

TRANSPower NEW ZEALAND LIMITED

Submission to the  
Commerce Commission on  
Implementing Valuation Choice  
for System Fixed Assets  
Draft Decisions and Discussion Paper

*February 2005*

**T R A N S P O W E R**



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## Contents

<b>1. EXECUTIVE SUMMARY</b>	<b>5</b>
<b>2. INTRODUCTION</b>	<b>6</b>
<b>3. RESPONSES TO THE COMMERCE COMMISSION'S DRAFT DECISIONS</b>	<b>7</b>
3.1 <i>First Draft Decision: Limiting the choice to Indexed Historic Cost</i>	7
3.2 <i>Second Draft Decision: The need for independent assessment of capital expenditure</i>	8
<b>4. TRANSPOWER'S RESPONSES TO THE QUESTIONS RAISED BY THE COMMISSION</b>	<b>10</b>
4.1 <i>Valuation updates</i>	10
4.2 <i>Capital expenditure reviews</i>	10
4.3 <i>Ex ante vs. ex post prudency tests</i>	12
4.4 <i>Valuation-related risks and incentives</i>	13
4.5 <i>Valuation compliance costs</i>	16
4.6 <i>Implications of mergers and acquisitions on valuations</i>	16
4.7 <i>Valuation handbooks and guidelines</i>	17
4.8 <i>Valuation reporting</i>	18
<b>5. OTHER RELATED ISSUES</b>	<b>20</b>
5.1 <i>Asset valuation and network pricing</i>	20
5.2 <i>Pseudo assets</i>	20

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## **1. Executive Summary**

1. This is Transpower's submission in response to the Commerce Commission's (the Commission) draft decisions and discussion paper on Implementing Valuation Choice for System Fixed Assets.
2. Transpower welcomes the Commission's decision to proceed with its decision to allow electricity lines businesses to choose a regulatory valuation method. Transpower urges the Commission to conclude its deliberations with some urgency, not least because the continuing uncertainty over future regulatory asset valuation is now creating the risk of inconsistency with the evolving Electricity Commission regime.
3. Transpower does not contest the Commission's draft decision that lines businesses' choices of valuation methods be limited to ODV and indexed historic cost (IHC).
4. However, Transpower considers that the Commission's second Draft Decision should be modified to explicitly recognise that the regulatory regimes administered by the Commission and the Electricity Commission must be closely aligned, and coordinated with one another.
5. In particular, Transpower submits that the Commission should explicitly recognise that the Grid Investment Test (GIT) will serve as the sole test for establishing the prudence and efficiency of transmission investment.
6. While some uncertainties remain with respect to the Electricity Commission's detailed intentions in terms of overseeing grid investment, it is clear that Transpower's application of a Grid Investment Test (GIT) will ensure that any investment undertaken by Transpower within the framework of Part F will be, by definition, "prudent".
7. Accordingly, there should be no threat of an ex post regulatory write-downs of asset values once an investment which satisfies the GIT has been committed. The Electricity Commission's ex ante approach to investment approval, renders any contemplation of any ex post prudency test inappropriate and unreasonable. Equally, a duplicative ex ante prudency test by the Commission would be unnecessary, as well as undermine any sense of regulatory integration or cooperation by the two Commissions.
8. Transpower wishes to appear at the Commission's forthcoming conference to make an oral submission on these matters.

## 2. Introduction

9. On 24 December 2004, the Commerce Commission published a paper titled Regulation of Electricity Lines Businesses - Implementing Valuation Choice for System Fixed Assets: Draft Decisions and Discussion Paper (the “Draft Decision”).
10. The Commission had previously proposed that lines businesses be permitted to choose between using either the Optimised Deprival Valuation (ODV) method or the historic cost (HC) method for valuing their system fixed assets under Part 4A; and be required to commit to applying the chosen method consistently thereafter.
11. The Commission had also stated that lines businesses would not be expected to choose between the ODV and the HC methods for ongoing regulatory asset valuations until such time as the Commission makes available sufficient information for businesses to make an informed decision. Transpower understands that the publication of the Draft Decision is a further step in this process.
12. In Part 1 of the Draft Decision the Commission’s examines the treatment of inflation under the HC approach and the treatment of capital expenditure. Part 2 of the Draft Decision discusses issues relating to the implementation of the IHC method, as well as implementation issues relevant to those lines businesses that choose to use the ODV method. Importantly, the Commission states:

*“The discussion in Part 2 is based on the preliminary assumption that the Commission’s draft decisions detailed in Part 1 will be implemented. At this stage the Commission does not have a predetermined view as to the final outcome of the Part 1 decisions and remains open-minded to any submission in respect of those draft decisions.” (Draft Decision, page 7.)*
13. This submission sets out Transpower’s response to the Draft Decision, and the various implementation issues canvassed by the Commission. The submission is structured as follows:
  - Section 3 sets out Transpower’s response to the Commission’s two draft decisions;
  - Section 4 presents Transpower’s responses to each of the seven questions canvassed in the Draft Decision.
  - Section 5 sets out Transpower’s views on issues relating to the Draft Decision which, in Transpower’s view, have not been appropriately addressed to date.

### 3. Responses to the Commerce Commission's draft decisions

14. In its Draft Decision, the Commission proposes that:
- lines businesses would be permitted to choose to use ODV or Indexed Historic Cost (IHC) as their basis for disclosure of the valuation of the system fixed assets of the business; and
  - for those lines businesses that choose to use the IHC method, the Commission would require an independent assessment of capital expenditure, and only prudent and efficient expenditure would be allowed to be rolled in to the regulatory asset base.

#### 3.1 *First Draft Decision: Limiting the choice to Indexed Historic Cost*

15. The Commission's Draft Decision proposes to limit the choice of valuation method to two alternatives: indexed historic cost (IHC), or ODV. The Commission proposes to not allow companies to adopt un-indexed historic cost (HC) as a basis for valuing assets for regulatory purposes.
16. In adopting this draft decision, the Commission states that it considers the IHC approach facilitates better comparisons across companies than an un-indexed historic cost approach would, allowing for the possibility that some companies may choose to continue to apply the ODV methodology. In addition, compared to un-indexed historic cost, the Commission argues that IHC:
- produces prices that are more allocatively efficient (i.e. reflect today's costs of resources) and this may be relevant for a post-breach inquiry or if price control were imposed;
  - facilitates resetting the price threshold (and conducting the associated inter-firm productivity studies), given greater comparability with ODV; and
  - reduces the accounting and regulatory issues that could arise from mergers and acquisitions between firms with different valuation methods.
17. To the extent that asset values drive revenue requirements, Transpower considers it is probably reasonable to assert that prices are likely to be more allocatively efficient if IHC is adopted. Having said this, however, Transpower considers that the structure of charges, rather than their average level, is likely to have a much greater bearing on allocative efficiency.
18. A revenue path designed to deliver a nominal return on assets valued at un-indexed historic cost will provide a higher cash flow in the early years of the asset's life, as shown in Figure 2 on page 37 of the Draft Decision. From a commercial perspective, such a revenue profile is generally more appealing to financiers and investors than one which delivers a real rate of return on an indexed asset base. Notwithstanding this, it is recognised that alternate revenue streams designed to deliver a real (or nominal) rate of return on an indexed (or un-indexed) asset base have equivalent present values over the life cycle of the asset base.

19. In addition, investors have demonstrated a willingness to invest in utilities that are subject to well administered incentive-based regulation in which the indexed value of assets is a key determinant of revenue and cash flow over the long term.
20. On this basis, from a theoretical perspective Transpower sees no obvious considerations that would favour the application of un-indexed HC over the IHC approach proposed by the Commission. It is noted that Transpower's position on this matter is consistent with positions stated previously by the company in response to the Commission's Asset Valuation Issues Paper.
21. In practice, the differing cash flow profiles (while theoretically NPV equivalent over the life cycle of the assets), have different exposures to risk of regulatory change, over the life cycle of the assets. Accordingly, there is a need to consider the appropriate rates of return consistent with the chosen approach and accompanying regulatory risks.
22. Having regard to all of the above factors, Transpower does not contest the Commission's draft decision that lines businesses' choices of valuation methods be limited to ODV and indexed historic cost.

### **3.2 *Second Draft Decision: The need for independent assessment of capital expenditure***

23. The Commission's second draft decision proposes that for those lines businesses choosing to use the IHC method, the Commission would require an independent assessment of capital expenditure, and only prudent and efficient expenditure would be allowed to be rolled in to the regulatory asset base.
24. As noted in paragraph 72 of the Draft Decision, Transpower agrees as a matter of principle that all significant new investments should be subject to a capital efficiency review process. The Draft Decision also correctly recognises that Transpower has argued that capital efficiency reviews are best determined on an ex ante rather than on an ex post basis, because ex post reviews create undue regulatory risks for investors.
25. In recent months, more detailed information has become available regarding the Electricity Commission's intentions in terms of overseeing grid investment. While from Transpower's perspective there remains uncertainty regarding a number of key issues in the Electricity Commission's proposed framework for grid investment, it is clear that:
  - Transpower's application of the proposed Grid Investment Test (GIT)<sup>1</sup> will ensure that any investment undertaken by the company within the framework of Part F<sup>2</sup> will be, by definition, "prudent"; and

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<sup>1</sup> For example: "...4. A proposed investment satisfies the grid investment test if the Board is reasonably satisfied that: 4.1. the proposed investment maximises the expected net market benefit compared with a number of alternative projects; 4.2. the expected net market benefit of the proposed investment is greater than zero; and 4.3. if sensitivity analysis is conducted, a conclusion that a proposed investment satisfies clauses 4.1 and 4.2 is sufficiently robust having regard to the results of that sensitivity analysis..", EGRs Schedule F4 - Grid Investment Test, refer <http://www.electricitycommission.govt.nz/rulesandregs/rulechanges/rulespdf/Rule-change-16.pdf>

- Transpower already faces incentives under the Commerce Commission's price path threshold regime to execute all capital expenditure in an efficient manner<sup>3</sup>.
26. Accordingly, Transpower considers that the Commerce Commission's second Draft Decision should be modified to explicitly recognise that:
- the regulatory regimes administered by the Commerce Commission and the Electricity Commission must be closely aligned, and coordinated with one another. In particular, Transpower submits that the Commerce Commission should explicitly recognise that the GIT will serve as the test for establishing the prudence and efficiency of transmission investment;
  - there should be no threat of ex-post regulatory write-downs of asset values once an investment which satisfies the GIT has been committed; and
  - Transpower already faces incentives under the price path threshold regime to execute all capital expenditure efficiently (and that these incentives are likely to be accentuated through the GUP approval process). Accordingly, there is no reasonable justification for subjecting Transpower to a further capital expenditure efficiency review.
27. Sections 4.2 and 4.3 of this submission set out detailed analyses to substantiate the company's views on these matters.

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<sup>2</sup> In principle, investment may occur outside of the framework of Part F. However, this is unlikely and in any event would be subject to bilateral contractual agreement that would (with appropriate contractual provisions) sit outside of the ambit of the Commission's threshold and related regulatory regime.

<sup>3</sup> Moreover, the final approach to capital approvals under the Grid Upgrade Plan (GUP) may also create further incentives for productive efficiency. For example, in appropriate circumstances, approvals may at some point fix the "capital allowance" (based on budgeted costs) to provide incentives for Transpower to manage costs to, or below, budget.

## 4. Transpower's responses to the questions raised by the Commission

### 4.1 Valuation updates

28. Question 1 of the Draft Decision asks:

**“What views do you have on the need and proposed process for undertaking annual updates of regulatory asset valuations using the ODV and HC methods? What method should be used to index values in this annual process?”**

29. In paragraph 51 of its paper, the Commission acknowledges that “a principle of dynamic efficiency implies that the asset valuation methodology should also support commercial sustainability.” Transpower notes that fulfilment of investors' legitimate expectations regarding returns on capital is a key prerequisite for ensuring commercial sustainability of infrastructure investment.
30. Where investors' returns are likely to be influenced by the choice of index applied in the valuation of assets,<sup>4</sup> the index should be a broadly-based measure of the diminution in the purchasing power of one dollar over time (i.e. CPI). This is because investors require compensation for the real time value of money (that is, the opportunity cost of capital after inflation) as well as compensation for the reduction in the purchasing power of money – due to general price inflation – over time.
31. Application of the CPI would ensure that the capital base value is indexed to reflect its value in real terms over time, and that measured returns reflect the real (that is, inflation-adjusted) returns achieved by investors.
32. To the extent that the CPI differs from an asset or industry specific cost index that might otherwise be applied by the Commission, the measured return observed may not reflect the underlying real returns delivered to the providers of capital. This may, in turn, lead to erroneous conclusions being made about the relationship between measured returns and the normal cost of capital which is required by investors to justify on-going investment. For instance, if the index used remains systematically below the CPI, the measured real return achieved will be below the normal real rate of required by the providers of capital.
33. For these reasons Transpower advocates the use of the CPI as the index in the IHC approach.

### 4.2 Capital expenditure reviews

34. Question 2 of the Draft Decision asks:

**“What frequency and process should be used to implement capital expenditure reviews for the roll-in of expenditure under the HC**

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<sup>4</sup> It is noted that paragraph 89 of the Draft Decision states: “In its Assessment and Inquiry Guidelines, the Commission has indicated that it could use a building blocks approach to determine efficient price levels during a post-breach inquiry.” Under a building blocks approach, the allowed revenue includes a provision for a return on the regulatory asset base, so there is a close link between the value of the assets and allowed revenue.

**method? What capital expenditure reviews, if any, do you consider are required in intervening years for those lines businesses that use periodic ODV valuations? What comment do you have on the need for and scope of prescriptive guidelines for capital expenditure reviews, similar to those used for optimisation under the ODV method?”**

35. As already noted, under its Draft Decision, the Commission proposes that lines businesses which choose to use the IHC method would be required to undergo an independent efficiency assessment of capital expenditure, and that only prudent and efficient expenditure would be allowed to be rolled in to the regulatory asset base.
36. The Commission argues that without this “capital efficiency test” there would be only limited incentives for lines businesses to undertake efficient investment.
37. In the case of transmission investment, Transpower considers that there are strong grounds to challenge the Commission’s assertion that there would be insufficient incentives for efficient investment under the IHC method if actual investment is rolled in to the regulatory asset base, for the reasons set out below.
38. Firstly, as noted in Section 3.2 Transpower will be required to comply with the requirements of the Grid Investment Test (GIT) administered by the Electricity Commission. The objective of the GIT has been described as follows:<sup>5</sup>

*“The objective of the GIT is to approve grid investment proposals when doing so maximises expected net market benefits to parties who produce, distribute, and consume electricity. These benefits comprise not just economic benefits (e.g. lower dispatch costs and competition benefits), but also reliability benefits and the benefits of certainty and acceptability.”*
39. Transpower considers it would be reasonable to infer that any investment proposal which satisfies the GIT is, by definition, “prudent”.
40. On this basis, it is Transpower’s submission that the Commerce Commission should require no further assurance or verification of the economic justification (i.e. “prudency”) of an investment which has been assessed by the Electricity Commission as having satisfied the GIT.
41. Secondly, for a particular investment which passes the GIT, there is a question as to whether Transpower faces incentives to deliver the project at an efficient cost. One possible way of addressing this question would involve the establishment of the transmission cost assumed in the GIT as a form of budget or “benchmark” cost at which Transpower would be required to deliver the project.<sup>6</sup> However, this aspect of the Electricity Commission regime has yet to be fully addressed.

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<sup>5</sup> Electricity Commission, Consultation Paper: Draft Grid Investment Test, September 2004, page 4.

<sup>6</sup> Obviously, the “benchmark” cost would have to be established in a reasonable and unbiased manner, to ensure that the company had a reasonable prospect of delivering the project at a cost not exceeding the benchmark allowance.

42. It is also noteworthy that Transpower is subject to a price path threshold, and the company faces strong incentives to only breach that threshold, where there are well justified increases in costs, related to the provision of increased level or quality of services.
43. One of the key drivers of Transpower's costs over the longer term is the level of investment it undertakes. Under the price path threshold regime, inefficient investment would place the company at greater risk of breaching the threshold that could not be explained to the Commission's satisfaction. Transpower therefore faces strong incentives to ensure that any investment undertaken is done so an efficient manner.

### **4.3 Ex ante vs. ex post prudency tests**

44. Transpower recognises that the Commission will require some form of "prudency test" to be applied to actual capital expenditure under the IHC approach for lines businesses at are not subject to the investment approval process under the GIT.
45. Transpower does not comment specifically on the approach the Commission should adopt to "prudency testing" for other lines businesses and in particular, the choice between ex ante and ex post testing. However, Transpower believes it is instructive to consider the merits of these two approaches, which have been the source of ongoing debate in other jurisdictions.
46. To illustrate the issue, the discussion below describes why, in the case of Transpower, the Electricity Commission's ex ante approach to investment approval, renders any contemplation of a further ex post prudency test inappropriate and iniquitous. (Equally, any duplicative ex ante prudency test by the Commission would be unjustified and undermine any sense of regulatory integration or cooperation).
47. Transpower notes that the GIT provides a means of ensuring that due process and thorough analysis of the best available data at the time of the decision leads to efficient investment decision-making. The application of "optimisation" after the GIT is completed (and the asset constructed) exposes past investment decisions (which were deemed efficient at the time) to on-going stranding risk, without providing any benefit in terms of improving the original investment decision.
48. It does not serve any purpose to reappraise a past investment decision using new information, and to redistribute wealth between infrastructure users and owners on the basis of an ex post review of past investment decisions. Indeed, in the context of a regulatory regime where there is a linkage between asset values and revenues<sup>7</sup>, ex post "optimisation" unduly exposes investors to an unmanageable risk of capital loss; hence it provides a disincentive to investment.

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<sup>7</sup> As foreshadowed in paragraph 89 and elsewhere on the Commission's *Draft Decisions and Discussion Paper*.

49. In this context, it is noteworthy that there has been considerable debate in Victoria regarding the merits of ex post regulatory reviews of capital expenditure. In a document published in December 2002, the then Office of the Regulator-General (now the Essential Services Commission) stated:<sup>8</sup>

*“In its Consultation Paper No. 4 for the Distribution Price Review, the Office noted that the regulatory stranding of assets implied by an approach [involving the regulated company bearing the risk of future optimisation] may not be the most efficient mechanism for encouraging efficient investment. The Office instead believes that efficient investment is best encouraged through transparent planning and due process at the time of investment, rather than the discipline of possible ‘after-the-event’ optimisation.”*

50. To summarise, the key points in respect of prudence testing:
- The Commission should, in Transpower’s submission, require no further assurance or verification of the economic justification (i.e. “prudence”) of an investment, which has been assessed by the Electricity Commission as having satisfied the GIT.
  - The nature of the GIT represents, in effect, an ex ante prudence test that it would be inappropriate and unreasonable for the Commission to either duplicate or, ex post, to revisit.
  - The Commission should consider the relative merits of ex ante and ex post prudence testing for lines businesses not subject to the GIT. Transpower does not make specific comment on this choice.

#### **4.4 Valuation-related risks and incentives**

51. Question 3 of the Draft Decision asks:

**“In what respect do you consider that the ODV and HC methods are likely to provide effective dynamic efficiency incentives on lines businesses? Do either of the methods produce perverse incentives or significant unmanageable risks?”**

52. In paragraph 123 of the Draft Decision, the Commission states:

*“... both [ODV and IHC] must provide similar incentives and a similar commercial outcome from a risk/return perspective, if the policy of allowing valuation choice is to be justified.”*

53. Notwithstanding the Commission’s view, from Transpower’s perspective, a major difference between the IHC and ODV frameworks is the extent to which investors are exposed to the risk of regulatory asset value write-downs under the two methods.

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<sup>8</sup> Office of the Regulator-General, *Guidance on Fair and Reasonable Terms for the Provision of Unanticipated Transmission Connection Services*, December 2002.

54. The Draft Decision states that the Commission believes that the purpose of optimisation is to provide incentives for efficient investment decisions (from a technical engineering and economic perspective). In assessing the different optimisation risks faced by lines businesses under the alternate valuation approaches, table 6 (page 42) of the Draft Decision states:

*“Provided [used and useful tests and prudence reviews] are to be required within the IHC approach, then they are similar in nature to optimisation tests under the ODV method. The main difference is probably that prudence reviews apply only to capital additions (since the previous review) whereas optimisation applies to the whole asset base, i.e., including assets which may have previously been fully accepted into the valuation.*

*A ‘used and useful’ test (under IHC) would apply a similar but arguably less rigorous assessment to pre-existing assets than optimisation.”*

55. As already noted, the Commission has foreshadowed that it could use a building blocks approach to determine efficient price levels during a post-breach inquiry. Under a building blocks approach, the allowed revenue includes a provision for a return on the regulatory asset base, so there is a close link between the value of the assets and allowed revenue.
56. Given the prospect of building block regulation in New Zealand, it is pertinent to examine the Australian experience when addressing the relative merits and different properties of ODV and IHC asset valuation approaches.
57. Transpower understands that in Australia asset valuation approaches which involve “optimisation” of the entire asset base are almost universally regarded as inherently and unacceptably risky to investors. In this regard, it is worth citing a paper prepared by the Allen Consulting Group (ACG) to advise the ACCC on the merits of periodic re-optimisation and revaluation, versus approaches that provide much greater certainty in relation to regulatory asset values over the life cycle of assets.<sup>9</sup> The ACG report sets out a comprehensive and robust analysis of the issues, with reference to the critical questions of:
- the incentive properties of the different options;
  - the feasibility of, and costs involved in implementing effective asset revaluation arrangements that involve the application of optimisation and/or current cost principles;
  - the risks (and therefore costs) involved in applying asset revaluation approaches that create higher uncertainty in relation to the recovery of investment; and
  - the potential impacts on allocative efficiency (that is, the profile of transmission prices and revenues over time) of the different approaches.

58. Pages 5 and 6 of ACG’s report to the ACCC state:

*“The ODRC [optimised depreciated replacement cost – an approach very similar to ODV] revaluation methodology represents the polar case along a*

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<sup>9</sup> The Allen Consulting Group, *Methodology for updating the regulatory value of electricity transmission assets: Final report*, August, 2003.

*spectrum of trade-offs relating to the strength of incentives to reduce cost, and the degree of certainty over the recovery of costs. The rolling-forward methodology [which is comparable to the IHC approach proposed in the Draft Decision], in contrast, provides a degree of certainty over the recovery of costs incurred – with the degree of certainty (and strength of the incentive to minimise cost) determined by the length of the regulatory period selected.*

*We do not consider that the setting of prices completely independent of cost is feasible for regulated electricity transmission businesses in the short term. The application of the ODRC revaluation approach would require significant refinement to the methodology for estimating ODRC values to the methodology used to set regulated charges – which would require a substantial investment by the Commission.*

*Moreover, we do not consider that the application of such a methodology is desirable in the longer term. Whether a transmission business would expect to recover the cost of continuing to provide the service – or expected to earn returns much larger than that required to justify its continued financing of the business – would depend upon the accuracy of the estimated ODRC value, for which substantial statistical uncertainty will be inevitable. Given the risks associated with estimation errors, it is difficult to see how the Commission could commit credibly to adhere to such a regulatory regime over the long term. As a consequence, we do not consider the ODRC revaluation methodology to be appropriate...*

*Another point of distinction between the valuation methods is the level of prices expected at each point in time in the future. The ODRC level would maintain average prices at (approximately) the level consistent with those of the hypothetical (efficient) new entrant, whereas under the roll-forward approach, average prices could be higher or lower. It is noted that the structure – rather than the average level – of charges is more important for efficiency. It is also noted that the time profile of charges of an efficient new entrant may not be the most efficient charges – and that the roll-forward methodology may permit the more efficient time profile of charges.”*

59. The ACG report concludes by stating on page 8:

*“Having regard to the merits of the ODRC methodology relative to rolling forward the asset base, we do not consider revaluations based on ODRC to be feasible in the short-term nor does it provide appropriate incentives for regulated transmission providers over the long term. A preferred approach is for the regulatory asset base to reflect the level of capital expenditure undertaken and return of funds received over the regulatory period – that is, the rolling forward methodology.”*

60. Whilst the ODV methodology may appear to be well developed and generally widely accepted in New Zealand compared to Australia, it needs to be recognised that the basic characteristics of economic regulation in New Zealand are changing, at least in respect of transmission.

61. The risks faced by investors who report financial returns on ODV assets in a light-handed information disclosure regime are far lower than those faced by investors under a building block regime which applies ODV to value the regulatory asset base. For these reasons, Transpower considers the Australian experience to be highly relevant to New Zealand policy makers.
62. On the basis of that experience, Transpower considers that any method that involves ex post adjustment of asset values by the regulator (either through periodic ODVs, or through the application of ex post efficiency reviews of capital expenditure under the IHC method) unduly exposes investors to an unmanageable risk of capital write-downs.

#### **4.5 Valuation compliance costs**

63. Question 4 of the Draft Decision asks:

**“Do you regard the compliance costs of the ODV and HC methods as being similar? What features of an ongoing valuation approach will best assist in minimising ongoing regulatory asset base valuation costs, while still meeting the Commission’s requirements under the Act?”**

64. The relativity between compliance costs for ODV and HC depends upon the nature of the capital expenditure review process.
65. If the Commission accepts Transpower’s position in relation to capital expenditure reviews for transmission investments, a move by Transpower to IHC for regulatory valuation purposes will result in a significant reduction in compliance costs relative to ODV.
66. Giving companies an opportunity to choose between IHC and ODV provides them with an opportunity to minimise their compliance costs.

#### **4.6 Implications of mergers and acquisitions on valuations**

67. Question 5 of the Draft Decision asks:

**“How should regulatory asset values best be adjusted to deal with the effects of mergers or acquisitions of lines businesses? What views do you have on the proposed process for allowing lines businesses to change their valuation method?”**

68. The Commission’s proposal for the treatment of mergers and acquisitions are focused on ensuring the integrity of information on the regulatory asset base. Other things being equal, a change in the ownership of assets should not change the regulatory asset base under either ODV or IHC.
69. The design of the valuation regime should not create incentives for companies to either inefficiently trade or retain assets. The incentives for sale or merger of assets depend on the regulatory framework as a whole, not just the valuation method in isolation. This is best illustrated by example.

70. Consider a lines company that is making efficiency gains such that its costs are falling more rapidly than the price threshold. Another lines company wishes to acquire it. If the excess sale price over the regulated value is treated as an over-recovery then the vendor has no incentive to sell the assets, as the business has a higher value as a going concern. Likewise the purchaser has no incentive to offer any more than the regulated value of the assets because they know that the vendor will be unable to retain any amount over the regulated value.
71. In this case the combined regulatory treatment has created a substantial barrier to the sale of the assets. The solution in this example is to ensure that proceeds from the sale of assets are not treated as regulated revenue.
72. In practice when assets are being transferred from an IHC asset base to an ODV asset base the assets will need to have an ODRC calculated for them in a similar fashion to when a new asset has an ODRC calculated for it. As this is simply a re-pricing of the assets any value change arising from that calculation would need to be treated as revenue.
73. In summary, Transpower supports the Commission's proposal that for mergers and acquisitions assets should initially be transferred between regulatory asset bases at their regulated values. However this treatment requires the proceeds of a sale to be excluded from the regulated revenue base to ensure that incentives for efficient investment are preserved.
74. Where assets have been transferred between lines companies using different regulatory valuation methodologies the acquirer is likely to need to realign the assets to its chart of accounts. The Commission has suggested it may address this issue by prescribing a set of categories for classification of system fixed assets for those companies using IHC, and that these categories could be the same as those used in the ODV Handbook.
75. At a high level, asset categories must be the same between ODV and IHC in order to ensure consistent treatment of depreciation between companies using DHC and ODV.

#### **4.7 Valuation handbooks and guidelines**

76. Question 6 the Draft Decision asks:

**“What further aspects of the regulatory asset base valuation process need to be covered by handbooks and guidelines? In what areas do you consider that there is the greatest need for prescription?”**
77. Depreciated historical cost is the most common method for valuing fixed assets by businesses. As a result, it is a well understood methodology and the Financial Reporting Standards (FRSs) provide extensive guidance on how to account for fixed assets using the DHC methodology. This familiarity is likely to lead to confusion over the requirements for application of Indexed Historical Cost. The need for an IHC Handbook is driven by the need to:
  - ensure consistency (where appropriate) between IHC and ODV

- prescribe tighter requirements than the principles based FRS-3 in order to improve consistency between similar entities e.g. stipulating depreciation methodologies and depreciation rates
- ensure regulatory objectives are met, which may not be achieved without a specific IHC Handbook
- present the differences between the ODV and IHC
- stipulate regulatory disclosure requirements that are not covered by FRSs

### ***Consistency with the ODV Handbook***

78. One of the benefits of having a IHC Handbook is to help ensure consistency between ODV and IHC, (but only where it is appropriate and necessary to have consistency). Obviously there will be some fundamental differences, however there are a number of areas where consistency between ODV and IHC can be achieved.
79. The following list notes the areas of the ODV Handbook that could be replicated within an IHC Handbook.
- Format and content
  - Asset database requirements
  - Standard asset classes
  - Depreciation methodology
  - Determining total asset lives and asset remaining lives
  - Treatment of fully depreciated assets
  - Disclosure requirements
80. The area where obtaining consistency is most important is depreciation related policies. This is an area where consistency can be obtained easily and will help ensure that one method does not gain an advantage over the other. In particular, the lives of assets need to be the same in order to achieve consistent depreciation.

### **4.8 Valuation reporting**

81. Question 7 of the Draft Decision asks:

**“In addition to the reporting requirements already in the ODV Handbook, what other information should be reported (for example, in relation to valuation of other assets, valuations using the HC method, updates of ODV valuations and treatments of mergers and acquisitions)?”**

82. The ODV Handbook includes a section detailing disclosures that are required to be made, and all of the disclosures are required within an ODV report. Moving to IHC raises questions about how much of the current disclosure requirements need to be retained given the fact that under the IHC methodology there are no replacement costs, no modern equivalent assets and no optimisation process.
83. The information disclosed in the valuation report would therefore be limited to:
- opening and closing asset values
  - accumulated depreciation
  - depreciation charged for the year
  - the depreciation methodology and depreciation rates used
  - impairment charges for the year
  - the amount of borrowing costs capitalised during the year
84. Other information that is required by the ODV Handbook and that may be relevant to a IHC valuation includes:
- details of any assets which have undergone refurbishment resulting in the extension of their remaining lives if these are part of the IHC regime
  - details of any minimum residual life adjustments made if these are part of the IHC regime
  - details of any impairment/economic valuations undertaken
85. Other disclosures that a IHC Handbook may require include:
- Details of how any capital expenditure reviews have been undertaken, and the outcome of those reviews. For transparency, it may be better to publish such details in a separate document to the valuation report, and in Transpower's case this information is already to be included in the Grid Upgrade Plan provided to the Electricity Commission.
  - Details of how the closing ODV asset values have been converted into opening IHC asset values. These disclosures would cover issues such as the allocation of "pseudo-asset" values back to physical assets (see below) and the treatment of assets acquired from lines businesses using the ODV valuation methodology.
  - Identification of movements in asset values arising from the sale and purchase of assets.

## **5. Other related issues**

### **5.1 *Asset valuation and network pricing***

86. A further regulatory framework issue is the use of asset values for revenue setting and the allocation of charges. While the Commerce Commission does not at present directly regulate the revenue of electricity lines businesses, or mandate a pricing methodology, the possibility that a building block approach may be used in the future raises questions as to whether businesses might be expected to allocate charges on the basis of regulatory asset values in the future.
87. In this context, it is noted that the Electricity Commission is reviewing the Transmission Pricing methodology. While Transpower has been requested by the Electricity Commission to develop a proposed methodology, the Electricity Commission will make the decision as to the final form of the methodology.
88. There is a potential risk that the two Commissions may adopt incompatible views on valuation methodology, significantly increasing the complexity of the regulatory framework as it relates to transmission. The Commerce Commission therefore should liaise closely with the Electricity Commission to ensure that the different parts of the framework work together consistently.
89. Transpower will also raise this issue (of ensuring a single and consistent approach to regulated asset valuation for transmission) with the Electricity Commission.

### **5.2 *Pseudo assets***

90. One of the results of using the ODV methodology is the creation of pseudo or notional assets in the place of physical assets, where those physical assets have been optimised out. GAAP does not allow the use of pseudo assets and under IHC there is no logical reason why they should be retained. Hence, the question arises as to how any pseudo assets should be treated.
91. Pseudo assets cannot be written off, because the value attaching to the assets is real and needs to be included as part of the opening IHC value. However, all pseudo assets should have physical assets or groups of physical assets to which they relate and therefore the logical approach is for the value of the pseudo assets to be allocated to the related physical assets. This ensures that the value of the pseudo assets is included in the opening IHC value and that pseudo assets are eliminated from the asset register. The IHC Handbook should provide guidance on how the value allocation should be undertaken.