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FINANCIAL GUIDELINES FOR RING FENCING OF ADDITIONAL GENERATING CAPACITY PROVIDED BY ECNZ

FINANCIAL GUIDELINES FOR RING-FENCING OF ADDITIONAL GENERATING CAPACITY PROVIDED BY ECNZ

Introduction

1 The Government of New Zealand and the Electricity Corporation of New Zealand Limited (ECNZ) have agreed on certain arrangements designed to reduce the dominance of ECNZ in New Zealand's electricity generation market. The arrangements are set out in the Memorandum of Understanding between the Government and ECNZ, dated 8 June 1995 (the MoU). That MoU was published in the New Zealand Gazette Supplement dated 22 February 1996.

2 The arrangements covered in the MoU include the "ring-fencing" of any additional generating capacity provided by ECNZ. In particular, appendix 5 of the MoU requires that[1]:

> 6. *Guidelines for the financial policies necessary to implement ring-fencing are to be specified in advance by ECNZ, and would be subject to approval by an independent person appointed by the Secretary of Commerce.*

3 These ring-fencing requirements and the need to specify guidelines for financial policies are also mentioned in ECNZ's Statement of Corporate Intent (SCI) dated 9 February 1996. The SCI was tabled in the House on 30 August 1996.

4 This document, the "Financial Guidelines", covers the financial policies necessary to implement ring-fencing. In order to record all matters concerning ring-fencing in one place, this document also repeats relevant parts of appendix 5 of the MoU.

5 Ernst & Young have been appointed by the Secretary of Commerce to approve the guidelines. Their certificate of approval is appended to this document.

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[1] Italicised sections of these guidelines are verbatim quotes from appendix 5 of the MoU.

Objectives of Ring-Fencing

6 The MoU states that:

Objective

1. *Additional generating capacity provided by ECNZ in New Zealand will be "ring-fenced" in order to -*

- *restrict ECNZ's ability to cross-subsidise the additional capacity and thereby ensure that the electricity produced from the additional capacity is priced to reflect the full cost of producing it; and accordingly*

- *facilitate competitive entry into the electricity market by other generators and demand-side management suppliers.*

General Rule

2. *Ring-fencing will be required for any additional generating capacity provided by ECNZ in New Zealand where the capacity is more than 10 MWs and -*

- *ECNZ would have effective control over the development of the capacity; or*

- *ECNZ would have effective control over the sale to any wholesale buyer (other than ECNZ) of all or any part of the electricity produced from the capacity.*

3. *However, any refurbishment or modification of an existing generating station which does not require ECNZ's entitlement to be debited under the cap regime in Appendix 4* [of the MoU] *will not have to be ring-fenced.*

Key Elements

4. *Ring-fencing of additional generating capacity will require*[2] *-*

a *the formation of a separate company to provide the additional capacity, which must be operating before tenders are called for the purchase of major plant or major capital works; and*

[2] The five points in this paragraph were not numbered in the MoU. Numbering has been added here for ease of reference.

b *ECNZ to charge the separate company on the basis of full costs for any capital, goods (except gas), and services it provides to the company, and on the basis of full opportunity costs for gas; and*

c *where the electricity produced by the separate company is sold on contract, the contract is to be completely separate from any contract for electricity produced by ECNZ or any person associated with ECNZ; and*

d *the achievement of a proper commercial return on the assets and shareholders funds in the separate company; and*

e *the separate company and ECNZ to comply with the financial guidelines established under paragraph 6 below.*[3]

Editorial note: In these guidelines, the "separate company" will henceforth be termed the "ring-fenced entity" ("RFE") or "entities" ("RFEs") as the case requires.

7 The MoU also notes that:

5. *For the avoidance of doubt, a ring-fenced company would be permitted to raise debt capital backed by guarantees from ECNZ, so long as an appropriate level of equity finance was provided to the company by ECNZ.*

8 Further, the MoU states that:

9. *The Secretary of Commerce will make the final decision on whether additional generating capacity is required by paragraph 2 above to be ring-fenced, having regard to the objective in paragraph 1 above.*[3]

Financial Guidelines for Accounting Policies

Guideline for Accounting Standards

9 In relation to the RFE, ECNZ will comply with all the relevant accounting concepts and standards as promulgated by the Institute of Chartered Accountants of New Zealand and approved by the Accounting Standards Review Board. Any departures from the policies used by ECNZ will be fully justified to the independent auditor.

[3] The paragraph references in this paragraph relate to Appendix 5 of the MoU, not to these guidelines.

Guideline for Depreciation

10 ECNZ will comply with the recognised accounting standards dealing with depreciation, currently SSAP 3, *Accounting for Depreciation*, and SSAP 28, *Accounting for Fixed Assets.*

Financial Guidelines for Cost Allocation and Pricing Methodologies

11 Wherever reasonable, ECNZ and the RFE will contract for and incur their own costs as if they were fully independent entities, operating on a stand-alone basis. However, where ECNZ provides goods or services to the RFE or vice versa, the following guidelines for cost allocation and pricing will apply.

12 Goods and services transferred from ECNZ to the RFE and from the RFE to ECNZ will be priced to recover the full costs related or attributable to those goods and services. This will include all direct costs and a fair and reasonable allocation of any material indirect costs, related or attributable to those goods and services. ECNZ must satisfy the independent auditor each year that all goods and services transferred have been identified and that the cost allocation and recovery bases that have been applied are consistent with paragraph 13 below.

13 As part of its determination of specific accounting policies, ECNZ will develop a transparent costing model for each RFE, which identifies ECNZ's direct costs attributable to the goods and services supplied to the RFE, and sets out the basis for a fair and reasonable allocation of ECNZ's material indirect costs to the RFE. This allocation will reflect the relationships between the costs and the goods and services provided. Similar procedures will apply should the RFE provide any goods or services to ECNZ. The independent auditor will review the costing model(s) each year to ensure that the objectives of paragraph 12 are met. This review will include an examination of the validity of the model in terms of the above specifications, as well as an audit of the application of the model in that particular year, to ensure compliance.

<u>Direct Costs</u>[4]

14 Under paragraph 11, wherever possible ECNZ and the RFE will incur their own direct costs. However, where ECNZ provides any goods or services to the RFE, any actual directly attributable costs will be on-

[4] "Direct costs" are costs incurred by ECNZ that are directly attributable to the RFE (or vice versa).

charged by ECNZ to the RFE. Typical costs under this heading which ECNZ might incur but which might be attributable to the RFE could include:

a Routine Station Operating Costs: ECNZ will on-charge any direct costs associated with operating the new power stations including the direct costs of operators.

b Routine Station Maintenance Costs: ECNZ will on-charge any direct costs of monitoring, minimising and rectifying faults and defects in the generating plant and equipment, together with the direct costs associated with environmental requirements, buildings and road maintenance and maintenance training.

c Contracting-out Costs: ECNZ will on-charge any costs involved where contractors are used to perform tasks for the stations.

d Ancillary Services: Where ECNZ provides ancillary services to the RFE, such as backup, spinning reserve, and hedge products, they will be charged at a comparable price to that which ECNZ would sell to any independent generator.

e Transmission Charges: Where possible, Trans Power will charge the RFE directly for Trans Power services (including an allocation of the costs of transmission constraints) on the same basis as other independent power producers. ECNZ will on-charge to the RFE any other transmission charges incurred by it that are related to the RFE.

f Fuel: Fuel provided to the RFE by ECNZ will be charged at full cost, except for gas which will be charged at the full opportunity cost.[5]

The same principles will apply should the RFE provide any goods or services to ECNZ.

Indirect Costs[6]

15 Typical costs under this heading which ECNZ might incur but which might be attributable to the RFE could include:

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[5] The "opportunity cost" of gas is the market value of that tranche of gas.

[6] "Indirect costs" are all the costs other than direct costs and depreciation which are incurred by ECNZ in connection with providing goods and services to the RFE (or vice versa).

- Corporate services (human resources, computer services, finance, strategic planning advice, generation scheduling, etc).
- Marketing services (where ECNZ information is used).
- Costs of construction management and external overview.
- Costs of shared management of fuel resources and catchment.

Guideline for Treatment of Opening Balance Sheet (including Pre-Incorporation Costs) and Ongoing Asset Transfers

16 Assets used primarily by the RFE will be passed to the RFE. Assets passed at any time from ECNZ to the RFE (and vice versa) will be transferred at book value.

17 After Board approval has been given for the establishment of the RFE, all relevant pre-incorporation costs directly related to the RFE, will be capitalised in the balance sheet of the RFE and amortised in accordance with recognised accounting standards as per paragraph 9. Note that the relevant pre-incorporation costs will include all costs that under ECNZ policy would be capitalised. ECNZ will not absorb or write off any pre-incorporation costs related to the RFE in such a way as to give an effective subsidy, and hence gain for the RFE a competitive advantage.

18 Typical pre-incorporation costs could include:

- Planning costs.
- Site evaluation costs.
- Costs of obtaining water and other rights.
- Costs of scoping and feasibility studies.
- Design costs.

Guideline for Determining Commercial Rate of Return

19 The RFE will use the same methodology as used by ECNZ for determining its commercial rate of return, adjusted for the capital structure and investor profile of each RFE.

20 ECNZ will satisfy the independent auditor that:

a the methodology has been properly applied, including that all relevant variables have been properly derived. The required commercial rate of return will be calculated assuming the RFE is an independent taxpayer, irrespective of its actual tax status; and

b the RFE is forecast to achieve a rate of return over its life which is consistent with its required commercial rate of return. The independent auditor will assess the reasonableness of the assumptions behind the cashflow projections used for determining the required commercial rate of return.

21 Each year, ECNZ will supply information to the independent auditor on the calculation of the commercial rate of return for each RFE, based on the methodology, and using relevant variables as at that date. This information is required in order that the independent auditor may assess the achievement of such a commercial rate of return by each RFE.

Annual Certification and Publication of Accounts

22 The MoU requires that:

> 7. *An independent auditor appointed by the Secretary of Commerce, in consultation with ECNZ, will be required to ascertain, and provide annual public certification (which would appear in ECNZ's annual report) as to, whether ECNZ is complying with these ring-fencing requirements.*

23 The public certificate of audit compliance for each RFE will be published in each year of its operation in ECNZ's annual report.

Duration

24 The MoU states that:

> 10. *These ring-fencing requirements will cease to apply when ECNZ's share (including its interests in ring-fenced companies and joint ventures as defined in Appendix 4) of the total New Zealand generating capacity measured in MW capacity terms is less than 45% of that total, and that share has been verified by the Secretary of Commerce.*

Conclusion

25 Should any situation emerge in which compliance with these guidelines is insufficient to meet the expectations of the Government and ECNZ as set out in appendix 5 of the MoU, ECNZ undertakes to take all reasonable steps to ensure that the spirit of the agreement in that appendix is achieved.

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30 October 1996

Electricity Corporation of New Zealand (ECNZ) Ring-fencing Guidelines

We have examined the attached guidelines for the financial policies necessary to implement ring-fencing of additional generation capacity provided by ECNZ. These guidelines have been prepared by ECNZ, and are required under the Memorandum of Understanding entered into by the Government and ECNZ in June 1995.

As the independent persons appointed to approve these ring-fencing guidelines we certify that the guidelines produced:

- are consistent with the objectives and requirements set out in the Memorandum of Understanding (reference Appendix 5); and
- in particular, ensure that competitive entry into the electricity market will be facilitated, as ECNZ's ability to cross-subsidise the additional capacity will be sufficiently restricted under the application of the guidelines.

The independent certification was performed solely to ensure that the financial policies adopted for ring-fencing are consistent with the aims of the Memorandum of Understanding. This certification relates only to the financial guidelines and does not extend to any other information.

Yours sincerely
ERNST & YOUNG

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