



# MAJOR ELECTRICITY USERS' GROUP

9 February 2004

Mr Gareth Wilson  
Acting Manager, Network Performance  
Commerce Commission

By email to [gareth.Wilson@comcom.govt.nz](mailto:gareth.Wilson@comcom.govt.nz)

Dear Gareth

## **Submission on Draft ODV Handbook and Draft Information Disclosure Requirements**

1. This is a submission by the Major Electricity Users' Group (MEUG) on the Draft Handbook for Optimised Deprival Value of System Fixed Assets (the "draft ODV handbook") and Draft Information Disclosure Requirements of 23 December 2003. Nothing in this submission is confidential.

### **Draft ODV Handbook**

2. Under the light-handed regulatory regime prior to Part 4A being enacted, electricity line businesses (ELB) undertook ODV principally to allow ex post evaluation of economic profit or loss. In that regime line pricing policies were explicitly uncoupled from ODV valuations. The draft ODV handbook has changed little in style and content from pre-2001 handbooks.
3. In the new threshold-assessment-control regime line business valuations based on ODV are needed for several reasons:
  - a) The primary reason is that ELB will be required to revalue assets using a revised ODV handbook and then elect to use either ODV or historic book value as the basis for any future assessment phase. This one time calibration against a revised ODV handbook needs to be as robust as possible.
  - b) After establishing revised asset values, the secondary ongoing need for an ODV handbook is to prescribe the level of information required for examining the cost and pricing structures of a line business that has breached the thresholds and is in the assessment phase. The assessment phase will require detailed information about actual and forecast costs, of which fixed assets form the largest component. The fixed cost information will be needed, not just at an aggregate company level, but disaggregated into for example regional, GXP related and or voltage classes.

This is consistent with the Commerce Commission approach for the Airports Price Control Inquiry and similar approach proposed for the Gas Line Business Price Control Inquiry where a detailed business model based on highly disaggregated costs structures was used. The draft ODV handbook for electricity line businesses

fails to meet this purpose. MEUG notes that a handbook will also be needed to prescribe detailed information on historic asset costs for those ELB that choose that option.

- c) The third ongoing need for the ODV handbook is for setting controls on specific costs and or prices as part of a control regime. The draft ODV handbook fails to meet this purpose because of the lack of detail prescribed for information on for example a regional, nearest GXP or voltage class basis.
- d) There is also the much wider information disclosure requirements of Part 4A, Subpart 3 – Information Disclosure. Section 57T(3) (b) specifically mentions asset values and valuation reports. But more importantly that requirement is in the context of a range of other information disclosure requirements such as pricing and pricing policies in the same section. Efficient pricing of capital-intensive line businesses is based on the underlying asset costs. The view prior to the enactment of Part 4A that pricing and ODV need not be related has passed. Efficient pricing under the new regime should reflect underlying costs. The statutory requirement of section 57T requires more relevant information about valuations and improved transparency and accessibility for line users. The draft ODV handbook fails to meet this purpose.

As an aside note that it is arguable that line charges based on ODV will lead to more efficient price signals than charges based on assets valued at historic cost. How the evolving regime reconciles efficient line pricing with the option of historic cost for valuing assets will be an important issue to be considered when the Commission releases further details of the assessment and control phases.

- e) Finally there is a need to ensure compliance with the existing information disclosure requirements that provide an assessment of economic profit and loss at the individual company level, ie equivalent to the principal purpose of ODV prior to the enactment of Part 4A as noted in paragraph 2 above.
4. Rather than retain the pre-2001 style and content, MEUG suggest the following changes to the draft ODV handbook to better align with Part 4A:
- a) The ODV handbook needs to be a stand-alone document so that valuers and line businesses undertaking valuations and users of valuations understand the context and purpose of ODV. Unless valuers are experts in all the various pieces of legislation, regulations and gazette notices that govern Part 4A, they will when exercising their judgement either assume the paradigm of the old regime, assume lines company advice is correct or take an erroneous view as to what the ODV is to be used for. The handbook needs to summarise the context and all the possible uses of the handbook to assist valuers when making judgements.
  - b) Paragraph 1.6 of Part one of the draft ODV handbook states, "*An optimised asset base should only have the service potential that an ELB reasonably requires.*" This sentence should be restated so that the service potential depends on the requirement of end consumers, not the requirements of an ELB. Paragraph 1.6 should also recognise that the quality of service end consumers' require and are prepared to pay for may also be lower than the service potential delivered by the actual assets in place.
  - c) MEUG disagree with the proposal (paragraph 1.11 of the draft handbook) that ELB and valuers have discretion to decide the value of a fixed asset in instances not covered by the handbook. The risk of bias or inconsistent approaches by different valuers for different ELB remains. If a bias does occur then there is no mechanism, other than when an assessment is conducted, to independently identify that bias. MEUG recommend that in instances where valuers need to value fixed assets not

covered by the handbook, that a ruling by the Commerce Commission be made and that ruling be made public so that clear precedents are established.

- d) The draft ODV handbook needs to improve on handbooks prior to Part 4A being enacted. In particular:
  - i) The ODV handbook should specify more relevant information. Valuation information needs to be disaggregated to meet the requirements of the assessment, control and Subpart 3 requirements as noted in paragraph 3 above. MEUG has made extensive submissions to the Commission on suggestions such as grouping assets values regionally, clustered around nearest GXP and by voltage class. There may be other options also. MEUG can discuss these with the Commission if that will assist; but only after the Commission recognises that the enterprise wide aggregated ODV of the past are no longer fit-for-purpose.
  - ii) The ODV handbook should improve transparency and accessibility by line users to asset information. Part 4A should lead to more reliable, useful, user friendly and timely information on asset values than the pre-2001 regime. There is little in the draft ODV handbook that improves transparency and accessibility for end consumers. MEUG has also made several suggestions on this point in prior submissions also, eg use of templates so that cross regional/ELB comparisons can be made (eg MEUG *submission on development of an ODV Handbook*, paragraph 19, 14 November 2003).
- e) The comment in paragraph 2.18 that a green-field approach will result in variable and inconsistent outcomes compared to a brown-field approach could be debated. A green-field approach would allow all ELB to be valued on a consistent design philosophy whereas the brown-field approach means the widely differing design philosophies of the past are carried through.
- f) All contracts by ELB with line users' referred to in paragraph 2.34 should be made public. This transparency will reduce the risk of inefficient cross-subsidies.
- g) Actual assets may be optimised out (paragraph 2.37) and "new" optimised assets included (paragraph 2.45). It is important that details of assets optimised in and out are made public so that the treatment of those assets in line prices can be tracked. This becomes even more important when the one-off recalibration based on ODV occurs and from that point on historic book values may be used. There is a risk that assets optimised out beforehand might be included in future book values or other "games" whereby consumers pay twice for assets optimised out. This reinforces the need for the linkages between valuation, WACC and pricing to be made clear to all parties – both in the ODV handbook and a handbook for historic book value.
- h) Paragraph 2.44 refers to "the incremental business owned by the ELB." To avoid any doubt it might be clearer to rephrase as, "other non-line businesses not subject to Part 4A owned by the ELB."
- i) MEUG disagree with the proposal in paragraph 2.55 to allow ELB to include values for assets when the life of the asset has exceeded the handbook total life. In standard economic theory and valuation practice, enterprises do not on average earn in NPV terms more than the value of the original investment – yet with this proposal the Commerce Commission is allowing regulated ELB to do just that. The rationale for the draft handbook approach needs to be reconsidered including an assessment of the value of the wealth transfer from consumers to ELB that will occur.

If the residual life is to be rolled over on an evergreen basis then logically at least the total life should be increased. Otherwise the ELB will effectively over recover the asset cost through depreciation claimed. This is "double-dipping."

- j) If the actual cost of underground trenching is lower than the handbook values because it was undertaken by co-locating with other utilities then that lower cost should be used (refer appendix B (g) of the draft handbook).
- k) MEUG disagree with excluding any assets from being subject to the EV test. Rather than exclude a particular set of assets, a more standardised approach to undertaking an EV test should be developed to make the task easier.
- l) The costs in appendix A of the draft handbook are listed under the heading \$000 but actually specified to two decimal places. To avoid confusion MEUG suggest costs be specified in dollars, ie remove the decimal point and add the last digit to give dollars not \$000.
- m) The PBA report (paragraph 4.2) recommends agreeing to a request by Transpower to use the 30 June 2003 ODV valuation adjusted for additions and deletions to give an ODV at 30 June 2004 that can then commence as the opening historic book value. MEUG has two concerns with this. First, the unilateral treatment of the EV credit accruing to consumers as at 30 June 2003 by Transpower needs to be carefully reviewed in the light of the Transpower request. That review and the impact on end consumers should be explained. Second, MEUG is surprised that Transpower has made a decision to proceed with a historic book value approach when all of the linkages have not been finalised by the Commerce Commission, eg the differential in WACC to be used for ELB electing to use ODV versus historic book value.

#### **Draft Information Disclosure Requirements**

- 5. The proposal to carry-over the existing information disclosure requirements is a pragmatic approach given a more substantial review is planned mid 2004.

#### **Concluding comments**

- 6. The draft ODV handbook needs to recognise the shift from the prior light-handed regime to the new threshold-assessment-control regime and the need for more relevant information on pricing and costs, of which asset values are the main component, and improved transparency and accessibility by line users to that information.
- 7. Carrying over the existing information disclosure regulations is pragmatic.
- 8. Exactly how the valuation methodology, changes in valuation, WACC and line pricing methodologies mesh in the assessment and control phases need to be known by ELB and line users. This needs to cover the option that ELB have of choosing ODV or historic book value after an initial recalibration based on the ODV handbook. Without viewing all of these components, comments on just the ODV handbook may miss important issues.

Yours sincerely



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