ELECTRICITY AND GAS INFORMATION DISCLOSURE SEMINAR

JAMES COOK HOTEL GRAND CHANCELLOR, WELLINGTON
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Regulatory Reporting

Presentation to Information Disclosure Seminar
March 2013

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Line by Line – An introduction to Regulatory Reporting of Financial Performance

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1.1 General Purpose Financial Reporting

New Zealand Equivalent to the IASB *Conceptual Framework for Financial Reporting 2010* (NZ *Framework*) :

- Provide financial information about the reporting entity that is useful to existing and potential investors, lenders and other creditors in making decisions about providing resources to the entity. Those decisions involve buying, selling or holding equity and debt instruments, and providing or settling loans and other forms of credit.

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1.2 Purpose of Information disclosure regulation

53A Purpose of information disclosure regulation:

- The purpose of information disclosure regulation is to ensure that sufficient information is readily available to interested persons to assess whether the purpose of this Part is being met.

1.2 Interested persons

Includes (but not limited to):

- regulated suppliers
- consumers and consumer groups
- electricity and gas retailers, electricity generators, and their representative groups
- central government and regional authorities
- other regulatory agencies, such as the Electricity Authority (EA) and the Gas Industry Company (GIC)
- any other stakeholder of the regulated supplier, including investors and their advisors (such as equity analysts and other professional advisors), and owners of regulated suppliers
- the Commission.

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1.3 Part 4 Commerce Act 1986

Part 4 Commerce Act 1986:

1. The purpose of this Part is to promote the long-term benefit of consumers in markets referred to in section 52 by promoting outcomes that are consistent with outcomes produced in competitive markets such that suppliers of regulated goods or services—
   a) have incentives to innovate and to invest, including in replacement, upgraded, and new assets; and
   b) have incentives to improve efficiency and provide services at a quality that reflects consumer demands; and
   c) share with consumers the benefits of efficiency gains in the supply of the regulated goods or services, including through lower prices; and
   d) are limited in their ability to extract excessive profits.

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1.3 Key performance questions under Part 4

Key performance questions	Relevance to the Part 4 purpose (s 52A(1))
1. Are suppliers operating and investing in their assets efficiently?	(a) and (b)
2. Are suppliers innovating where appropriate?	(a)
3. Are suppliers providing services at a quality that reflects consumer demands?	(b)
4. Are suppliers sharing the benefits of efficiency gains with consumers, including through lower prices?	(c)
5. Do the prices set by suppliers promote efficiency?	(a) and (b)
6. Are suppliers earning an appropriate economic return over time?	(d)

1.4 The nature and scope of regulatory reporting

GPFR	Part 4 Commerce Act
1. Fair presentation frameworks 2. Differential reporting 3. Consolidated reporting 4. Materiality in legislation via GAAP and authoritative support (NZ Framework)	1. Compliance and monitoring frameworks: • Information Disclosure • Default price-quality path (DPP) • Customised price-quality path (CPP) 2. Information disclosure only for exempt suppliers, but same rules as for non-exempt suppliers under ID 3. Regulated services only (but reconciliation to consolidated reporting) 4. No materiality other than implied by reference to GAAP

2. Setting rules in the monopoly context

- S 52 – Part 4 provides for "regulation of the price and quality of goods or services in markets where there is little or no competition and little or no likelihood of a substantial increase in competition."
- Link between asset values and future cash flows in a monopoly regulatory context is circular
- Asset values are established by the regulator
- Revenue and prices set using efficient costs and 'building blocks' approach
- Efficiency-incentive mechanisms (e.g. 'X' factor in CPI-X, and IRIS) and the links between price-quality regulation and information disclosure regulation
- Information asymmetry

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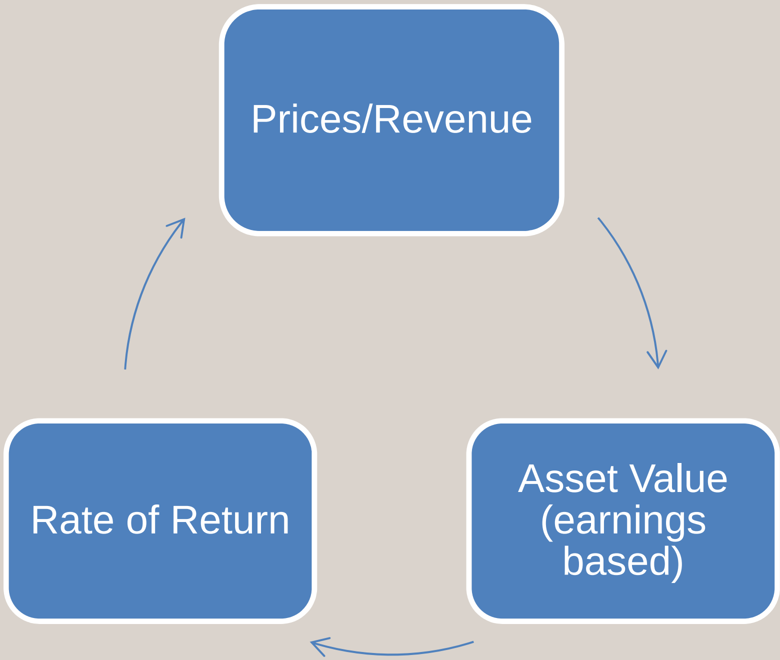
2.1 The asset valuation circularity problem

The Asset Valuation Circularity



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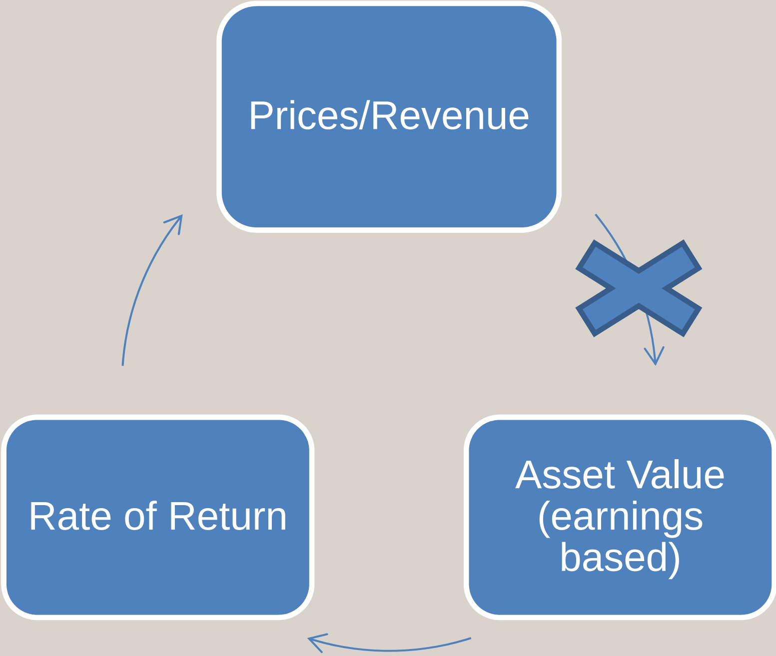
2.1 The asset valuation circularity problem

Breaking the Asset Valuation Circularity



2.2 FCM and performance measurement

- The concept of financial capital maintenance, (FCM) provides for a normal return over the lifetime of the regulated assets, irrespective of whether the asset is sold or transferred between regulated suppliers.
- Profits expected to be just sufficient to reward investment, innovation and efficiency.
- Provides a valuable guiding principle for specifying how the value of the RAB is to be rolled forward and how changes in asset value should be treated in the measurement of returns.

2.3 The "building blocks" in price regulation

A simplified representation:

Regulatory Revenue **=** ***RIV* x WACC*** *(nominal, vanilla)*

+ Term credit spread differential allowance

+ Depreciation

+ Opex

+ Regulatory Tax

- Other regulated income

- Revaluations

* Regulatory Investment Value (=RAB + Deferred Tax Balance).

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2.4 The "building blocks" and ROI

ROI* *(vs WACC)* **=** ***(Regulatory revenue***

- Term credit spread differential allowance

- Depreciation

- Opex

- Regulatory Tax

+ Other regulated income

+ Revaluations)

/RIV

* Prior to 2012 disclosure year but disclosed now per 2(iv): Year-End ROI Rates for Comparison Purposes

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3. Important departures from GAAP

Key areas where regulatory financial reporting departs from GAAP are:

- Regulatory ‘Balance Sheet’ limited to relevant asset information
- No disclosure of financing costs (except notionally in calculating tax costs)
- Activity based reporting
- Detailed asset valuation rules, which may differ from GAAP treatment
- No goodwill on acquisitions

3. Important departures from GAAP

- CPI indexation rather than periodic valuation of assets
- Detailed cost and asset allocation rules
- Taxation (modified deferred tax approach, ring-fencing)
- Information relevant to setting of price-quality regulation (e.g. IRIS)
- Standard classification (to assist analysis of performance)
- Specification of cost definitions

3. Departures from GAAP – standard classification

High level capital expenditure categories for EDBs, GDBs and GTBs

ID Determinations (EDBs, GDBs, GTBs)	CPP IMs
Consumer connection	Customer connection
System growth	System growth
Asset replacement and renewal	Asset replacement and renewal
Asset relocations	Asset relocations
Quality of supply	Reliability, safety and environment
Legislative and regulatory	Reliability, safety and environment
Other reliability, safety and environment	Reliability, safety and environment
Non-network assets	Non-system fixed assets

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3. Departures from GAAP – standard classification

High level operational expenditure categories for EDBs, GDBs and GTBs

ID Determination for EDBs	ID Determination for GDBs	ID Determination for GTBs	CPP IM
Service interruptions and emergencies	Service interruptions, incidents and emergencies	Service interruptions, incidents and emergencies	Fault and emergency maintenance
Routine and corrective maintenance and inspection	Routine and corrective maintenance and inspection	Routine and corrective maintenance and inspection	Routine and preventative maintenance
Vegetation management		Land management and associated activity	
Asset replacement and renewal	Asset replacement and renewal	Asset replacement and renewal	Refurbishment and renewal maintenance
Business support	Business support	Business support	General management, administration and overheads
System operations and network support	System operations and network support	System operations	System management and operations
		Network support	
		Compressor fuel	
—	—	—	Other

3. Departures from GAAP – definition of capital costs

- **capital expenditure** means costs…
  i. incurred in the **acquisition** or development of an asset that is, or is intended to be, **commissioned**; and
  ii. that are or are intended to be included in the **value of commissioned asset**

- **commissioned** means used by a **[business]** to provide **[description of] services**

- Allowance for financing costs of works under construction

3. Departures from GAAP – definition of operating costs

- **operating cost** means a cost incurred by the **[business]** in question relating to the **supply** of-
  - a. **regulated services alone; or**
  - b. **regulated services** and one or more **unregulated service**,

    and excludes-
  - c. a cost that is treated as a cost of an asset by **GAAP**;
  - d. amounts that are depreciation, tax, subvention payments, revaluations or an interest expense, in accordance with their meanings under **GAAP**;
  - e. **pass-through costs**; and
  - f. **recoverable costs**

- ID Requirements govern recognition of some types of expenditure

4. Regulatory reporting rules - inherent incentives to under/over report results

Financial reporting	Regulatory reporting
Inflate earnings - maximise profit and comprehensive income: • Overstate revenue • Understate costs • Overstate asset values • Understate liabilities • Misclassify costs to conceal unauthorised expenditure, avoid triggering covenants	**Minimise reported returns/maximise allowable revenue:** • Understate revenue/other regulated income • Overstate costs, including by allocating cost to the regulated service • Overstate asset values • Misclassify costs to improve measures of efficiency

4. Regulatory reporting rules - key features

- Standard classification of costs
- Causation-based cost allocation methodology & rules to avoid double-counting of common cost allocations
- Intra-group reporting in more detail than GAAP to make transfers between business units transparent
- Depreciation based on physical asset life - prescribed in some cases (e.g. 45 years for new electricity distribution assets)
- No impairment except where physical life is nil at end of disclosure year
- Specified related party transaction values
- No recognition of changes in asset values as a result of transfers between regulated businesses and/or related parties

4. Regulatory reporting rules – key features

- Exclusion of fair value in excess of consideration for vested assets
- Exclusions from operating costs (e.g. subvention payments)
- Specification of pass-through and recoverable costs
- Partial recognition of some operating expenditure (e.g M&A costs, self-insurance except as approved under CPP)
- Cash flow timing recognition
- IRR approach to ROI
- Removal of income and ROI volatility (that might distort results)
  - Capital contributions netted off associated asset value
  - Revaluation gains recorded through indexation each year

Conclusion

- Some new and possibly strange definitions and rules, but-

- Principled approach that takes into account legislative context and costs of compliance.

- For further background refer:
  - http://www.comcom.govt.nz/assets/Gas/Information-Disclosure/Information-Disclosure-for-EDBs-and-GPBs-Final-Reasons-Paper.PDF

These slides formed the basis of the seminar presented to suppliers and auditors by Commission staff in March 2013. They are intended to be used as general guidance only, and do not replace or summarise the information disclosure determinations themselves. In order to comply fully with the requirements of the determinations, suppliers and auditors should read the EDB, GDB and GTB determinations published on 1 October 2012. These documents can be found at:

- http://www.comcom.govt.nz/current-electricity-information-disclosure-requirements/ for EDBs; and
- http://www.comcom.govt.nz/gas-information-disclosure/ for GPBs.

www.comcom.govt.nz

CONTACT

To contact the Commission with information about false or misleading trading practices, or anti-competitive behavior by businesses:

CALL the Contact Centre on 0800 943 600
WRITE to Contact Centre, PO Box 2351, Wellington
EMAIL contact@comcom.govt.nz

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