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Network Performance Group
Commerce Commission
By e-mail

SUBMISSION ON DRAFT DECISIONS AND DISCUSSION PAPER ON IMPLEMENTING VALUATION CHOICE FOR SYSTEM FIXED ASSETS

Purpose

1. This letter constitutes Vector's submission on the Commerce Commission's (Commission) draft decisions and discussion paper (paper) on the implementing valuation choice for system fixed asserts. Vector welcomes the opportunity to make this submission. Vector has provided a number of general comments, as well as comments answering the specific questions asked by the Commission.

General Comments

Principle based approach to valuation

2. In previous submissions to the Commission, Vector has promoted a principle-based approach to valuation. Vector continues to promote such an approach, as it is the only way to ensure valuations are fair and accurate over time.

3. In developing any valuation handbook, the natural temptation is to delve into greater and greater prescription in an effort to ensure all possible issues are covered. Principles are better suited to dealing with a range of complex issues that may arise over time. Principles can also readily ensure a true and fair valuation, so long as their application is scrutinised by an auditor (and Vector has previously suggested to the Commission how a principle-based approach could be implemented). The importance of ensuring accurate regulatory valuations is further underscored by the Commission' paper

on information disclosure (submitted on separately), which suggests that the disclosed valuations may not only be used for information disclosure and comparative purposes (when resetting the thresholds), but also for the purpose of post-breach inquiries and possible imposition of control (the need for clarity around the use of asset valuations is discussed further below and in Vector's submission on the Commission's information disclosure paper).

4. The principles adopted by the Commission should be consistent with Generally Accepted Accounting Principles (GAAP) and, in particular with the relevant financial reporting standards (currently FRS-3, but soon to be replaced by international standards). The adoption of such principles would ensure that New Zealand is on par with international reporting standards and encourage investment in the electricity lines industry through giving investors confidence that they will be able to recover their investment and a reasonable return. This is critical at a time when the industry is facing the need for significant new investment to replace aging assets (so-called "wall of wire") and meet challenges arising from population and demand growth. Were the Commission not to adopt a principle-based approach, innovation, investment and use of new technologies are likely to be deterred.

5. Vector is aware of the Commission's concerns that, in its view, a principle based valuation methodology may not provide sufficient incentives for lines businesses to make efficient investments. However, Vector considers that this concern can be addressed without the need for a heavily prescriptive regulatory methodology. Vector suggests the Commission should examine possible ways of addressing these concerns (for example expert technical reviews of lines businesses' investments), rather than opting for the prescriptive approach simply because it is currently the status quo (in the form of the ODV handbook).

<u>Actual costs should be allowed where competitive processes used</u>

6. While there is merit in providing a set of general maximum costs as a guide, it is unlikely that any broad based maxima will be sufficient to cover all scenarios for all companies over time. Such maximum costs will need to be regularly updated as they quickly become outdated. For example, Vector and other lines companies are currently facing fast escalating costs when commissioning network build and maintenance. The rapid escalation of costs as a result of resource constraints in the country from a lack of resources and significant demand for these resources from other infrastructure industries (roading, water works and telecommunications).

7. Vector, therefore, suggested previously, and continues to suggest, that the Handbook have an overarching principle of allowing use of actual costs where it can be demonstrated to an independent auditing party that a competitive tender process has been used. This principle would ensure that companies facing different operating environments can recover a return on the true and efficient (as evidenced by a competitive process) costs of investment.

8. Noting that the Commission does not appear to agree with the above views (which have been submitted to the Commission previously), Vector has nonetheless provided detailed comments on the Commission's prescriptive approach.

Need for Consistent Framework

9. It is important at the outset to recognise that it must be clear to what purpose asset valuation is going to be used. This is presently unclear. Is it the Commisison's intent that the choice of asset valuation feeds into some or all of setting an allowable return for the purpose of setting a price path, and in making profitability and productivity comparisons in setting the parameters of price path thresholds?

10. Different asset valuation approaches entail different attitudes to risk-bearing by shareholders and consumers, for example:

- what is the nature of inflation risks under the IHC approach compared to direct measurement of asset replacement costs?
- what are the risks associated with a "used and useful test" compared to an optimisation test or economic value adjustment?

11. Until lines businesses are aware of the approaches that will be taken to these important matters of detail, no real "choice" exists in respect of either asset valuation method and lines businesses will be confronted with the risk that inadequate compensation would be paid under any particular method for bearing risks. Until these questions are addressed, it is also not clear whether the asset valuations resulting from IHC will be comparable to those under ODV.

12. To the extent that the two valuation methods diverge, the C1 and C2 factors will need to compensate for distinctions between the choices of asset valuation methodologies. For example, a business choosing ODV will face the ongoing risk of asset optimisation, and thus require on average higher compensation over time for bearing that risk (assuming the "used and useful test" is less rigorous). C2 factor assessments, to the extent they exist in future, will need to accommodate that risk by benchmarking against a higher threshold for each profitability "category" and similarly if assets are already optimised out of an asset base, then C1 assessments will need to use optimised asset levels (as well as valuations) to make proper assessments. The Commission must also issue guidelines as to how it will approach these tasks before lines businesses can make informed assessments about asset valuation methods.

13. The remainder of Vector's comments on the Commission's discussion paper are made therefore on the basis that the discussion paper is incomplete since it omits key aspects of detail pertaining to how the choice of asset valuation method would be made consistent across the regime.

Valuation Choice

14. Vector agrees in principle with the Commission's decision to allow valuation choice. Where possible, maximum flexibility (and thereby avoidance of prescription and mandating) should be promoted, which is what the Commission's proposal constructively sought to do. While appreciative of the intent, Vector does not consider that the conceptual attractiveness of "choice" will be borne out in practice.

15. Specifically, the Indexed Historic Cost ("IHC") methodology proposed in the paper appears significantly different from the Depreciated Historic Cost methodology described in the Commission's earlier papers.[1] In those earlier papers, the Commission made it clear that the two methodologies proposed would carry a different level of regulatory risk:

> "Lines businesses choosing ODV as the basis for their regulatory accounts will be exposed to optimisation risk. Accordingly, the Commission may assess excess profits for such businesses using a higher WACC-based threshold than for businesses using DHC"[2]
>
> "Businesses that are not exposed to optimisation risk, such as under DHC, will nevertheless face incentives for prudent investment. Among other things, the price path threshold should provide such incentives."[3]

16. The underlying reasoning behind adopting such a choice was also clearly set out by the Commission, viz

> "Investors in system fixed assets should always expect to recover their reasonable costs. In theory, there are an infinite number of revenue profiles that can deliver this outcome. In particular, it does not matter whether revenues are driven by high or low rates of depreciation, or if returns are based on historic or replacement costs."[4]

17. It is clear from the above quotes that the underlying principle for allowing the choice was that investors in system fixed assets would expect to recover reasonable costs under either ODV or DHC. The Commission's latest paper does not discuss this principle. Rather, the Commission's main criterion for the accuracy of the Historic Cost methodology proposed is how comparable it is to valuations resulting from the ODV method – hence the need for indexing and the resulting IHC approach.

18. It seems, therefore, that the choice proposed in the Commission's paper is somewhat superficial in nature, as both approaches are intended to provide the same (or at least very similar) asset value result to ensure "allocative efficiency".[5] Whereas the choice proposed in the Commission's earlier papers was clearly between two different methodologies, with differences to be appropriately accounted for and explained where necessary.

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[1] Regulation of Electricity Lines Businesses, Targeted Control Regime, Draft Decisions, 23 December 2002; Regulation of Electricity Lines Businesses, Targeted Control Regime, Implementation Details, Draft Decisions, 31 January 2003

[2] Para 53, Draft Decisions, 23 December 2002

[3] Para 122, supra

[4] Para 111, supra

[5] Vector notes that the Commission's use of the term "allocative efficiency" does not reflect a use of that term as an economist would recognise it. Allocative efficiency is achieved when price is equal to marginal cost, not when average price is equal to the average of the sum of operating and depreciated capital costs. Allocative efficiency is invariant to the choice of asset valuation methodology.

19. Vector suggests that, if the Commission wishes to provide lines businesses with a choice, it should revert to its original proposed approach of allowing ODV and DHC (rather than IHC), since this reflects a legitimate choice between risk bearing on the part of consumers or shareholders. If that change is not contemplated by the Commission, Vector, for the above reasons and more discussed below, does not see any ongoing merit in a choice being provided (and in fact some potentially significant downsides from doing so). Again, Vector is appreciative of the choice intent; in practice, however, the benefits of flexibility are potentially limited based on the Commission's proposal now, with additional downside costs.

Comparability and Underlying Principles of Asset Valuation Methodologies

20. As noted above, the Commission's paper focuses on discussing alterations to the Depreciated Historic Cost method that would help ensure its consistency with ODV (e.g. – indexing and expenditure reviews), with the resulting proposed method being IHC. Vector notes however that, despite best efforts, it is likely that IHC and ODV valuations will systematically diverge over time (at least to some degree). This is likely to happen due to the lack of periodical reconciliation to standardised costs under IHC, as well as the differing effects of expenditure reviews under IHC compared to optimisation under ODV. The Commission will likely find itself having to continuously make more and more adjustments to IHC to ensure comparability with ODV (if this is the objective), making it unclear what the objective of the choice was in the first place.

21. This seems unnecessary because of the duplication of costs resulting from operating two methodologies along side each other (writing and updating two hand books, etc). If the Commission has decided that the primary objective is for both methodologies to provide the same outcome (Vector considers the primary objective should be ensuring efficient network investment and the recovery of reasonable costs by investors), it would be more efficient for only one methodology to be retained. Should this eventuate (and should the principle based approach suggested by Vector not be adopted), Vector submits that ODV would be the more appropriate methodology as it is more consistent with FRS-3, significant experience exists with its application and it has been developed in more detail to date.

22. As noted above, Vector considers that the overriding principle in valuations should be GAAP. Departures from GAAP (if required) should be kept to a minimum, as they make it more difficult to interpret valuation results, particularly for those persons with limited knowledge of the regulatory environment. Such departures also increase compliance costs as the preparation of information according to principles differing from GAAP requires additional training for staff and realignment of accounting systems.

23. A further reason working against choice in valuation is that different approaches, or different standards of rigor, may give rise to unfairness concerns when thresholds are reset. Specifically, to the extent the profitability factor remains (and Vector considers there are good reasons for it not to), asset valuation will play a role in determining reported levels of returns. Given that changes in C2 rankings (as for C1) can give rise to

significant value implications, any perceived unfairness in profitability assessment would make for a more contentious threshold resetting process (than if only one valuation method was used and consistently applied).

Issues outstanding with ODV handbook

24. The current paper does not address outstanding issues with the ODV handbook, such as developing and documenting the process for the regular updating of standard costs. At the very least, this issue should be addressed before meaningful comments can be made on the possible timing of ODV preparation and the appropriate method to account for capital expenditure in between valuations. As the Commission now knows first hand, replacement costs can become outdated relatively quickly, requiring a regular and robust updating process to ensure accurate valuations are prepared over time.

Specific comments

Q1. Valuation updates: 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?

25. No published index will ever result in 100% accurate indexing of valuations. While some indexes would be relevant (e.g. CPI, PPI and CGPI), these are aggregate measures that do not accurately reflect the changes in the electricity lines industry; nor regional differences. Should the Commission adopt indexes that are not reflective of underlying cost drivers, a systematic difference may result between IHC and ODV valuations, impairing comparability. Even if inflation under ODV and IHC turns out *ex post* to be similar, the risk of differences emerging is relevant to any comparison of performance.

26. In the case of ODV, the need for indexing can be avoided through annual updates of standardised replacement costs by the Commission. Lines businesses could then make updates to their valuations, using these up to date replacement costs, without having to go through a full valuation process (which would be done every 5 years). While it may be possible to recalibrate an IHC valuation over time through using updated replacement costs, this would further weaken the case for having an HC valuation approach in the first place.

Q2. Capital expenditure reviews: What frequency and process should be used to implement capital expenditure reviews for the roll-in of expenditure under the HC 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?

27. Vector does not support the use of an IHC methodology as proposed in the Commission's paper and therefore has no comment on independent expenditure reviews relating to the IHC method. The prudent investment reviews proposed by the Commission in earlier papers were to be *ex post* reviews and carried out in the course of a post breach investigation. Vector would agree with such an approach, should the Commission revert to the DHC method originally proposed. As noted above, however, this may cause inequities at the time thresholds are reset, depending on the extent to which valuations play a role in the price path composition.

28. Vector re-iterates its concern raised in the general comments that whatever approach is taken to capital expenditure reviews must be reflected in any profitability assessment. The greater the opportunity under an asset valuation approach for asset stranding as a result of economic conditions or optimisation, the higher the *ex ante* compensation in the form of a higher return on capital is required. In other words, the ex ante conditions faced when making an investment must be respected ex post when valuing or measuring the return on that investment. This is a fundamental principle of ensuring regulatory certainty over time.

29. Vector does not consider that independent expenditure reviews are required in intervening years for businesses using ODV. The independent reviews that will be undertaken in the year when a full ODV valuation is carried out, coupled with annual updating of standardised replacement costs by the Commission, should be sufficient to ensure updates carried out by lines businesses are accurate.

30. Vector also considers that, where it can be demonstrated that the costs incurred result from a competitive process (e.g. a tender), actual capital expenditure should be permitted in the valuation. Vector has outlined to the Commission in earlier submissions how this could be operationalised. Should the Commission favour rolling in the value of all capital additions (whether resulting from a competitive process or not) using standardised replacement costs, it is even more paramount that the ODV Handbook be annually updated to avoid inaccuracies in valuation figures. The scale of the inaccuracies that can result from a lack of updates is well known to the Commission from its work on the recent updating of the ODV Handbook.

Q3. Valuation-related risks and incentives: 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?

31. At the outset, it is important to recognise that both the thresholds and threat of price cap regulation under control are intended to provide incentives for businesses to minimise the costs of providing services, thus the choice of asset valuation method is

likely to be of second order importance (at best) to providing incentives for capital expenditure efficiency.

32. Vector considers that both methods will pose risks if they are not updated regularly and do not adequately recognise the actual costs faced by lines businesses. As the Commission knows, Vector, like many other lines businesses, has experienced instances when the ODV Handbook grossly understates the value of the work undertaken, i.e. only a portion of the actual spend (which meets the efficiency criteria) is represented in the ODV value. While the updated Handbook addresses this problem to some degree (at least temporarily), the continued emphasis on prescribed replacement costs nonetheless preserves the potential problem of real money being, in effect, expropriated by a sub-optimal valuation approach. Only when a principle of allowing actual costs to be used (subject to constraint and verification) is adopted will this problem be overcome.

33. Vector considers that having two methodologies, where one (IHC) is specifically altered to ensure it produces values comparable to the other (ODV), is likely to provide perverse incentives and increase compliance costs. If the two methodologies, despite best efforts, result in systematically divergent values, the lines businesses that are disadvantaged by the discrepancy will be pressured to perform a valuation using the other method in order to show that they "stack up". Such behaviour would be an inefficient outcome with some lines businesses performing two sets of valuations. Indeed, if no, or inadequate allowance was made for the risks of adopting a particular asset valuation approach in setting C1 and C2 factors, businesses would find it in their interest to demonstrate the penalty imposed by the less favourable valuation method (and, therefore, a desire to use the alternate methodology).

<u>Q4. Valuation compliance costs: 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?</u>

34. It is difficult to comment on this question, given that the full HC structure is not yet clear. Since the Commission is aiming to ensure that the IHC approach will be comparable to ODV, it is logical to assume that similar costs would be incurred. In Vector's view, the bulk of the costs come from record keeping, auditing (technical and financial) and preparing reports that address the Handbook's essential elements. These are likely to be similar for both methods.

35. As noted above, where perverse incentives exist to carry out valuations under both methods (as is likely to be the case under the Commission's proposed approach), compliance costs would likely significantly increase.

36. The Commission should recognise that there will be additional administrative costs in terms of making comparisons between businesses and setting C1 and C2 factors resulting from the different choices of asset valuation methods.

Q5. Implications of mergers and acquisitions on valuations: 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?

37. Vector suggests that at the time of a merger or acquisition, assets should be revalued by the new owner to reflect the most up to date depreciated standard costs when they are purchased. This suggestion assumes that any standard handbook costs are reflective of current costs, as could be achieved through annual updates to the handbook.

38. Vector is not clear on the Commission's particular concern with respect to mergers and acquisitions. As the Commission notes, the regulatory valuation of the acquired business would be relevant to the Commission, not the price paid. That said, it is important that the regulated valuation reflects all assets associated with running a lines business, not just system fixed assets as defined by the ODV Handbook. This is likely to significantly reduce, if not eliminate, perceived differences between regulated valuations and market purchase prices.

39. Other than that issue, Vector is not aware of other problems that mergers and acquisitions create with respect to asset valuation. While an acquisition may distort or abort a time series of data, this is inevitable when two or more companies are put together, and the benefits of such rationalisation are likely to significantly exceed any costs from impacts on the data series.

40. More generally, at any point in time, the appropriate valuation for the Commission to focus on, as required, is the most up to date valuation for the business in question. That being the case, the Commission should simply focus, at the time required, on the most up to date valuation of the new network owner. If the Commission's concern is that the valuation by the new owner is different to the valuation of the old owner (either because it has been embedded within a broader valuation including other networks, or some other reason), then the Commission should simply ask the new owner to explain any such differences. This could occur at any time given there are natural incentives on lines businesses to provide a satisfactory explanation to the Commission. It could also be required at the time of any threshold breach. Vector does not see any overriding need for a new owner to prepare a new valuation for its overall business, or partial business, from day one. The ongoing reporting requirements should simply apply and the ODV be updated at the time required.

41. As discussed in Vector's information disclosure submission, Vector is concerned that the Commission is undermining the lighter-handed intent of the thresholds regime by trying to address, ex ante, all potential issues that may arise in future, even if no problems have been raised by interested parties or been proven to exist. This approach risks the regime quickly transcending into a detailed inputs-based control type environment (or a proxy of such through intrusive disclosure), which Vector is strongly against. The Commission has extensive information gathering powers that it can use as

required. This is much preferable in Vector's view to the Commission requiring/imposing a wide range of disclosures/requirements for possible future use. As discussed in Vector's accompanying submission, this also cuts to robustly defining the purpose of disclosure to ensure only information that is required to achieve the purpose is to be disclosed (and disclosure preferable to other options the Commission has at its disposal).

42. In the case that the Commission adopts the choice between ODV and IHC (not preferred by Vector) there appear to be no concerns with businesses switching methodologies, as the methods are intended to be comparable. However, such a situation would, as proposed by the Commission, create unnecessary complexity and increase compliance costs. This supports Vector's view that, if the Commission is not minded to revert to a choice between the use of ODV and DHC, it would make more sense to only use one methodology going forward (being ODV).

Q6. Valuation handbooks and guidelines: 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?

43. As a general rule Vector considers that, where possible, a principle based approach is preferable to detailed prescription. Vector considers that the ODV Handbook is sufficiently detailed. In Vector's understanding, the main benefit of the DHC methodology proposed originally was that it could be implemented largely on a principle basis. However, the IHC methodology proposed in the paper is likely to require a level of prescription similar to that of the current ODV handbook. This further undermines the need for an IHC methodology to be used in the first place.

44. As noted below, non-system fixed assets (some of which are now intrinsically part of the system fixed assets of operating a lines business) must also be part of a regulatory asset base.

Q7. Valuation reporting: 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)?

45. As noted in earlier submissions, in order for regulatory valuations to be robust and accurate, non-system fixed assets and intangible assets must be included in the valuation. The Commission has itself noted that:

> "While it is not typical for non-system fixed assets used to provide lines businesses services to be valued using the ODV methodology, these assets are normally included in the regulatory

> asset base...The Commission considers that non-system fixed assets, and an allowance for working capital, would normally be included in the regulatory asset base"[6]

46. The valuation of these assets should be carried out in accordance with GAAP, in particular with FRS-3. Although there are currently no detailed New Zealand guidelines for valuing intangible assets, with the adoption of international financial reporting standards in the near future, new standards that deal with intangible assets will apply. The ODV treatment of intangible assets, therefore, should be consistent with these new standards.

Closing comment

47. Thank you for considering this submission. Should you require further assistance, please contact Anton Murashev, Vector's Regulatory Analyst, in the first instance, (anton.murashev@vectornetworks.co.nz; 021 273 0709).

Kind regards

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[6] Para 25, Regulation of Electricity Lines Businesses, Invitation for Submissions on Handbook for Optimised Deprival Valuation of System Fixed Assets of Electricity Lines Businesses: Revised Draft for Consultation, 9 July 2004