17.001 We last reported on the energy sector in 1998, when we outlined our role in respect of auditing energy companies and focused on some of the issues arising from the changes in the sector which were having an impact on our audits.[1] The report noted that the Audit Office was the auditor of 28 of the 37 energy companies – 6 wholly-owned or majority-owned by local authorities and 22 wholly-owned or majority-owned by community trusts.

17.002 This article outlines the effect on our audit arrangements of the Electricity Industry Reform Act 1998, as well as two areas on which our auditors will focus during the 1998-99 audits.

Electricity Industry Reform Act 1998

17.003 The Electricity Industry Reform Act 1998 (the Act) was passed on 8 July 1998. The key feature of the Act was requiring an ownership separation between the lines businesses and the supply (retailing and generation) businesses – cross-shareholdings between lines businesses and supply businesses are restricted through percentage limits on aggregate cross-ownership provisions in the Act.

17.004 All electricity supply companies were required to elect to either:

- by 1 April 1999, set up a separate trust-owned company for their distribution or electricity retailing/generation activities (this option was available only to trust-owned companies); or
- by 31 December 2003, sell their distribution or electricity retailing/generation activities and, between 1 April 1999 and the time of sale, operate these activities as separate companies on an arm's-length basis.

17.005 All 28 energy companies we are responsible for auditing have already opted for the sale of their distribution or electricity retailing activities.

1 *First Report for 1998*, parliamentary paper B.29[98a], pages 129-135.

17.006 By the end of March 1999, two of these 28 companies had chosen to sell their distribution businesses, the others opting to sell their energy retail businesses. Included in these figures is one company that sold both businesses, leaving itself with only a generation business.

Accounting and Auditing Issues

17.007 The changes occurring to the companies as a result of these sales have highlighted a number of accounting and auditing issues. Particular issues that we have asked our auditors to focus on as a result of changes occurring under the Act, include:

- Ensuring correct accounting treatments of items associated with sale contracts – for example: goodwill on an energy company's customer base; employee issues such as treatment of holiday pay; and the sale of fixed assets such as meters. In addition, valuation and disclosure issues may need to be considered for surplus accommodation, redundant software, and residual book values on assets not taken over.

- Ensuring appropriate disclosure of discontinued activities or post-balance-date events.

- Reviewing restructuring expenses and costs associated with mergers or proposed acquisitions, to ensure appropriate treatment and disclosure. We have released a policy on accounting for restructuring costs to assist in this regard.

- Reviewing costs of feasibility studies and other research and development costs, to ensure that they are appropriately recognised and disclosed in accordance with financial reporting standards.

Asset Management Plans

17.008 The Ministerial Inquiry into the Auckland power supply failure noted:

> *To avoid unpredictable and unacceptable failures of critical system components, condition-based assessment and measurement becomes a necessary methodology, as transmission assets age, to prove their ongoing reliability. Maintenance based on a performance reliability assessment then becomes inadequate, as it does not provide reliable forward projections of performance and life duration.*[2]

17.009 In our 1998 report, we noted that an asset management plan (when prepared properly) not only provides a comprehensive inventory of an entity's assets but can also be a valuable management tool. By the use of both financial and non-financial information, the plan can provide a picture of the condition of each asset (or the component parts of larger assets) and, thus, the basis for determining future needs for asset maintenance and replacement.

17.010 Our auditors will continue to encourage all energy companies to develop asset management plans for distribution and other infrastructural assets, and also to encourage those companies whose plans are not adequate to improve them. The *Electricity (Information Disclosure) Regulations 1999* require all energy companies owning line businesses to publicly disclose their asset management plans from the 2000 financial year.

Statements of Corporate Intent

17.011 In 1998, we asked our auditors to evaluate whether the performance report produced by each company continued to meaningfully identify and report against appropriate targets, given that energy companies have now had four years of reporting under the Energy Companies Act 1992.

17.012 We asked our auditors to ensure that the information dealt with in the performance report was consistent with performance targets established each year in the Statement

2 *Report of the Ministerial Inquiry into the Auckland Power Supply Failure 1998*, page 161.

of Corporate Intent (SCI). We also suggested that they evaluate whether the performance targets continue to remain relevant, given any updates in the objectives of the company as detailed in the SCI.

17.013 These audit requirements remain valid (especially given the operational and structural changes occurring in the sector) and are supported by what we said in the article *Statements of Corporate Intent: Are They Working?* in our *Third Report for 1998.*[3] We had examined SCIs in a number of sectors, including the energy sector.

17.014 The 1998 report notes a general lack of compliance with the legislative requirements of the SCI model, and our views of best practice, including:

- publication of SCIs the contents of which did not fully meet the legislative requirements;
- failure on the part of a small number of entities to establish appropriate business objectives;
- failure of entities to include performance measures in their SCI that fully embodied the objectives set out in the SCI;
- an over-emphasis on measures of financial performance;
- provision by some entities of information that was not readily understandable;
- failure to provide in the annual report a complete reporting of performance achieved against the performance measures and standards in the SCI; and
- failure to explain in the annual report variances between performance standards specified in the SCI and actual performance.

17.015 We have told our auditors to use our 1998 findings as a basis for discussing enhancements to energy companies' SCIs.

3 Parliamentary paper B.29[98c]. See also Part 8 of this report on page 61.