



***unison***

*Submission by*

**UNISON NETWORKS LIMITED**

*on the*

**Revised Draft Handbook for Optimised Deprival  
Valuation**

**of System Fixed Assets**

**of Electricity Lines Businesses**

**30 July 2004**

## **Executive Summary**

This submission is made by Unison on the revised draft ODV handbook dated 9 July 2004 released by the Commerce Commission.

Unison is concerned that fundamental flaws in assumptions underlying the ODV method, as described in the revised draft ODV handbook, render the ODV method internally inconsistent and inconsistent with the Purpose Statement in Part 4A of the Commerce Act 1986.

Unison's previous submission identified limits to the appropriateness of setting standard replacement costs based on a theoretical lowest possible cost. As most standard assets are replaced on a piecemeal basis this should be recognised in the standard replacement costs given in the new ODV handbook.

A standard replacement cost determined under the best circumstances in respect of every parameter is unlikely to represent a realistic, real world efficient cost for individual assets or for a network as a whole. This demonstrates a fundamental flaw in the logic underpinning the Commission's position that efficient costs in the real world, which should be the relevant standard for regulatory regimes meeting the Part 4A Purpose Statement, equates to minimum possible costs in an abstract, theoretical construct.

Unison believes that the property right inherent in an easement owned by an incumbent ELB is not a barrier to entry. An entrant ELB is able to acquire its own easements, will pay market rates and ODV easement values should reflect this.

There are significant barriers to exit, where ELBs have statutory obligations to continue to supply line function services, as under the Electricity Act 1992. Accordingly, assets should only be subject to an EV test where the ELB has the choice of implementing an alternative or exiting the service provision.

For the avoidance of doubt, the "alternative service" contemplated in the EV test must be clearly specified as being an "equivalent" alternative service.

Where a Trust holds the shares of the ELB in trust for consumers the ELB should be able to treat the Trustees confirmation that undergrounding is in the interests of their beneficiaries as adequate "consultation" under criterion 4 in paragraph B.7 of Appendix B of the revised draft ODV handbook.

## Introduction

1. This submission is made by Unison Networks Limited (Unison) in response to the *Handbook for Optimised Deprival Valuation of System Fixed Assets of Electricity Lines Businesses, 9 July 2004, Revised Draft for Consultation* (the revised draft ODV handbook) released by the Commerce Commission (the Commission).
2. The revised draft ODV handbook was released in conjunction with *Review of Optimised Deprival Valuation Handbook Replacement Costs of System Fixed Assets*, a report prepared for the Commission by Parsons Brinckerhoff Associates.
3. The draft ODV handbook “details the optimised deprival valuation (ODV) methodology that large electricity lines businesses, large line owners, and large electricity distributors (collectively, ELBs), are required to use when valuing their “system fixed assets” on an ODV basis for the purposes of the regulatory regime under Part 4A of the Commerce Act 1986.” (para 1.1 revised draft ODV handbook).
4. While it is understood that the Commission is seeking comments of a technical nature in respect of the revised draft ODV handbook, Unison is concerned that fundamental flaws in assumptions underlying the ODV method as described in the revised draft ODV handbook remain. Further, it is of concern that these fundamental flaws render the ODV method:
  - internally inconsistent; and
  - inconsistent with the Purpose Statement in Part 4A of the Commerce Act 1986 (the Commerce Act).
5. Suggested drafting changes are highlighted in bold type in this submission.

**Fundamental flaws in assumptions render the ODV method internally inconsistent and inconsistent with the Purpose Statement in Part 4A of the Commerce Act**

## Standard Asset Replacement Costs

6. Unison’s previous submission identified limits to the appropriateness of setting ODV handbook standard replacement costs based on a theoretical lowest possible cost. The standard replacement costs in the revised draft ODV handbook continue to represent the theoretical least possible costs

that an ELB would incur if it were to replace its existing assets (with a notional set of MEAs and with the benefit of hindsight as to the service potential required).

7. Thus the outcome of the ODV method essentially makes it impossible for an ELB to construct system fixed assets at less than ORC (as specified by the standard replacement costs in Appendix A), and extremely fortunate if it were able to consistently construct them at ORC. As previously advised to the Commission, Unison's experience is that, despite selecting the lowest tender prices, actual costs will generally be above the standard replacement costs.
8. Actual costs will be higher in many cases because of the project scale. As PBA have previously noted, project costs depend on the size of the project. For non-standard assets the replacements costs are assumed to "be commensurate with a significant scale of construction rather than with piecemeal additions. As a guide, replacement costs for zone substations, subtransmission circuits and distribution feeders should be determined on the basis that each complete substation, circuit or feeder is constructed as a single project." (para 2.13 revised draft ODV handbook)
9. While many non-standard assets may be installed on this basis, most standard assets are replaced on a piecemeal basis and this should be recognised in the standard replacement costs given in the new ODV handbook.
10. Use of replacement costs as "standard" costs, rather than as "maximum" cost with actual cost being the replacement cost where this was lower, appears to provide short term relief that, perhaps in part, countervails instances where best actual costs are higher than the draft revised ODV handbook replacement costs.
11. However, these changes in the revised draft ODV handbook do not address the fundamental point that a standard replacement cost determined under the best circumstances in respect of every parameter is unlikely to represent a realistic, real world efficient cost for individual assets or for a network as a whole. The proposed standard replacement cost is not consistent with the deprival principle as at any point in time if an ELB

were deprived of its system (or parts of its system) it, or any competitor, would pay market rates – which will not necessarily ever be the “best” rates – to replace or rebuild the assets.

12. The approach to standard replacement costs in the revised draft ODV handbook, therefore, also fails to meet the Purpose Statement of Part 4A of the Commerce Act. It is not practically possible for ELBs to replicate the service capability of their systems at ORC. This demonstrates a fundamental flaw in the logic underpinning the Commission’s position that efficient costs in the real world, which should be the relevant standard for regulatory regimes meeting the Part 4A Purpose Statement, equates to minimum possible costs in an abstract, theoretical construct.
13. It is therefore better to set the “standard” cost on the basis of a mean or median value from a range of values based on reasonable, real world assumptions. **It is submitted, therefore, that the Commission request Parsons Brinckerhoff Associates to revisit the determination of standard replacement costs with this outcome in mind.**

**Efficient costs in the real world do not necessarily equate to minimum possible costs in an abstract, theoretical construct**

## **Valuation of Easements at Historical Cost**

14. The revised draft ODV handbook specifically stipulates that “Easements ... are to be valued at historic [sic] cost, without ... indexation. In respect of easements, this implies a hypothetical operating environment where a new entrant has access to existing line routes on the same basis as the incumbent ELB. This is consistent with the overriding assumption that there are no material barriers to entry into the ELB market.” (para 1.4c revised draft ODV handbook)
15. This argument does not provide a logical basis for prohibiting the revaluation of easement values as the property right inherent in an easement owned by an incumbent ELB is not a barrier to entry. An entrant ELB is able to acquire its own easements (albeit on different, and perhaps, with hindsight, more optimal routes). However, to do so the entrant ELB will have to pay market rates – not historical cost.
16. The logic applied to easements in the revised draft ODV handbook is analogous to assuming an entrant ELB also has the right to use the

**An easement owned by an incumbent ELB is no more a barrier to entry than the incumbent ELB's ownership of physical system assets**

incumbent ELB's physical system assets on the same basis as the incumbent.

17. The fundamental touchstone of the ODV method is determination of the cost for an ELB to replace its property at least cost if the ELB were deprived of that property. This "rule" should be applied equally to property rights such as easements.
18. The approach in the revised draft ODV handbook, therefore, is inconsistent with a key underlying principle of the ODV method. It is also inconsistent with the Purpose Statement in Part 4A of the Commerce Act in that, by undervaluing easements it does not support an efficient price, as proxied through the assumptions in paragraphs 1.2 and 1.3 of the revised draft ODV handbook, and therefore does not "promote the efficient operation of markets directly related to electricity distribution and transmission services".
19. **Accordingly, it is submitted that the prohibition on valuing easements at market rates be removed from paragraph 1.4c of the revised draft ODV handbook.**

### **Requirement to Undertake Economic Value Tests**

20. Unison has previously submitted that, where an ELB has a statutory obligation to continue the provision of line function services and where there is no written expression of a willingness by the consumer to terminate the supply of the line function service, then there should be no requirement for an economic value (EV) test.
21. In the theoretically competitive world described in paragraphs 1.2 and 1.3 of the revised draft ODV handbook and underpinning the ODV method, the absence of barriers to entry should be accompanied by an absence of barriers to exit. Where ELBs have statutory obligations to continue to supply line function services, as under section 62 of the Electricity Act 1992, there are significant barriers to exit in relation to the specified services. Accordingly, assets should only be subject to an EV test where the ELB has the choice of implementing an alternative or exiting the service provision.

**Statutory obligations to continue to supply services represent a barrier to exit and should not attract an EV test on affected lines**

22. While the materiality test is a sensible and pragmatic requirement to be introduced into the EV process, this should not mask a fundamental problem with the assumptions employed to build the ODV method. **This issue needs to be addressed in its own right by inserting, after paragraph 2.59, a specific exclusion from the requirement to undertake an EV test where the ELB is required to continue to provide line function services in accordance with section 62 of the Electricity Act 1992.**
23. Furthermore, in the event that a particular customer does agree to the cessation of the line function service, as provided for under section 62(2) of the Electricity Act 1992, then the residual value of the assets that were providing the line function service should be recoverable by the ELB from customers generally. This is analogous to an enterprise in a contestable or competitive world being able to dispose of its business (or part of its business) at fair value to a prospective market entrant.
24. For example, in the event that an ELB determines that, upon agreement from its customer, it will replace the line function service with an alternative (eg generation), the ELB will only be in a position to invest funds in the alternative if it has recovered the invested capital representing the remaining service potential of the assets currently providing the line function service.

### **Equivalence of Service in the EV Test**

25. The "alternative service" contemplated in the EV test must be an "equivalent" alternative service. This is clear in paragraph 1.5 of the revised draft ODV handbook. However, the substantive sub-clauses of paragraph 2.60 refer only to "alternative service". For the avoidance of doubt, this should be aligned with the terminology in paragraph 1.5.
26. **It is submitted that clauses 2.60.1, 2.60.2 and 2.60.4 are amend to refer to "equivalent alternative service" rather than "alternative service".**

**The alternative service in the EV test must be an "equivalent" alternative service**

## Criteria for Justifying Underground Cables

27. Paragraph B.7 of Appendix B of the revised draft ODV handbook requires ELBs to justify the undergrounding of cables, with optimisation of underground cables to overhead lines where justification does not satisfy one or more of the following criteria:

- Local authority planning criteria prohibit the construction of new overhead circuits;
- Underground cabling provides the most cost-efficient means of achieving the disclosed quality of supply criteria;
- Economic analysis shows that underground cabling is the most cost efficient option for providing the required network service;
- Consultation with customers affected by the undergrounding (including those affected by having to pay higher line charges) has demonstrated a willingness to pay the additional cost of the underground service.

28. Where a Trust holds the shares of the ELB in trust for consumers and where the Trustees confirm that undergrounding is in the interests of their beneficiaries then, providing the recovery of the cost of the undergrounded services falls only on those beneficiaries, the ELB should be able to treat the Trustees confirmation as adequate "consultation" under criterion 4 in paragraph B.7 of Appendix B of the revised draft ODV handbook. In other words, the ELB should be able to rely on the Trustees executing their duties in the best interests of the beneficiaries, regardless of whether the Trustees have undertaken specific consultation on the matter in their own right.

**A community trust owned ELB should be able to rely on Trustees confirming that undergrounding is in the interests of the beneficiary consumers**

**29. It is submitted that this be clarified in criterion 4 or added as a fifth criterion for justifying underground cabling in place of overhead lines.**

Submission ends.