



# **Powerco's Submission on the Commission's draft decision - Implementing Valuation Choice for System Fixed Assets**

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## 1 INTRODUCTION

1. This submission from Powerco Limited (“**Powerco**”) is in response to the Draft Decisions and Discussion Paper (the “**Draft Decision**”) released by the Commerce Commission (“**Commission**”) on 24 December 2004 titled *Regulation of Electricity Lines Businesses- Implementing Valuation Choice for System Fixed Assets*.
2. The Commission earlier concluded - in its decision on the targeted control regime - that the regulatory objectives of Part 4A could be met by the use of either the ODV or the DHC method for valuing system fixed assets. The Commission also indicated that lines businesses would be required to adopt and commit to using either ODV or DHC for the preparation of their regulatory accounts - including the disclosure of any excess profits under the profit threshold - and apply the chosen method consistently thereafter. The Commission signalled that exceptions to this rule could arise in the case of mergers or acquisitions between lines businesses, or where the Commission was satisfied a change were justified due to materiality or cost-benefit reasons.
3. Powerco notes, therefore, that the Draft Decision focuses on the relatively narrow issue of how the historic cost methodology should be applied. In particular the Draft Decision focuses on:
  - the approach to indexing historic costs; and
  - the process by which new capital expenditure is included in the regulated asset based.

In addition, the Draft Decision also examines a number of implementation issues, based on the presumption that the Commission’s proposed approach on the valuation issues is eventually adopted.

4. Rather than focusing on the detailed analysis presented in the Draft Decision, Powerco would like to comment on the key principles for asset valuation outlined by the Commission. Powerco has also provided some brief answers to each of the questions posed by the Commission.

## 2 KEY PRINCIPLES FOR ASSET VALUATION

5. The Commission identified the following key principles for guiding its approach to asset valuation (page 21 of the Draft Decision):
  - *Efficiency*: The asset valuation approach should support outcomes that are allocatively, productively and dynamically efficient.
  - *Profit measurement*: The approach should facilitate the identification of excessive profits on a basis that reflects sound regulatory economic principles and practices.
  - *Cost effectiveness*: The approach should achieve regulatory valuation objectives at a reasonable compliance cost.



- *Consistency and accuracy*: The approach should be consistent and accurate to the extent appropriate to the relevant function under Part 4A (i.e., information disclosure, resetting the thresholds, post-breach inquiries or control).
6. Powerco broadly supports these principles. In particular, Powerco has consistently argued that creating an environment aimed at fostering efficient levels of on-going investment should be a key goal of regulation. It is essential, however, that the Commission examines the incentive properties of the overall regulatory regime *as a whole*, rather than developing particular policies in a piecemeal fashion. In this context, Powerco's view is that the Commission's Draft Decision fails to take account of the incentive properties of the threshold regime. As noted in further detail below, this has led the Commission to propose costly, unnecessary and inappropriate controls over new investment.
  7. Lines businesses are presently restricted in the prices that can be charged to customers; the businesses are also required to satisfy certain minimum service quality standards. Against a price constraint of this type, lines businesses have a strong incentive to minimise costs – including capital expenditure. Powerco is therefore surprised that the Commission argues on page 40 of the Draft Decision that:
 

“One of the most important implementation matters to address in implementing the HC method is the mechanism for applying any capital expenditure efficiency incentives. As in other jurisdictions where actual capital expenditure is rolled into the regulatory asset base, the Commission considers that it is necessary to require some form of regulatory prudence or efficiency review of that expenditure.”
  8. In Powerco's view, the Commission appears to be overly focused on ensuring that only efficient investment is remunerated, whereas the likely outcome is that the regulatory regime will lead to under-investment. In making this observation, Powerco also notes that the Commission's companion paper on information disclosure proposes a number of approaches that, if implemented, would have the effect of transferring wealth from investors to customers. These types of regulatory decisions will mean that in future only those investments that are almost entirely free of regulatory risk will take place. Against this backdrop, the Commission is wrong to focus its attention on prudent investment tests.
  9. In any event, the costs associated with prudence reviews of capital expenditure would be very substantial. Although the Commission has identified “cost effectiveness” as a principle for its choice of asset valuation, it is not clear that this principle has been given any weight in the Commission's deliberations.
  10. Powerco notes that the Commission is willing to allow lines businesses to choose between asset valuation methodologies on the basis that it considers that the methodologies will provide consistent valuations, and result in businesses facing similar risks. Powerco's view is that the ODV methodology may unreasonably expose lines businesses to uneconomic stranding of assets. The stranding is “uneconomic” in the sense that it relates entirely to the uncertainties of the ODV methodology, which involves a substantial degree of subjectivity, and may reflect factors that are largely beyond the reasonable



control of lines businesses (such as changes in asset prices and technology over time) rather than the quality of the original investment decision.

11. Powerco notes that the Australian Competition and Consumer Commission (ACCC) has determined that the ODV methodology exposes regulated companies to unnecessary risk. This now brings the ACCC into line with other regulators in Australia who have realised that a “roll-forward” methodology similar to indexed historic cost is the most appropriate approach for remunerating new investment.
12. A key principle that underpins the ACCC’s approach to asset valuation is “financial capital maintenance” (FCM). Under this principle, the financial value of a business or asset is maintained, and as a result there is a fair prospect that returns on investment will be at least equivalent to the normal return on capital. This outcome, in turn, ensures that sufficient incentives exist for providers of capital to continue to invest. In Powerco’s view, an important benefit of indexed historic cost (IHC), compared to ODV, is that it better assures the business of FCM. If, however, the Commission believes that IHC and ODV should provide the same outcome, then the potential benefit of IHC will be removed. Powerco does not believe that lines businesses should necessarily be exposed to the stranding risks associated with ODV – and if they choose to be exposed to this risk, their allowed rate of return should be enhanced to compensate for the additional risk.<sup>1</sup>
13. In summary, Powerco is not convinced that the Commission has properly developed its approach to asset valuation. In particular, it seems curious to allow valuation choice, but then to require each method to deliver the same outcome.
14. In addition, the Commission wrongly asserts that a test to check the prudence of investment is required. This assertion is based on a false premise that lines businesses would otherwise over-invest, when in fact the Commission’s price path threshold regime, if implemented properly, would provide incentives to lines businesses to minimise costs, including capital expenditure. In Powerco’s view is that the regulatory environment foreshadowed by the Commission is unlikely to encourage adequate investment, let alone encourage over-investment.

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<sup>1</sup> In this context it is noteworthy that the Australian National Gas Code expressly recognises the additional risk that is borne by investors under asset valuation arrangements that enable regulators to remove “redundant assets” from the regulatory asset base. For instance, section 8.27 of that Code requires a regulator to “take into account the uncertainty such a mechanism [which involves “optimisation” or removal of assets from the regulatory capital base] would cause and the effect that uncertainty would have on the Service Provider”. The Code goes on to say: “If a Reference Tariff does include such a mechanism, the determination of the Rate of Return [WACC] and the economic life of the assets should take account of the resulting risk and cost to the Service Provider of a fall in the revenue received [as a result of the redundant asset being removed from the regulatory asset base].”



### 3 ANSWERS TO COMMISSION'S QUESTIONS

#### Question 1: Valuation updates

15. Powerco does not believe that annual revaluations using the ODV methodology are appropriate. It is important to have regard to the costs of revaluations, and, more importantly, their purpose within the regulatory framework. In Powerco's view, the Commission has not yet articulated why lines businesses should be exposed to stranded asset risk or demonstrated that they are adequately remunerate for it.

#### Question 2: Capital expenditure reviews

16. As noted in the above submission, Powerco believes that if the price path threshold regime is implemented correctly, lines businesses will face incentives to invest efficiently. In this context, it is worth examining the practices and approaches of regulators in other jurisdictions where actual capital expenditure is rolled into the regulatory asset base. In its present review of electricity distribution prices the Essential Services Commission (Victoria) stated:<sup>2</sup>

“[The Commission proposes] to rely on the incentive properties of the regulatory regime to encourage efficient expenditure to draw an inference that the actual expenditure undertaken was efficient rather than undertaking a prudence test of expenditure.”

17. Contrary to the Commission's statement on page on page 40 of the Draft Decision, the Australian experience provides a clear example of a jurisdiction where actual capital expenditure is rolled into the regulatory asset base, and after careful consideration, the regulator has decided that it is **not** necessary to require some form of regulatory prudence or efficiency review of that expenditure. On this basis, Powerco does not accept that capital expenditure or “prudence” reviews are necessary.

#### Question 3: Valuation-related risks and incentives

18. As noted in the above submission, Powerco believes that ODV could have a detrimental impact on dynamic efficiency unless lines businesses are adequately remunerated for the increased risk. To the extent that IHC is implemented so as to mirror the outcomes of ODV (although it is not clear why this should be the case), IHC will also have a similar impact.
19. Again, it is instructive to examine the views of the Australian regulators on the risks faced by investors under regimes that permit regulators to remove redundant or “stranded” assets from the capital base:

“The Commission has taken a position that it would not seek to identify or remove stranded assets from the asset base. The Commission's view was that regulatory stranding subjects distributors to considerable uncertainty regarding the treatment of long-term investments, and this threat (lack of

<sup>2</sup> ESC Victoria (2004) *Electricity Distribution Price Review 2006 - Final Framework and Approach: Volume 1, Guidance Paper*, page 78.



investment) is more likely to outweigh any positive incentive for efficient investment that stranding may encourage.”<sup>3</sup>

**Question 4: Valuation compliance costs**

20. It is difficult to assess the relative compliance costs of IHC and ODV without knowing the details of each methodology. Presumably, lines businesses will tend to select the methodology that has lower compliance costs, all other things being equal.

**Question 5: Implications of mergers and acquisitions on valuations**

21. The process for adopting a single valuation methodology following a merger or acquisition seems reasonable on the face of it. Powerco notes, however, that the regulatory rules must be clear if such merger and acquisition activity is to be facilitated. At present, Powerco believes that the Commission’s rulings in other aspects of the regulatory regime (notably information disclosure) will severely limit future merger and acquisition activity.
22. Whilst the Discussion Paper is not clear it is assumed that the proposal is that companies post merger would be able to choose between the continuation of the valuation methodologies of the existing component parts or where these differ then choose to align using either of the methodologies going forward.
23. Where Powerco would disagree with the Discussion paper is that revaluations should not be included in the measure of excess profits. This should only occur if and when prices actual rose to maintain a reasonable level of return.

**Question 6: Valuation handbooks and guidelines**

24. Powerco believes that the level of prescription is already too onerous and costly.

**Question 7: Valuation reporting**

25. The Commission should consider that reporting of information is not a costless exercise, and there should be a clear business case made for any increase in reporting requirements.

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<sup>3</sup> ESC Victoria (2004) *Final Decision: Embedded Generation Guideline*, page 22.