation to commence from the date of asset commissioning and be calculated in accordance with GAAP. Proposed drafting:</p> <p>(1) Unallocated depreciation, in the case of an asset with an unallocated opening RAB value, is determined, subject to subclause (3) and clause 2.2.5, in accordance with the formula <u>GAAP</u></p> <p>$[1 \div \text{remaining asset life}] \times \text{unallocated opening RAB value}$.</p> <p>(2) Depreciation, in the case of an asset with an opening RAB value, is determined, subject to subclause (3)(a), in accordance with the formula <u>GAAP</u></p> <p>$[1 \div \text{remaining asset life}] \times \text{opening RAB value}$.</p> <p>In addition, there may be some consequential drafting changes that we have not identified at this point.</p>
Reason why clarification or amendment is required	<p>The depreciation calculations as set out in the IM result in accounting treatments that diverge from GAAP. This requires Transpower to assess forecast and actual depreciation for revenue setting purposes using a separate process from our general GAAP-based corporate accounting.</p> <p>For our 2010/11 MAR wash-up, we adopted a manual spreadsheet-based, project-level approach to assess the depreciation wash-up. A similarly manual approach was required for the initial RCP1 MAR forecasting</p>

	<p>exercise. Together, these exercises required more than 10 FTE days of internal resource, plus a commensurate amount of external auditing resource. Each year, the manual wash-up process will be repeated and each control period the manual forecasting process will be repeated.</p> <p>In addition to these resourcing concerns, a manual process is inherently more error-prone, less robust and less flexible than the systems approach we could use if depreciation rules aligned with GAAP.</p> <p>Overall we can see no benefit to the current drafting but considerable disbenefit in terms of complexity, transparency and additional cost. The proposed amendment, which is NPV neutral, is consistent with provisions elsewhere in the IM that refer to GAAP, such as the “value of commissioned assets”.</p> <p>Adherence to GAAP would help maintain consistency (and transparency for stakeholders) as well as minimise compliance costs. It would also be consistent with the precedent set by the Commerce Act (Transpower Thresholds) Notice 2008 and other regulatory provisions, including the transmission pricing methodology in Schedule 12.4 of Part 12 of the Electricity Industry Participation Code, which uses GAAP to determine charges for connection assets</p>
Reasons Paper reference (if applicable)	The policy shift away from GAAP in this area was not signalled during the consultation process and we can find no reference to it in the Reasons Paper
Date amendment is required to be made by and why (if applicable)	The amendment should be made to apply from the beginning of RCP2, with provision to align depreciation of assets commissioned during RCP1

Attachment 3: Transpower's additional information supplied in relation to part-year depreciation of assets in the year of commissioning

IM01 – depreciation in the year of commissioning (DIYOC)

The problem

We have been unable to find a satisfactory systems-based approach to calculating the amount of depreciation on an asset in the year of commissioning. The calculation must be performed manually using large Excel spread sheets.

Background

Transpower's financial systems are set up to maintain Net Book Value and depreciation values for two books: the accounting book for GAAP purposes and the tax book for tax purposes. They also maintain a pricing book. There are various legal and statutory requirements that ensure these records are maintained to a high standard, regularly reviewed and audited as part of the annual financial audit process.

The 'no depreciation to be recovered in the year of commissioning' rule (DIYOC) is a departure from GAAP and unique. To perform the calculations necessary to comply with this rule Transpower had to either

- 1) introduce a "regulatory" book (fourth book), or
- 2) maintain a manual calculation of the necessary adjustments

In practice, we dismissed the option of introducing another book due to the short timeframe in which the calculation was required and the high cost and risk of this option. Also we believe that a system might reduce, but would not eliminate, a number of the manual steps involved. Manual calculation of the necessary adjustment is the only feasible option.

When a project is commissioned it can take a number of months to be fully broken down into its component assets. There are delays as the project staff complete core commissioning work, pay further invoices and determine the detailed breakdowns of the assets created and subscribe costs to these assets. We depreciate these projects at a macro level, then reverse this macro depreciation once the asset is entered into the register. This reversal offsets (but not exactly) the catch-up depreciation calculated in the asset register. Creating a system solution for the various scenarios that arise, and across financial years is very difficult, particularly on an asset register as complex as Transpower's.

Calculation of the DIYOC adjustment

The manual calculation has been performed using a number of large Excel spread sheets.

Following issues arise due to the nature of the DIYOC calculation

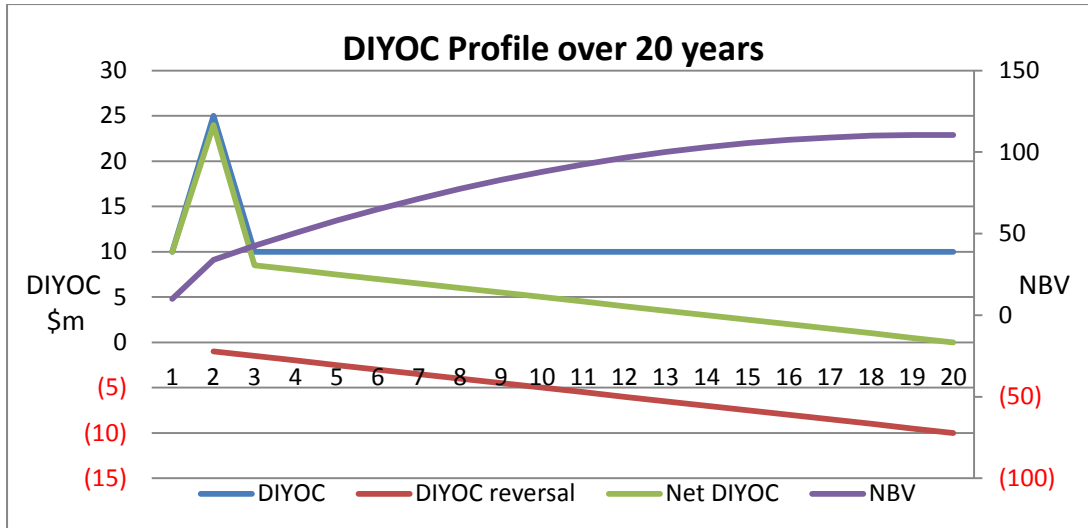
- *Increased risk of errors:* The calculation is problematic because it is impractical to go through every asset to ensure that the correct depreciation figure has been picked up. We review the calculation to ensure that it is in line with our expectations, but we cannot ensure that it is 'correct'. The calculation is audited, but within the context of the wash-up calculation the audit objective is to ensure that our *revenue* is free from material misstatement, *not* that our

DIYOC calculation – as a stand-alone calculation – is free from misstatements that would be material to itself. The cost of addressing the latter audit objective would be considerably more than at present. There is, therefore, an element of risk that the DIYOC calculation includes non-material errors.

- *Track adjustments over 60 years:* DIYOC adjustments to our regulatory depreciation figures and the corresponding RAB net book value need to be tracked – over decades – to ensure that the adjustment is included in the depreciation charged in the final years of an asset’s life. That could be as many as 60 years after commissioning. We do not believe there is a satisfactory means of tracking these depreciation adjustments on individual assets over this timeframe.
- *Manual intervention in all revenue calculations:* The DIYOC adjustment means that any revenue-related calculation (for example, estimating the customer impact of a project, preparing the forecast MAR calculations, the MAR wash-up, business plan baseline and scenario modelling) needs significant manual intervention to calculate the depreciation in the year of commissioning and apply adjustments to the Net Book Value through time. This is time-consuming when performed for the annual wash-up, and is a drag on the business during other times of the year. We are unable to integrate revenue calculations and modelling into the accounting systems, because the DIYOC calculation is a manual step. That’s true whether we are modelling new projects, single assets or the entire RAB.
- *MAR wash-up:* The full, audited version of the calculation for the entire RAB must be performed for the annual MAR wash-up calculation. Every year that calculation takes around 6 FTE days, together with the associated time spent with the auditors. It’s not simply the time taken to do the calculation and deal with the associated audit: it’s that the calculation comes at the busiest time of year for that team, who also have to deal with the annual audit; the other analyses required for the Annual Regulatory Report; the deferred tax calculation and the annual pricing asset calculations. These matters are too complex to bring in temporary staff and the bottleneck in workload therefore puts great pressure on this team at a time when some crucial work is being done – to the detriment of the business.
- *Divergence and integrity between RAB and GAAP NBV:* After two years (2011/12 and 2012/13) of this adjustment the accumulated DIYOC amounts to \$34.4 million. This is a measure of the divergence between our GAAP fixed assets and those same assets in the RAB – a divergence that will continue to increase for 20 years (the average useful economic life of the RAB). Given this divergence, there is a considerable risk that material errors will creep – over time – into the net book value; and/or that the difference between the GAAP and RAB net book values will create unacceptable uncertainty over the valuation of those assets.

Financial impact of the DIYOC adjustment

The initial years of the DIYOC adjustment from 2011/12 to 2012/13 has seen the commissioning of two major projects resulting in the large DIYOC adjustments. The DIYOC adjustment has the effect of delaying recovery of depreciation in year of commissioning until the end of the life of the assets. From an aggregated point of view the regulatory depreciation will initially be lower each year than the financial depreciation (due to excluding DIYOC) but within 20 years (average asset life) regulatory depreciation will return to comparable levels to the financial depreciation. This is due to the DIYOC being added on to the end of the asset life for regulatory depreciation purposes. The following graph illustrates this.



In terms of NBV, the regulatory RAB would increase each year and plateau around the average life of the assets when the DIYOC reversal offsets the new DIYOC in that year. Maximum difference would equate to approximately half the annual depreciation, or circa \$120m.

In the long-term the DIYOC adjustment will result in the RAB being higher (circa 2-3%) than the financial value for GAAP purposes, and the depreciation for each book would be roughly equal. In terms of revenue, this adjustment has an immaterial impact on the overall revenue.

Changing from a manual to a systems-based approach

As discussed above, we don't believe it is possible to have a full system based approach. If we did attempt this it would significantly increase the lifecycle costs of our key (financial) systems. It would be at odds with our strategy of reducing customisations. In the past when we have discussed depreciation rules expert advice has been not to touch the depreciation calculations due to their complexity and criticality. We doubt any such change would be supported – at any reasonable cost – by any credible external provider.

DIYOC serves no purpose

The DIYOC has a material impact in terms of time and efficiency of any revenue related calculations and associated audits. The DIYOC has no material impact on the overall transmission charges. As there appears to be no compelling regulatory reason for this adjustment then we suggest that it would be better to remove it.

Implementation

If the Commission removes the DIYOC rule, then as a transitional issue we will have to address the RCP1 legacy DIYOC. We expect that DIYOC may be around \$50m by the end of RCP1. Transition options include:

- retaining a fixed difference between our GAAP and RAB net book values in perpetuity, with the RAB being higher by an amount equivalent to the closing RCP1 DIYOC balance
- Setting our RAB to be equivalent to our GAAP net book value, and establishing pseudo HVAC and HVDC assets equivalent to the DIYOC balance. These assets could then be depreciated over a timeframe that avoids a price shock, but provides a finite transition timeframe.

Our preference would be the second option, with a transition period of two control periods. This would produce incremental revenue on the order of \$9 million initially, declining to \$5 million by the end of the transition period.