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Dear Paula

Regulation of ELBs ODV Handbook Process Paper

I refer to the Process Paper published by the Commerce Commission on 19 May 2004 in which it is proposed, inter alia, that:

- the Commission's revised ODV handbook will be published in August 2004 to be used by distribution businesses to value their system fixed assets as at 31 March 2004; and
- an update will be published in November 2004, which will incorporate updated replacements costs for transmission, to be used by Transpower to value its system fixed assets as at 30 June 2004.

This will cause problems for Transpower and lead to a further increase in regulatory compliance costs. Therefore, I would like to propose an alternative.

Before setting out this alternative I would like to clarify Transpower's position as set out in previous submissions (which seem to have created some confusion) and describe the problems that I refer to above.

Transpower submissions on valuation methodology and handbook

There are some key points to note from the Commission's process for determining a revised ODV handbook and Transpower's submissions:

- Transpower has throughout sought confirmation of the Commission's draft decision on valuation methodology i.e. that a lines business could commit to either ODV or DHC for the ongoing valuation of system fixed assets.

- Transpower initially submitted that it should be able to move to DHC based on Transpower's 2003 ODV, thus negating further consideration of the issues involved in applying ODV to transmission fixed assets.

- Following the Commission's draft decision that lines businesses would be required to conduct an ODV in 2004 under the Commission's new handbook, Transpower made two new points, taking into account the following.
 - The Commission had not accepted the recommendation of its advisors (PBA) to allow Transpower to move to DHC based on its 2003 ODV ¹.
 - The final position on valuation methodology remained uncertain and, therefore, there was a prospect that Transpower would be bound by the Commission's new ODV handbook for the foreseeable future (rather than just as a one-off exercise for the 2004 ODV to set an opening DHC value).
 - For administrative reasons, by the time of Transpower's submission in February 2004 (with the Commission's response not expected until mid March or later) business decisions were having to be made to prepare for a 2004 ODV. It is important to note that Transpower has to date adopted its annual ODV as the modified historical cost valuation for the purposes of its financial statements. There has been, therefore, a strict timetable linking the preparation of the annual ODV to the lodging of Transpower's audited financial statements for the year ending 30 June with Shareholding Ministers by 30 September ².

- The two new points submitted by Transpower were that:
 - (a) the new ODV handbook should have updated transmission replacement costs; and
 - (b) there would not be time to update transmission replacement costs for the purposes of the 2004 ODV.

This revised position may well have led to the Commission's latest proposals (namely, a new ODV handbook in August revised in November to incorporate updated transmission replacement costs), without a full appreciation that Transpower's new points reflected Transpower's concern that if the Commission did not confirm its draft decision on valuation methodology, Transpower would be bound by the new ODV handbook for the foreseeable future.

Timing implications

I now turn to the problems that arise.

¹ Refer Section 4.2 (page 10) "Development of a handbook for optimised deprival valuation of system fixed assets of electricity lines businesses", PBA Draft report for the Commerce Commission 23 December 2003.

² As required by Section 15 of State-Owned Enterprises Act 1986.

The principal problem arises in respect of the preparation of Transpower's 2004 ODV for transmission price setting. Under the pricing methodology set by Transpower's contracts and the Electricity (Transpower's Pricing Methodology) Regulations 2004, Transpower must base its prices on the ODV methodology, as described in the prevailing ODV handbook³.

In order to prepare and notify customers before 31 December 2004 of transmission prices effective from 1 April 2005 (as required by contract), Transpower will need to conduct an ODV based on the prevailing ODV handbook in August. It would not be possible to use an ODV handbook with updated transmission replacement costs published in November, as this would not allow sufficient time for the valuation and pricing processes.

If, in addition, to comply with its regulatory obligations as now proposed by the Commission, Transpower must undertake the 2004 ODV as required by the ODV handbook with updated transmission replacement costs to be published in November, Transpower faces the prospect of undertaking one 2004 ODV (as per the August handbook) for price setting purposes, and another 2004 ODV (as per the November revised handbook) for regulatory purposes.

I would also note that the further delay in finalising the ODV handbook creates an issue in respect of the preparation of Transpower's audited financial statements. As noted above, Transpower has to date adopted its annual ODV as the basis of a modified historical cost valuation for its financial statements. This consistency of approach (between financial statements and price setting) has aided transparency of revenue setting, information disclosure, calculation of economic value adjustments etc. For preparation of audited financial statements for the year ended 30 June 2004 by 30 September 2004, a new ODV handbook in either August or November will be too late. Accordingly, given the further delay in finalising the ODV handbook, Transpower is most likely move to DHC based on its 2003 ODV for the purposes of preparing its financial statements from 30 June 2004^{4,5}.

Transpower's Alternative

Transpower wants to avoid the need for two different 2004 ODVs, which would result in increased compliance costs and create potential confusion for Transpower's customers

³ The Electricity (Transpower's Pricing Methodology) Regulations defines the pricing methodology by reference to Transpower's *Pricing for Grid Connection Services from 1 April 2001* December 2000 booklet which defines the ODV methodology (as at the date of the publication of booklet) as that described in the MED's ODV handbook published in October 2000, which has of course been replaced by the Commission's interim handbook. In Transpower's view, the reference to the MED ODV handbook is to be interpreted as a reference to the prevailing replacement ODV handbook.

⁴ At the time of writing, this decision is subject to the approval of the Transpower Board.

⁵ For the avoidance of doubt, it is noted that the decision to move to DHC for financial statements (based on the 2003 ODV with subsequent additions at HC) is not a pre-emptive move for regulatory valuation purposes. Transpower expects (based on the information currently available) to move to DHC for regulatory purposes (once the Commission's draft valuation decision is confirmed) but based on a 2004 ODV. In other words, a different DHC valuation for regulatory purposes than that derived for the purposes of its financial statements.

and other stakeholders.

I therefore propose that the Commission proceed to finalise a new ODV handbook in August on the basis that it will apply to both Transpower and distribution businesses and that it abandon the proposal for the publication in November of a revised handbook with updated transmission replacement costs.

On this basis, Transpower would undertake a 2004 ODV as required by the new August ODV handbook for pricing purposes and would use that same 2004 ODV as the opening book value of system fixed assets for regulatory purposes.

Transpower would not get the benefit of updated transmission replacement costs, but Transpower's submissions in this regard were based on its concern that it could be subject to an ODV handbook without updated replacement costs in the long term. Transpower now has the comfort of your statement at the ODV handbook Conference that the Commission's draft decision on valuation methodology will be confirmed and, therefore, Transpower no longer has this concern.

The process for the choice of a valuation methodology and the development of a new ODV handbook has had its difficulties and there has been some confusion. From Transpower's perspective, the alternative described above, together with the Commission's final decision on valuation methodology confirming Transpower's ability to commit to DHC, will help resolve this and clarify the way forward.

I would be happy to meet with you to discuss this matter further if that would be of assistance to the Commission.

Yours sincerely

Dr Ralph Craven
Chief Executive