

## Or... what to do when it's dull, complicated and low on the priority list

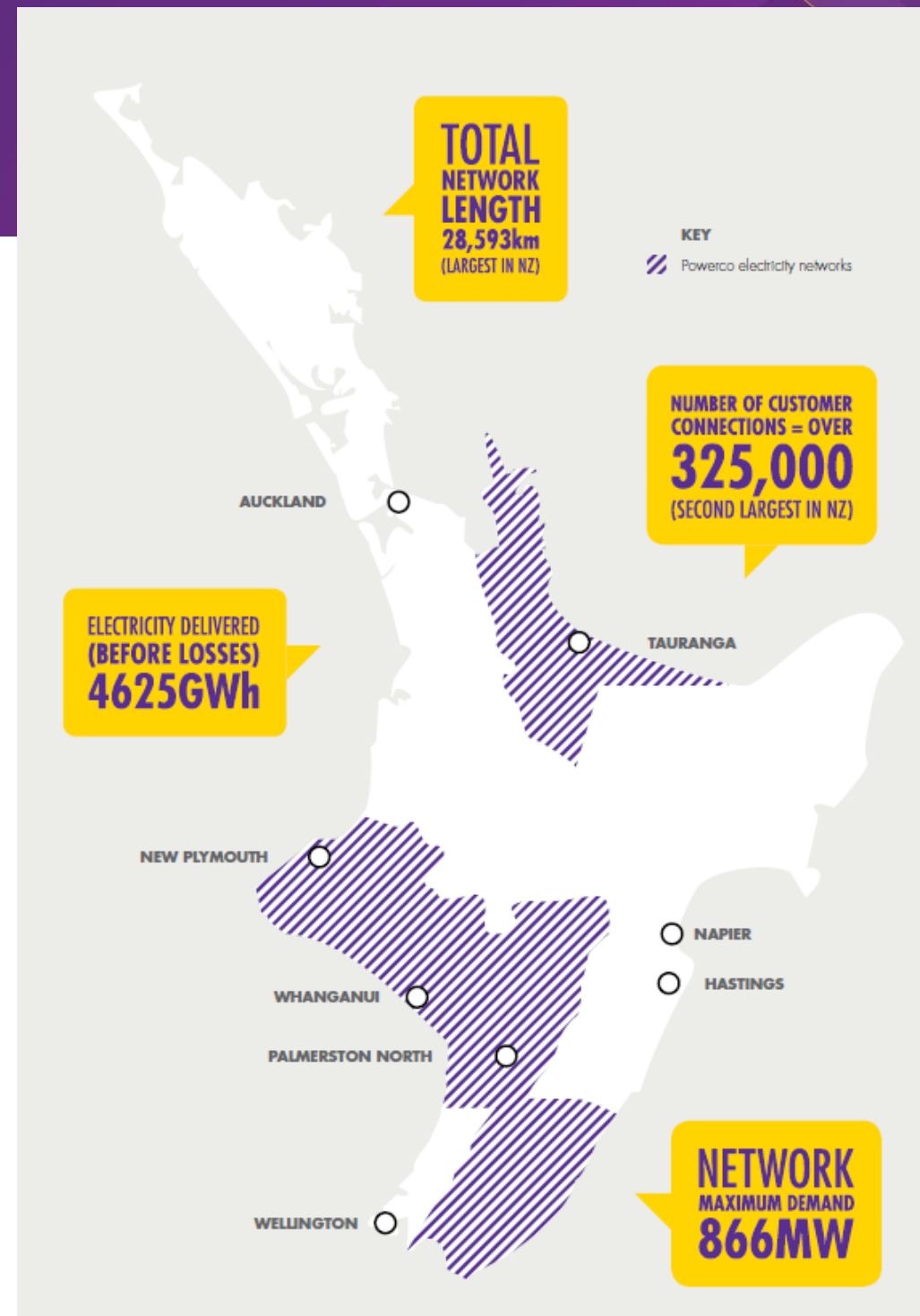
*Five top tips from Powerco's regulatory disclosure journey*

Charlotte Littlewood, Powerco Regulatory Manager

---

# Background

- Powerco is an electricity and gas distribution company in the North Island
- ~ \$415m in annual revenue
- A monopoly with prices set by the Commerce Commission
- Required to publish a substantial financial and engineering information for transparency
  - This was not always the case
- Presentation tells the journey for Powerco of ensuring compliance with an increasing amount of regulatory rules and disclosures
- It ends with our five top tips from what we learned along the way.



# The start of the journey...

## Before 2008....

- Rules very similar to GAAP
- Mainly financial and relatively easy for accountants to apply

### ELECTRICITY DIVISION

#### Income Statement For the year ended 31 March 2007

Notes	12 months to 31 March 2007 \$000	9 months to 31 March 2007 \$000	12 months to 30 June 2006 \$000
Revenue	274,839	200,457	259,680
Cost of goods sold	(75,086)	(51,782)	(69,467)
<b>Gross profit</b>	<b>199,753</b>	<b>148,675</b>	<b>190,213</b>
Other income	12,379	8,405	4,210
Operating expenses	(28,802)	(21,467)	(29,061)
Administration expenses	(20,602)	(14,407)	(25,213)
Other expenses	(61,783)	(47,693)	(38,901)
<b>Earnings before interest and taxation</b>	<b>100,945</b>	<b>73,513</b>	<b>101,248</b>
Finance costs	(39,353)	(29,945)	(39,856)
<b>Operating Surplus before taxation</b>	<b>61,592</b>	<b>43,568</b>	<b>61,392</b>
Taxation expense	(15,698)	(11,050)	(18,870)
<b>Operating Surplus Attributable to the Shareholders</b>	<b>45,894</b>	<b>32,518</b>	<b>42,522</b>

## After 2008....

- Many different approaches to GAAP (e.g. cost allocation and tax)
- Far beyond financial information

Company Name

Powerco Limited

For Year Ended

31 March 2014

**SCHEDULE 2: REPORT ON RETURN ON INVESTMENT**

This schedule requires information on the Return on Investment (ROI) for the EDB relative to the Commerce Commission's estimates of post tax WACC and vanilla WACC. EDBs must calculate their ROI based on a monthly basis if required by clause 2.3.3 of the ID Determination or if they elect to. If an EDB makes this election, information supporting this calculation must be provided in 2(i).

EDBs must provide explanatory comment on their ROI in Schedule 14 (Mandatory Explanatory Notes).

This information is part of audited disclosure information (as defined in section 1.4 of the ID determination), and so is subject to the assurance report required by section 2.8.

sch ref

**2(i): Return on Investment**

**Post tax WACC**

ROI—comparable to a post tax WACC

Mid-point estimate of post tax WACC

25th percentile estimate

75th percentile estimate

**Vanilla WACC**

ROI—comparable to a vanilla WACC

Mid-point estimate of vanilla WACC

25th percentile estimate

75th percentile estimate

**2(ii): Information Supporting the ROI**

(\$000)

Total opening RAB value

plus Opening deferred tax

Opening RIV

Operating surplus / (deficit)

less Regulatory tax allowance

less Assets commissioned

plus Asset disposals

Notional net cash flows

Total closing RAB value

CY-2	CY-1	Current Year CY
31 Mar 12	31 Mar 13	31 Mar 14
%	%	%

5.10%	5.98%	6.45%
-------	-------	-------

6.40%	5.85%	5.43%
-------	-------	-------

5.68%	5.13%	4.73%
-------	-------	-------

7.11%	6.56%	6.14%
-------	-------	-------

5.92%	6.76%	7.13%
-------	-------	-------

7.22%	6.62%	6.11%
-------	-------	-------

6.51%	5.91%	5.39%
-------	-------	-------

7.94%	7.34%	6.83%
-------	-------	-------

1,385,119		
-----------	--	--

(23,572)		
----------	--	--

	1,361,547	
--	-----------	--

167,037		
---------	--	--

24,806		
--------	--	--

101,470		
---------	--	--

8,275		
-------	--	--

	49,036	
--	--------	--

1,439,790		
-----------	--	--

# If you thought financial rules were dull and complicated...

Powerco has two businesses (gas and electricity) that have shared costs.

In Powerco's annual financial statements we disclose the total costs for Powerco as a whole.

# In regulation there are six pages of rules on cost allocation...

## SUBPART 1 Cost allocation

### 2.1.1 Cost allocation process

#### (1) Any-

- (a) operating costs; and
- (b) regulated service asset values,

that are directly attributable to electricity distribution services supplied by the EDB must be allocated to electricity distribution services.

#### (2) Any-

- (a) operating costs; and
  - (b) regulated service asset values,
- that are directly attributable may be allocated to regulated services, in aggregate, using ACAM.

### (3) Any operating costs an accordance with subcl services and other regi

- (a) ABAA; or
- (b) subject to c

### 2.1.2 Allocation approaches

#### (1) For the purpose of clau OVABAA to allocate-

- (a) operating c
- (b) regulated s

#### (2) Where, in respect of a all unregulated service

- (a) less than 20% supplied by
- (b) in all other

#### (3) Where this subclause a

### 2.1.3 Accounting-based allocation

#### (1) Cost allocators must be use any arm's-length deduction

- (a) electricity distri
- (b) other regulated

#### (2) Asset allocators must be us attributable, less any arm's

- (a) electricity distri
- (b) other regulated

### 2.1.4 Avoidable cost allocation methodology (ACAM)

#### (1) In respect of-

- (a) operating costs; and
- (b) regulated service asset values,

not directly attributable, less any arm's-length deduction, an assessment made as to the proportion of each that would be non-avoidable were the to supply unregulated services.

#### (2) The amounts of non-avoidable-

- (a) operating costs; or
- (b) regulated service asset values,

not directly attributable, assessed in accordance with subclause (1), must allocated to regulated services in aggregate.

#### (3) Where the EDB supplies other regulated services, the amounts allocated in acc with subclause (2) must be allocated to each regulated service supplied by the EDB using the ABAA.

### 2.1.5 Optional variation to accounting-based allocation approach (OVABAA)

#### (1) This clause applies to the allocation of-

- (a) only operating costs not directly attributable;
- (b) only regulated service asset values not directly attributable; or
- (c) operating costs not directly attributable and regulated service asset values not directly attributable,

as elected in accordance with clause 2.1.2(4)(c).

#### (2) Operating costs not directly attributable less any arm's-length deduction must be initially allocated to-

- (a) electricity distribution services;
- (b) other regulated services; and
- (c) each unregulated service,

using cost allocators.

#### (3) Regulated service asset values not directly attributable less any arm's-length deduction must be initially allocated to-

- (a) electricity distribution services;
- (b) other regulated services; and
- (c) each unregulated service,

using asset allocators.

#### (4) Where, after application of-

- (a) subclause (2)(c);
- (b) subclause (3)(c); or
- (c) subclauses (2)(c) and (3)(c),

an unregulated service would-

- (d) be unduly deterred, subclause (5) applies; and
- (e) not be unduly deterred, the allocation of either or both of-

- (i) operating costs not directly attributable; and
- (ii) regulated service asset values not directly attributable

as the case may be, must remain as carried out in accordance with either or both of subclauses (2)(c) and (3)(c), as the case may be.

#### (5) Where this subclause applies, i

- (a) operating costs; an
  - (b) regulated service a
- not directly attributable t accordance with either or may be reduced to the am be unduly deterred.

#### (6) For the avoidance of doubt, thi subclause (5) must be treated i

- (a) operating costs; an
  - (b) regulated service a
- not directly attributable t

#### (7) The adjusted amounts determi from either or both the-

- (a) operating costs not
- (b) regulated service a
- (c) electricity distribut
- (d) other regulated ser

#### (8) Where, after application of subclause (7), the-

- (e) each remaining unregulated service, in accordance with subclauses (2) and (3), as the case may be.

#### (9) When re-applying-

- (a) subclause (5) to another unregulated service, the starting values of-
  - (i) operating costs; and
  - (ii) regulated service asset values,
- not directly attributable allocated to that unregulated service must be the values obtained in relation to that unregulated service as a result of the previous application of subclause (7); and
- (b) subclause (7), for "to which subclause (2) or (3) applied after any arm's-length deduction was made", substitute "to which this subclause previously applied".

#### (10) Subclauses (5) and (7) may be re-applied sequentially in respect of each unregulated service which is unduly deterred until any remaining regulated service asset values or operating costs or both are of such quantum that their allocation to the remaining unregulated services does i

#### (11) For the avoidance of doubt, is carried out by grossing up electricity distribution serv unregulated service based may be, used under subclai allocation percentages for t made under subclause (5).

not directly attributable to other regulated services supplied by the EDB must be consistent with allocations made in accordance with input methodologies relating to cost allocation applying to those other regulated services.

(2) Where the OVABAA is applied to both operating costs not directly attributable and regulated service asset values not directly attributable, the combined amount of such costs and values that is re-allocated in accordance with clause 2.1.5(5) must not exceed the amount required to ensure that the unregulated service is not unduly deterred.

(3) For the avoidance of doubt, after application of this subpart, notwithstanding anything else that may suggest otherwise, each unregulated service must bear at least the total-

### 2.1.6 Allocation constraints

#### (1) For the avoidance of doubt,

- (a) operating costs;
- (b) regulated serv

- (a) operating costs; and
  - (b) value of assets,
- directly attributable to that unregulated service.

#### (4) Notwithstanding anything else in this Subpart, the maximum value of-

- (a) operating costs that may be allocated to electricity distribution services and other regulated services, in aggregate, must not exceed the total value of operating costs; and
- (b) regulated service asset values that may be allocated to electricity distribution services and other regulated services, in aggregate, must not exceed the total regulated service asset values,

that would be allocated to electricity distribution services and other regulated services, in aggregate, using ACAM.

## An extract...

- (a) where, in a disclosure year, operating costs not directly attributable less any arm's-length deduction are less than 15% of operating costs, ACAM may be applied to the allocation of operating costs not directly attributable;
- (b) where, in a disclosure year, the total value of regulated service asset values not directly attributable less any arm's-length deduction is less than 10% of the aggregated unallocated closing RAB value, ACAM may be applied to the allocation of regulated service asset values not directly attributable; and
- (c) in all other cases, ABAA or OVABAA, at the supplier's election, may be applied to the allocation of either or both-
  - (i) operating costs not directly attributable; or
  - (ii) regulated service asset values not directly attributable,as the case may be.

- Not the easiest to read
- A whole new set of definitions and concepts.
- Nothing like how accountants usually think

# The challenges...

- Disclosures are only completed once a year
  - Definitions learned and then forgotten as not regularly practiced
  - People leave/ change jobs – every year was like starting from scratch
  - Errors in rules and clarifications needed – long process to improve.
- Information required from engineers and commercial teams as well as from Finance
  - At least accountants were used to applying GAAP and following annual accounts process
  - Engineers and commercial teams not used to this.
- Initially seen as a “tick-box” exercise as disclosures not used by anyone
  - Not seen by the finance team as their core function
  - No members of the public ever asked for the information – did not help cause
  - Commerce Commission rarely used or analysed the data



# Five top tips



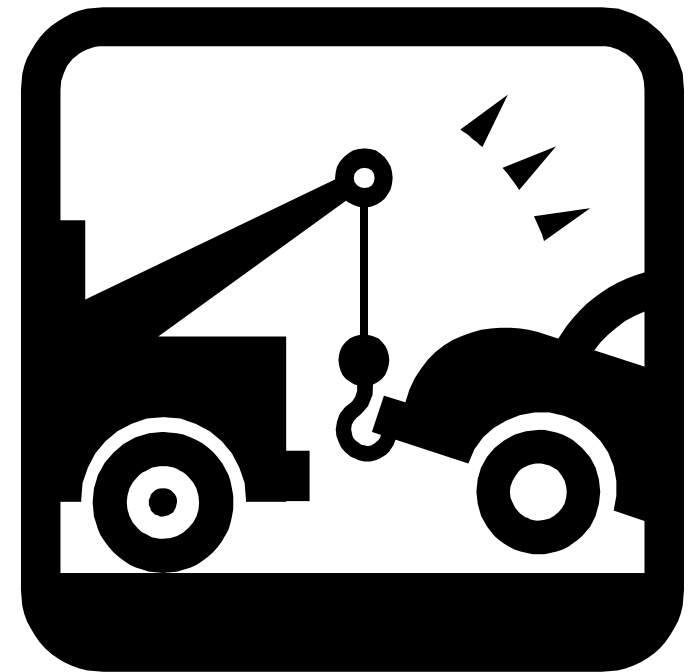
# Top tip 1: Senior management buy-in vital

- The journey at Powerco has been led from the top.
- Powerco's Board placed high importance on accurate information and assurances from management.
- Accurate disclosures viewed as being credible with the regulator.
- Message that regulatory disclosures are as important and financial disclosures.
- Powerco changed its financial year to align with the regulatory year to make it easier to disclose and compare information.



## Top tip 2: Don't assume people read anything

- We initially sent people the new rules and expected them to understand them and apply them
- This did not work
- Many people were not used to following very detailed and complex rules
- Some interpretations of definitions needed to be made
- People naturally assumed the rules were like financial rules or engineering definitions, and jumped to conclusions
- A large step forward was to develop a standard for people to follow.
- Main benefit was actually from the process of writing the standard.



## Top tip 3: Even if they do understand it, they'll make mistakes

- Even when we sat down with people, made them read the standard and carefully explained things, mistakes were still made.
- Not deliberate – part of being something done only once a year and the complexity.
- It was also difficult for people to see the whole picture.
- An overall sense check was very important.
- We now have an in house expert who carefully checks all variances and raises issues with senior management.
- Important to look after the in house expert – as it's expertise created over several years of understanding the business and the mistakes people have made in the past.



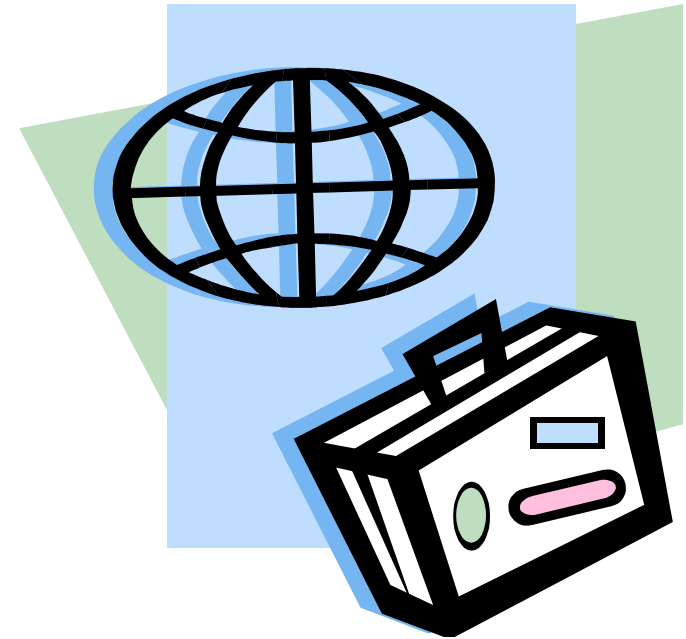
## Top tip 4: Work with the people who make the rules

- It is much easier to apply the rules when you understand the reasons behind them
- Important to feed into the development of the rules, including what applying the rules means in practice.
- Regulators can have an unrealistic view of how much information a business collects and the costs of delivering information to a high degree of accuracy.
- Eg for a business we can tolerate an accuracy of +/- 5%, but regulator wants 100% accuracy. Getting that extra 5% is very expensive.
- Be honest about your mistakes – the Commerce Commission was understanding when we explained if we had made a mistake.
- (Just don't make the mistake again.)



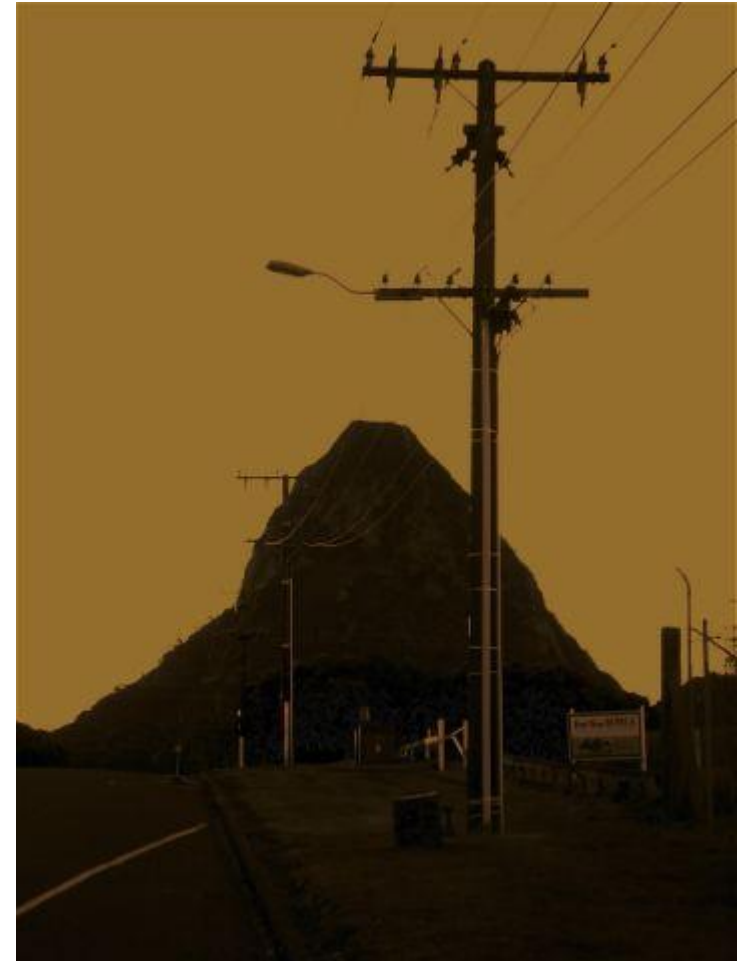
## Top tip 5: It's a journey and takes time

- We've come a long way, but still continually improving
- Commerce Commission regulation is also an area that continually evolves
- Issues register with 360 questions on it from electricity and gas distribution businesses
- Another round of wording changes in 2015
- Requires constant refinement and understanding of how disclosure process has evolved.



# Conclusions

- Regulation and compliance increasing everywhere, particularly for the utilities sectors
- Regulations often written in a way that people in the business struggle to understand
- Often need a cultural change to achieve high compliance – and that won't happen overnight.
- But with leadership and persistence can get there.



# Questions

---