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Mark Berry
Chair
Commerce Commission
PO Box 2351
WELLINGTON

Dear Mark

Permitted asset adjustments for electricity distribution businesses

A. Summary

1. In its recent draft decision on starting price adjustments for Electricity Distribution Businesses ("EDBs"), the Commerce Commission ("Commission") has accepted various regulatory asset base ("RAB") adjustments made by EDBs. In making this decision, the Commission has in essence provided further guidance on the principles and approaches to asset base adjustments that are permitted under the Input Methodologies (IMs)¹. The clarity that has now been provided by the Commission's decision was not previously available to EDBs.
2. Vector considers that all EDBs should now be given the opportunity to make further asset base adjustments in the light of the new information on what is permissible under the IMs. If this is not done, some EDBs will have been materially prejudiced by the lack of information initially provided by the Commission (where EDBs had to second guess what might or might not have been meant by the IM Determinations). The result is unequal application of the asset valuation IM determination across EDBs.
3. Vector considers that resubmitting the asset valuation adjustment should be achievable within the current timeframes. The information will be relatively limited and should be able to be readily reviewed and applied to the Commission's model.

¹ Commerce Commission, Decision No. 710, Commerce Act (Electricity Distribution Services Input Methodologies) Determination 2010.

B. Different asset adjustment approaches have been adopted by certain EDBs

4. The IMs permit various adjustments to be made to historical asset valuations that were undertaken in accordance with the ODV Handbook². EDBs are able to make none, some, or all of the adjustments. EDBs have recently been required to choose which adjustments to make to the disclosed 2010 RAB value.
5. There was no or little guidance provided as to how to interpret the permitted adjustments (other than “technical guidance” in response to specific questions asked during the recent statutory notice process). This lack of information has, in Vector's view, resulted in prejudice to those EDBs who, due to limited information about how to interpret the IMs, inferred a more limited interpretation than that in fact adopted by the Commission.
6. Specifically, EDBs have now completed their asset adjustments as allowed for in the IMs and have reported these adjustments to the Commission. Having reviewed the information on the Commission's web site (EDBs' valuation adjustment reports and the review of these undertaken on behalf of the Commission – the “Final Review Report”³), it is clear that the Commission had accepted interpretations of the IMs adopted by other EDBs which differ materially from Vector's interpretation of the prescribed approach under the IMs. Vector is concerned that the result is a lack of consistency in the valuation approaches taken by EDBs and prejudice for those EDBs that have taken narrower interpretations of the allowable adjustments.
7. EDBs will now be relying on the indication provided by the Commission that these treatments have been accepted⁴. Given this is a one off asset valuation adjustment, some EDBs will be significantly prejudiced by the Commission's failure to clarify the meaning of the IM at an earlier time. Unless EDBs are allowed to resubmit adjustments in accordance with the Commission's approach, asset valuations will be bedded in that are unequal across EDBs.

² Handbook for Optimised Deprival Valuation of System Fixed Assets of Electricity Lines Businesses, 30 August 2004.

³ Nel Consulting Ltd., *The Review of the Independent Engineer's Reports on the Asset Adjustment Process of Electricity Distribution Businesses: Final Review Report*, July 2011.

⁴ The Commission has provided this indication by including the adjusted RAB values in its draft decision starting price adjustment model.

C. Areas where different asset adjustment approaches have been approved

8. Vector has identified a number of principles / approaches that, based on acceptance of adjustments by other EDBs, are now approved by the Commission but where it was not clear from the IMs that they were permissible. These are summarised below:
- a) "more accurate information" includes new cost information in the form of recent (post 2004) actual projects and current quotations for notional projects, adjusted by CPI (and therefore locking in input price increases in excess of CPI), to justify an increase in 2004 multiplier values.
 - b) cost information from a single project, rather than a reasonable sample of projects, is sufficient to justify new multiplier values.
 - c) Intellectual Property and "transfer of assets in service from Work in Progress" are valid adjustments to the RAB value.
 - d) replacement costs can be used as quantity weights in determining the average remaining asset life. On this point, we note that Vector's "residual asset lifetime for amortisation" value is materially higher than the value supplied by any other EDB. This suggests a calculation error which, in our view, is most likely as Vector based weighted average remaining lives of assets on depreciated replacement costs as quantity weights. All other EDBs seem to have based their weighted average remaining lives of assets on replacement costs as quantity weights. If Vector had adopted this approach our weighted average remaining life would be significantly less than was reported in the statutory notice.
9. It is useful that these points have now been clarified. However, it was not previously clear that such approaches were permitted under the IMs. Vector would have made use of these approaches to make further RAB adjustments had we been aware that this was how the IM Determinations would be interpreted.

D. Next Steps

10. Vector now wishes to provide the Commission with updated asset value information. This new information will be based on reconsidering multiplier costs with regard to current (2010) project cost data and determining a value for intellectual property arising from documentation of plans, policies and procedures and from inherent features such as network design. Other EDBs may request a similar opportunity, which would be desirable to ensure

consistent approaches across EDBs. The adjusted asset value information should be taken into account when the Commission makes starting price adjustments for EDBs.

11. Vector will now make these adjustments and provide the revised asset base information, with supporting audit and independent engineer sign-off, to the Commission as soon as possible. Vector expects that this new information will be taken into account by the Commission when it makes its final decision on starting price adjustments.
12. Providing information at this time should not create any timing difficulties for the Commission's ability to making its final decision on starting price adjustments by 20 October 2011. The changes, while material, will result in a change to a very few numbers, which can be quickly and directly entered into the starting price adjustment model. If the Commission is taking a principled approach to setting starting prices that does not involve goal seeking a particular outcome, it should not need to make any further modelling adjustments on the basis of the new data. It will only need to satisfy itself that the adjustments were made in accordance with the principles outlined above and then enter the new values into its model. This should not be a time consuming task.
13. I look forward to your response. If you would like to discuss this matter further, please contact me on 09 978 8340 or by email to allan.carvell@vector.co.nz.

Yours sincerely



Allan Carvell

Group General Manager Regulation and Pricing