

1 will be over the next week, and we look forward to an
2 informative Conference.

3 The Commission released its Draft Report on the 21st
4 of May setting out the Commission's preliminary view on
5 whether gas pipeline services should be controlled.
6 Following the release of the Draft Report interested
7 parties were asked to make submissions on the draft by the
8 2nd of July. Public versions of all submissions received
9 are available on the Commission's website.

10 The Commission will complete its final report to the
11 Minister of Energy once it has considered submissions,
12 completed this Conference and considered post-Conference
13 cross-submissions.

14 I'd now like to make some brief comments on the
15 procedures for this Conference. We've set down four days,
16 aiming to complete the Conference by 1 o'clock Wednesday
17 afternoon, the 28th of July. [**Pause**].

18 If at any time you can't hear at the back, please let
19 me know; I know I particularly don't have a loud voice, so
20 please don't hesitate to let us know. How's that now?
21 Can you hear now? [**Pause**].

22 Let's try again and stop me if it doesn't come through
23 more clearly.

24 A full record of the Conference will be maintained by
25 both transcription and tape recording. Could any person
26 speaking please do so from one of the microphones
27 available and speak clearly and precisely. I'd also ask
28 that each speaker state their name and the party they are
29 representing so that we can identify them clearly.

30 I would like to ask that everyone, and especially
31 persons not engaged in presenting, keep noise to a minimum

1 during the Conference. I'd also request that all
2 cellphones are switched off. It's not proposed to close
3 this Conference venue during the lunch breaks, however a
4 Commission staff member will be in attendance during those
5 times.

6 We will have tea breaks at appropriate times during
7 the day, and I believe we're scheduled for one today at
8 11 o'clock. Tea and coffee will be available to the area
9 to the right at the back, and I would note that
10 Commissioners and Commission staff will not be available
11 for discussion during those breaks.

12 These Conferences are designed to allow the Commission
13 to test the submissions put forward by interested parties
14 with questions and for parties to highlight the key points
15 of their arguments and submissions to the Commission. It
16 is not an opportunity for new evidence or submissions.

17 In some cases the Commission will request additional
18 information to be provided by presenting parties. At the
19 time that this information is requested a date for
20 delivery of the information will be agreed and noted as
21 part of the record of the Conference. The Commission will
22 consider further written submissions following the
23 Conference provided they are received by 12 clock noon on
24 Friday the 13th of August. Any such submissions must be
25 confined to issues or matters raised for the first time by
26 other parties at the Conference. Public versions of these
27 cross-submissions will be placed on the Commission's
28 website.

29 During the Conference the Commission shall provide for
30 as little formality and technicality as possible. This
31 Conference is not and is not intended to be an adversarial

Opening Remarks

1 proceeding. There will be no cross-examination. There
2 will also be no questioning of Commissioners or Commission
3 experts and staff by any party. There will, however, be
4 the opportunity for questioning of presenters by
5 Commission members, staff and Commission advisors. While
6 the public are welcome to attend during the session, they
7 do not have speaking rights or the right to ask questions.

8 Commissioners have read all of the submissions
9 carefully, so please make any summaries of submissions as
10 succinct as possible.

11 We do not wish and in turn may not allow you to read
12 your submissions to us. It would be appreciated if
13 speakers focused on the key issues in their addresses to
14 the Commission and kept to the time allocated to them. I
15 might note that, that time is meant to allow for
16 questioning time as well as presentation.

17 The Commission is open to hearing any points you wish
18 to make. We do, however, point out that the Commission
19 has a statutory duty to conduct the Inquiry under Part 4
20 of the Commerce Act. Therefore, submissions that critique
21 the legislation or question whether an inquiry is
22 necessary will be less helpful than those that focus on
23 the best method to meet the objectives of the legislation.

24 It is expected that a number of experts will be
25 attending and presenting at this Conference. I'd like to
26 stress that their role is as experts in their field. An
27 expert is not to act as an advocate for any particular
28 party. If the Commission considers that experts are in
29 fact acting as advocates for a particular party, their
30 submissions will be treated as though they are part of
31 that particular party's submission rather than as expert

1 opinion.

2 As it will be necessary to consider material which is
3 confidential, the Conference will be closed during that
4 discussion to all persons except for Commission members,
5 staff, advisors, and the party providing the confidential
6 information. We will also allow legal counsel and
7 relevant experts who provide appropriate undertakings from
8 other interested parties. I emphasise, however, that we
9 have a strong preference for as much as possible of this
10 Conference to be heard in public sessions.

11 Please note that transcriptions of all public sessions
12 will be made available on the Commission's website as soon
13 as possible after each day's proceedings. If you have
14 specific information contained within your submissions
15 that is confidential but that does not require an entire
16 confidential session, please note the status of the
17 information before commencing to discuss it so that we may
18 consider and, if necessary, rule that it be excluded from
19 the public transcription record.

20 I'd just like to add a further note here, and that is,
21 if at any time confidential information is inadvertently
22 mentioned by anyone, I would ask that you alert me
23 immediately so I can deal to the issue promptly, and if
24 that means interrupting the discussion, I'd be grateful to
25 you if you would do that please.

26 That concludes the administrative matters relating to
27 the Conference procedures. At this time I'd like to ask
28 if anyone has any questions relating to the procedures for
29 this Conference or any other issue that I have raised?
30 **[No comments].**

31 If questions on procedures or the agenda do arise

1 during the Conference, please don't hesitate to raise
2 those with the Commission staff in the first instance.

3 Before starting the day's presentations I'd like to
4 make a further comment on one particular matter, and that
5 relates to the treatment of tax within the Commission's
6 cost-benefit analysis. After the release of the
7 Commission's Draft Report a number of interested parties
8 have suggested that the Commission's cost-benefit analysis
9 did not correctly account for the interest tax shield for
10 some of the gas pipeline businesses subject to the
11 inquiry. As a result of those submissions, the Commission
12 has considered the issue and agrees that the interest tax
13 shield has been incorrectly applied in some cases.

14 In addition to the treatment of the interest tax
15 shield, the Commission has requested further tax
16 information from the businesses to ensure that the tax
17 figures provided by those businesses and used in the cost-
18 benefit analysis are the actual tax paid figures.

19 The Commission's proposed approach to calculating any
20 excess returns is based on using the actual tax paid.
21 Affected parties will have an opportunity to review and
22 comment on the Commission's treatment of the interest tax
23 shield and the tax figures used in the cost-benefit
24 analysis prior to the final report being provided to the
25 Minister of Energy.

26 So, I just want to emphasise that we will be putting
27 that information back to you in written form and you will
28 have a certain amount of time to provide written responses
29 to us after the proceedings.

30 Can I just ask if there are any questions on that
31 point? [**No comments**].

Opening Remarks

1 The Commission now is looking forward with interest in
2 hearing the submissions that will be presented at the
3 Conference. I'd like to thank you once again for your
4 attendance and begin by asking the representatives on
5 behalf of Powerco to present their submissions. Thank
6 you.

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1 PRESENTATION ON BEHALF OF POWERCO

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3 **MR HANCOCK:** Thank you very much. I'll firstly introduce
4 myself for the record. My name is John Hancock, I'm the
5 Utilities Practice Leader for the consulting firm Cap
6 Gemini and I've been involved with Powerco helping them to
7 coordinate their responses to this inquiry and also the
8 Electricity Thresholds Inquiry.

9 The reason I am here is that, the senior management of
10 Powerco, as you may be aware, are involved in a due
11 diligence exercise at the moment so they can't be here
12 this week.

13 We're going to split Powerco's input to this
14 Conference in two sessions. Today the independent experts
15 who have been commissioned by Powerco will be presenting
16 their evidence and providing themselves for discussion
17 with the Commission and the Commission staff, and then
18 Powerco senior management will make a short presentation
19 next Wednesday on the final day of the Conference.

20 In light of that, it might be more appropriate to
21 defer empirical discussion about Powerco's specific
22 matters, for example the interest tax shield issue, until
23 Wednesday. The experts who are appearing today aren't
24 experts in Powerco's business, they're experts in the
25 theory and practice of economic regulation.

26 The Chief Executive has asked me to, sort of, bring
27 his apologies to you. Powerco remains very committed to
28 providing the Commission with whatever support it can to
29 help it do the job it has to do and understands that it's
30 not that easy a job.

31 So, I'll just introduce today's speakers. The first

1 expert that we have appearing before the Commission is
2 Geoffrey Horton. Now, when I first came across Geoff, he
3 was one of the architects in the electricity pool in the
4 UK and, subsequent to that, he regulated me actually; he
5 was the Director of Regulation and Business Affairs at the
6 UK office of Electricity Regulation, and in that role he
7 worked directly for Stephen Littlechild where his
8 responsibility was the administration of price control,
9 and this obviously was the sort of definitive period in
10 the use of CPI-X as an incentive mechanism.

11 Subsequent to that, Geoff was the Director-General for
12 Electricity Supply in Northern Ireland, so he was the
13 regulator in that jurisdiction. Since ceasing to work as
14 a public servant, Geoff has been an independent
15 consultant. He specialises in economic regulation, and
16 his clients have covered many industries, but obviously
17 he's worked in the gas industry as well as the electricity
18 industry, and at the moment he is working with British Gas
19 Transco, which is the gas pipeline company in the UK, so
20 has familiarity with this industry.

21 Geoff has recently presented evidence to the
22 Commerce Commission as part of the electricity process.
23 His evidence was related to the revisions to the ODV
24 handbook and in particular the treatment of intangible
25 assets within the regulatory asset base. Some of the
26 themes are actually common in the submission he'll be
27 making today to the submission he made there, which is one
28 of the reasons Powerco asked him to provide evidence here.
29 So, Geoff...

30 **MR HORTON:** Thank you. [**Pause taken for technical glitch**].

31 Sorry about that. However, there are hard copies of this,

1 just with fewer pretty colours.

2 **CHAIR:** Is it the paper that's been handed out to us?

3 **MR HORTON:** Yes, it is, just a few sheets to illustrate a few
4 points I wanted to -- I didn't intend to speak for very
5 long because I've written it and you've read it.

6 I just wanted to bring up the main point to say a very
7 few words briefly about the competition analysis, but
8 mainly to talk about the cost-benefit analysis and the
9 uncertainties involved in them.

10 I think it's very difficult to do these things. You
11 go along and you have to make awkward choices on all sorts
12 of points, and one could have made different choices at
13 those points and one would have got different answers had
14 one done so.

15 Then I want to talk about the uncertainties. In
16 really making cost-benefit analyses you're comparing two
17 or more states of the world working, and I want to talk
18 about the different states of the world that don't depend
19 on estimating a price and the ones that do, and in
20 particular to talk about asset valuation which is an
21 important part of estimating the price to compare with
22 prices that exist now.

23 On the competition analysis: Now, I'm not at all
24 expert in the New Zealand energy market and I don't think
25 I can help you a great deal in it. It's difficult in
26 this sort of market. The standard market definition
27 tests, a hypothetical monopolist's SSNIP test, look at in
28 market definition a small but sustained increase in price.
29 It's not sustained very long though, and it is small; sort
30 of 5 or 10% for about a year, and in energy markets that
31 doesn't do very much. So, I think you're quite right to

1 conclude that there isn't a big impact, although if you
2 look at energy markets in the long-term you are getting
3 elasticity of substitution between fuels such as gas and
4 electricity which can be quite big; minus 2, that sort of
5 thing. That's for the fuel as a whole, not for the
6 pipeline or wires part of it.

7 Within the market, and I think one inevitably has to
8 define the market fairly narrowly, as you have, although
9 bypass does introduce an element of competition, it's
10 bound to be oligopolistic, and one might expect there to
11 be, sort of, a game solution result rather than a pure
12 competitive result.

13 I gather that, in the South Island particularly, that
14 the gas that's being delivered is liquid petroleum gas,
15 and so that, in some markets other forms of delivery
16 (lorries) would need to be considered in saying whether
17 those markets are competitive. But, for those reasons, I
18 don't want to say very much about the competition
19 analysis; it's the cost-benefit side that I want to
20 concentrate on.

21 There are various different sums that you have to do.
22 There's a, sort of, social cost-benefit analysis, the one
23 that doesn't worry about who gets the money, it just says,
24 is there more economic welfare all round regardless of
25 whether it's gone to the pipeline providers or to the
26 acquirers? In looking at that one needs to consider
27 whether there is more productive efficiency in a state of
28 the world where there is control than the state of the
29 world where there isn't control and more dynamic
30 efficiency, or more allocative efficiency, more production
31 of the right sorts of things, and of course one also needs

1 to consider the regulatory costs. So that's, as it were,
2 the first calculation, the overall economic benefit.

3 Then the benefit to the acquirers obviously also takes
4 into account the amount the acquirers are paying to the
5 gas pipeline providers. I've reproduced your picture on
6 one page here, where you very neatly illustrate this.
7 It's a downward sloping demand curve. In fact, on this
8 diagram it's not as downward sloping as an elasticity of
9 minus 0.3 would suggest, and if there is a monopoly price
10 rather than a price that covers all costs, then there are
11 two sorts of losses. There's that little dotted triangle,
12 which is the economic welfare loss, which is the extra
13 benefit that customers or acquirers could enjoy over and
14 above the price they pay for it were they to consume that
15 extra little bit of gas transport. There is a much larger
16 area, which is the transfer payment, with the diagonal
17 shading, from the acquirers to the pipeline owners or
18 providers.

19 In doing these sums, as indeed you know, you found
20 out, the overall benefit to economic efficiency is likely
21 to be very small or negative, but the benefit to the
22 acquirers may be much bigger, and it all depends on this
23 gap in prices. Of course, there are, sort of, three
24 prices on the chart -- I think I may have put the third
25 one in, I can't remember whether your diagram had the
26 third price as well -- which is that, if one's looking for
27 allocative efficiency, one ought to price to preferably
28 equal marginal cost. So that, if there is more benefit in
29 terms of the price people would pay for something than the
30 cost of doing it, then you do a bit more of it. Whereas,
31 if the cost exceeds the price, then you don't, and so,

1 it's nice if the signal's price to cover marginal cost.
2 But of course, if there are economies of scale, as there
3 probably are here, you price at marginal cost, you go
4 bust; you can't cover all the costs and, as I'm sure you
5 are well aware, there is all sorts of theory as to how one
6 should price up to cover all costs rather than just the
7 marginal cost. So, the price you're rightly comparing
8 when you're looking at these prices, is the price that
9 covers all costs and a price that exists in the market.

10 However, there are overall three scenarios, as again
11 you've said. There's what is happening now and what is
12 likely to happen in the future, which of course involves a
13 forecast of the future. There's this competitive pricing
14 scenario, the ideal world, which has to be estimated for
15 the present, the past and the future. Then, of course,
16 there's the world of control that has all the errors that
17 any regulator is bound to introduce, and its additional
18 costs. All these three scenarios have to be estimated,
19 and they're all uncertain.

20 Many of the comparisons are just between the first and
21 the third, just between the present and forecast future
22 scenario -- sort of, on a business as usual basis, and the
23 control scenario. So that, if one's talking about
24 productive efficiency, or obviously, if one's talking
25 about regulatory costs, which is just looking at now
26 versus the control scenario.

27 When one's looking at allocative efficiency and how
28 far each scenario is away from this ideal price, this
29 uncertain ideal price, then of course one needs to
30 consider the competitive pricing scenario as well.

31 Just thinking, first of all, of the comparisons that

1 don't involve worrying about what this price is quite so
2 much. They're all hard, but I think wondering about what
3 the price is, is perhaps the hardest one.

4 The direct regulatory costs: I mean, I haven't looked
5 in detail at the estimates you've made. I think that,
6 when one introduces a form of price control, that enormous
7 extra resources seem to get involved and it seems almost
8 to escalate as the process goes on; that people seem to
9 think of what happened last time and then they do more the
10 next time round and the regulator has to respond to the
11 companies doing more, and the companies then respond to
12 the regulator doing more.

13 I suppose it's not surprising that this happens
14 because, if a company's revenue depends essentially on a
15 regulatory decision, it is going to deploy a lot of
16 resources into attempting to maximise its revenue.

17 **MS BATES:** Excuse me, attempting to...?

18 **MR HORTON:** Maximise, increasing its revenue. It's almost
19 like, sort of, if it was operating in a market normally,
20 it would be putting a lot of resources into its sales
21 force. It's still doing that, it's got to sell the
22 services of whatever it's providing (to sell gas, to sell
23 services and gas pipelines) but the fact that the price at
24 which it can sell is being determined by somebody else in
25 the control scenario means that it is really worth as well
26 putting a lot of effort into that, and I think that it's
27 not unreasonable that it should do so. Of course, it also
28 increases the consultancy market for people like me, and
29 of course, I'm not taking that into account at all when I
30 say it's reasonable.

31 On productive efficiency, I think I was surprised that

1 you thought that there will be more productive efficiency
2 under a control scenario than without control. I can sort
3 of see an argument for that in that, if one thinks that
4 the companies are getting away with it now, they're able
5 to charge higher than competitive prices, then maybe
6 they're taking an easy life and not bearing down on their
7 costs as much as one would. But, on the other hand, with
8 maximising profits, they've still got an incentive to bear
9 down on costs; I mean, the companies that are privately
10 owned. If you take them into control, then you get into
11 this complicated benchmarking game, which is -- I mean, I
12 started a lot of this econometric estimating for
13 benchmarking, and I'm doing a lot of it now as well. It's
14 something that, it would be very nice if one could
15 determine this benchmark and say, that's the truth and
16 that's the thing we can measure all your costs against,
17 but in practice you can't and what happens is that, the
18 benchmarked costs that are used in the next price control
19 period are nearly always dependent to some extent on the
20 costs that a company has incurred in the previous period.
21 That means that its incentives to reduce costs at any time
22 are reduced, particularly at various stages of the price
23 control, because it will believe that its price allowance
24 in the next period will, to some extent, be dependant on
25 the costs it's recorded in this period, and the wrong way
26 round; that if it's got higher costs, it will get more
27 money.

28 There are all sorts of games one could play, and lots
29 of the details of benchmarking as well, which can take
30 their eye off the ball in cost-cutting. So, it's not a
31 comparison that I think there's a lot of evidence on and

1 one can say, "Oh, yes I'll point to that, more productive
2 efficiency here than there", but just on the incentive
3 properties, I was surprised that you took it that way
4 round. I would have thought it would be, if anything, it
5 would be slightly the other way round, though it's hard to
6 tell.

7 On dynamic efficiency, there's -- on quality
8 regulation, I thought conversely that there was something
9 more to be said for the control scenario in the quality
10 regulation, because there's an incentive for a private
11 monopolist to under-provide quality of service, just as
12 those incentives to under-provide quantity of output and
13 price up, there's an incentive to under-provide quality
14 and price up. So that, if control is able to get a handle
15 on regulating quality -- which is, I mean, it's not easy,
16 it's something we're struggling with all over the world,
17 including in the UK at the moment -- then one might get
18 some benefits. There, one's considering whether the
19 incentive on the company to under-provide quality in the
20 one scenario is greater than the regulator ability to make
21 a mistake in the other scenario. I say "regulator's
22 ability to make a mistake"; regulators have to focus on a
23 particular indicator, which is likely to be badly
24 measured, and that may be the wrong indicator, the
25 regulator may pick the wrong level, or just, you can't
26 measure the thing properly so what you get is a company
27 target-chasing rather than actually providing a good
28 service. But one might well have a net benefit from
29 control on that sort of side.

30 On the other aspects of dynamic efficiency, and that's
31 where we, I think, move back to the price-related

1 considerations, because the essential problem in all this
2 is whether one is providing financial capital maintenance,
3 whether efficient investments are rewarded, or whether
4 companies are going to worry that they're not going to be
5 rewarded and, therefore, be unwilling to invest. That's
6 possibly the big potential error for regulators. If you
7 get it wrong one way, then the customer pays too much and
8 is generally worse off and a monopolist goes laughing to
9 the bank. If you're the other way round, then one has a
10 danger of dynamic inefficiency, under-provision, and a
11 lack of investment.

12 So, I want to move on to these price comparisons. On
13 financial capital maintenance, when you have a price
14 control system up and running, normally there's a lot of
15 effort put into ensuring that, for efficient decisions --
16 and that's an important caveat I'll come back to -- that
17 there is financial capital maintenance and that people
18 worry about moving the regulatory asset value on, you
19 know, checking that all the right expenditure goes into
20 moving the regulatory asset value on from one time to
21 another time, and that the total amount of depreciation
22 adds up to what was invested.

23 When one's moving from a situation of not control to
24 control there is the problem that indeed you pointed out
25 in the report, that you don't know what's happened in the
26 past; you don't know how much of that financial capital
27 has already been rewarded and how much remains to be
28 rewarded. In that situation it's -- I was going to say
29 "in principle impossible", but I'm just checking that
30 because it sounds a bit strong -- but I think it is in
31 principle impossible to say whether they are charging too

1 much or not. What this is down to is that one's choosing
2 a method of asset valuation and whatever you choose
3 presupposes something about the past, and you say taking
4 this method of valuation I've calculated its price and
5 their price is too high/too low. Well, that's only given
6 these assumptions about the past, and that's something you
7 did point out, but it is a very big caveat.

8 Going on to the price comparisons and the
9 uncertainties of them. There's obviously uncertainty over
10 that elasticity that determines the size of the that
11 little triangle on the end. There's uncertainty --

12 **CHAIR:** Can I just interrupt you for just a minute, Mr Horton,
13 just to ask a few questions and we'll come back to the
14 rest of your presentation, if you don't mind.

15 You rightly noted that some of these comments we've
16 made in the Discussion Document. I'm kind of interested
17 in your experience as a regulator yourself. You may be
18 aware that when we, for instance, set up the threshold
19 regime for electricity we did have Dr Littlechild advise
20 us on some initial work that we did, so we had some input
21 from that experience.

22 I think, for the record here, first of all I just want
23 to ask you, were you involved in regulation in either the
24 UK or Ireland when you went from 'no control' to a
25 'control' environment? Were you involved at that stage?

26 **MR HORTON:** Yes.

27 **CHAIR:** How did you deal with some of these issues that you
28 have raised with us?

29 **MR HORTON:** Well, it's -- we had an easy life compared with
30 you, because the 'no control' was a Government-owned
31 position, so that the Government sold the businesses to

1 somebody else, and then the somebody else started doing
2 bits of investment.

3 So, we agonised about all sorts of things and did all
4 sorts of accounting -- looked at all sorts of accounting
5 possibilities, but what we actually did was, we took the
6 amount they paid to the Government for the businesses and
7 put on a little premium, a little market premium for the
8 gain they'd expect to make on the flotation, and then we
9 added in the money that they put in for investment, and
10 the price control allowed revenue for the depreciation
11 return on those sums of money. That, assuming the cost of
12 capital number was right, meant that they got their
13 investment back and their financial capital was
14 maintained.

15 But, since all that had happened was, the Government
16 had sold them the business, so they put that money in, we
17 only had to worry about what sort of premium or what sort
18 of valuation should be put on that sale. I mean, there
19 was enough angst and disagreement about that, and there
20 are many people who say "you stole our money".

21 **CHAIR:** Can I just ask you a question: When you move from an
22 environment of 'no control' to 'control', it might have
23 been part of privatisation, but before you actually
24 decided to move to a control environment, did you do any
25 analysis on whether there was a reason why control was
26 necessary, or was there just a presumption, because you
27 were dealing with a monopolist, you needed to control
28 them?

29 **MR HORTON:** It wasn't a sort of pure 'no control' because the
30 Government and the industries, and the industries put the
31 price rises that they were proposing to the Government for

1 approval when they were nationalised.

2 **CHAIR:** Voluntarily, without any requirement?

3 **MR HORTON:** It -- [**pause**]. I think it varied. I think in
4 some cases there were instructions issued to that, and in
5 others they volunteered. But, had they not volunteered, I
6 think somebody would have said something to them.

7 **CHAIR:** And, as a regulator, it sounds to me like you didn't
8 go through an exercise like this and ask a prior question,
9 was control necessary or desirable; there was a
10 presumption that it was.

11 What was the basis of that presumption?

12 **MR HORTON:** The basis of the presumption was that they were
13 monopolies and one would need to control the price of a
14 monopoly.

15 **CHAIR:** Why?

16 **MR HORTON:** Because monopolists have an incentive to under-
17 provide outputs and price too high. It's just -- it was
18 just straight from the economic theory, and in fact the
19 tests have been the other way round, where removing price
20 control from things like electricity or gas supply or
21 telephone supply -- the telephone networks. The tests
22 have been, is there enough competition to remove price
23 control, because in general we were moving from state-
24 owned industries where there was some sort of system, even
25 if fairly informal, of the controlling of prices.

26 **CHAIR:** So, you would accept that presumption, that control on
27 a, sort of, a priori basis is desirable?

28 **MR HORTON:** Yes. I think it's likely to be necessary, yes.

29 **CHAIR:** I wanted to go back to a comment you made about taking
30 the acquisition price.

31 Of course, the Government would have had some idea,

1 since it was the previous owner, whether that acquisition
2 price might have included and perhaps had built into it an
3 expected monopoly rent; would have a fair amount of
4 understanding about what different prices might mean.

5 Would that be fair to say?

6 **MR HORTON:** Yes, I think it would be fair to say that we got
7 into a problem because the Government made a bit of a mess
8 of its calculations, and they were sold with a price
9 control in place; in electricity and gas.

10 **CHAIR:** So, you weren't really concerned about extensive
11 monopoly rents being built into the acquisition price?

12 **MR HORTON:** Well, it was a badly done price control, and there
13 were monopoly rents as it happened, but they weren't
14 realised -- they appear to have not been realised by the
15 market at the time of flotation. So what happened was,
16 there was a very large share price rise after flotation,
17 and then a big argument as to what extent that subsequent
18 share price rise should be recognised.

19 **CHAIR:** So, when you faced this large increase, was that
20 increase justified by the acquisition price? In other
21 words, did the acquisition price suggest that that was an
22 efficient price if you accepted that that was an
23 appropriate price, an efficient price, for the assets of
24 the company?

25 **MR HORTON:** Well, there are very much two views on it. The
26 price that electricity, and to a lesser extent gas
27 transmission distribution services are being provided at
28 is one where, if you had some sort of replacement
29 valuation, it would be likely to be much higher. So that,
30 arguably there is over-consumption being encouraged by
31 these low prices which had been based on capital asset

1 maintenance.

2 **CHAIR:** What was the view that you had as regulator at the
3 time? What was your view as regulator about those prices
4 that were charged post-acquisition?

5 **MR HORTON:** I thought that there was a mistake made in that a
6 price control was put in place that allowed rising prices,
7 and the Government didn't get the value of that money in
8 selling the companies because it didn't -- because of the
9 worries about writing a prospectus and convincing its
10 bankers; it didn't get the value back in selling the
11 companies.

12 So, we ended up in a difficult position where --

13 **CHAIR:** So, are you telling me that you were comfortable using
14 the acquisition price because the acquisition price was
15 actually lower than what it perhaps ought to have been?

16 Is that the implication of what you're saying?

17 **MR HORTON:** Yes. I mean, there was a new system being put in
18 place and there was a sort of "greater good" argument that
19 we were introducing a competitive system, and we do not
20 want price disturbance on doing that, because the whole
21 regime would be unpopular.

22 **CHAIR:** I understand that. Do you think that's likely to be
23 the case we face when we contemplate the use of
24 acquisition price for, say, some assets a company might
25 have purchased in an environment where control has never
26 been contemplated?

27 **MR HORTON:** If it had never been contemplated -- I mean, I'd
28 be surprised if it had never been contemplated...

29 **CHAIR:** I apologise for that statement. Some people suggest
30 that's the environment here; I wouldn't want to suggest
31 it, but we do -- I always think it's an interesting

1 discussion because there may be some evidence here that
2 local firms have a different attitude about the risk of --
3 or the threat of control than foreign firms do, and they
4 look at the New Zealand environment because of their
5 familiarity with what is generally a reluctance to
6 regulate and our caution to regulate in New Zealand.

7 You will be aware that we, without any doubt, are
8 probably one of the least regulated economies in the
9 world, and I always find it interesting at these hearings
10 because we have industry coming to us and telling us we
11 have a bias towards regulation, and everywhere I go in the
12 world they're saying to me, "What is going on in
13 New Zealand", regulators such as yourself or the role you
14 had before. I just came back from the OECD and felt like
15 an island in the sea. So, I'm just...

16 **MR HORTON:** Whether there are small networks that are
17 expanding, I think there's less -- I'm thinking now of
18 Northern Ireland where the gas network is subject to much
19 less regulation than the comparatively mature gas network
20 in Britain. So, the two bits in the UK behave differently
21 in looking at their gas networks.

22 Yes, these acquisitions. I mean, clearly if, you
23 know, there's a purchase going on and there is a prospect
24 of obtaining monopoly rents, then the seller will want to
25 get a price from the buyer that reflects that.

26 I mean, it's obviously a worry, and I don't think
27 there's really any alternative than going back and looking
28 at the decision. And, if it's a public authority
29 extracting monopoly rent, and it may be for -- obviously
30 before we were talking about things like easements; the
31 fact that a public authority has got these free and has

1 then sold them to somebody else for a value that reflects
2 the cost of -- the now cost of getting a different
3 easement perhaps, the opportunity cost of the easement,
4 and who knows whether it might also have a bit of monopoly
5 rent in it; I think that, in regulating that, that that's
6 an economic value of the purchase. It would be hard to
7 say that it was an inefficient purchase.

8 So that, if one was going to say that this investment
9 should not be rewarded, there shouldn't be capital
10 financial maintenance on this investment, it would need to
11 be an inefficient investment.

12 **CHAIR:** But you agree with the general proposition that we
13 couldn't necessarily simply start with the acquisition
14 price and assume that it represented efficient investment
15 with no monopoly rents built into it, in the New Zealand
16 environment?

17 **MR HORTON:** No, I agree, yes, you'd need to look at it.

18 **CHAIR:** I'll just see if my colleagues have questions before I
19 let you return to your presentation.

20 **MS BATES:** Yes, I do have one, and it's just around your
21 proposition that there would be not necessarily an
22 incentive to reduce costs, that it might be an incentive
23 to inflate costs for the next regulatory period.

24 **MR HORTON:** Yes, or a reduced incentive to reduce costs; a
25 mixed incentive.

26 **MS BATES:** A mixed incentive. How is that really played out
27 in your experience? Are you able to tell us?

28 **MR HORTON:** What's happened is that, there have been
29 substantial reductions in costs in industries I've been
30 regulating and in industries I've been advising, but that
31 has nearly always come at the beginning of price control

1 periods, and there's then really a sort of flattening off.
2 So, you sort of wham in the cost reductions early on, and
3 then you don't do anything until the end of the price
4 control period, you keep them up.

5 The other thing you do are various performances of,
6 sort of -- I'll just choose my words more carefully than I
7 was going to -- that there is an incentive to transfer
8 costs from one bit to another bit, and obviously the
9 proportions of common costs you assign, and regulators
10 have had to almost prescribe what costs should be assigned
11 to which businesses, and there have been all sorts of
12 complications about supplies of services by other
13 companies within a group.

14 **MS BATES:** I'm familiar with the sort of issues that you're
15 talking about.

16 Just in terms of in, say, the second regulatory period
17 where you are resetting the price path maybe, how are the
18 costs taken into account by the regulator when looking at
19 the next period, in your experience?

20 **MR HORTON:** Well --

21 **MS BATES:** I just preface that we're controlling prices, not
22 returns, so I'm just trying to understand where it fits
23 in.

24 **MR HORTON:** Well, if you calculate the price for the next
25 period from the building block method, and costs are one
26 of the building blocks that you put in, and the question
27 is -- a forecast of costs -- and the question is, how you
28 derive that forecast of costs. What I'm saying is that,
29 in almost all cases that forecast of costs is in some way
30 dependent on the level of costs that were actually there
31 in the first period.

1 For instance, in the Littlechild price control
2 decisions there was an attempt to get some sort of
3 equation that said, right hand variables and the left hand
4 gives you the level of efficient costs, and as usual in
5 these things it didn't work properly, and so he took --
6 from memory, I think it was a half and half weighted
7 average of what the costs actually were and what the
8 equation said. So that, what the costs actually were had
9 a significant impact on the allowance in the next period.

10 I've just written a paper for an industry client in
11 the present Electricity Wires Price Control Review saying
12 much the same sort of thing, that you've got a great
13 uncertainty in this equation you've just estimated, and
14 you can't put full weight on the equation because of the
15 huge error there is in this equation. But, of course, if
16 you do that and you actually take the actual costs, you
17 have these unfortunate incidental properties.

18 **MS BATES:** You say the experience you had was that there was
19 some inefficiencies stripped out at the beginning?

20 **MR HORTON:** Oh, there certainly were, but it's difficult to
21 know what it was that made those inefficiencies be
22 stripped out. What we were doing was going from public
23 ownership to private ownership, and one set of people came
24 up and said --

25 **MS BATES:** We've already done that here quite some time ago,
26 so it's not quite the same situation.

27 **MR HORTON:** Quite. You could say that that's the thing that
28 strips out the inefficiencies, and the price control
29 doesn't do anything, whereas other people might say...

30 **CHAIR:** I wonder how important corporatisation is as opposed
31 to privatisation. Were the companies corporatised? We

1 went through a corporatisation process here, and there's a
2 lot of argument that that's what yielded the efficiencies
3 rather than -- I'm sure that privatisation added to it,
4 but there is always a debate about that.

5 **MR HORTON:** Some of them were corporate. By and large though
6 there were special structures there with international
7 industry boards, there were independent boards appointed
8 by the Government. But it is possible that, had there
9 been a change towards corporatisation, it would have
10 effectively given them slightly more independence and a
11 greater ability to bring about efficiency improvements.

12 **MR STEVENS:** Did they have the rigors of external financing,
13 or were the Government predominantly the bankers at that
14 stage?

15 **MR HORTON:** The Government were the bankers, they were setting
16 the external financing limit, and the money was coming
17 from the Treasury, yeah.

18 **CHAIR:** We'll let you proceed, sorry for the long
19 interruption, but it's quite helpful to us to ask
20 questions as you go. Thank you.

21 **MR HORTON:** Well, getting back to the uncertainty of the
22 building block decision for setting prices, and I've been
23 speaking about the uncertainty about what's the efficient
24 level of operating costs. There's uncertainty about
25 what's the cost of capital of course, which I'll just
26 leave to one side entirely because I know you're going to
27 talk about that a lot later.

28 I want to talk about the asset values in the
29 depreciation profiles and to talk about it both from the
30 point of view of whether one's hitting a sort of marginal
31 cost concept of allocative efficiency, and also from the

1 point of view of financial capital maintenance. There are
2 all sorts of ways that you can value assets, as you know,
3 and I just brought out five to talk about briefly here.

4 Straightforward historic cost: I mean, most company
5 accounts are historic cost accounts; they write down what
6 they paid for it and they depreciate it over time, and
7 that's how they measure their capital stocks. Sometimes
8 they revalue things, but if it's not property or something
9 like that, they often don't.

10 Then there's the thing that's used a lot in UK
11 regulation, which is, you index the historic cost value
12 for movements in some general price index. Normally a
13 Consumer Price Index because, even though it might not be
14 the appropriate price index, nobody revises it.

15 Then there's a modern equivalent asset value, where
16 you take what's there and say, well, there's this possible
17 set of things; if you bought them now, how much would it
18 cost. Then, of course, there's the ODV that we talked
19 about when I was here before, and I want to the talk about
20 two sorts of ODV valuation.

21 To go back to what's happening here, this competitor
22 coming along, that the idea of ODV is to get at some sort
23 of competitive price and so you imagine somebody coming
24 along and saying that, if this is the competitive market,
25 I could enter this market with my system using present
26 technology and looking at what the present demand is, and
27 I can provide it using this. Of course, it will be all
28 new, and then there's the question of what you would need
29 to charge for that, and of course that would depend on how
30 fast they wanted the return back; whether they thought
31 that somebody else would come along in a year or two's

1 time with another new system in this imaginary world so
2 that the value of their system would depreciate rapidly
3 because of the competitive pressures.

4 However, even if that fear is not great, they would
5 want some sort of annuity calculation on these new assets.
6 In fact, there should be very little fear. If you treated
7 them in a normal regulatory accounting way, they'd want
8 the return on the full value of the assets, the new value
9 of assets, and a year's depreciation, and gradually the
10 return they would want on those assets would go down over
11 time as the return is only on the depreciated value and
12 not on the full purchase value.

13 That brings me to the fifth method, which is
14 depreciated ODV, where you get an optimal deprival value
15 for the assets but then you say, ahh, but what's actually
16 in place there is old, so I will not take the new value, I
17 will take the one with 20 years depreciation, if what's
18 there is 20 years old, and that isn't a sustainable
19 competitive position. You can't imagine anybody being
20 able to come in with 20 year old new assets; it's an
21 inconsistent thought experiment. So, marginal cost in
22 these various things.

23 Now, historic costs are clearly not reflective of
24 marginal costs because the asset may be very old, I don't
25 know many places -- New Zealand's had several years, the
26 recent past now, of 16% inflation and that erodes asset
27 values very fast.

28 If you have an index to historic cost you're getting
29 nearer to some sort of marginal cost, but of course you're
30 missing the relative price changes. If the price of
31 whatever this is or something that provides the service

1 has changed relative to the RPI or whatever you're using,
2 then you've missed the marginal cost. And, MEA is a more
3 direct attempt to get at a marginal cost, but of course
4 there's a possibility of error in doing it and one finds -
5 - I mean, it's quite an interesting thing, as I'm sure
6 you've found, having several companies making MEA
7 estimates of similar things and you can see how you can
8 get quite a wide range of numbers in doing that and how
9 there is a subjective element in doing it.

10 I think, from the point of view of marginal cost, that
11 ODV, even though we can get it right, it's actually not a
12 concept that will produce marginal cost because an ODV
13 valuation is a sort of competitive entry valuation; it's a
14 means of getting a return to assets over time. It's not
15 actually measuring what will it cost if you need some more
16 output, because what will actually happen is that there
17 will be an expansion to the existing system; not a new ODV
18 system compared to an old ODV system. So, that, from the
19 point of view of this purpose, it's not a handy thing to
20 do because it isn't actually getting you to a marginal
21 cost.

22 On financial capital maintenance: Any of these things
23 can give you financial capital maintenance providing that
24 you apply them consistently over time. It doesn't matter
25 what means you use to depreciate an asset. If you reward
26 the depreciation and give whatever the right return on the
27 asset is to reward the cost of capital, then you will have
28 financial capital maintenance. The trouble is in knowing
29 whether you will be consistent.

30 In the report I made up some price paths for
31 straightforward historic cost and ODV under certain

1 assumptions and indexes across this area, I called it CCA.
2 You can see different pictures of different rewards over
3 long periods.

4 I think you tried heroically to get several years of
5 data to try and get round this problem, but it really is
6 only the recent past and an extrapolation. So that,
7 compared with the lives of the assets, it's quite a small
8 picture. To say, of that picture, that compared with the
9 reward that gives financial capital maintenance, this is
10 too high or too low, requires quite a lot of confidence.
11 And so, I'm back to the uncertainty theme.

12 **CHAIR:** How many years -- what situation did you find yourself
13 in as a regulator? Did you have -- how much certainty did
14 you have about -- how many years data did you have to work
15 with when you went about putting in place control? Did
16 you have longer than we have in terms of reliability data?

17 **MR HORTON:** Well, I'm -- from this point of view, I say that
18 we had it easy because we didn't have to go back. I think
19 we could have gone back, that the data existed, but it
20 would have been a long process to get it.

21 **CHAIR:** But looking forward --

22 **MR HORTON:** But, given that we were looking for financial
23 capital maintenance and we were more concerned about that
24 aspect than on the long-term price signals.

25 **CHAIR:** When you looked forward in time, did you take the
26 forecast figures that the companies put to you pretty much
27 on faith?

28 **MR HORTON:** No. No, not at all, no. They varied. Of course,
29 it involves you having lots of companies. In the first --
30 or, we were lucky with electricity, there were lots of
31 companies, and with the gas pipelines it's just the one

1 company. But the first electricity distribution forecast,
2 the unit operating cost projections for the next 5 years
3 varied between, one company a reduction in 20%, and
4 another company an increase of 30% without huge
5 differences in the environment.

6 **CHAIR:** I just want to pursue this a little bit. The theme is
7 about uncertainty and not -- I assume about being cautious
8 about what to do with, and the Commission's pretty
9 sympathetic to that sort of proposition.

10 But, if the Commission's taken an approach where we've
11 done a long list of things, and I asked the staff
12 yesterday to list them out for me, and I'll just put them
13 past you because you have put up this theme about the
14 uncertainty, and there are so many parameters that go into
15 estimating whether there have been excess returns, but let
16 me put the list to you and ask you which way you think the
17 results might be biased one way or the other; in other
18 words, we may have underestimated or overestimated or been
19 too conservative. I'll just put to you the long list of
20 ones that might suggest we've taken a conservative
21 approach.

22 We ignored revaluation gains prior to 1997. When we
23 looked at forecast and actual figures we didn't, in a
24 significant way, challenge common costs and direct costs;
25 not yet anyway. When we looked at actual figures, we
26 didn't challenge the value of ODV, we pretty much largely
27 accepted it, as well as depreciation. The value and scope
28 of other assets were unchallenged, depreciation on other
29 assets was unchallenged. Interest expense allocation for
30 tax; we're looking at that but we've taken the numbers
31 from the companies. Forecast figures revenue, including

1 possible future price increases was unchallenged, demand
2 projections unchallenged, CapEx unchallenged, direct cost
3 including maintenance and OpEx unchallenged, revaluation
4 gains looking forward for the most part were unchallenged.
5 Any work in progress that was presented to us was
6 unchallenged. Optimisation, we assumed no gold-plating or
7 imprudent investment by the companies.

8 We assumed no capital contributions by external
9 players, we adopted a long-run model, we included metering
10 that arguably is competitive and would have brought down
11 the average and masked some of the excess returns if there
12 were any in the noncompetitive part, and on top of that,
13 when we got to the finish on benefits, we discounted the
14 estimated benefits of control by 20% to account for the
15 costs of control, and in the case of allocative
16 inefficiencies, we discounted it by 36%.

17 Now WACC, I know there's a huge debate about the
18 parameters of WACC, but we did go to the 75th percentile
19 of the range that we thought would be the reasonable
20 range, and I'm sure we'll have long debates about that.

21 But I would suggest to you that a lot of the issues
22 you've raised with us about where there's uncertainty --
23 if you know, having listed them all out for you, that
24 we've taken the company's numbers, figures in most cases
25 unchallenged, would you think that the Commission's
26 approach would tend to be likely to underestimate or
27 overestimate excess returns based on that long list of
28 factors?

29 **MR HORTON:** If you took the company's figures alone and didn't
30 adjust them at all, then -- I mean, I think -- I guessed
31 that you were likely to produce an overestimate, but there

1 is a complicated incentive on the companies that you have
2 produced in doing this, so that one, I think, couldn't be
3 confident as to what it would be. I mean, if the
4 companies are attempting to demonstrate -- [pause]. No, I
5 think I wouldn't qualify that. That, if you make no
6 adjustment at all, and they thought you would make no
7 adjustment at all, then it will be likely to be an
8 overestimate.

9 On the individual points --

10 **CHAIR:** An overestimate on the excess returns?

11 **MR HORTON:** Yes. On the individual points that you've made
12 though on some of the methods, and particularly the -- but
13 I think that you have specified methods to the market -- I
14 mean, I haven't looked at the details, so I just don't
15 know.

16 Say the revaluation gains, and those are revaluation
17 gains relative to historic cost. It is unlikely, though
18 not impossible, that you would have had a pricing profile
19 that reflected historic cost. Now, one doesn't know how
20 much the companies are going to be front-loading their
21 pricing decisions. If you had 50% inflation, which of
22 course you haven't had, then you wouldn't expect the
23 pricing decision to reflect historic cost. So that, you
24 wouldn't -- [pause]. I mean, you wouldn't necessarily
25 think that the revaluation gains should be going through
26 the profit and loss account. I mean, it would depend what
27 cost of capital you were giving them; I mean, if the
28 inflation rate was fully reflected in the cost of capital,
29 then maybe you would need to add it back in, as it were,
30 as a counterbalance to the thing.

31 No, I mean, I -- if you take in all the company's

1 numbers and not changed them, then I agree you are being
2 conservative. I've only overheard of things Powerco have
3 said --

4 **CHAIR:** I guess, I wouldn't say we've taken them all; we've
5 looked at them carefully, but in the vast majority of
6 cases at this point we have accepted them. It seems to me
7 that, when you're concerned about the uncertainty around
8 these parameters and you ask yourself, well, how concerned
9 do I have to be that perhaps we're leaving the companies
10 in a position looking forward where they can't recover
11 their cost of capital?

12 I'd suggest to you that one way of managing that
13 uncertainty and minimising the risk around it, I would
14 have thought, would be to have taken largely the company's
15 numbers, and the fact that they haven't been significantly
16 second-guessed on those numbers ought to suggest that the
17 risks around some of those uncertainties have been --
18 well, the risk in one direction has been minimised, we'd
19 probably have allowed a great deal of risk if the numbers
20 might include a different kind of risk, not the kind the
21 companies are worried about, but perhaps the consumers.

22 **MR HORTON:** And if they thought the ODV value involved a
23 substantial writing down of the assets, they could have
24 just pointed that out, and I don't know whether they have.

25 **CHAIR:** Can I just ask you: This is always an interesting
26 conversation we have when we look at the costs of control,
27 and we've done a number -- a few of these studies, and
28 traditionally discounted the benefits by 20% in order to
29 build in a serious allowance for the cost of control and,
30 for example, a wide range of things.

31 In your experience, when you were putting in place a

1 control regime, did you make any adjustment of that sort
2 to acknowledge the difficulties of a control regime and
3 the limitations of it?

4 **MR HORTON:** I haven't been involved in a decision to put in
5 place a control; I've been involved in decisions to remove
6 controls, and those have involved assumptions about the
7 errors that there will be in the regulatory process. I
8 think the answer's yes, but the answer's not going to the
9 precise question.

10 **CHAIR:** It's going the other way. And, how much margin did
11 you build in for those errors?

12 **MR HORTON:** It depends very much which bit you're looking at.
13 If you're looking at a transfer value, then clearly the
14 difference in the two scenarios is between the price that
15 they're likely to charge and the price you will impose.
16 So it's -- sort of, it's not an error, because it's a
17 prediction of what you will do, and this is a prediction
18 of what you will do.

19 If you're looking at the economic efficiency gains,
20 then there's I think much more concern about -- but I
21 mean, they are small compared to the costs one knows about
22 anyway.

23 The sort of error that -- I mean, these are things
24 like supply, involved an increasing of an allowed margin
25 by something like 4%, 5% of the price so that it was --
26 but that was setting a price as a backstop, and that was
27 the decision first of all rather than to remove the
28 control entirely, you set a backstop, and the error
29 implicit in that backstop was very high. A multiple of
30 the, as it were, the variable's been considered in what
31 had previously been a price control calculation. So, it

1 wasn't something like 20%, it was a factor of 7 or 8
2 times. Probably there were circumstances that don't
3 directly apply here, but much bigger than 20%.

4 **CHAIR:** Can I just ask you: I'm curious really, of the
5 reviews you participated in looking at removing control,
6 did you in the end take the decision to remove control?

7 **MR HORTON:** Yes.

8 **CHAIR:** And which industries did you look at?

9 **MR HORTON:** I was involved in electricity, in actually doing
10 it in electricity, and was involved in discussions on gas,
11 and I have discussed later the telecommunications
12 decisions. I wasn't involved at all in actually making
13 the decision in telecommunications.

14 **CHAIR:** Has control been removed in the gas transmission
15 distribution area?

16 **MR HORTON:** Not, it hasn't been removed in transmission
17 distribution, no; only in the supply of gas.

18 **CHAIR:** Have they done the analysis that we've just been
19 talking about, to look at whether there would be net
20 benefits in removing control? Has that work been done in
21 the UK?

22 **MR HORTON:** No, it hasn't, and the only work has been about
23 removing at the margins, things like connections, metres,
24 that sort of thing.

25 **CHAIR:** Okay, thank you. I'll just see if any of my
26 colleagues have anything at this point.

27 **MR STEVENS:** I just really wanted to follow-up on an earlier
28 comment, and probably a comment from one of slides which
29 the others haven't had the benefit of seeing given
30 technology issues.

31 But, in one of your bulletpoints there you mention the

1 method of asset valuation presupposes a profit history
2 that may not be true, and more so if recent purchase
3 values are ignored.

4 I just wanted to explore that in light of your earlier
5 comment that there is a possible problem of building
6 expected monopoly rents into that value, and I guess that
7 is a concern of this whole inquiry per se, and really to
8 say, wouldn't you see the value more likely to reflect the
9 forward revenue and expenditure than past depreciation
10 practices?

11 **MR HORTON:** I think yes, but it ignores the purchase value.
12 The example we were talking about was where, maybe the
13 previous owner had got whatever it was free, and now he's
14 now selling it at something that reflects its value, and
15 that value may be an opportunity cost in an ODV sense of
16 replacing it with something else, getting a different
17 easement, or indeed the monopoly rent; it should be the
18 smaller of these things.

19 **MR STEVENS:** So, which --

20 **MR HORTON:** And that's what you would pay. So that, if you
21 can provide the service more cheaply than -- then you
22 would wish to value in a way that reflected your cost in
23 doing that.

24 Now, if you thought there were monopoly rents
25 available from the whole business, and that, unless you've
26 got -- unless you just bought a legal monopoly, and you
27 couldn't extract these monopoly rents, then you might get
28 an inflation; but there is going to be a cost basis for
29 the thing as well as the future revenue basis.

30 So that, I mean, if you thought there was an ODV way
31 of doing this, you could implicitly in the negotiations

1 threaten ODV value.

2 **MR STEVENS:** So, how would you propose -- with your experience
3 as a regulator, how would you deal with the possibility of
4 the built-in monopoly rent to the acquisition price?

5 **MR HORTON:** I think you would have to examine the acquisition.

6 **MR STEVENS:** So, in each one of those cases, it suggests that
7 we would need to examine the acquisition price, and on
8 what basis would that examination be conducted? [**Pause**].

9 I guess I'm trying to explore if you have a better
10 methodology.

11 **MR HORTON:** I see. I think that there's a problem if the
12 acquisition has been, sort of, decomposed so that there
13 are some things that are based on the value of the
14 acquisition and some things that are not.

15 If a business has been bought for a price that
16 reflects a value of the assets implied that is not
17 implausible, and I think it is reasonable to ask the
18 people who paid it why they thought that was a reasonable
19 price for the assets involved, rather than having to sit
20 down one's self and say, scratch my head and how can I get
21 the number up to that. It's up to them to justify, but
22 there might be all sorts of reasons or justifications for
23 what was paid.

24 **MR STEVENS:** I guess, responding to that question that we
25 posed to them, they may have certain conflicts of interest
26 in how they respond?

27 **MR HORTON:** Yes, but they do in every question you ask them.
28 There's an incentive on the -- I mean, I'm sure they're
29 completely honest in doing it anyway, but the fact there
30 is an incentive is bound to effect the response, as it
31 does with any regulated company.

1 **MR STEVENS:** I guess I'm still having a difficulty why we
2 would look at something which we acknowledge may have
3 built-in monopoly rents in the value, vis-a-vis an ODV
4 methodology, and why you see that the ODV possibly may
5 have built-in monopoly rents?

6 **MR HORTON:** I didn't understand the last bit.

7 **MR STEVENS:** You're suggesting, I presume in your presentation
8 to us, that we should more look at the acquisition price
9 paid by the company and see that as the value we should be
10 bringing the assets in at, as opposed to the current
11 methodology that we're using, and I'm trying to understand
12 why that would be better than the other.

13 **MR HORTON:** As I understand it, you're not using the ODV value
14 on everything.

15 **MR STEVENS:** No, not on everything.

16 **MR HORTON:** That you have a mixed approach.

17 I think that there is a problem, particularly with the
18 historic cost approach, and if you're using historic cost
19 of assets you would be unlikely to get something that
20 mimics a normal pricing decision.

21 If you look at historic cost returns to quoted
22 companies, and they're normally much higher than the sort
23 of numbers we're talking about with WACC, and historic
24 cost depreciation profile normally involves far more
25 front-loading of returns, and so that you would implicitly
26 be assuming that much more of the financial capital has
27 been recorded than is the case here.

28 Whether ODV works depends how one does it and what the
29 history is, you know, whether there has been a big fall.
30 I mean, if you did ODV in telecommunications, then one
31 might expect a problem, but probably less so here, I don't

1 know.

2 **MR STEVENS:** We're not using a pure historic cost basis though
3 in our methodology.

4 **MR HORTON:** Yes. You're doing something that is -- I mean, I
5 think closer to an MEA valuation than an ODV valuation of
6 the -- I mean, because you're not reconfiguring. I think
7 what we said last time; I mean, you're not replanning the
8 network.

9 **MR STEVENS:** No.

10 **MR HORTON:** It is ODV in the sense of getting an MEA value for
11 a set of equipment at a given site rather than for
12 individual pieces, so that it's a sort of cross between
13 MEA and ODV.

14 But, to say that that number gives you an answer with
15 a degree of accuracy, and within 5% really on the final
16 price, is difficult. I mean, I think -- I know the
17 Chairman's questions earlier I think are implicitly
18 saying -- I mean, surely there was a presumption that you
19 control a monopoly, and I think in the administrations
20 I've worked in, yes, there is a presumption of a monopoly.
21 The worry is, of course, what one considers the right
22 price to do that at, and there's a financial capital
23 maintenance problem in doing that.

24 Given that that's the problem, the price that you
25 assume you would bring in as a control, and which error do
26 you want to avoid most? Do you want to avoid the whole
27 financial capital maintenance error most, or do you want
28 to avoid the charging customers too much error most, means
29 that when you're imagining bringing in a control do you
30 pitch it, or where do you pitch it in the uncertainty
31 spectrum? And the Chairman was saying, we can pitch it

1 quite high, and what I am saying is, I suppose, are you
2 sure?

3 **CHAIR:** I don't know if you've got through your presentation,
4 but we'll let you --

5 **MS BATES:** I did have a question. Maybe I'll leave it to the
6 end actually.

7 **MR HORTON:** We've covered a lot of what I was going to say,
8 but I think I got to talking about asset values and
9 financial capital maintenance. As we were saying just
10 now, that a pure historic cost approach involves a lot of
11 front-loading, particularly if there's significant
12 inflation, and one wouldn't expect that that would
13 normally mimic pricing decisions.

14 If you index it by some sort of price index, then you
15 then impose an inflation path. Where there are
16 established regimes of control, the path that is imposed
17 and the depreciation that is imposed, can be done, as it
18 were, just to fiddle the final prices. Because of the
19 financial capital maintenance decisions that were taken at
20 the time of electricity privatisation, and because that
21 price was low relative to the long-run price, there was
22 quite a high depreciation of the vesting assets; they were
23 depreciating fast. There's now accelerated depreciation
24 of the investment that took place during the 1990s to keep
25 up the control price because of the worry that this is a
26 dip before lots of the system needs replacing and the
27 price would then rise.

28 So, I mean, I think that's a particularly blatant
29 example of a regulatory decision to move the depreciation
30 profile to produce the right result, but it's one -- it's
31 easier to do, as I say, it's a much easier job that we had

1 to do once you have got the various parameters that you
2 would need to preserve financial capital maintenance, even
3 if some people disagree on what that would be.

4 On the ODV path, I think -- oh, there was something I
5 should have said in the question before: That using
6 depreciated ODV, I think, is cheating. But it may still
7 be the case that the ODV values actually being used are
8 high enough to preserve financial capital maintenance. I
9 mean, if there was some advance, then using the new value
10 and depreciating it for the fact that it's 20 years old
11 would not produce the thought experiment that I think
12 one's after, but it might or might not produce financial
13 capital maintenance, and I think it's very much up to the
14 companies to tell you if it doesn't. So, I don't know
15 whether they are or not, but I think it's sort of their
16 job to say that this value doesn't give us financial
17 capital maintenance if that's the case.

18 Given all the other uncertainties, the only other
19 thing I was going to add is that -- there are lots of
20 possible values for all these parameters, some
21 illustration of the spread, the possible spread, and even
22 a Monte Carlo analysis, just because there are so many
23 possible numbers, to illustrate the range of uncertainty,
24 and that's was all I was going to say.

25 **CHAIR:** Thank you for that, Mr Horton. I just turn to
26 Commissioner Bates, please.

27 **MS BATES:** I just want to understand your position in summary,
28 so this is why I'm asking you this series of questions,
29 just so I have your position in my mind.

30 You've put a lot of emphasis on uncertainty, and in a
31 position where it's uncertain you have, I think you would

1 agree, balancing up of the risk of regulating against the
2 risk of not regulating.

3 Now, the risk of regulating, you would see as what, a
4 lack of investment?

5 **MR HORTON:** Yes.

6 **MS BATES:** Is that the primary risk?

7 **MR HORTON:** Yes.

8 **MS BATES:** And is there any other risk we ought to be aware
9 of?

10 **MR HORTON:** I think there will be some risk on productive
11 efficiency, but the risk of investment's a big one.

12 **MS BATES:** Yeah, that's the two I've got on my list.

13 **MR HORTON:** And other regulatory costs. I mean, it's not so
14 much a risk, it's a thing one brings in.

15 **MS BATES:** And then, look at the other side, the risk of not
16 regulating; that's monopoly rents presumably?

17 **MR HORTON:** Yes, that's right. I mean, the risk of not
18 regulating in economic welfare terms are small because of
19 these low elasticities, so that, it seems pretty likely
20 that regulation is going to reduce overall economic
21 welfare. However, it's who it goes to that it is likely
22 to change.

23 **MS BATES:** But the risk is monopoly rents?

24 **MR HORTON:** Yes, that's right. The risk is customers paying
25 too much to the providers, yes.

26 **MS BATES:** In our particular circumstances, are you saying you
27 don't assess that risk as being very great?

28 **MR HORTON:** It is restrained by the extent to which there is
29 certain competition, and by the fact that, sort of, the
30 industry's a bit small in many places and it is
31 establishing a market. I mean, there clearly is a risk;

1 it is something in which competition is very difficult.

2 **MS BATES:** Yes, it's just, you agree with the presumption
3 that --

4 **MR HORTON:** I agree with the presumption. There is -- their
5 degree of market power is not as great as in some places,
6 and they're worried about the threat of regulation, I
7 presume, so that, there are factors restraining the extent
8 to which they would be wishing to use that.

9 **MS BATES:** I just want to see what you think of this
10 situation. You agree that it's a presumption, you agree
11 that it's a weighing up of risks; what is your
12 professional view of the situation? Do you think that
13 control is not necessary and desirable in this particular
14 circumstance?

15 **MR HORTON:** I haven't been through the numbers in remotely the
16 sort of detail that is associated to give a proper
17 opinion. My expectation on, sort of, what I would expect
18 to see coming into a situation like this is that, there
19 will be likely to be a degree of monopoly rent, and so
20 that, yes, I think there is a probability that there will
21 be a degree of monopoly rent.

22 I would also think that there is a danger, if control
23 is introduced, that it would be at a level that might more
24 than remove that. So that, I think that there's an
25 expectation that there's a degree of monopoly rent, and
26 it's possible that a direction of control could just
27 remove that and produce a net benefit. I'm not sure I
28 would say it's likely that that's the case.

29 **MS BATES:** Do you think much turns on the form of control?

30 **MR HORTON:** Yes. But I mean, it's -- I find it difficult to
31 imagine what it would be other than some form of price

1 control.

2 **MS BATES:** So, I'm still not clear whether you would or
3 wouldn't control in this situation. Is it fair to say
4 that you haven't looked at the detail -- you haven't done
5 a sufficient amount of work on the detail to be able to
6 give us a definitive view on it?

7 **MR HORTON:** Yes, that's absolutely right, but also I think
8 that I'm more worried about the level at which a control
9 would be introduced than whether this is one at all.

10 **MS BATES:** Yes, so that was coming on to my next question. So
11 I think that, if say you thought maybe you should control
12 in this situation, really your focus is really on how
13 conservative or otherwise the control is?

14 **MR HORTON:** Yes.

15 **MS BATES:** The numbers which are adopted --

16 **MR HORTON:** I'm more worried about that. As I say, I think
17 it's hard to argue that, in something where there is
18 clearly limited competition, one should definitely not
19 have control. I mean, there is clearly a risk of monopoly
20 rent. Whether there is -- or, how big it is, I don't
21 know.

22 **MS BATES:** One of the key inputs is what you choose for your
23 asset valuation, that's what we've been talking about, and
24 I just want to try and clarify what I think the position
25 might be on that because I'm not sure, when Commissioner
26 Stevens was asking you about, well, what do you actually
27 do if you think that the acquisition price includes a
28 component for monopoly rents; you said, well then, you
29 would look -- you'd scrutinise or carefully look at the
30 acquisition itself.

31 **MR HORTON:** Yes. I mean, I think you'd need to ask -- I mean,

1 if you find that you have looked at the asset valuation,
2 preferably several ways round, and you find that they have
3 paid a sum of money which is very different from that,
4 then obviously you ask them why, and how is your asset
5 valuation so different from ours. If you are not going to
6 reward them on that, then clearly they are not going to
7 have financial capital maintenance. So that, there is an
8 important incentive --

9 **MS BATES:** I'm not clear on the -- the point you're making is
10 what?

11 **MR HORTON:** If you are not going to reward them for what they
12 paid for the assets, they do not have financial capital
13 maintenance, and you are saying that is an inefficient
14 investment that they have made.

15 **MS BATES:** Yes, if it included the monopoly rent component, it
16 may well be.

17 **MR HORTON:** But then I think the onus of proof shifts
18 slightly; that, if you are saying that is an inefficient
19 investment we will not reward it, then you're clearly
20 running the risk of there being an incentive effect on
21 investors unless you put forward convincing reasons why
22 you think it was an inefficient investment. Obviously the
23 main one is, you say, there are monopoly rents and they
24 have brought forward these arguments for why this asset
25 valuation is justified, and we think they are rubbish for
26 this, this and this reason; but I think you have to look
27 at it.

28 **MS BATES:** Just assume that you did look at it and you found
29 that the asset values were accepted as put out in the
30 accounts, in the deal, in the acquisition deal, and that
31 it was really -- you really came to the conclusion that it

1 was based on the income stream, as many business
2 valuations are of course based on the income stream. Say
3 you looked at the acquisition and you couldn't get any
4 help on the asset valuation question because, simply, the
5 buyer accepted the values as put out in the accounts and
6 it was in fact the income stream that was generating the
7 purchase price. Then what would you do?

8 **MR HORTON:** Well, I think that the accounts that they issued
9 at the time, they may not have apportioned the value of
10 the business accurately assuming various assets. I mean,
11 companies often buy businesses and just maintain the
12 historic cost values --

13 **MS BATES:** Yes, of course they do.

14 **MR HORTON:** -- for tangible assets, and they just stick the
15 rest in goodwill or something like that. And, a company
16 might quite reasonably turn around and say, well, okay, if
17 you want us to do this properly then we can explain how
18 these assets should have been valued at that time to
19 apportion all the bits properly. We didn't actually do
20 that in the accounts we put out then.

21 **MS BATES:** But if it was a purchase that was driven by the
22 returns, and no particular thought was given to the asset
23 value, and you come along as a regulator and you are
24 looking into this deal and you are trying to decide, as we
25 are, what value to assign, then my question to you is,
26 which method would you choose?

27 **MR HORTON:** Well, I would be very cautious about saying that I
28 am now going to give a company investing in the business
29 less than its cost of capital, which is what you would be
30 doing, and you would say -- because it had made an
31 imprudent investment, and I would think that I would need

1 to establish that to some extent. I mean, --

2 **MS BATES:** Just assume you had established it.

3 **MR HORTON:** If I thought that the purchase could not be
4 justified from a reasonable expectation of a standard
5 industry price -- and, I mean, that might include some
6 assumption that you could increase efficiency beyond the
7 industry norm; you know, companies involved in takeovers
8 normally think they can strip out costs to a big extent;
9 one would have to allow for that. One would have to allow
10 for other valuations of the assets, and we spoke about
11 easements.

12 **MS BATES:** But just in general terms, you've outlined the
13 methods that you can choose, and I'm trying --

14 **MR HORTON:** It would be certainly possible for one to reach
15 the decision, yes.

16 **MS BATES:** I'm trying to understand which of those
17 possibilities that -- and you've had regulatory
18 experience -- which of those possibilities would you think
19 was the most likely or the best to go with?

20 **MR HORTON:** "The best". I mean, I've known access prices be
21 paid where there was an expectation of what a regulatory
22 regime would produce. It would be easier though because
23 the regulatory regime has been in place with an
24 established methodology. And, prices have been paid that
25 assumed there was going to be more borrowed.

26 What the assumptions would have been here, I mean, I'm
27 just not knowledgeable enough to say. I mean, if they
28 really thought they could get away with it when they
29 bought it, and if there was a climate then that suggested
30 that, you know, well look, this is a good monopoly area,
31 the regulator is going to do nothing, we can milk this;

1 then, yes, there may well have been a monopoly rent
2 element in the price. But it's something I don't know; I
3 can't say.

4 **MS BATES:** I'm not asking you as to whether there has or
5 hasn't been, I'm just given you a theoretical situation,
6 you don't have to answer it if you feel you can't. But,
7 if I give you a theoretical situation where the regulator
8 investigates the acquisition and comes to the valid view
9 that the price is based on a monopoly rent, then what does
10 the regulator do? Has to establish a method of valuing
11 the assets, and I'm asking you, of the possibilities,
12 which would you think was the best to go with? It's a
13 theoretical question.

14 **MR HORTON:** [Pause]. I'm pausing because I'm thinking what
15 method one would have used in saying that the future
16 revenues were over-rewarding the assets in place; that one
17 would implicitly be saying that the reward that has been
18 paid to those assets already is sufficient.

19 I suppose that some sort of MEA value at the time
20 would be the way to look at it, but I'm -- it's top-of-
21 the-head, I'm not hugely confident in that answer.

22 **MS BATES:** I understand that. Just to take this one more
23 step, and that's the question of consistency over -- if
24 you are a regulator and you want to bring in a system, I
25 think consistency over the companies is something you're
26 probably trying to achieve.

27 This is theoretically again; say you're faced with a
28 number of companies, and you're saying, well okay, we'll
29 take the acquisition value in every case as being the
30 right value to go forward with, and in some cases that
31 acquisition price had a monopoly rent component in it and

1 in some cases it didn't.

2 Wouldn't that present the regulator with a bit of a
3 problem? Doesn't that mean there's an unfair situation?

4 **MR HORTON:** Yes, although, I mean, when I was a regulator I --
5 unfairness is not always the worst one worries about; I
6 keep saying to my children "life's unfair".

7 I think that one needs to be careful about the
8 consistency between companies argument. I mean, there may
9 be situations where companies have adopted different
10 profiles for rewarding the assets because that is the
11 commercial reality. I mean, in some area where one needs
12 to expand the system, you may be looking for rewards later
13 on to get the payback for that, whereas a mature system
14 would be having the rewards in the earlier periods.

15 So that, the proportion of reward to the assets that
16 is coming in the years you're looking at here, so the end
17 of the 90s and the early 2000s, may be different for
18 different companies, so that using the same system for
19 them all may not give you the right answer.

20 **MS BATES:** I take your point about unfairness, and it might
21 have been a not particularly correct word to use.

22 I think the more important point is, if you adopted an
23 asset value which has a significant monopoly rent
24 component in it, then you're simply perpetuating that for
25 the future, and I think that's more the problem, isn't it;
26 perpetuating the monopoly rent aspect so that the
27 acquirers are stuck with paying more than they ought to
28 be?

29 **MR HORTON:** Yes, and from the point of view of the future as
30 well, that you are giving a signal that such monopoly
31 rents would not be tolerated in the future and, therefore,

1 reducing the probability of them being in purchase values.
2 The people who were selling the assets would not be able
3 to extract them so easily from companies in the future.

4 **MS BATES:** Yeah, but the problem with monopolies though is
5 that, the lack of competition means that these things
6 don't get competed away; you're stuck with them.

7 **MR HORTON:** [**Pause**]. Yes. I mean, there are -- if one's --
8 the sort of Chicago or Austrian schools -- and if you
9 don't say that in the long run, we're all dead -- that
10 competition does work in the longer term, and I mentioned
11 right at the beginning, there are quite substitution
12 elasticities between fuels; there are in the long-term.
13 So that -- I mean, if you thought monopoly rents were
14 there, you'd really be thinking of getting them out quite
15 quickly, I think.

16 **MS BATES:** Yes. Thank you very much.

17 **CHAIR:** I just want to pursue one question.

18 If I recall correctly, when you regulated the lines
19 companies in the UK, in the initial period there were very
20 sizeable P0 adjustments that were taken, in excess of 1%
21 if I recall; well in excess.

22 Is that correct?

23 **MR HORTON:** Yes, it's somewhere on here, if I can get this to
24 work, yes. But, yes, there were -- I think there were in
25 excess of 20%.

26 **CHAIR:** Yes, that's my recollection, and I just wonder, given
27 the view you've expressed about being very cautious about
28 doing precisely what you did in the UK, which was take a
29 20% P0 adjustment which is, I'd have to say, we had some
30 interesting debates with some of your former colleagues on
31 this point. Because, as you know, with our electricity

1 regime we put in a glide path over 5 years and took no P0
2 adjustment in the threshold regime, probably because of
3 some of the concerns you've expressed today.

4 What analysis did you do, and how did you go about it,
5 to reconcile your concern about not compensating companies
6 adequately and still come up with a 20% P0 adjustment in
7 that case? I mean, you must have done some analysis of
8 their returns and came to a clear view, a very clear view
9 that they were pricing well in excess of what was
10 justified from a price efficiency perspective.

11 So, what did you do? Did you do some MEA analysis? I
12 know you did a full building block analysis, but what
13 methodology did you use?

14 **MR HORTON:** Well, it's mainly a building block analysis with a
15 financial capital maintenance principle for the asset
16 values. The main thing that had happened was that there
17 had been very large reductions in operating costs, and
18 that the original price control had been -- and the lowest
19 was RPI plus 0, and then we went to RPI plus 2.5, so that
20 there had been for some companies 12.5% price rises.
21 Plus, another slightly bizarre error to do with the RPI
22 forecast, where an assumption had been put in first of all
23 that there is there was an RPI increase of 6%, whereas
24 what in fact happened that October was 11.9%, i.e. Almost
25 6% higher. So that, there was this -- for some companies
26 2.5% times 5 is 12.5% plus that 6% that had gone in there
27 inflating prices in the price control they were sold with.
28 Obviously, when the Government was selling, it had -- it
29 didn't want to appear too tough. It was selling, and it
30 was selling an industry that had just been re-organised,
31 with a pooling system that many people thought was

1 ridiculous, and so, it was being very cautious.

2 But it meant that in some cases there was almost 20%
3 of padding through the -- I mean, straightforward errors
4 in the original price control they were sold with, plus
5 they had been cutting out costs at 6%, 7% a year during
6 this period. Plus, in many cases that the investment they
7 had undertaken was quite low so that the asset base had
8 not moved forward that much. And that doing the sums just
9 came out with very low numbers.

10 Now, there was a response to that where a company
11 said, well look, our shares have been trading. Well, we
12 tried to work out what was behind these original price
13 controls, and so that people who have bought shares on the
14 assumption that it won't be financial capital maintenance,
15 it will be some other valuation of these assets, which is
16 higher, and people have bought the shares on that basis.
17 So that, I mean, maybe it is analogous to some of the
18 problems you face, and where we needed to consider what
19 had been said and whether the expectations of people
20 buying shares in those circumstances were reasonable
21 expectations.

22 **CHAIR:** But nevertheless, despite your acknowledgment that you
23 sort of have asymmetric risk; if you get it wrong, you
24 still felt justified to put in a 20% plus P0 adjustment.
25 So, even if you accept all of these uncertainties, the
26 analysis may lead you to a conclusion that, even given all
27 of that in some certain circumstances, you may feel --

28 **MR HORTON:** Yes. Stephen reopened it and did a second go at
29 it, and I was there helping him, but I think there is an
30 argument that we overdid that.

31 **CHAIR:** Okay, thank you. I'll just turn to Dr Lally.

1 **DR LALLY:** Yes, a few questions, Mr Horton.

2 If I can take you to page 11 of your submission, it's
3 about the middle of the page, and there's a sentence there
4 which says:

5 "Use of the transfer value was also necessary to
6 maintain the financial capital of the purchasing
7 shareholders."

8 You've talked a fair bit about that and I don't want
9 to pursue that. It's the sentence that comes after it
10 that I'm interested in, and it says:

11 "If that is not done -- i.e. You don't maintain the
12 financial capital of the purchasing shareholders -- it may
13 result in a subsequent increase in the industry's cost of
14 capital."

15 Now, I'm struggling to see how that would happen,
16 particularly within the context of the capital asset
17 pricing model technology that's been used here for
18 assessing WACC.

19 Can you help me out here?

20 **MR HORTON:** I think it's less complex than -- all I'm just
21 saying is, they would add some things for pessimism bias.

22 **DR LALLY:** They, being the firm? The regulated entity?

23 **MR HORTON:** Yes, it's the cost of capital in assessing any
24 decision rather than the return required by -- I think
25 you're probably picking up slightly loose use of language.
26 That, I don't mean that the amount they will have to pay
27 investors will be increased. I mean that the cost of
28 capital that would be applied in looking at projects will
29 be higher because they will put in something for pessimism
30 bias.

31 **DR LALLY:** That clarifies it nicely, thanks.

1 Just turn over the page. You present some numbers
2 here from the regulatory situation in the UK and compare
3 them to the WACC numbers that are being talked about here
4 by the Commission. In one of these cases, after
5 correcting for differences in the WACC model that's being
6 used -- and it seems to me that's been done properly -- in
7 one of these cases the UK number's lower and in another
8 case it's higher. So, it kind of looks like the UK
9 numbers are broadly comparable with the sort of numbers
10 that the Commission's talking about here.

11 However, you go on to say that there's two differences
12 between the UK situation, which is a price control
13 situation and the New Zealand situation, which is just
14 simply looking at whether control should be put in place.

15 The first difference, you will note, is that of course
16 the UK situation is the price control one, the New Zealand
17 one isn't, and you go on to say that it has been argued
18 that the former point warrants the use of a higher WACC in
19 New Zealand because the question is one that should be
20 settled beyond a level of reasonable doubt rather than a
21 search for a single best estimate. Now, clearly, in a
22 price control situation you do have a single best estimate
23 and that gives rise to the price that's allowed, whereas
24 you're not doing that in the New Zealand situation.

25 However, when you come up with this single best
26 estimate in a price control situation you are presumably
27 conscious of the possibility that you might make a
28 mistake, and I think you've alluded to the asymmetrical
29 nature of the errors; that if you allow a price that's too
30 high, there's a bit of damage to consumers, but if the
31 price isn't high enough the damage to the regulated firms

1 in terms of dynamic inefficiencies could be very very
2 severe.

3 Now, given those asymmetrical errors, in a price
4 control situation when you grant the single best estimate,
5 wouldn't you be inclined to put it on the high side rather
6 than the low because of the asymmetrical nature of those
7 errors?

8 **MR HORTON:** And in most cases they have done that in these. I
9 mean, they have done it essentially building up a range,
10 high, medium and low. I think it's probably fair to say,
11 although I'm not sure they'd agree, that at the low end
12 they have put some really low numbers in, and the range
13 does look quite a long way down, but they have all been
14 choosing somewhere towards the high end of the range.

15 It strikes me -- I mean, I've done this sort of thing
16 as a regulator, I don't have your experience of it, but
17 when I do it, it always seems to be horrific that the
18 range of numbers one's considering is so vast and that you
19 could put in numbers that are perhaps not the ones you
20 believe, but aren't ludicrous, and get such radically
21 different answers.

22 When I started doing it, and I went to a transmission
23 company, we were sitting down first of all and I produced
24 a set of numbers and knew we were going to have an
25 argument, and I produced a set of numbers with a real
26 number of 5, and theirs was 11.9, and neither of us was
27 talking complete and utter rubbish.

28 **DR LALLY:** But, bearing in mind this point here, that in a
29 price control situation you are concerned, very concerned
30 about the possibility that you come up with a single best
31 number that's too low, you might be inclined to push it up

1 in the range. Would you think that in a price control
2 situation the consequences of getting it wrong are even
3 more severe than in the present situation contemplated
4 here in New Zealand?

5 And, if the consequences of getting it wrong are even
6 more severe in the UK price control situation, you might
7 be even more inclined to push the numbers up than you
8 would in New Zealand, which is quite the opposite of what
9 you're suggesting here?

10 **MR HORTON:** I think that I would say that, because in the
11 price control situation you've got a better handle on the
12 financial capital maintenance position, the danger from
13 that side of --

14 **DR LALLY:** I'm just focussing on WACC.

15 **MR HORTON:** Yes, but the danger of a company being under-
16 rewarded is greater if there is uncertainty about the
17 other items as opposed to WACC and, therefore, you may
18 need to push the WACC up above your -- what the number you
19 might have first thought of by more if there's more
20 uncertainty about everything else, and that was the reason
21 I said that about this.

22 **DR LALLY:** Okay, that's helpful.

23 So, in the New Zealand situation you might push the
24 WACC up to compensate for possible errors in the asset
25 valuation area?

26 **MR HORTON:** Yes.

27 **DR LALLY:** Okay. Okay, thanks for that.

28 One further question: The second of these differences
29 that you refer to between the New Zealand and UK
30 situations, this is your second bulletpoint on page 12, is
31 that:

1 "Pricing decisions in New Zealand have been made by
2 companies in the absence of a system of control whereas
3 those in the UK are on average dictated by a regulatory
4 system."

5 You suggest, as a result of that, that the WACC number
6 in the New Zealand situation would therefore need to be
7 higher, as you put it, "because of greater risk in an
8 unregulated system".

9 **MR HORTON:** Well, I am sort of hedging what I'm saying. The
10 text says "it has been argued that", and what I was then
11 saying is, well in fact, you can do a Monte Carlo or
12 something and illustrate this uncertainty rather than
13 bumping the WACC up.

14 What I was thinking of, and the argument that I was
15 considering being made rather than very definitely saying
16 myself, was that there's an existing regulatory system and
17 it's got a way of doing things that's established, so
18 there's less uncertainty about what the regulatory
19 system's going to do in the future.

20 **DR LALLY:** That's fine. I just wanted to pursue a point with
21 you.

22 You seem to be suggesting here that there is the
23 unregulated situation and the regulated situation, and
24 because you don't differentiate between possible
25 regulatory situations you seem to be suggesting that all
26 regulatory situation belong in the same box.

27 If you take the US system in which the regulatory
28 cycle is about a year, versus the UK system where the
29 regulatory cycle is 5 years; do you think that difference
30 in cycle would make a material difference to the WACC
31 figure that would be appropriate in those two situations?

1 **MR HORTON:** Yes.

2 **DR LALLY:** The reason why I'm asking you that is, in my WACC
3 paper my judgment is that the unregulated situation, as
4 you put it in New Zealand, is somewhere between those two
5 extreme regulatory situations. So, when you say "the lack
6 of regulation would justify a higher WACC", the question
7 becomes, which regulatory benchmark are you referring to;
8 is it the US regulatory situation or is it the UK
9 regulatory situation?

10 **MR HORTON:** And the US -- I mean, by the time you've, as it
11 were, got things done the US time horizon's a bit longer
12 than that really, so there's less difference between the
13 US and the UK than one might think at first sight. But
14 yes, I mean, the longer you let the thing run on, the more
15 there can be impacts on the return that's achieved, and it
16 might correlate with the market as a whole and increase
17 the beta.

18 [Pause]. I was thinking, in the New Zealand system,
19 of there sort of being a lack of a regulatory guarantee
20 and that, you know, you're out there with the wolves and,
21 if it goes bad, it goes bad. So that, I was thinking of
22 New Zealand being beyond the UK rather than in the middle.

23 **DR LALLY:** Okay, that's fine; it's just a clarification.

24 Just one final point. In the last paragraph on that
25 page 12 you talk about, amongst other things, stranding
26 issues. You say there:

27 "While it may be true that a regulatory system can
28 deal with these stranding type shocks by adjusting when
29 they occur, the pricing that is being assessed is that of
30 a company which is setting prices knowing that such
31 adjustments would be difficult and so is likely to make an

1 ex ante adjustment to deal with them. If these shocks had
2 not been present in the recent past the recorded return
3 may appear excessive."

4 Now, those couple of sentences are preceded in that
5 paragraph by something of a suggestion that this view you
6 are expressing is rather different to the view that I have
7 expressed, but in fact, if you were to go to pages 55 and
8 56 of my report what you have said there is almost
9 identical to what I have said, so there doesn't seem to be
10 any discrepancy between us in that area, and yet you're
11 suggesting that there is.

12 **MR HORTON:** Sorry, I'll check that. If that's the case, I
13 apologise.

14 **DR LALLY:** Okay. Thanks very much.

15 **MS BEGG:** I just had a question of clarification; this is on
16 the thought experiment you talked about with ODV and MEA.
17 It wasn't clear to me whether you were suggesting that the
18 MEA should be the undepreciated MEA. Is that what you're
19 suggesting, that the prices should be set on that basis?
20 This is on page 10.

21 **MR HORTON:** I think, if one's using MEA, one's trying to do
22 something slightly different from using ODV, and in MEA
23 it's not a particular thought experiment, you might be
24 trying to get nearer to the marginal cost and so instead
25 of upping by the RPI, why on earth use the RPI, you're
26 trying to get something nearer to a price index that
27 applies to that particular type of thing. When you're
28 doing that, you just have to make sure that your
29 depreciation profile matches the fact that you're using a
30 different means of adjusting the value of the asset.

31 ODV is, I think, different because it is a complete

1 thought experiment based on the idea of a competitor
2 coming in, and it's an attempt to move the price charged
3 as if to mimic a competitive industry, and it's not
4 mirroring what would actually happen, it's trying to bring
5 in a difficult quasi-competitive pressure.

6 **MS BEGG:** So, you are not proposing to use the undepreciated
7 MEA standard for assessing returns?

8 **MR HORTON:** Well, I think you need to look at a variety of
9 asset measures because you don't know what is implicit
10 behind the prices, and the problem with using any
11 particular value is -- well, you'd get the snapshot and,
12 as the report says, it might not be consistent with what's
13 actually been going on.

14 The thing that Dr Lally quoted just now is that, if
15 you have an ODV value or an MEA value and you ex ante sort
16 of say, well, we've got this asset in the base, I'm going
17 to set my prices and assume a return like this which has
18 got some sort of smooth path for its depreciation, and
19 then low and behold a couple of years later something
20 dramatic happens and all my customers disappear in that
21 bit, or there's a great technical breakthrough where the
22 price of copper plummets and I don't actually adjust my
23 prices in that year for these things, but if the assets
24 are being valued on that basis there will be a big bumpf
25 down in the asset value, but the smooth profile that's
26 there will look as if it's very high return on the asset
27 value that's there, and that's the worry I was pointing
28 out.

29 **MS BEGG:** Just one other question which is on productive
30 efficiency and how control might induce productive
31 efficiency. I think one mechanism that's proposed is that

1 a declining price path puts pressure on revenues of the
2 regulated companies, and perhaps it proposes an asymmetry
3 between concerns about maximising the revenues that they
4 have incentives to do when they're not controlled, and a
5 concern that they might be forced into a position of loss
6 and that, by facing this price path, they have incentives
7 because they're being squeezed on the revenue side to also
8 try and achieve cost savings.

9 Now, I know in an unregulated scenario shareholders
10 and directors can achieve some of this pressure through,
11 you know, requiring the company to have debt or to make
12 dividend payouts. I just wondered whether you had any
13 views on whether this squeezing of revenues through a
14 price path, whether it can achieve some pressure that
15 wouldn't have been there in an unregulated scenario?

16 **MR HORTON:** Yes, I mentioned that argument at the beginning,
17 but I think I remember that I failed to say whether I
18 agreed with it or not. I think I said that there's
19 something in it, and I think that's right. If you put in
20 a path, which often -- I mean, you've often published the
21 building blocks so you've actually published the costs
22 that you think can be achieved for the individual company,
23 and I think that probably does change the incentive to
24 match those costs, which might mean not minimising.

25 But it would also -- one thing that happens in that is
26 that the regulator, sort of, takes responsibility for
27 quality, and that -- I mean, I've come across various
28 companies who have just sort of targeted those things,
29 whether it's for operating costs or investment, and said
30 okay, we'll do that, we'll target our spending on that and
31 then, if anything goes wrong, it's the regulator's fault.

1 So, I mean, I agree that you can get an impact from
2 that, but it may not be maximising productive efficiency,
3 both in the sense that they might have done better without
4 it in reducing costs, but also that they're losing sight
5 of the quality, cost trade-off; you know, explosions and
6 that sort of thing.

7 **MR WYDEVELD:** I just wanted to ask a few questions.

8 The first one, just by way of qualification; I was
9 wondering just maybe to explore a bit more what's meant
10 by -- what you mean by financial capital maintenance.

11 I heard a few things when you were talking that seemed
12 to suggest that in one sense it might be a backward-
13 looking concept in the sense of actually returning, you
14 know, funds invested. I also picked up on some other more
15 forward-looking arguments where you could effectively be
16 arguing that maybe firms should be building up funds so
17 that they can replace assets in the future that presumably
18 will cost more in the future.

19 So, I just wanted to get a bit more of a feel about
20 what you actually envisaged in terms of capital financial
21 maintenance in those two regards for a start.

22 **MR HORTON:** When I was using those words, I meant the
23 backward-looking one, yes, so that efficient investment
24 gets rewarded. The other thing, I mean, I was -- it was a
25 phenomenon that is a concern in the UK, that the
26 investment path may mean that if you're employing
27 financial capital maintenance as a principle, unless you
28 do some funny things with the depreciation path, the
29 prices may bob around.

30 **MR WYDEVELD:** Thanks for that.

31 Another question: You may be aware that in New Zealand

1 there was a movement from historic cost to ODV across a
2 number of the industries that the Commission is now
3 looking at. Generally this has resulted in higher asset
4 prices, asset bases. If the Commission ignores these
5 changes in its analysis, in doing the sort of analysis
6 we're doing, do you think this makes financial cost
7 recovery more or less likely, or can't you tell?

8 **MR HORTON:** Well, I mean, I think that on long-lived assets
9 the use of historic cost values is most unlikely to give
10 you a sensible answer. Using whatever happened to be paid
11 in 1980 for something, it's a freak as to whether it's
12 real value; it just depends on what's happened to
13 inflation in the meantime. So that, I don't think a
14 straight-forward historic cost value is a very sensible
15 guide and so that most company accounts are not very
16 sensible guides.

17 **MR WYDEVELD:** But does it meet the financial cost maintenance
18 standard?

19 **MR HORTON:** Normally there isn't somebody looking from outside
20 and saying, is there financial cost maintenance going on,
21 so the fact that the accounting profession has decided
22 that current cost accounting is too difficult doesn't
23 matter too much, and people look at company accounts in a
24 different sort of way. That regulators can't; regulators
25 are actually trying to get a return on some sort of asset
26 base, so they need to worry about how the path of this
27 asset base is going to change through time.

28 Moving from something like HCA to something like ODV
29 is merely moving towards something that might be a
30 sensible asset level as opposed to something that isn't.
31 So that, the revaluation gain is not a true gain, it's not

1 something that should go in the profit and loss account.

2 **CHAIR:** I'm just mindful of the time, so I'll take one more
3 question from Commission staff and then I'd like to take
4 the tea break.

5 **MR WYDEVELD:** I just wanted to ask one final question, it was
6 on that product efficiency as well, and just the comment
7 you said about the tailing off of cost savings towards the
8 end of regulatory period.

9 Have regulators responded to this at all, or is it
10 just something that can't be overcome?

11 **MR HORTON:** I think they have. Typically, but not always, you
12 get plans from the companies that show a tailing off of
13 the reduction of operating costs, and often a big boost in
14 investment at the end of the -- you know, in the years
15 that haven't yet happened under the present price control,
16 and I think that the regulators tend to discount that.
17 But, it's real, you can't discount it entirely. If it
18 happened time after time after time after time then you
19 will be able to discount it more, but...

20 **MR WYDEVELD:** I suppose I was thinking in terms of, like we've
21 seen in Australia, they've adopted in some cases things
22 like rolling carry-over mechanisms and glide paths and
23 other things to try to minimise this.

24 **MR HORTON:** Rolling carry-over mechanisms are actually much
25 more complicated to implement than you might at first
26 suppose. In the UK the regulators have tended to say,
27 yes, I'm going to do that, and then shied away from it at
28 the last moment because the actual process of doing that
29 when you're setting a price control before the end of a
30 price control period involves more uncertainty, but I
31 suspect we haven't got...

1 **CHAIR:** We haven't got time, thanks for that.

2 I just wanted to check with Dick and Shubha, did you
3 want to pursue more questions after the break?

4 **MS SARMA:** I have one question. I am just interested in
5 knowing, how did you get a fix on costs? I mean, direct
6 costs it's easy to get a fix on, but in terms of common
7 costs, what methodology did you or what process did you go
8 through to determine what were appropriate common costs?

9 **MR HORTON:** Gradually there has been a move to actually
10 separate the businesses, not mainly because of the common
11 cost problem but for competition reasons, but as the
12 businesses are more separated, so the common costs problem
13 is reduced.

14 I think that it was a process that was concentrated on
15 more for common costs where they still remained; which
16 was, if the service is being purchased from another part
17 of the same group, what process of competitive tendering
18 was undertaken before the implicit contract was signed,
19 and where there wasn't a process of competitive tendering
20 or where the process was so restricted, there could only
21 be one possible winner, then there was examination of the
22 costs of the thing and perhaps the profit element stripped
23 out, something like that, some sort of almost punitive
24 response to it.

25 **CHAIR:** Dick, would you like me to have Mr Horton available
26 after the break?

27 **MR ADAMS:** I have one quick question.

28 **CHAIR:** I have no control around here.

29 **MR ADAMS:** The point you raised earlier on was about the
30 inevitability of the costs of the regulator increasing
31 as -- the thing of increasingly complex questions to ask

1 and so on.

2 It's a point Vector made in its submission too, and it
3 cited the expenses incurred by a number of regulators,
4 including OFGEM, and it's produced a table which showed
5 that OFGEM's costs have increased by something like, oh,
6 five or six times in 12 years, and also talks about the
7 Treasury in the UK suggesting that the cost of regulation
8 in general had doubled.

9 Was that your experience at OFGEM? Is that sort of
10 increase put down to the increasing complexity or the
11 inevitability of regulators imposing more costs?

12 **MR HORTON:** It was after I had left. They paid my successor
13 five times as much.

14 But it was -- no, I think somebody should put RPI-X on
15 regulators as well, and it was certainly true that the
16 consultancy budget in OFGEM when I last looked was twice
17 the entire office's budget when I was last there. I mean,
18 I wasn't too upset about that. But, yes, they have gone
19 up too much, and it isn't completely inevitable. The main
20 problem is our friends, the lawyers, who --

21 **MS BATES:** The main problem is the, what?

22 **MR HORTON:** Sorry, I didn't say that.

23 I think, well, probably the over-caution of the
24 regulators in response to the possibility of legal
25 challenge and that the process that is considered due has
26 perhaps increased by more than is really necessary, and
27 also, that they've got all their staff for the peak times
28 and they keep on doing things at times in between the peak
29 times, so that they produce yet more consultation papers
30 on things that may not necessarily need fixing.

31 **CHAIR:** Okay, thank you for that. It's my intention now to

1 break until 20 minutes to 12, and I'd ask everyone to be
2 here promptly.

3 At that time we will be hearing from NECG, I believe,
4 on behalf of Powerco, and that session is scheduled to end
5 at 1 o'clock, and I'd just like to let participants know
6 that it is my intention to break at 1 o'clock because
7 Commission members have another meeting to attend to at
8 that time. So, we will be breaking promptly at 1 o'clock,
9 so if you have any arrangements to make you can count on
10 that time.

11 I would now like to thank Powerco for making
12 Mr Horton's evidence available to the Commission, and
13 Mr Horton, I'd like to thank you for letting us take so
14 much more with you than we had planned, it's been very
15 valuable to us and I'd just like to acknowledge the
16 frankness that you have spoken to us with and thank you on
17 behalf of the Commission.

18 So, thank you very much.

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21 **Adjournment taken from 11.20 am to 11.40 am**

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