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UNISON NETWORKS LIMITED

Cross-submission and response to questions

in respect of

**Implementing Valuation Choice for System Fixed
Assets and Review of the Information Disclosure
Regime**

18 April 2005

1. Introduction

This is Unison Networks Ltd's cross-submission and response to questions from the Commission following the Commerce Commission's conference in respect of Valuation Choice and the Review of the Information Disclosure Regime.

2. Treatment of tax for assessment and disclosure purposes

During Unison's oral presentation to the Commission, Unison was asked to clarify its comment that, for the purposes of regulatory disclosure and excess earnings assessment, tax should be calculated more appropriately. To exemplify Unison's concerns, the example of the tax claw back on acquired assets can be described as follows:

Firm 1 acquires assets for their ODV, which is also their pre-sale tax book value. The post-acquisition tax book value is therefore the same as the pre-acquisition tax book value of the assets. Firm 1 sets its revenue at a certain level, such that over the remaining life of the assets it earns zero excess earnings each year, based on a certain and acceptable post-tax WACC, say 8.5%.

Firm 2 acquires an identical set of assets, but acquires them for more than ODV. The pre-acquisition tax book value is the ODV of the assets. Accordingly, the post-acquisition tax book value is higher than the pre-acquisition tax book value of the assets, resulting in a higher post-acquisition deduction for tax depreciation. Given the Commission's effective treatment of the tax claw back in respect of the seller of the assets, Firm 2 will have to set its revenue at a level below that of firm 1 so that, after allowing for its lower level of tax, it also earns zero excess earnings each year, based on the same post-tax WACC (of 8.5%), over the remaining life of the assets.

In summary, Firm 2 has acquired the assets for an amount in excess of ODV but is required to set its revenue lower than a firm that has acquired identical assets for ODV. Firm 2 has valued benefits of ownership in excess of ODV and has established the price it is prepared to pay in recognition of the workings of New Zealand tax law, including positive tax cash flows post acquisition that, in effect, form part of the acquisition price. There is no obvious logic behind this result.

This result is demonstrated in the following table, where Firm 2 has revenue below the competitively acceptable level set by Firm 1:

	Firm 1	Firm 2
Asset acquisition price	\$1,000	\$1,500
Asset ODV	\$1,000	\$1,000
Asset tax value	\$1,000	\$1,500
Revenue	\$227	\$202
ODV depreciation	\$100	\$100
Tax depreciation	\$100	\$150
Tax expense ¹	\$42	\$17
Net profit after tax	\$85	\$85
Rate of Return on ODV value of Investment ²	8.5%	8.5%

¹ Tax is calculated as (revenue less tax depreciation) x 0.33

² Rate of return on ODV investment is calculated as (revenue less ODV depreciation less tax)/asset ODV

3. Responses to specific questions

3.1 Historical capital expenditure

A profile of Unison's renewal capital expenditure compared with its depreciation charge for the last three completed and audited financial years is provided in the following table:

	2001/02 \$000	2002/03 ³ \$000	2003/04 \$000
Renewals Capex	1,887	3,146	6,083
Depreciation of System Fixed Assets	4,640	6,493	10,439

3.2 Satisfying section 57V

The Commission has asked Unison to provide a response on what the Commission could or should do to meet the objective, under section 57V of the Commerce Act, of promoting greater understanding of the relative performance of individual lines businesses and the changes in performance over time.

Unison notes that the purpose of subpart 3 is:

Sec 57T(1) ... to promote the efficient operation of markets directly related to electricity distribution and transmission services by ensuring that large line owners and large electricity distributors make publicly available reliable and timely information about the operation and behaviour of those businesses, so that a wide range of people are informed about such factors as profits, costs, asset values, price (including terms and conditions of supply), quality, security, and reliability of supply of those businesses."

To achieve this, the Commission:

Sec 57T(2)(a) must require large line owners and large electricity distributors to disclose information concerning their business as a line owner or as an electricity distributor.

and

Sec 57V The Commerce Commission must, as soon as practicable after information is publicly disclosed under [subpart 3 of the Act], publish a summary and analysis of the publicly disclosed information for the purpose of promoting greater understanding of the relative performance of individual line owners and electricity distributors, and the changes in performance over time.

Unison's position in respect of information disclosure was expressed in its written submission⁴. These themes were emphasised in the oral presentation made to the Commission at its hearing on 17 March 2005. In summary, in Unison's view there is unlikely to be any material benefit from increasing the range or extent of information disclosure because there are few groupings of the wider audience who are willing or capable of engaging with issues such as the complex trade-offs between price and quality, the optimality of network design and performance or the efficiency of asset construction, maintenance, operation and valuation. Providing more information will not necessarily achieve the "greater understanding" described in section 57V of the Act.

³ Note that Unison acquire the Rotorua and Taupo networks in November 2002.

⁴ Unison Networks Limited Submission to the Commerce Commission in respect of Review of the Information Disclosure Regime; 2 March 2005

The changes in the regulatory scene have modified the environment since the information disclosure regime was first introduced and recognition should be given to the ex-ante disclosures and market-based processes employed by lines businesses in areas that drive much of these businesses' cost and service level performance. These factors may facilitate a reduction and simplification of the information disclosure requirements on businesses. Moving in this direction may not only improve efficiency of the "markets" by reduce compliance costs, but may also lead to "greater understanding".

The purpose of subpart 3 is clearly not to increase the amount of disclosure by electricity distribution and transmission businesses but is *"to promote the efficient operation of markets directly related to electricity distribution and transmission services"*. Increased disclosure is only warranted (or, indeed, permitted under the Act) if the benefits of providing the information outweigh the cost. Unison is strongly of the view that there is an onus on the Commission to confirm that material efficiency benefits will arise from any change to the current information disclosure requirements before imposing further compliance costs on the disclosing businesses. To do otherwise would be contrary to the purpose of subpart 3 of the Act.

The factors that are noted in section 57T(1) of subpart 3 of the Act as being factors about which people might be informed by information disclosure are all currently addressed through the existing information disclosure requirements. Unison does not support the public disclosure of detailed feeder level performance information to, as submitted by Genesis Energy Limited, promote consideration of price/quality trade-off. Unison's experience is that the vast majority of its consumer base is not interested in higher service quality where this would come at a higher price. Those consumers who are actively interested in considering price/quality trade-off are the larger commercial and industrial consumers with whom Unison has a direct dialogue in respect of their requirements.

Unison is also of the view that subpart 3 should not be considered in isolation to Part 4A. Many of the attributes of line business performance, in terms of price and service, are now addressed, managed and constrained by the application of the price and quality threshold (and consequential control) regime. Unison believes, therefore, that there is likely to be little, if any, additional benefit to be derived from implementing more onerous information disclosure requirements than those already in existence.

Section 57V requires the Commission to publish a summary and analysis of the information. Such a summary would be of value to stakeholders if one were not already produced by industry analysts, ie PricewaterhouseCoopers. Perhaps, therefore, the Commission should employ PricewaterhouseCoopers to compile the summary and undertake the analysis, with the resulting document being freely available to the wide range of people who the legislation expects to be informed by the disclosure.

3.3 Incentives for mergers and acquisitions

Unison has been asked to provide views on incentives for mergers and acquisitions and, in particular, on any effects on incentives from requiring lines businesses to disclose reconciliations showing whether or not common costs due to the overall entity are being over-recovered.

The specific question from Commissioner Taylor was '[does Unison] *think it's reasonable to see the extent of the incentive that's being created* [by a

merger/acquisition] *and therefore should it ... come through as part of the reconciliation process, albeit it might be confidential ... to ensure in an overall sense it's not too much of an incentive.*"

In regard to the issue of recovery of common costs, Unison considers the Commission's choice of language, such as "over-recovery", "double-dipping", to be pejorative, seemingly reflecting a presumption that all enterprise gains accrue to the consumer rather than to the shareholder.

Unison firmly believes that any such reconciliation should be confidential, as it relates to particulars of competitive, non-regulated businesses. While the sensitivity of this information may be mitigated if more than one non-regulated activity is included in respect of any single lines business, the existence of multiple non-regulated activities cannot be guaranteed and, therefore, the reconciliation should be kept confidential.

In the context of two business operating solely in the electricity distribution industry, where the whole operation of each falls undisputedly within the ambit of subpart 3 and Part 4A of the Commerce Act, and neither business has breached their respective price or quality thresholds, then the Commission appears to have no "interest" in these firms, meaning that, as far as the Commission is concerned the firms are each sufficiently efficient, well performing and not acting to the detriment of their respective consumers.⁵

One firm may acquire the other or there may be a merger between the two firms, promoted by the incentive of additional value. In the context of the Commission's incentive-based price and quality threshold regime the following points seem apparent:

- The shareholders of the acquiring firm or of both firms in the case of a merger, have exposed their capital to risk, for which they should be entitled to a return, which might include an additional premium;
- In the absence of the acquisition or merger activity, the efficiency benefits that might arise will probably never be realised for the benefit of any party, ie industry costs will be will remain higher than they might be in the event of an acquisition or merger;
- Consumers do not share in the downside risk of the acquisition or merger not being as successful as expected, due to the price and quality thresholds regime;
- The concept of recovery of "common costs due to the overall entity", as referred to by the Commission, being the benchmark which would lead to a resetting of the financial performance bar for the combined businesses seems to be fundamentally at odds with an incentive-based regulatory regime and much more consistent with a cost-plus, rate of return-based regulatory regime;
- The act of acquisition or merger should not necessarily result in a change in the Commission's attitude towards the firms, relative to that in respect of the two separate firms pre-acquisition/merger.

⁵ Refer, for example, to the comments of Commissioner Bates at page 59 of the transcript on Unison's oral submission on 17 March 2005, in the context of firms reporting double digit rates of return throughout the regulatory period "Would you accept that at least in the regulatory period, if the thresholds are not breached, then that's not a problem?"

In the context of businesses that consist of both regulated and unregulated activities, Unison supports the principle underpinning the ACAM cost allocation approach, ie that the relevant costs in respect of a regulated monopoly are those costs that would be incurred if the firm did not also operate in non-regulated sectors. This means that two firms with similar regulated operations but only one of which has additional non-regulated operations, will be assessed for regulatory purposes on a similar basis.

It follows that, were a distribution business to use unutilised (and perhaps optimised out) capacity on its distribution network for non-regulated purposes, such as telecommunications, then there is no case for distribution business consumers to benefit from the firm entering into and operating that non-regulated business. This is notwithstanding views that the electricity consumers have “paid” for those assets as the nature of electricity reticulation assets is that they need to be installed to a certain level to provide the service required by the consumers at peak times. Consumers will therefore incur the cost of the assets regardless of any alternative/complementary use they may be able to be put to.

The decision to enter into a non-regulated business, albeit utilising electricity related assets and resources, is a discretionary decision by the firm, ie one that it need not make. The capacity or resources that are utilised by the non-regulated activity could be left unutilised and the electricity consumers would be no better off. The consumers are insulated against the possibility of the non-regulated activity performing poorly, as any direct cost blow-out would be excluded from the regulated business and because of the price and quality thresholds in place in respect of the regulated business. They should not, therefore, share in the benefits of the non-regulated activity by having some of the stand alone regulated business costs being shifted to the non-regulated activity.

Unison takes a consistent view in respect of firms in different regulated industries, eg gas and electricity, acquiring or merging. The synergy benefits from the acquisition or merger need to be allowed to flow to the business and its shareholders, as reward for taking the risk. The Commission’s attitude towards the combined firm should change from that it had towards the separate firms solely due to the acquisition or merger activity.

3.4 Prudency review in IHC-based approach

The Commission has asked for Unison’s views on the need to incorporate within an IHC framework a level of discipline on capital expenditure, through some form of prudency review process, in a similar way to the optimisation process under the ODV methodology.

As Unison noted in its written submission⁶, there needs to be consistency in the treatment of capital expenditure between an IHC approach and an ODV approach where capital expenditure in one case is subject to a prudency test (perhaps ex ante) and in the other case is subject to optimisation (ex post).

Under ODV the following is understood to be the current/proposed arrangement:

- The firm makes a capital investment in system fixed assets;

⁶ Unison Networks Limited Submission to the Commerce Commission in respect of Implementing Valuation Choice for System Fixed Assets; 2 March 2005: page 5

- The assets are subject to a periodic (5 yearly) optimisation test;
- Prior to the optimisation, the firm has earned a return on the capital invested in the particular assets and has recovered some of the capital invested (through the recovery of depreciation);
- Following optimisation, any write-down in the value of the assets is able to be recovered through increased revenue without any excess earnings being identified because it is treated as a negative revaluation.⁷

This results in very little “incentive” or “discipline” on capital expenditure. The ramifications of this conclusion are in respect of efficiency of regulatory overhead cost rather than efficiency of investment. In its oral presentation to the Commission on 17 March 2005, Unison referred to the relative complexity of the ODV methodology as a means of disciplining investment decisions when the evidence suggests that there is little active over investment by distribution lines businesses. Unison provided an estimate of the extent of optimisation and economic value adjustments for lines businesses, relying on a sample of the larger distribution lines businesses (for which information was adequately disclosed on their web sites at the time) accounting for \$3.4 billion of system fixed assets. The relevant rates of optimisation and economic value adjustment reported by Unison were less than 2.5% and 0%, respectively. Based on information subsequently released by the Commission, Unison confirms that the correct rates across the entire distribution lines sector are 2.2% in respect of optimisation and 0.1% in respect of economic value adjustments. These figures are based on the valuations as at 31 March 2004 using the Commission’s updated ODV handbook.

Unison reiterates its view that the apparent low rate of optimised investment does not primarily reflect the discipline of having an optimisation process in place. Rather, recognising the long lived nature of the assets, and that the vast majority of the current investment in assets was made prior to any optimisation process, this reflects the natural inclination of the governance structures controlling and managing distribution lines businesses to be prudent and responsible.

To provide a similar level of investment discipline in the context of an IHC-based approach the following high level process steps could be used:

- Following consultation with key stakeholders, the firm prepares an annual Assets Management Plan;
- On a periodic (5 yearly) basis the AMP is “peer-reviewed” and unsupported projects or expenditure levels within the first five years of the AMP are either removed from the plan or excluded from the regulatory asset base;
- Approved AMP expenditures are “safe-harboured” in respect of subsequent reviews;
- Any material departures from the approved AMP expenditure levels planned in subsequent AMPs are submitted to the reviewer for “approval”;

⁷ So, even if the business were to breach its price threshold as a result, it could demonstrate no excess earnings by applying the Commission’s assessment framework and would not be penalised by the imposition of control.

- After five years a reconciliation of the previous five years' expenditure against the approved AMP should be provided to the reviewer along with the next AMP for review.

Because of the treatment of optimisation under the ODV approach, outlined above, there is an inconsistency of treatment in respect of the second step described above for an IHC prudency test process. In particular, any expenditure not supported by the "peer-review" but undertaken by the business is not recoverable. This is less favourable than the scenario in respect of the ODV-based approach. It is likely, however, that the situation where the business wanted to invest despite the investment not being supported by the peer review is where the management and Directors of the business have strongly differing views on the need for the investment. In these cases the Commissioners could be called on to arbitrate on the status of the proposed investment.

3.5 "Long term equivalence – short term squeeze"

Unison presented a graphical representation of revenue streams resulting from application of an ODV-based revenue setting process and a DHC-based revenue setting process. In both cases, the revenue setting achieved zero excess earnings in each period of the model. Unison offered to provide the model to the Commission and, accordingly, an electronic copy of the model is attached.

The model reflects the following assumptions:

A portfolio of assets which all have an economic life of 50 years and which, at the commencement of the model have remaining lives that vary from 1 year to 50 years. The average remaining life of the assets is, therefore, 25 years. The opening depreciated value of the assets is approximately \$300(million).

The Chair of the Commission was unclear about the extent of the wedge of revenue foregone in the short to medium term under the ODV-based approach by comparison with the DHC-based approach. Her point seemed to revolve around the relative age profile of the assets being modelled, ie the wedge would appear greater for a portfolio of assets that were all new on day 1 of the model and would be less significant if some of the assets were old and at or near replacement. This is correct; however, as described above, the modelling represents a portfolio of variously aged assets with a realistic replacement requirement in each period of the model. Whereas the Commission's modelling suggests the cross-over of the alternative revenue streams is at year 12, in Unison's modelling the cross over is at year 8. This difference may be accounted for by Unison's assumption of a portfolio of assets with mixed ages as at the start of the modelling period.

In any case, Unison would urge the Commission to recognise that, for those running distribution lines businesses, a period of 8 years (nearly two complete regulatory periods) is a significant period of time over which to have a reduced cash flow. It is also a significantly long period to be exposed to regulatory risk and the potential that the rules will change and the value foregone by the business will be lost forever.

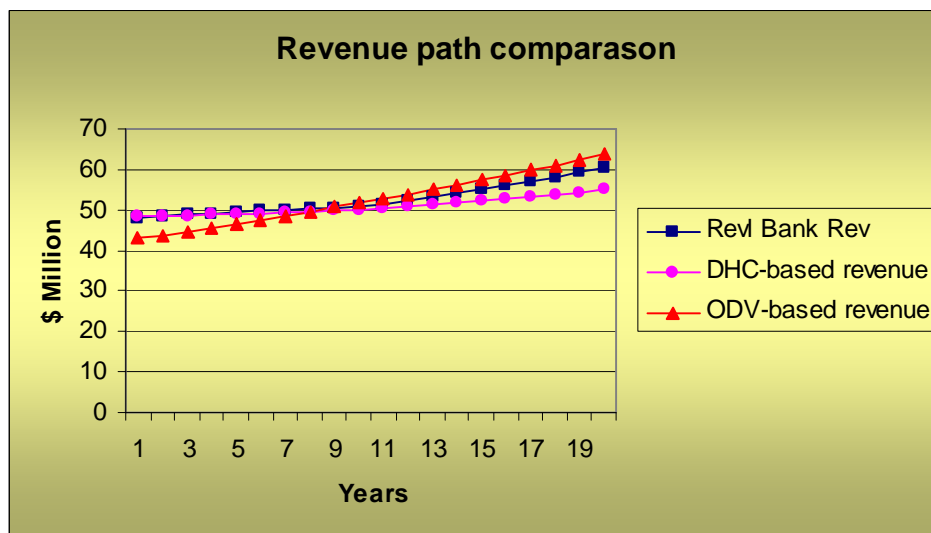
This model presents a stylised version of the Unison asset base. Based on the 31 March 2004 ODV, Unison has an average asset class life of 48 years and an average remaining life of 26 years, ie virtually half way through their economic life on average.

Asset replacement in the model is at the rate of 4% of depreciated replacement cost per annum (effectively 1 asset per year, being 2% of total replacement cost and 4% of depreciated replacement cost – consistent with assets having a total life of 50 years).

Replacement cost is assumed to increase at the rate of 2% per annum (ie at CPI). Asset revaluations are imputed each year, in accordance with Commission instructions to Unison in respect of modelling its business. Based on these assumptions, the revenue setting in year 1 of the ODV-based approach reflects an anticipated asset revaluation for that year. This assumption is necessary to achieve zero excess earnings in year 1, ie the ex ante revenue setting process needs to proxy the ex post excess earnings assessment process. Associate Commissioner Hemmingway sought clarification on this issue.

The model assumes that, for both ODV and DHC-based approaches, the opening asset value is the same. This reflects Unison’s understanding of the Commission’s proposal in respect of valuation choice, regardless of whether ELBs adopt ODV or D/IHC for valuing assets going forward, the start point will be the ODV as at 31 March 2004 based on the Commission’s updated ODV handbook.

The graph of comparative ODV and DHC-based revenue streams resulting from the model is shown below:



3.6 Reasonable and practical level of disaggregation

The Commission has asked for Unison’s view on what is a reasonable and practical level of disaggregation of networks for information disclosure purposes.

In terms of financial performance, Unison remains unconvinced that disaggregation of lines businesses is necessary or likely to be helpful to stakeholders in general.

The Commissioners posed a scenario to Unison in respect of a lines business with one sub-network” earning a 6% rate of return and another earning a 12% rate of return. The Commissioners suggested:

- a) That is a piece of information that that the information disclosure was intended to get out to the public; and

b) That would be an issue of proper concern for the Commission.

Unison does not agree that this is information that should necessarily be included in the information disclosures. The requirements for satisfying section 57V of the Act are discussed in 3.2 above. Providing disaggregated financial information would result in the addition of further information of little value to the public.

Disaggregated financial information can only be provided if arbitrary rules are applied to allocate common costs between the sub-networks in a business. Where a segment is reported as producing a 12% rate of return based on, say one method of allocating costs, it may report an 8% rate of return, for example, if it were reported based on it being a stand alone business carrying a full set of overhead costs. It is possible that the prices being charged to the sub-network consumers are less than the prices that would be necessary if the network were a stand alone business or if the network were owned by another entity. This is not clearly demonstrated through a disaggregated rate of return style disclosure. These material uncertainties undermine the value of the information in the public domain.

It is uncertain what the acceptable parameters are, in the context of the scenario painted by the Commissioners. It is not clear what the appropriate WACC is in respect of a lines business. The Commission has issued a framework for determining WACC which provides a point solution but the Commission's own advisor talks in terms of ranges for the parameter inputs and, therefore, for the WACC outcome – acknowledging that for the purposes of investigation and subsequently control values towards or at the higher end of the range should be utilised. There is also evidence that the asset beta parameter is inversely correlated to size, meaning that if a firm is notionally broken into smaller component parts for the purposes of analysis, then the appropriate WACC for each component part may be higher than that used in respect of the business as a whole. Without known and sensible treatments for these issues, Unison believes providing disaggregated financial information into the public domain will not assist "greater understanding" of line business performance.

Unison does agree that the performance of subparts of a lines business does fall within the wide scope of the Commission and is, therefore, a "proper concern of the Commission". Accordingly, Unison believes that issues such as the relative performance of sub-networks is one the Commission should pursue under its powers to investigate lines businesses, eg in the case of a breach of the price and quality thresholds.

3.7 Double jeopardy

Commission staff sought clarification of reference by Unison to the potential for double jeopardy in respect of the application of ODV (ie optimisation) to distribution lines businesses. Quoting from page 74 of the transcript of Unison's oral submission presentation;

Mr Carvell:[Unison's] preference in [the context of an historical cost-based approach is] to rely on the existing market based activities that surround capital investment; asset management plan, the consultation around that and, from at least a productive efficiency point of view, reliance on competitive tendering for asset acquisition and installation. And those things, in our view, seem to fit better with indexed historical cost than with ODV, which ... per the

conversation [the Commission] had with Transpower,... introduces this concept of double jeopardy.”

In summary, Unison believes that there are market oriented processes that support the asset management and investment processes and that can be relied upon in place of an optimisation process. To apply an ex post optimisation, when these market type processes are being faithfully applied by distribution lines businesses, introduces double jeopardy (similar to that considered to face Transpower, as a consequence of Electricity Commission pre-approval of investments).

Unison observed that it would have a similar reservation about an ex ante prudency review but accepts that exercise to be a considerably lesser evil than ex post optimisation. This concern underpins Unison’s considered preference for IHC over ODV, given the choice that appears to be on offer.