



***unison***

**UNISON NETWORKS LIMITED**

**Submission**

**to the Commerce Commission**

**in respect of**

**Implementing Valuation Choice for System Fixed  
Assets**

**2 March 2005**

## **1. Introduction**

This submission has been prepared by Unison Networks Ltd in response to the Commerce Commission's draft decision and discussion paper dated 24 December 2004.

In summary, Unison has concerns about the practical implications on businesses of the tightly articulated regulatory framework being proposed by the Commission. The linkage between asset valuation, information disclosure and earnings performance assessment (consistent with the assessment framework used in "investigations"), coupled with the impact of the price path thresholds, has the potential to undermine the viability of some lines businesses. This threat will lead to a disincentive to invest.

Unison believes that further thought is required into the design of some aspects of the regulatory regime to, without undermining the medium to long term effects of the regime to provide more flexibility in the short term.

## **2. Draft Decision to exclude Depreciated Historical Cost**

Unison believes that there are potentially fundamental issues for the industry and the Commission to consider in the context of adoption of valuation methodologies. These issues impact directly on the draft decision by the Commission to limit the choice of valuation methodology to Optimised Deprival Valuation (ODV) and Indexed Historic Cost (IHC), with the exclusion of Depreciated Historical Cost (DHC).

### **2.1 Regulatory Context**

The Commission has identified the strong nexus between valuation methodology, price path and excess returns assessment. This is important, because it is clear that the current price and quality threshold regime is insufficient to satisfy the purpose statement of subpart 1 of Part 4A of the Commerce Act.

A price path alone is not effective in ensuring suppliers are limited in their ability to extract excessive profits. Businesses that already had high prices and high returns at the start of the regime may continue to extract "excessive" profits for an extended period of time under the regime. This is clearly not conducive to the long-term benefit of consumers. Accordingly, the Commission needs to bolster the price threshold regime through monitoring of earnings.

The conclusion to be drawn is that the disclosure of earnings performance, underpinned by a particular valuation methodology, will become a major plank in the Commission's delivery of outcomes that meet the purpose of subpart 1 of Part 4A of the Act. In short, the Commission can be expected to take action as a result of some degree of persistent reporting of earnings results which exceed it's perception of a reasonable return.

This would be a fundamental shift from the environment under the previous structure, where the Ministry of Economic Development's (MED) focus was on ensuring disclosure requirements were met, rather than acting on the information disclosed. The regime was, after all, "light handed". Furthermore, the known weaknesses in the valuation approach did not help.

### **2.2 The Treatment of Revaluations Arising from IHC or ODV**

Looking forward, adoption of valuation methodologies that include a revaluation or indexing component means that businesses' earnings performance will be assessed inclusive of the annual movement in asset values arising from that component.

As discussed by the Commission in the Draft Decisions and Discussion Paper:

- Revenue paths based on any of DHC, IHC or ODV, when measured on a basis appropriate to the asset/revenue setting approach, can be demonstrated to satisfy a zero excess earnings test; however
- The revenue paths, especially between DHC and ODV or IHC based approaches will be different.

It is the case, therefore, that businesses' cash flows over time are affected by the choice of valuation method. The graphical representations of revenues or prices the Commission present show the different revenue paths over time between DHC and ODV based approaches.<sup>1</sup> The critical point is that for businesses that currently have a revenue level that is justifiable on a DHC based approach have to manage a reduction in revenue to fit within an ODV based approach.

That reduction in revenue is likely to be material. Allowance for indexing of asset values at CPI, ie 2-3% p.a., translates into changes in revenue of the order of 8-12%. Notwithstanding that the respective revenue paths cross over at some future date (ie 12 years or more than two regulatory periods into the future), lines businesses are trading off lower revenue now for the prospect of higher revenue in the future. However, the future, and therefore the ability of firms to recover higher revenue in the future, is uncertain due to:

- the potential for regulatory intervention in subsequent periods;
- changes in economic drivers that may alter the extent or direction of revaluation adjustments –businesses may not survive if asset cost inflation is materially greater than current inflation; the Commission may not apply symmetrical treatment to net asset write downs (ie allow increases in revenue); and
- political risk that the regulatory regime may be altered or transferred to the jurisdiction of another body.

Any intervention that limits the revenue streams in the future compromises the value of the revaluation today. In effect, the adjustment to revenue or earnings on account of an annual revaluation is overstated, even if it is considered appropriate. That is because the adjustment should be probability weighted and it is unlikely that anyone would rationally weight the probability of recovery in the future at 100%.

Furthermore, the short term impact on lines businesses may be of such significance to their financial position that they have no choice but to sustain and to report rates or return in excess of those considered acceptable by the regulator in the short term. Constructs that limit lines businesses' cash flows below otherwise justifiable levels will impinge on capital expenditure programmes at a time when there is general acceptance of a greater need for infrastructure investment. Lines businesses have been signalling the need for greater reinvestment in their networks as assets coincidentally age and require replacement. This is the "wall of wire". Lines businesses, many of which have limited access to additional equity capital, generally will be relying on retained earnings to fund this expenditure.

The principle concern being highlighted here is that the revenue setting or assessment process that the Commission sees as going hand in hand with adoption of IHC or ODV

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<sup>1</sup> Implementing Valuation Choice for System Fixed Assets – Draft Decision and Discussion Paper; 24 December 2004; pp 37-38

valuation methods leads to a mismatch between the recognition of the “gain” and the crystallisation of that gain. That is, the revaluation is recognised this period and revenue and cash flows are reduced accordingly but the benefit of higher cash flows are received, from determining revenues based on inflated asset values, over the remaining 50 year life of the asset.

An alternative assessment framework should be devised to support the adoption of IHC and ODV based valuation approaches, that better matches the timing of recognition of the “gain” with the realisation of the gain and thus mitigate the short term revenue reduction that may otherwise adversely impact lines businesses incentives and practical capability to invest.

### **3. The Commission’s Questions**

#### **Question 1**

##### *Proposed process for annual of regulatory valuations*

If asset revaluation or value indexing is implicit in the valuation methods available to choose between, then there needs to be a mechanism to allow annual updates. The Commission identifies the issues with consistency of performance assessment from year to year. Given the likely emphasis the Commission will place on the intuitive linkages between asset valuation method and earnings performance assessment, less frequent valuation changes may lead to price shocks.

##### *Method for indexing valuations*

It can be argued that there are more appropriate indices for the purposes of indexing asset replacement costs than CPI. Asset costs are generally driven by labour and material costs. This might point to an index such as the producer price index or some composite index as being more appropriate. However, there seems little to be gained by over complicating the indexing process. This is only a proxy for real price changes that are best reflected by periodic but frequent review of replacement costs.

CPI is best relied on in the intervening years as it is readily available, widely forecast and well understood by the “wide range of people” who are the intended recipients of the disclosure information. A review of ODV replacement costs every three years could provide a more specific index that could then be applied over the three year period. This would provide consistency between the treatment of replacement costs in ODV and IHC based valuations. The ODV replacement cost review should, if possible, be based on the same processes lines businesses apply in the real world, ie sourcing competitive tenders for common items of plant. This recognises that lines businesses already pursue efficient mechanisms for equipment acquisition and installation.

#### **Question 2**

##### *Frequency of capital expenditure reviews*

An annual exercise for prudency and efficiency reviews is unnecessary. The existence of a periodic review will discipline lines company expenditure. An ideal time frame would be once every five years as this coincides with the regulatory review period.

It is noted that ODVs are proposed to be required once every five years. This is supported as the previous three yearly review was largely driven by the desire to align with accounting requirements. This driver appears much less relevant now as ODV does not comply with accounting standards for valuations and the IHC option will similarly not comply with accounting standards. The potential for lines businesses to rely on a single

valuation for both regulatory and accounting purposes appears to have disappeared. The other driver for three yearly ODVs was to avoid large valuation shocks. This will be mitigated by annual updates of the ODV (albeit largely in terms of indexed replacement costs) thus the regulatory timeframe for valuations can be varied and the frequency of ODV can also be aligned to the five yearly regulatory cycle.

*Capital expenditure reviews for ODV*

There is a need to maintain some consistency of treatment between of capital expenditure between the ODV and IHC approaches. If option 2 (roll-in only “allowed” capital expenditure) were preferred then annual capital expenditure reviews are necessary for ODV, with only “allowed” capital expenditure being rolled-in to the ODV asset base. To do otherwise would allow firms adopting ODV to effectively recover the “loss” on optimising out of unnecessary capital expenditure. Lines businesses using IHC would be disadvantaged.

However, annual capital expenditure reviews are not preferred and, as discussed above, five yearly reviews are preferred.

*Need for Guidelines for Capital Expenditure reviews*

The same issues of consistency will arise in respect of capital expenditure reviews as arises for optimisations, therefore guidelines will be necessary to govern the capital expenditure review process.

**Question 3**

This is discussed in section 2 above.

**Question 4**

*Compliance costs*

Intuitively, the compliance costs for ODV will be similar to those for IHC. This will depend, however, on the extent to which the prudency/used and useful test that will apply to IHC investments is equivalent to the optimisation test in ODV. The level of optimisation in the industry is low, raising the question of whether it is adding value other than in the case of significant capital works such as those undertaken by Transpower or, in the case of the tunnel, Vector.

As regulation is becoming more intrusive, regulatory costs will increase.

**Question 5**

*Impact of mergers and acquisitions*

The Commission’s approach (ie the requirement to value assets at previous owners regulatory value and to take any valuation method change as a ‘return’) will be a disincentive to mergers and acquisition in the industry, thus limiting potential for efficiency. The likely differences between the two approaches is small and the potential “disadvantage” to consumers from a change in ownership, where the acquirer is able to align the valuation methodology to that it uses is probably outweighed by the saving in cost that would be incurred if the valuation methods were not aligned as well as the efficiency benefits derived from the valuation.

While the Commission’s point about incentives for acquirers to make a prudent offer is noted, the impact of the price path threshold seems to be dismissed too lightly. Given the high reliance the Commission places on the price path thresholds this appears to be strongest provider of incentives to industry participants.

**Question 6**

No comment

**Question 7**

No comment